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

File No.* SR - 2020 - * 041
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 Firms 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.

Date 11/16/2020

By Patrice Gliniecki
(Name *)

(Title *)
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] the Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to: (1) adopt FINRA Rule 4111 (Restricted Firm Obligations) to require member firms that are identified as "Restricted Firms" to maintain a deposit in a segregated account from which withdrawals would be restricted, adhere to specified conditions or restrictions, or comply with a combination of such obligations; and (2) adopt a new FINRA Rule 9561 (Procedures for Regulating Activities Under Rule 4111), and amend FINRA Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series), to create a new expedited proceeding to implement proposed Rule 4111.[2] In addition, FINRA proposes to adopt Capital Acquisition Broker ("CAB") Rule 412 (Restricted Firm Obligations), to clarify that member firms that have elected to be treated as CABs would be subject to proposed FINRA Rule 4111, and to amend Funding Portal Rule 900(a) (Application of FINRA Rule 9000 Series (Code of Procedure) to Funding Portals), to clarify that funding portals would not be subject to proposed FINRA Rule 9561.

The text of the proposed rule change is set forth in Exhibit 5.

(b) Not applicable.

(c) Not applicable.

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

[2] This reflects a different numbering than was originally proposed. See Regulatory Notice 19-17 (proposing to number the proposed new expedited proceeding rule as Rule "9559" and to renumber current Rule 9559 as Rule "9560").

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 60 days following Commission approval. The effective date will be no later than 60 days following publication of the Regulatory Notice announcing Commission approval.

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

(a) Purpose

Background

FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and member firms that have a history of misconduct. As part of these efforts, FINRA is proposing to adopt Rule 4111, which would impose obligations on member firms that have significantly higher levels of risk-related disclosures than similarly sized peers. FINRA would preliminarily identify these member firms by using numeric, threshold-based criteria and several additional steps that would guard against misidentification. The obligations could include requiring a member firm to maintain a specific deposit amount, with cash or qualified securities, in a segregated account at a bank or clearing firm, from which the member firm could make withdrawals only with FINRA's approval. The obligations also could include conditions or restrictions on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the preliminary identification criteria and protect investors and the public interest. FINRA also is proposing to adopt FINRA Rule 9561, and amend FINRA Rule 9559, to create a new expedited proceeding to implement proposed Rule 4111.

FINRA has a number of tools to deter and remedy misconduct by member firms and the individuals they hire, including review of membership applications, focused examinations, risk monitoring and disciplinary actions. These tools have been effective in identifying and addressing a range of misconduct by individuals and member firms, and FINRA has continued to strengthen them. In recent years, for example, FINRA has enhanced its key investor protection rules and examination programs, expanded its risk-based monitoring of brokers and member firms, and deployed new technologies designed to make its regulatory efforts more effective and efficient.[3]

These efforts have strengthened protections for investors and the markets, but persistent compliance issues continue to arise in some FINRA member firms, which are a top focus of FINRA regulatory programs. While historically small in number, such firms generally do not carry out their supervisory obligations to ensure compliance with applicable securities laws and regulations and FINRA rules, and they act in ways that could harm their customers and erode trust in the brokerage industry. Recent academic

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[3] For example, in October 2018, FINRA announced plans to consolidate its Examination and Risk Monitoring Programs, integrating three separate programs into a single, unified program to drive more effective oversight and greater consistency, eliminate duplication and create a single point of accountability for the examination of member firms. The consolidation brings those programs under a single framework designed to better direct and align examination resources to the risk profile and complexity of member firms. FINRA is conducting its examinations under this unified program in 2020.

studies, for example, find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence that the past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events.[4] While these firms may eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with a history of misconduct that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers.

Such firms expose investors to real risk. For example, FINRA has identified certain firms that have a concentration of associated persons with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. These firms generally have a retail business engaging in cold calling to make recommendations of securities, often to vulnerable customers. FINRA has also identified groups of individual brokers who move from one firm of concern to another firm of concern. Such firms and their associated persons often have substantial numbers of disclosures on their records. In such situations, FINRA

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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? (OCE 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.

closely examines the firms' and brokers' conduct, and where appropriate, FINRA will bring enforcement actions to bar or suspend the firms and individuals involved.

However, individuals and firms with a history of misconduct can pose a particular challenge for FINRA's existing examination and enforcement programs. In particular, examinations 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 without an enforcement action. While these constraints on the examination process protect firms from potentially arbitrary or overly onerous examination findings, an individual or firm with a history of misconduct can take advantage of these limits to simply continue activities that pose risk of harm to investors until they result in an enforcement action.

Enforcement actions in turn can only be brought after a rule has been violated and any resulting customer harm has already occurred. In addition, these proceedings can take significant time to develop, prosecute and conclude, during which time the individual or firm is able to continue misconduct, with significant risks of additional harm to customers and investors. Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council ("NAC"), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel 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. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership and shifted its business to another member or other type of financial firm, limiting FINRA's jurisdiction and avoiding the sanction, including making restitution to customers.

Temporary cease and desist proceedings, while useful, do not always provide an effective remedy for potential ongoing harm to investors during the enforcement process.[5] Temporary cease and desist proceedings are available only in narrowly defined circumstances. Moreover, initiation by FINRA of a temporary cease and desist action does not necessarily enable more rapid intervention, because FINRA must be prepared to file the underlying disciplinary complaint at the same time.

In addition, by the time sanctions are imposed, as noted above, the firm may have exited the industry, thereby limiting FINRA's jurisdiction over the misconduct. In such circumstance, the firm may also fail to pay arbitration awards owed to claimants, leaving investors uncompensated and diminishing confidence in the securities markets.

Therefore, FINRA is strengthening its tools to respond to firms and brokers with a significant history of misconduct, and the firms that employ those brokers, several of which are described below.

Additional Steps Undertaken by FINRA

To address these problems, FINRA has undertaken the following:

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5 See FINRA Rule 9800 Series (Temporary and Permanent Cease and Desist Orders).

- Published Regulatory Notice 18-15, which rearticulates the obligation of member firms to implement heightened supervisory procedures tailored to the associated persons with a history of misconduct;
- Proposed rule amendments that would require a member firm to conduct with FINRA a materiality consultation before allowing persons with a history of misconduct to become owners, control persons, principals or registered persons of a member firm; authorize the imposition in a disciplinary proceeding of conditions and restrictions on the activities of a respondent member firm or respondent broker that are reasonably necessary for the purpose of preventing customer harm, and require a respondent broker's member firm to adopt heightened supervisory procedures for such broker, when a disciplinary matter is appealed to the NAC or called for NAC review; require firms that apply to continue associating with a statutorily disqualified person to include in that application an interim plan of heightened supervision that would be effective throughout the application process; and 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);[6]
- Published Regulatory Notice 18-17, which announced revisions to the FINRA Sanction Guidelines;

6 See Securities Exchange Act Release No. 88600 (April 8, 2020), 85 FR 20745 (April 14, 2020) (Notice of Filing of File No. SR-FINRA-2020-011); see also Regulatory Notice 18-16 (April 2018).

- Raised fees for statutory disqualification applications;[7] and
- Revised the qualification examination waiver guidelines to permit FINRA to more broadly consider past misconduct when considering examination waiver requests.[8]

While these efforts should help mitigate the risks posed by individual brokers with a history of misconduct, challenges remain where a member firm itself has a concentration of such brokers—in some cases because the firm seeks out such brokers—or otherwise has a history of substantial compliance failures.

Proposed Rule 4111 (Restricted Firm Obligations)

FINRA is proposing to adopt Rule 4111 (Restricted Firm Obligations), a new rule that would use numeric thresholds based on firm-level and individual-level disclosure events and impose a Restricted Deposit Requirement on member firms that present a high degree of risk to the investing public. FINRA believes that the direct financial impact of a restricted deposit is most likely to change such member firms' behavior—and therefore protect investors. An added benefit of this proposal would be to preserve member firm funds for payment of arbitration awards against them and their associated persons. The proposal would consider "Covered Pending Arbitration Claims"[9] and unpaid arbitration

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7 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).

8 See Regulatory Notice 18-16 (April 2018).

9 The term "Covered Pending Arbitration Claim" is defined in proposed Rule 4111(i)(2) to mean, for purposes of Rule 4111, an investment-related, consumer initiated claim filed against the member or its associated persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital.

awards[10] in determining the size of a Restricted Firm's "Restricted Deposit Requirement."[11] The proposal also would establish presumptions that, when assessing an application by a member firm or former member firm that was previously designated as a Restricted Firm for withdrawal from a Restricted Deposit Account,[12] the Department of Member Regulation ("Department") shall: (i) deny an application for withdrawal if the member firm, the member firm's Associated Persons who are owners or control persons, or the former member firm have any Covered Pending Arbitration Claims or unpaid arbitration awards, or if the member firm's Associated Persons have any Covered Pending Arbitration Claims or unpaid arbitration awards relating to arbitrations outstanding that involved conduct or alleged conduct that occurred while associated with the member firm; but (ii) approve a former member firm's application for withdrawal when that former member firm commits in the manner specified by the Department to use

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The claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees, and shall be the maximum amount for which the member or associated person, as applicable, is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount. This term conforms, in relevant part, to the definition of Covered Pending Arbitration Claim in Rule 1011(c). See Securities Exchange Act Release No. 88482 (March 26, 2020), 85 FR 18299 (April 1, 2020) (Order Approving File No. SR-FINRA-2019-030).

10 For purposes of this Form 19b-4, "unpaid arbitration awards" also includes unpaid settlements related to arbitrations.

11 The term "Restricted Deposit Requirement" is defined in proposed Rule 4111(i)(15).

12 See proposed Rule 4111(i)(14) (proposed definition of "Restricted Deposit Account").

the amount it seeks to withdraw from its Restricted Deposit to pay the former member firm's specified unpaid arbitration awards.

The proposed rule would create a multi-step process for FINRA's determination of whether a member firm raises investor-protection concerns substantial enough to require that it be subject to additional obligations. Those obligations could include a requirement to maintain a deposit of cash or qualified securities in an account from which withdrawals would be restricted, or conditions or restrictions on the member firm's operations that are necessary or appropriate for the protection of investors and in the public interest. The proposed rule would give each affected member firm several ways to affect outcomes, including a one-time opportunity to reduce staffing so as to no longer trigger the preliminary identification criteria and numeric thresholds. The firm also could explain to the Department why it should not be subject to a Restricted Deposit Requirement or propose alternatives, and the firm could challenge a Department determination by requesting a hearing before a Hearing Officer in an expedited proceeding.

The proposed multi-step process includes numerous features designed to narrowly focus the new obligations on the firms most of concern. As the flow chart in Exhibit 2d reflects, this process is akin to a "funnel." The top of the funnel applies to the range of member firms with the most disclosures, with a narrowing in the middle of the potential member firms that may be subject to additional obligations, and the bottom of the funnel reflecting the smaller number of member firms that are determined to present high risks to the investing public.

- General (Proposed Rule 4111(a))

Proposed Rule 4111(a) would require a member designated as a Restricted Firm to establish a Restricted Deposit Account and maintain in that account deposits of cash or qualified securities with an aggregate value that is not less than the member's Restricted Deposit Requirement, except in certain identified situations, and be subject to conditions or restrictions on the member's operations as determined by the Department to be necessary or appropriate for the protection of investors and in the public interest.

- Annual Calculation by FINRA of the Preliminary Criteria for Identification (Proposed Rule 4111(b))

The multi-step process would begin with an annual calculation. As explained more below, proposed Rule 4111(b) would require the Department to calculate annually (on a calendar-year basis) the "Preliminary Identification Metrics"[13] to determine whether a member firm meets the "Preliminary Criteria for Identification."[14] A key driver of that is whether a member firm's "Preliminary Identification Metrics" meet quantitative, risk-based "Preliminary Identification Metrics Thresholds."[15]

Several principles guided FINRA's development of the proposed Preliminary Criteria for Identification and the proposed Preliminary Identification Metrics Thresholds. The criteria and thresholds are intended to be replicable and transparent to

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13 See proposed Rule 4111(i)(10) (definition of "Preliminary Identification Metrics").

14 See proposed Rule 4111(i)(9) (definition of "Preliminary Criteria for Identification").

15 See proposed Rule 4111(i)(11) (definition of "Preliminary Identification Metrics Thresholds").

FINRA and affected member firms; employ the most complete and accurate data available to FINRA; be objective; account for different firm sizes and business profiles; and target the sales-practice concerns that are motivating the proposal. These criteria are intended to identify member firms that present a high risk but avoid imposing obligations on member firms whose risk profile and activities do not warrant such obligations.

Using these guiding principles, FINRA is proposing numeric thresholds based on six categories of events or conditions, nearly all of which are based on information disclosed through the Uniform Registration Forms.[16] The six categories, collectively defined as the "Disclosure Event and Expelled Firm Association Categories,"[17] are:

1. Registered Person Adjudicated Events;[18]

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16 One of the event categories, Member Firm Adjudicated Events, includes events that are derived from customer arbitrations filed with FINRA's dispute resolution forum.

17 See proposed Rule 4111(i)(4).

18 "Registered Person Adjudicated Events," defined in proposed Rule 4111(i)(4)(A), means any one of the following events that are reportable on the registered person's Uniform Registration Forms: (i) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party, or was a "subject of" the customer arbitration award or civil judgment; (ii) a final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation; (iii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or Commodity Futures Trading Commission ("CFTC"), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (v) a criminal matter in which the registered person was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

2. Registered Person Pending Events;[19]

3. Registered Person Termination and Internal Review Events;[20]

4. Member Firm Adjudicated Events;[21]

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[19] "Registered Person Pending Events," defined in proposed Rule 4111(i)(4)(B), means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms: (i) a pending investment-related civil judicial matter; (ii) a pending investigation by a regulatory authority; (iii) a pending regulatory action that was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (iv) a pending criminal charge associated with any felony or any reportable misdemeanor. Registered Person Pending Events does not include pending arbitrations, pending civil litigations, or consumer-initiated complaints that are reportable on the registered person's Uniform Registration Forms.

[20] "Registered Person Termination and Internal Review Events," defined in proposed Rule 4111(i)(4)(C), means any one of the following events associated with the registered person at a previous member firm that are reportable on the registered person's Uniform Registration Forms: (i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign from a previous member after allegations; or (ii) a pending or closed internal review by a previous member. FINRA has revised this definition, from the version proposed in Regulatory Notice 19-17 (May 2019), to clarify that termination and internal review disclosures concerning a person whom a member firm terminated would not impact that member firm's own Registered Person Termination and Internal Review Metric; rather, they would only impact the metrics of member firms that subsequently register the terminated individual.

[21] "Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D), means any one of the following events that are reportable on the member firm's Uniform Registration Forms or based on customer arbitrations filed with FINRA's dispute resolution forum: (i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party; (ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (iv) a criminal matter in which the member was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

5. Member Firm Pending Events;[22] and

6. Registered Persons Associated with Previously Expelled Firms (also referred to as the Expelled Firm Association category).[23]

To calculate whether a member firm meets the Preliminary Criteria for Identification, the Department would first compute the Preliminary Identification Metrics for each of the Disclosure Event and Expelled Firm Association Categories. Each category's Preliminary Identification Metric computation would start with a calculation of the sum of the pertinent disclosure events or, for the Expelled Firm Association category, the sum of the Registered Persons Associated with Previously Expelled Firms. For the adjudicated disclosure-event based categories, the counts would include disclosure events that were resolved during the prior five years from the date of the calculation. For the pending events categories and pending internal reviews, the counts would include disclosure events that are pending as of the date of the calculation. In addition, for the three Registered Person disclosure-event based categories, the counts would include disclosure events across all Registered Persons In-Scope, which is defined

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[22] "Member Firm Pending Events," defined in proposed Rule 4111(i)(4)(E), means any one of the same kinds of events as the "Registered Person Pending Events," but that are reportable on the member firm's Uniform Registration Forms.

[23] "Registered Persons Associated with Previously Expelled Firms," defined in proposed Rule 4111(i)(4)(F), means any "Registered Person In-Scope" who was registered for at least one year with a previously expelled firm and whose registration with the previously expelled firm terminated during the "Evaluation Period" (i.e., the prior five years from the "Evaluation Date," which is the annual date as of which the Department calculates the Preliminary Identification Metrics). See proposed Rule 4111(i)(5), (6), and (13) (proposed definitions of "Evaluation Date," "Evaluation Period," and "Registered Persons In-Scope"). This proposed definition is narrower than the definition proposed in Regulatory Notice 19-17.

to include persons registered with the member firm for one or more days within the one year prior to the calculation date.[24]

Each of those six sums would then be standardized to determine the member's six Preliminary Identification Metrics. For the five "Registered Person and Member Firm Events" categories (Categories 1-5 above),[25] the proposed Preliminary Identification Metrics are in the form of an average number of events per registered broker, calculated by taking each category's sum and dividing it by the number of Registered Persons In-Scope. The sixth Preliminary Identification Metric—the proposed Expelled Firm Association Metric—is in the form of a percentage concentration at the member firm of Registered Persons Associated with Previously Expelled Firms. This concentration is calculated by taking the number of Registered Persons Associated with Previously Expelled Firms and dividing it by the number of Registered Persons In-Scope.

A firm's six Preliminary Identification Metrics are used to determine if the member firm meets the Preliminary Criteria for Identification. To meet the Preliminary Criteria for Identification, a member firm would need to meet the Preliminary Identification Metrics Thresholds, set forth in proposed Rule 4111(i)(11), for two or more of the appropriate metrics listed above for its size and, if it does, one of these metrics must be for adjudicated events or the Expelled Firm Association Metric, and the firm must have two or more Registered Person and Member Firm Events (i.e., events in categories besides the Registered Persons Associated with Previously Expelled Firms

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[24] See proposed Rule 4111(i)(13).

[25] See proposed Rule 4111(i)(12) (definition of Registered Person and Member Firm Events).

category).[26] This involves analyzing the extent to which the Preliminary Identification Metrics meet the specified numeric Preliminary Identification Metrics Thresholds and meet additional conditions intended to prevent a member firm from becoming potentially subject to additional obligations solely as a result of pending matters or a single event or condition.[27] Specifically, the Department would:

- first, pursuant to proposed Rules 4111(b) and (i)(9)(A), evaluate whether two or more of the member firm's Preliminary Identification Metrics are equal to or more than the corresponding Preliminary Identification Metrics Thresholds for the member firm's size, and whether at least one of those Preliminary Identification Metrics is the Registered Person Adjudicated Event Metric, the Member Firm Adjudicated Event Metric, or the Expelled Firm Association Metric; and
- second, pursuant to proposed Rules 4111(b) and (i)(9)(B), evaluate whether the member firm has two or more Registered Person or Member Firm Events (i.e., two or more events from Categories 1-5 above).

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[26] Including an Expelled Firm Association Metric in the Preliminary Criteria for Identification is similar to how FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms) imposes recording requirements on firms with specific percentages of registered persons who were previously associated with disciplined firms.

[27] The purpose of ensuring that a firm does not meet the Preliminary Criteria for Identification solely because of pending matters is because FINRA recognizes that pending matters include disclosure events that may remain unresolved or that may subsequently be dismissed or concluded with no adverse action. As explained in more detail in the Economic Impact Assessment, FINRA also evaluated the impact of including and excluding pending matters from the Preliminary Criteria for Identification. Based on this evaluation, FINRA has included pending matters in the proposed criteria because they are critical to identifying firms that pose greater risks to their customers.

If all of these conditions are met, the member firm would meet the Preliminary Criteria for Identification.

Each specific numeric threshold in the Preliminary Identification Metrics Thresholds grid in proposed Rule 4111(i)(11) is a number which represents outliers with respect to peers for the type of events in the category (i.e., the firm is at the far tail of the respective category's distribution), which is intended to preliminarily identify member firms that present significantly higher risk than a large percentage of the membership. In addition, there are numeric thresholds for seven different firm sizes, to ensure that each member firm is compared only to its similarly sized peers.[28] As explained more below in the Economic Impact Assessment, based on recent history FINRA expects that its annual calculations will identify between 45-80 member firms that meet the Preliminary Criteria for Identification.[29]

The following three examples demonstrate—in practical terms—the point at which a member firm's Preliminary Identification Metrics would meet the Preliminary Identification Metrics Thresholds in proposed Rule 4111(i)(11):

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28 Because FINRA has narrowed the definition of Registered Persons Associated with Previously Expelled Firms from the version that was originally proposed in Regulatory Notice 19-17, FINRA also has revised the Expelled Firm Association Metric Thresholds.

29 Due to the revisions in the Preliminary Criteria for Identification, discussed above, and the inclusion of the year 2019 in the review period, this estimate and other corresponding estimates in the Economic Impact Assessment have changed from the ones in Regulatory Notice 19-17.

	Preliminary Identification Metrics Thresholds	Practical Equivalent
Example 1 (member firm size between 1-4 registered persons)	The Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric, for a member firm that has between one and four Registered Persons In-Scope as of the Evaluation Date,[30] is 0.50 (or 0.50 events per Registered Broker In-Scope).	For a member firm with four Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric if the sum of its four Registered Persons In-Scope's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was two or more. (4 Registered Persons In-Scope) * (0.50 Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric) = (2 Adjudicated Events)
Example 2 (member firm size between 20-50 registered persons)	The Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric, for a member firm that has between 20-50 Registered Persons In-Scope as of the Evaluation Date, is 0.20 (or 0.20 events per Registered Broker In-Scope).	For a member firm with 50 Registered Persons In-Scope as of the Evaluation Date, the member firm would meet the Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric if the sum of the member firm's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was ten or more. (50 Registered Persons In-Scope) * (0.20 Preliminary

[30] The "Evaluation Date" is defined in proposed Rule 4111(i)(5) to mean the date, each calendar year, as of which the Department calculates the Preliminary Identification Metrics to determine if the member firm meets the Preliminary Criteria for Identification.

		Identification Metrics Threshold for the Member Firm Adjudicated Event Metric) = (10 Adjudicated Events)
Example 3 (member firm size between 51-150 registered persons)	The Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric, for a member firm that has between 51-150 Registered Persons In-Scope as of the Evaluation Date, is 0.03 (or a 3% concentration level).	For a member firm with 100 Registered Persons In-Scope as of the Evaluation Date, the member firm would meet the Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric if the sum of its Registered Persons Associated with Previously Expelled Firms was three or more. (100 Registered Persons In-Scope) * (0.03 Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric) = (three Registered Persons Associated with Previously Expelled Firms)

In a comment to Regulatory Notice 19-17, SIFMA requested more clarity around when the annual Evaluation Date would be. FINRA would announce the first Evaluation Date no less than 120 calendar days before the first Evaluation Date. Subsequent Evaluation Dates would be on the same month and day each year, except when that date falls on a Saturday, Sunday or federal holiday, in which case the Evaluation Date would be on the next business day.

FINRA has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily identify the types of member firms that are motivating this rule proposal.[31] As explained below, however, the proposed rule involves several additional steps to guard against the risk of misidentification.

- Initial Department Evaluation (Proposed Rule 4111(c)(1))

For each member firm that meets the Preliminary Criteria for Identification, the Department would conduct, pursuant to proposed Rule 4111(c)(1), an initial internal evaluation to determine whether the member firm does not warrant further review under Rule 4111. In doing so, the Department would review whether it has information to conclude that the computation of the member firm's Preliminary Identification Metrics included disclosure events or other conditions that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. For example, the Department may have information that the computation included disclosure events that were not sales-practice related, were duplicative (involving the same customer and the same matter), or mostly involved compliance concerns best addressed by a different regulatory response by FINRA. The Department would evaluate the events to determine, among other things, whether they indicated risks to investors or market integrity, rather than, for instance, repeated violations of procedural rules.

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31 OCE has tested the Preliminary Criteria for Identification, including the Preliminary Identification Metrics Thresholds, in several ways. For example, OCE has compared the firms captured by the proposed criteria to the firms that have recently been expelled or that have unpaid arbitration awards. OCE also has consulted with Department staff and examiners about whether, based on their experience, the criteria identifies firms that appear to present high risks to investors.

The Department would also consider whether the member firm has addressed the concerns signaled by the disclosure events or conditions or altered its business operations, including staffing reductions, such that the threshold calculation no longer reflects the member firm's current risk profile. Essentially, the purpose of the Department's initial evaluation is to determine whether it is aware of information that would show that the member firm—despite having met the Preliminary Criteria for Identification—does not pose a high degree of risk.

Pursuant to proposed Rule 4111(c)(3), if the Department determines, after this initial evaluation, that the member firm does not warrant further review, the Department would conclude that year's Rule 4111 process for the member firm and would not seek that year to impose any obligations on it. If, however, the Department determines that the member firm does warrant further review, the Rule 4111 process would continue.

➢ <u>One-Time Opportunity to Reduce Staffing Levels (Proposed Rule 4111(c)(2))</u>

If the Department determines, after its initial evaluation, that a member firm warrants further review under proposed Rule 4111, such member firm—if it would be meeting the Preliminary Criteria for Identification for the first time—would have a one-time opportunity to reduce its staffing levels to no longer meet these criteria, within 30 business days after being informed by the Department. The member firm would be required to demonstrate the staff reduction to the Department by identifying the terminated individuals. The proposed rule would prohibit the member firm from rehiring any persons terminated pursuant to this option, in any capacity, for one year. A member firm that has reduced staffing levels at this stage may not use that staff-reduction opportunity again.

If the Department determines that the member firm's reduction of staffing levels results in its no longer meeting the Preliminary Criteria for Identification, the Department would close out that year's Rule 4111 process for the member firm and would not seek that year to impose any obligations on that firm. If, on the other hand, the Department determines that the member firm still meets the Preliminary Criteria for Identification even after its staff reductions, or if the member firm elects not to use its one-time opportunity to reduce staffing levels, the Department would proceed to determine the firm's maximum Restricted Deposit Requirement, and the member firm would proceed to a "Consultation" with the Department.

- <u>FINRA's Determination of a Maximum Restricted Deposit Requirement (Proposed Rule 4111(i)(15))</u>

For members that warrant further review after being deemed to meet the Preliminary Criteria for Identification and after the initial Department evaluation, the Department would then determine the member's maximum "Restricted Deposit Requirement."

The Department would tailor the member firm's maximum Restricted Deposit Requirement amount to its size, operations and financial conditions. As provided in proposed Rule 4111(i)(15), the Department would consider the nature of the member firm's operations and activities, revenues, commissions, assets, liabilities, expenses, net capital, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, insurance coverage for customer arbitration awards or settlements, concerns raised during FINRA exams, and the amount of any of the firm's or its Associated Persons' "Covered Pending Arbitration Claims" or unpaid arbitration awards.[32] Based on a consideration of these factors, the Department would determine a maximum Restricted Deposit Requirement for the member firm that would be consistent with the objectives of the rule, but not significantly undermine the continued financial stability and operational capability of the member firm as an ongoing enterprise over the next 12 months. FINRA's intent is that the maximum Restricted Deposit Requirement should be significant enough to change the member firm's behavior but not so burdensome that it would force the member firm out of business solely by virtue of the imposed deposit requirement.

- Consultation (Proposed Rule 4111(d))

If the Department determines, after the process discussed above, that a member firm warrants further Rule 4111 review, the Department would consult with the member firm, pursuant to proposed Rule 4111(d). This Consultation will give the member firm an

32 The proposed factors that the Department would consider when determining a maximum Restricted Deposit Requirement have been revised from the ones proposed in Regulatory Notice 19-17. Some of the revisions are to ensure that proposed Rule 4111(i)(15) describes more accurately the factors that would be relevant to a determination of the maximum Restricted Deposit Requirement. In this regard, the "annual revenues" and "net capital requirements" factors proposed in Regulatory Notice 19-17 have been modified to "revenues" and "net capital," and "assets," "expenses," and "liabilities" have been added as factors. Another revision clarifies that the Covered Pending Arbitration Claims and unpaid arbitration awards factors include claims and awards against the firm and its Associated Persons. The Department's consideration of claims and awards against the firm's Associated Persons would focus on claims and awards against Associated Persons who are owners or control persons and on claims and awards relating to arbitrations that involved conduct or alleged conduct that occurred while associated with the member firm. The revised proposed definition also adds the member firm's "insurance coverage for customer arbitration awards or settlements" as a factor. FINRA believes that, if Restricted Firms were able to procure errors and omissions policies, or other kinds of insurance coverage, for some or all of the kinds of arbitration claims that customers typically bring, that could warrant a reduced Restricted Deposit Requirement and would be behavior to encourage.

opportunity to demonstrate why it does not meet the Preliminary Criteria for Identification, why it should not be designated as a Restricted Firm, and why it should not be subject to the maximum Restricted Deposit Requirement.

In the Consultation, there would be two rebuttable presumptions: that the member firm should be designated as a Restricted Firm; and that it should be subject to the maximum Restricted Deposit Requirement. The member firm would bear the burden of overcoming those presumptions.

Proposed Rule 4111(d)(1) governs how a member may overcome these two presumptions. First, a member may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation that the member meets the Preliminary Criteria for Identification is inaccurate because, among other things, it included events, in the six categories described above, that should not have been included because, for example, they are duplicative, involving the same customer and the same matter, or are not sales-practice related. Second, a member firm may overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement by clearly demonstrating to the Department that the member firm would face significant undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement and that a lesser deposit requirement would satisfy the objectives of Rule 4111 and be consistent with the protection of investors and the public interest; or that other conditions and restrictions on the operations and activities of the member firm and its associated persons would address the concerns indicated by the thresholds and protect investors and the public interest.

Proposed Rule 4111(d)(2) governs how the Department would schedule and provide notice of the Consultation. In a change from the proposal in Regulatory Notice 19-17, the Department would provide the written letter required by the rule at least seven days prior to the Consultation, and would establish a process whereby the member can request a postponement for good cause shown. These changes, which are in response to a comment on Regulatory Notice 19-17, are intended to ensure that the firms have sufficient time to prepare for the Consultation and to enhance the procedural protections.

Proposed Rule 4111(d)(3) provides guidance on what the Department would consider during the Consultation when evaluating whether a member firm should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement. This provision also provides member firms with guidance on how to attempt to overcome the two rebuttable presumptions. For example, proposed Rule 4111(d)(3) requires that the Department consider:

- information provided by the member firm during any meetings as part of the Consultation;
- relevant information or documents, if any, submitted by the member firm, in the manner and form prescribed by the Department, as would be necessary or appropriate for the Department to review the computation of the Preliminary Criteria for Identification;
- any plan submitted by the member firm, in the manner and form prescribed by the Department, proposing in detail the specific conditions or restrictions that the member firm seeks to have the Department consider;

- such other information or documents as the Department may reasonably request from the member firm related to the evaluation; and
- any other information the Department deems necessary or appropriate to evaluate the matter.

To the extent a member firm seeks to claim undue financial hardship, it would be the member firm's burden to support that with documents and information.

➢ Department Decision and Notice (Proposed Rule 4111(e)); No Stays

After the Consultation, proposed Rule 4111(e) would require that the Department render a Department decision. Under proposed Rule 4111(e)(1), there are three paths that decision might take:

- If the Department determines that the member firm has rebutted the presumption that it should be designated as a Restricted Firm, the Department's decision would state that the member firm will not be designated that year as a Restricted Firm.
- If the Department determines that the member firm has not rebutted the presumption that it should be designated as a Restricted Firm or the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member firm as a Restricted Firm and require the member firm to promptly establish a Restricted Deposit Account, deposit and maintain in that account the maximum Restricted Deposit Requirement, and implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member firm and its associated persons

that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

- If the Department determines that the member firm has not rebutted the presumption that it should be designated as a Restricted Firm but has rebutted the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member firm as a Restricted Firm; would impose no Restricted Deposit Requirement on the member firm, or would require the member firm to promptly establish a Restricted Deposit Account, deposit and maintain in that account a Restricted Deposit Requirement in such dollar amount less than the maximum Restricted Deposit Requirement as the Department deems necessary or appropriate; and would require the member firm to implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

Pursuant to proposed Rule 4111(e)(2), the Department would provide a written notice of its decision to the member firm, pursuant to proposed Rule 9561 and no later than 30 days from the latest scheduling letter provided to the member firm under proposed Rule 4111(d)(2), that states the obligations to be imposed on the member firm, if any, and the ability of the member firm to request a hearing with the Office of Hearing Officers in an expedited proceeding, as further described below.

Proposed Rule 4111(e)(2) would provide that a request for a hearing would not stay the effectiveness of the Department's decision. However, upon requesting a hearing of a Department decision that imposes a Restricted Deposit Requirement, the member firm would only be required to maintain in a Restricted Deposit Account the lesser of 25% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year, until the Office of Hearing Officers or the NAC issues its final written decision in the expedited proceeding.[33] This has one exception: a member firm that is re-designated as a Restricted Firm and is already subject to a previously imposed Restricted Deposit Requirement would be required to maintain the full amount of its Restricted Deposit Requirement until the Office of Hearing Officers or the NAC issues its final written decision in the expedited proceeding.

Considering the nature of the firms identified as Restricted Firms and the risks they present, the immediate effectiveness of the Department's decision will help protect investors during the pendency of the expedited proceeding. Moreover, FINRA believes that the no-stay provision is consistent with fairness principles, because obligations would be imposed only after firms are preliminarily identified, from among their firm-

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[33] In Regulatory Notice 19-17 (May 2019), FINRA originally proposed that the member firm would be required, upon requesting a hearing, to deposit the lesser of 50% of the Restricted Deposit Requirement or 25% of the firm's average excess net capital during the prior calendar year. FINRA has revised this provision because, although the no-stay provisions are a fundamental part of how the proposed rule would protect investors, FINRA believes that this aspect of the no-stay provisions could be less burdensome than originally proposed and still achieve its intended purpose.

size peer group, by transparent criteria and a process that involves an initial evaluation and a consultation with the firm.

- Continuation or Termination of Restricted Firm Obligations (Proposed Rule 4111(f))

The proposed Restricted Firm Obligations Rule would require FINRA to determine annually whether each member firm is, or continues to be, a Restricted Firm and whether the member firm should be subject to any obligations. For this reason, proposed Rule 4111(f) contains provisions that set forth how any obligations that were imposed during the Rule 4111 process in one year are continued or terminated in that same year and in subsequent years.

Proposed Rule 4111(f)(1), titled "Currently Designated Restricted Firms," establishes constraints on a member firm's ability to seek to modify or terminate, directly or indirectly, any obligations imposed pursuant to Rule 4111. Because the Restricted Firm Obligations Rule would entail annual reviews by the Department to determine whether a member firm is a Restricted Firm that should be subject to obligations, a Restricted Firm could seek each year to terminate or modify any obligations that continue to be imposed. For this reason, proposed Rule 4111 does not authorize a Restricted Firm to seek, outside of the Consultation process and any ensuing expedited proceedings after a Department decision, a separate interim termination or modification of any obligations imposed. Rather, proposed Rule 4111(f)(1) provides that a member firm that has been designated as a Restricted Firm will not be permitted to withdraw all or any portion of its Restricted Deposit Requirement, or seek to terminate or modify any deposit requirement, conditions, or restrictions that have been imposed on it, without the prior written consent of the Department. In a change from the proposal in Regulatory Notice 19-17, there would be a presumption that the Department shall deny an application by a member firm or former member firm that is currently designated as a Restricted Firm to withdraw all or any portion of its Restricted Deposit Requirement.[34]

Proposed Rule 4111(f)(2), titled "Re-Designation as a Restricted Firm," addresses the scenario when the Department determines in one year that a member firm is a Restricted Firm, and in the following year determines that the member firm still meets the Preliminary Criteria for Identification. In that instance, the Department would re-designate the member firm as a Restricted Firm, and the obligations previously imposed on the member firm would continue unchanged, unless either the member firm or the Department requests, within seven days of the Department's decision to re-designate the member firm as a Restricted Firm, a Consultation.[35] If a Consultation is requested, the obligations previously imposed would continue unchanged unless and until the Department modifies or terminates them after the Consultation. In addition, in the Consultation process, a presumption would apply that any previously imposed Restricted Deposit Requirement, conditions or restrictions would remain effective and unchanged, absent a showing by the party seeking changes that they are no longer necessary or appropriate for the protection of investors or in the public interest. At the end of the Consultation, the Department would be required to provide written notice of its

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34 This revision, and additional revisions to proposed Rule 4111(f)(3) discussed below, are intended to make more clear the process that would guide the Department's assessment of applications for withdrawal from a Restricted Deposit Requirement.

35 The seven-day period to request a Consultation is a revision from the proposal in Regulatory Notice 19-17 (May 2019), which proposed a 30-day period.

determination to the member firm, no later than 30 days from the date of the latest scheduling letter provided to the member firm under Rule 4111(d)(2).

Proposed Rule 4111(f)(3), titled "Previously Designated Restricted Firms," addresses the scenario where the Department determines in one year that a member firm is a Restricted Firm, but in the following year(s) determines that the member firm or former member firm[36] either does not meet the Preliminary Criteria for Identification or should not be designated as a Restricted Firm. In that case, the member firm or former member firm would no longer be subject to any obligations previously imposed under proposed Rule 4111. There would be one exception: a former Restricted Firm would not be permitted to withdraw any portion of its Restricted Deposit Requirement without submitting an application and obtaining the Department's prior written consent for the withdrawal. Such an application would be required to include, among other things set forth in proposed Rule 4111(f)(3)(A), evidence as to whether the firm, its Associated Persons, or the former member firm have Covered Pending Arbitration Claims or any unpaid arbitration awards outstanding.

The Department would determine whether to authorize a withdrawal, in part or in whole. Proposed Rule 4111(f)(3)(B)(i) would establish a presumption that the Department shall approve an application for withdrawal if the member firm, its Associated Persons, or the former member firm have no Covered Pending Arbitration Claims or unpaid arbitration awards. Proposed Rule 4111(f)(3)(B)(ii) would establish presumptions that the Department shall: (a) deny an application for withdrawal if the member firm, the member firm's Associated Persons who are owners or control persons,

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[36] See proposed Rule 4111(i)(7) (definition of "Former Member").

or the former member have any “Covered Pending Arbitration Claims,” unpaid arbitration awards, or if the member’s Associated Persons have any “Covered Pending Arbitration Claims” or unpaid arbitration awards relating to arbitrations that involved conduct or alleged conduct that occurred while associated with the member; but (b) approve an application by a former member for withdrawal if the former member commits in the manner specified by the Department to use the amount it seeks to withdraw from its Restricted Deposit to pay the former member’s specified unpaid arbitration awards.[37] The Department would be required to issue, pursuant to proposed Rule 9561, a notice of its decision on an application to withdraw from the Restricted Deposit Account within 30 days from the date the application is received by the Department.

- Restricted Deposit Account (Proposed Rule 4111(i)(14))

If a Department decision requires a member firm to establish a Restricted Deposit Account, proposed Rule 4111(i)(14) would govern this account. The underlying policy for the proposed account requirements is that, to make a deposit requirement effective in creating appropriate incentives to member firms that pose higher risks to change their behavior, the member firm must be restricted from withdrawing any of the required deposit amount, even if it terminates its FINRA membership.

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[37] The presumptions in proposed Rule 4111(f)(3)(B) have been modified from what was proposed in Regulatory Notice 19-17. In addition, in clarifying changes from Regulatory Notice 19-17, proposed Rule 4111(f)(3) expressly provides that the Covered Pending Arbitration Claims and unpaid arbitration awards of a member firm’s “Associated Persons” are pertinent to an application for a withdrawal from the Restricted Deposit Requirement.

The proposed rule would require that the Restricted Deposit Account be established, in the name of the member firm, at a bank or the member firm's clearing firm. The account must be subject to an agreement in which the bank or the clearing firm agrees: not to permit withdrawals from the account absent FINRA's prior written consent; to keep the account separate from any other accounts maintained by the member firm with the bank or clearing firm; that the cash or qualified securities on deposit will not be used directly or indirectly as security for a loan to the member firm by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm; that if the member firm becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and withdrawals will not be permitted without FINRA's prior written consent; that FINRA is a third-party beneficiary to the agreement; and that the agreement may not be amended without FINRA's prior written consent. In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member.[38]

➢ <u>Books and Records (Proposed Rule 4111(g))</u>

Proposed Rule 4111(g) would establish new requirements to maintain books and records that evidence the member firm's compliance with the Restricted Firm Obligations Rule and any Restricted Deposit Requirement or other conditions or restrictions imposed under that rule. In addition, the proposed books and records provision would specifically

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[38] In the event of a liquidation of a Restricted Firm, funds or securities on deposit in the Restricted Deposit Account would be additional financial resources available for the Restricted Firm's trustee to distribute to those with claims against the Restricted Firm.

require a member firm subject to a Restricted Deposit Requirement to provide to the Department, upon its request, records that demonstrate the member firm's compliance with that requirement.

- Notice of Failure to Comply (Proposed Rule 4111(h))

FINRA also is proposing a requirement to address the situation when a member firm fails to comply with the obligations imposed pursuant to proposed Rule 4111. Under proposed Rule 4111(h), FINRA would be authorized to issue a notice pursuant to proposed Rule 9561 directing a member firm that is not in compliance with its Restricted Deposit Requirement, or with any conditions or restrictions imposed under Rule 4111, to suspend all or a portion of its business.

- Definitions (Proposed Rule 4111(i))

A complete list of defined terms used in proposed Rule 4111 appears in proposed Rule 4111(i).[39]

- Net Capital Treatment of the Deposits in the Restricted Deposit Account (Proposed Rule 4111.01)

Proposed Supplementary Material .01 would clarify that because of the restrictions on withdrawals from a Restricted Deposit Account, deposits in such an account cannot be readily converted to cash and therefore shall be deducted in determining the member's net capital under Exchange Act Rule 15c3-1[40] and FINRA Rule 4110.

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39 See Exhibit 5.

40 17 CFR 240.15c3-1.

➢ Compliance with Continuing Membership Application Rule (Proposed Rule 4111.02 - Compliance with Rule 1017)

Proposed Supplementary Material .02 would clarify that nothing in proposed Rule 4111 would alter a member firm's obligations under Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations). A member firm subject to proposed Rule 4111 would need to continue complying with the requirements of Rule 1017 and submit continuing membership applications as necessary.

➢ Examples of Conditions and Restrictions (Proposed Rule 4111.03)

In a change from Regulatory Notice 19-17, FINRA is proposing to add, in supplementary material to proposed Rule 4111, a non-exhaustive list of examples of conditions and restrictions that the Department could impose on Restricted Firms. FINRA believes that providing these examples will provide clarity about the Department's authority to impose conditions and restrictions without restricting the Department's flexibility to react and respond to different sources of risk. The non-exhaustive list of examples of conditions and restrictions includes: (1) limitations on business expansions, mergers, consolidations or changes in control; (2) filing all advertising with FINRA's Department of Advertising Regulation; (3) imposing requirements on establishing and supervising offices; (4) requiring a compliance audit by a qualified, independent third party; (5) limiting business lines or product types offered; (6) limiting the opening of new customer accounts; (7) limiting approvals of registered persons entering into borrowing or lending arrangements with their customers; (8) requiring the member to impose specific conditions or limitations on, or to prohibit, registered persons' outside business activities of which the member has received notice pursuant to Rule 3270; and (9) requiring the member to prohibit or, as part of its supervision of approved private securities transactions for compensation under Rule 3280 or otherwise, impose specific conditions on associated persons' participation in private securities transactions of which the member has received notice pursuant to Rule 3280.

- Planned Review of Proposed Rule 4111

FINRA plans to conduct a review of proposed Rule 4111 after gaining sufficient experience under proposed Rule 4111. Among other things, FINRA would review whether the Preliminary Identification Metrics Thresholds remain targeted and effective at identifying member firms that pose higher risks.

Proposed Amendments to the Rule 9550 Series to Establish a New Expedited Proceeding to Implement the Requirements of Proposed Rule 4111

FINRA is proposing to establish a new expedited proceeding in proposed Rule 9561 (Procedures for Regulating Activities Under Rule 4111) that would allow member firms to request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and grant a right to challenge any of the "Rule 4111 Requirements," including any Restricted Deposit Requirements, imposed.[41] The new expedited proceeding would govern how the Department provides notice of its determinations and afford affected member firms the right to seek a Hearing Officer's review of those determinations. The proposed expedited proceeding is similar in nature to FINRA's other expedited proceedings.

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[41] Proposed Rule 9561(a)(1) would define the "Rule 4111 Requirements" to mean the requirements, conditions, or restrictions imposed by a Department determination under proposed Rule 4111.

➢ Notices Under Proposed Rule 4111 (Proposed Rule 9561(a))

Proposed Rule 9561(a) would establish an expedited proceeding for the Department's determinations under proposed Rule 4111 to designate a member firm as a Restricted Firm and impose obligations on the member; and to deny a member's request to access all or part of its Restricted Deposit Requirement.

Proposed Rule 9561(a) would require the Department to serve a notice that provides its determination and the specific grounds and factual basis for the Department's action; states when the action will take effect; informs the member firm that it may file, pursuant to Rule 9559, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explains the Hearing Officer's authority. The proposed rule also would provide that, if a member firm does not request a hearing, the notice of the Department's determination will constitute final FINRA action.

Proposed Rule 9561(a) also would provide that any of the Rule 4111 Requirements imposed in a notice issued under proposed Rule 9561(a) are immediately effective. In general, a request for a hearing would not stay those requirements. There would be one partial exception: when a member firm requests review of a Department determination under proposed Rule 4111 that imposes a Restricted Deposit Requirement on the member for the first time, the member firm would be required to deposit, while the expedited proceeding was pending, the lesser of 25% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year.

- Notice for Failure to Comply with the Proposed Rule 4111 Requirements (Proposed Rule 9561(b))

Proposed Rule 9561(b) would establish an expedited proceeding to address a member firm's failure to comply with any requirements imposed pursuant to proposed Rule 4111.

Proposed Rule 9561(b) would authorize the Department, after receiving authorization from FINRA's chief executive officer ("CEO"), or such other executive officer as the CEO may designate, to serve a notice stating that the member firm's failure to comply with the Rule 4111 Requirements, within seven days of service of the notice, will result in a suspension or cancellation of membership. The proposed rule would require that the notice identify the requirements with which the member firm is alleged to have not complied; include a statement of facts specifying the alleged failure; state when the action will take effect; explain what the member firm must do to avoid the suspension or cancellation; inform the member firm that it may file, pursuant to Rule 9559, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explain the Hearing Officer's authority. The proposed rule also would provide that, if a member firm does not request a hearing, the suspension or cancellation will become effective seven days after service of the notice.

Proposed Rule 9561(b) also would provide that a member firm could file a request seeking termination of a suspension imposed pursuant to the rule, on the ground of full compliance with the notice or decision. The proposed rule would authorize the head of the Department to grant relief for good cause shown.

- Hearings (Proposed Amendments to the Hearing Procedures Rule)

If a member firm requests a hearing under proposed Rule 9561, the hearing would be subject to Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series). FINRA is proposing several amendments to Rule 9559 that would be specific to hearings requested pursuant to proposed Rule 9561.

Hearings in expedited proceedings under proposed Rule 9561 would have processes that are similar to the hearings in most of FINRA's other expedited proceedings—including requirements for the parties' exchange of documents and exhibits, the time for conducting the hearing, evidence, the record of the hearing, the record of the proceeding, failures to appear, the timing and contents of the Hearing Officer's decision, the Hearing Officer's authority, and the authority of the NAC to call an expedited proceeding for review—and FINRA is proposing amendments to the Rule 9559 provisions that govern these processes to adapt them for expedited proceedings under proposed Rule 9561. A few features of the proposed amendments to Rule 9559 warrant emphasis or guidance.

- Hearing Officer's Authority (Proposed Amended Rule 9559(d) and (n))

Hearings in expedited proceedings under proposed Rule 9561 would be presided over by a Hearing Officer. The Hearing Officer's authority would differ depending on whether the hearing is in an action brought under proposed Rule 9561(a) (Notices Under Rule 4111) or 9561(b) (Notice for Failure to Comply with the Rule 4111 Requirements).

Proposed amended Rule 9559(n)(6) would provide that the Hearing Officer, in actions brought under proposed Rule 9561(a), may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the Department, but may not modify any of the Rule 4111 Requirements, or impose any other requirements or obligations available under proposed Rule 4111.

Proposed amended Rule 9559(n)(6) would authorize the Hearing Officer, in failure-to-comply actions under proposed Rule 9561(b), to approve or withdraw the suspension or cancellation of membership, and impose any other fitting sanction. Authorizing a Hearing Officer to impose any other fitting sanction is intended to provide a Hearing Officer with authority that is appropriate for responding to situations involving member firms that repeatedly fail to comply with an effective FINRA action under proposed Rule 4111.

- Timing Requirements

The proposed amendments to the Hearing Procedures Rule are intended to give member firms a prompt process for challenging a Department decision under proposed Rule 4111. Proposed amended Rule 9559(f) would require that a hearing in actions under proposed Rule 9561(a) be held within 30 days, and that a hearing in failure-to-comply actions under proposed Rule 9561(b) be held within 14 days, after the member firm requests a hearing.[42]

Proposed amended Rule 9559(o) would require the Hearing Officer, in all actions pursuant to proposed Rule 9561, to prepare a proposed written decision, and provide it to the NAC's Review Subcommittee, within 60 days of the date of the close of the hearing. Pursuant to Rule 9559(q), the Review Subcommittee could call the proceeding for review

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[42] Proposed amendments to Rule 9559 contain other related timing requirements for proceedings pursuant to proposed Rule 9561.

within 21 days after receipt of the proposed decision. As in most expedited proceedings, the timing of FINRA's final decision would then depend on whether or not the Review Subcommittee calls the matter for review.[43]

- Contents of the Decision

Proposed amended Rule 9559(p) would govern the contents of the Hearing Officer's decision. The proposed amendments would broaden Rule 9559(p)(6) to account for the kinds of obligations that could be imposed under proposed Rule 4111. Rule 9559(p) would otherwise remain the same. For example, Rule 9559(p) would continue to require that the Hearing Officer's decision include a statement setting forth the findings of fact with respect to any act or practice the respondent was alleged to have committed or omitted or any condition specified in the notice, the Hearing Officer's conclusions regarding the condition specified in the notice, and a statement in support of the disposition of the principal issues raised in the proceeding.

Additional guidance may be helpful, considering the different kinds of issues that may arise in an expedited proceeding pursuant to proposed Rule 9561. For example, in a request for a hearing of a Department determination that imposes a Restricted Deposit Requirement or other obligations under Rule 4111, the principal issues raised may include whether: (1) the member firm should not be designated a Restricted Firm; (2) the Department incorrectly included disclosure events when calculating whether the member firm meets the Preliminary Criteria for Identification; (3) a Restricted Deposit Requirement would impose an undue financial burden on the member firm; or (4) the obligations imposed are inconsistent with the standards set forth in proposed Rule

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43 See FINRA Rule 9559(q).

4111(e). In a request for a hearing of a Department determination that denies a request to withdraw amounts from a Restricted Deposit Account, the principal issues raised may include whether the member firm or its Associated Persons have Covered Pending Arbitration Claims or unpaid arbitration awards and the nature of those claims or awards.

- No Collateral Attacks on Underlying Disclosure Events

In expedited proceedings pursuant to proposed Rule 9561(a) to review a Department determination under the Restricted Firm Obligations Rule, a member firm may sometimes seek to demonstrate that the Department included incorrectly disclosure events when calculating whether the member firm meets the Preliminary Criteria for Identification. When the member firm does so, however, it would not be permitted to collaterally attack the underlying merits of those final actions. An expedited proceeding under proposed Rule 9561 would not be the forum for attempting to re-litigate past final actions.[44]

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 60 days following Commission approval.

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44 Attempts to collaterally attack final matters are also precluded in other FINRA proceedings. Cf. Dep't of Enforcement v. Amundsen, Complaint No. 2010021916601, 2012 FINRA Discip. LEXIS 54, at *21-24 (FINRA NAC Sept. 20, 2012) (rejecting respondent's attempt to collaterally attack a judgment that was required to be disclosed on Form U4), aff'd, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148 (Apr. 18, 2013), aff'd, 575 F. App'x 1 (D.C. Cir. 2014); Membership Continuance Application of Member Firm, Application No. 20060058633, 2007 FINRA Discip. LEXIS 31, at *51 (July 2007) (holding, in a membership proceeding, that a firm may not address its and its FINOP's past disciplinary history by collaterally attacking those past violations) (citing BFG Sec., Inc., 55 S.E.C. 276, 279 n.5 (2001)); Jan Biesiadecki, 53 S.E.C. 182, 185 (1997) (describing, in eligibility proceedings, FINRA's long-standing policy of prohibiting collateral attacks on underlying disqualifying events).

The effective date will be no later than 60 days following publication of the Regulatory Notice announcing Commission approval.[45]

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[46] 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 member firms with a significant history of misconduct, including firms at which individuals with a significant history of misconduct concentrate. The proposed rule would create strong measures of deterrence while a firm is designated as a Restricted Firm, limiting the potential for harm to the public. It also should create incentives for firms to change

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45 FINRA notes that the proposed rule change would impact all member firms, including member firms that have elected to be treated as capital acquisition brokers ("CABs"), given that the CAB rule set incorporates the FINRA Rule 9550 Series by reference. In addition, FINRA is proposing to adopt CAB Rule 412, to reflect that a CAB would be subject to Rule 4111.

The proposed rule change would not impact, however, member firms that are funding portals. At this time, regulatory experience with funding portals is still at an early stage. The permissible business activities of funding portals are limited and, as such, it is not clear that funding portals present the corresponding risks that FINRA is seeking to address in the broker-dealer space. Moreover, developing relevant metrics and thresholds for funding portals would require a separate effort and analysis because, unlike broker-dealers, the Uniform Registration Forms do not apply to funding portals and their associated persons. Accordingly, FINRA is proposing to amend Funding Portal Rule 900(a) to add proposed Rule 9561 as a rule to which funding portal members would not be subject.

46 15 U.S.C. 78o-3(b)(6).

behaviors and activities, either to avoid being designated as a Restricted Firm or lose an existing Restricted Firm designation, 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.

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.

Economic Impact Assessment

A. Regulatory Need

FINRA uses a number of measures to deter and discipline misconduct by firms and brokers, and continually strives to strengthen its oversight of the brokers and firms it regulates. These measures span across several FINRA programs, including review of new and continuing membership applications, risk monitoring of broker and firm activity, cycle and cause examinations, and enforcement and disciplinary actions.

As part of its efforts to monitor and deter misconduct, FINRA has adopted rules that impose supervisory obligations on firms to ensure they are appropriately supervising their brokers' activities. These rules require each firm 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. Under this regulatory framework, FINRA also provides guidance to ensure consistency in interpretation of the rules and to further strengthen compliance across firms. As such, all firms play an important role in ensuring effective compliance with applicable securities laws and FINRA rules to prevent misconduct. This is consistent with the incentives of economic agents.[47]

Nonetheless, some firms do not effectively carry out these supervisory obligations to ensure compliance and they act in ways that could harm their customers—sometimes substantially. For example, recent academic studies find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence of predictability of future disciplinary and other regulatory-related events for brokers and firms with a history of past similar events.[48] These patterns suggest that some firms may not be acting appropriately as a first line of defense to prevent customer harm. Further, some firms may take advantage of the fair-process protections afforded to them under the federal securities laws and FINRA rules to forestall timely and appropriate regulatory actions, thereby limiting FINRA's ability to curb misconduct promptly. Without additional protections, the risk of potential customer harm may continue to exist at firms that fail to effectively carry out their supervisory obligations or are associated with a significant number of regulatory-related events. Further, even where harmed investors obtain arbitration awards, harm

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[47] See, e.g., Roland Strausz, Delegation of Monitoring in a Principal-Agent Relationship, Rev. Econ. Stud. 64(3):337-57 (July 1997). The paper shows that in a standard principal-agent framework, the delegation of monitoring by the principal (e.g., a regulator) to the agent (e.g., a firm) can be economically efficient for both parties.

[48] See supra note 4.

followed by recompense typically comes with some economic costs to customers and brokers, and firms may still fail to pay those awards. Unpaid arbitration awards harm successful customer claimants and may diminish investors' confidence in the arbitration process.[49]

To mitigate these risks, FINRA seeks additional authority to impose obligations on firms that pose these types of greater risk to their customers. The proposed Restricted Firm Obligations Rule would identify firms based upon a concentration of significant firm and broker events on their disclosure records that meet the proposed criteria and specified thresholds. Under the proposal, FINRA seeks to impose obligations on the operations and activities of the member and its associated persons that are necessary or appropriate to address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

B. Economic Baseline

The economic baseline used to evaluate the economic impacts of the proposed rules is the current regulatory framework, including FINRA rules relating to supervision, the membership application process, statutory disqualification proceedings and disciplinary proceedings that provide rules to deter and discipline misconduct by firms and brokers. This baseline serves as the primary point of comparison for assessing economic impacts of the proposed rules, including incremental benefits and costs.

The proposals are intended to apply to firms that pose far greater risks to their customers than other firms. One identifier of these types of firms is that they and their

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[49] Investors may also file claims in courts or other dispute resolution forums. Successful claimants in these forums may face similar challenges associated with collecting awards or judgments.

brokers generally have substantially more regulatory-related events on their records than do their peers.[50] Consistent with this, the proposed Restricted Firm Obligations Rule would specifically apply to firms that have far more Registered Person and Member Firm Events, or far higher concentrations of Registered Persons Associated with Previously Expelled Firms, compared to their peers.[51] Based on staff analysis of all firms registered with FINRA between 2013 and 2019, firms that would have met the Preliminary Criteria for Identification had on average four to nine times more Registered Person and Member Firm Events than peer firms at the time of identification. Specifically, the number of events per firm, for firms that would have met the Preliminary Criteria for Identification, ranged, on average, from 25-52 events during the Evaluation Period, compared to 4-5 events per firm for firms that would not have met the Preliminary Criteria for Identification. The median number of events per firm, for the firms that would have met the Preliminary Criteria for Identification, ranged from approximately 9-18 events, compared to zero events among other firms that would not have met the Preliminary Criteria for Identification.

Although disciplinary and regulatory-related events are one of the identifiers for firms posing higher risk, FINRA recognizes that firms posing higher risks do not always

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50 As discussed above, recent studies provide evidence of predictability of future regulatory-related events for brokers and firms with a history of past regulatory-related events. As a result, brokers and firms with a history of past regulatory-related events pose greater risk of future harm to their customers than other brokers and firms.

51 For example, for each of the six Preliminary Identification Metrics, the Preliminary Identification Metrics Threshold was chosen to capture one to five percent of the firms with the highest number of events per registered broker or the highest concentrations of Registered Persons Associated with Previously Expelled Firms, in respective firm-size categories.

manifest themselves with greater disclosures on their records. These firms may be newer, have recently made changes in management, staff or approach, or simply may be more effective in avoiding regulatory marks.

C. Economic Impacts

1. Proposed Restricted Firm Obligations Rule

To estimate the number and types of firms that would meet the Preliminary Criteria for Identification, FINRA analyzed the categories of events and conditions associated with the proposed criteria for all firms during the 2013-2019 review period. For each year, FINRA determined the approximate number of firms that would have met the proposed criteria. The number of firms that would have met the proposed criteria during the review period serves as a reasonable estimate for the number of firms that would have been directly impacted by this proposal had it been in place at the time. This analysis indicates that there were 45-80 such firms at the end of each year during the review period, as shown in Exhibit 3a. These firms represent 1.3-2.0% of all firms registered with FINRA in any year during the review period. The population of firms identified by the proposed criteria reflects the distribution of firm size in the full population of registered firms. Approximately 88-94% of these firms were small, 4-12% were mid-size and 0-3% were large at the end of each year during the review period, as shown in Exhibit 3b.[52]

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[52] 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.

FINRA notes that the number of firms that would have met the proposed criteria during the review period have declined (by approximately 44%) from 80 firms in 2013 to 45 firms in 2019. This decline is associated with an overall decrease in the number of Registered Person and Member Firm Events and the number of firms associated with these events.[53] Specifically, the Registered Person and Member Firm Events have declined by 24% and the number of firms with one or more of these events has declined by 22% during the review period. However, the average number of events per firm identified by the proposed criteria has increased, suggesting that there may be an increase in concentration of events across a smaller set of firms that may pose greater risks to their customers. For example, the average number of Registered Person and Member Firm Events for the firms identified by the criteria has increased by 94% from 24 events per firm in 2013 to 47 events per firm in 2019. These trends over the 2013-2019 review period suggest that while many firms continue to improve their regulatory records over time, a small proportion of firms may continue to further engage in activities that pose greater risks to their customers, which the proposed rule is intended to address.

In developing the proposed Preliminary Criteria for Identification, FINRA paid significant attention to the impact of possible misidentification of firms, specifically, the economic trade-off between including firms that are less likely to subsequently pose risk of harm to customers, and not including firms that are more likely to subsequently pose risk of harm to customers. There are costs associated with both types of

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[53] FINRA notes that part of the decline in the number of events and the firms that would have met the proposed criteria may be associated with an approximately 15% decline in the overall number of registered firms during the 2013-2019 review period.

misidentifications.[54] The proposed criteria, including the proposed numerical thresholds, aim to balance these economic trade-offs associated with over- and under-identification.[55] Further protection against misidentification would be provided by the proposed initial Department evaluation and the Consultation process.

➢ Anticipated Benefits

The proposal's primary benefit would be to reduce the risk and associated costs of possible future customer harm. This benefit would arise directly from additional restrictions placed on firms identified as Restricted Firms and resulting expected increased scrutiny by these firms on their brokers. Further, this benefit would also accrue indirectly from improvements in the compliance culture, both by firms that meet the proposed criteria and by firms that do not. For example, the proposal may create incentives for firms that meet the Preliminary Criteria for Identification to change activities and behaviors, to mitigate the Department's concerns. Similarly, the proposal may have a deterrent effect on firms that do not meet the Preliminary Criteria for Identification, particularly firms that may be close to meeting the proposed criteria.

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54 For example, subjecting firms that are less likely to pose a risk to customers to the proposed Restricted Deposit Requirement or other obligations would impose additional and unwarranted costs on these firms, their brokers and their customers.

55 In order to evaluate the effectiveness of the proposed criteria at identifying firms that pose greater risks, FINRA examined the overlap between the firms that would have met the Preliminary Criteria for Identification each year during the review period and the firms that were subsequently expelled, associated with unpaid awards, or identified by Department staff as suitable candidates for additional obligations. Finally, as discussed below, FINRA also examined disclosure events associated with firms that would have met the Preliminary Criteria for Identification each year during the review period, subsequent to meeting the criteria, to assess the extent of risk posed by these firms.

These firms may change behavior and enhance their compliance culture in ways that better protect their customers.

The proposal also may help address unpaid arbitration awards. Under the proposed rule, the Department may require a Restricted Firm to maintain a restricted deposit at a bank or a clearing firm that agrees not to permit withdrawals absent FINRA's approval. The amount of the Restricted Deposit Requirement would take into consideration, among other factors, the amount of any Covered Pending Arbitration Claims and unpaid arbitration awards against the member firm or its Associated Persons. Moreover, the proposed rule would have presumptions that the Department would: (a) deny an application by a member firm or former member firm that was previously designated as a Restricted Firm for a withdrawal from the Restricted Deposit if the member firm, its Associated Persons who are owners or control persons, or the former member firm have any Covered Pending Arbitration Claims or unpaid arbitration awards, or if the member firm's Associated Persons have any Covered Pending Arbitration Claims or unpaid arbitration awards relating to arbitrations that involved conduct or alleged conduct that occurred while associated with the member firm; but (b) approve a former member firm's application for withdrawal if the former member firm commits in the manner specified by the Department to use the amount it seeks to withdraw from its Restricted Deposit to pay the former member firm's specified unpaid arbitration awards. Accordingly, the proposed rule could potentially create incentives for firms to pay unpaid arbitration awards against the firm or its Associated Persons, thereby alleviating, to some extent, harm to successful claimants and enhancing investor confidence in the arbitration process.[56]

To scope these potential benefits and assess the potential risk posed by firms that would meet the proposed Preliminary Criteria for Identification, FINRA evaluated the extent to which firms that would have met the criteria during 2013-2017[57] (had the criteria existed) and their brokers were associated with "new" Registered Person and Member Firm Events after having met the proposed criteria. These "new" events correspond to events that were identified or occurred after the firm's identification, and do not include events that were pending at the time of identification and subsequently resolved in the years after identification. As shown in Exhibit 3c, FINRA estimates that there were 77 firms that would have met the Preliminary Criteria for Identification in 2013. These firms were associated with 1,552 "new" Registered Person and Member Firm Events that occurred after their identification, between 2014 and 2019. Exhibit 3c similarly shows the number of events associated with firms that would have met the Preliminary Criteria for Identification in 2014, 2015, 2016 and 2017. Across 2013-2017, there were 180 unique firms[58] that would have met the proposed Preliminary Criteria for

56 Further, as discussed above, the Department would consider a member firm's and its Associated Persons' unpaid arbitration awards as one of the factors in determining the amount of the Restricted Deposit Requirement. As a result, there would be additional incentives to pay unpaid arbitration awards.

57 This analysis examines firms that would have met the Preliminary Criteria for Identification from 2013 until 2017 (instead of the 2013-2019 review period) to allow sufficient time for the "new" events to resolve in the post-identification period.

58 Certain firms would have met the criteria in multiple years during the review period. The 180 firms discussed in the text correspond to the unique number of

Identification, and these firms were associated with a total of 2,995 Registered Person and Member Firm Events that occurred in the years after they met the proposed criteria.[59]

Exhibit 3c also shows the number of Registered Person and Member Firm Events for these firms compared to other firms. Specifically, FINRA calculated a factor which represents a multiple for the average number of events (on a per registered person basis) for firms that would have met the Preliminary Criteria for Identification relative to other firms of the same size that would not have met the Preliminary Criteria for Identification. For example, as shown in Exhibit 3c, the factor of 6.1x for 2013 indicates that firms meeting the Preliminary Criteria for Identification in 2013 had 6.1 times more new disclosure events (per registered person) in the years after identification (2014-2019) than other firms of the same size registered in 2013 that would not have met the Preliminary Criteria for Identification. Overall, this analysis demonstrates that firms that would have met the Preliminary Criteria for Identification during the 2013-2017 period had on average approximately 6-20 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the Preliminary Criteria for Identification.

- Anticipated Costs

The anticipated costs of this proposal would fall primarily upon firms that meet the Preliminary Criteria for Identification and that the Department deems to warrant

firms that would have met the criteria in one or more years during the review period.

59 Specifically, FINRA examined and counted all Registered Person and Member Firm Events that occurred any time after the firms were identified until December 31, 2019.

further review after its initial evaluation. Although FINRA would perform the annual calculation and conduct an internal evaluation, firms may choose to expend effort to monitor whether they would meet the Preliminary Criteria for Identification, and incur associated costs, at their own discretion. To the extent that a firm deemed to warrant further review under proposed Rule 4111 chooses to seek to rebut the presumption that it is a Restricted Firm subject to the maximum Restricted Deposit Requirement, it would incur costs associated with collecting and providing information to FINRA. For example, these firms may provide information on any disclosure events that may be duplicative or not sales-practice related. These firms may also provide information on any undue significant financial hardship that would result from a maximum Restricted Deposit Requirement. Likewise, a firm availing itself of the one-time staffing reduction opportunity incurs the separation costs, along with the potential for lost future revenues.

In addition, firms subject to a Restricted Deposit Requirement or other obligations would incur costs associated with these additional obligations. These would include, for example, costs associated with setting up the Restricted Deposit Account and ongoing compliance costs associated with maintaining the account. Further, as a result of restrictions on the use of cash or qualified securities in the deposit account or other restrictions on the firm's activities, the firm may lose economic opportunities, and its customers may lose the benefits associated with the provision of these services.

Similarly, a firm required to apply heightened supervision to its brokers would incur implementation and ongoing costs associated with its heightened supervision plan.[60] Firms that meet the Preliminary Criteria for Identification also may incur costs associated with enhancing their compliance culture, including possibly terminating registered persons with a significant number of disclosure events—through exercising the one-time staffing reduction option under proposed Rule 4111 or otherwise—and reassigning the responsibilities of these individuals to other registered persons. Finally, there may be indirect costs, including greater difficulty or increased cost associated with maintaining a clearing arrangement, loss of trading partners, or similar impairments where third parties can determine that a firm meets the proposed Preliminary Criteria for Identification or has been deemed to be a Restricted Firm.

Firms that do not meet the proposed Preliminary Criteria for Identification, particularly ones that understand they are close to meeting the proposed criteria, also may incur costs associated with enhancing their compliance culture or making other changes in order to avoid meeting the proposed criteria in the future. These costs may include terminating registered persons with disciplinary records, replacing them with existing or new hires, enhancing compliance policies and procedures, and improving supervision of registered persons. Finally, registered persons with significant number of disciplinary or other disclosure events on their records may find it difficult to retain employment, or get employed by new firms, particularly where those firms and their associated registered persons already have disciplinary records. Similarly, firms meeting the proposed criteria

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[60] These costs would likely vary significantly across firms. Costs would depend on the specific obligations imposed specific to the firm and its business model. In addition, costs could escalate if a heightened supervision plan applied to brokers that serve as principals, executive managers, owners, or in other senior capacities. Such plans may entail reassignments of responsibilities, restructuring within senior management and leadership, and more complex oversight and governance approaches.

or those close to meeting the proposed criteria may find it difficult to hire registered persons with disclosure events. FINRA notes, however, that the anticipated economic impacts on firms hiring and registered persons seeking employment would likely be limited to a small proportion of registered persons and member firms.[61]

- Other Economic Impacts

FINRA also has considered the possibility that, in some cases, this proposal may impose restrictions on brokers' and firms' activities that are less likely to subsequently harm their customers. In such cases, these brokers and firms may lose economic opportunities or find it difficult to retain brokers or customers. FINRA believes that the proposal mitigates such risks by requiring an initial layer of Departmental review, and providing affected firms an opportunity to engage in a Consultation with the Department and request a review of the Department's determination in an expedited proceeding.

FINRA also considered that some firms may consider not reporting, underreporting, or failing to file timely, required disclosures on Uniform Registration Forms in an effort to avoid costs associated with the proposals. However, this potential impact is mitigated because many events are reported by regulators or in separate public notices by third parties and, as a result, FINRA can monitor for these unreported events. Further, failing to timely update Uniform Registration Forms is a violation of FINRA

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[61] For example, during the 2013 to 2019 review period, only one to two percent of the registered persons had any qualifying events in their regulatory records, which represents the most conservative estimate of the set of registered persons who might be impacted by the proposed rule. Further, the vast majority of member firms, approximately 98%, would likely be able to employ most of the individuals seeking employment in the industry—including ones who have some disclosures—without coming close to meeting the Preliminary Criteria for Identification.

rules and can result in fines and penalties, thereby serving as a deterrent for underreporting, misreporting and failing to file timely required disclosures.

Considering that the proposed criteria are based on a firm's experience relative to its similarly sized peers, FINRA does not believe that the proposed criteria impose costs on competition between firms of different sizes. Further, because FINRA would perform the annual calculation to determine the firms that meet the Preliminary Criteria for Identification, the costs a firm incurs to monitor its status in relation to the proposed criteria would be discretionary and not likely create any competitive disadvantage based on firm size. Although the proposed rule would not impose these monitoring costs, FINRA would provide transparency around how the Preliminary Criteria for Identification are calculated and appropriate guidance to assist firms seeking to monitor their status. Similarly, FINRA does not anticipate that the proposed Restricted Firm Obligations Rule, including the Restricted Deposit Requirement or any required conditions and restrictions, would create competitive disadvantages across firms of different sizes. This is, in part, because FINRA would consider the number of offices and registered persons, among other factors, when determining the appropriate maximum Restricted Deposit Requirement or any conditions and restrictions, to ensure that the obligations are appropriately tailored to the firm's business model but do not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the ensuing 12 months.

As discussed above, FINRA would exercise some discretion in determining the maximum Restricted Deposit Requirement and tailor it to the size, operations and financial conditions of the firm, among other factors. This approach is intended to align with FINRA's objective to have the specific financial obligation be significant enough to change a Restricted Firm's behavior but not so burdensome that it would indirectly force it out of business. In determining the specific maximum Restricted Deposit Requirement, FINRA would consider a range of factors, including the nature of the firm's operations and activities, revenues, commissions, assets, liabilities, expenses, net capital, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, insurance coverage for customer arbitration awards or settlements, concerns raised during FINRA exams, and the amount of any of the firm's or its Associated Persons' "Covered Pending Arbitration Claims" or unpaid arbitration awards. In developing the proposal, FINRA considered the possibility of having a transparent formula, based on some of these factors, to determine a maximum Restricted Deposit Requirement. However, as discussed in more detail below, given the range of relevant factors and differences in firms' business models, operations, and financial conditions, FINRA decided not to propose a uniform, formulaic approach across all firms.

In developing the proposal, FINRA also considered the possibility that the size of the maximum Restricted Deposit Requirement may be too burdensome for the firms, and could undermine their financial stability and operational capability. FINRA believes that these risks are mitigated by providing affected firms an opportunity to engage in a Consultation process with FINRA and propose a lesser Restricted Deposit Requirement or restrictions or conditions on their operations. Further, as discussed above, Restricted Firms would have the opportunity to request a review of the Department's determination in an expedited proceeding.

2. Proposed Expedited Proceeding Rule

When FINRA imposes obligations on a firm pursuant to the proposed Restricted Firm Obligations Rule, the firm may experience significant limitations to its business activities and incur direct and indirect costs associated with the obligations imposed. The proposed Expedited Proceeding Rule would, in general, require that these obligations apply immediately, even during the pendency of any appeal.

The proposed rule would be associated with investor protection benefits through the impact of the no-stay provision in proposed Rule 9561(a)(4). Under the proposal, obligations imposed by the Department would be effective immediately, except that a firm that is subject to a Restricted Deposit Requirement under proposed Rule 4111 and requests a hearing would be required to make only a partial deposit while the hearing is pending. This would reduce the risk of investor harm during the pendency of a hearing. Similarly, the no-stay provision may limit hearing requests by firms that seek to use them only as a way to forestall FINRA obligations.

The benefit of the proposed rule accruing to firms would be to permit firms to appeal FINRA's determinations (both to request prompt review of obligations imposed or of determinations for failure to comply) in an expedited proceeding, thereby reducing undue costs where firms may have been misidentified or where the obligations imposed are not necessary or appropriate to address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest. For example, the proposed rule is anticipated to reduce any undue costs by the proceeding's expedited nature. Similarly, the proposed rule's time deadlines may also reduce the costs of the proceedings, in certain cases.

The costs would be borne by firms that choose to seek review via the proposed expedited proceeding, and these costs can be measured relative to a standard proceeding. These firms would incur costs associated with provisions and procedures specific to this proposed rule, including the provision that the obligations imposed would not be stayed.[62] This would include the obligations imposed under the proposed rule, including the Restricted Deposit Requirement, and the requirement that the firm, upon the Department's request, provide evidence of its compliance with these obligations. However, the extent of the costs associated with the Restricted Deposit Requirement would be mitigated by the expedited nature of the proceeding and by the provision that would require a firm, during the pendency of an expedited hearing process, to maintain only a partial deposit requirement.

As with the other proposals, FINRA does not anticipate that the proposed rule would have differential competitive effects based on firm size or other criteria. The costs and benefits are anticipated to apply to all firms that request a hearing in an expedited proceeding.

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 firms, brokers, regulators, investors and the public. Accordingly, in developing its rule proposals, FINRA seeks to identify ways to enhance the efficiency and effectiveness of the

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[62] The effect of the no-stay provision is that imposed obligations would apply immediately, even during the pendency of any hearing request. As a result, the no-stay provision would impose direct costs on misidentified firms or firms for which the obligations imposed are not necessary or appropriate.

proposed rules while maintaining their regulatory objectives. For example, FINRA considered several alternatives to addressing the risks posed by firms and their brokers that have a history of misconduct, including alternative approaches and alternative specifications to the numeric threshold based-approach and the Restricted Deposit Requirement.

1. Alternative to the Proposed Numeric Threshold-based Approach

In addition to the proposed approach based on numeric thresholds, FINRA considered an approach similar to the Investment Industry Regulatory Organization of Canada's (IIROC) "terms and conditions" rule, IIROC Consolidated Rule 9208, that would allow FINRA to identify a limited number of firms with significant compliance failures and impose on them appropriate terms and conditions to ensure their continuing compliance with the securities laws, the rules thereunder, and FINRA rules.[63] FINRA considered and evaluated the economic impacts of such a terms and conditions rule relative to proposed Rule 4111.

Compared to proposed Rule 4111, a terms and conditions rule would provide FINRA with greater flexibility in identifying firms that should be subject to additional obligations. This greater flexibility could help better target its application and reduce misidentification by allowing FINRA to leverage non-public information, including regulatory insights collected as part of its monitoring and examination programs, in identifying firms that pose the greatest risk. Further, under a terms and conditions rule,

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[63] IIROC Consolidated Rule 9208 permits IIROC to impose terms and conditions on an IIROC Dealer Member's membership when IIROC considers these terms and conditions appropriate to ensure the member's continuing compliance with IIROC requirements.

FINRA could quickly update its identification of firms based on emerging risk patterns, to ensure that the rule continues to be effective at addressing firms that presently pose the greatest risk. This flexibility could mitigate the risk that the criteria and thresholds in proposed Rule 4111 no longer identify the appropriate firms.

Further, as discussed above, the identification criteria in proposed Rule 4111 may not identify all the firms that pose material risk to their customers, such as firms that may act to stay just below the proposed criteria and thresholds by any means, including misreporting or underreporting disclosure events. The absence of a set identification criteria in a terms and conditions rule would make it more difficult for firms to evade the identification criteria and thus could provide greater investor protections.

At the same time, a terms and conditions rule may have certain disadvantages relative to proposed Rule 4111. For example, a benefit of proposed Rule 4111 is the deterrent effect it may have on firms that do not meet the proposed Preliminary Criteria for Identification, particularly firms that may be close to meeting the criteria. These firms may change behavior and enhance their compliance culture in ways that could better protect their customers. By comparison, under a terms and conditions rule, in the absence of transparent criteria, firms would have to assess FINRA’s view of the significance of repeated exam findings to determine whether to change their conduct to avoid potential terms and conditions.

Although FINRA has considered, and will continue to explore, this alternative, it is not proposing a terms and conditions rule at this time.

2. Alternative Specifications for the Proposed Numeric Threshold-based Approach

FINRA also considered several alternatives to the numerical thresholds and conditions for the Preliminary Criteria for Identification. In determining the proposed criteria, FINRA focused significant attention on the economic trade-off between incorrect identification of firms that may not subsequently pose risk of harm to their customers, and not including firms that may subsequently pose risk of harm to customers. FINRA also considered three key factors: (1) the different categories of reported disclosure events and metrics, including the Expelled Firm Association Metric; (2) the counting criteria for the number of reported events or conditions; and (3) the time period over which the events or conditions are counted. FINRA considered several alternatives for each of these three factors.

- Alternatives Associated with the Categories of Disclosure Events and Metrics

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. FINRA decided to exclude financial disclosures because while financial events, such as bankruptcies, civil bonds, or judgments and liens, may be of interest to investors in evaluating whether or not to engage a broker or a firm, these types of events by themselves are not evidence of customer harm.

In developing the Preliminary Criteria for Identification, FINRA also considered whether pending criminal, internal review, judicial and regulatory events should be excluded from the threshold test. Pending matters are often associated with an emerging pattern of customer harm and capture timely information of potential ongoing or recent misconduct. However, pending matters may include pending regulatory investigations and criminal proceedings that do not result in a finding.[64] FINRA evaluated the impact of eliminating pending matters from the Preliminary Criteria for Identification. Specifically, FINRA identified the firms that would no longer meet the proposed criteria (had the criteria existed) during the evaluation period if pending-events categories were eliminated from the criteria, and examined the extent to which such firms were associated with "new" Registered Person and Member Firm Events. As shown in Exhibit 3d, FINRA estimates that these firms had on average approximately 8.0-13.1 times more new disclosure events than other firms in the industry during the same period that would not have met the Preliminary Criteria for Identification.[65] Accordingly, based on this review and other validations, FINRA decided to include pending matters in the proposed criteria because they are critical to identifying firms that pose greater risks to their customers.

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64 As discussed in more detail below, several commenters expressed concerns about including pending and un-adjudicated events in the Preliminary Criteria for Identification. Commenters suggested that pending events are often associated with frivolous cases and that many pending regulatory investigations and criminal proceedings are discontinued without action.

65 In assessing the impact of removing pending events from the Preliminary Criteria for Identification and restricting the criteria solely to final events, FINRA also examined the number of firms that would have met or exceeded at least one Preliminary Identification Metrics Threshold in the Registered Person Adjudicated Events, Member Firm Adjudicated Events, or Registered Persons Associated with Expelled Firms categories, during the relevant period. This analysis showed that the number of firms identified by this alternative criteria would increase from 45-80 firms to 131-196 firms, each year, during the review period. Similarly, FINRA estimates the number of firms that would have met or exceeded at least two thresholds within these categories to be 32-57 firms, each year, during the review period.

As with other categories, the proposed Preliminary Identification Metrics Thresholds for the relevant Preliminary Identification Metrics, including the Registered Person Pending Event Metric and the Member Firm Pending Event Metric, are intended to capture firms that are on the far tail of the distributions. Thus, firms meeting these thresholds have far more pending matters on their records than other firms in the industry that do not meet these thresholds. Nonetheless, FINRA recognizes that pending matters include disclosure events that may remain unresolved or that may subsequently be dismissed or concluded with no adverse action because they lack merit or suitable evidence.[66] In order to ensure that a firm does not meet the Preliminary Criteria for Identification solely because of pending matters, FINRA has proposed the conditions that, to meet the criteria, the firm must meet or exceed at least two of the six Preliminary Identification Metrics Thresholds, and at least one of the thresholds for the Registered Person Adjudicated Event Metric, Member Firm Adjudicated Event Metric, or Expelled Firm Association Metric.

In developing the Preliminary Criteria for Identification, FINRA also considered alternatives to the Expelled Firm Association Metric. For example, in Regulatory Notice 19-17, FINRA initially proposed the metric to be based on all registered persons who were previously associated with one or more previously expelled firms, at any time in their career and irrespective of their duration of association at the previously expelled firm. FINRA subsequently narrowed the Expelled Firm Association Metric by only including registered persons who were registered with a previously expelled firm within

66 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 arbitrators or judges.

the prior five years (i.e., whose registration with a previously expelled firm terminated during the prior five years) and who were registered with the expelled firm for at least one year. FINRA selected this formulation to analyze because the five-year lookback is consistent with the lookback periods for the other proposed metrics in the proposal and, based on staff experience, FINRA believes that individuals who are more recently associated with previously expelled firms (e.g., in the last five years) and have longer tenures at expelled firms (e.g., a year or more, instead of a shorter employment duration) generally pose higher risk than other individuals.

In developing the proposal, FINRA conducted several validations on the firms meeting the criteria, including the proposed Expelled Firm Association Metric, by reviewing the extent to which firms identified during 2013-2017 (had the criteria existed) were subsequently expelled, associated with unpaid awards, or identified by the Department as suitable candidates for additional obligations. As discussed above, FINRA also evaluated the extent to which firms that would have met the criteria during 2013-2017 (had the criteria existed) and their brokers were associated with "new" Registered Person and Member Firm Events after having met the criteria. As shown in Exhibit 3c, FINRA estimates that the identified firms had on average approximately 6.1-19.9 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the Preliminary Criteria for Identification. Based on staff review and validations, FINRA believes that the proposed Expelled Firm Association Metric preserves the usefulness of the Preliminary Criteria for Identification (as originally proposed in Regulatory Notice 19-17) and continues to identify firms that pose greater risks to their customers.

➢ Alternatives Associated with the Counting Criteria for the Proposed Criteria and Metrics

FINRA considered a range of alternative counting criteria for the Preliminary Criteria for Identification. For example, FINRA considered whether the Preliminary Criteria for Identification should be based on firms meeting two or more Preliminary Identification Metrics Thresholds, or whether the number of required thresholds should be decreased or increased. Decreasing the number of required thresholds from two to one would increase the number of firms that would have met the Preliminary Criteria for Identification during the review period from 45-80 firms to 155-217 firms, each year. Alternatively, increasing the number of required thresholds from two to three would decrease the number of firms that would have met the Preliminary Criteria for Identification from 45-80 firms to 11-20 firms, each year. FINRA reviewed the list of firms identified under these alternative counting criteria and examined the extent to which they included firms that were subsequently expelled, associated with unpaid awards, or identified by the Department as suitable candidates for additional obligations. FINRA also paid particular attention to firms that would have been identified by these alternative criteria but subsequently were not associated with high-risk activity, as well as firms that would not have been identified by these alternatives that were associated with high-risk events. Based on this review, FINRA believes that the proposed approach—meeting two or more of the Preliminary Identification Metrics Thresholds—more appropriately balances these trade-offs between misidentifications than the alternative criteria.

- Alternatives Associated with the Time Period over which the Metrics Are Calculated

The proposed Preliminary Identification Metrics are based on two different time periods over which different categories of events and conditions are counted ("lookback periods"). Pending events, including the Registered Person Pending Events and the Member Firm Pending Events categories, are counted in the Preliminary Identification Metrics only if they are pending as of the Evaluation Date. Adjudicated events, including the Registered Person Adjudicated Events and the Member Firm Adjudicated Events categories, and Registered Persons Associated with Previously Expelled Firms are counted in the Preliminary Identification Metrics over a five-year lookback period.[67]

In developing the proposal, FINRA considered alternative criteria for the time period over which the disclosure events or conditions are counted. For example, FINRA considered whether adjudicated events should be counted over the individual's or firm's entire reporting period or counted over a more recent period. Based on its experience, FINRA believes that more recent events (e.g., events occurring in the last five years) generally pose a higher level of possible future risk to customers than other events. Further, counting events over an individual's or firm's entire reporting period would imply that brokers and firms would always be included in the Preliminary Identification Metrics for adjudicated events, even if they subsequently worked without being

[67] Registered Persons In-Scope include all persons registered with the firm for one or more days within the one year prior to the Evaluation Date.

associated with any future adjudicated events. Accordingly, FINRA decided to include adjudicated events only in the more recent period (i.e., a five-year period).[68]

Similarly, FINRA also considered alternative limits on the time periods over which components of the Expelled Firm Association Metric would be calculated. For example, FINRA considered alternative metrics based on only firms that have been expelled within three to five years prior to the Evaluation Date. Further, FINRA considered alternatives where the individual broker's association with the previously expelled firm was within a five-year window around the firm's expulsion. In evaluating these alternatives, FINRA recalculated the underlying thresholds to capture firms that are on the far tail of the distribution for these alternative metrics.[69] As with other alternatives, FINRA conducted several validations on alternative specifications of time periods for calculating the Expelled Firm Association Metric. These validations included reviewing the extent to which firms identified by alternative specifications of the proposed criteria were associated with "new" events after identification, subsequently expelled or associated with unpaid awards, or were identified by the Department as suitable candidates for additional obligations. Based on these validations, FINRA selected the proposed five-year period for calculating the Expelled Firm Association

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68 This also is consistent with the time period used for counting "specified risk events" in SR-FINRA-2020-011.

69 These alternatives would have identified approximately the same number of firms as meeting the Preliminary Criteria for Identification, during the review period.

Metric as the alternative specifications did not result in any material change to the proposed criteria's ability to identify firms that pose greater risk of customer harm.[70]

3. Alternatives to the Restricted Deposit Requirement

In developing the proposal, FINRA considered alternative approaches to the Restricted Deposit Requirement. For example, FINRA considered increasing the capital requirements on identified firms, in lieu of the Restricted Deposit Requirement. A net capital approach would provide the identified firms greater flexibility and control over the assets. These firms would be able to use the assets for cash flow and operating expenses. As a result, an additional net capital charge would be associated with lower direct and indirect costs to these firms. However, there are several drawbacks with respect to economic incentives and anticipated impacts to relying upon a net capital approach as a tool for addressing the risks posed by firms with a significant history of misconduct. For example, the firm assets that would be maintained pursuant to an increased net capital requirement would not be deposited into a separate restricted account and may be fungible with other firm assets. As a result, these assets could be withdrawn by the identified firms at any time and these firms could employ the capital during the pendency of the restriction period. This suggests that the deterrent effect of an increased net capital approach would be much lower on a dollar-for-dollar basis than the proposed Restricted Deposit Requirement. An increased net capital approach also may not be sufficiently impactful in providing incentives to change firm behavior if a

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[70] For example, as discussed above, FINRA estimates that the firms identified by the proposed criteria (based on a five-year period for calculating the Expelled Firm Association Metric) had on average approximately 6.1-19.9 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the proposed criteria.

Restricted Firm already maintains substantial excess net capital. Further, considering that the identified firms could withdraw their assets at any time under a net capital approach, FINRA would not be able to ensure that any funds would be available for satisfying unpaid arbitration awards. In light of these considerations, FINRA decided to propose a Restricted Deposit Requirement approach, rather than changes to the capital requirements on identified firms.

FINRA also considered whether the Restricted Deposit Requirement amount should be based on a formula or include a cap in order to provide greater transparency to the member firms. To assess the feasibility of a strict formula or cap in setting the Restricted Deposit Requirement, FINRA assessed the financial condition of the firms that would have been identified by the Preliminary Criteria for Identification in 2019 (if the criteria had existed) and found significant variation across firms. These variations existed even across firms within the same size category. For example, FINRA found that the highest firm’s revenues were approximately 1,750 times that of the firm with the lowest revenue when standardized by the number of registered persons at the firm. Within firm size categories, the corresponding difference in revenues per registered person was as high as over 80 times. Similarly, there was significant variation in the reported cash and ownership equity across these firms. The highest firm’s excess net capital was over 3,500 times that of the firm with the lowest excess net capital (standardized per registered person).[71] The firm reporting the highest ownership equity was over 2,300 times that of the lowest firm’s ownership equity (standardized per

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[71] See Exhibit 3e, which reflects the firms that would have met the Preliminary Criteria for Identification in 2019, had the criteria existed.

registered person). Further, firms' awards and settlements appear to be unrelated to their financial condition. For example, FINRA estimates that over 20% of the identified firms with high awards and settlement amounts have low or medium revenues (on a per registered person basis) or high revenues and low or medium awards and settlement amounts.[72] Thus there appears to be no consistent relationship between firm size, and basic metrics of the financial condition of the firm, and potential obligations to harmed customers. Given these significant variations in quantitative factors and the qualitative nature of some of the factors for consideration (e.g., concerns raised during FINRA exams), FINRA decided to maintain the Department's discretion for determining the Restricted Deposit Requirement, instead of proposing a formula or a cap. Additionally, FINRA believes that if the proposal were to include a precise formula, it may undermine the effectiveness of the rule by providing an opportunity for firms to take actions to minimize the expected restricted deposit.

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 19-17 (May 2019). Thirty-two comments were received in response to the Regulatory Notice.[73] Exhibit 2a is a copy of the Regulatory Notice. Exhibit 2b is a list of commenters.

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72 For purposes of this Form 19b-4, "high" arbitration awards, settlement amounts and revenues means the top tercile (above 66th percentile) of these awards, settlements and revenues among firms that would have met the proposed criteria, and "medium" and "low" arbitration awards, settlement amounts and revenues means the middle tercile (33rd-66th percentile) and bottom tercile (below the 33rd percentile). See Exhibit 3f, which reflects the firms meeting the Preliminary Criteria for Identification in 2019.

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

Exhibit 2c contains copies of the comment letters received in response to the Regulatory Notice. Of the 32 comment letters received, 11 were generally in favor of the proposed rule change, and 18 were generally opposed.

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 the Proposal

Several commenters expressed general support for the proposed rule changes in Regulatory Notice 19-17.[74] For example, NASAA commended FINRA's attempt to strategically identify, and more strongly regulate, the limited number of member firms with histories of regulatory noncompliance, and stated that the proposal should increase investor protection while imposing minimal burdens on the brokerage industry. Massachusetts called the proposal a positive step toward protecting investors from the riskiest corners of the brokerage industry, and asserted that the proposal rightly places the burden of investor protection on the firms that hire bad brokers and ensures that investors have meaningful recourse when harmed. CAI likewise expressed support for how the proposal would enhance customer protection by imposing additional obligations on a targeted group of firms. SIFMA supported how the proposal fits into FINRA's continuing efforts to help ensure that arbitration claims, awards, and settlements are paid in full. Cetera supported both the concept and manner in which FINRA has approached

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74 CAI, Cambridge, Cetera, FSI, Massachusetts, MIRC, NASAA, PIABA, PIRC, SIFMA, St. John's SOL. Supportive commenters also suggested ways in which the proposal could be modified or enhanced, which are discussed in more detail below.

this effort. Cambridge agreed that an objective data assessment coupled with a comprehensive and transparent review of that data—which is the general structure of the proposed Restricted Firm Obligations Rule—will aid FINRA in identifying those high risk member firms and registered persons contemplated by this proposal.

General Opposition to the Proposal

Several commenters generally opposed proposed Rule 4111, on a variety of grounds. For example, several commenters wrote that the proposal would disproportionately affect small firms or reflected an attempt to put small firms out of business.[75] PIRC, however, characterized industry objections that the proposed rule would disproportionately affect small firms as unwarranted noting that the rule accounts for different firm sizes in its threshold calculations. Each specific numeric threshold in the Preliminary Identification Metrics Thresholds grid (proposed Rule 4111(i)(11)) represents an outlier with respect to similarly sized peers. Moreover, the process of determining a Restricted Deposit Requirement would require the Department to consider several factors that relate to firm size and a parameter directly influenced by firm size.[76] Thus, while the revised proposal includes several modifications that will lessen some of the original proposal's burdens on all firms, the modifications are not specific to small firms.

75 Brooklight, Colorado FSC, Dempsey, FSI, IBN, Joseph Stone, Luxor, McNally, Moss & Gilmore, Westpark.

76 See proposed Rule 4111(i)(15)(A) (including as factors, inter alia, the "nature of the firm's operations and activities" and "the number of offices and registered persons," and requiring that the Department determine a maximum Restricted Deposit Requirement that "would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months").

Some commenters generally opposed the proposal on the basis of its potential adverse impacts on individuals.[77] For example, some commenters contended that many terminated individuals would have to uproot their lives and be unable to find a new broker-dealer.[78] Brooklight commented that innocent representatives who associated with a firm expelled for firm-level issues would be marked with a "scarlet letter" that could end their careers. Westpark commented that the proposed rule would make it financially untenable for small firms to employ brokers with certain levels of disclosures, essentially making them unemployable. HLBS commented that the proposed rule will allow FINRA to grossly intrude on member firms' recruiting and termination decisions. Some commenters expressed concern that the proposal would unfairly affect some persons who previously worked at disciplined firms and persons with any regulatory incidents regardless of their intent.[79]

FINRA notes, however, that between 2013 and 2019, only one to two percent of registered persons in any year had any qualifying events in their regulatory records, which represents the most conservative estimate of the set of brokers who might be associated with the proposed rule. Further, approximately 98% of member firms would be able to employ individuals seeking employment in the industry—including ones who have some disclosures and ones who were terminated by Restricted Firms—without meeting the Preliminary Criteria for Identification. Moreover, under a separately

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[77] Brooklight, Dempsey, Joseph Stone, Westpark.

[78] Dempsey, Joseph Stone.

[79] Brooklight, Dempsey, Joseph Stone.

proposed rule, a member firm could register an individual who has only one "specified risk event" in their record without having to request a materiality consultation.[80]

For these reasons, FINRA is not proposing to revise proposed Rule 4111 to address these comments, except to narrow the scope of the Expelled Firm Association Metric. FINRA recognizes that proposed Rule 4111 could result in some firms declining to employ persons who have associated with a firm that has been expelled, even when it would not cause the firm to meet the Preliminary Criteria for Identification. FINRA does not believe this concern—which is similar to how some firms may respond to FINRA's "Taping Rule"[81]—warrants removing the Expelled Firm Association Metric from the Preliminary Criteria for Identification. Nevertheless, as explained more below, FINRA has narrowed the Expelled Firm Association Metric, to narrow its impact on individuals.

Westpark commented that the proposal is inconsistent with Section 15(b)(6) of the Exchange Act, which requires that FINRA rules not be designed to permit unfair discrimination between brokers or dealers, and Section 15A(b)(9) of the Exchange Act, which requires that FINRA rules not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. Proposed Rule 4111, however, will allow FINRA to impose obligations only on the limited number of member firms that pose substantially higher risks to investors compared to their similarly sized peers, and only after a multi-step process that has numerous procedural protections, for the purpose

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80 See Securities Exchange Act Release No. 88600 (April 8, 2020), 85 FR 20745 (April 14, 2020) (Notice of Filing of File No. SR-FINRA-2020-011).

81 See Rule 3170 (Tape Recording of Registered Persons by Certain Firms). The Taping Rule provides, in general, that a firm is a "taping firm" when specified percentages of its registered persons have been associated with one or more "disciplined firms" in a registered capacity within the last three years.

of protecting investors and the public interest. Therefore, FINRA believes the proposal is an appropriate means of protecting investors and the public interest, and is not unfair.[82]

Several commenters predicted that, for a variety of reasons, the proposal will not achieve its intended goals[83] or commented that the proposal is insufficient.[84] For example: (1) some question the underlying premise of using disclosure data to predict future customer harm;[85] (2) Rockfleet suggested that when a Restricted Deposit Requirement would essentially shut a firm down, the firm would likely terminate its membership and "leav[e] FINRA in exactly the position it is seeking to avoid"; (3) Joseph Stone commented that firms that dilute their concentration of brokers that meet the threshold criteria can still pose risks, and that the proposal will "force firm management to push quality and compliant representatives out of their firms"; (4) Luxor commented that there is no evidence to prove that the proposal will cure the problem it is intended to solve; (5) Massachusetts wrote that the annual calculation is predictable and may provide an incentive for firms to comply only enough to remain just below the triggering thresholds; (6) Cambridge predicted that member firms without significant retained earnings would be given exceptions to the Restricted Deposit Requirement; (7) Network 1 wrote "[t]here will always be 'bad' brokers"; and (8) ASA commented that

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82 See Securities Exchange Act Release No. 17371 (December 12, 1980), 45 FR 83707 (December 19, 1980) (Order Approving File No. SR-NASD-78-3) (explaining that disparate treatment of differently situated parties is not necessarily either fair or unfair).

83 ASA, Dempsey, Joseph Stone, Luxor, PIABA, Rockfleet, Worden.

84 ASA, Better Markets.

85 Cetera, Dempsey, Luxor.

certain aspects of the proposal "do not go far enough to remove the most egregious actors from our industry" and would "marginally increase the financial obligations of bad actor firms and allow [them] to continue their abuse of Main Street investors."

The primary goal of the proposed rule change is to incentivize members with a significant history of misconduct relative to their peers to change behavior, and FINRA believes that the proposed rule change is reasonably designed to achieve that goal. The way the proposal identifies the affected firms is consistent with recent academic studies that analyzed correlations between disclosure data and risks to investors. The proposed rule change creates substantial, ongoing incentives for the firms that present the highest levels of risk to change behavior, and gives FINRA an important new tool to respond to those firms that continue to present outlier-level risks to investors. FINRA also believes that the most effective measure to incentivize such firms to change behavior is a financial restriction—including the mere potential for a financial restriction.

Several commenters state that the proposal's impacts are too broad to address the risks posed. For example, Brooklight expressed that instead of impacting just a "few bad actors," the proposal imposes increased regulatory burdens on "every single member" and could "sweep in wholly innocent firms." HLBS commented that the proposed rule would impose punishment based only on the mere suspicion of misconduct. Rockfleet commented that the burdens would be unwarranted, because unpaid arbitration awards are "not a widespread industry issue," and the proposal would unfairly capture firms that only employ a single individual with numerous disclosure events. Sichenzia commented that reducing unpaid arbitration awards is better achieved through less onerous means.

FSI expressed concern that the proposal does not provide adequate safeguards to protect against misidentification.

FINRA believes, however, that the proposed rule change is reasonably designed to impact a relatively small number of firms posing outlier-level risks. The proposed Rule 4111 "funnel" process has numerous safeguards designed to protect against misidentification. Furthermore, although the proposal would have ancillary benefits for addressing unpaid arbitration awards, the proposal's primary purpose is to create incentives for members that pose outlier-level risks to change behavior.

Luxor commented that the proposal is inconsistent with the usual "causal relationship inherent in any regulatory schema" where misconduct precedes the sanctions imposed. Proposed Rule 4111, however, is similar to other kinds of rules and regulations that impose requirements and restrictions based on a firm's circumstances. For example, FINRA's membership rules permit FINRA to impose restrictions on new member applicants that are reasonably designed to address specific concerns, including—besides disciplinary concerns—financial, operational, supervisory, investor protection, or other regulatory concerns.[86] As another example, Exchange Act Rule 15c3-1,[87] the Net Capital Rule, imposes different minimum net capital requirements based on the types of securities business the broker-dealer conducts. Moreover, the obligations that FINRA may impose pursuant to Rule 4111 are not "sanctions" for violations; rather, they are

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[86] See Rule 1014(c)(2) (describing granting of applications for new membership subject to restrictions).

[87] 17 CFR 240.15c3-1.

obligations that relate directly to firm profiles that pose substantially more risk to investors than the profiles of the vast majority of other member firms of similar sizes.

Some commenters opposed the proposal on the ground that it is unnecessary. For example, Rockfleet commented that FINRA's membership program and examinations should be sufficient to deal with firms that have a poor supervisory structure and compliance culture. Likewise, Network 1 wrote that FINRA's enforcement program is a practical solution for addressing "bad brokers." As explained above, however, while FINRA has a number of tools for identifying and addressing a range of misconduct by individuals and firms, and has strengthened these protections for investors and the markets, persistent compliance issues continue to arise in some member firms. Proposed Rule 4111 reflects FINRA's belief that more can be done to protect investors from firms with a significant history of misconduct.

Notwithstanding that FINRA has generally retained the proposal as it was originally proposed, FINRA appreciates the concerns raised by the commenters about the potential impacts and effectiveness of proposed Rule 4111. If approved, FINRA plans to review proposed Rule 4111 after gaining sufficient experience under the rule, at which time it will assess the rule's ongoing effectiveness and efficiency.

Concerns that the Proposal Gives FINRA Too Much Discretion, and Requests for Increased Transparency

Several commenters contended that, in numerous respects, the proposal gives FINRA too much discretion.[88] Commenters pointed to how the proposal gives the Department discretion to decide: (1) in the initial Department evaluation stage, which

[88] CAI, Cambridge, FSI, Sichenzia, Westpark.

firms require further review; (2) the maximum and actual Restricted Deposit Requirement; and (3) the types of conditions or restrictions that may be imposed.[89] Some commenters further requested that the proposal provide more transparency on how FINRA would exercise its discretion. For example, Sichenzia suggested which kinds of disclosure events FINRA should eliminate from consideration during the initial Department evaluation, and some commenters requested that FINRA clarify how the Department would calculate a Restricted Deposit Requirement[90] and what kinds of conditions or restrictions could be imposed.[91] Some commenters recommended specific conditions and restrictions that FINRA should impose.[92]

FINRA believes that the proposal contains numerous steps that are objective and do not involve the use of discretion or that limit or focus FINRA's discretion. FINRA notes that the annual calculation—the first and most significant step that identifies member firms that are subject to the proposed rule—does not involve the use of discretion. The annual calculation uses objective, transparent criteria to identify outlier firms with the most significant history of misconduct relative to their peers (based on a review of the criteria as if it existed today, the number of member firms would be between 45-80 firms). Following the annual calculation, the Department would conduct an evaluation to review whether it has information that a member firm's calculation included disclosure events or conditions that should not have been included because they

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89 CAI, Cambridge, FSI, Rockfleet, Sichenzia, Westpark, Whitehall.

90 CAI, Westpark, Whitehall.

91 FSI, Massachusetts, NASAA, PIRC, St. John's SOL.

92 Massachusetts, MIRC, NASAA, St. John's SOL.

are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk, whether the member has already addressed the concerns signaled by the disclosure events or conditions, or whether the member firm has altered its business operations such that the calculation no longer reflects the member firm's current risk profile. During the Consultation, the Department would evaluate whether the member firm has demonstrated that the calculation included disclosure events that should not have been included (because they are duplicative or not sales-practice related). When the Department considers whether a member firm should be subject to the maximum Restricted Deposit Requirement, it will evaluate whether the maximum amount would impose an undue financial hardship and whether a lesser amount, or conditions and restrictions, would satisfy the objectives of the rule and be consistent with the protection of investors and the public interest. The ability to request a Hearing Officer's review also would protect against overreaching.

To ensure that the member firms identified as Restricted Firms are of the type motivating this proposal and incentivize Restricted Firms to reduce the risks posed to investors, however, the Department will need some degree of flexibility to identify, react and respond to different sources of risk. For this reason, the revised proposal retains the ability of the Department to make internal assessments during the evaluation and Consultation, including ones concerning the amount of the Restricted Deposit Requirement and the conditions and restrictions that may be imposed, to appropriately address the concerns indicated by the Preliminary Criteria for Identification.

Nevertheless, FINRA agrees with commenters' request for additional clarity regarding the conditions and restrictions that could be imposed under the proposed rule.[93] For this reason, the revised proposal provides a non-exhaustive list of conditions and restrictions that could be imposed on Restricted Firms. Moreover, the proposed rule's descriptions of the Department's tasks and discretion are broad enough to allow FINRA to provide further guidance as it gains experience implementing the rule. For example, FINRA could provide additional guidance if it learns of categories of disclosure events that could be described as not consistent with the purpose of the Preliminary Criteria for Identification or not reflective of a firm posing a high degree of risk. FINRA also could provide further guidance on the kinds of conditions and restrictions that might be warranted in different contexts.

Comments Concerning the Preliminary Criteria for Identification

Numerous commenters suggested alternatives to several aspects of the Preliminary Criteria for Identification. Some suggested narrower criteria, including, for example, requests to: (1) exclude criminal events in which the registered person pled nolo contendere;[94] (2) exclude or narrow criteria based on final regulatory actions;[95] (3) remove or narrow criteria based on pending events or unadjudicated events;[96] (4)

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[93] See, e.g., FSI, NASAA, PIRC.

[94] Westpark.

[95] Moss & Gilmore, Westpark.

[96] AdvisorLaw, Cambridge, Cetera, HLBS, Joseph Stone, Luxor, Moss & Gilmore, Westpark, Worden.

remove or modify the criteria based on terminations or internal reviews;[97] (5) remove or substantially narrow the Expelled Firm Association Metric;[98] (6) increase the $15,000 threshold for settlements[99] and establish a minimum threshold for awards and judgments;[100] (7) decrease the lookback period;[101] (8) distinguish between events by recidivist and non-recidivist brokers;[102] (9) exclude all matters that are not sales-practice or investment-related[103] or that do not involve customer harm;[104] (10) address or remove "nuisance arbitrations . . . settled without admission of guilt" and "disclosure events . . . filed by a compensated non-attorney representative";[105] (11) narrow the term "Registered Persons In-Scope" to exclude persons who were registered with a member firm for only one day and include only those who have been employed with a member firm for at least 180 days;[106] (12) reconsider the inclusion in the criteria of settlements of arbitrations and

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97 Cambridge, Cetera, Westpark. Two of these commenters cautioned that including termination and internal review events could discourage firms from conducting internal reviews and filing appropriate termination disclosures on the Uniform Registration Forms, thereby reducing internal compliance procedures and potentially leading to underreporting of such events. Cetera, Westpark.

98 Cambridge, Cetera, Joseph Stone, Luxor, Network 1, Sichenzia, Westpark.

99 Cambridge, Joseph Stone, Luxor.

100 Cambridge.

101 Westpark.

102 Sichenzia.

103 Cambridge.

104 Westpark.

105 Luxor, Moss & Gilmore, Sichenzia.

106 Westpark.

regulatory actions,[107] disclosure events against persons who were named due to their position within a chain of supervision,[108] and "allegation-driven" disclosures;[109] and (13) account for widespread product or market collapse that could result in a high number of new disclosure events.[110]

Some commenters suggested broader criteria, including requests to: (1) lower the dollar threshold for settlements;[111] (2) increase the lookback period;[112] (3) include financial disclosures like judgments, liens, bankruptcies and compromises;[113] (4) include non-investment related civil matters that involve dishonesty, deceit, or reckless or intentional wrongdoing;[114] (5) include internal reviews by other member firms;[115] (6) include a category based on specific products sold by the member firm;[116] and (7) include expunged Registered Person Adjudicated Events.[117]

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107 HLBS, Moss & Gilmore, Westpark.

108 Cambridge, Westpark.

109 Worden.

110 Cambridge.

111 Better Markets.

112 Better Markets.

113 Massachusetts, NASAA.

114 Massachusetts.

115 Massachusetts.

116 MIRC, PIABA.

117 NASAA.

Two commenters criticized or questioned how the metrics thresholds were based on firm size.[118]

In response to the comments about the proposed criteria's underlying categories and metrics, FINRA made two modifications to the proposal in Regulatory Notice 19-17. First, as explained above, the revised proposal uses a narrower definition of Registered Persons Associated with Previously Expelled Firms. Instead of an unlimited lookback over a registered person's entire career and no limitations based on the duration of the person's registration with the expelled firm as originally proposed in Regulatory Notice 19-17, the revised proposal would include only those registered persons who were registered with a previously expelled firm for at least one year and within the five years prior to the date the Preliminary Criteria for Identification are calculated. Persons' previous registrations with expelled firms (i.e., beyond the five-year lookback) would not be counted in this category or towards an employing member firm's Expelled Firm Association Metric. Moreover, FINRA believes using a five-year lookback would be consistent with the lookback periods for the other metrics.[119]

Second, FINRA believes that the comments about the termination and internal review events demonstrated a need for clarification of the relevant metric. The revised proposal would make clear that termination and internal review disclosures concerning a person that a member firm terminated would not impact that member firm's own Registered Person Termination and Internal Review Metric; rather, those disclosures

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118 Rockfleet, Worden.

119 FINRA analyzed whether the revised Expelled Firm Association Metric still preserves its usefulness, and FINRA determined that it does, as explained in the Economic Impact Assessment.

would only impact the metrics of member firms that subsequently register the terminated individual.

Otherwise, FINRA has decided to retain the rest of the Preliminary Criteria for Identification as originally proposed in Regulatory Notice 19-17. Many of the commenters' other proposed alternative definitions and criteria comments concern issues that FINRA already considered and addressed in the economic assessment in Regulatory Notice 19-17, and the comments have not persuaded FINRA that any changes would be more efficient or effective at addressing the potential for future customer harm presented. As FINRA explained in Regulatory Notice 19-17, the primary benefit of the proposed rule change would be to reduce the risk and associated costs of possible future customer harm by member firms that meet the proposed criteria, by applying additional restrictions on firms identified as Restricted Firms and by the increased scrutiny that will likely result by these firms on their brokers. 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 the firm had the potential to be designated as a Restricted Firm. This is why—unlike many of the alternatives suggested by commenters—FINRA's proposal is based on events disclosed on the Uniform Registration Forms, which are generally available to firms and FINRA.

Several commenters expressed concern over how the Preliminary Criteria for Identification relies on data in the Uniform Registration Forms.[120] Several commenters contended that there are underlying problems with the information disclosed through the

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[120] AdvisorLaw, Cambridge, Moss & Gilmore, Worden.

Uniform Registration Forms, stemming primarily from the allegation-based disclosures that must be made and frivolous arbitrations.[121] One commenter pointed to the number of expungements as evidence of the unreliability of the disclosure data.[122] NASAA, PIABA, and some law school clinics raised a concern from a different perspective, writing that expungements are granted too frequently and will cause the annual calculation of the Preliminary Criteria for Identification to not identify all firms that pose the highest risks.[123] Relatedly, several commenters suggested that the proposed Preliminary Criteria for Identification highlights problems with expungements, including that the proposal will incentivize even more expungement requests,[124] that FINRA should simultaneously pursue meaningful expungement reform,[125] or that FINRA should make it easier to expunge certain customer dispute information because Uniform Registration Form disclosures would now carry greater weight.[126] Some commenters predicted that the proposal will create perverse incentives to avoid making required disclosures on the Uniform Registration Forms.[127]

FINRA believes, however, that the data reported on the Uniform Registration Forms is reliable enough on which to base proposed Rule 4111. FINRA rules require

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121 AdvisorLaw, Cambridge, Moss & Gilmore, Worden.

122 AdvisorLaw.

123 MIRC, NASAA, PIABA, PIRC.

124 MIRC, NASAA, PIABA, PIRC.

125 NASAA, PIABA.

126 Cambridge.

127 Cetera, PIRC, St. John’s SOL.

firms and individuals to make accurate disclosures, and they could be subject to disciplinary action and possible disqualification if they fail to do so. Regulators are the source of disclosures on Form U6. FINRA's Department of Credentialing, Registration, Education and Disclosure conducts a public records review to verify the completeness and accuracy of criminal disclosure reporting. And although some commenters take issue with some of the specific events that must be disclosed on the Uniform Registration Forms, the SEC has taken the position that "essentially all of the information that is reportable on the Form U4 is material."[128]

FINRA recognizes that the number of expungement requests may increase as a result of this proposal. However, the existing regulatory framework and FINRA rules are designed to ensure that expungements are granted only after a neutral adjudicator (arbitrator or judge) concludes that expungement is appropriate. Furthermore, OCE has tested the proposed thresholds in several ways using the existing Central Registration Depository ("CRD") data, including comparing the firms captured by the proposed thresholds to the firms that have recently been expelled, that have unpaid arbitration awards, that Department staff has identified as high risk for sales practice and fraud based on the Department's own risk-based analysis, and that subsequently had additional disclosures after identification. Moreover, FINRA is actively engaged in efforts to address concerns with the current system of arbitration-based expungement of customer allegations from brokers' records.[129] FINRA's planned review of proposed Rule 4111

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[128] Joseph S. Amundsen, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *41 (Apr. 18, 2013), aff'd, 575 F. App'x 1 (D.C. Cir. 2014).

[129] FINRA recently filed a proposed rule change that would amend the Codes of Arbitration Procedure for Customer and Industry Disputes ("Codes") to modify

would necessarily account for any future amendments to the expungement process and any associated impact on the underlying data in CRD. Accordingly, FINRA does not believe that the proposal would directly result in inappropriate expungements being granted or appropriate expungements being not granted, or that it would undermine the quality of the underlying CRD information used for the proposed metrics.

Annual Calculation of the Preliminary Criteria for Identification

Massachusetts contends that calculations of the Preliminary Criteria for Identification should occur more than annually. FINRA appreciates this suggestion, but believes that it should gain experience with an annual requirement before considering whether to conduct more frequent reviews.

SIFMA requested that the proposal provide more transparency around the variables for the annual calculation of the Preliminary Criteria for Identification, so that firms can have the same ability as FINRA to calculate whether they meet the thresholds.

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the current process relating to requests to expunge customer dispute information. The proposed rule change would amend the Codes to: (1) impose requirements on expungement requests filed either during an investment-related, customer-initiated arbitration or separate from a customer-initiated arbitration ("straight-in requests"); (2) establish a roster of arbitrators with enhanced training and experience from which a three-person panel would be randomly selected to decide straight-in requests; (3) establish procedural requirements for expungement hearings; and (4) codify and update the best practices of the Notice to Arbitrators and Parties on Expanded Expungement Guidance that arbitrators and parties must follow. See Securities Exchange Act Release No. 90000 (September 25, 2020), 85 FR 62142 (October 1, 2020) (Notice of Filing of File No. SR-FINRA-2020-030); Notice to Arbitrators and Parties on Expanded Expungement Guidance, available at https://www.finra.org/arbitration-andmediation/notice-arbitrators-and-parties-expanded-expungement-guidance). In addition, FINRA recently amended the Codes to apply minimum fees to requests to expunge customer dispute information. See Securities Exchange Act Release No. 88945 (May 26, 2020), 85 FR 33212 (June 1, 2020) (Order Approving Filing of File No. SR-FINRA-2020-005); Regulatory Notice 20-25 (July 2020).

For example, SIFMA explained that firms will need specific information about the Evaluation Date to make the calculations on their own.

FINRA agrees that additional clarity should be provided regarding the timing of the calculation. Proposed Rule 4111 is intended to be transparent enough so that member firms can understand whether they are at risk of being subject to additional obligations, and member firms will need to know the exact Evaluation Date to do their own calculations. FINRA would announce in a Regulatory Notice the first Evaluation Date no less than 120 days before the first Evaluation Date. FINRA also would announce that subsequent Evaluation Dates would be on the same month and day each year, except when that date falls on a Saturday, Sunday, or federal holiday, in which case the Evaluation Date would be on the next business day.

Some commenters requested that FINRA provide member firms with assistance in determining if they meet the Preliminary Criteria for Identification. For example, CAI requested clarification on whether FINRA would provide advance notice to firms that meet or come close to meeting the Preliminary Criteria for Identification. Cambridge wrote that FINRA should notify firms in advance that they meet the criteria and publish a list of expelled firms. SIFMA requested that FINRA provide an electronic worksheet, available year round.

FINRA does not currently plan to provide member firms with advance notice about whether they would meet, or are close to meeting, the Preliminary Criteria for Identification, because the calculation under the proposal would occur annually, not on a rolling basis, and calculating the events included in the Preliminary Criteria for Identification based on an earlier date may lead to different results. Moreover, the proposed rule is designed to be transparent enough to allow member firms to perform their own calculations. FINRA agrees, however, that additional guidance and resources could facilitate member firms' independent calculations, and FINRA will explore ways to provide helpful resources. For example, this could include mapping the Disclosure Event and Expelled Firm Association Categories to the relevant disclosure questions on the Uniform Registration Forms. It also could include making available, year round, a worksheet that member firms could populate with the number of Registered Persons In-Scope, the number of disclosure events in each category, and the number of Registered Persons Associated with Previously Expelled Firms to generate information about whether the member firm meets or is close to meeting the Preliminary Criteria for Identification.[130] FINRA also would consider making available to member firms a list of expelled firms, if that information is burdensome for member firms to obtain on their own.

<u>One-Time Staffing Reduction</u>

Several comments addressed the proposal's one-time staffing reduction opportunity. PIRC expressed support for the one-time staffing reduction opportunity, commenting that it will have the benefit of lowering the number of representatives who have repeatedly harmed investors. Joseph Stone commented that member firms should have several opportunities to reduce staff, not just one. Westpark stated that the one-time opportunity should renew after three years. HLBS called the staffing reduction

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130 Such a year-round worksheet could be a tool for member firms to monitor their status in relation to the Preliminary Criteria for Identification, but not a determinate one. Whether a member firm will meet the criteria could only be definitively established on the annual Evaluation Date.

opportunity the proposal's "most alarming and punitive measure," because member firms would "conduct a mass termination not because of an independent business decision but because . . . failing to do so . . . would essentially result in financial ruin."

FINRA has retained the one-time staffing reduction opportunity as originally proposed. The one-time staffing reduction opportunity is intended to provide another procedural protection for member firms, because it would give a firm that meets the Preliminary Criteria for Identification one opportunity to reduce staff so as to fall below the criteria's thresholds. It has been designed as only a single opportunity to deter member firms from resurrecting a high-risk business model after a staff reduction. Moreover, FINRA does not agree with HLBS's assertion that the proposed staffing reduction opportunity removes member firms' independence to make business decisions. FINRA believes that a member firm that meets the Preliminary Criteria for Identification, possibly inadvertently, in one year should have the choice of whether to exercise the staffing reduction option. Furthermore, a firm that chooses to exercise the staffing reduction option would have the independence to decide how to proceed going forward, with the knowledge that it has once met the Preliminary Criteria for Identification, that the preliminary criteria are fully transparent, and that it would not have another opportunity to reduce staff to avoid a review under Rule 4111.

Better Markets stated that the staffing reduction opportunity needs to better protect investors, by prohibiting other high-risk firms from hiring terminated persons, prohibiting any firms from hiring the terminated persons for one year, or requiring that staff reductions commence with brokers with the highest number of disclosure events or with frequent and severe violations. FINRA is already pursuing, however, a separate proposal that would require a member firm to request a materiality consultation with FINRA staff when a person who has one final criminal matter or two "specified risk events" seeks to become an owner, control person, principal or registered person of the member.[131] That related proposal would potentially impact persons terminated pursuant to the staffing reduction opportunity.

Consultation

Westpark commented that proposed Rule 4111 does not give firms enough time to prepare for the Consultation. Because the proposed rule sets tight deadlines for the Department's decision, FINRA agrees that the proposed deadlines for the Consultation would also be tight. For this reason, FINRA has revised proposed Rule 4111(d)(2) to require that the letter scheduling the Consultation provide at least seven days' notice of the Consultation date, and also give the member firm the opportunity to request a postponement of the Consultation for good cause shown. Postponements would not exceed 30 days unless the member firm establishes the reasons a longer postponement is necessary.

Other comments about the Consultation did not prompt FINRA to make revisions. For example, FSI commented that the Consultation should be an opportunity for FINRA to work collaboratively with the identified firm. FINRA believes the Consultation is already intended to give member firms an opportunity to meet with FINRA and demonstrate why the calculation of the Preliminary Criteria for Identification should not include certain events or provide a rationale as to why the firm should not be required to

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131 See Securities Exchange Act Release No. 88600 (April 8, 2020), 85 FR 20745 (April 14, 2020) (Notice of Filing of File No. SR-FINRA-2020-011).

maintain the maximum Restricted Deposit Requirement. As such, FINRA does not believe further revisions are necessary.

Chiu and Luxor wrote that although proposed Rule 4111 would allow members during the Consultation to request a waiver of the maximum Restricted Deposit Requirement for financial hardship reasons, member firms will not do so because it would deter recruitment and cause brokers to leave. Allowing member firms to demonstrate undue financial hardship, however, is consistent with the intent of the Restricted Deposit Requirement that it not significantly undermine the member firm's continued financial stability and operational capability as an ongoing enterprise over the next 12 months. Moreover, FINRA anticipates that member firms subject to the requirement will not be deterred from asserting that a Restricted Deposit Requirement would cause an undue financial hardship, given that such arguments could lead to a reduced Restricted Deposit Requirement or no deposit requirement at all. Moreover, the proposal would not make public any such assertions by a member firm.

In a comment related to the Consultation, FSI commented that firms should not shoulder the risk of misidentification, and that FINRA should have to demonstrate its reasons for continuing the review process for firms preliminarily identified as high risk. Proposed Rule 4111 only places burdens of proof on the small number of firms that meet the Preliminary Criteria for Identification and that the Department determines, after conducting its initial evaluation, warrants further review. Each of these firms would have the opportunity to overcome the presumption that it should be designated as a Restricted Firm and subject to the maximum Restricted Deposit Requirement. Under the proposed rule, the affected firms would initiate this process because they would be in the best position to provide the relevant information. For example, proposed Rule 4111(d)(1)(A) would provide that a member firm may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation included events that should not have been included because, for example, they are duplicative, involving the same customer and the same matter, or are not sales practice related. The member firm, not Department staff, is in the best position to provide that kind of information about the disclosure data. Likewise, the member firm would be in the best position to demonstrate, pursuant to proposed Rule 4111(d)(1)(B), that it would face undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement.

Restricted Deposit Requirement

FINRA also received general comments concerning the proposed Restricted Deposit Requirement concept. Some commenters were generally opposed to the proposed requirement. Their reasons include: (1) a deposit requirement may trigger unintended consequences which result in harm to the investing public;[132] (2) a deposit requirement may lead to competitive disadvantages, because members without significant retained earnings may receive exceptions, while members with greater working capital would not;[133] (3) the only members likely to be able to satisfy a deposit requirement would be ones that do not anticipate being subject to the rule;[134] (4) a deposit requirement

132 Cambridge.

133 Cambridge.

134 Cambridge.

would "result[ ] in cash flow problems, increased borrowing, and layoffs"[135] and a "devastating economic impact" on the broker-dealer and its employees, customers, vendors, and counterparties;[136] (5) restricted funds could be better used for other purposes;[137] (6) there is little evidence why restricted deposits are necessary;[138] (7) requiring "up front financing of uninsured claims, many of which are specious, would have negative net capital implications";[139] (8) any assertion that unpaid arbitration awards is rampant and justifies the deposit requirement is false;[140] (9) a deposit requirement would put small firms out of business and result in less choice for investors;[141] and (10) many members do not have sufficient cash to hold as restricted deposits.[142]

Other commenters were generally supportive of the Restricted Deposit Requirement concept. PIRC said that Restricted Deposit Requirements should help deter misconduct and also help FINRA "rein in Restricted Firms that shut down and reconstitute themselves in an attempt to avoid paying settlements and awards." SIFMA

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135 Westpark.

136 Rockfleet.

137 Chiu.

138 Brooklight.

139 Moss & Gilmore.

140 Moss & Gilmore.

141 Chiu, IBN, Whitehall. Whitehall also wrote that the proposal entails "FINRA . . . demanding funds for itself" and "using [members] as bank accounts to expand" FINRA's activities. Nothing in the proposal, however, results in FINRA receiving any assets from firms. At all times, a Restricted Firm would continue to own the assets that it maintains in a Restricted Deposit Account.

142 Whitehall.

opined that the proposal "appropriately embraces the 'front-end' approach" to addressing unpaid awards by "seeking to identify those small number of firms with an extensive history of misconduct and/or relevant disclosure events, and as appropriate, requiring [them] to set aside cash deposits or qualified securities that could be applied to . . . unpaid awards."

FINRA's proposal continues to provide that the Department could impose a Restricted Deposit Requirement on Restricted Firms. FINRA believes that a financial requirement is the measure most likely to motivate Restricted Firms to change behavior. As such, the Restricted Deposit Requirement is an essential feature of the proposal to protect investors, with the possible secondary benefit of helping to address the issue of unpaid arbitration awards. Moreover, the proposal attempts to counteract firms' preemptively withdrawing capital by instructing the Department to consider several financial factors—not just net capital—when determining a Restricted Deposit Requirement. In addition, FINRA believes the implications of a Restricted Deposit Requirement on a member firm's net capital levels—that a member firm would have to deduct deposits in Restricted Deposit Accounts in determining the firm's net capital[143]—is one reason why the proposal would incentivize member firms to avoid becoming Restricted Firms, not a reason to abandon the Restricted Deposit Requirement concept. Finally, the proposal contemplates that the Restricted Deposit Requirement should

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[143] See proposed Rule 4111.01.

correlate to the financial realities at the member firm, and allows the firm to attempt to demonstrate that it would impose undue financial burdens.[144]

Calculating a Restricted Deposit Requirement

FINRA received several comments about the Department's determination of a Restricted Deposit Requirement. CAI expressed support for some of the proposed factors that the Department would consider when calculating the Restricted Deposit Requirement. In addition, CAI endorsed the proposed limitation in proposed Rule 4111(i)(15) that the maximum Restricted Deposit Requirement be an amount that would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months.

Several commenters expressed concerns about the proposed factors that the Department would consider when calculating the Restricted Deposit Requirement. For example, Sichenzia called the factors "arbitrary"; some commenters opposed the inclusion of, or requested modifications to, the "Covered Pending Arbitration Claims" factor;[145] Network 1 commented that the Restricted Deposit Requirement should not consider "bona fide nuisance claims brought in arbitration"; Cambridge objected to the "gross revenues" factor, on the grounds that that factor would not contemplate the firm's contractual obligations for which the revenues have already been allocated; and Moss &

[144] Westpark commented that proposed Rule 4111 is inconsistent with Section 15A(b)(5) of the Exchange Act, which requires that FINRA's rules "provide for the equitable allocation of reasonable dues, fees, and other charges among members." The proposed Restricted Deposit Requirement, however, is not a due, fee or charge. Assets that a member maintains in a Restricted Deposit Account would remain the member's assets; they would not be provided to, used by, or owned by FINRA.

[145] Moss & Gilmore, Network 1, Sichenzia, Westpark.

Gilmore objected to considering "concerns raised during FINRA exams" on the grounds that "novice examiners . . . [often] conduct the front-line examinations."[146]

Some commenters believed that the list of factors should be expanded. For example, two commenters requested that FINRA account for instances in which the firm has insurance coverage for arbitration claims.[147] MIRC commented that the Covered Pending Arbitration Claims factor should be expanded to include other kinds of pending claims that could lead to unpaid awards, not just ones limited to the arbitration setting. PIABA requested that the Restricted Deposit Requirement calculation also take into account the nature and extent of harm that the Restricted Firm has done in the past.

As explained above, FINRA has made several revisions to the factors that the Department would consider when determining a maximum Restricted Deposit Requirement. The "annual revenues" and "net capital requirements" factors proposed in Regulatory Notice 19-17 have been modified to "revenues" and "net capital," and "assets," "expenses," and "liabilities" have been added as factors. In addition, FINRA has clarified that unpaid arbitration awards against a member firm's Associated Persons is one relevant factor. FINRA believes this modified and expanded list of factors would lead to a more complete consideration of the firm's financial situation.

FINRA has retained the other proposed factors, however, because they appropriately and accurately describe the factors, financial and otherwise, that would be most relevant to the Department when calculating a Restricted Deposit Requirement. This includes the Covered Pending Arbitration Claims factor. Because one purpose of

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146 Moss & Gilmore.

147 Network 1, Sichenzia.

the Restricted Deposit Requirement is to preserve some of a Restricted Firm's assets for potential payment of arbitration awards, FINRA believes that purpose is served by allowing the Department to consider Covered Pending Arbitration Claims when determining a Restricted Deposit Requirement. At the same time, the revised proposed rule also adds as a factor the member's "insurance coverage for customer arbitration awards or settlements." FINRA believes that if Restricted Firms were able to procure errors and omissions insurance policies or other kinds of insurance coverage for some or all of the kinds of claims that customers typically bring in arbitrations, at meaningful coverage amounts, that could warrant a reduced Restricted Deposit Requirement and would be behavior to encourage.

Two commenters contended that because potential liabilities relating to pending arbitrations must be accrued on financial statements, a Restricted Deposit Requirement that is based in part on Covered Pending Arbitration Claims (which would be a non-allowable asset) would "double[ ] the net capital impact."[148] While there would not usually be a double impact—accruals of contingent liabilities based on pending arbitrations usually reflect only a small percentage of the potential liability—a member firm's net capital level could be impacted by a Restricted Deposit Requirement based in part on Covered Pending Arbitration Claims and a member firm's accruals of potential liabilities stemming from the same pending arbitration claims. For this reason, the Department's consideration of Covered Pending Arbitration Claims could take into account whether any liability accruals for those same claims warrant a reduction in the Restricted Deposit Requirement. It should be noted, however, that the purposes of

[148] Network 1, Rockfleet.

accruing a liability on a financial statement are different from the purposes of the proposed Rule 4111 requirement to deposit money in a Restricted Firm's segregated, restricted account.

In addition to comments about the specific factors that the Department would consider, some commenters requested that the proposal describe with more specificity how the Restricted Deposit Requirement would be calculated or establish caps. CAI, for example, requested that FINRA develop specific limitations such as caps and a formula that focuses on the correlation between revenues that may give rise to unpaid arbitration awards (e.g., penny stock sales) and unpaid arbitration award amounts. FSI suggested that FINRA use published guidelines to provide transparency. Westpark suggested that the proposal should cap the Restricted Deposit Requirement at a specified percentage of required net capital amounts or a percentage of average net income over a three-year lookback period. Whitehall asked whether FINRA would have a formula for calculating the Restricted Deposit Requirement. MIRC suggested that FINRA should impose Restricted Deposit Requirements that are sufficient to meet all unpaid awards and pending claims related to products and product types.

FINRA has not proposed a uniform formulaic approach for calculating the Restricted Deposit Requirement because of the range of relevant factors and differences in member firms' business models, operations, and financial conditions. In addition, although formulas do provide objective, transparent methodologies, here they would allow member firms the opportunity to manipulate their revenue numbers during the calculation periods. For these reasons, FINRA has retained the factor-based, principles-based approach to determining a Restricted Deposit Amount.

Impact on Unpaid Arbitration Awards

PIABA contended that the proposal will not solve the issue of unpaid arbitration awards, because there is no indication that the Restricted Deposit Requirements will be sufficient to cover anticipated arbitration awards. Relatedly, several commenters requested that the proposal also provide more clarity on how the Restricted Deposit Requirement could be used to pay investor claims.[149]

With respect to the relationship between proposed Rule 4111 and unpaid arbitration awards, FINRA notes that FINRA rules currently prohibit member firms or registered representatives who do not pay arbitration awards in a timely manner from continuing to engage in the securities business under FINRA's jurisdiction.[150] As to proposed Rule 4111, it was designed to address a broader range of investor protection concerns posed by firms and individuals with a significant history of misconduct, including but not limited to unpaid arbitration awards. The Rule would apply to firms who, based on statistical analysis of their prior disclosure events, are substantially more likely than their peers to subsequently have a range of additional events indicating various types of harm or potential harm to investors.

Nevertheless, FINRA believes proposed Rule 4111 may have important ancillary effects in addressing unpaid customer arbitration awards. In particular, the Rule may deter behavior that could otherwise result in unpaid arbitration awards, by incentivizing

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149 MIRC, PIABA, PIRC.

150 See FINRA Rule 9554. Under FINRA rules, unless a respondent has specified defenses to non-payment, the respondent must pay a monetary award within 30 days of receipt. See FINRA Rule 12904(j). In addition, firms with unpaid awards cannot re-register with FINRA and individuals cannot register as representatives of any member firm, without paying or discharging the outstanding award.

firms to reduce their risk profile and violative conduct in order to avoid being deemed a Restricted Firm and becoming subject to the Restricted Deposit Requirement (or other conditions or restrictions). In addition, firms may be incentivized to obtain insurance coverage for potential arbitration awards, because such coverage would be taken into account in determining any Restricted Deposit Requirement. Moreover, and as explained above, the proposed rule includes several presumptions, applicable to the Department's assessment of an application by a firm previously designated as a Restricted Firm for a withdrawal from a Restricted Deposit, that would further incentivize the payment of arbitration awards.

FINRA has made several revisions to proposed Rule 4111(f) to make more clear the process that would guide the Department's evaluation of a request for a withdrawal from a Restricted Deposit Account. As explained above, these include several presumptions of approval or denial that set forth how Covered Pending Arbitration Claims or unpaid arbitration awards would impact the Department's evaluation. The presumptions of denial that would apply when a Restricted Firm or previously designated Restricted Firm applies for a withdrawal from a Restricted Deposit would still apply when the firm seeks to use the funds to satisfy unpaid arbitration awards; unless the presumption of denial can be overcome, those firms would generally need to satisfy unpaid arbitration awards using funds other than those in a Restricted Deposit Account.[151] There would be a separate presumption that a request by a former member firm previously designated as a Restricted Firm to access its Restricted Deposit would be approved when it commits in the manner specified by the Department to use the amount

151 See proposed Rule 4111(f)(1) and (f)(3)(B)(ii)(a).

it seeks to withdraw from its Restricted Deposit to pay the former member's specified unpaid arbitration awards.

PIABA also raised the concern that thinly capitalized firms would have smaller Restricted Deposit Requirements. A member's thin capitalization at the time of the Consultation, however, would be only one factor of many that the Department would consider when determining a Restricted Deposit Requirement, and would not necessarily result in a lower requirement.

Custodians of the Restricted Deposit Account

Some commenters expressed concern about how proposed Rule 4111 would require the Restricted Deposit Account to be maintained with a bank or clearing firm. Rockfleet predicted that it will be unlikely that banks or clearing firms will create new policies and procedures for the small amount of Restricted Deposit Accounts that would result from the proposal. SIFMA commented that a number of clearing firms believe it would be problematic to custody a Restricted Deposit Account "given the clearing firm's unique role in the relationship between an introducing broker and its clients," and how the proposed rule would impose additional duties and responsibilities that are not now part of clearing firms' systems and procedures. SIFMA also stated that custody by a clearing firm of the Restricted Deposit Requirement likely would not provide FINRA with the level of transparency that FINRA would want.

The revised proposal retains the option for Restricted Firms to establish Restricted Deposit Accounts with clearing firms. FINRA believes that member firms have an existing relationship with their clearing firms and should be permitted to establish the Restricted Deposit Account with them if the parties choose. Nothing in the proposal requires clearing firms to establish Restricted Deposit Accounts. Where a clearing firm is unwilling or unable to establish these accounts, the proposal would permit Restricted Firms to establish such accounts at banks.

SIFMA also commented that the proposal should be revised to expressly allow trust companies to maintain the accounts. FINRA believes that the original proposal includes many trust companies and so gives members sufficient options and flexibility.

Comments Concerning Proposed Expedited Proceedings

As originally proposed in Regulatory Notice 19-17, proposed Rule 9561(a) would have provided that any of the Rule 4111 Requirements imposed in a notice issued under proposed Rule 9561(a) would be immediately effective; that, in general, a request for a hearing would not stay those requirements; and that, if a member firm requests a hearing of a Department determination that imposes a Restricted Deposit Requirement for the first time, the member firm would be required to deposit, while the expedited proceeding was pending, the lesser of either 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year. Westpark commented that the expedited proceedings would not be meaningful because obligations would not be stayed. Luxor commented that the requirement to deposit a percentage of the Restricted Deposit Requirement would be "devastating."

In general, FINRA has retained the no-stay provisions as originally proposed. FINRA believes that the proposed no-stay provisions are a fundamental part of how the proposed rules would protect investors. Requiring Restricted Firms to comply with obligations imposed during the short pendency of an expedited proceeding would afford more immediate protections to investors from firms that pose outlier-level risks.

Moreover, requiring immediate compliance with the Department's decision would be similar to other situations in which firms and individuals posing substantial risks must abide by FINRA decisions before underlying proceedings are resolved, such as when disciplinary respondents must abide by temporary cease and desist orders before an underlying disciplinary proceeding is complete or comply with FINRA-imposed bars while an SEC appeal is pending. Nonetheless, FINRA believes that one aspect of the proposed no-stay provisions could be less burdensome without compromising its intended purpose. Accordingly, FINRA has revised the proposed rules to lower the proposed partial-deposit requirement to the lesser of 25% of the Restricted Deposit Requirement or 25% of the firm's average excess net capital during the prior calendar year.

Cetera commented that the hearings should be conducted by a Hearing Panel that includes two industry members and one Hearing Officer, because Hearing Officers are viewed as "not as objective." FINRA has retained, however, the proposal to have Hearing Officers preside over the new expedited proceedings. Hearing Officers preside over several kinds of proceedings.[152] And here, FINRA believes the need for swift proceedings as a result of the proposed no-stay provisions and to protect investors works in favor of the efficiency of Hearing Officer-only proceedings. Moreover, FINRA believes there are additional protections for the firms in the proposal, given that the

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152 See FINRA Rule 9559(d) (providing that Hearing Officers preside over, and act as the sole adjudicator for, proceedings initiated under Rules 9553 (failures to pay FINRA dues, fees and other charges), 9554 (failures to comply with arbitration awards or related settlements or orders of restitution or settlements providing for restitution), and 9556(h) (subsequent proceedings for failures to comply with temporary or permanent cease and desist orders)).

Hearing Officer's authority will be circumscribed and that the NAC's Review Subcommittee will have the right to call the proceeding for review.

Cetera commented that the proposed rule would require hearings to be held in expedited proceedings in an unreasonably short time after the firm receives notice of its Restricted Firm status. FINRA believes, however, that the proposed rule offers reasonable time limits and an opportunity to seek extensions. Under proposed Rules 9561(a)(5) and 9559(f)(5), a member would be required to request a hearing within seven days after service of a notice of a determination that a firm is a Restricted Firm, and a hearing would be required to be held within 30 days after the member files that hearing request. In addition, under an existing provision in Rule 9559, the Hearing Officer could extend the time limits for holding the hearing for good cause shown or with the consent of all the parties.

PIABA commented that under proposed Rule 9561(b), which would establish an expedited proceeding to address a member firm's failure to comply with any requirements imposed pursuant to proposed Rule 4111, FINRA should be required to immediately suspend a non-compliant firm and should not have the discretion not to act. Although FINRA expects that non-compliant Restricted Firms would be a high priority for the Department of Enforcement, the revised proposal retains FINRA's prosecutorial discretion to ensure that FINRA can use its best judgments about how to deploy its limited resources.

Rockfleet commented that the proposed Rule 9561(b) expedited proceeding is counterintuitive, because canceling a Restricted Firm's membership would result in FINRA losing any control over the firm. FINRA respectfully disagrees and believes that proposed Rule 4111 must provide a tool for FINRA to compel the immediate compliance with obligations that have been imposed pursuant to the rule.

Procedural Protections

Several commenters contended that the proposal is an attempt to impose the equivalent of sanctions while avoiding the fair-process requirements that would be present in a disciplinary proceeding, and to ban persons who are not statutorily disqualified.[153] The proposed Rule 4111 process, however, is neither a disciplinary nor an eligibility proceeding, and the obligations that could be imposed pursuant to proposed Rule 4111 would not be sanctions imposed for violations. Furthermore, FINRA believes the proposal gives affected member firms substantial procedural protections. These include providing notice that a member has met the Preliminary Criteria for Identification and of the maximum Restricted Deposit Requirement; a one-time staffing reduction opportunity for firms that meet the Preliminary Criteria for Identification for the first time; a Consultation, which will allow affected firms to attempt to show why they should not be deemed Restricted Firms or be subject to the maximum Restricted Deposit Requirement; and the right to seek an expedited hearing before a Hearing Officer.[154] These procedural protections are in addition to the Preliminary Criteria for Identification, which would be fully transparent and enable firms to monitor whether they are at risk of meeting the threshold criteria.

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[153] Brooklight, Luxor, Network 1, Rockfleet, Westpark.

[154] The right to have a Hearing Officer's decision reviewed by the SEC would be governed by Section 19 of the Exchange Act.

Moreover, the proposal is neither intended nor designed to expel member firms and persons that are not statutorily disqualified. In this regard, FINRA notes that the rule text contains express language that the Department determine a maximum Restricted Deposit Requirement that "would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months," and also contemplates situations in which Restricted Firms remain member firms for years. Furthermore, persons terminated pursuant to the Rule 4111 staffing reduction opportunity would be permitted to seek employment with any other member firm and allowed to apply to re-associate with the Restricted Firm after one year.[155]

Unintended Consequences

Rockfleet expressed concern that clearing firms will terminate clearing agreements for firms deemed to be Restricted Firms, and that firms using tri-party clearing agreements could be impacted through no fault of their own. CAI raised a concern that being deemed as a Restricted Firm could have ramifications for firms that are parties to selling agreements. FINRA appreciates that proposed Rule 4111 may have potential unintended consequences, and plans to examine issues like those when FINRA reviews proposed Rule 4111 after gaining sufficient experience under the rule.

Public Disclosure Issues

Several commenters addressed whether there should be public disclosure of a firm's status as a Restricted Firm. Some opposed any disclosure at all, warning that disclosure could adversely impact the affected firms, and would make it more likely the

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155 Some commenters (Network 1, Westpark) asserted that the proposed rule change would be unconstitutional, for a variety of reasons. FINRA, however, is not a state actor.

firm would fail.[156] Several commenters, particularly regulators and public advocacy groups, argue that FINRA should disclose the names of Restricted Firms to the public or, at least, to other regulators or clearing firms.[157]

FINRA believes the aim of the proposal is to address the risks posed by Restricted Firms by imposing appropriate restrictions on them and, at the same time, providing them with opportunities and incentives to remedy the underlying concerns (e.g., the one-time staff reduction, the opportunity to roll off the Restricted Firms list). Because requiring FINRA to publicly disclose a firm's Restricted Firm status may potentially interfere with those purposes, FINRA is not proposing to require the public disclosure of a firm's status as a Restricted Firm at this time. FINRA believes that it is necessary to gain meaningful experience with the proposed rule to evaluate the impact of creating an affirmative disclosure program.[158]

Economic Impact Assessment

Rockfleet commented that the proposal appears to be reverse engineered to target firms that FINRA has already chosen. As discussed above, the proposed Preliminary Criteria for Identification are based on metrics that are replicable and transparent to FINRA and the affected member firms, and are intended to identify firms that pose far

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[156] Cetera, FSI.

[157] Better Markets, Massachusetts, NASAA, SIFMA, St. John's SOL.

[158] It should be noted that information about a firm's status as a Restricted Firm, and any restricted deposit it must maintain, could become publicly available through existing sources or processes. Such disclosures could occur, for example, through Form BD, Form CRS, or financial statements, or when a Hearing Officer's decision in an expedited proceeding is published pursuant to FINRA's publicity rule.

greater risks to their customers than other firms. One identifier of these types of firms is that they and their brokers generally have substantially more Registered Person and Member Firm Events compared to their peers. This is consistent with a growing academic literature that provides evidence on past disciplinary and other regulatory events associated with a firm or individual being predictive of similar future events.[159] These patterns indicate a persistent, albeit limited, population of firms with a history of misconduct that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers. Accordingly, the proposed rule is intended to strengthen FINRA's toolkit to respond to these firms and brokers with a significant history of misconduct based on a proposed criteria that relies on regulatory and other disclosure events, similar to those used in the literature.

FINRA also conducted several validations on the firms meeting the criteria, by reviewing the extent to which firms identified were subsequently expelled, associated with unpaid awards, or were associated with "new" Registered Person and Member Firm Events. For example, these validations showed that the identified firms had on average approximately 6.1-19.9 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the Preliminary Criteria for Identification. This suggests that the proposed criteria is effective in identifying firms that may be associated with additional events after identification, which is consistent with the literature's finding on regulatory events being predictive of similar future events.

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[159] See supra note 4.

Better Markets commented that the Economic Impact Assessment did not quantify the harm to investors when firms with a significant history of misconduct are permitted to continue engaging with investors. The proposed rule is intended to place additional restrictions on identified firms and increase scrutiny by these firms on their brokers. As a result, FINRA anticipates that the proposed rule will reduce the risk and associated costs of possible future customer harm and lead to improvements in the compliance culture, relative to the economic baseline of the current regulatory framework. The proposed rule is intended to create incentives for firms and brokers to limit or end practices that result in customer harm and provide increasing restrictions on those that choose not to alter their activities. Nonetheless, it is difficult to predict or quantify, before the proposed rule is implemented, the extent to which firms may continue to engage in harmful activities despite any additional restrictions imposed. However, FINRA plans to review the proposed rule after gaining sufficient experience with it, at which time FINRA will assess the rule's ongoing effectiveness and efficiency.

Westpark wrote that FINRA should analyze how many brokers who are currently licensed and in good standing would become "unemployable" if the proposed rule were approved. FINRA's Economic Impact Assessment of the proposed rule includes the economic impacts on firms hiring and registered persons seeking employment. For example, as discussed above, FINRA estimates that during the 2013-2019 review period only one to two percent of the registered persons had any qualifying events in their regulatory records. Accordingly, 98%-99% of the registered persons (with no qualifying events) should have no adverse economic impacts associated with their employment opportunities. Further, the vast majority of member firms, approximately 98%, would likely be able to employ most of the individuals seeking employment in the industry—including ones who have some disclosures—without coming close to meeting the Preliminary Criteria for Identification. Accordingly, FINRA believes that these anticipated economic impacts would likely be limited to a small proportion of registered persons and member firms, particularly in cases where registered persons with disclosures are seeking employment at firms at or near the Preliminary Criteria for Identification.

Westpark commented that FINRA should back-test the impact of the proposed rule to cover a period that was not a bull market. The economic impact assessment evaluated the proposed criteria over the 2013-2019 period. Because of the criteria's 5-year lookback period for adjudicated events, the evaluation included events that reached a resolution between 2009 and 2019, which includes the period of the global financial crisis.

Suggested Alternatives or Additional Measures

Several comments suggested alternatives to proposed Rule 4111. For example, several commenters suggested that FINRA improve how it uses its existing rules and programs. For example, Network 1 commented that FINRA's enforcement program is already a practical solution for addressing "bad brokers." Brooklight suggested that FINRA try to solve for any gaps in its enforcement authority and processes that prevent FINRA from dealing with the "few bad actors" motivating the proposal. ASA wrote that FINRA should pursue the expulsion of firms that do not carry out their supervisory obligations and act in ways that harm customers, and impose immediate lifetime bans on those who engage in certain egregious acts, such as theft of customer funds. ASA further commented that FINRA "has an obligation to penalize and, if necessary, revoke the licenses of bad actors," and that "[i]f FINRA believes it lacks the authority or the tools necessary to stop the most egregious abuses, . . . then it should work with the . . . SEC, Congress and the industry to correct the problem." Joseph Stone commented that FINRA should continue focusing on firms' supervisory systems.

As explained above, FINRA has a number of current programs through which it strives to prevent and deter misconduct by member firms and the individuals they hire. These tools have been effective in identifying and addressing a range of misconduct by individuals and firms, and FINRA has continued to strengthen them. Despite FINRA's efforts, however, persistent compliance issues continue to arise in some member firms, as explained above. Thus, while FINRA continues to explore whether additional enhancements to existing programs, including relevant statutory or regulatory changes,[160] would help FINRA target firms or individuals that engage in serious misconduct with greater speed and effectiveness, FINRA believes there remains a strong need to equip FINRA with authority to address more proactively the current risks posed by the limited population of firms with a significant history of misconduct.

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160 The Exchange Act includes fair procedure requirements for various SRO actions, including the disciplining of members and persons associated with members, and sets out the types of misconduct that presumptively exclude brokers from engaging in the securities business (identified as statutory disqualifications or "SDs"). The Exchange Act and SEC rules thereunder also establish a framework within which FINRA evaluates whether to allow individuals who are the subject of a statutory disqualification. In addition, 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 misconduct when it evaluates an SD application.

Some commenters proposed that, instead of a Restricted Deposit Requirement, FINRA should impose insurance or performance bond requirements,[161] create a national investor recovery pool funded from fines that FINRA receives[162] or a restitution fund,[163] or impose additional capital requirements on identified firms.[164] FINRA believes these alternatives present challenges and is continuing to propose a Restricted Firm Obligations Rule that would authorize the imposition of Restricted Deposit Requirements.

Some commenters proposed other alternatives for FINRA's consideration. Chiu wrote that FINRA should instead focus attention on investor education and encouraged the creation of more tools like the Senior Helpline. Colorado FSC recommended that FINRA assign "disciplinary training and behavior restructuring" to address disclosure related issues. FINRA does not believe, however, that the suggested alternatives would be as effective as the proposed Restricted Firm Obligations Rule at addressing firms with a significant history of misconduct and encouraging such firms to modify their behavior and risk profile.

Several commenters proposed steps that FINRA should take in addition to the proposal. These included: (1) requiring firms to provide BrokerCheck reports to customers;[165] (2) expelling firms that are Restricted Firms for two consecutive years;[166]

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161 Brooklight, Cetera, Rockfleet.

162 PIRC.

163 Sichenzia.

164 ASA.

165 PIRC.

166 Better Markets.

(3) “de-licensing” all current brokers who worked at such firms when they were initially designated as Restricted Firms;[167] (4) disclosing more information on BrokerCheck, such as the percentage of brokers at a firm with disclosures and the average number of brokers’ and firm’s disclosures,[168] or which brokers have a demonstrable pattern of violating the law;[169] and (5) explaining to investors the methods that “recidivist” firms employ.[170] Several commenters also suggested that FINRA give more consideration to proposing a rule like Investment Industry Regulatory Organization of Canada (IIROC) Consolidated Rule 9208, which is a terms and conditions rule.[171]

FINRA appreciates receiving suggestions on additional steps it might take to address firms with a significant history of misconduct, and FINRA will continue to explore ways to address firms with a significant history of misconduct. As FINRA explained in Regulatory Notice 19-17, this includes continuing to consider whether to propose a terms and conditions rule. FINRA notes, however, that some of Better Markets’ suggestions essentially request that FINRA broaden the statutory definition of disqualified persons, which is not within FINRA’s jurisdiction to do.[172]

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[167] Better Markets.

[168] St. John’s SOL.

[169] Better Markets.

[170] Better Markets.

[171] Better Markets, Brooklight, Cambridge, Cetera, Luxor, Massachusetts, MIRC, PIRC.

[172] See 15 U.S.C. 78c(a)(39) (defining “statutory disqualification”).

Miscellaneous Comments Outside the Scope of the Proposal

Some commenters raised concerns regarding issues that are not directly related to the proposal, such as whether barring “rogue brokers” or firms is effective,[173] whether the Uniform Registration Forms should request disclosure of unsubstantiated allegations or unadjudicated alleged rule violations,[174] and whether FINRA Hearing Officers are impartial.[175] FINRA believes, however, that these comments are outside the scope of the proposal.

6. Extension of Time Period for Commission Action

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.[176]

7. 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)

Not applicable.

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

Not applicable.

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

Not applicable.

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173 Chiu.

174 AdvisorLaw.

175 Moss & Gilmore.

176 15 U.S.C. 78s(b)(2).

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

Not applicable.

11. <u>Exhibits</u>

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

Exhibit 2a. Regulatory Notice 19-17 (May 2019).

Exhibit 2b. List of comment letters received in response to Regulatory Notice 19-17 (May 2019).

Exhibit 2c. Copies of the comment letters received in response to Regulatory Notice 19-17 (May 2019).

Exhibit 2d. Flow chart of the proposed Rule 4111 process.

Exhibit 3a. Number of Firms Meeting the Preliminary Criteria for Identification.

Exhibit 3b. Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size.

Exhibit 3c. New Events (after identification) Associated with Firms Meeting the Preliminary Criteria for Identification.

Exhibit 3d. New Events Associated with Firms No Longer Meeting the Preliminary Criteria for Identification after removing Pending Events.

Exhibit 3e. Variation in Financial Metrics for Firms Meeting the Preliminary Criteria for Identification.

Exhibit 3f. Association between Revenues and Award & Settlement Amounts for Firms Meeting the Preliminary Criteria for Identification.

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2020-041)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 4111 (Restricted Firm Obligations) and FINRA Rule 9561 (Procedures for Regulating Activities Under Rule 4111)

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 , the 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) adopt FINRA Rule 4111 (Restricted Firm Obligations) to require member firms that are identified as "Restricted Firms" to maintain a deposit in a segregated account from which withdrawals would be restricted, adhere to specified conditions or restrictions, or comply with a combination of such obligations; and (2) adopt a new FINRA Rule 9561 (Procedures for Regulating Activities Under Rule 4111), and amend FINRA Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series), to create a new expedited proceeding to implement

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

[2] 17 CFR 240.19b-4.

proposed Rule 4111.[3] In addition, FINRA proposes to adopt Capital Acquisition Broker ("CAB") Rule 412 (Restricted Firm Obligations), to clarify that member firms that have elected to be treated as CABs would be subject to proposed FINRA Rule 4111, and to amend Funding Portal Rule 900(a) (Application of FINRA Rule 9000 Series (Code of Procedure) to Funding Portals), to clarify that funding portals would not be subject to proposed FINRA Rule 9561.

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.

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

Background

FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and

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3 This reflects a different numbering than was originally proposed. See Regulatory Notice 19-17 (proposing to number the proposed new expedited proceeding rule as Rule "9559" and to renumber current Rule 9559 as Rule "9560").

member firms that have a history of misconduct. As part of these efforts, FINRA is proposing to adopt Rule 4111, which would impose obligations on member firms that have significantly higher levels of risk-related disclosures than similarly sized peers. FINRA would preliminarily identify these member firms by using numeric, threshold-based criteria and several additional steps that would guard against misidentification. The obligations could include requiring a member firm to maintain a specific deposit amount, with cash or qualified securities, in a segregated account at a bank or clearing firm, from which the member firm could make withdrawals only with FINRA's approval. The obligations also could include conditions or restrictions on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the preliminary identification criteria and protect investors and the public interest. FINRA also is proposing to adopt FINRA Rule 9561, and amend FINRA Rule 9559, to create a new expedited proceeding to implement proposed Rule 4111.

FINRA has a number of tools to deter and remedy misconduct by member firms and the individuals they hire, including review of membership applications, focused examinations, risk monitoring and disciplinary actions. These tools have been effective in identifying and addressing a range of misconduct by individuals and member firms, and FINRA has continued to strengthen them. In recent years, for example, FINRA has enhanced its key investor protection rules and examination programs, expanded its risk-based monitoring of brokers and member firms, and deployed new technologies designed to make its regulatory efforts more effective and efficient.[4]

These efforts have strengthened protections for investors and the markets, but persistent compliance issues continue to arise in some FINRA member firms, which are a top focus of FINRA regulatory programs. While historically small in number, such firms generally do not carry out their supervisory obligations to ensure compliance with applicable securities laws and regulations and FINRA rules, and they act in ways that could harm their customers and erode trust in the brokerage industry. Recent academic studies, for example, find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence that the past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events.[5] While these firms may

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[4] For example, in October 2018, FINRA announced plans to consolidate its Examination and Risk Monitoring Programs, integrating three separate programs into a single, unified program to drive more effective oversight and greater consistency, eliminate duplication and create a single point of accountability for the examination of member firms. The consolidation brings those programs under a single framework designed to better direct and align examination resources to the risk profile and complexity of member firms. FINRA is conducting its examinations under this unified program in 2020.

[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? (OCE 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.

eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with a history of misconduct that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers.

Such firms expose investors to real risk. For example, FINRA has identified certain firms that have a concentration of associated persons with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. These firms generally have a retail business engaging in cold calling to make recommendations of securities, often to vulnerable customers. FINRA has also identified groups of individual brokers who move from one firm of concern to another firm of concern. Such firms and their associated persons often have substantial numbers of disclosures on their records. In such situations, FINRA closely examines the firms' and brokers' conduct, and where appropriate, FINRA will bring enforcement actions to bar or suspend the firms and individuals involved.

However, individuals and firms with a history of misconduct can pose a particular challenge for FINRA's existing examination and enforcement programs. In particular, examinations 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 without an enforcement action. While these constraints on the examination process protect firms from potentially arbitrary or overly onerous examination findings, an individual or firm with a history of misconduct can take advantage of these limits to simply continue activities that pose risk of harm to investors until they result in an enforcement action.

Enforcement actions in turn can only be brought after a rule has been violated and any resulting customer harm has already occurred. In addition, these proceedings can take significant time to develop, prosecute and conclude, during which time the individual or firm is able to continue misconduct, with significant risks of additional harm to customers and investors. Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council ("NAC"), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel 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. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership and shifted its business to another member or other type of financial firm, limiting FINRA's jurisdiction and avoiding the sanction, including making restitution to customers.

Temporary cease and desist proceedings, while useful, do not always provide an effective remedy for potential ongoing harm to investors during the enforcement process.[6] Temporary cease and desist proceedings are available only in narrowly defined circumstances. Moreover, initiation by FINRA of a temporary cease and desist action does not necessarily enable more rapid intervention, because FINRA must be prepared to file the underlying disciplinary complaint at the same time.

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6 See FINRA Rule 9800 Series (Temporary and Permanent Cease and Desist Orders).

In addition, by the time sanctions are imposed, as noted above, the firm may have exited the industry, thereby limiting FINRA's jurisdiction over the misconduct. In such circumstance, the firm may also fail to pay arbitration awards owed to claimants, leaving investors uncompensated and diminishing confidence in the securities markets.

Therefore, FINRA is strengthening its tools to respond to firms and brokers with a significant history of misconduct, and the firms that employ those brokers, several of which are described below.

Additional Steps Undertaken by FINRA

To address these problems, FINRA has undertaken the following:

- Published Regulatory Notice 18-15, which rearticulates the obligation of member firms to implement heightened supervisory procedures tailored to the associated persons with a history of misconduct;
- Proposed rule amendments that would require a member firm to conduct with FINRA a materiality consultation before allowing persons with a history of misconduct to become owners, control persons, principals or registered persons of a member firm; authorize the imposition in a disciplinary proceeding of conditions and restrictions on the activities of a respondent member firm or respondent broker that are reasonably necessary for the purpose of preventing customer harm, and require a respondent broker's member firm to adopt heightened supervisory procedures for such broker, when a disciplinary matter is appealed to the NAC or called for NAC review; require firms that apply to continue associating with a statutorily disqualified person to include in that application an interim plan of heightened supervision that would be effective

throughout the application process; and 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);[7]

- Published Regulatory Notice 18-17, which announced revisions to the FINRA Sanction Guidelines;
- Raised fees for statutory disqualification applications;[8] and
- Revised the qualification examination waiver guidelines to permit FINRA to more broadly consider past misconduct when considering examination waiver requests.[9]

While these efforts should help mitigate the risks posed by individual brokers with a history of misconduct, challenges remain where a member firm itself has a concentration of such brokers—in some cases because the firm seeks out such brokers—or otherwise has a history of substantial compliance failures.

Proposed Rule 4111 (Restricted Firm Obligations)

FINRA is proposing to adopt Rule 4111 (Restricted Firm Obligations), a new rule that would use numeric thresholds based on firm-level and individual-level disclosure events and impose a Restricted Deposit Requirement on member firms that present a high degree of risk to the investing public. FINRA believes that the direct financial impact of

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[7] See Securities Exchange Act Release No. 88600 (April 8, 2020), 85 FR 20745 (April 14, 2020) (Notice of Filing of File No. SR-FINRA-2020-011); see also Regulatory Notice 18-16 (April 2018).

[8] 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).

[9] See Regulatory Notice 18-16 (April 2018).

a restricted deposit is most likely to change such member firms' behavior—and therefore protect investors. An added benefit of this proposal would be to preserve member firm funds for payment of arbitration awards against them and their associated persons. The proposal would consider "Covered Pending Arbitration Claims"[10] and unpaid arbitration awards[11] in determining the size of a Restricted Firm's "Restricted Deposit Requirement."[12] The proposal also would establish presumptions that, when assessing an application by a member firm or former member firm that was previously designated as a Restricted Firm for withdrawal from a Restricted Deposit Account,[13] the Department of Member Regulation ("Department") shall: (i) deny an application for withdrawal if the member firm, the member firm's Associated Persons who are owners or control persons, or the former member firm have any Covered Pending Arbitration Claims or unpaid

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[10] The term "Covered Pending Arbitration Claim" is defined in proposed Rule 4111(i)(2) to mean, for purposes of Rule 4111, an investment-related, consumer initiated claim filed against the member or its associated persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. The claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees, and shall be the maximum amount for which the member or associated person, as applicable, is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount. This term conforms, in relevant part, to the definition of Covered Pending Arbitration Claim in Rule 1011(c). See Securities Exchange Act Release No. 88482 (March 26, 2020), 85 FR 18299 (April 1, 2020) (Order Approving File No. SR-FINRA-2019-030).

[11] For purposes of this Form 19b-4, "unpaid arbitration awards" also includes unpaid settlements related to arbitrations.

[12] The term "Restricted Deposit Requirement" is defined in proposed Rule 4111(i)(15).

[13] See proposed Rule 4111(i)(14) (proposed definition of "Restricted Deposit Account").

arbitration awards, or if the member firm's Associated Persons have any Covered Pending Arbitration Claims or unpaid arbitration awards relating to arbitrations outstanding that involved conduct or alleged conduct that occurred while associated with the member firm; but (ii) approve a former member firm's application for withdrawal when that former member firm commits in the manner specified by the Department to use the amount it seeks to withdraw from its Restricted Deposit to pay the former member firm's specified unpaid arbitration awards.

The proposed rule would create a multi-step process for FINRA's determination of whether a member firm raises investor-protection concerns substantial enough to require that it be subject to additional obligations. Those obligations could include a requirement to maintain a deposit of cash or qualified securities in an account from which withdrawals would be restricted, or conditions or restrictions on the member firm's operations that are necessary or appropriate for the protection of investors and in the public interest. The proposed rule would give each affected member firm several ways to affect outcomes, including a one-time opportunity to reduce staffing so as to no longer trigger the preliminary identification criteria and numeric thresholds. The firm also could explain to the Department why it should not be subject to a Restricted Deposit Requirement or propose alternatives, and the firm could challenge a Department determination by requesting a hearing before a Hearing Officer in an expedited proceeding.

The proposed multi-step process includes numerous features designed to narrowly focus the new obligations on the firms most of concern. As the flow chart in Exhibit 2d reflects, this process is akin to a "funnel." The top of the funnel applies to the range of member firms with the most disclosures, with a narrowing in the middle of the potential member firms that may be subject to additional obligations, and the bottom of the funnel reflecting the smaller number of member firms that are determined to present high risks to the investing public.

- General (Proposed Rule 4111(a))

Proposed Rule 4111(a) would require a member designated as a Restricted Firm to establish a Restricted Deposit Account and maintain in that account deposits of cash or qualified securities with an aggregate value that is not less than the member's Restricted Deposit Requirement, except in certain identified situations, and be subject to conditions or restrictions on the member's operations as determined by the Department to be necessary or appropriate for the protection of investors and in the public interest.

- Annual Calculation by FINRA of the Preliminary Criteria for Identification (Proposed Rule 4111(b))

The multi-step process would begin with an annual calculation. As explained more below, proposed Rule 4111(b) would require the Department to calculate annually (on a calendar-year basis) the "Preliminary Identification Metrics"[14] to determine whether a member firm meets the "Preliminary Criteria for Identification."[15] A key driver of that is whether a member firm's "Preliminary Identification Metrics" meet quantitative, risk-based "Preliminary Identification Metrics Thresholds."[16]

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14 See proposed Rule 4111(i)(10) (definition of "Preliminary Identification Metrics").

15 See proposed Rule 4111(i)(9) (definition of "Preliminary Criteria for Identification").

16 See proposed Rule 4111(i)(11) (definition of "Preliminary Identification Metrics Thresholds").

Several principles guided FINRA's development of the proposed Preliminary Criteria for Identification and the proposed Preliminary Identification Metrics Thresholds. The criteria and thresholds are intended to be replicable and transparent to FINRA and affected member firms; employ the most complete and accurate data available to FINRA; be objective; account for different firm sizes and business profiles; and target the sales-practice concerns that are motivating the proposal. These criteria are intended to identify member firms that present a high risk but avoid imposing obligations on member firms whose risk profile and activities do not warrant such obligations.

Using these guiding principles, FINRA is proposing numeric thresholds based on six categories of events or conditions, nearly all of which are based on information disclosed through the Uniform Registration Forms.[17] The six categories, collectively defined as the "Disclosure Event and Expelled Firm Association Categories,"[18] are:

1. Registered Person Adjudicated Events;[19]

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17 One of the event categories, Member Firm Adjudicated Events, includes events that are derived from customer arbitrations filed with FINRA's dispute resolution forum.

18 See proposed Rule 4111(i)(4).

19 "Registered Person Adjudicated Events," defined in proposed Rule 4111(i)(4)(A), means any one of the following events that are reportable on the registered person's Uniform Registration Forms: (i) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party, or was a "subject of" the customer arbitration award or civil judgment; (ii) a final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation; (iii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or Commodity Futures Trading Commission

2. Registered Person Pending Events;[20]

3. Registered Person Termination and Internal Review Events;[21]

4. Member Firm Adjudicated Events;[22]

("CFTC"), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (v) a criminal matter in which the registered person was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

20 "Registered Person Pending Events," defined in proposed Rule 4111(i)(4)(B), means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms: (i) a pending investment-related civil judicial matter; (ii) a pending investigation by a regulatory authority; (iii) a pending regulatory action that was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (iv) a pending criminal charge associated with any felony or any reportable misdemeanor. Registered Person Pending Events does not include pending arbitrations, pending civil litigations, or consumer-initiated complaints that are reportable on the registered person's Uniform Registration Forms.

21 "Registered Person Termination and Internal Review Events," defined in proposed Rule 4111(i)(4)(C), means any one of the following events associated with the registered person at a previous member firm that are reportable on the registered person's Uniform Registration Forms: (i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign from a previous member after allegations; or (ii) a pending or closed internal review by a previous member. FINRA has revised this definition, from the version proposed in Regulatory Notice 19-17 (May 2019), to clarify that termination and internal review disclosures concerning a person whom a member firm terminated would not impact that member firm's own Registered Person Termination and Internal Review Metric; rather, they would only impact the metrics of member firms that subsequently register the terminated individual.

22 "Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D), means any one of the following events that are reportable on the member firm's Uniform Registration Forms or based on customer arbitrations filed with FINRA's dispute resolution forum: (i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party; (ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-

5. Member Firm Pending Events;[23] and

6. Registered Persons Associated with Previously Expelled Firms (also referred to as the Expelled Firm Association category).[24]

To calculate whether a member firm meets the Preliminary Criteria for Identification, the Department would first compute the Preliminary Identification Metrics for each of the Disclosure Event and Expelled Firm Association Categories. Each category's Preliminary Identification Metric computation would start with a calculation of the sum of the pertinent disclosure events or, for the Expelled Firm Association category, the sum of the Registered Persons Associated with Previously Expelled Firms. For the adjudicated disclosure-event based categories, the counts would include disclosure events that were resolved during the prior five years from the date of the calculation. For the pending events categories and pending internal reviews, the counts would include disclosure events that are pending as of the date of the calculation. In addition, for the three Registered Person disclosure-event based categories, the counts

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regulatory organization; or (iv) a criminal matter in which the member was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

[23] "Member Firm Pending Events," defined in proposed Rule 4111(i)(4)(E), means any one of the same kinds of events as the "Registered Person Pending Events," but that are reportable on the member firm's Uniform Registration Forms.

[24] "Registered Persons Associated with Previously Expelled Firms," defined in proposed Rule 4111(i)(4)(F), means any "Registered Person In-Scope" who was registered for at least one year with a previously expelled firm and whose registration with the previously expelled firm terminated during the "Evaluation Period" (i.e., the prior five years from the "Evaluation Date," which is the annual date as of which the Department calculates the Preliminary Identification Metrics). See proposed Rule 4111(i)(5), (6), and (13) (proposed definitions of "Evaluation Date," "Evaluation Period," and "Registered Persons In-Scope"). This proposed definition is narrower than the definition proposed in Regulatory Notice 19-17.

would include disclosure events across all Registered Persons In-Scope, which is defined to include persons registered with the member firm for one or more days within the one year prior to the calculation date.[25]

Each of those six sums would then be standardized to determine the member's six Preliminary Identification Metrics. For the five "Registered Person and Member Firm Events" categories (Categories 1-5 above),[26] the proposed Preliminary Identification Metrics are in the form of an average number of events per registered broker, calculated by taking each category's sum and dividing it by the number of Registered Persons In-Scope. The sixth Preliminary Identification Metric—the proposed Expelled Firm Association Metric—is in the form of a percentage concentration at the member firm of Registered Persons Associated with Previously Expelled Firms. This concentration is calculated by taking the number of Registered Persons Associated with Previously Expelled Firms and dividing it by the number of Registered Persons In-Scope.

A firm's six Preliminary Identification Metrics are used to determine if the member firm meets the Preliminary Criteria for Identification. To meet the Preliminary Criteria for Identification, a member firm would need to meet the Preliminary Identification Metrics Thresholds, set forth in proposed Rule 4111(i)(11), for two or more of the appropriate metrics listed above for its size and, if it does, one of these metrics must be for adjudicated events or the Expelled Firm Association Metric, and the firm must have two or more Registered Person and Member Firm Events (i.e., events in categories besides the Registered Persons Associated with Previously Expelled Firms

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[25] See proposed Rule 4111(i)(13).

[26] See proposed Rule 4111(i)(12) (definition of Registered Person and Member Firm Events).

category).[27] This involves analyzing the extent to which the Preliminary Identification Metrics meet the specified numeric Preliminary Identification Metrics Thresholds and meet additional conditions intended to prevent a member firm from becoming potentially subject to additional obligations solely as a result of pending matters or a single event or condition.[28] Specifically, the Department would:

- first, pursuant to proposed Rules 4111(b) and (i)(9)(A), evaluate whether two or more of the member firm's Preliminary Identification Metrics are equal to or more than the corresponding Preliminary Identification Metrics Thresholds for the member firm's size, and whether at least one of those Preliminary Identification Metrics is the Registered Person Adjudicated Event Metric, the Member Firm Adjudicated Event Metric, or the Expelled Firm Association Metric; and
- second, pursuant to proposed Rules 4111(b) and (i)(9)(B), evaluate whether the member firm has two or more Registered Person or Member Firm Events (i.e., two or more events from Categories 1-5 above).

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[27] Including an Expelled Firm Association Metric in the Preliminary Criteria for Identification is similar to how FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms) imposes recording requirements on firms with specific percentages of registered persons who were previously associated with disciplined firms.

[28] The purpose of ensuring that a firm does not meet the Preliminary Criteria for Identification solely because of pending matters is because FINRA recognizes that pending matters include disclosure events that may remain unresolved or that may subsequently be dismissed or concluded with no adverse action. As explained in more detail in the Economic Impact Assessment, FINRA also evaluated the impact of including and excluding pending matters from the Preliminary Criteria for Identification. Based on this evaluation, FINRA has included pending matters in the proposed criteria because they are critical to identifying firms that pose greater risks to their customers.

If all of these conditions are met, the member firm would meet the Preliminary Criteria for Identification.

Each specific numeric threshold in the Preliminary Identification Metrics Thresholds grid in proposed Rule 4111(i)(11) is a number which represents outliers with respect to peers for the type of events in the category (i.e., the firm is at the far tail of the respective category's distribution), which is intended to preliminarily identify member firms that present significantly higher risk than a large percentage of the membership. In addition, there are numeric thresholds for seven different firm sizes, to ensure that each member firm is compared only to its similarly sized peers.[29] As explained more below in the Economic Impact Assessment, based on recent history FINRA expects that its annual calculations will identify between 45-80 member firms that meet the Preliminary Criteria for Identification.[30]

The following three examples demonstrate—in practical terms—the point at which a member firm's Preliminary Identification Metrics would meet the Preliminary Identification Metrics Thresholds in proposed Rule 4111(i)(11):

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29 Because FINRA has narrowed the definition of Registered Persons Associated with Previously Expelled Firms from the version that was originally proposed in Regulatory Notice 19-17, FINRA also has revised the Expelled Firm Association Metric Thresholds.

30 Due to the revisions in the Preliminary Criteria for Identification, discussed above, and the inclusion of the year 2019 in the review period, this estimate and other corresponding estimates in the Economic Impact Assessment have changed from the ones in Regulatory Notice 19-17.

	Preliminary Identification Metrics Thresholds	Practical Equivalent
Example 1 (member firm size between 1-4 registered persons)	The Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric, for a member firm that has between one and four Registered Persons In-Scope as of the Evaluation Date,[31] is 0.50 (or 0.50 events per Registered Broker In-Scope).	For a member firm with four Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric if the sum of its four Registered Persons In-Scope's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was two or more. (4 Registered Persons In-Scope) * (0.50 Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric) = (2 Adjudicated Events)
Example 2 (member firm size between 20-50 registered persons)	The Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric, for a member firm that has between 20-50 Registered Persons In-Scope as of the Evaluation Date, is 0.20 (or 0.20 events per Registered Broker In-Scope).	For a member firm with 50 Registered Persons In-Scope as of the Evaluation Date, the member firm would meet the Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric if the sum of the member firm's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was ten or more. (50 Registered Persons In-Scope) * (0.20 Preliminary Identification Metrics Threshold for the

[31] The "Evaluation Date" is defined in proposed Rule 4111(i)(5) to mean the date, each calendar year, as of which the Department calculates the Preliminary Identification Metrics to determine if the member firm meets the Preliminary Criteria for Identification.

		Member Firm Adjudicated Event Metric) = (10 Adjudicated Events)
Example 3 (member firm size between 51-150 registered persons)	The Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric, for a member firm that has between 51-150 Registered Persons In-Scope as of the Evaluation Date, is 0.03 (or a 3% concentration level).	For a member firm with 100 Registered Persons In-Scope as of the Evaluation Date, the member firm would meet the Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric if the sum of its Registered Persons Associated with Previously Expelled Firms was three or more. (100 Registered Persons In-Scope) * (0.03 Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric) = (three Registered Persons Associated with Previously Expelled Firms)

In a comment to Regulatory Notice 19-17, SIFMA requested more clarity around when the annual Evaluation Date would be. FINRA would announce the first Evaluation Date no less than 120 calendar days before the first Evaluation Date. Subsequent Evaluation Dates would be on the same month and day each year, except when that date falls on a Saturday, Sunday or federal holiday, in which case the Evaluation Date would be on the next business day.

FINRA has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily identify the types of member firms that are motivating this rule proposal.[32] As explained below,

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[32] OCE has tested the Preliminary Criteria for Identification, including the Preliminary Identification Metrics Thresholds, in several ways. For example,

however, the proposed rule involves several additional steps to guard against the risk of misidentification.

- Initial Department Evaluation (Proposed Rule 4111(c)(1))

For each member firm that meets the Preliminary Criteria for Identification, the Department would conduct, pursuant to proposed Rule 4111(c)(1), an initial internal evaluation to determine whether the member firm does not warrant further review under Rule 4111. In doing so, the Department would review whether it has information to conclude that the computation of the member firm's Preliminary Identification Metrics included disclosure events or other conditions that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. For example, the Department may have information that the computation included disclosure events that were not sales-practice related, were duplicative (involving the same customer and the same matter), or mostly involved compliance concerns best addressed by a different regulatory response by FINRA. The Department would evaluate the events to determine, among other things, whether they indicated risks to investors or market integrity, rather than, for instance, repeated violations of procedural rules.

The Department would also consider whether the member firm has addressed the concerns signaled by the disclosure events or conditions or altered its business operations, including staffing reductions, such that the threshold calculation no longer

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OCE has compared the firms captured by the proposed criteria to the firms that have recently been expelled or that have unpaid arbitration awards. OCE also has consulted with Department staff and examiners about whether, based on their experience, the criteria identifies firms that appear to present high risks to investors.

reflects the member firm's current risk profile. Essentially, the purpose of the Department's initial evaluation is to determine whether it is aware of information that would show that the member firm—despite having met the Preliminary Criteria for Identification—does not pose a high degree of risk.

Pursuant to proposed Rule 4111(c)(3), if the Department determines, after this initial evaluation, that the member firm does not warrant further review, the Department would conclude that year's Rule 4111 process for the member firm and would not seek that year to impose any obligations on it. If, however, the Department determines that the member firm does warrant further review, the Rule 4111 process would continue.

➢ <u>One-Time Opportunity to Reduce Staffing Levels (Proposed Rule 4111(c)(2))</u>

If the Department determines, after its initial evaluation, that a member firm warrants further review under proposed Rule 4111, such member firm—if it would be meeting the Preliminary Criteria for Identification for the first time—would have a one-time opportunity to reduce its staffing levels to no longer meet these criteria, within 30 business days after being informed by the Department. The member firm would be required to demonstrate the staff reduction to the Department by identifying the terminated individuals. The proposed rule would prohibit the member firm from rehiring any persons terminated pursuant to this option, in any capacity, for one year. A member firm that has reduced staffing levels at this stage may not use that staff-reduction opportunity again.

If the Department determines that the member firm's reduction of staffing levels results in its no longer meeting the Preliminary Criteria for Identification, the Department would close out that year's Rule 4111 process for the member firm and would not seek that year to impose any obligations on that firm. If, on the other hand, the Department determines that the member firm still meets the Preliminary Criteria for Identification even after its staff reductions, or if the member firm elects not to use its one-time opportunity to reduce staffing levels, the Department would proceed to determine the firm's maximum Restricted Deposit Requirement, and the member firm would proceed to a "Consultation" with the Department.

- FINRA's Determination of a Maximum Restricted Deposit Requirement (Proposed Rule 4111(i)(15))

For members that warrant further review after being deemed to meet the Preliminary Criteria for Identification and after the initial Department evaluation, the Department would then determine the member's maximum "Restricted Deposit Requirement."

The Department would tailor the member firm's maximum Restricted Deposit Requirement amount to its size, operations and financial conditions. As provided in proposed Rule 4111(i)(15), the Department would consider the nature of the member firm's operations and activities, revenues, commissions, assets, liabilities, expenses, net capital, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, insurance coverage for customer arbitration awards or settlements, concerns raised during FINRA exams, and the amount of any of the firm's or its Associated Persons' "Covered Pending Arbitration Claims" or unpaid arbitration awards.[33] Based on a consideration of these factors, the Department would determine a

33 The proposed factors that the Department would consider when determining a maximum Restricted Deposit Requirement have been revised from the ones proposed in Regulatory Notice 19-17. Some of the revisions are to ensure that

maximum Restricted Deposit Requirement for the member firm that would be consistent with the objectives of the rule, but not significantly undermine the continued financial stability and operational capability of the member firm as an ongoing enterprise over the next 12 months. FINRA's intent is that the maximum Restricted Deposit Requirement should be significant enough to change the member firm's behavior but not so burdensome that it would force the member firm out of business solely by virtue of the imposed deposit requirement.

- Consultation (Proposed Rule 4111(d))

If the Department determines, after the process discussed above, that a member firm warrants further Rule 4111 review, the Department would consult with the member firm, pursuant to proposed Rule 4111(d). This Consultation will give the member firm an opportunity to demonstrate why it does not meet the Preliminary Criteria for Identification, why it should not be designated as a Restricted Firm, and why it should not be subject to the maximum Restricted Deposit Requirement.

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proposed Rule 4111(i)(15) describes more accurately the factors that would be relevant to a determination of the maximum Restricted Deposit Requirement. In this regard, the "annual revenues" and "net capital requirements" factors proposed in Regulatory Notice 19-17 have been modified to "revenues" and "net capital," and "assets," "expenses," and "liabilities" have been added as factors. Another revision clarifies that the Covered Pending Arbitration Claims and unpaid arbitration awards factors include claims and awards against the firm and its Associated Persons. The Department's consideration of claims and awards against the firm's Associated Persons would focus on claims and awards against Associated Persons who are owners or control persons and on claims and awards relating to arbitrations that involved conduct or alleged conduct that occurred while associated with the member firm. The revised proposed definition also adds the member firm's "insurance coverage for customer arbitration awards or settlements" as a factor. FINRA believes that, if Restricted Firms were able to procure errors and omissions policies, or other kinds of insurance coverage, for some or all of the kinds of arbitration claims that customers typically bring, that could warrant a reduced Restricted Deposit Requirement and would be behavior to encourage.

In the Consultation, there would be two rebuttable presumptions: that the member firm should be designated as a Restricted Firm; and that it should be subject to the maximum Restricted Deposit Requirement. The member firm would bear the burden of overcoming those presumptions.

Proposed Rule 4111(d)(1) governs how a member may overcome these two presumptions. First, a member may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation that the member meets the Preliminary Criteria for Identification is inaccurate because, among other things, it included events, in the six categories described above, that should not have been included because, for example, they are duplicative, involving the same customer and the same matter, or are not sales-practice related. Second, a member firm may overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement by clearly demonstrating to the Department that the member firm would face significant undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement and that a lesser deposit requirement would satisfy the objectives of Rule 4111 and be consistent with the protection of investors and the public interest; or that other conditions and restrictions on the operations and activities of the member firm and its associated persons would address the concerns indicated by the thresholds and protect investors and the public interest.

Proposed Rule 4111(d)(2) governs how the Department would schedule and provide notice of the Consultation. In a change from the proposal in Regulatory Notice 19-17, the Department would provide the written letter required by the rule at least seven days prior to the Consultation, and would establish a process whereby the member can request a postponement for good cause shown. These changes, which are in response to a comment on Regulatory Notice 19-17, are intended to ensure that the firms have sufficient time to prepare for the Consultation and to enhance the procedural protections.

Proposed Rule 4111(d)(3) provides guidance on what the Department would consider during the Consultation when evaluating whether a member firm should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement. This provision also provides member firms with guidance on how to attempt to overcome the two rebuttable presumptions. For example, proposed Rule 4111(d)(3) requires that the Department consider:

- information provided by the member firm during any meetings as part of the Consultation;
- relevant information or documents, if any, submitted by the member firm, in the manner and form prescribed by the Department, as would be necessary or appropriate for the Department to review the computation of the Preliminary Criteria for Identification;
- any plan submitted by the member firm, in the manner and form prescribed by the Department, proposing in detail the specific conditions or restrictions that the member firm seeks to have the Department consider;
- such other information or documents as the Department may reasonably request from the member firm related to the evaluation; and
- any other information the Department deems necessary or appropriate to evaluate the matter.

To the extent a member firm seeks to claim undue financial hardship, it would be the member firm's burden to support that with documents and information.

➢ Department Decision and Notice (Proposed Rule 4111(e)); No Stays

After the Consultation, proposed Rule 4111(e) would require that the Department render a Department decision. Under proposed Rule 4111(e)(1), there are three paths that decision might take:

- If the Department determines that the member firm has rebutted the presumption that it should be designated as a Restricted Firm, the Department's decision would state that the member firm will not be designated that year as a Restricted Firm.
- If the Department determines that the member firm has not rebutted the presumption that it should be designated as a Restricted Firm or the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member firm as a Restricted Firm and require the member firm to promptly establish a Restricted Deposit Account, deposit and maintain in that account the maximum Restricted Deposit Requirement, and implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

- If the Department determines that the member firm has not rebutted the presumption that it should be designated as a Restricted Firm but has rebutted the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member firm as a Restricted Firm; would impose no Restricted Deposit Requirement on the member firm, or would require the member firm to promptly establish a Restricted Deposit Account, deposit and maintain in that account a Restricted Deposit Requirement in such dollar amount less than the maximum Restricted Deposit Requirement as the Department deems necessary or appropriate; and would require the member firm to implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

Pursuant to proposed Rule 4111(e)(2), the Department would provide a written notice of its decision to the member firm, pursuant to proposed Rule 9561 and no later than 30 days from the latest scheduling letter provided to the member firm under proposed Rule 4111(d)(2), that states the obligations to be imposed on the member firm, if any, and the ability of the member firm to request a hearing with the Office of Hearing Officers in an expedited proceeding, as further described below.

Proposed Rule 4111(e)(2) would provide that a request for a hearing would not stay the effectiveness of the Department's decision. However, upon requesting a hearing of a Department decision that imposes a Restricted Deposit Requirement, the member firm would only be required to maintain in a Restricted Deposit Account the lesser of 25% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year, until the Office of Hearing Officers or the NAC issues its final written decision in the expedited proceeding.[34] This has one exception: a member firm that is re-designated as a Restricted Firm and is already subject to a previously imposed Restricted Deposit Requirement would be required to maintain the full amount of its Restricted Deposit Requirement until the Office of Hearing Officers or the NAC issues its final written decision in the expedited proceeding.

Considering the nature of the firms identified as Restricted Firms and the risks they present, the immediate effectiveness of the Department's decision will help protect investors during the pendency of the expedited proceeding. Moreover, FINRA believes that the no-stay provision is consistent with fairness principles, because obligations would be imposed only after firms are preliminarily identified, from among their firm-size peer group, by transparent criteria and a process that involves an initial evaluation and a consultation with the firm.

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[34] In Regulatory Notice 19-17 (May 2019), FINRA originally proposed that the member firm would be required, upon requesting a hearing, to deposit the lesser of 50% of the Restricted Deposit Requirement or 25% of the firm's average excess net capital during the prior calendar year. FINRA has revised this provision because, although the no-stay provisions are a fundamental part of how the proposed rule would protect investors, FINRA believes that this aspect of the no-stay provisions could be less burdensome than originally proposed and still achieve its intended purpose.

- Continuation or Termination of Restricted Firm Obligations (Proposed Rule 4111(f))

The proposed Restricted Firm Obligations Rule would require FINRA to determine annually whether each member firm is, or continues to be, a Restricted Firm and whether the member firm should be subject to any obligations. For this reason, proposed Rule 4111(f) contains provisions that set forth how any obligations that were imposed during the Rule 4111 process in one year are continued or terminated in that same year and in subsequent years.

Proposed Rule 4111(f)(1), titled "Currently Designated Restricted Firms," establishes constraints on a member firm's ability to seek to modify or terminate, directly or indirectly, any obligations imposed pursuant to Rule 4111. Because the Restricted Firm Obligations Rule would entail annual reviews by the Department to determine whether a member firm is a Restricted Firm that should be subject to obligations, a Restricted Firm could seek each year to terminate or modify any obligations that continue to be imposed. For this reason, proposed Rule 4111 does not authorize a Restricted Firm to seek, outside of the Consultation process and any ensuing expedited proceedings after a Department decision, a separate interim termination or modification of any obligations imposed. Rather, proposed Rule 4111(f)(1) provides that a member firm that has been designated as a Restricted Firm will not be permitted to withdraw all or any portion of its Restricted Deposit Requirement, or seek to terminate or modify any deposit requirement, conditions, or restrictions that have been imposed on it, without the prior written consent of the Department. In a change from the proposal in Regulatory Notice 19-17, there would be a presumption that the Department shall deny an application by a member firm or former member firm that is currently designated as a Restricted Firm to withdraw all or any portion of its Restricted Deposit Requirement.[35]

Proposed Rule 4111(f)(2), titled "Re-Designation as a Restricted Firm," addresses the scenario when the Department determines in one year that a member firm is a Restricted Firm, and in the following year determines that the member firm still meets the Preliminary Criteria for Identification. In that instance, the Department would re-designate the member firm as a Restricted Firm, and the obligations previously imposed on the member firm would continue unchanged, unless either the member firm or the Department requests, within seven days of the Department's decision to re-designate the member firm as a Restricted Firm, a Consultation.[36] If a Consultation is requested, the obligations previously imposed would continue unchanged unless and until the Department modifies or terminates them after the Consultation. In addition, in the Consultation process, a presumption would apply that any previously imposed Restricted Deposit Requirement, conditions or restrictions would remain effective and unchanged, absent a showing by the party seeking changes that they are no longer necessary or appropriate for the protection of investors or in the public interest. At the end of the Consultation, the Department would be required to provide written notice of its determination to the member firm, no later than 30 days from the date of the latest scheduling letter provided to the member firm under Rule 4111(d)(2).

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35 This revision, and additional revisions to proposed Rule 4111(f)(3) discussed below, are intended to make more clear the process that would guide the Department's assessment of applications for withdrawal from a Restricted Deposit Requirement.

36 The seven-day period to request a Consultation is a revision from the proposal in Regulatory Notice 19-17 (May 2019), which proposed a 30-day period.

Proposed Rule 4111(f)(3), titled "Previously Designated Restricted Firms," addresses the scenario where the Department determines in one year that a member firm is a Restricted Firm, but in the following year(s) determines that the member firm or former member firm[37] either does not meet the Preliminary Criteria for Identification or should not be designated as a Restricted Firm. In that case, the member firm or former member firm would no longer be subject to any obligations previously imposed under proposed Rule 4111. There would be one exception: a former Restricted Firm would not be permitted to withdraw any portion of its Restricted Deposit Requirement without submitting an application and obtaining the Department's prior written consent for the withdrawal. Such an application would be required to include, among other things set forth in proposed Rule 4111(f)(3)(A), evidence as to whether the firm, its Associated Persons, or the former member firm have Covered Pending Arbitration Claims or any unpaid arbitration awards outstanding.

The Department would determine whether to authorize a withdrawal, in part or in whole. Proposed Rule 4111(f)(3)(B)(i) would establish a presumption that the Department shall approve an application for withdrawal if the member firm, its Associated Persons, or the former member firm have no Covered Pending Arbitration Claims or unpaid arbitration awards. Proposed Rule 4111(f)(3)(B)(ii) would establish presumptions that the Department shall: (a) deny an application for withdrawal if the member firm, the member firm's Associated Persons who are owners or control persons, or the former member have any "Covered Pending Arbitration Claims," unpaid arbitration awards, or if the member's Associated Persons have any "Covered Pending

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[37] See proposed Rule 4111(i)(7) (definition of "Former Member").

Arbitration Claims" or unpaid arbitration awards relating to arbitrations that involved conduct or alleged conduct that occurred while associated with the member; but (b) approve an application by a former member for withdrawal if the former member commits in the manner specified by the Department to use the amount it seeks to withdraw from its Restricted Deposit to pay the former member's specified unpaid arbitration awards.[38] The Department would be required to issue, pursuant to proposed Rule 9561, a notice of its decision on an application to withdraw from the Restricted Deposit Account within 30 days from the date the application is received by the Department.

➢ Restricted Deposit Account (Proposed Rule 4111(i)(14))

If a Department decision requires a member firm to establish a Restricted Deposit Account, proposed Rule 4111(i)(14) would govern this account. The underlying policy for the proposed account requirements is that, to make a deposit requirement effective in creating appropriate incentives to member firms that pose higher risks to change their behavior, the member firm must be restricted from withdrawing any of the required deposit amount, even if it terminates its FINRA membership.

The proposed rule would require that the Restricted Deposit Account be established, in the name of the member firm, at a bank or the member firm's clearing firm. The account must be subject to an agreement in which the bank or the clearing firm agrees: not to permit withdrawals from the account absent FINRA's prior written

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[38] The presumptions in proposed Rule 4111(f)(3)(B) have been modified from what was proposed in Regulatory Notice 19-17. In addition, in clarifying changes from Regulatory Notice 19-17, proposed Rule 4111(f)(3) expressly provides that the Covered Pending Arbitration Claims and unpaid arbitration awards of a member firm's "Associated Persons" are pertinent to an application for a withdrawal from the Restricted Deposit Requirement.

consent; to keep the account separate from any other accounts maintained by the member firm with the bank or clearing firm; that the cash or qualified securities on deposit will not be used directly or indirectly as security for a loan to the member firm by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm; that if the member firm becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and withdrawals will not be permitted without FINRA’s prior written consent; that FINRA is a third-party beneficiary to the agreement; and that the agreement may not be amended without FINRA’s prior written consent. In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member.[39]

- Books and Records (Proposed Rule 4111(g))

Proposed Rule 4111(g) would establish new requirements to maintain books and records that evidence the member firm’s compliance with the Restricted Firm Obligations Rule and any Restricted Deposit Requirement or other conditions or restrictions imposed under that rule. In addition, the proposed books and records provision would specifically require a member firm subject to a Restricted Deposit Requirement to provide to the Department, upon its request, records that demonstrate the member firm’s compliance with that requirement.

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39 In the event of a liquidation of a Restricted Firm, funds or securities on deposit in the Restricted Deposit Account would be additional financial resources available for the Restricted Firm’s trustee to distribute to those with claims against the Restricted Firm.

➢ Notice of Failure to Comply (Proposed Rule 4111(h))

FINRA also is proposing a requirement to address the situation when a member firm fails to comply with the obligations imposed pursuant to proposed Rule 4111. Under proposed Rule 4111(h), FINRA would be authorized to issue a notice pursuant to proposed Rule 9561 directing a member firm that is not in compliance with its Restricted Deposit Requirement, or with any conditions or restrictions imposed under Rule 4111, to suspend all or a portion of its business.

➢ Definitions (Proposed Rule 4111(i))

A complete list of defined terms used in proposed Rule 4111 appears in proposed Rule 4111(i).[40]

➢ Net Capital Treatment of the Deposits in the Restricted Deposit Account (Proposed Rule 4111.01)

Proposed Supplementary Material .01 would clarify that because of the restrictions on withdrawals from a Restricted Deposit Account, deposits in such an account cannot be readily converted to cash and therefore shall be deducted in determining the member's net capital under Exchange Act Rule 15c3-1[41] and FINRA Rule 4110.

➢ Compliance with Continuing Membership Application Rule (Proposed Rule 4111.02 - Compliance with Rule 1017)

Proposed Supplementary Material .02 would clarify that nothing in proposed Rule 4111 would alter a member firm's obligations under Rule 1017 (Application for

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40 See Exhibit 5.

41 17 CFR 240.15c3-1.

Approval of Change in Ownership, Control, or Business Operations). A member firm subject to proposed Rule 4111 would need to continue complying with the requirements of Rule 1017 and submit continuing membership applications as necessary.

- Examples of Conditions and Restrictions (Proposed Rule 4111.03)

In a change from Regulatory Notice 19-17, FINRA is proposing to add, in supplementary material to proposed Rule 4111, a non-exhaustive list of examples of conditions and restrictions that the Department could impose on Restricted Firms. FINRA believes that providing these examples will provide clarity about the Department's authority to impose conditions and restrictions without restricting the Department's flexibility to react and respond to different sources of risk. The non-exhaustive list of examples of conditions and restrictions includes: (1) limitations on business expansions, mergers, consolidations or changes in control; (2) filing all advertising with FINRA's Department of Advertising Regulation; (3) imposing requirements on establishing and supervising offices; (4) requiring a compliance audit by a qualified, independent third party; (5) limiting business lines or product types offered; (6) limiting the opening of new customer accounts; (7) limiting approvals of registered persons entering into borrowing or lending arrangements with their customers; (8) requiring the member to impose specific conditions or limitations on, or to prohibit, registered persons' outside business activities of which the member has received notice pursuant to Rule 3270; and (9) requiring the member to prohibit or, as part of its supervision of approved private securities transactions for compensation under Rule 3280 or otherwise, impose specific conditions on associated persons' participation in private securities transactions of which the member has received notice pursuant to Rule 3280.

➢ Planned Review of Proposed Rule 4111

FINRA plans to conduct a review of proposed Rule 4111 after gaining sufficient experience under proposed Rule 4111. Among other things, FINRA would review whether the Preliminary Identification Metrics Thresholds remain targeted and effective at identifying member firms that pose higher risks.

Proposed Amendments to the Rule 9550 Series to Establish a New Expedited Proceeding to Implement the Requirements of Proposed Rule 4111

FINRA is proposing to establish a new expedited proceeding in proposed Rule 9561 (Procedures for Regulating Activities Under Rule 4111) that would allow member firms to request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and grant a right to challenge any of the "Rule 4111 Requirements," including any Restricted Deposit Requirements, imposed.[42] The new expedited proceeding would govern how the Department provides notice of its determinations and afford affected member firms the right to seek a Hearing Officer's review of those determinations. The proposed expedited proceeding is similar in nature to FINRA's other expedited proceedings.

➢ Notices Under Proposed Rule 4111 (Proposed Rule 9561(a))

Proposed Rule 9561(a) would establish an expedited proceeding for the Department's determinations under proposed Rule 4111 to designate a member firm as a Restricted Firm and impose obligations on the member; and to deny a member's request to access all or part of its Restricted Deposit Requirement.

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[42] Proposed Rule 9561(a)(1) would define the "Rule 4111 Requirements" to mean the requirements, conditions, or restrictions imposed by a Department determination under proposed Rule 4111.

Proposed Rule 9561(a) would require the Department to serve a notice that provides its determination and the specific grounds and factual basis for the Department's action; states when the action will take effect; informs the member firm that it may file, pursuant to Rule 9559, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explains the Hearing Officer's authority. The proposed rule also would provide that, if a member firm does not request a hearing, the notice of the Department's determination will constitute final FINRA action.

Proposed Rule 9561(a) also would provide that any of the Rule 4111 Requirements imposed in a notice issued under proposed Rule 9561(a) are immediately effective. In general, a request for a hearing would not stay those requirements. There would be one partial exception: when a member firm requests review of a Department determination under proposed Rule 4111 that imposes a Restricted Deposit Requirement on the member for the first time, the member firm would be required to deposit, while the expedited proceeding was pending, the lesser of 25% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year.

- <u>Notice for Failure to Comply with the Proposed Rule 4111 Requirements (Proposed Rule 9561(b))</u>

Proposed Rule 9561(b) would establish an expedited proceeding to address a member firm's failure to comply with any requirements imposed pursuant to proposed Rule 4111.

Proposed Rule 9561(b) would authorize the Department, after receiving authorization from FINRA's chief executive officer ("CEO"), or such other executive officer as the CEO may designate, to serve a notice stating that the member firm's failure to comply with the Rule 4111 Requirements, within seven days of service of the notice, will result in a suspension or cancellation of membership. The proposed rule would require that the notice identify the requirements with which the member firm is alleged to have not complied; include a statement of facts specifying the alleged failure; state when the action will take effect; explain what the member firm must do to avoid the suspension or cancellation; inform the member firm that it may file, pursuant to Rule 9559, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explain the Hearing Officer's authority. The proposed rule also would provide that, if a member firm does not request a hearing, the suspension or cancellation will become effective seven days after service of the notice.

Proposed Rule 9561(b) also would provide that a member firm could file a request seeking termination of a suspension imposed pursuant to the rule, on the ground of full compliance with the notice or decision. The proposed rule would authorize the head of the Department to grant relief for good cause shown.

➢ Hearings (Proposed Amendments to the Hearing Procedures Rule)

If a member firm requests a hearing under proposed Rule 9561, the hearing would be subject to Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series). FINRA is proposing several amendments to Rule 9559 that would be specific to hearings requested pursuant to proposed Rule 9561.

Hearings in expedited proceedings under proposed Rule 9561 would have processes that are similar to the hearings in most of FINRA's other expedited proceedings—including requirements for the parties' exchange of documents and exhibits, the time for conducting the hearing, evidence, the record of the hearing, the record of the proceeding, failures to appear, the timing and contents of the Hearing Officer's decision, the Hearing Officer's authority, and the authority of the NAC to call an expedited proceeding for review—and FINRA is proposing amendments to the Rule 9559 provisions that govern these processes to adapt them for expedited proceedings under proposed Rule 9561. A few features of the proposed amendments to Rule 9559 warrant emphasis or guidance.

- <u>Hearing Officer's Authority (Proposed Amended Rule 9559(d) and (n))</u>

Hearings in expedited proceedings under proposed Rule 9561 would be presided over by a Hearing Officer. The Hearing Officer's authority would differ depending on whether the hearing is in an action brought under proposed Rule 9561(a) (Notices Under Rule 4111) or 9561(b) (Notice for Failure to Comply with the Rule 4111 Requirements).

Proposed amended Rule 9559(n)(6) would provide that the Hearing Officer, in actions brought under proposed Rule 9561(a), may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the Department, but may not modify any of the Rule 4111 Requirements, or impose any other requirements or obligations available under proposed Rule 4111.

Proposed amended Rule 9559(n)(6) would authorize the Hearing Officer, in failure-to-comply actions under proposed Rule 9561(b), to approve or withdraw the suspension or cancellation of membership, and impose any other fitting sanction. Authorizing a Hearing Officer to impose any other fitting sanction is intended to provide a Hearing Officer with authority that is appropriate for responding to situations involving member firms that repeatedly fail to comply with an effective FINRA action under proposed Rule 4111.

- Timing Requirements

The proposed amendments to the Hearing Procedures Rule are intended to give member firms a prompt process for challenging a Department decision under proposed Rule 4111. Proposed amended Rule 9559(f) would require that a hearing in actions under proposed Rule 9561(a) be held within 30 days, and that a hearing in failure-to-comply actions under proposed Rule 9561(b) be held within 14 days, after the member firm requests a hearing.[43]

Proposed amended Rule 9559(o) would require the Hearing Officer, in all actions pursuant to proposed Rule 9561, to prepare a proposed written decision, and provide it to the NAC's Review Subcommittee, within 60 days of the date of the close of the hearing. Pursuant to Rule 9559(q), the Review Subcommittee could call the proceeding for review within 21 days after receipt of the proposed decision. As in most expedited proceedings, the timing of FINRA's final decision would then depend on whether or not the Review Subcommittee calls the matter for review.[44]

- Contents of the Decision

Proposed amended Rule 9559(p) would govern the contents of the Hearing Officer's decision. The proposed amendments would broaden Rule 9559(p)(6) to account for the kinds of obligations that could be imposed under proposed Rule 4111. Rule 9559(p) would otherwise remain the same. For example, Rule 9559(p) would

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[43] Proposed amendments to Rule 9559 contain other related timing requirements for proceedings pursuant to proposed Rule 9561.

[44] See FINRA Rule 9559(q).

continue to require that the Hearing Officer's decision include a statement setting forth the findings of fact with respect to any act or practice the respondent was alleged to have committed or omitted or any condition specified in the notice, the Hearing Officer's conclusions regarding the condition specified in the notice, and a statement in support of the disposition of the principal issues raised in the proceeding.

Additional guidance may be helpful, considering the different kinds of issues that may arise in an expedited proceeding pursuant to proposed Rule 9561. For example, in a request for a hearing of a Department determination that imposes a Restricted Deposit Requirement or other obligations under Rule 4111, the principal issues raised may include whether: (1) the member firm should not be designated a Restricted Firm; (2) the Department incorrectly included disclosure events when calculating whether the member firm meets the Preliminary Criteria for Identification; (3) a Restricted Deposit Requirement would impose an undue financial burden on the member firm; or (4) the obligations imposed are inconsistent with the standards set forth in proposed Rule 4111(e). In a request for a hearing of a Department determination that denies a request to withdraw amounts from a Restricted Deposit Account, the principal issues raised may include whether the member firm or its Associated Persons have Covered Pending Arbitration Claims or unpaid arbitration awards and the nature of those claims or awards.

- No Collateral Attacks on Underlying Disclosure Events

In expedited proceedings pursuant to proposed Rule 9561(a) to review a Department determination under the Restricted Firm Obligations Rule, a member firm may sometimes seek to demonstrate that the Department included incorrectly disclosure events when calculating whether the member firm meets the Preliminary Criteria for

Identification. When the member firm does so, however, it would not be permitted to collaterally attack the underlying merits of those final actions. An expedited proceeding under proposed Rule 9561 would not be the forum for attempting to re-litigate past final actions.[45]

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 60 days following Commission approval. The effective date will be no later than 60 days following publication of the Regulatory Notice announcing Commission approval.[46]

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[45] Attempts to collaterally attack final matters are also precluded in other FINRA proceedings. Cf. Dep't of Enforcement v. Amundsen, Complaint No. 2010021916601, 2012 FINRA Discip. LEXIS 54, at *21-24 (FINRA NAC Sept. 20, 2012) (rejecting respondent's attempt to collaterally attack a judgment that was required to be disclosed on Form U4), aff'd, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148 (Apr. 18, 2013), aff'd, 575 F. App'x 1 (D.C. Cir. 2014); Membership Continuance Application of Member Firm, Application No. 20060058633, 2007 FINRA Discip. LEXIS 31, at *51 (July 2007) (holding, in a membership proceeding, that a firm may not address its and its FINOP's past disciplinary history by collaterally attacking those past violations) (citing BFG Sec., Inc., 55 S.E.C. 276, 279 n.5 (2001)); Jan Biesiadecki, 53 S.E.C. 182, 185 (1997) (describing, in eligibility proceedings, FINRA's long-standing policy of prohibiting collateral attacks on underlying disqualifying events).

[46] FINRA notes that the proposed rule change would impact all member firms, including member firms that have elected to be treated as capital acquisition brokers ("CABs"), given that the CAB rule set incorporates the FINRA Rule 9550 Series by reference. In addition, FINRA is proposing to adopt CAB Rule 412, to reflect that a CAB would be subject to Rule 4111.

The proposed rule change would not impact, however, member firms that are funding portals. At this time, regulatory experience with funding portals is still at an early stage. The permissible business activities of funding portals are limited and, as such, it is not clear that funding portals present the corresponding risks that FINRA is seeking to address in the broker-dealer space. Moreover, developing relevant metrics and thresholds for funding portals would require a separate effort and analysis because, unlike broker-dealers, the Uniform Registration Forms do not apply to funding portals and their associated persons. Accordingly, FINRA is proposing to amend Funding Portal Rule 900(a) to add

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[47] 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 member firms with a significant history of misconduct, including firms at which individuals with a significant history of misconduct concentrate. The proposed rule would create strong measures of deterrence while a firm is designated as a Restricted Firm, limiting the potential for harm to the public. It also should create incentives for firms to change behaviors and activities, either to avoid being designated as a Restricted Firm or lose an existing Restricted Firm designation, to mitigate FINRA's concerns.

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.

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.

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proposed Rule 9561 as a rule to which funding portal members would not be subject.

[47] 15 U.S.C. 78o-3(b)(6).

Economic Impact Assessment

1. Regulatory Need

FINRA uses a number of measures to deter and discipline misconduct by firms and brokers, and continually strives to strengthen its oversight of the brokers and firms it regulates. These measures span across several FINRA programs, including review of new and continuing membership applications, risk monitoring of broker and firm activity, cycle and cause examinations, and enforcement and disciplinary actions.

As part of its efforts to monitor and deter misconduct, FINRA has adopted rules that impose supervisory obligations on firms to ensure they are appropriately supervising their brokers' activities. These rules require each firm 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. Under this regulatory framework, FINRA also provides guidance to ensure consistency in interpretation of the rules and to further strengthen compliance across firms. As such, all firms play an important role in ensuring effective compliance with applicable securities laws and FINRA rules to prevent misconduct. This is consistent with the incentives of economic agents.[48]

Nonetheless, some firms do not effectively carry out these supervisory obligations to ensure compliance and they act in ways that could harm their customers—sometimes

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48 See, e.g., Roland Strausz, Delegation of Monitoring in a Principal-Agent Relationship, Rev. Econ. Stud. 64(3):337-57 (July 1997). The paper shows that in a standard principal-agent framework, the delegation of monitoring by the principal (e.g., a regulator) to the agent (e.g., a firm) can be economically efficient for both parties.

substantially. For example, recent academic studies find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence of predictability of future disciplinary and other regulatory-related events for brokers and firms with a history of past similar events.[49] These patterns suggest that some firms may not be acting appropriately as a first line of defense to prevent customer harm. Further, some firms may take advantage of the fair-process protections afforded to them under the federal securities laws and FINRA rules to forestall timely and appropriate regulatory actions, thereby limiting FINRA's ability to curb misconduct promptly. Without additional protections, the risk of potential customer harm may continue to exist at firms that fail to effectively carry out their supervisory obligations or are associated with a significant number of regulatory-related events. Further, even where harmed investors obtain arbitration awards, harm followed by recompense typically comes with some economic costs to customers and brokers, and firms may still fail to pay those awards. Unpaid arbitration awards harm successful customer claimants and may diminish investors' confidence in the arbitration process.[50]

To mitigate these risks, FINRA seeks additional authority to impose obligations on firms that pose these types of greater risk to their customers. The proposed Restricted Firm Obligations Rule would identify firms based upon a concentration of significant firm and broker events on their disclosure records that meet the proposed criteria and

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[49] See supra note 5.

[50] Investors may also file claims in courts or other dispute resolution forums. Successful claimants in these forums may face similar challenges associated with collecting awards or judgments.

specified thresholds. Under the proposal, FINRA seeks to impose obligations on the operations and activities of the member and its associated persons that are necessary or appropriate to address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

2. Economic Baseline

The economic baseline used to evaluate the economic impacts of the proposed rules is the current regulatory framework, including FINRA rules relating to supervision, the membership application process, statutory disqualification proceedings and disciplinary proceedings that provide rules to deter and discipline misconduct by firms and brokers. This baseline serves as the primary point of comparison for assessing economic impacts of the proposed rules, including incremental benefits and costs.

The proposals are intended to apply to firms that pose far greater risks to their customers than other firms. One identifier of these types of firms is that they and their brokers generally have substantially more regulatory-related events on their records than do their peers.[51] Consistent with this, the proposed Restricted Firm Obligations Rule would specifically apply to firms that have far more Registered Person and Member Firm Events, or far higher concentrations of Registered Persons Associated with Previously Expelled Firms, compared to their peers.[52] Based on staff analysis of all firms registered

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51 As discussed above, recent studies provide evidence of predictability of future regulatory-related events for brokers and firms with a history of past regulatory-related events. As a result, brokers and firms with a history of past regulatory-related events pose greater risk of future harm to their customers than other brokers and firms.

52 For example, for each of the six Preliminary Identification Metrics, the Preliminary Identification Metrics Threshold was chosen to capture one to five percent of the firms with the highest number of events per registered broker or the

with FINRA between 2013 and 2019, firms that would have met the Preliminary Criteria for Identification had on average four to nine times more Registered Person and Member Firm Events than peer firms at the time of identification. Specifically, the number of events per firm, for firms that would have met the Preliminary Criteria for Identification, ranged, on average, from 25-52 events during the Evaluation Period, compared to 4-5 events per firm for firms that would not have met the Preliminary Criteria for Identification. The median number of events per firm, for the firms that would have met the Preliminary Criteria for Identification, ranged from approximately 9-18 events, compared to zero events among other firms that would not have met the Preliminary Criteria for Identification.

Although disciplinary and regulatory-related events are one of the identifiers for firms posing higher risk, FINRA recognizes that firms posing higher risks do not always manifest themselves with greater disclosures on their records. These firms may be newer, have recently made changes in management, staff or approach, or simply may be more effective in avoiding regulatory marks.

3. <u>Economic Impacts</u>

A. <u>Proposed Restricted Firm Obligations Rule</u>

To estimate the number and types of firms that would meet the Preliminary Criteria for Identification, FINRA analyzed the categories of events and conditions associated with the proposed criteria for all firms during the 2013-2019 review period. For each year, FINRA determined the approximate number of firms that would have met the proposed criteria. The number of firms that would have met the proposed criteria

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highest concentrations of Registered Persons Associated with Previously Expelled Firms, in respective firm-size categories.

during the review period serves as a reasonable estimate for the number of firms that would have been directly impacted by this proposal had it been in place at the time. This analysis indicates that there were 45-80 such firms at the end of each year during the review period, as shown in Exhibit 3a. These firms represent 1.3-2.0% of all firms registered with FINRA in any year during the review period. The population of firms identified by the proposed criteria reflects the distribution of firm size in the full population of registered firms. Approximately 88-94% of these firms were small, 4-12% were mid-size and 0-3% were large at the end of each year during the review period, as shown in Exhibit 3b.[53]

FINRA notes that the number of firms that would have met the proposed criteria during the review period have declined (by approximately 44%) from 80 firms in 2013 to 45 firms in 2019. This decline is associated with an overall decrease in the number of Registered Person and Member Firm Events and the number of firms associated with these events.[54] Specifically, the Registered Person and Member Firm Events have declined by 24% and the number of firms with one or more of these events has declined by 22% during the review period. However, the average number of events per firm identified by the proposed criteria has increased, suggesting that there may be an increase in concentration of events across a smaller set of firms that may pose greater risks to their

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53 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.

54 FINRA notes that part of the decline in the number of events and the firms that would have met the proposed criteria may be associated with an approximately 15% decline in the overall number of registered firms during the 2013-2019 review period.

customers. For example, the average number of Registered Person and Member Firm Events for the firms identified by the criteria has increased by 94% from 24 events per firm in 2013 to 47 events per firm in 2019. These trends over the 2013-2019 review period suggest that while many firms continue to improve their regulatory records over time, a small proportion of firms may continue to further engage in activities that pose greater risks to their customers, which the proposed rule is intended to address.

In developing the proposed Preliminary Criteria for Identification, FINRA paid significant attention to the impact of possible misidentification of firms, specifically, the economic trade-off between including firms that are less likely to subsequently pose risk of harm to customers, and not including firms that are more likely to subsequently pose risk of harm to customers. There are costs associated with both types of misidentifications.[55] The proposed criteria, including the proposed numerical thresholds, aim to balance these economic trade-offs associated with over- and under-identification.[56] Further protection against misidentification would be provided by the proposed initial Department evaluation and the Consultation process.

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55 For example, subjecting firms that are less likely to pose a risk to customers to the proposed Restricted Deposit Requirement or other obligations would impose additional and unwarranted costs on these firms, their brokers and their customers.

56 In order to evaluate the effectiveness of the proposed criteria at identifying firms that pose greater risks, FINRA examined the overlap between the firms that would have met the Preliminary Criteria for Identification each year during the review period and the firms that were subsequently expelled, associated with unpaid awards, or identified by Department staff as suitable candidates for additional obligations. Finally, as discussed below, FINRA also examined disclosure events associated with firms that would have met the Preliminary Criteria for Identification each year during the review period, subsequent to meeting the criteria, to assess the extent of risk posed by these firms.

➢ Anticipated Benefits

The proposal's primary benefit would be to reduce the risk and associated costs of possible future customer harm. This benefit would arise directly from additional restrictions placed on firms identified as Restricted Firms and resulting expected increased scrutiny by these firms on their brokers. Further, this benefit would also accrue indirectly from improvements in the compliance culture, both by firms that meet the proposed criteria and by firms that do not. For example, the proposal may create incentives for firms that meet the Preliminary Criteria for Identification to change activities and behaviors, to mitigate the Department's concerns. Similarly, the proposal may have a deterrent effect on firms that do not meet the Preliminary Criteria for Identification, particularly firms that may be close to meeting the proposed criteria. These firms may change behavior and enhance their compliance culture in ways that better protect their customers.

The proposal also may help address unpaid arbitration awards. Under the proposed rule, the Department may require a Restricted Firm to maintain a restricted deposit at a bank or a clearing firm that agrees not to permit withdrawals absent FINRA's approval. The amount of the Restricted Deposit Requirement would take into consideration, among other factors, the amount of any Covered Pending Arbitration Claims and unpaid arbitration awards against the member firm or its Associated Persons. Moreover, the proposed rule would have presumptions that the Department would: (a) deny an application by a member firm or former member firm that was previously designated as a Restricted Firm for a withdrawal from the Restricted Deposit if the member firm, its Associated Persons who are owners or control persons, or the former member firm have any Covered Pending Arbitration Claims or unpaid arbitration awards, or if the member firm's Associated Persons have any Covered Pending Arbitration Claims or unpaid arbitration awards relating to arbitrations that involved conduct or alleged conduct that occurred while associated with the member firm; but (b) approve a former member firm's application for withdrawal if the former member firm commits in the manner specified by the Department to use the amount it seeks to withdraw from its Restricted Deposit to pay the former member firm's specified unpaid arbitration awards. Accordingly, the proposed rule could potentially create incentives for firms to pay unpaid arbitration awards against the firm or its Associated Persons, thereby alleviating, to some extent, harm to successful claimants and enhancing investor confidence in the arbitration process.[57]

To scope these potential benefits and assess the potential risk posed by firms that would meet the proposed Preliminary Criteria for Identification, FINRA evaluated the extent to which firms that would have met the criteria during 2013-2017[58] (had the criteria existed) and their brokers were associated with "new" Registered Person and Member Firm Events after having met the proposed criteria. These "new" events correspond to events that were identified or occurred after the firm's identification, and do not include events that were pending at the time of identification and subsequently

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[57] Further, as discussed above, the Department would consider a member firm's and its Associated Persons' unpaid arbitration awards as one of the factors in determining the amount of the Restricted Deposit Requirement. As a result, there would be additional incentives to pay unpaid arbitration awards.

[58] This analysis examines firms that would have met the Preliminary Criteria for Identification from 2013 until 2017 (instead of the 2013-2019 review period) to allow sufficient time for the "new" events to resolve in the post-identification period.

resolved in the years after identification. As shown in Exhibit 3c, FINRA estimates that there were 77 firms that would have met the Preliminary Criteria for Identification in 2013. These firms were associated with 1,552 "new" Registered Person and Member Firm Events that occurred after their identification, between 2014 and 2019. Exhibit 3c similarly shows the number of events associated with firms that would have met the Preliminary Criteria for Identification in 2014, 2015, 2016 and 2017. Across 2013-2017, there were 180 unique firms[59] that would have met the proposed Preliminary Criteria for Identification, and these firms were associated with a total of 2,995 Registered Person and Member Firm Events that occurred in the years after they met the proposed criteria.[60]

Exhibit 3c also shows the number of Registered Person and Member Firm Events for these firms compared to other firms. Specifically, FINRA calculated a factor which represents a multiple for the average number of events (on a per registered person basis) for firms that would have met the Preliminary Criteria for Identification relative to other firms of the same size that would not have met the Preliminary Criteria for Identification. For example, as shown in Exhibit 3c, the factor of 6.1x for 2013 indicates that firms meeting the Preliminary Criteria for Identification in 2013 had 6.1 times more new disclosure events (per registered person) in the years after identification (2014-2019) than other firms of the same size registered in 2013 that would not have met the Preliminary Criteria for Identification. Overall, this analysis demonstrates that firms that would have

[59] Certain firms would have met the criteria in multiple years during the review period. The 180 firms discussed in the text correspond to the unique number of firms that would have met the criteria in one or more years during the review period.

[60] Specifically, FINRA examined and counted all Registered Person and Member Firm Events that occurred any time after the firms were identified until December 31, 2019.

met the Preliminary Criteria for Identification during the 2013-2017 period had on average approximately 6-20 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the Preliminary Criteria for Identification.

- Anticipated Costs

The anticipated costs of this proposal would fall primarily upon firms that meet the Preliminary Criteria for Identification and that the Department deems to warrant further review after its initial evaluation. Although FINRA would perform the annual calculation and conduct an internal evaluation, firms may choose to expend effort to monitor whether they would meet the Preliminary Criteria for Identification, and incur associated costs, at their own discretion. To the extent that a firm deemed to warrant further review under proposed Rule 4111 chooses to seek to rebut the presumption that it is a Restricted Firm subject to the maximum Restricted Deposit Requirement, it would incur costs associated with collecting and providing information to FINRA. For example, these firms may provide information on any disclosure events that may be duplicative or not sales-practice related. These firms may also provide information on any undue significant financial hardship that would result from a maximum Restricted Deposit Requirement. Likewise, a firm availing itself of the one-time staffing reduction opportunity incurs the separation costs, along with the potential for lost future revenues.

In addition, firms subject to a Restricted Deposit Requirement or other obligations would incur costs associated with these additional obligations. These would include, for example, costs associated with setting up the Restricted Deposit Account and ongoing compliance costs associated with maintaining the account. Further, as a result of restrictions on the use of cash or qualified securities in the deposit account or other restrictions on the firm's activities, the firm may lose economic opportunities, and its customers may lose the benefits associated with the provision of these services.

Similarly, a firm required to apply heightened supervision to its brokers would incur implementation and ongoing costs associated with its heightened supervision plan.[61] Firms that meet the Preliminary Criteria for Identification also may incur costs associated with enhancing their compliance culture, including possibly terminating registered persons with a significant number of disclosure events—through exercising the one-time staffing reduction option under proposed Rule 4111 or otherwise—and reassigning the responsibilities of these individuals to other registered persons. Finally, there may be indirect costs, including greater difficulty or increased cost associated with maintaining a clearing arrangement, loss of trading partners, or similar impairments where third parties can determine that a firm meets the proposed Preliminary Criteria for Identification or has been deemed to be a Restricted Firm.

Firms that do not meet the proposed Preliminary Criteria for Identification, particularly ones that understand they are close to meeting the proposed criteria, also may incur costs associated with enhancing their compliance culture or making other changes in order to avoid meeting the proposed criteria in the future. These costs may include terminating registered persons with disciplinary records, replacing them with existing or

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61 These costs would likely vary significantly across firms. Costs would depend on the specific obligations imposed specific to the firm and its business model. In addition, costs could escalate if a heightened supervision plan applied to brokers that serve as principals, executive managers, owners, or in other senior capacities. Such plans may entail reassignments of responsibilities, restructuring within senior management and leadership, and more complex oversight and governance approaches.

new hires, enhancing compliance policies and procedures, and improving supervision of registered persons. Finally, registered persons with significant number of disciplinary or other disclosure events on their records may find it difficult to retain employment, or get employed by new firms, particularly where those firms and their associated registered persons already have disciplinary records. Similarly, firms meeting the proposed criteria or those close to meeting the proposed criteria may find it difficult to hire registered persons with disclosure events. FINRA notes, however, that the anticipated economic impacts on firms hiring and registered persons seeking employment would likely be limited to a small proportion of registered persons and member firms.[62]

- Other Economic Impacts

FINRA also has considered the possibility that, in some cases, this proposal may impose restrictions on brokers' and firms' activities that are less likely to subsequently harm their customers. In such cases, these brokers and firms may lose economic opportunities or find it difficult to retain brokers or customers. FINRA believes that the proposal mitigates such risks by requiring an initial layer of Departmental review, and providing affected firms an opportunity to engage in a Consultation with the Department and request a review of the Department's determination in an expedited proceeding.

FINRA also considered that some firms may consider not reporting, underreporting, or failing to file timely, required disclosures on Uniform Registration

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[62] For example, during the 2013 to 2019 review period, only one to two percent of the registered persons had any qualifying events in their regulatory records, which represents the most conservative estimate of the set of registered persons who might be impacted by the proposed rule. Further, the vast majority of member firms, approximately 98%, would likely be able to employ most of the individuals seeking employment in the industry—including ones who have some disclosures—without coming close to meeting the Preliminary Criteria for Identification.

Forms in an effort to avoid costs associated with the proposals. However, this potential impact is mitigated because many events are reported by regulators or in separate public notices by third parties and, as a result, FINRA can monitor for these unreported events. Further, failing to timely update Uniform Registration Forms is a violation of FINRA rules and can result in fines and penalties, thereby serving as a deterrent for underreporting, misreporting and failing to file timely required disclosures.

Considering that the proposed criteria are based on a firm's experience relative to its similarly sized peers, FINRA does not believe that the proposed criteria impose costs on competition between firms of different sizes. Further, because FINRA would perform the annual calculation to determine the firms that meet the Preliminary Criteria for Identification, the costs a firm incurs to monitor its status in relation to the proposed criteria would be discretionary and not likely create any competitive disadvantage based on firm size. Although the proposed rule would not impose these monitoring costs, FINRA would provide transparency around how the Preliminary Criteria for Identification are calculated and appropriate guidance to assist firms seeking to monitor their status. Similarly, FINRA does not anticipate that the proposed Restricted Firm Obligations Rule, including the Restricted Deposit Requirement or any required conditions and restrictions, would create competitive disadvantages across firms of different sizes. This is, in part, because FINRA would consider the number of offices and registered persons, among other factors, when determining the appropriate maximum Restricted Deposit Requirement or any conditions and restrictions, to ensure that the obligations are appropriately tailored to the firm's business model but do not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the ensuing 12 months.

As discussed above, FINRA would exercise some discretion in determining the maximum Restricted Deposit Requirement and tailor it to the size, operations and financial conditions of the firm, among other factors. This approach is intended to align with FINRA's objective to have the specific financial obligation be significant enough to change a Restricted Firm's behavior but not so burdensome that it would indirectly force it out of business. In determining the specific maximum Restricted Deposit Requirement, FINRA would consider a range of factors, including the nature of the firm's operations and activities, revenues, commissions, assets, liabilities, expenses, net capital, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, insurance coverage for customer arbitration awards or settlements, concerns raised during FINRA exams, and the amount of any of the firm's or its Associated Persons' "Covered Pending Arbitration Claims" or unpaid arbitration awards. In developing the proposal, FINRA considered the possibility of having a transparent formula, based on some of these factors, to determine a maximum Restricted Deposit Requirement. However, as discussed in more detail below, given the range of relevant factors and differences in firms' business models, operations, and financial conditions, FINRA decided not to propose a uniform, formulaic approach across all firms.

In developing the proposal, FINRA also considered the possibility that the size of the maximum Restricted Deposit Requirement may be too burdensome for the firms, and could undermine their financial stability and operational capability. FINRA believes that these risks are mitigated by providing affected firms an opportunity to engage in a

Consultation process with FINRA and propose a lesser Restricted Deposit Requirement or restrictions or conditions on their operations. Further, as discussed above, Restricted Firms would have the opportunity to request a review of the Department's determination in an expedited proceeding.

B. Proposed Expedited Proceeding Rule

When FINRA imposes obligations on a firm pursuant to the proposed Restricted Firm Obligations Rule, the firm may experience significant limitations to its business activities and incur direct and indirect costs associated with the obligations imposed. The proposed Expedited Proceeding Rule would, in general, require that these obligations apply immediately, even during the pendency of any appeal.

The proposed rule would be associated with investor protection benefits through the impact of the no-stay provision in proposed Rule 9561(a)(4). Under the proposal, obligations imposed by the Department would be effective immediately, except that a firm that is subject to a Restricted Deposit Requirement under proposed Rule 4111 and requests a hearing would be required to make only a partial deposit while the hearing is pending. This would reduce the risk of investor harm during the pendency of a hearing. Similarly, the no-stay provision may limit hearing requests by firms that seek to use them only as a way to forestall FINRA obligations.

The benefit of the proposed rule accruing to firms would be to permit firms to appeal FINRA's determinations (both to request prompt review of obligations imposed or of determinations for failure to comply) in an expedited proceeding, thereby reducing undue costs where firms may have been misidentified or where the obligations imposed are not necessary or appropriate to address the concerns indicated by the Preliminary

Criteria for Identification and protect investors and the public interest. For example, the proposed rule is anticipated to reduce any undue costs by the proceeding's expedited nature. Similarly, the proposed rule's time deadlines may also reduce the costs of the proceedings, in certain cases.

The costs would be borne by firms that choose to seek review via the proposed expedited proceeding, and these costs can be measured relative to a standard proceeding. These firms would incur costs associated with provisions and procedures specific to this proposed rule, including the provision that the obligations imposed would not be stayed.[63] This would include the obligations imposed under the proposed rule, including the Restricted Deposit Requirement, and the requirement that the firm, upon the Department's request, provide evidence of its compliance with these obligations. However, the extent of the costs associated with the Restricted Deposit Requirement would be mitigated by the expedited nature of the proceeding and by the provision that would require a firm, during the pendency of an expedited hearing process, to maintain only a partial deposit requirement.

As with the other proposals, FINRA does not anticipate that the proposed rule would have differential competitive effects based on firm size or other criteria. The costs and benefits are anticipated to apply to all firms that request a hearing in an expedited proceeding.

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63 The effect of the no-stay provision is that imposed obligations would apply immediately, even during the pendency of any hearing request. As a result, the no-stay provision would impose direct costs on misidentified firms or firms for which the obligations imposed are not necessary or appropriate.

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 firms, brokers, regulators, investors and the public. Accordingly, in developing its rule proposals, FINRA seeks to identify ways to enhance the efficiency and effectiveness of the proposed rules while maintaining their regulatory objectives. For example, FINRA considered several alternatives to addressing the risks posed by firms and their brokers that have a history of misconduct, including alternative approaches and alternative specifications to the numeric threshold based-approach and the Restricted Deposit Requirement.

A. Alternative to the Proposed Numeric Threshold-based Approach

In addition to the proposed approach based on numeric thresholds, FINRA considered an approach similar to the Investment Industry Regulatory Organization of Canada's (IIROC) "terms and conditions" rule, IIROC Consolidated Rule 9208, that would allow FINRA to identify a limited number of firms with significant compliance failures and impose on them appropriate terms and conditions to ensure their continuing compliance with the securities laws, the rules thereunder, and FINRA rules.[64] FINRA considered and evaluated the economic impacts of such a terms and conditions rule relative to proposed Rule 4111.

Compared to proposed Rule 4111, a terms and conditions rule would provide FINRA with greater flexibility in identifying firms that should be subject to additional

64 IIROC Consolidated Rule 9208 permits IIROC to impose terms and conditions on an IIROC Dealer Member's membership when IIROC considers these terms and conditions appropriate to ensure the member's continuing compliance with IIROC requirements.

obligations. This greater flexibility could help better target its application and reduce misidentification by allowing FINRA to leverage non-public information, including regulatory insights collected as part of its monitoring and examination programs, in identifying firms that pose the greatest risk. Further, under a terms and conditions rule, FINRA could quickly update its identification of firms based on emerging risk patterns, to ensure that the rule continues to be effective at addressing firms that presently pose the greatest risk. This flexibility could mitigate the risk that the criteria and thresholds in proposed Rule 4111 no longer identify the appropriate firms.

Further, as discussed above, the identification criteria in proposed Rule 4111 may not identify all the firms that pose material risk to their customers, such as firms that may act to stay just below the proposed criteria and thresholds by any means, including misreporting or underreporting disclosure events. The absence of a set identification criteria in a terms and conditions rule would make it more difficult for firms to evade the identification criteria and thus could provide greater investor protections.

At the same time, a terms and conditions rule may have certain disadvantages relative to proposed Rule 4111. For example, a benefit of proposed Rule 4111 is the deterrent effect it may have on firms that do not meet the proposed Preliminary Criteria for Identification, particularly firms that may be close to meeting the criteria. These firms may change behavior and enhance their compliance culture in ways that could better protect their customers. By comparison, under a terms and conditions rule, in the absence of transparent criteria, firms would have to assess FINRA's view of the significance of repeated exam findings to determine whether to change their conduct to avoid potential terms and conditions.

Although FINRA has considered, and will continue to explore, this alternative, it is not proposing a terms and conditions rule at this time.

B. Alternative Specifications for the Proposed Numeric Threshold-based Approach

FINRA also considered several alternatives to the numerical thresholds and conditions for the Preliminary Criteria for Identification. In determining the proposed criteria, FINRA focused significant attention on the economic trade-off between incorrect identification of firms that may not subsequently pose risk of harm to their customers, and not including firms that may subsequently pose risk of harm to customers. FINRA also considered three key factors: (1) the different categories of reported disclosure events and metrics, including the Expelled Firm Association Metric; (2) the counting criteria for the number of reported events or conditions; and (3) the time period over which the events or conditions are counted. FINRA considered several alternatives for each of these three factors.

➢ Alternatives Associated with the Categories of Disclosure Events and Metrics

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. FINRA decided to exclude financial disclosures because while financial events, such as bankruptcies, civil bonds, or judgments and liens, may be of interest to investors in evaluating whether or not to engage a broker or a firm, these types of events by themselves are not evidence of customer harm.

In developing the Preliminary Criteria for Identification, FINRA also considered whether pending criminal, internal review, judicial and regulatory events should be excluded from the threshold test. Pending matters are often associated with an emerging pattern of customer harm and capture timely information of potential ongoing or recent misconduct. However, pending matters may include pending regulatory investigations and criminal proceedings that do not result in a finding.[65] FINRA evaluated the impact of eliminating pending matters from the Preliminary Criteria for Identification. Specifically, FINRA identified the firms that would no longer meet the proposed criteria (had the criteria existed) during the evaluation period if pending-events categories were eliminated from the criteria, and examined the extent to which such firms were associated with "new" Registered Person and Member Firm Events. As shown in Exhibit 3d, FINRA estimates that these firms had on average approximately 8.0-13.1 times more new disclosure events than other firms in the industry during the same period that would not have met the Preliminary Criteria for Identification.[66] Accordingly, based on this review

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65 As discussed in more detail below, several commenters expressed concerns about including pending and un-adjudicated events in the Preliminary Criteria for Identification. Commenters suggested that pending events are often associated with frivolous cases and that many pending regulatory investigations and criminal proceedings are discontinued without action.

66 In assessing the impact of removing pending events from the Preliminary Criteria for Identification and restricting the criteria solely to final events, FINRA also examined the number of firms that would have met or exceeded at least one Preliminary Identification Metrics Threshold in the Registered Person Adjudicated Events, Member Firm Adjudicated Events, or Registered Persons Associated with Expelled Firms categories, during the relevant period. This analysis showed that the number of firms identified by this alternative criteria would increase from 45-80 firms to 131-196 firms, each year, during the review period. Similarly, FINRA estimates the number of firms that would have met or exceeded at least two thresholds within these categories to be 32-57 firms, each year, during the review period.

and other validations, FINRA decided to include pending matters in the proposed criteria because they are critical to identifying firms that pose greater risks to their customers.

As with other categories, the proposed Preliminary Identification Metrics Thresholds for the relevant Preliminary Identification Metrics, including the Registered Person Pending Event Metric and the Member Firm Pending Event Metric, are intended to capture firms that are on the far tail of the distributions. Thus, firms meeting these thresholds have far more pending matters on their records than other firms in the industry that do not meet these thresholds. Nonetheless, FINRA recognizes that pending matters include disclosure events that may remain unresolved or that may subsequently be dismissed or concluded with no adverse action because they lack merit or suitable evidence.[67] In order to ensure that a firm does not meet the Preliminary Criteria for Identification solely because of pending matters, FINRA has proposed the conditions that, to meet the criteria, the firm must meet or exceed at least two of the six Preliminary Identification Metrics Thresholds, and at least one of the thresholds for the Registered Person Adjudicated Event Metric, Member Firm Adjudicated Event Metric, or Expelled Firm Association Metric.

In developing the Preliminary Criteria for Identification, FINRA also considered alternatives to the Expelled Firm Association Metric. For example, in Regulatory Notice 19-17, FINRA initially proposed the metric to be based on all registered persons who were previously associated with one or more previously expelled firms, at any time in their career and irrespective of their duration of association at the previously expelled

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[67] 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 arbitrators or judges.

firm. FINRA subsequently narrowed the Expelled Firm Association Metric by only including registered persons who were registered with a previously expelled firm within the prior five years (i.e., whose registration with a previously expelled firm terminated during the prior five years) and who were registered with the expelled firm for at least one year. FINRA selected this formulation to analyze because the five-year lookback is consistent with the lookback periods for the other proposed metrics in the proposal and, based on staff experience, FINRA believes that individuals who are more recently associated with previously expelled firms (e.g., in the last five years) and have longer tenures at expelled firms (e.g., a year or more, instead of a shorter employment duration) generally pose higher risk than other individuals.

In developing the proposal, FINRA conducted several validations on the firms meeting the criteria, including the proposed Expelled Firm Association Metric, by reviewing the extent to which firms identified during 2013-2017 (had the criteria existed) were subsequently expelled, associated with unpaid awards, or identified by the Department as suitable candidates for additional obligations. As discussed above, FINRA also evaluated the extent to which firms that would have met the criteria during 2013-2017 (had the criteria existed) and their brokers were associated with "new" Registered Person and Member Firm Events after having met the criteria. As shown in Exhibit 3c, FINRA estimates that the identified firms had on average approximately 6.1-19.9 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the Preliminary Criteria for Identification. Based on staff review and validations, FINRA believes that the proposed Expelled Firm Association Metric preserves the usefulness of the Preliminary Criteria for

Identification (as originally proposed in Regulatory Notice 19-17) and continues to identify firms that pose greater risks to their customers.

- Alternatives Associated with the Counting Criteria for the Proposed Criteria and Metrics

FINRA considered a range of alternative counting criteria for the Preliminary Criteria for Identification. For example, FINRA considered whether the Preliminary Criteria for Identification should be based on firms meeting two or more Preliminary Identification Metrics Thresholds, or whether the number of required thresholds should be decreased or increased. Decreasing the number of required thresholds from two to one would increase the number of firms that would have met the Preliminary Criteria for Identification during the review period from 45-80 firms to 155-217 firms, each year. Alternatively, increasing the number of required thresholds from two to three would decrease the number of firms that would have met the Preliminary Criteria for Identification from 45-80 firms to 11-20 firms, each year. FINRA reviewed the list of firms identified under these alternative counting criteria and examined the extent to which they included firms that were subsequently expelled, associated with unpaid awards, or identified by the Department as suitable candidates for additional obligations. FINRA also paid particular attention to firms that would have been identified by these alternative criteria but subsequently were not associated with high-risk activity, as well as firms that would not have been identified by these alternatives that were associated with high-risk events. Based on this review, FINRA believes that the proposed approach—meeting two or more of the Preliminary Identification Metrics Thresholds—more appropriately balances these trade-offs between misidentifications than the alternative criteria.

➢ Alternatives Associated with the Time Period over which the Metrics Are Calculated

The proposed Preliminary Identification Metrics are based on two different time periods over which different categories of events and conditions are counted ("lookback periods"). Pending events, including the Registered Person Pending Events and the Member Firm Pending Events categories, are counted in the Preliminary Identification Metrics only if they are pending as of the Evaluation Date. Adjudicated events, including the Registered Person Adjudicated Events and the Member Firm Adjudicated Events categories, and Registered Persons Associated with Previously Expelled Firms are counted in the Preliminary Identification Metrics over a five-year lookback period.[68]

In developing the proposal, FINRA considered alternative criteria for the time period over which the disclosure events or conditions are counted. For example, FINRA considered whether adjudicated events should be counted over the individual's or firm's entire reporting period or counted over a more recent period. Based on its experience, FINRA believes that more recent events (e.g., events occurring in the last five years) generally pose a higher level of possible future risk to customers than other events. Further, counting events over an individual's or firm's entire reporting period would imply that brokers and firms would always be included in the Preliminary Identification Metrics for adjudicated events, even if they subsequently worked without being

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68 Registered Persons In-Scope include all persons registered with the firm for one or more days within the one year prior to the Evaluation Date.

associated with any future adjudicated events. Accordingly, FINRA decided to include adjudicated events only in the more recent period (i.e., a five-year period).[69]

Similarly, FINRA also considered alternative limits on the time periods over which components of the Expelled Firm Association Metric would be calculated. For example, FINRA considered alternative metrics based on only firms that have been expelled within three to five years prior to the Evaluation Date. Further, FINRA considered alternatives where the individual broker's association with the previously expelled firm was within a five-year window around the firm's expulsion. In evaluating these alternatives, FINRA recalculated the underlying thresholds to capture firms that are on the far tail of the distribution for these alternative metrics.[70] As with other alternatives, FINRA conducted several validations on alternative specifications of time periods for calculating the Expelled Firm Association Metric. These validations included reviewing the extent to which firms identified by alternative specifications of the proposed criteria were associated with "new" events after identification, subsequently expelled or associated with unpaid awards, or were identified by the Department as suitable candidates for additional obligations. Based on these validations, FINRA selected the proposed five-year period for calculating the Expelled Firm Association Metric as the alternative specifications did not result in any material change to the proposed criteria's ability to identify firms that pose greater risk of customer harm.[71]

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69 This also is consistent with the time period used for counting "specified risk events" in SR-FINRA-2020-011.

70 These alternatives would have identified approximately the same number of firms as meeting the Preliminary Criteria for Identification, during the review period.

71 For example, as discussed above, FINRA estimates that the firms identified by the proposed criteria (based on a five-year period for calculating the Expelled Firm

C. Alternatives to the Restricted Deposit Requirement

In developing the proposal, FINRA considered alternative approaches to the Restricted Deposit Requirement. For example, FINRA considered increasing the capital requirements on identified firms, in lieu of the Restricted Deposit Requirement. A net capital approach would provide the identified firms greater flexibility and control over the assets. These firms would be able to use the assets for cash flow and operating expenses. As a result, an additional net capital charge would be associated with lower direct and indirect costs to these firms. However, there are several drawbacks with respect to economic incentives and anticipated impacts to relying upon a net capital approach as a tool for addressing the risks posed by firms with a significant history of misconduct. For example, the firm assets that would be maintained pursuant to an increased net capital requirement would not be deposited into a separate restricted account and may be fungible with other firm assets. As a result, these assets could be withdrawn by the identified firms at any time and these firms could employ the capital during the pendency of the restriction period. This suggests that the deterrent effect of an increased net capital approach would be much lower on a dollar-for-dollar basis than the proposed Restricted Deposit Requirement. An increased net capital approach also may not be sufficiently impactful in providing incentives to change firm behavior if a Restricted Firm already maintains substantial excess net capital. Further, considering that the identified firms could withdraw their assets at any time under a net capital approach, FINRA would not be able to ensure that any funds would be available for satisfying

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Association Metric) had on average approximately 6.1-19.9 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the proposed criteria.

unpaid arbitration awards. In light of these considerations, FINRA decided to propose a Restricted Deposit Requirement approach, rather than changes to the capital requirements on identified firms.

FINRA also considered whether the Restricted Deposit Requirement amount should be based on a formula or include a cap in order to provide greater transparency to the member firms. To assess the feasibility of a strict formula or cap in setting the Restricted Deposit Requirement, FINRA assessed the financial condition of the firms that would have been identified by the Preliminary Criteria for Identification in 2019 (if the criteria had existed) and found significant variation across firms. These variations existed even across firms within the same size category. For example, FINRA found that the highest firm's revenues were approximately 1,750 times that of the firm with the lowest revenue when standardized by the number of registered persons at the firm. Within firm size categories, the corresponding difference in revenues per registered person was as high as over 80 times. Similarly, there was significant variation in the reported cash and ownership equity across these firms. The highest firm's excess net capital was over 3,500 times that of the firm with the lowest excess net capital (standardized per registered person).[72] The firm reporting the highest ownership equity was over 2,300 times that of the lowest firm's ownership equity (standardized per registered person). Further, firms' awards and settlements appear to be unrelated to their financial condition. For example, FINRA estimates that over 20% of the identified firms with high awards and settlement amounts have low or medium revenues (on a per registered person basis) or high revenues and low or medium awards and settlement

[72] See Exhibit 3e, which reflects the firms that would have met the Preliminary Criteria for Identification in 2019, had the criteria existed.

amounts.[73] Thus there appears to be no consistent relationship between firm size, and basic metrics of the financial condition of the firm, and potential obligations to harmed customers. Given these significant variations in quantitative factors and the qualitative nature of some of the factors for consideration (e.g., concerns raised during FINRA exams), FINRA decided to maintain the Department's discretion for determining the Restricted Deposit Requirement, instead of proposing a formula or a cap. Additionally, FINRA believes that if the proposal were to include a precise formula, it may undermine the effectiveness of the rule by providing an opportunity for firms to take actions to minimize the expected restricted deposit.

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 19-17 (May 2019). Thirty-two comments were received in response to the Regulatory Notice.[74] Exhibit 2a is a copy of the Regulatory Notice. Exhibit 2b is a list of commenters. Exhibit 2c contains copies of the comment letters received in response to the Regulatory Notice. Of the 32 comment letters received, 11 were generally in favor of the proposed rule change, and 18 were generally opposed.

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73 For purposes of this Form 19b-4, "high" arbitration awards, settlement amounts and revenues means the top tercile (above 66th percentile) of these awards, settlements and revenues among firms that would have met the proposed criteria, and "medium" and "low" arbitration awards, settlement amounts and revenues means the middle tercile (33rd-66th percentile) and bottom tercile (below the 33rd percentile). See Exhibit 3f, which reflects the firms meeting the Preliminary Criteria for Identification in 2019.

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

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 the Proposal

Several commenters expressed general support for the proposed rule changes in Regulatory Notice 19-17.[75] For example, NASAA commended FINRA's attempt to strategically identify, and more strongly regulate, the limited number of member firms with histories of regulatory noncompliance, and stated that the proposal should increase investor protection while imposing minimal burdens on the brokerage industry. Massachusetts called the proposal a positive step toward protecting investors from the riskiest corners of the brokerage industry, and asserted that the proposal rightly places the burden of investor protection on the firms that hire bad brokers and ensures that investors have meaningful recourse when harmed. CAI likewise expressed support for how the proposal would enhance customer protection by imposing additional obligations on a targeted group of firms. SIFMA supported how the proposal fits into FINRA's continuing efforts to help ensure that arbitration claims, awards, and settlements are paid in full. Cetera supported both the concept and manner in which FINRA has approached this effort. Cambridge agreed that an objective data assessment coupled with a comprehensive and transparent review of that data—which is the general structure of the proposed Restricted Firm Obligations Rule—will aid FINRA in identifying those high risk member firms and registered persons contemplated by this proposal.

75 CAI, Cambridge, Cetera, FSI, Massachusetts, MIRC, NASAA, PIABA, PIRC, SIFMA, St. John's SOL. Supportive commenters also suggested ways in which the proposal could be modified or enhanced, which are discussed in more detail below.

General Opposition to the Proposal

Several commenters generally opposed proposed Rule 4111, on a variety of grounds. For example, several commenters wrote that the proposal would disproportionately affect small firms or reflected an attempt to put small firms out of business.[76] PIRC, however, characterized industry objections that the proposed rule would disproportionately affect small firms as unwarranted noting that the rule accounts for different firm sizes in its threshold calculations. Each specific numeric threshold in the Preliminary Identification Metrics Thresholds grid (proposed Rule 4111(i)(11)) represents an outlier with respect to similarly sized peers. Moreover, the process of determining a Restricted Deposit Requirement would require the Department to consider several factors that relate to firm size and a parameter directly influenced by firm size.[77] Thus, while the revised proposal includes several modifications that will lessen some of the original proposal's burdens on all firms, the modifications are not specific to small firms.

Some commenters generally opposed the proposal on the basis of its potential adverse impacts on individuals.[78] For example, some commenters contended that many terminated individuals would have to uproot their lives and be unable to find a new

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76 Brooklight, Colorado FSC, Dempsey, FSI, IBN, Joseph Stone, Luxor, McNally, Moss & Gilmore, Westpark.

77 See proposed Rule 4111(i)(15)(A) (including as factors, inter alia, the "nature of the firm's operations and activities" and "the number of offices and registered persons," and requiring that the Department determine a maximum Restricted Deposit Requirement that "would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months").

78 Brooklight, Dempsey, Joseph Stone, Westpark.

broker-dealer.[79] Brooklight commented that innocent representatives who associated with a firm expelled for firm-level issues would be marked with a “scarlet letter” that could end their careers. Westpark commented that the proposed rule would make it financially untenable for small firms to employ brokers with certain levels of disclosures, essentially making them unemployable. HLBS commented that the proposed rule will allow FINRA to grossly intrude on member firms’ recruiting and termination decisions. Some commenters expressed concern that the proposal would unfairly affect some persons who previously worked at disciplined firms and persons with any regulatory incidents regardless of their intent.[80]

FINRA notes, however, that between 2013 and 2019, only one to two percent of registered persons in any year had any qualifying events in their regulatory records, which represents the most conservative estimate of the set of brokers who might be associated with the proposed rule. Further, approximately 98% of member firms would be able to employ individuals seeking employment in the industry—including ones who have some disclosures and ones who were terminated by Restricted Firms—without meeting the Preliminary Criteria for Identification. Moreover, under a separately proposed rule, a member firm could register an individual who has only one “specified risk event” in their record without having to request a materiality consultation.[81]

For these reasons, FINRA is not proposing to revise proposed Rule 4111 to address these comments, except to narrow the scope of the Expelled Firm Association

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[79] Dempsey, Joseph Stone.

[80] Brooklight, Dempsey, Joseph Stone.

[81] See Securities Exchange Act Release No. 88600 (April 8, 2020), 85 FR 20745 (April 14, 2020) (Notice of Filing of File No. SR-FINRA-2020-011).

Metric. FINRA recognizes that proposed Rule 4111 could result in some firms declining to employ persons who have associated with a firm that has been expelled, even when it would not cause the firm to meet the Preliminary Criteria for Identification. FINRA does not believe this concern—which is similar to how some firms may respond to FINRA's "Taping Rule"[82]—warrants removing the Expelled Firm Association Metric from the Preliminary Criteria for Identification. Nevertheless, as explained more below, FINRA has narrowed the Expelled Firm Association Metric, to narrow its impact on individuals.

Westpark commented that the proposal is inconsistent with Section 15(b)(6) of the Exchange Act, which requires that FINRA rules not be designed to permit unfair discrimination between brokers or dealers, and Section 15A(b)(9) of the Exchange Act, which requires that FINRA rules not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. Proposed Rule 4111, however, will allow FINRA to impose obligations only on the limited number of member firms that pose substantially higher risks to investors compared to their similarly sized peers, and only after a multi-step process that has numerous procedural protections, for the purpose of protecting investors and the public interest. Therefore, FINRA believes the proposal is an appropriate means of protecting investors and the public interest, and is not unfair.[83]

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[82] See Rule 3170 (Tape Recording of Registered Persons by Certain Firms). The Taping Rule provides, in general, that a firm is a "taping firm" when specified percentages of its registered persons have been associated with one or more "disciplined firms" in a registered capacity within the last three years.

[83] See Securities Exchange Act Release No. 17371 (December 12, 1980), 45 FR 83707 (December 19, 1980) (Order Approving File No. SR-NASD-78-3) (explaining that disparate treatment of differently situated parties is not necessarily either fair or unfair).

Several commenters predicted that, for a variety of reasons, the proposal will not achieve its intended goals[84] or commented that the proposal is insufficient.[85] For example: (1) some question the underlying premise of using disclosure data to predict future customer harm;[86] (2) Rockfleet suggested that when a Restricted Deposit Requirement would essentially shut a firm down, the firm would likely terminate its membership and "leav[e] FINRA in exactly the position it is seeking to avoid"; (3) Joseph Stone commented that firms that dilute their concentration of brokers that meet the threshold criteria can still pose risks, and that the proposal will "force firm management to push quality and compliant representatives out of their firms"; (4) Luxor commented that there is no evidence to prove that the proposal will cure the problem it is intended to solve; (5) Massachusetts wrote that the annual calculation is predictable and may provide an incentive for firms to comply only enough to remain just below the triggering thresholds; (6) Cambridge predicted that member firms without significant retained earnings would be given exceptions to the Restricted Deposit Requirement; (7) Network 1 wrote "[t]here will always be 'bad' brokers"; and (8) ASA commented that certain aspects of the proposal "do not go far enough to remove the most egregious actors from our industry" and would "marginally increase the financial obligations of bad actor firms and allow [them] to continue their abuse of Main Street investors."

The primary goal of the proposed rule change is to incentivize members with a significant history of misconduct relative to their peers to change behavior, and FINRA

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84 ASA, Dempsey, Joseph Stone, Luxor, PIABA, Rockfleet, Worden.

85 ASA, Better Markets.

86 Cetera, Dempsey, Luxor.

believes that the proposed rule change is reasonably designed to achieve that goal. The way the proposal identifies the affected firms is consistent with recent academic studies that analyzed correlations between disclosure data and risks to investors. The proposed rule change creates substantial, ongoing incentives for the firms that present the highest levels of risk to change behavior, and gives FINRA an important new tool to respond to those firms that continue to present outlier-level risks to investors. FINRA also believes that the most effective measure to incentivize such firms to change behavior is a financial restriction—including the mere potential for a financial restriction.

Several commenters state that the proposal's impacts are too broad to address the risks posed. For example, Brooklight expressed that instead of impacting just a "few bad actors," the proposal imposes increased regulatory burdens on "every single member" and could "sweep in wholly innocent firms." HLBS commented that the proposed rule would impose punishment based only on the mere suspicion of misconduct. Rockfleet commented that the burdens would be unwarranted, because unpaid arbitration awards are "not a widespread industry issue," and the proposal would unfairly capture firms that only employ a single individual with numerous disclosure events. Sichenzia commented that reducing unpaid arbitration awards is better achieved through less onerous means. FSI expressed concern that the proposal does not provide adequate safeguards to protect against misidentification.

FINRA believes, however, that the proposed rule change is reasonably designed to impact a relatively small number of firms posing outlier-level risks. The proposed Rule 4111 "funnel" process has numerous safeguards designed to protect against misidentification. Furthermore, although the proposal would have ancillary benefits for addressing unpaid arbitration awards, the proposal's primary purpose is to create incentives for members that pose outlier-level risks to change behavior.

Luxor commented that the proposal is inconsistent with the usual "causal relationship inherent in any regulatory schema" where misconduct precedes the sanctions imposed. Proposed Rule 4111, however, is similar to other kinds of rules and regulations that impose requirements and restrictions based on a firm's circumstances. For example, FINRA's membership rules permit FINRA to impose restrictions on new member applicants that are reasonably designed to address specific concerns, including—besides disciplinary concerns—financial, operational, supervisory, investor protection, or other regulatory concerns.[87] As another example, Exchange Act Rule 15c3-1,[88] the Net Capital Rule, imposes different minimum net capital requirements based on the types of securities business the broker-dealer conducts. Moreover, the obligations that FINRA may impose pursuant to Rule 4111 are not "sanctions" for violations; rather, they are obligations that relate directly to firm profiles that pose substantially more risk to investors than the profiles of the vast majority of other member firms of similar sizes.

Some commenters opposed the proposal on the ground that it is unnecessary. For example, Rockfleet commented that FINRA's membership program and examinations should be sufficient to deal with firms that have a poor supervisory structure and compliance culture. Likewise, Network 1 wrote that FINRA's enforcement program is a practical solution for addressing "bad brokers." As explained above, however, while FINRA has a number of tools for identifying and addressing a range of misconduct by

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87 See Rule 1014(c)(2) (describing granting of applications for new membership subject to restrictions).

88 17 CFR 240.15c3-1.

individuals and firms, and has strengthened these protections for investors and the markets, persistent compliance issues continue to arise in some member firms. Proposed Rule 4111 reflects FINRA's belief that more can be done to protect investors from firms with a significant history of misconduct.

Notwithstanding that FINRA has generally retained the proposal as it was originally proposed, FINRA appreciates the concerns raised by the commenters about the potential impacts and effectiveness of proposed Rule 4111. If approved, FINRA plans to review proposed Rule 4111 after gaining sufficient experience under the rule, at which time it will assess the rule's ongoing effectiveness and efficiency.

Concerns that the Proposal Gives FINRA Too Much Discretion, and Requests for Increased Transparency

Several commenters contended that, in numerous respects, the proposal gives FINRA too much discretion.[89] Commenters pointed to how the proposal gives the Department discretion to decide: (1) in the initial Department evaluation stage, which firms require further review; (2) the maximum and actual Restricted Deposit Requirement; and (3) the types of conditions or restrictions that may be imposed.[90] Some commenters further requested that the proposal provide more transparency on how FINRA would exercise its discretion. For example, Sichenzia suggested which kinds of disclosure events FINRA should eliminate from consideration during the initial Department evaluation, and some commenters requested that FINRA clarify how the

89 CAI, Cambridge, FSI, Sichenzia, Westpark.

90 CAI, Cambridge, FSI, Rockfleet, Sichenzia, Westpark, Whitehall.

Department would calculate a Restricted Deposit Requirement[91] and what kinds of conditions or restrictions could be imposed.[92] Some commenters recommended specific conditions and restrictions that FINRA should impose.[93]

FINRA believes that the proposal contains numerous steps that are objective and do not involve the use of discretion or that limit or focus FINRA's discretion. FINRA notes that the annual calculation—the first and most significant step that identifies member firms that are subject to the proposed rule—does not involve the use of discretion. The annual calculation uses objective, transparent criteria to identify outlier firms with the most significant history of misconduct relative to their peers (based on a review of the criteria as if it existed today, the number of member firms would be between 45-80 firms). Following the annual calculation, the Department would conduct an evaluation to review whether it has information that a member firm's calculation included disclosure events or conditions that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk, whether the member has already addressed the concerns signaled by the disclosure events or conditions, or whether the member firm has altered its business operations such that the calculation no longer reflects the member firm's current risk profile. During the Consultation, the Department would evaluate whether the member firm has demonstrated that the calculation included disclosure events that should not have been included (because they are duplicative or not

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[91] CAI, Westpark, Whitehall.

[92] FSI, Massachusetts, NASAA, PIRC, St. John's SOL.

[93] Massachusetts, MIRC, NASAA, St. John's SOL.

sales-practice related). When the Department considers whether a member firm should be subject to the maximum Restricted Deposit Requirement, it will evaluate whether the maximum amount would impose an undue financial hardship and whether a lesser amount, or conditions and restrictions, would satisfy the objectives of the rule and be consistent with the protection of investors and the public interest. The ability to request a Hearing Officer's review also would protect against overreaching.

To ensure that the member firms identified as Restricted Firms are of the type motivating this proposal and incentivize Restricted Firms to reduce the risks posed to investors, however, the Department will need some degree of flexibility to identify, react and respond to different sources of risk. For this reason, the revised proposal retains the ability of the Department to make internal assessments during the evaluation and Consultation, including ones concerning the amount of the Restricted Deposit Requirement and the conditions and restrictions that may be imposed, to appropriately address the concerns indicated by the Preliminary Criteria for Identification.

Nevertheless, FINRA agrees with commenters' request for additional clarity regarding the conditions and restrictions that could be imposed under the proposed rule.[94] For this reason, the revised proposal provides a non-exhaustive list of conditions and restrictions that could be imposed on Restricted Firms. Moreover, the proposed rule's descriptions of the Department's tasks and discretion are broad enough to allow FINRA to provide further guidance as it gains experience implementing the rule. For example, FINRA could provide additional guidance if it learns of categories of disclosure events that could be described as not consistent with the purpose of the Preliminary Criteria for

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94 See, e.g., FSI, NASAA, PIRC.

Identification or not reflective of a firm posing a high degree of risk. FINRA also could provide further guidance on the kinds of conditions and restrictions that might be warranted in different contexts.

Comments Concerning the Preliminary Criteria for Identification

Numerous commenters suggested alternatives to several aspects of the Preliminary Criteria for Identification. Some suggested narrower criteria, including, for example, requests to: (1) exclude criminal events in which the registered person pled nolo contendere;[95] (2) exclude or narrow criteria based on final regulatory actions;[96] (3) remove or narrow criteria based on pending events or unadjudicated events;[97] (4) remove or modify the criteria based on terminations or internal reviews;[98] (5) remove or substantially narrow the Expelled Firm Association Metric;[99] (6) increase the $15,000 threshold for settlements[100] and establish a minimum threshold for awards and judgments;[101] (7) decrease the lookback period;[102] (8) distinguish between events by

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95 Westpark.

96 Moss & Gilmore, Westpark.

97 AdvisorLaw, Cambridge, Cetera, HLBS, Joseph Stone, Luxor, Moss & Gilmore, Westpark, Worden.

98 Cambridge, Cetera, Westpark. Two of these commenters cautioned that including termination and internal review events could discourage firms from conducting internal reviews and filing appropriate termination disclosures on the Uniform Registration Forms, thereby reducing internal compliance procedures and potentially leading to underreporting of such events. Cetera, Westpark.

99 Cambridge, Cetera, Joseph Stone, Luxor, Network 1, Sichenzia, Westpark.

100 Cambridge, Joseph Stone, Luxor.

101 Cambridge.

102 Westpark.

recidivist and non-recidivist brokers;[103] (9) exclude all matters that are not sales-practice or investment-related[104] or that do not involve customer harm;[105] (10) address or remove "nuisance arbitrations . . . settled without admission of guilt" and "disclosure events . . . filed by a compensated non-attorney representative";[106] (11) narrow the term "Registered Persons In-Scope" to exclude persons who were registered with a member firm for only one day and include only those who have been employed with a member firm for at least 180 days;[107] (12) reconsider the inclusion in the criteria of settlements of arbitrations and regulatory actions,[108] disclosure events against persons who were named due to their position within a chain of supervision,[109] and "allegation-driven" disclosures;[110] and (13) account for widespread product or market collapse that could result in a high number of new disclosure events.[111]

Some commenters suggested broader criteria, including requests to: (1) lower the dollar threshold for settlements;[112] (2) increase the lookback period;[113] (3) include

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[103] Sichenzia.

[104] Cambridge.

[105] Westpark.

[106] Luxor, Moss & Gilmore, Sichenzia.

[107] Westpark.

[108] HLBS, Moss & Gilmore, Westpark.

[109] Cambridge, Westpark.

[110] Worden.

[111] Cambridge.

[112] Better Markets.

[113] Better Markets.

financial disclosures like judgments, liens, bankruptcies and compromises;[114] (4) include non-investment related civil matters that involve dishonesty, deceit, or reckless or intentional wrongdoing;[115] (5) include internal reviews by other member firms;[116] (6) include a category based on specific products sold by the member firm;[117] and (7) include expunged Registered Person Adjudicated Events.[118]

Two commenters criticized or questioned how the metrics thresholds were based on firm size.[119]

In response to the comments about the proposed criteria's underlying categories and metrics, FINRA made two modifications to the proposal in Regulatory Notice 19-17. First, as explained above, the revised proposal uses a narrower definition of Registered Persons Associated with Previously Expelled Firms. Instead of an unlimited lookback over a registered person's entire career and no limitations based on the duration of the person's registration with the expelled firm as originally proposed in Regulatory Notice 19-17, the revised proposal would include only those registered persons who were registered with a previously expelled firm for at least one year and within the five years prior to the date the Preliminary Criteria for Identification are calculated. Persons' previous registrations with expelled firms (i.e., beyond the five-year lookback) would not

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114 Massachusetts, NASAA.

115 Massachusetts.

116 Massachusetts.

117 MIRC, PIABA.

118 NASAA.

119 Rockfleet, Worden.

be counted in this category or towards an employing member firm's Expelled Firm Association Metric. Moreover, FINRA believes using a five-year lookback would be consistent with the lookback periods for the other metrics.[120]

Second, FINRA believes that the comments about the termination and internal review events demonstrated a need for clarification of the relevant metric. The revised proposal would make clear that termination and internal review disclosures concerning a person that a member firm terminated would not impact that member firm's own Registered Person Termination and Internal Review Metric; rather, those disclosures would only impact the metrics of member firms that subsequently register the terminated individual.

Otherwise, FINRA has decided to retain the rest of the Preliminary Criteria for Identification as originally proposed in Regulatory Notice 19-17. Many of the commenters' other proposed alternative definitions and criteria comments concern issues that FINRA already considered and addressed in the economic assessment in Regulatory Notice 19-17, and the comments have not persuaded FINRA that any changes would be more efficient or effective at addressing the potential for future customer harm presented. As FINRA explained in Regulatory Notice 19-17, the primary benefit of the proposed rule change would be to reduce the risk and associated costs of possible future customer harm by member firms that meet the proposed criteria, by applying additional restrictions on firms identified as Restricted Firms and by the increased scrutiny that will likely result by these firms on their brokers. In developing this proposal, one of the guiding principles

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[120] FINRA analyzed whether the revised Expelled Firm Association Metric still preserves its usefulness, and FINRA determined that it does, as explained in the Economic Impact Assessment.

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 the firm had the potential to be designated as a Restricted Firm. This is why—unlike many of the alternatives suggested by commenters—FINRA's proposal is based on events disclosed on the Uniform Registration Forms, which are generally available to firms and FINRA.

Several commenters expressed concern over how the Preliminary Criteria for Identification relies on data in the Uniform Registration Forms.[121] Several commenters contended that there are underlying problems with the information disclosed through the Uniform Registration Forms, stemming primarily from the allegation-based disclosures that must be made and frivolous arbitrations.[122] One commenter pointed to the number of expungements as evidence of the unreliability of the disclosure data.[123] NASAA, PIABA, and some law school clinics raised a concern from a different perspective, writing that expungements are granted too frequently and will cause the annual calculation of the Preliminary Criteria for Identification to not identify all firms that pose the highest risks.[124] Relatedly, several commenters suggested that the proposed Preliminary Criteria for Identification highlights problems with expungements, including that the proposal will incentivize even more expungement requests,[125] that FINRA should

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121 AdvisorLaw, Cambridge, Moss & Gilmore, Worden.

122 AdvisorLaw, Cambridge, Moss & Gilmore, Worden.

123 AdvisorLaw.

124 MIRC, NASAA, PIABA, PIRC.

125 MIRC, NASAA, PIABA, PIRC.

simultaneously pursue meaningful expungement reform,[126] or that FINRA should make it easier to expunge certain customer dispute information because Uniform Registration Form disclosures would now carry greater weight.[127] Some commenters predicted that the proposal will create perverse incentives to avoid making required disclosures on the Uniform Registration Forms.[128]

FINRA believes, however, that the data reported on the Uniform Registration Forms is reliable enough on which to base proposed Rule 4111. FINRA rules require firms and individuals to make accurate disclosures, and they could be subject to disciplinary action and possible disqualification if they fail to do so. Regulators are the source of disclosures on Form U6. FINRA's Department of Credentialing, Registration, Education and Disclosure conducts a public records review to verify the completeness and accuracy of criminal disclosure reporting. And although some commenters take issue with some of the specific events that must be disclosed on the Uniform Registration Forms, the SEC has taken the position that "essentially all of the information that is reportable on the Form U4 is material."[129]

FINRA recognizes that the number of expungement requests may increase as a result of this proposal. However, the existing regulatory framework and FINRA rules are designed to ensure that expungements are granted only after a neutral adjudicator (arbitrator or judge) concludes that expungement is appropriate. Furthermore, OCE has

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[126] NASAA, PIABA.

[127] Cambridge.

[128] Cetera, PIRC, St. John's SOL.

[129] Joseph S. Amundsen, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *41 (Apr. 18, 2013), aff'd, 575 F. App'x 1 (D.C. Cir. 2014).

tested the proposed thresholds in several ways using the existing Central Registration Depository ("CRD") data, including comparing the firms captured by the proposed thresholds to the firms that have recently been expelled, that have unpaid arbitration awards, that Department staff has identified as high risk for sales practice and fraud based on the Department's own risk-based analysis, and that subsequently had additional disclosures after identification. Moreover, FINRA is actively engaged in efforts to address concerns with the current system of arbitration-based expungement of customer allegations from brokers' records.[130] FINRA's planned review of proposed Rule 4111 would necessarily account for any future amendments to the expungement process and any associated impact on the underlying data in CRD. Accordingly, FINRA does not believe that the proposal would directly result in inappropriate expungements being granted or appropriate expungements being not granted, or that it would undermine the quality of the underlying CRD information used for the proposed metrics.

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130 FINRA recently filed a proposed rule change that would amend the Codes of Arbitration Procedure for Customer and Industry Disputes ("Codes") to modify the current process relating to requests to expunge customer dispute information. The proposed rule change would amend the Codes to: (1) impose requirements on expungement requests filed either during an investment-related, customer-initiated arbitration or separate from a customer-initiated arbitration ("straight-in requests"); (2) establish a roster of arbitrators with enhanced training and experience from which a three-person panel would be randomly selected to decide straight-in requests; (3) establish procedural requirements for expungement hearings; and (4) codify and update the best practices of the Notice to Arbitrators and Parties on Expanded Expungement Guidance that arbitrators and parties must follow. See Securities Exchange Act Release No. 90000 (September 25, 2020), 85 FR 62142 (October 1, 2020) (Notice of Filing of File No. SR-FINRA-2020-030); Notice to Arbitrators and Parties on Expanded Expungement Guidance, available at https://www.finra.org/arbitration-andmediation/notice-arbitrators-and-parties-expanded-expungement-guidance). In addition, FINRA recently amended the Codes to apply minimum fees to requests to expunge customer dispute information. See Securities Exchange Act Release No. 88945 (May 26, 2020), 85 FR 33212 (June 1, 2020) (Order Approving Filing of File No. SR-FINRA-2020-005); Regulatory Notice 20-25 (July 2020).

Annual Calculation of the Preliminary Criteria for Identification

Massachusetts contends that calculations of the Preliminary Criteria for Identification should occur more than annually. FINRA appreciates this suggestion, but believes that it should gain experience with an annual requirement before considering whether to conduct more frequent reviews.

SIFMA requested that the proposal provide more transparency around the variables for the annual calculation of the Preliminary Criteria for Identification, so that firms can have the same ability as FINRA to calculate whether they meet the thresholds. For example, SIFMA explained that firms will need specific information about the Evaluation Date to make the calculations on their own.

FINRA agrees that additional clarity should be provided regarding the timing of the calculation. Proposed Rule 4111 is intended to be transparent enough so that member firms can understand whether they are at risk of being subject to additional obligations, and member firms will need to know the exact Evaluation Date to do their own calculations. FINRA would announce in a Regulatory Notice the first Evaluation Date no less than 120 days before the first Evaluation Date. FINRA also would announce that subsequent Evaluation Dates would be on the same month and day each year, except when that date falls on a Saturday, Sunday, or federal holiday, in which case the Evaluation Date would be on the next business day.

Some commenters requested that FINRA provide member firms with assistance in determining if they meet the Preliminary Criteria for Identification. For example, CAI requested clarification on whether FINRA would provide advance notice to firms that meet or come close to meeting the Preliminary Criteria for Identification. Cambridge wrote that FINRA should notify firms in advance that they meet the criteria and publish a list of expelled firms. SIFMA requested that FINRA provide an electronic worksheet, available year round.

FINRA does not currently plan to provide member firms with advance notice about whether they would meet, or are close to meeting, the Preliminary Criteria for Identification, because the calculation under the proposal would occur annually, not on a rolling basis, and calculating the events included in the Preliminary Criteria for Identification based on an earlier date may lead to different results. Moreover, the proposed rule is designed to be transparent enough to allow member firms to perform their own calculations. FINRA agrees, however, that additional guidance and resources could facilitate member firms' independent calculations, and FINRA will explore ways to provide helpful resources. For example, this could include mapping the Disclosure Event and Expelled Firm Association Categories to the relevant disclosure questions on the Uniform Registration Forms. It also could include making available, year round, a worksheet that member firms could populate with the number of Registered Persons In-Scope, the number of disclosure events in each category, and the number of Registered Persons Associated with Previously Expelled Firms to generate information about whether the member firm meets or is close to meeting the Preliminary Criteria for Identification.[131] FINRA also would consider making available to member firms a list of expelled firms, if that information is burdensome for member firms to obtain on their own.

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131 Such a year-round worksheet could be a tool for member firms to monitor their status in relation to the Preliminary Criteria for Identification, but not a determinate one. Whether a member firm will meet the criteria could only be definitively established on the annual Evaluation Date.

<u>One-Time Staffing Reduction</u>

Several comments addressed the proposal's one-time staffing reduction opportunity. PIRC expressed support for the one-time staffing reduction opportunity, commenting that it will have the benefit of lowering the number of representatives who have repeatedly harmed investors. Joseph Stone commented that member firms should have several opportunities to reduce staff, not just one. Westpark stated that the one-time opportunity should renew after three years. HLBS called the staffing reduction opportunity the proposal's "most alarming and punitive measure," because member firms would "conduct a mass termination not because of an independent business decision but because . . . failing to do so . . . would essentially result in financial ruin."

FINRA has retained the one-time staffing reduction opportunity as originally proposed. The one-time staffing reduction opportunity is intended to provide another procedural protection for member firms, because it would give a firm that meets the Preliminary Criteria for Identification one opportunity to reduce staff so as to fall below the criteria's thresholds. It has been designed as only a single opportunity to deter member firms from resurrecting a high-risk business model after a staff reduction. Moreover, FINRA does not agree with HLBS's assertion that the proposed staffing reduction opportunity removes member firms' independence to make business decisions. FINRA believes that a member firm that meets the Preliminary Criteria for Identification, possibly inadvertently, in one year should have the choice of whether to exercise the staffing reduction option. Furthermore, a firm that chooses to exercise the staffing reduction option would have the independence to decide how to proceed going forward, with the knowledge that it has once met the Preliminary Criteria for Identification, that the preliminary criteria are fully transparent, and that it would not have another opportunity to reduce staff to avoid a review under Rule 4111.

Better Markets stated that the staffing reduction opportunity needs to better protect investors, by prohibiting other high-risk firms from hiring terminated persons, prohibiting any firms from hiring the terminated persons for one year, or requiring that staff reductions commence with brokers with the highest number of disclosure events or with frequent and severe violations. FINRA is already pursuing, however, a separate proposal that would require a member firm to request a materiality consultation with FINRA staff when a person who has one final criminal matter or two “specified risk events” seeks to become an owner, control person, principal or registered person of the member.[132] That related proposal would potentially impact persons terminated pursuant to the staffing reduction opportunity.

Consultation

Westpark commented that proposed Rule 4111 does not give firms enough time to prepare for the Consultation. Because the proposed rule sets tight deadlines for the Department’s decision, FINRA agrees that the proposed deadlines for the Consultation would also be tight. For this reason, FINRA has revised proposed Rule 4111(d)(2) to require that the letter scheduling the Consultation provide at least seven days’ notice of the Consultation date, and also give the member firm the opportunity to request a postponement of the Consultation for good cause shown. Postponements would not exceed 30 days unless the member firm establishes the reasons a longer postponement is necessary.

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[132] See Securities Exchange Act Release No. 88600 (April 8, 2020), 85 FR 20745 (April 14, 2020) (Notice of Filing of File No. SR-FINRA-2020-011).

Other comments about the Consultation did not prompt FINRA to make revisions. For example, FSI commented that the Consultation should be an opportunity for FINRA to work collaboratively with the identified firm. FINRA believes the Consultation is already intended to give member firms an opportunity to meet with FINRA and demonstrate why the calculation of the Preliminary Criteria for Identification should not include certain events or provide a rationale as to why the firm should not be required to maintain the maximum Restricted Deposit Requirement. As such, FINRA does not believe further revisions are necessary.

Chiu and Luxor wrote that although proposed Rule 4111 would allow members during the Consultation to request a waiver of the maximum Restricted Deposit Requirement for financial hardship reasons, member firms will not do so because it would deter recruitment and cause brokers to leave. Allowing member firms to demonstrate undue financial hardship, however, is consistent with the intent of the Restricted Deposit Requirement that it not significantly undermine the member firm's continued financial stability and operational capability as an ongoing enterprise over the next 12 months. Moreover, FINRA anticipates that member firms subject to the requirement will not be deterred from asserting that a Restricted Deposit Requirement would cause an undue financial hardship, given that such arguments could lead to a reduced Restricted Deposit Requirement or no deposit requirement at all. Moreover, the proposal would not make public any such assertions by a member firm.

In a comment related to the Consultation, FSI commented that firms should not shoulder the risk of misidentification, and that FINRA should have to demonstrate its reasons for continuing the review process for firms preliminarily identified as high risk.

Proposed Rule 4111 only places burdens of proof on the small number of firms that meet the Preliminary Criteria for Identification and that the Department determines, after conducting its initial evaluation, warrants further review. Each of these firms would have the opportunity to overcome the presumption that it should be designated as a Restricted Firm and subject to the maximum Restricted Deposit Requirement. Under the proposed rule, the affected firms would initiate this process because they would be in the best position to provide the relevant information. For example, proposed Rule 4111(d)(1)(A) would provide that a member firm may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation included events that should not have been included because, for example, they are duplicative, involving the same customer and the same matter, or are not sales practice related. The member firm, not Department staff, is in the best position to provide that kind of information about the disclosure data. Likewise, the member firm would be in the best position to demonstrate, pursuant to proposed Rule 4111(d)(1)(B), that it would face undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement.

Restricted Deposit Requirement

FINRA also received general comments concerning the proposed Restricted Deposit Requirement concept. Some commenters were generally opposed to the proposed requirement. Their reasons include: (1) a deposit requirement may trigger unintended consequences which result in harm to the investing public;[133] (2) a deposit requirement may lead to competitive disadvantages, because members without significant

[133] Cambridge.

retained earnings may receive exceptions, while members with greater working capital would not;[134] (3) the only members likely to be able to satisfy a deposit requirement would be ones that do not anticipate being subject to the rule;[135] (4) a deposit requirement would "result[ ] in cash flow problems, increased borrowing, and layoffs"[136] and a "devastating economic impact" on the broker-dealer and its employees, customers, vendors, and counterparties;[137] (5) restricted funds could be better used for other purposes;[138] (6) there is little evidence why restricted deposits are necessary;[139] (7) requiring "up front financing of uninsured claims, many of which are specious, would have negative net capital implications";[140] (8) any assertion that unpaid arbitration awards is rampant and justifies the deposit requirement is false;[141] (9) a deposit requirement would put small firms out of business and result in less choice for

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[134] Cambridge.

[135] Cambridge.

[136] Westpark.

[137] Rockfleet.

[138] Chiu.

[139] Brooklight.

[140] Moss & Gilmore.

[141] Moss & Gilmore.

investors;[142] and (10) many members do not have sufficient cash to hold as restricted deposits.[143]

Other commenters were generally supportive of the Restricted Deposit Requirement concept. PIRC said that Restricted Deposit Requirements should help deter misconduct and also help FINRA "rein in Restricted Firms that shut down and reconstitute themselves in an attempt to avoid paying settlements and awards." SIFMA opined that the proposal "appropriately embraces the 'front-end' approach" to addressing unpaid awards by "seeking to identify those small number of firms with an extensive history of misconduct and/or relevant disclosure events, and as appropriate, requiring [them] to set aside cash deposits or qualified securities that could be applied to . . . unpaid awards."

FINRA's proposal continues to provide that the Department could impose a Restricted Deposit Requirement on Restricted Firms. FINRA believes that a financial requirement is the measure most likely to motivate Restricted Firms to change behavior. As such, the Restricted Deposit Requirement is an essential feature of the proposal to protect investors, with the possible secondary benefit of helping to address the issue of unpaid arbitration awards. Moreover, the proposal attempts to counteract firms' preemptively withdrawing capital by instructing the Department to consider several financial factors—not just net capital—when determining a Restricted Deposit

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142 Chiu, IBN, Whitehall. Whitehall also wrote that the proposal entails "FINRA . . . demanding funds for itself" and "using [members] as bank accounts to expand" FINRA's activities. Nothing in the proposal, however, results in FINRA receiving any assets from firms. At all times, a Restricted Firm would continue to own the assets that it maintains in a Restricted Deposit Account.

143 Whitehall.

Requirement. In addition, FINRA believes the implications of a Restricted Deposit Requirement on a member firm's net capital levels—that a member firm would have to deduct deposits in Restricted Deposit Accounts in determining the firm's net capital[144]—is one reason why the proposal would incentivize member firms to avoid becoming Restricted Firms, not a reason to abandon the Restricted Deposit Requirement concept. Finally, the proposal contemplates that the Restricted Deposit Requirement should correlate to the financial realities at the member firm, and allows the firm to attempt to demonstrate that it would impose undue financial burdens.[145]

Calculating a Restricted Deposit Requirement

FINRA received several comments about the Department's determination of a Restricted Deposit Requirement. CAI expressed support for some of the proposed factors that the Department would consider when calculating the Restricted Deposit Requirement. In addition, CAI endorsed the proposed limitation in proposed Rule 4111(i)(15) that the maximum Restricted Deposit Requirement be an amount that would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months.

Several commenters expressed concerns about the proposed factors that the Department would consider when calculating the Restricted Deposit Requirement. For

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[144] See proposed Rule 4111.01.

[145] Westpark commented that proposed Rule 4111 is inconsistent with Section 15A(b)(5) of the Exchange Act, which requires that FINRA's rules "provide for the equitable allocation of reasonable dues, fees, and other charges among members." The proposed Restricted Deposit Requirement, however, is not a due, fee or charge. Assets that a member maintains in a Restricted Deposit Account would remain the member's assets; they would not be provided to, used by, or owned by FINRA.

example, Sichenzia called the factors "arbitrary"; some commenters opposed the inclusion of, or requested modifications to, the "Covered Pending Arbitration Claims" factor;[146] Network 1 commented that the Restricted Deposit Requirement should not consider "bona fide nuisance claims brought in arbitration"; Cambridge objected to the "gross revenues" factor, on the grounds that that factor would not contemplate the firm's contractual obligations for which the revenues have already been allocated; and Moss & Gilmore objected to considering "concerns raised during FINRA exams" on the grounds that "novice examiners . . . [often] conduct the front-line examinations."[147]

Some commenters believed that the list of factors should be expanded. For example, two commenters requested that FINRA account for instances in which the firm has insurance coverage for arbitration claims.[148] MIRC commented that the Covered Pending Arbitration Claims factor should be expanded to include other kinds of pending claims that could lead to unpaid awards, not just ones limited to the arbitration setting. PIABA requested that the Restricted Deposit Requirement calculation also take into account the nature and extent of harm that the Restricted Firm has done in the past.

As explained above, FINRA has made several revisions to the factors that the Department would consider when determining a maximum Restricted Deposit Requirement. The "annual revenues" and "net capital requirements" factors proposed in Regulatory Notice 19-17 have been modified to "revenues" and "net capital," and "assets," "expenses," and "liabilities" have been added as factors. In addition, FINRA

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[146] Moss & Gilmore, Network 1, Sichenzia, Westpark.

[147] Moss & Gilmore.

[148] Network 1, Sichenzia.

has clarified that unpaid arbitration awards against a member firm's Associated Persons is one relevant factor. FINRA believes this modified and expanded list of factors would lead to a more complete consideration of the firm's financial situation.

FINRA has retained the other proposed factors, however, because they appropriately and accurately describe the factors, financial and otherwise, that would be most relevant to the Department when calculating a Restricted Deposit Requirement. This includes the Covered Pending Arbitration Claims factor. Because one purpose of the Restricted Deposit Requirement is to preserve some of a Restricted Firm's assets for potential payment of arbitration awards, FINRA believes that purpose is served by allowing the Department to consider Covered Pending Arbitration Claims when determining a Restricted Deposit Requirement. At the same time, the revised proposed rule also adds as a factor the member's "insurance coverage for customer arbitration awards or settlements." FINRA believes that if Restricted Firms were able to procure errors and omissions insurance policies or other kinds of insurance coverage for some or all of the kinds of claims that customers typically bring in arbitrations, at meaningful coverage amounts, that could warrant a reduced Restricted Deposit Requirement and would be behavior to encourage.

Two commenters contended that because potential liabilities relating to pending arbitrations must be accrued on financial statements, a Restricted Deposit Requirement that is based in part on Covered Pending Arbitration Claims (which would be a non-allowable asset) would "double[ ] the net capital impact."[149] While there would not usually be a double impact—accruals of contingent liabilities based on pending

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[149] Network 1, Rockfleet.

arbitrations usually reflect only a small percentage of the potential liability—a member firm's net capital level could be impacted by a Restricted Deposit Requirement based in part on Covered Pending Arbitration Claims and a member firm's accruals of potential liabilities stemming from the same pending arbitration claims. For this reason, the Department's consideration of Covered Pending Arbitration Claims could take into account whether any liability accruals for those same claims warrant a reduction in the Restricted Deposit Requirement. It should be noted, however, that the purposes of accruing a liability on a financial statement are different from the purposes of the proposed Rule 4111 requirement to deposit money in a Restricted Firm's segregated, restricted account.

In addition to comments about the specific factors that the Department would consider, some commenters requested that the proposal describe with more specificity how the Restricted Deposit Requirement would be calculated or establish caps. CAI, for example, requested that FINRA develop specific limitations such as caps and a formula that focuses on the correlation between revenues that may give rise to unpaid arbitration awards (e.g., penny stock sales) and unpaid arbitration award amounts. FSI suggested that FINRA use published guidelines to provide transparency. Westpark suggested that the proposal should cap the Restricted Deposit Requirement at a specified percentage of required net capital amounts or a percentage of average net income over a three-year lookback period. Whitehall asked whether FINRA would have a formula for calculating the Restricted Deposit Requirement. MIRC suggested that FINRA should impose Restricted Deposit Requirements that are sufficient to meet all unpaid awards and pending claims related to products and product types.

FINRA has not proposed a uniform formulaic approach for calculating the Restricted Deposit Requirement because of the range of relevant factors and differences in member firms' business models, operations, and financial conditions. In addition, although formulas do provide objective, transparent methodologies, here they would allow member firms the opportunity to manipulate their revenue numbers during the calculation periods. For these reasons, FINRA has retained the factor-based, principles-based approach to determining a Restricted Deposit Amount.

Impact on Unpaid Arbitration Awards

PIABA contended that the proposal will not solve the issue of unpaid arbitration awards, because there is no indication that the Restricted Deposit Requirements will be sufficient to cover anticipated arbitration awards. Relatedly, several commenters requested that the proposal also provide more clarity on how the Restricted Deposit Requirement could be used to pay investor claims.[150]

With respect to the relationship between proposed Rule 4111 and unpaid arbitration awards, FINRA notes that FINRA rules currently prohibit member firms or registered representatives who do not pay arbitration awards in a timely manner from continuing to engage in the securities business under FINRA's jurisdiction.[151] As to proposed Rule 4111, it was designed to address a broader range of investor protection concerns posed by firms and individuals with a significant history of misconduct,

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150 MIRC, PIABA, PIRC.

151 See FINRA Rule 9554. Under FINRA rules, unless a respondent has specified defenses to non-payment, the respondent must pay a monetary award within 30 days of receipt. See FINRA Rule 12904(j). In addition, firms with unpaid awards cannot re-register with FINRA and individuals cannot register as representatives of any member firm, without paying or discharging the outstanding award.

including but not limited to unpaid arbitration awards. The Rule would apply to firms who, based on statistical analysis of their prior disclosure events, are substantially more likely than their peers to subsequently have a range of additional events indicating various types of harm or potential harm to investors.

Nevertheless, FINRA believes proposed Rule 4111 may have important ancillary effects in addressing unpaid customer arbitration awards. In particular, the Rule may deter behavior that could otherwise result in unpaid arbitration awards, by incentivizing firms to reduce their risk profile and violative conduct in order to avoid being deemed a Restricted Firm and becoming subject to the Restricted Deposit Requirement (or other conditions or restrictions). In addition, firms may be incentivized to obtain insurance coverage for potential arbitration awards, because such coverage would be taken into account in determining any Restricted Deposit Requirement. Moreover, and as explained above, the proposed rule includes several presumptions, applicable to the Department's assessment of an application by a firm previously designated as a Restricted Firm for a withdrawal from a Restricted Deposit, that would further incentivize the payment of arbitration awards.

FINRA has made several revisions to proposed Rule 4111(f) to make more clear the process that would guide the Department's evaluation of a request for a withdrawal from a Restricted Deposit Account. As explained above, these include several presumptions of approval or denial that set forth how Covered Pending Arbitration Claims or unpaid arbitration awards would impact the Department's evaluation. The presumptions of denial that would apply when a Restricted Firm or previously designated Restricted Firm applies for a withdrawal from a Restricted Deposit would still apply when the firm seeks to use the funds to satisfy unpaid arbitration awards; unless the presumption of denial can be overcome, those firms would generally need to satisfy unpaid arbitration awards using funds other than those in a Restricted Deposit Account.[152] There would be a separate presumption that a request by a former member firm previously designated as a Restricted Firm to access its Restricted Deposit would be approved when it commits in the manner specified by the Department to use the amount it seeks to withdraw from its Restricted Deposit to pay the former member's specified unpaid arbitration awards.

PIABA also raised the concern that thinly capitalized firms would have smaller Restricted Deposit Requirements. A member's thin capitalization at the time of the Consultation, however, would be only one factor of many that the Department would consider when determining a Restricted Deposit Requirement, and would not necessarily result in a lower requirement.

Custodians of the Restricted Deposit Account

Some commenters expressed concern about how proposed Rule 4111 would require the Restricted Deposit Account to be maintained with a bank or clearing firm. Rockfleet predicted that it will be unlikely that banks or clearing firms will create new policies and procedures for the small amount of Restricted Deposit Accounts that would result from the proposal. SIFMA commented that a number of clearing firms believe it would be problematic to custody a Restricted Deposit Account "given the clearing firm's unique role in the relationship between an introducing broker and its clients," and how the proposed rule would impose additional duties and responsibilities that are not now

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152 See proposed Rule 4111(f)(1) and (f)(3)(B)(ii)(a).

part of clearing firms' systems and procedures. SIFMA also stated that custody by a clearing firm of the Restricted Deposit Requirement likely would not provide FINRA with the level of transparency that FINRA would want.

The revised proposal retains the option for Restricted Firms to establish Restricted Deposit Accounts with clearing firms. FINRA believes that member firms have an existing relationship with their clearing firms and should be permitted to establish the Restricted Deposit Account with them if the parties choose. Nothing in the proposal requires clearing firms to establish Restricted Deposit Accounts. Where a clearing firm is unwilling or unable to establish these accounts, the proposal would permit Restricted Firms to establish such accounts at banks.

SIFMA also commented that the proposal should be revised to expressly allow trust companies to maintain the accounts. FINRA believes that the original proposal includes many trust companies and so gives members sufficient options and flexibility.

Comments Concerning Proposed Expedited Proceedings

As originally proposed in Regulatory Notice 19-17, proposed Rule 9561(a) would have provided that any of the Rule 4111 Requirements imposed in a notice issued under proposed Rule 9561(a) would be immediately effective; that, in general, a request for a hearing would not stay those requirements; and that, if a member firm requests a hearing of a Department determination that imposes a Restricted Deposit Requirement for the first time, the member firm would be required to deposit, while the expedited proceeding was pending, the lesser of either 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year. Westpark commented that the expedited proceedings would not be meaningful because obligations would not be stayed.

Luxor commented that the requirement to deposit a percentage of the Restricted Deposit Requirement would be "devastating."

In general, FINRA has retained the no-stay provisions as originally proposed. FINRA believes that the proposed no-stay provisions are a fundamental part of how the proposed rules would protect investors. Requiring Restricted Firms to comply with obligations imposed during the short pendency of an expedited proceeding would afford more immediate protections to investors from firms that pose outlier-level risks. Moreover, requiring immediate compliance with the Department's decision would be similar to other situations in which firms and individuals posing substantial risks must abide by FINRA decisions before underlying proceedings are resolved, such as when disciplinary respondents must abide by temporary cease and desist orders before an underlying disciplinary proceeding is complete or comply with FINRA-imposed bars while an SEC appeal is pending. Nonetheless, FINRA believes that one aspect of the proposed no-stay provisions could be less burdensome without compromising its intended purpose. Accordingly, FINRA has revised the proposed rules to lower the proposed partial-deposit requirement to the lesser of 25% of the Restricted Deposit Requirement or 25% of the firm's average excess net capital during the prior calendar year.

Cetera commented that the hearings should be conducted by a Hearing Panel that includes two industry members and one Hearing Officer, because Hearing Officers are viewed as "not as objective." FINRA has retained, however, the proposal to have Hearing Officers preside over the new expedited proceedings. Hearing Officers preside over several kinds of proceedings.[153] And here, FINRA believes the need for swift proceedings as a result of the proposed no-stay provisions and to protect investors works in favor of the efficiency of Hearing Officer-only proceedings. Moreover, FINRA believes there are additional protections for the firms in the proposal, given that the Hearing Officer's authority will be circumscribed and that the NAC's Review Subcommittee will have the right to call the proceeding for review.

Cetera commented that the proposed rule would require hearings to be held in expedited proceedings in an unreasonably short time after the firm receives notice of its Restricted Firm status. FINRA believes, however, that the proposed rule offers reasonable time limits and an opportunity to seek extensions. Under proposed Rules 9561(a)(5) and 9559(f)(5), a member would be required to request a hearing within seven days after service of a notice of a determination that a firm is a Restricted Firm, and a hearing would be required to be held within 30 days after the member files that hearing request. In addition, under an existing provision in Rule 9559, the Hearing Officer could extend the time limits for holding the hearing for good cause shown or with the consent of all the parties.

PIABA commented that under proposed Rule 9561(b), which would establish an expedited proceeding to address a member firm's failure to comply with any requirements imposed pursuant to proposed Rule 4111, FINRA should be required to immediately suspend a non-compliant firm and should not have the discretion not to act.

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153 See FINRA Rule 9559(d) (providing that Hearing Officers preside over, and act as the sole adjudicator for, proceedings initiated under Rules 9553 (failures to pay FINRA dues, fees and other charges), 9554 (failures to comply with arbitration awards or related settlements or orders of restitution or settlements providing for restitution), and 9556(h) (subsequent proceedings for failures to comply with temporary or permanent cease and desist orders)).

Although FINRA expects that non-compliant Restricted Firms would be a high priority for the Department of Enforcement, the revised proposal retains FINRA's prosecutorial discretion to ensure that FINRA can use its best judgments about how to deploy its limited resources.

Rockfleet commented that the proposed Rule 9561(b) expedited proceeding is counterintuitive, because canceling a Restricted Firm's membership would result in FINRA losing any control over the firm. FINRA respectfully disagrees and believes that proposed Rule 4111 must provide a tool for FINRA to compel the immediate compliance with obligations that have been imposed pursuant to the rule.

Procedural Protections

Several commenters contended that the proposal is an attempt to impose the equivalent of sanctions while avoiding the fair-process requirements that would be present in a disciplinary proceeding, and to ban persons who are not statutorily disqualified.[154] The proposed Rule 4111 process, however, is neither a disciplinary nor an eligibility proceeding, and the obligations that could be imposed pursuant to proposed Rule 4111 would not be sanctions imposed for violations. Furthermore, FINRA believes the proposal gives affected member firms substantial procedural protections. These include providing notice that a member has met the Preliminary Criteria for Identification and of the maximum Restricted Deposit Requirement; a one-time staffing reduction opportunity for firms that meet the Preliminary Criteria for Identification for the first time; a Consultation, which will allow affected firms to attempt to show why they should not be deemed Restricted Firms or be subject to the maximum Restricted Deposit

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[154] Brooklight, Luxor, Network 1, Rockfleet, Westpark.

Requirement; and the right to seek an expedited hearing before a Hearing Officer.[155] These procedural protections are in addition to the Preliminary Criteria for Identification, which would be fully transparent and enable firms to monitor whether they are at risk of meeting the threshold criteria.

Moreover, the proposal is neither intended nor designed to expel member firms and persons that are not statutorily disqualified. In this regard, FINRA notes that the rule text contains express language that the Department determine a maximum Restricted Deposit Requirement that "would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months," and also contemplates situations in which Restricted Firms remain member firms for years. Furthermore, persons terminated pursuant to the Rule 4111 staffing reduction opportunity would be permitted to seek employment with any other member firm and allowed to apply to re-associate with the Restricted Firm after one year.[156]

Unintended Consequences

Rockfleet expressed concern that clearing firms will terminate clearing agreements for firms deemed to be Restricted Firms, and that firms using tri-party clearing agreements could be impacted through no fault of their own. CAI raised a concern that being deemed as a Restricted Firm could have ramifications for firms that are parties to selling agreements. FINRA appreciates that proposed Rule 4111 may have

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[155] The right to have a Hearing Officer's decision reviewed by the SEC would be governed by Section 19 of the Exchange Act.

[156] Some commenters (Network 1, Westpark) asserted that the proposed rule change would be unconstitutional, for a variety of reasons. FINRA, however, is not a state actor.

potential unintended consequences, and plans to examine issues like those when FINRA reviews proposed Rule 4111 after gaining sufficient experience under the rule.

Public Disclosure Issues

Several commenters addressed whether there should be public disclosure of a firm's status as a Restricted Firm. Some opposed any disclosure at all, warning that disclosure could adversely impact the affected firms, and would make it more likely the firm would fail.[157] Several commenters, particularly regulators and public advocacy groups, argue that FINRA should disclose the names of Restricted Firms to the public or, at least, to other regulators or clearing firms.[158]

FINRA believes the aim of the proposal is to address the risks posed by Restricted Firms by imposing appropriate restrictions on them and, at the same time, providing them with opportunities and incentives to remedy the underlying concerns (e.g., the one-time staff reduction, the opportunity to roll off the Restricted Firms list). Because requiring FINRA to publicly disclose a firm's Restricted Firm status may potentially interfere with those purposes, FINRA is not proposing to require the public disclosure of a firm's status as a Restricted Firm at this time. FINRA believes that it is necessary to gain meaningful experience with the proposed rule to evaluate the impact of creating an affirmative disclosure program.[159]

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[157] Cetera, FSI.

[158] Better Markets, Massachusetts, NASAA, SIFMA, St. John's SOL.

[159] It should be noted that information about a firm's status as a Restricted Firm, and any restricted deposit it must maintain, could become publicly available through existing sources or processes. Such disclosures could occur, for example, through Form BD, Form CRS, or financial statements, or when a Hearing Officer's decision in an expedited proceeding is published pursuant to FINRA's publicity rule.

Economic Impact Assessment

Rockfleet commented that the proposal appears to be reverse engineered to target firms that FINRA has already chosen. As discussed above, the proposed Preliminary Criteria for Identification are based on metrics that are replicable and transparent to FINRA and the affected member firms, and are intended to identify firms that pose far greater risks to their customers than other firms. One identifier of these types of firms is that they and their brokers generally have substantially more Registered Person and Member Firm Events compared to their peers. This is consistent with a growing academic literature that provides evidence on past disciplinary and other regulatory events associated with a firm or individual being predictive of similar future events.[160] These patterns indicate a persistent, albeit limited, population of firms with a history of misconduct that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers. Accordingly, the proposed rule is intended to strengthen FINRA's toolkit to respond to these firms and brokers with a significant history of misconduct based on a proposed criteria that relies on regulatory and other disclosure events, similar to those used in the literature.

FINRA also conducted several validations on the firms meeting the criteria, by reviewing the extent to which firms identified were subsequently expelled, associated with unpaid awards, or were associated with "new" Registered Person and Member Firm Events. For example, these validations showed that the identified firms had on average approximately 6.1-19.9 times more new disclosure events after their identification than other firms in the industry during the same period that would not have met the

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[160] See supra note 5.

Preliminary Criteria for Identification. This suggests that the proposed criteria is effective in identifying firms that may be associated with additional events after identification, which is consistent with the literature's finding on regulatory events being predictive of similar future events.

Better Markets commented that the Economic Impact Assessment did not quantify the harm to investors when firms with a significant history of misconduct are permitted to continue engaging with investors. The proposed rule is intended to place additional restrictions on identified firms and increase scrutiny by these firms on their brokers. As a result, FINRA anticipates that the proposed rule will reduce the risk and associated costs of possible future customer harm and lead to improvements in the compliance culture, relative to the economic baseline of the current regulatory framework. The proposed rule is intended to create incentives for firms and brokers to limit or end practices that result in customer harm and provide increasing restrictions on those that choose not to alter their activities. Nonetheless, it is difficult to predict or quantify, before the proposed rule is implemented, the extent to which firms may continue to engage in harmful activities despite any additional restrictions imposed. However, FINRA plans to review the proposed rule after gaining sufficient experience with it, at which time FINRA will assess the rule's ongoing effectiveness and efficiency.

Westpark wrote that FINRA should analyze how many brokers who are currently licensed and in good standing would become "unemployable" if the proposed rule were approved. FINRA's Economic Impact Assessment of the proposed rule includes the economic impacts on firms hiring and registered persons seeking employment. For example, as discussed above, FINRA estimates that during the 2013-2019 review period only one to two percent of the registered persons had any qualifying events in their regulatory records. Accordingly, 98%-99% of the registered persons (with no qualifying events) should have no adverse economic impacts associated with their employment opportunities. Further, the vast majority of member firms, approximately 98%, would likely be able to employ most of the individuals seeking employment in the industry—including ones who have some disclosures—without coming close to meeting the Preliminary Criteria for Identification. Accordingly, FINRA believes that these anticipated economic impacts would likely be limited to a small proportion of registered persons and member firms, particularly in cases where registered persons with disclosures are seeking employment at firms at or near the Preliminary Criteria for Identification.

Westpark commented that FINRA should back-test the impact of the proposed rule to cover a period that was not a bull market. The economic impact assessment evaluated the proposed criteria over the 2013-2019 period. Because of the criteria's 5-year lookback period for adjudicated events, the evaluation included events that reached a resolution between 2009 and 2019, which includes the period of the global financial crisis.

Suggested Alternatives or Additional Measures

Several comments suggested alternatives to proposed Rule 4111. For example, several commenters suggested that FINRA improve how it uses its existing rules and programs. For example, Network 1 commented that FINRA's enforcement program is already a practical solution for addressing "bad brokers." Brooklight suggested that FINRA try to solve for any gaps in its enforcement authority and processes that prevent

FINRA from dealing with the "few bad actors" motivating the proposal. ASA wrote that FINRA should pursue the expulsion of firms that do not carry out their supervisory obligations and act in ways that harm customers, and impose immediate lifetime bans on those who engage in certain egregious acts, such as theft of customer funds. ASA further commented that FINRA "has an obligation to penalize and, if necessary, revoke the licenses of bad actors," and that "[i]f FINRA believes it lacks the authority or the tools necessary to stop the most egregious abuses, . . . then it should work with the . . . SEC, Congress and the industry to correct the problem." Joseph Stone commented that FINRA should continue focusing on firms' supervisory systems.

As explained above, FINRA has a number of current programs through which it strives to prevent and deter misconduct by member firms and the individuals they hire. These tools have been effective in identifying and addressing a range of misconduct by individuals and firms, and FINRA has continued to strengthen them. Despite FINRA's efforts, however, persistent compliance issues continue to arise in some member firms, as explained above. Thus, while FINRA continues to explore whether additional enhancements to existing programs, including relevant statutory or regulatory changes,[161]

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[161] The Exchange Act includes fair procedure requirements for various SRO actions, including the disciplining of members and persons associated with members, and sets out the types of misconduct that presumptively exclude brokers from engaging in the securities business (identified as statutory disqualifications or "SDs"). The Exchange Act and SEC rules thereunder also establish a framework within which FINRA evaluates whether to allow individuals who are the subject of a statutory disqualification. In addition, 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 misconduct when it evaluates an SD application.

would help FINRA target firms or individuals that engage in serious misconduct with greater speed and effectiveness, FINRA believes there remains a strong need to equip FINRA with authority to address more proactively the current risks posed by the limited population of firms with a significant history of misconduct.

Some commenters proposed that, instead of a Restricted Deposit Requirement, FINRA should impose insurance or performance bond requirements,[162] create a national investor recovery pool funded from fines that FINRA receives[163] or a restitution fund,[164] or impose additional capital requirements on identified firms.[165] FINRA believes these alternatives present challenges and is continuing to propose a Restricted Firm Obligations Rule that would authorize the imposition of Restricted Deposit Requirements.

Some commenters proposed other alternatives for FINRA's consideration. Chiu wrote that FINRA should instead focus attention on investor education and encouraged the creation of more tools like the Senior Helpline. Colorado FSC recommended that FINRA assign "disciplinary training and behavior restructuring" to address disclosure related issues. FINRA does not believe, however, that the suggested alternatives would be as effective as the proposed Restricted Firm Obligations Rule at addressing firms with a significant history of misconduct and encouraging such firms to modify their behavior and risk profile.

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162 Brooklight, Cetera, Rockfleet.

163 PIRC.

164 Sichenzia.

165 ASA.

Several commenters proposed steps that FINRA should take in addition to the proposal. These included: (1) requiring firms to provide BrokerCheck reports to customers;[166] (2) expelling firms that are Restricted Firms for two consecutive years;[167] (3) "de-licensing" all current brokers who worked at such firms when they were initially designated as Restricted Firms;[168] (4) disclosing more information on BrokerCheck, such as the percentage of brokers at a firm with disclosures and the average number of brokers' and firm's disclosures,[169] or which brokers have a demonstrable pattern of violating the law;[170] and (5) explaining to investors the methods that "recidivist" firms employ.[171] Several commenters also suggested that FINRA give more consideration to proposing a rule like Investment Industry Regulatory Organization of Canada (IIROC) Consolidated Rule 9208, which is a terms and conditions rule.[172]

FINRA appreciates receiving suggestions on additional steps it might take to address firms with a significant history of misconduct, and FINRA will continue to explore ways to address firms with a significant history of misconduct. As FINRA explained in Regulatory Notice 19-17, this includes continuing to consider whether to propose a terms and conditions rule. FINRA notes, however, that some of Better

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[166] PIRC.

[167] Better Markets.

[168] Better Markets.

[169] St. John's SOL.

[170] Better Markets.

[171] Better Markets.

[172] Better Markets, Brooklight, Cambridge, Cetera, Luxor, Massachusetts, MIRC, PIRC.

Markets' suggestions essentially request that FINRA broaden the statutory definition of disqualified persons, which is not within FINRA's jurisdiction to do.[173]

Miscellaneous Comments Outside the Scope of the Proposal

Some commenters raised concerns regarding issues that are not directly related to the proposal, such as whether barring "rogue brokers" or firms is effective,[174] whether the Uniform Registration Forms should request disclosure of unsubstantiated allegations or unadjudicated alleged rule violations,[175] and whether FINRA Hearing Officers are impartial.[176] FINRA believes, however, that these comments are 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

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

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173 See 15 U.S.C. 78c(a)(39) (defining "statutory disqualification").

174 Chiu.

175 AdvisorLaw.

176 Moss & Gilmore.

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-2020-041 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-2020-041. 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-2020-041 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.[177]

Jill M. Peterson
Assistant Secretary

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[177] 17 CFR 200.30-3(a)(12).

Exhibit 2a

Regulatory Notice 19-17

Protecting Investors from Misconduct

FINRA Requests Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct

Comment Period Expires: July 1, 2019

Summary

As part of FINRA's ongoing initiatives to protect investors from misconduct, FINRA is requesting comment on proposed new Rule 4111 (Restricted Firm Obligations) that would impose tailored obligations, including possible financial requirements, on designated member firms that cross specified numeric disclosure-event thresholds. These thresholds were developed through a thorough analysis and are based on the number of events at similarly sized peers. The member firms that could be subject to these obligations, while small in number, present heightened risk of harm to investors and their activities may undermine confidence in the securities markets as a whole. The proposal would further promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards.

FINRA is requesting comment on:

1. proposed new Rule 4111 (Restricted Firm Obligations), which would authorize FINRA to require "Restricted Firms," identified by a multi-step process involving threshold calculations, to make deposits of cash or qualified securities that could not be withdrawn without FINRA's prior written consent, adhere to other conditions or restrictions on the member's operations that are necessary or appropriate for the protection of investors and in the public interest, or be subject to some combination of those obligations; and

May 2, 2019

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Risk
- Senior Management

Key Topics

- Expedited Proceedings
- Restricted Deposit and other Obligations

Referenced Rules & Notices

- FINRA Rule 3110
- FINRA Rule 4110
- FINRA Rule 9559
- Regulatory Notice 18-06
- Regulatory Notice 18-15
- Regulatory Notice 18-16
- Regulatory Notice 18-17

Financial Industry Regulatory Authority

2. proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111) (new Rule 9559) and amendments to existing Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) to be renumbered as Rule 9560 (Rule 9560 or the Hearing Procedures Rule) to create an expedited proceeding that allows a prompt review of the determinations under the Restricted Firm Obligations Rule and grants a member a right to challenge any obligations imposed.[1]

The proposed rule text is available in Attachment A. A flow chart describing proposed Rule 4111 is available in Attachment B. A chart presenting examples of restricted deposit requirements is available as Attachment C. The attachments referenced in the Economic Impact Assessment are available in Attachment D (Attachments D-1, D-2 and D-3).

Questions concerning this *Notice* should be directed to:

- Kosha Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6903 or *Kosha.Dalal@finra.org*; or
- Michael Garawski, Associate General Counsel, OGC, at (202) 728-8835 or *Michael.Garawski@finra.org*.

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 or *Jonathan.Sokobin@finra.org*; or
- Hammad Qureshi, Senior Economist, OCE, at (202) 728-8150 or *Hammad.Qureshi@finra.org*.

Action Requested

FINRA encourages all interested parties to comment. Comments must be received by July 1, 2019.

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.

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.[2]

Before becoming effective, the proposed rule change must be filed with and approved by the Securities and Exchange Commission (SEC or Commission) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).[3]

Background & Discussion

FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and member firms that have a history of misconduct. FINRA has a number of tools to deter and remedy misconduct by member firms and the individuals they hire, including review of membership applications, focused examinations, risk monitoring and disciplinary actions. These tools have been effective in identifying and addressing a range of misconduct by individuals and firms, and FINRA has continued to strengthen them. In recent years, for example, we have enhanced our key investor protection rules and examination programs, expanded our risk-based monitoring of brokers and firms and deployed new technologies designed to make our regulatory efforts more effective and efficient.[4]

While these efforts have strengthened protections for investors and the markets, persistent compliance issues continue to arise in some FINRA member firms. While historically small in number and a top focus of FINRA regulatory programs, such firms generally do not carry out their supervisory obligations to ensure compliance with applicable securities laws and regulations and FINRA rules, and they often act in ways that harm their customers and erode trust in the brokerage industry. Recent academic studies, for example, find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence that the past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events.[5] While these firms may eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with a history of misconduct that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers.

Such firms expose investors to real risk. For example, FINRA has identified certain firms that have a concentration of individuals with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. These firms generally have a retail business with vulnerable customers and engage in cold calling to make recommendations of securities. FINRA has also identified groups of individual brokers who move from one firm of concern to another firm of concern. In addition, certain firms, along with their representatives, have substantial numbers of disclosures on their records. For example, as of year-end 2018, there were 20 small firms (*i.e.*, firms with no more than 150 registered persons) with 30 or more disclosure events over the prior five years, 10 mid-size firms (*i.e.*, firms with between 151 and 499 registered persons) with 45 or more disclosure events over the prior five years, and five large firms (*i.e.*, firms with 500 or more registered persons) with 750 or more disclosure events over the prior five years.[6] In such situations, FINRA closely examines the firms' and brokers' conduct, and where appropriate, FINRA will bring enforcement actions to bar or suspend the firms and individuals involved.

However, individuals and firms with a history of misconduct can pose a particular challenge for FINRA's existing examination and enforcement programs. In particular, examinations 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, an individual or firm with a history of misconduct can take advantage of these limits to simply continue ongoing activities that harm or pose risk of harm to investors until they result in an enforcement action.

Enforcement actions in turn can only be brought after a rule has been violated—and any resulting customer harm has already occurred. In addition, these proceedings can take significant time to develop, prosecute and conclude, during which time the individual or firm is able to continue misconduct, perpetuating significant risks of additional harm to customers and investors. Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council (NAC), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel imposes a significant sanction, the firm can forestall its effectiveness through the appeals process, because sanctions are stayed during appeals to the NAC and potentially the SEC. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership, limiting FINRA's jurisdiction and eliminating the leverage that FINRA has to incent the firm to comply with the sanction, including making restitution to customers.

Temporary cease and desist proceedings do not always provide an effective remedy for potential ongoing harm to investors during the enforcement process.[7] Temporary cease and desist proceedings are available only in narrowly defined circumstances. Moreover, initiation by FINRA of a temporary cease and desist action does not necessarily enable more rapid intervention, because FINRA must be prepared to file the underlying disciplinary complaint at the same time.

In addition, by the time intervention is practical, as noted above, the firm may have exited the industry, thereby limiting FINRA's jurisdiction over the misconduct. In such circumstance, the firm may also fail to pay arbitration awards in favor of harmed investors, preventing their recovery and potentially diminishing confidence in the arbitration process.

A typical example of these challenges would be a firm that hires representatives with numerous disclosure events, has a poor supervisory structure and compliance culture, consistently engages in aggressive sales practices to retail customers relating to unregistered penny stocks, private placements or illiquid securities, and affirmatively seeks to stall the imposition of disciplinary sanctions. In FINRA's experience, such a firm may attempt to prolong FINRA's examination and investigation efforts by failing to provide full and timely responses to FINRA's requests for information. This lack of cooperation requires FINRA to increase regulatory pressure to gain cooperation and seek other sources for information, delaying FINRA's investigative efforts.

When FINRA is ready to pursue enforcement action against such a firm, a temporary cease and desist order may not be available (since many circumstances are not within the scope of that authority) or may not enable more rapid intervention (since the disciplinary complaint must be ready to be filed at the same time). While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm can further prolong the disciplinary action by litigating through the stages described above.

In light of these considerations, FINRA has undertaken an initiative to better address the issues created by individuals and firms with a history of misconduct. The initial focus of this initiative has been to strengthen the controls by FINRA and firms over the risks posed by *individuals* with a history of misconduct, including:

- *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;
- *Regulatory Notice 18-16* (FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them), which seeks comment on proposed rule amendments that, among other things, would impose additional restrictions on member firms that employ brokers with a history of specified misconduct events by requiring the filing with FINRA of a materiality consultation when such individuals seek to become owners, control persons, principals or registered persons of a firm; authorize Hearing Panels and Hearing Officers to impose conditions and restrictions on a respondent in a disciplinary proceeding that are reasonably necessary for the purpose of preventing customer harm during that respondent's appeal of a disciplinary decision; and require firms that apply to continue associating with a statutorily disqualified person to include in that application an interim plan of heightened supervision that would be effective throughout the application process; and
- *Regulatory Notice 18-17* (FINRA Revises the Sanction Guidelines), which announced revisions to the FINRA Sanction Guidelines.

In addition, FINRA raised fees for statutory disqualification applications,[8] and it revised the qualification examination waiver guidelines to more broadly consider past misconduct when considering examination waiver requests.[9]

While these efforts should help mitigate the risks posed by individual brokers with a history of misconduct, challenges remain where a member firm itself has a concentration of such brokers without adequate supervision—in some cases because the firm seeks out such brokers—or otherwise has a history of substantial compliance failures.

As a result, FINRA is proposing to adopt Rule 4111, which would impose obligations on members that have significantly higher levels of risk-related disclosures than similarly sized peers. FINRA would preliminarily identify these members by using numeric, threshold-based criteria and several additional steps that would guard against misidentification. The obligations could include requiring a member to maintain a specific deposit amount, with cash or qualified securities, in a segregated account at a bank or clearing firm, from which the member could make withdrawals only with FINRA's approval. This proposal also aims to preserve firm funds for payment of arbitration awards against them. The proposal would achieve this both through how a member's "covered pending arbitration claims" and unpaid arbitration awards could impact the size of its restricted deposit requirement, and a presumption that a member would continue to maintain a restricted deposit if it has any "covered pending arbitration claims" or unpaid arbitration awards.[10]

FINRA also considered proposing a "terms and conditions" rule similar to Investment Industry Regulatory Organization of Canada (IIROC) Consolidated Rule 9208, which permits IIROC, in an effort to strategically target the most problematic firms, to exercise discretion to identify firms and develop appropriate terms and conditions on their operations.[11] Although FINRA is still considering such a rule, it is not proposing it at this time.

Proposed Amendments

1. Proposed Rule 4111 (Restricted Firm Obligations)

FINRA is proposing to adopt Rule 4111 (Restricted Firm Obligations), a new rule that would use numeric-based thresholds based on firm-level and individual-level disclosure events or conditions disclosed on the Uniform Registration Forms[12] and, subject to an internal Department of Member Supervision (Department) review and member firm consultation process, presumptively impose a "Restricted Deposit Requirement" on members that present a high degree of risk to the investing public. FINRA believes that a restricted deposit is most likely to change such members' behavior—and therefore protect investors—through its direct financial impact.

- General/Multi-Step Process for Identifying "Restricted Firms" (Proposed Rule 4111(a))

The proposed rule would create a multi-step process to guide FINRA's determination of whether a member raises investor-protection concerns substantial enough to require that it be subject to additional obligations. Those obligations could include a requirement to maintain a deposit of cash or qualified securities in an account from which withdrawals would be restricted, or conditions or restrictions on the member's operations that are necessary or appropriate for the protection of investors and in the public interest.[13] The proposed rule would give each affected member firm several ways to affect outcomes, including a one-time opportunity to reduce staffing so as to no longer trigger the preliminary identification criteria and numeric thresholds, a consultation with the Department at which the member could explain why it should not be subject to a Restricted Deposit Requirement or propose alternatives, and the right to challenge a Department determination by requesting a hearing before a Hearing Officer in an expedited proceeding.

The proposed multi-step process includes numerous features designed to focus the obligations on the small number of firms motivating this rule proposal. As the attached flow chart reflects (Attachment B), this process is akin to a "funnel." The top of the funnel applies to a limited set of firms with numerous disclosures, with a narrowing in the middle of the potential member firms that may be subject to additional obligations, and the bottom of the funnel reflecting the small number of member firms that present high risks to the investing public.

  - Annual Calculation by FINRA of Preliminary Criteria for Identification (Proposed Rule 4111(b))

The multi-step process would begin with an annual calculation. As explained more below, the Department would calculate annually a member firm's "Preliminary Identification Metrics" to determine if it meets the "Preliminary Criteria for Identification." A key driver of that is whether a firm's "Preliminary Identification Metrics" meet quantitative, risk-based "Preliminary Identification Metrics Thresholds."[14]

Several principles guide the Preliminary Criteria for Identification and the Preliminary Identification Metrics Thresholds. The criteria and thresholds are intended to be replicable and transparent to FINRA and affected member firms; employ the most complete and accurate data available to FINRA; are objective; account for different firm sizes and business profiles; and target the sales-practice concerns that are motivating the proposal. FINRA also has sought to develop criteria and thresholds that identify members that present a high risk but limit improperly imposing obligations on firms whose risk profile and activities do not warrant such obligations.

Using these guiding principles, FINRA is proposing numeric thresholds based on six categories of events or conditions, nearly all of which are based on information disclosed through the Uniform Registration Forms.[15] The six categories are:

1. Registered Person Adjudicated Events;[16]
2. Registered Person Pending Events;[17]
3. Registered Person Termination and Internal Review Events;[18]
4. Member Firm Adjudicated Events;[19]
5. Member Firm Pending Events;[20] and
6. Registered Persons Associated with Previously Expelled Firms (also referred to as the Expelled Firm Association category).[21]

To calculate whether a member meets the Preliminary Criteria for Identification, which is defined in proposed Rule 4111(i)(9), the Department would first compute the Preliminary Identification Metrics for each category, which are set forth in proposed Rule 4111(i)(10). Each category's Preliminary Identification Metric computation would start with a calculation of the sum of the pertinent disclosure events or, for the Expelled Firm Association category, the sum of the Registered Persons Associated with Previously Expelled Firms. For the adjudicated disclosure-event based categories, the counts would include disclosure events that reached a resolution during the prior five years from the date of the calculation. For the pending-events categories and pending internal reviews, the counts would include disclosure events that are pending as of the date of the calculation. In addition, for the three Registered Person disclosure-event based categories, the counts would include disclosure events across all "Registered Persons In-Scope," defined in proposed Rule 4111(i)(13) as persons registered with the member firm for one or more days within the one year prior to the calculation date.

Each of those six sums would then be standardized to determine the member's six Preliminary Identification Metrics. For the five Registered Person and Member Firm event categories (Categories 1-5 above), the proposed Preliminary Identification Metrics are in the form of an average number of events per registered broker, calculated by taking each category's sum and dividing it by the number of Registered Persons In-Scope. For the Registered Persons Associated with Expelled Firms category (Category 6), the proposed Preliminary Identification Metric is in the form of a percentage concentration at the member of registered persons who, at any time in their career, were associated with previously expelled firms. This concentration is calculated by taking the number of Registered Persons Associated with Previously Expelled Firms and dividing it by the number of Registered Persons In-Scope.

A firm's six Preliminary Identification Metrics are used to determine if the member firm meets the Preliminary Criteria for Identification. To meet the Preliminary Criteria for Identification, a firm would need to meet the Preliminary Identification Metrics Thresholds, set forth in proposed Rule 4111(i)(11), for two or more of the appropriate categories listed above for its size and, if it does, one of these categories must be for adjudicated events and the firm must have two or more events (in categories besides the Expelled Firm Association category). This involves analyzing the extent to which the Preliminary Identification Metrics meet the specified numeric Preliminary Identification Metrics Thresholds and meet additional conditions intended to prevent a member from becoming potentially subject to additional obligations solely as a result of pending matters or a single event or condition. Specifically, the Department would:

- first, pursuant to proposed Rule 4111(b) and (i)(9)(A), evaluate whether two or more of the member firm's Preliminary Identification Metrics are equal to or more than the corresponding Preliminary Identification Metrics Thresholds for the member firm's size,[22] and whether at least one of those Preliminary Identification Metrics is the Registered Person Adjudicated Event Metric, the Member Firm Adjudicated Event Metric, or the Expelled Firm Association Metric; and

- second, pursuant to proposed Rule 4111(b) and (i)(9)(B), evaluate whether the member firm has two or more Registered Person or Member Firm Events (*i.e.*, two or more events from Categories 1-5 above).[23]

If all these conditions are met, the member would meet the Preliminary Criteria for Identification.

Each specific numeric threshold in the Preliminary Identification Metrics Thresholds grid in proposed Rule 4111(i)(11) is a number which represents outliers with respect to peers for the type of events in the category (*i.e.*, the firm is at the far tail of the respective category's distribution), which is intended to preliminarily identify member firms that present significantly higher risk than a large percentage of the membership. In addition, there are numeric thresholds for seven different firm sizes, to ensure that each member firm is compared only to its similarly sized peers. As explained more below in the Economic Impact Assessment, based on recent history FINRA expects that its annual calculations will identify between 60-98 member firms that meet the Preliminary Criteria for Identification.

The following three examples demonstrate—in practical terms—the point at which a member firm's Preliminary Identification Metrics would meet the Preliminary Identification Metrics Thresholds in proposed Rule 4111(i)(11):

	Preliminary Identification Metrics Thresholds	Practical Equivalent
Example 1 (member firm size between 1-4 registered persons)	The Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric, for a member that has between one and four Registered Persons In-Scope as of the Evaluation Date,[24] is 0.50 (or 0.50 events per Registered Broker In-Scope).	For a member with four Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric if the sum of its four Registered Persons In-Scope's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was *two or more*. (4 Registered Persons In-Scope) * (0.50 Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric) = (2 Adjudicated Events)
Example 2 (member firm size between 20-50 registered persons)	The Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric, for a member that has between 20-50 Registered Persons In-Scope as of the Evaluation Date, is 0.20 (or 0.20 events per Registered Broker In-Scope).	For a member with 50 Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric if the sum of the member's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was *ten or more*. (50 Registered Persons In-Scope) * (0.20 Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric) = (10 Adjudicated Events)
Example 3 (member firm size between 51-150 registered persons)	The Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric, for a member that has between 51-150 Registered Persons In-Scope as of the Evaluation Date, is 0.25 (or a 25% concentration level).	For a member with 100 Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric if the sum of its Registered Persons Associated with Previously Expelled Firms was *25 or more*. (100 Registered Persons In-Scope) * (0.25 Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric) = (25 Registered Persons Associated with Previously Expelled Firms)

FINRA has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily identify the member firms that are motivating this rule proposal.[25] As explained below, however, the proposed rule involves several additional steps to guard against the risk of misidentification.

- Initial Department Evaluation (Proposed Rule 4111(c)(1))

For each member firm that meets the Preliminary Criteria for Identification, the Department would conduct, pursuant to proposed Rule 4111(c)(1), an initial internal evaluation to determine whether the member does not warrant further review under Rule 4111. In doing so, the Department would review whether it has information to conclude that the computation of the member's Preliminary Identification Metrics included disclosure events or other conditions that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. For example, the Department may have information that the computation included disclosure events that were not sales-practice related, were duplicative (involving the same customer and the same matter), or mostly involved compliance concerns best addressed by a different regulatory response by FINRA. As another example, the Department may have information that the Expelled Firm Association Metric calculation included registered persons who had associated with previously expelled firms only for a brief amount of time. The Department would also consider whether the member has addressed the concerns signaled by the disclosure events or conditions or altered its business operations, including staffing reductions, such that the threshold calculation no longer reflects the member's current risk profile. Essentially, the purpose of the Department's initial evaluation is to determine whether it is aware of information that would show that the member—despite having met the Preliminary Criteria for Identification—does not pose a high degree of risk.

If the Department determines, after this initial evaluation, that the member does not warrant further review, the Department would conclude that year's Rule 4111 process for the member and would not seek that year to impose any obligations on the member. If, however, the Department determines that the member does warrant further review, the Rule 4111 process would continue.

- One-Time Opportunity to Reduce Staffing Levels (Proposed Rule 4111(c)(2))

If the Department determines, after its initial evaluation, that a member that meets the Preliminary Criteria for Identification warrants further review under Rule 4111, such member—if it would be meeting the Preliminary Criteria for Identification for the first time—would have a one-time opportunity to reduce its staffing levels to no longer meet these criteria, within 30 business days after being informed by the Department. The member would be required to demonstrate the staff reduction to the Department by identifying the terminated individuals. The proposed rule would prohibit the member from rehiring any persons terminated pursuant to this option, in any capacity, for one year. A member that has reduced staffing levels at this stage may not use that staff-reduction opportunity again.

If the Department determines that the member firm's reduction of staffing levels results in its no longer meeting the Preliminary Criteria for Identification, the Department would close out that year's Rule 4111 process for the member and would not seek that year to impose any obligations on that member. If, on the other hand, the Department determines that the member still meets the Preliminary Criteria for Identification even after its staff reductions, or if the member elects not to use its one-time opportunity to reduce staffing levels, the Department would proceed to determine the member's maximum Restricted Deposit Requirement, and the member would proceed to a Consultation with the Department.

- FINRA's Determination of a Maximum Restricted Deposit Requirement (Proposed Rule 4111(i)(15))

For members that warrant further review after being deemed to meet the Preliminary Criteria for Identification and after the initial Department evaluation, the Department would then determine the member's maximum "Restricted Deposit Requirement."

The Department would tailor the member's maximum Restricted Deposit Requirement amount to its size, operations and financial conditions. As provided in proposed Rule 4111(i)(15), the Department would consider the nature of the member's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any "covered pending arbitration claims" or unpaid arbitration awards, and concerns raised during FINRA exams.[26] Based on a consideration of these factors, the Department would determine a maximum Restricted Deposit Requirement for the member that would be consistent with the objectives of the rule, but not significantly undermine the continued financial stability and operational capability of the member as an ongoing enterprise over the next 12 months. FINRA's intent is that the maximum Restricted Deposit Requirement should be significant enough to change the member's behavior but not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement.

To provide increased transparency, Attachment C contains several examples that are intended to demonstrate how, in different scenarios, the Department might exercise its discretion in determining a maximum Restricted Deposit Requirement. Nothing in the examples is intended to suggest that the Department will follow specific formulas in determining a maximum Restricted Deposit Requirement or the weight that any specific circumstances carry. FINRA welcomes comments on alternative ways of calculating the Restricted Deposit Requirement that would be more predictable while remaining impactful but avoiding disproportionate effects on different types of firms.

- Consultation (Proposed Rule 4111(d))

As explained above, if the Department determines, after initially calculating that a member firm meets the Preliminary Criteria for Identification, conducting its internal evaluation, and affording the one-time opportunity to reduce staffing levels (if available), that a member warrants further Rule 4111 review, the Department would consult with the member, pursuant to proposed Rule 4111(d). This Consultation will give the member an opportunity to demonstrate why it does not meet the Preliminary Criteria for Identification, why it should not be designated as a Restricted Firm, and why it should not be subject to the maximum Restricted Deposit Requirement.

In the Consultation, there would be two rebuttable presumptions: that the member should be designated as a Restricted Firm; and that it should be subject to the maximum Restricted Deposit Requirement. The member would bear the burden of overcoming those presumptions.

Proposed Rule 4111(d)(1) governs how a member may overcome these two presumptions. Proposed Rule 4111(d)(1)(A) provides that a member may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation that the member meets the Preliminary Criteria for Identification is inaccurate because, among other things, it included events, in the six categories described above, that should not have been included because, for example, they are duplicative, involving the same customer and the same matter, or are not sales-practice related. Proposed Rule 4111(d)(1)(B) provides that a member may overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement by clearly demonstrating to the Department that the member would face significant undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement and that a lesser deposit requirement would satisfy the objectives of Rule 4111 and be consistent with the protection of investors and the public interest; or that other conditions and restrictions on the operations and activities of the member and its associated persons would address the concerns indicated by the thresholds and protect investors and the public interest.

Proposed Rule 4111(d)(2) governs how the Department would schedule and provide notice of the Consultation.

Proposed Rule 4111(d)(3) provides guidance on what the Department would consider during the Consultation, when evaluating whether a member should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement. This provision also provides members with guidance on how to attempt to overcome the two rebuttable presumptions. For example, proposed Rule 4111(d)(3) requires that the Department consider information provided by the member during any meetings as part of the Consultation; relevant information or documents, if any, submitted by the member, in the manner and form prescribed by the Department, as would be necessary or appropriate for the Department to review the computation of the Preliminary Criteria for

Identification; a plan, if any, submitted by the member, in the manner and form prescribed by the Department, proposing in detail the specific conditions or restrictions that the member seeks to have the Department consider; such other information or documents as the Department may reasonably request from the member related to the evaluation; and information provided by the member during any meetings as part of the Consultation. To the extent a member seeks to claim undue financial hardship, it would be the member's burden to support that with documents and information.

- Department Decision (Proposed Rule 4111(e)); No Stays

After the Consultation, proposed Rule 4111(e) would require that the Department render a Department decision. Under proposed Rule 4111(e)(1), there are three paths that decision might take:

- If the Department determines that the member has rebutted the presumption that it should be designated as a Restricted Firm, the Department's decision would be required to state that the member will not be designated that year as a Restricted Firm.

- If the Department determines that the member has not rebutted the presumption that it should be designated as a Restricted Firm or the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member as a Restricted Firm and require the member to promptly establish a Restricted Deposit Account, deposit and maintain in that account the maximum Restricted Deposit Requirement, and implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

- If the Department determines that the member has not rebutted the presumption that it should be designated as a Restricted Firm but has rebutted the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member as a Restricted Firm; would impose no Restricted Deposit Requirement on the member or require the member to promptly establish a Restricted Deposit Account, deposit and maintain in that account a Restricted Deposit Requirement in such dollar amount less than the maximum Restricted Deposit Requirement as the Department deems necessary or appropriate; and would require the member to implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

Pursuant to proposed Rule 4111(e)(2), the Department would be required to provide a written notice of its determination to the member, pursuant to proposed new Rule 9559,[27] no later than 30 days from the date of the letter that scheduled the Consultation. Where the Department decision imposes a Restricted Deposit Requirement or other conditions or restrictions, it also would inform the member of its ability to request a hearing with the Office of Hearing Officers in an expedited proceeding, as further described below.

Proposed Rule 4111(e)(2) would provide that a request for a hearing would not stay the effectiveness of the Department's determination. However, upon requesting a hearing of a Department determination that imposes a Restricted Deposit Requirement, the member would only be required to maintain in a Restricted Deposit Account the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year, until the Office of Hearing Officers or the National Adjudicatory Council (NAC) issues its final written order in the expedited proceeding. This has one exception: a member that is re-designated as a Restricted Firm and is already subject to a previously imposed Restricted Deposit Requirement would be required to maintain the full amount of its Restricted Deposit Requirement until the Office of Hearing Officers or the NAC issues its final written order in the expedited proceeding.

- Continuation or Termination of Restricted Firm Obligations (Proposed Rule 4111(f))

The proposed Restricted Firm Obligations Rule would require FINRA to evaluate annually whether each member is, or continues to be, a Restricted Firm and whether the member should be subject to any obligations. For this reason, proposed Rule 4111(f) contains provisions that set forth how any obligations that were imposed during the Rule 4111 process in one year are continued or terminated in that same year and in subsequent years.

Proposed Rule 4111(f)(1), titled "Currently Designated Restricted Firms," establishes constraints on a member's ability to seek to modify or terminate, directly or indirectly, any obligations imposed pursuant to Rule 4111. Because the Restricted Firm Obligations Rule would entail annual reviews by the Department to determine whether a member is a Restricted Firm that should be subject to obligations, a Restricted Firm would have an annual opportunity to seek the termination or modification of any obligations that continue to be imposed. For this reason, proposed Rule 4111 does not authorize a Restricted Firm to seek, outside of the Consultation process and any ensuing expedited proceedings after a Department decision, an interim termination or modification of any obligations imposed. Rather, proposed Rule 4111(f)(1) provides that a member that has been designated as a Restricted Firm will not be permitted to withdraw all or any portion of its Restricted Deposit Requirement, or seek to terminate or modify any deposit requirement, conditions, or restrictions that have been imposed on it, without the prior written consent of the Department.

Proposed Rule 4111(f)(2), titled "Re-Designation as a Restricted Firm," addresses the scenario when the Department determines in one year that a member is a Restricted Firm, and in the following year determines that the member still meets the Preliminary Criteria for Identification. In that instance, the Department would re-designate the member as a Restricted Firm, and the obligations previously imposed on the member would remain effective and unchanged, unless either the member or the Department requests, within 30 days of the Department's decision to re-designate the member as a Restricted Firm, a Consultation. If a Consultation is requested, the obligations previously imposed would remain effective and unchanged unless and until the Department modifies or terminates them after the Consultation. In addition, in the Consultation process, a presumption would apply that any previously imposed Restricted Deposit Requirement, conditions or restrictions would remain effective and unchanged, absent a showing by the party seeking changes that they are no longer necessary or appropriate for the protection of investors or in the public interest. At the end of the Consultation, the Department would be required to provide written notice of its determination to the member, no later than 30 days from the date of the letter provided to the member under Rule 4111(d)(2) that schedules the Consultation.

Proposed Rule 4111(f)(3), titled "Previously Designated Restricted Firms," addresses the scenario where the Department determines in one year that a member is a Restricted Firm, but in the following years determines that the member either does not meet the Preliminary Criteria for Identification or should not be designated as a Restricted Firm. In that case, the member would no longer be subject to any obligations previously imposed under proposed Rule 4111. There would be one exception: a former Restricted Firm would not be permitted to withdraw any portion of its Restricted Deposit Requirement without submitting an application and obtaining the Department's prior written consent for the withdrawal. Such an application would be required to include, among other things set forth in proposed Rule 4111(f)(3), evidence as to whether the member has "covered pending arbitration claims" or any unpaid arbitration awards outstanding against the member. The Department would determine whether to authorize a withdrawal, in part or in whole, but there would be a presumption that the member would be required to continue to maintain its Restricted Deposit Requirement if it has any "covered pending arbitration claims" or any unpaid arbitration awards. The Department would be required to issue a notice of its decision on an application to withdraw from the Restricted Deposit Account, pursuant to proposed new Rule 9559, within 30 days from the date the application is received.

- Restricted Deposit Account (Proposed Rule 4111(i)(14))

If a Department decision requires a member to establish a Restricted Deposit Account, proposed Rule 4111(i)(14) would govern this account. The underlying policy for the proposed account requirements is that, to make a deposit requirement effective in creating appropriate incentives to members that pose higher risks to change their behavior, the member must be restricted from withdrawing any of the required deposit amount, even if it terminates its FINRA membership.

The proposed rule would require that the Restricted Deposit Account be established, in the name of the member, at a bank or the member's clearing firm. The account must be subject to an agreement in which the bank or the clearing firm agrees: not to permit withdrawals from the account absent FINRA's prior written consent; to keep the account separate from any other accounts maintained by the member with the bank or clearing firm; that the cash or qualified securities on deposit will not be used directly or indirectly as security for a loan to the member by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm; that if the member becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and withdrawals will not be permitted without FINRA's prior written consent; that FINRA is a third-party beneficiary to the agreement; and that the agreement may not be amended without FINRA's prior written consent. In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member.

These account restrictions would impact how a Restricted Firm calculates its net capital levels. As explained in proposed Rule 4111.01, a deposit in the Restricted Deposit Account would be an asset of the member firm that could not readily be converted into cash, due to the restrictions on accessing it. Accordingly, the member would be required to deduct deposits in the Restricted Deposit Account when determining its net capital under Exchange Act Rule 15c3-1 and FINRA Rule 4110.

- Books and Records (Proposed Rule 4111(g))

Proposed Rule 4111(g) would establish new requirements to maintain books and records that evidence the member's compliance with the Restricted Firm Obligations Rule and any Restricted Deposit Requirement or other conditions or restrictions imposed under that rule. In addition, the proposed books and records provision would specifically require a member subject to a Restricted Deposit Requirement to provide to the Department, upon its request, records that demonstrate the member's compliance with that requirement.

- Notice of Failure to Comply (Proposed Rule 4111(h))

FINRA also is proposing a requirement to address the situation when a member fails to comply with the obligations imposed. Under proposed Rule 4111(h), FINRA would be authorized to issue a notice pursuant to proposed new Rule 9559 directing a member that is not in compliance with its Restricted Deposit Requirement, or with any conditions or restrictions imposed under Rule 4111, to suspend all or a portion of its business.

- Definitions (Proposed Rule 4111(i))

The above description of proposed Rule 4111 introduces many of the terms that would be defined by Rule 4111. A complete list of defined terms used in the proposed rule appears in proposed Rule 4111(i).

- Compliance with Continuing Membership Application Rule (Proposed Rule 4111.02 - Compliance with Rule 1017)

Proposed Supplementary Material .02 would clarify that nothing in the proposed rule would alter a member's obligations under Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations). A member firm subject to proposed Rule 4111 would need to continue complying with the requirements of Rule 1017 and submit continuing membership applications as necessary.

- Periodic Review of Preliminary Identification Metrics Thresholds

FINRA would review the Preliminary Identification Metrics Thresholds on a periodic basis, to consider whether the thresholds remain targeted and effective at identifying firms that pose higher risks.

2. Proposed Amendments to the Rule 9550 Series to Establish a New Expedited Proceeding to Implement the Requirements of Proposed Rule 4111

FINRA is proposing to establish a new expedited proceeding in the Rule 9550 Series (Expedited Proceedings), specifically proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111), that would allow member firms to request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and grant a right to challenge any of the "Rule 4111 Requirements," including any Restricted Deposit Requirements, imposed.[28] The new expedited proceeding would govern how the Department provides notice of its determinations and afford affected member firms the right to seek a Hearing Officer's review of those determinations.

- Notices Under Proposed Rule 4111 (Proposed New Rule 9559(a))

Proposed new Rule 9559(a) would establish an expedited proceeding for the Department's determinations under proposed Rule 4111 to designate a member as a Restricted Firm and impose obligations on the member; and to deny a member's request to access all or part of its Restricted Deposit Requirement.

Proposed new Rule 9559(a) would require the Department to serve a notice that provides its determination and the specific grounds and factual basis for the Department's action; states when the action will take effect; informs the member that it may file, pursuant to Rule 9560, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explains the Hearing Officer's authority. The proposed rule also would provide that, if a member does not request a hearing, the notice of the Department's determination will constitute final FINRA action.

Proposed new Rule 9559(a) also would provide that any of the Rule 4111 Requirements imposed in a notice issued under proposed new Rule 9559(a) are immediately effective. In general, a request for a hearing would not stay those requirements. There would be one partial exception: when a member requests review of a Department determination under proposed Rule 4111 that imposes a Restricted Deposit Requirement on the member for the first time, the member would be required to deposit, while the expedited proceeding was pending, the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year.

- Notice for Failure to Comply with the Proposed Rule 4111 Requirements (Proposed New Rule 9559(b))

Proposed new Rule 9559(b) would establish an expedited proceeding to address a member's failure to comply with any requirements imposed pursuant to proposed Rule 4111.

Proposed new Rule 9559(b) would authorize the Department, after receiving authorization from FINRA's CEO, or such other executive officer as the CEO may designate, to serve a notice stating that the member's failure to comply with the Rule 4111 Requirements, within seven days of service of the notice, will result in a suspension or cancellation of membership. The proposed rule would require that the notice identify the requirements with which the member is alleged to have not complied; include a statement of facts specifying the alleged failure; state when the action will take effect; explain what the member must do to avoid the suspension or cancellation; inform the member that it may file, pursuant to Rule 9560, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explain the Hearing Officer's authority. The proposed rule also would provide that, if a member does not request a hearing, the suspension or cancellation will become effective seven days after service of the notice.

Proposed new Rule 9559(b) also would provide that a member could file a request seeking termination of a suspension imposed pursuant to the rule, on the ground of full compliance with the notice or decision. The proposed rule would authorize the head of the Department to grant relief for good cause shown.

- Hearings (Proposed Amendments to the Hearing Procedures Rule)[29]

If a member requests a hearing under proposed new Rule 9559, the hearing would be subject to Rule 9560 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series). FINRA is proposing several amendments to Rule 9560 that would be specific to hearings requested pursuant to proposed new Rule 9559.

Hearings in expedited proceedings under proposed new Rule 9559 would have processes that are similar to the hearings in most of FINRA's other expedited proceedings—including requirements for the parties' exchange of documents and exhibits, the time for conducting the hearing, evidence, the record of the hearing, the record of the proceeding, failures to appear, the timing and contents of the Hearing Officer's decision, the Hearing Officer's authority, and the authority of the NAC to call an expedited proceeding for review—and FINRA is proposing amendments to the Rule 9560 provisions that govern these processes to adapt them for expedited proceedings under proposed new Rule 9559. A few features of the proposed amendments to Rule 9560 warrant emphasis or guidance:

- Hearing Officer's Authority (Proposed Amended Rule 9560(d) and (n))

Hearings in expedited proceedings under proposed new Rule 9559 would be presided over by a Hearing Officer. The Hearing Officer's authority would differ depending on whether the hearing is in an action brought under proposed new Rule 9559(a) (Notices Under Rule 4111) or 9559(b) (Notice for Failure to Comply with the Rule 4111 Requirements):

  - Proposed amended Rule 9560(n)(6) would provide that the Hearing Officer, in actions brought under proposed new Rule 9559(a), may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the Department, but may not modify any of the Rule 4111 Requirements, or impose any other requirements or obligations available under proposed Rule 4111.

  - Proposed amended Rule 9560(n)(6) would authorize the Hearing Officer, in failure-to-comply actions under proposed new Rule 9559(b), to approve or withdraw the suspension or cancellation of membership, and impose any other fitting sanction. Authorizing a Hearing Officer to impose any other fitting sanction is intended to provide a Hearing Officer with authority that is appropriate for responding to situations involving firms that repeatedly fail to comply with an effective FINRA action under proposed Rule 4111.

- Timing Requirements

The proposed amendments to the Hearing Procedures Rule are intended to give members a prompt process for challenging a Department decision under proposed Rule 4111. Proposed amended Rule 9560(f) would require that a hearing in actions under proposed new Rule 9559(a) be held within 30 days, and that a hearing in failure-to-comply actions under proposed new Rule 9559(b) be held within 14 days, after the member requests a hearing.[30]

Proposed amended Rule 9560(o) would require the Hearing Officer, in all actions pursuant to proposed new Rule 9559, to prepare a proposed written decision, and provide it to the NAC's Review Subcommittee, within 60 days of the date of the close of the hearing. Pursuant to Rule 9560(q), the Review Subcommittee could call the proceeding for review within 21 days after receipt of the proposed decision. As in most expedited proceedings, the timing of FINRA's final decision would then depend on whether or not the Review Subcommittee calls the matter for review.[31]

- Contents of the Decision

Proposed amended Rule 9560(p) governs the contents of the Hearing Officer's decision. The proposed amendments would broaden Rule 9560(p)(6) to account for the kinds of obligations that could be imposed under proposed Rule 4111. Rule 9560(p) would otherwise remain the same. For example, Rule 9560(p) would continue to require that the Hearing Officer's decision include a statement setting forth the findings of fact with respect to any act or practice the respondent was alleged to have committed or omitted or any condition specified in the notice, the Hearing Officer's conclusions regarding the condition specified in the notice, and a statement in support of the disposition of the principal issues raised in the proceeding.

Additional guidance may be helpful, considering the different kinds of issues that may arise in an expedited proceeding pursuant to proposed new Rule 9559. For example, in a request for a hearing of a Department determination that imposes a Restricted Deposit Requirement or other obligations under Rule 4111, the principal issues raised may include whether: (1) the member firm should not be designated a Restricted Firm; (2) the Department incorrectly included disclosure events when calculating whether the member meets the Preliminary Criteria for Identification; (3) a Restricted Deposit Requirement would impose an undue financial burden on the member; or (4) the obligations imposed are inconsistent with the standards set forth in proposed Rule 4111(e). In a request for a hearing of a Department determination that denies a request to withdraw amounts from a Restricted Deposit Account, the principal issues raised may include whether the member firm has covered pending arbitration claims or unpaid arbitration awards.

- No Collateral Attacks on Underlying Disclosure Events

In expedited proceedings pursuant to proposed new Rule 9559(a) to review a Department determination under the Restricted Firm Obligations Rule, a member firm may sometimes seek to demonstrate that the Department included incorrectly disclosure events when calculating whether the member meets the Preliminary Criteria for Identification. When the member does so, however, it would not be permitted to collaterally attack the underlying merits of those final actions. An expedited proceeding under proposed new Rule 9559 would not be the forum for attempting to re-litigate past final actions.[32]

Additional Approach Considered

FINRA also has considered a "terms and conditions" rule, but is not proposing such a rule at this time. As further discussed below in the Economic Impact Assessment, the numeric threshold-based approach in Rule 4111 has benefits and limitations. Because the rule would provide transparent, objective criteria based on public disclosure events, it would allow firms to understand clearly how they could become subject to the rule. On the other hand, the numeric-based criteria and thresholds may not identify all firms that raise the concerns motivating this proposal; firms may minimally change behavior simply to stay below established criteria and thresholds; firms may attempt to underreport required disclosures on Uniform Registration Forms; and the numerous steps that guard against misidentifications will affect how quickly FINRA can intervene.

Because of these limitations, FINRA also has considered an additional option for addressing firms with a history of misconduct that may pose a risk to investors. A key objective in developing possible approaches was to strengthen FINRA's ability to take earlier, effective intervention. The firms motivating FINRA action in this area typically have substantial and unaddressed compliance failures over multiple examination cycles that put investors or market integrity at risk. These serious compliance failures may be prolonged by firms while FINRA works to build a case of violations of specific securities requirements, which often requires obtaining the willing cooperation of customers. To meet this challenge, FINRA has considered another option that would permit FINRA to address prolonged noncompliance by the small number of firms whose activities present heightened risk of harm to investors and that may undermine confidence in the securities markets as a whole.

Specifically, FINRA has considered a proposal that would be similar to the IIROC's "terms and conditions" rule. Under this rule, IIROC may impose terms and conditions on an IIROC Dealer Member's membership when IIROC considers these terms and conditions appropriate to ensure the member's continuing compliance with IIROC requirements. IIROC has indicated that it will use this authority against its dealers that fail to address significant compliance findings or that fail to demonstrate a commitment to the development of a strong compliance culture, and primarily to address situations in which there are outstanding compliance issues that clearly require regulatory action, but that may not be best addressed through an enforcement proceeding.[33] IIROC's imposition of terms and conditions may be challenged by requesting a hearing panel review and a further appeal to provincial authorities, but the terms and conditions do not appear to be stayed during an appeal.

Compared to proposed Rule 4111, the regulatory benefits of a "terms and conditions" rule approach could arise from greater flexibility in identifying firms of concern, which may not trigger Rule 4111's thresholds, and quicker intervention to ensure compliance. Such an approach could also help mitigate the under- and over-inclusive concerns of the threshold-based criteria approach, and it could help fill the gap where a firm might not otherwise meet the numeric thresholds of proposed Rule 4111 but still has a history of serious noncompliance that poses a high degree of risk to investors or the markets. It also could allow for the imposition of tailored limitations and controls on firms and their brokers who might otherwise endanger customers, while motivating changes in the practices, activities and culture of firms seeking to terminate any terms and conditions imposed.

This approach could empower FINRA—outside of the continuing membership application process, the enforcement process and the proposed new Restricted Firm Obligations Rule—to require that a member abide by identified terms and conditions to incent its compliance with the federal securities laws and FINRA rules. Possible terms and conditions could include operational, conduct, financial, or sales practice obligations; limitations on business expansions; or other obligations on the business of the member or its associated persons.

Under this "terms and conditions" approach, the circumstances in which FINRA could intervene would be limited to when a member has repeatedly and significantly demonstrated a lack of compliance with the securities laws, the rules thereunder, or FINRA rules in specific ways that threaten investors or market integrity, and has not acted promptly to resolve the noncompliant condition. To ensure that the authority could be used in only the most serious circumstances, the imposition of terms and conditions would require the prior approval of FINRA's Chief Executive Officer or other executive officer not in FINRA's Departments of Member Supervision or Enforcement. In addition, a firm could be given an opportunity to request a prompt review of any terms and conditions imposed through an expedited proceeding process.

Although FINRA has closely considered, and will continue to further explore, this option, it is not proposing a terms and conditions approach at this time pending consideration of proposed Rule 4111.

Economic Impact Assessment

1. Regulatory Need

FINRA uses a number of measures to deter and discipline misconduct by firms and brokers, and continually strives to strengthen its oversight of the brokers and firms it regulates. These measures span across several FINRA programs, including review of new and continuing membership applications, risk monitoring of broker and firm activity, cycle and cause examinations, and enforcement and disciplinary actions.

As part of its efforts to monitor and deter misconduct, FINRA has adopted rules that impose supervisory obligations on firms to ensure they are appropriately supervising their brokers' activities. These rules require each firm 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. Under this regulatory framework, FINRA also provides guidance to ensure consistency in interpretation of the rules and to further strengthen compliance across firms. As such, all firms play an important role in ensuring effective compliance with applicable securities laws and FINRA rules to prevent misconduct. This is consistent with the incentives of economic agents.[34]

Nonetheless, some firms do not effectively carry out these supervisory obligations to ensure compliance and they act in ways that could harm their customers—sometimes substantially. For example, recent academic studies find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence of predictability of future disciplinary and other regulatory-related events for brokers and firms with a history of past similar events.[35] These patterns suggest that some firms may not be acting appropriately as a first line of defense to prevent customer harm. Further, some firms may take advantage of the fair-process protections afforded to them under the federal securities laws and FINRA rules to forestall timely and appropriate regulatory actions, thereby limiting FINRA's ability to curb misconduct promptly. Without additional protections, the risk of potential customer harm may continue to exist at firms that fail to effectively carry out their supervisory obligations or are associated with a significant number of regulatory-related events. Further, even where harmed investors obtain arbitration awards, brokers and firms may still fail to pay those awards. Unpaid arbitration awards harm successful customer claimants and may diminish investors' confidence in the arbitration process.[36]

To mitigate these risks, FINRA seeks additional authority to impose obligations on firms that pose these types of greater risk to their customers. The proposed Restricted Firm Obligations Rule would identify firms based upon a concentration of significant firm and broker events on their disclosure records that meet the proposed criteria and specified thresholds. Under the proposal, FINRA seeks the authority to impose obligations on firms that are necessary or appropriate.

2. Economic Baseline

The economic baseline used to evaluate the economic impacts of the proposed rules is the current regulatory framework, including FINRA rules relating to supervision, the membership application process, statutory disqualification proceedings and disciplinary proceedings that provide rules to deter and discipline misconduct by firms and brokers. This baseline serves as the primary point of comparison for assessing economic impacts of the proposed rules, including incremental benefits and costs.

The proposals are intended to apply to firms that pose greater risks to their customers than other firms. One identifier of these types of firms is that they and their brokers generally have substantially more regulatory-related events on their records than do their peers.[37] Consistent with this, the proposed Restricted Firm Obligations Rule would specifically apply to firms that have far more Registered Person and Member Firm Events, or far higher concentrations of Registered Persons Associated with Previously Expelled Firms, compared to their peers.[38] Based on staff analysis of all firms registered with FINRA between 2013 and 2018, firms that would have met the Preliminary Criteria for Identification had on average 4-8 times more Registered Person and Member Firm Events than peer firms at the time of identification. Specifically, the number of events per firm, for firms that would have met the Preliminary Criteria for Identification, ranged, on average, from 26-42 events during the Evaluation Period, compared to 5-7 events per firm for other firms. The median number of events per firm, for the firms that would have met the Preliminary Criteria for Identification, ranged from approximately 10-17 events, compared to 0 events amongst other firms.

Although disciplinary and regulatory-related events are one of the identifiers for firms posing higher risk, FINRA recognizes that firms posing higher risks do not always manifest themselves with greater disclosures on their records. These firms may be newer, have recently made changes in management, staff or approach, or simply may be more effective in avoiding regulatory marks.

3. Economic Impacts

A. Proposed Restricted Firm Obligations Rule

To estimate the number and types of firms that would meet the Preliminary Criteria for Identification, FINRA analyzed the categories of events and conditions associated with the proposed criteria for all firms during the 2013-2018 review period. For each year, FINRA determined the approximate number of firms that would have met the proposed criteria. The number of firms that would have met the proposed criteria during the review period serves as a reasonable estimate for the number of firms that would have been directly impacted by this proposal had it been in place at the time. This analysis indicates that there were 60-98 such firms at the end of each year during the review period, as shown in Attachment D-1. These firms represent 1.6-2.4% of all firms registered with FINRA in any year during the review period. The population of firms identified by the proposed criteria reflects the distribution of firm size in the full population of registered firms. Approximately 90-94% percent of these firms were small, 4-10% percent were mid-sized and 0-2% percent were large at the end of each year during the review period, as shown in Attachment D-2.[39]

In developing the proposed Preliminary Criteria for Identification, FINRA paid significant attention to the impact of possible misidentification of firms; specifically, the economic trade-off between including firms that are less likely to subsequently pose risk of harm to customers, and not including firms that are more likely to subsequently pose risk of harm to customers. There are costs associated with both types of misidentifications.[40] The proposed criteria, including the proposed numerical thresholds, aim to balance these economic trade-offs associated with over- and under-identification.[41] Further protection to misidentification would be provided by the proposed initial Department evaluation and the Consultation process.

- Anticipated Benefits

The proposal's primary benefit would be to reduce the risk and associated costs of possible future customer harm. This benefit would arise directly from additional restrictions placed on firms identified as Restricted Firms and increased scrutiny by these firms on their brokers. Further, this benefit would also accrue indirectly from improvements in the compliance culture, both by firms that meet the proposed criteria and by firms that do not. For example, the proposal may create incentives for firms that meet the Preliminary Criteria for Identification to change activities and behaviors, to mitigate the Department's concerns. Similarly, the proposal may have a deterrent effect on firms that do not meet the

Preliminary Criteria for Identification, particularly firms that may be close to meeting the proposed criteria. These firms may change behavior and enhance their compliance culture in ways that better protect their customers.

The proposal also may help address unpaid arbitration awards associated with firms identified as Restricted Firms under the proposal. Under the proposed rule, the Department may require a Restricted Firm to maintain a restricted deposit at a bank or a clearing firm that agrees not to permit withdrawals absent FINRA's approval. Moreover, the proposed rule would have a presumption that the Restricted Firm maintain the deposit if it has any covered pending arbitration claims or unpaid arbitration awards. Accordingly, the proposed rule could potentially create incentives for firms to pay unpaid arbitration awards, thereby alleviating, to some extent, harm to successful claimants and enhancing investor confidence in the arbitration process.[42]

To scope these potential benefits and assess the potential risk posed by firms that would meet the proposed Preliminary Criteria for Identification, FINRA evaluated the extent to which firms that would have met the criteria during 2013-2016[43] (had the criteria existed) and their brokers were associated with "new" Registered Person and Member Firm Events after having met the proposed criteria. These "new" events correspond to events that were identified or occurred after the firm's identification, and do not include events that were pending at the time of identification and subsequently resolved in the years after identification. As shown in Attachment D-3, FINRA estimates that there were 89 firms that would have met the Preliminary Criteria for Identification in 2013. These firms were associated with 1,859 "new" Registered Person and Member Firm Events that occurred after their identification, between 2014 and 2018. Attachment D-3 similarly shows the number of events associated with firms that would have met the Preliminary Criteria for Identification in 2014, 2015 and 2016. Across 2013-2016, there were 183 unique firms[44] that would have met the proposed Preliminary Criteria for Identification, and these firms were associated with a total of 2,793 Registered Person and Member Firm Events that occurred in the years after they met the proposed criteria.[45]

Attachment D-3 also shows the number of Registered Person and Member Firm Events for these firms compared to other firms. Specifically, FINRA calculated a factor which represents a multiple for the average number of events (on a per registered person basis) for firms that would have met the Preliminary Criteria for Identification relative to other firms of the same size. For example, as shown in Attachment D-3, the factor of 6.3x for 2013 indicates that firms meeting the Preliminary Criteria for Identification in 2013 had 6.3 times more new disclosure events (per registered person) in the years after identification (2014-2018) than other firms of the same size registered in 2013. Overall, this analysis demonstrates that firms that would have met the Preliminary Criteria for Identification during the review period had on average approximately 6-9 times more new disclosure events after their identification than other firms in the industry during the same period.

- Anticipated Costs

The anticipated costs of this proposal would fall primarily upon firms that meet the Preliminary Criteria for Identification and that the Department deems to warrant further review after its initial evaluation. Although FINRA would perform the annual calculation and conduct an internal evaluation, firms may choose to expend effort to determine if they would meet the Preliminary Criteria for Identification, and incur associated costs, at their own discretion. To the extent that a firm deemed to warrant further review under proposed Rule 4111 chooses to rebut the presumption that it is a Restricted Firm subject to the maximum Restricted Deposit Requirement, it would incur costs associated with collecting and providing information to FINRA. For example, these firms may provide information on any disclosure events that may be duplicative or not sales-practice related. These firms may also provide information on any undue financial hardship that would result from a Restricted Deposit Requirement. Likewise, a firm availing itself of the one-time staffing reduction opportunity incurs the separation costs, along with the potential for lost future revenues.

In addition, firms subject to a Restricted Deposit Requirement or other obligations would incur costs associated with these additional obligations. These would include, for example, costs associated with setting up the Restricted Deposit Account and ongoing compliance costs associated with maintaining the account. Further, as a result of restrictions on the use of cash or qualified securities in the deposit account or other restrictions on the firm's activities, the firm may lose economic opportunities, and its customers may lose the benefits associated with the provision of these services.

Similarly, a firm required to apply heightened supervision to its brokers would incur implementation and ongoing costs associated with its heightened supervision plan.[46] Firms that meet the Preliminary Criteria for Identification also may incur costs associated with enhancing their compliance culture, including possibly terminating registered persons with significant number of disclosure events—through exercising the one-time staffing reduction option under proposed Rule 4111 or otherwise—and reassigning the responsibilities of these individuals to other registered persons. Finally, there may be indirect costs, including greater difficulty or increased cost associated with maintaining a clearing arrangement, loss of trading partners, or similar impairments where third parties can determine that a firm meets the proposed Preliminary Criteria for Identification or has been deemed to be a Restricted Firm.

Firms that do not meet the proposed Preliminary Criteria for Identification, particularly ones that understand they are close to meeting the proposed criteria, also may incur costs associated with enhancing their compliance culture to avoid meeting the proposed criteria. These costs may include terminating registered persons with disciplinary records, replacing them with existing or new hires, enhancing compliance policies and procedures, and improving supervision of registered persons. Finally, registered persons with significant number of disciplinary or other disclosure events on their records may find it difficult to retain employment, or get employed by new firms.

- Other Economic Impacts

FINRA also has considered the possibility that, in some cases, this proposal may impose restrictions on brokers' and firms' activities that are less likely to subsequently harm their customers. In such cases, these brokers and firms may lose economic opportunities or find it difficult to retain brokers or customers. FINRA believes that the proposal mitigates such risks by requiring an initial layer of Departmental review, and providing affected firms an opportunity to engage in a Consultation with the Department and request a review of FINRA's determination in an expedited proceeding. FINRA recognizes that some firms may elect to terminate the registrations of certain brokers with disclosure events, and these brokers may find it difficult to get employed by other firms.

FINRA also considered that some firms may consider not reporting, underreporting, or failing to file timely, required disclosures on Uniform Registration Forms in an effort to avoid costs associated with the proposals. However, this potential impact is mitigated because many events are reported by regulators or in separate public notices by third parties and, as a result, FINRA can monitor for these unreported events. Further, failing to update timely Uniform Registration Forms is a violation of FINRA rules and can result in fines and penalties, thereby serving as a deterrent for underreporting or misreporting.

Considering that the proposed criteria are based on a firm's experience relative to its similarly sized peers, FINRA does not believe that the proposed criteria impose costs on competition between firms of different sizes. Further, because FINRA would perform the annual calculation to determine the firms that meet the Preliminary Criteria for Identification, the costs a firm incurs to monitor its status in relation to the proposed criteria would be discretionary and not likely create any competitive disadvantage based on firm size. Although the proposed rule would not impose these monitoring costs, FINRA would provide transparency around how the Preliminary Identification Metrics are calculated and appropriate guidance to assist firms seeking to determine their status. Similarly, FINRA does not anticipate that the proposed Restricted Firm Obligations Rule, including the Restricted Deposit Requirement or any required conditions and restrictions, would create competitive disadvantages across firms of different sizes. This is, in part, because FINRA would consider firm size, among other factors, when determining the appropriate maximum Restricted Deposit Requirement or any conditions and restrictions, to ensure that the obligations are appropriately tailored to the firms' business models but do not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the ensuing 12 months.

As discussed above, FINRA would exercise some discretion in determining the maximum Restricted Deposit Requirement and tailor it to the size, operations and financial conditions of the firm. This approach is intended to align with FINRA's objective to have the specific financial obligation be significant enough to change a Restricted Firm's behavior but not so burdensome that it would indirectly force it out of business. In determining the specific maximum Restricted Deposit Requirement, FINRA would consider a range of factors, including the nature of the firm's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric threshold, the amount of any "covered pending arbitration claims" or unpaid arbitration awards, and concerns raised during FINRA exams. In developing the proposal, FINRA considered the possibility of having a transparent formula, based on some of these factors, to determine a maximum Restricted Deposit Requirement. However, given the range of relevant factors and differences in firms' business models, operations, and financial conditions, FINRA decided not to propose a uniform, formulaic approach across all firms. Nonetheless, FINRA recognizes that in the absence of a transparent formulaic approach, firms that meet the Preliminary Criteria for Identification may overestimate or underestimate the maximum Required Deposit Requirement and incur associated costs.[47] Accordingly, FINRA seeks comment on alternative approaches that could be used to determine the maximum Restricted Deposit Requirement, and why these alternatives may be more efficient and effective than the proposed rule.

In developing the proposal, FINRA also considered the possibility that the size of the maximum Restricted Deposit Requirement may be too burdensome for the firms, and could undermine their financial stability and operational capability. FINRA believes that these risks are mitigated by providing affected firms an opportunity to engage in a Consultation process with FINRA and propose a lesser Restricted Deposit Requirement or restrictions or conditions on their operations. Further, as discussed above, Restricted Firms would have the opportunity to request a review of FINRA's determination in an expedited proceeding.

B. Proposed Expedited Proceeding Rule

When FINRA imposes obligations on a firm pursuant to the proposed Restricted Firm Obligations Rule, the firm may experience significant limitations to its business activities and incur direct and indirect costs associated with the obligations imposed. The proposed Expedited Proceeding Rule would, in general, require that these obligations apply immediately, even during the pendency of any appeal.

The proposed rule would be associated with investor protection benefits through the impact of the no-stay provision (proposed new Rule 9559(a)(4)). Under the proposal, obligations imposed by FINRA would be effective immediately, except that a firm subject to a Restricted Deposit Requirement under proposed Rule 4111 would be required to make a partial deposit while the matter is pending review. This would reduce the risk of investor harm during the pendency of a hearing requested by the firm. Similarly, the no-stay provision may limit hearing requests by firms that seek to use them only as a way to forestall FINRA obligations.

The benefit of the proposed rule accruing to firms would be to permit firms to appeal FINRA's determinations (both to request prompt review of obligations imposed or of determinations for failure to comply) in an expedited proceeding, thereby reducing undue costs where firms may have been misidentified. For example, the proposed rule is anticipated to reduce the costs associated with obligations imposed on misidentified firms by the proceeding's expedited nature. Similarly, the proposed rule's time deadlines may also reduce the costs of the proceedings, in certain cases.

The costs would be borne by firms that choose to seek review via the proposed expedited proceeding, and these costs can be measured relative to a standard proceeding. These firms would incur costs associated with provisions and procedures specific to this proposed rule, including the provision that the obligations imposed would not be stayed.[48] This would include the obligations imposed under the proposed rule, including the Restricted Deposit Requirement, and the requirement that the firm, upon the Department's request, provide evidence of its compliance with these obligations. However, the extent of the costs associated with the Restricted Deposit are mitigated by the expedited nature of the proceeding and by the provision that would require a firm, during an expedited hearing process, to maintain only a partial deposit requirement.

As with the other proposals, FINRA does not anticipate that the proposed rule would have differential competitive effects based on firm size or other criteria. The costs and benefits are anticipated to apply to all firms that request an expedited hearing.

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 firms, brokers, 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 and firm misconduct than the proposed amendments.

In developing this proposal, FINRA considered several alternatives to addressing the risks posed by firms and their brokers that have a history of misconduct, including an alternative to the proposed numeric threshold-based approach and alternative specifications to the proposed numeric threshold based-approach.

A. Alternative to the Proposed Numeric Threshold-Based Approach

In addition to the proposed approach based on numeric thresholds, FINRA considered an approach similar to IIROC's "terms and conditions" rule that would allow FINRA to identify a limited number of firms with significant compliance failures and impose on them appropriate terms and conditions to ensure their continuing compliance with the securities laws, the rules thereunder, and FINRA rules. FINRA considered and evaluated the economic impacts of such a Terms and Conditions rule relative to proposed Rule 4111.

Compared to proposed Rule 4111, a Terms and Conditions rule would provide FINRA with greater flexibility in identifying firms that should be subject to additional obligations. This greater flexibility could help better target its application and reduce misidentification by allowing FINRA to leverage non-public information, including regulatory insights collected as part of its monitoring and examination programs, in identifying firms that pose the greatest risk. Further, under a Terms and Conditions rule, FINRA could quickly update its identification of firms based on emerging risk patterns, to ensure that the rule continues to be effective at addressing firms that presently pose the greatest risk. This flexibility could mitigate the risk that the criteria and thresholds in proposed Rule 4111 no longer identify the appropriate firms.

Further, as discussed above, the identification criteria in proposed Rule 4111 may not identify all the firms that pose material risk to their customers, such as firms that may act to stay just below the proposed criteria and thresholds by any means, including misreporting or underreporting disclosure events. The absence of a set identification criteria in a Terms and Conditions rule would make it more difficult for firms to evade the identification criteria and thus could provide greater investor protections.

A Terms and Conditions rule also may have certain disadvantages relative to proposed Rule 4111. For example, a benefit of proposed Rule 4111 is the deterrent effect it may have on firms that do not meet the proposed Preliminary Criteria for Identification, particularly firms that may be close to meeting the criteria. These firms may change behavior and enhance their compliance culture in ways that could better protect their customers. By comparison, under a Terms and Conditions rule, in the absence of transparent criteria, firms must assess FINRA's view of the significance of repeated exam findings to determine whether to change their conduct to avoid potential terms and conditions.

Although FINRA has considered, and will continue to explore this alternative, it is not proposing a terms and conditions approach at this time.

B. Alternative Specifications for the Proposed Numeric Threshold-Based Approach

FINRA also considered several alternatives to the numerical thresholds and conditions for the Preliminary Criteria for Identification. In determining the proposed criteria, FINRA focused significant attention on the economic trade-off between incorrect identification of firms that may not subsequently pose risk of harm to their customers, and not including firms that may subsequently pose risk of harm to customers but do not meet the proposed thresholds. FINRA also considered three key factors: (1) the different categories of reported disclosure events and metrics; (2) the counting criteria for the number of reported events or conditions; and (3) the time period over which the events or conditions are counted. FINRA considered several alternatives for each of these three factors.

- Alternatives Associated with the Categories of Disclosure Events and Metrics

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. FINRA decided to exclude financial disclosures because while financial events, such as bankruptcies, civil bonds, or judgments and liens, may be of interest to investors in evaluating whether or not to engage a broker or a firm, these types of events by themselves are not evidence of customer harm.

In developing the Preliminary Criteria for Identification, FINRA also considered whether pending criminal, internal review, judicial and regulatory events should be excluded from the threshold test. FINRA decided to include these pending events because they often are associated with an emerging pattern of customer harm and capture timely information of potential ongoing or recent misconduct. Further, as with other categories, the proposed Preliminary Identification Metrics Thresholds for the relevant Preliminary Identification Metrics, including the Registered Person Pending Event Metric and the Member Firm Pending Event Metric, are intended to capture firms that are on the far tail of the distributions. Thus, firms meeting these thresholds have far more pending matters on their records than other firms in the industry. Nonetheless, FINRA recognizes that pending matters include disclosure events that may remain unresolved or that may subsequently be dismissed or concluded with no adverse action because they lack merit or suitable evidence.[49] In order to ensure that a firm does not meet the Preliminary Criteria for Identification solely because of pending matters, FINRA has proposed the conditions that, to meet the criteria, the firm must meet or exceed at least two of the six Preliminary Identification Metrics Thresholds, and at least one of the thresholds for the Registered Person Adjudicated Event Metric, Member Firm Adjudicated Event Metric, or Expelled Firm Association Metric.[50]

- Alternatives Associated with the Counting Criteria for the Proposed Criteria and Metrics

FINRA considered a range of alternative counting criteria for the Preliminary Criteria for Identification. For example, FINRA considered whether the Preliminary Criteria for Identification should be based on firms meeting two or more Preliminary Identification Metrics Thresholds, or whether the number of required thresholds should be decreased or increased. Decreasing the number of required thresholds from two to one would increase the number of firms that would have met the Preliminary Criteria for Identification during the review period from 60-98 firms to 150-220 firms, each year. Alternatively, increasing the number of required thresholds from two to three decreases the number of firms that would have met the Preliminary Criteria for Identification from 60-98 to 15-35, each year. FINRA reviewed the list of firms identified under these alternative counting criteria and examined the extent to which they included firms that were subsequently expelled, associated with unpaid awards, or identified as suitable candidates for additional obligations by the Department. FINRA also paid particular attention to firms that would have been identified by these alternative criteria but subsequently were not associated with high-risk activity, as well as firms that would not have been identified by these alternatives that were associated with high-risk events. Based on this review, FINRA believes that the proposed approach—meeting two or more of the Preliminary Identification Metrics Thresholds—more appropriately balances these trade-offs between misidentifications than the alternative criteria.

- Alternatives Associated with the Time Period over which the Metrics Are Calculated

The proposed Preliminary Identification Metrics are based on three different time periods over which different categories of events and conditions are counted (look-back periods). Pending events, including the Registered Person Pending Events and the Member Firm Pending Events categories, are counted in the Preliminary Identification Metrics only if they are pending as of the Evaluation Date. Adjudicated events, including the Registered Person Adjudicated Events and the Member Firm Adjudicated Events categories, are counted in the Preliminary Identification Metrics over a five-year look-back period. The Expelled Firm Association Metric does not have a limit on the look-back period, and is based on the association of Registered Persons In-Scope with a previously expelled firm at any time in their career.[51]

In developing the proposal, FINRA considered alternative criteria for the time period over which the disclosure events or conditions are counted. For example, FINRA considered whether adjudicated events should be counted over the individual's or firm's entire reporting period or counted over a more recent period. Based on its experience, FINRA believes that events that are more recent (*e.g.*, events occurring in the last five years) generally pose a higher level of possible future risk to customers than other events. Further, counting events over an individual's or firm's entire reporting period would imply that brokers and firms would always be included in the Preliminary Identification Metrics for adjudicated events, even if they subsequently worked without being associated with any future adjudicated events. Accordingly, FINRA decided to include adjudicated events only in the more recent period (*i.e.*, a five-year period).[52]

Similarly, FINRA also considered whether there should be limits on the time period over which the Expelled Firm Association Metric is calculated. For example, FINRA considered alternative metrics that would only be based on firm expulsions over the last three to five years. Further, FINRA considered alternatives where the individual broker's association with the previously expelled firm was within a five-year window around the firm's expulsion. In evaluating these alternatives, FINRA recalculated the underlying thresholds to capture firms that are on the far tail of the distribution for these alternative metrics.[53] As with other alternatives, FINRA evaluated these alternatives by paying particular attention to the economic trade-offs of misidentifications, including over- and under-identification of firms. Based on this evaluation, FINRA determined that the Expelled Firm Association Metric proposed in this *Notice* better accounts for these economic trade-offs. Nonetheless, FINRA specifically seeks comments on alternatives FINRA should consider for the Expelled Firm Association Metric and why these alternatives may be more effective and efficient for identifying the firms that this proposal seeks to address.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues.

General

1. Are there alternative ways to address members that pose a high degree of risk that should be considered? What are the alternative approaches that FINRA should consider?
2. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:
   c. What are these economic impacts and what are their primary sources?
   d. To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models?
   e. What would be the magnitude of these impacts, including costs and benefits?
3. 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?

Proposed Rule 4111

4. As discussed above, the framework in proposed Rule 4111 for identifying members that pose a high degree of risk is based on identifying members with significantly more reportable events than their peers, based upon six proposed categories of events and conditions.
   a. Does this appear to be a reasonable approach for identifying members that could be subject to additional obligations? Are there other approaches FINRA should consider?
   b. Do the seven firm-size categories in proposed Rule 4111(i)(11) appropriately group firms of similar sizes? Should FINRA consider additional size categories or consider combining certain size categories?
   c. The framework is based on six different categories of events and conditions. Each of these categories is based on a combination of disclosure events. Do these categories appropriately combine similar types of disclosure events? Should FINRA consider additional disclosure categories or consider aggregating or disaggregating certain categories?
   d. FINRA anticipates that the distributions of the six categories of events and conditions would change over time. Should FINRA consider updating the Preliminary Identification Metrics Thresholds periodically, to ensure that they continue to identify members that are significantly different than their peers? If so, how frequently should FINRA consider updating the thresholds?

5. As discussed above, when developing proposed Rule 4111, FINRA considered several numerical and categorical thresholds for identifying member firms that could potentially be subject to a Restricted Deposit Requirement and other obligations. In determining the proposed metrics and thresholds, FINRA paid significant attention to the economic trade-offs associated with misidentifications, including both over- and under-identification of member firms. FINRA seeks comments on the proposed numerical thresholds and metrics, including the following key factors associated with developing the metrics: (a) the different categories of reported disclosure events and conditions; (b) the counting criteria for the metrics; and (c) the time period over which the metrics are calculated. Specifically, FINRA seeks comment on whether alternative inputs for any of these factors should be considered, and why these alternatives may better identify firms that pose greater risks to their investors.
6. Should FINRA consider alternative thresholds or look-back periods for the Expelled Firm Association Metric? What factors or conditions should FINRA consider when developing a metric with respect to expelled firm association?
7. Proposed Rule 4111 includes several processes, including qualitative reviews and consultations, to minimize potential sources of misidentifications. These processes may aid in the identification of the members motivating this proposal, but may also delay the imposition of obligations on them. Are there alternative processes that should be considered?
8. Proposed Rule 4111 is premised on a notion that the most effective tool to change the behavior of a member firm that presents a high degree of risk is a financial restriction. The proposal, however, affords members that meet the Preliminary Criteria for Identification the opportunity to advocate for a lower Restricted Deposit Requirement or for conditions and restrictions as alternatives to a Restricted Deposit Requirement. Are there better ways to create a potential financial restriction that serves as an effective incentive to change firm behavior?
9. Proposed Rule 4111 would restrict a member firm from withdrawing any amount from the Restricted Deposit Account, even if it terminates its FINRA membership. However, the proposed Restricted Deposit Account would not be bankruptcy remote and could be used to satisfy claims in a bankruptcy proceeding. Should FINRA consider ways to structure the Restricted Deposit Account so that it is bankruptcy remote or preferentially available to customer claims in the event of a bankruptcy? If so, how should FINRA structure the Restricted Deposit Account, and what conditions and priorities should FINRA consider placing on claims in the event of a bankruptcy?
10. Proposed Rule 4111 would allow a member firm that meets the Preliminary Criteria for Identification, and that the Department determines warrants further review under Rule 4111, to present why certain disclosure events should not be counted.

For example, a member could maintain that disclosure events should not be included in the annual calculation because they involved the same person and the same event or were non-sales-practice related. Are there other characteristics of disclosure events that should lead to not including those events in the calculation of whether the member firm meets the Preliminary Criteria for Identification?

11. Proposed Rule 4111 uses a principles-based approach for determining a maximum Restricted Deposit Requirement.
    a. FINRA intends to take several factors into account in determining the maximum Restricted Deposit Requirement, including the nature of the member's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of covered pending arbitration claims or unpaid arbitration awards, and concerns raised during FINRA examinations. Are there other factors FINRA should consider in making this determination? What are those factors, and how should FINRA account for them?
    b. Should FINRA instead consider a formula-based approach(es)? If so, what would be an appropriate formula-based approach that results in a meaningful Restricted Deposit Requirement? How would the formula-based approach account for differences in firms' business models, financial conditions, or other factors discussed above?
12. Should there be a cap on the maximum Restricted Deposit Requirement? If so, what should the cap be? Should it be expressed as a specific dollar amount? As a number derived from a firm-specific figure, such as a percentage of the member's gross revenues? Or something else?
13. Apart from having to comply with a Restricted Deposit Requirement or other obligations, are there collateral consequences that could result from being designated as a Restricted Firm, even if FINRA does not publicly disclose that designation? If so, what are those collateral consequences?
14. This *Notice* explains that FINRA would review the Preliminary Identification Metrics Thresholds in proposed Rule 4111 on a periodic basis, to consider whether the thresholds remain targeted and effective at identifying member firms that pose higher risks. How frequently should FINRA conduct those periodic reviews?

Proposed New Rule 9559 and Proposed Amended Rule 9560

15. Hearings in expedited proceedings under proposed new Rule 9559 would be presided over by a Hearing Officer. By requiring the appointment of a Hearing Officer instead of a Hearing Panel, FINRA intends to create efficiencies, considering the number of potential expedited proceedings that could result from the proposed rule and the substantial amount of time and resources that the Office of Hearing Officers could expend in identifying Hearing Panelists. However, there would be potential benefits to having a Hearing Panel preside over the proceedings, especially due to the industry experience that Hearing Panelists may have. Should FINRA consider requiring that a Hearing Panel be appointed in proceedings under proposed new Rule 9559? Would the benefits of appointing Hearing Panelists outweigh the costs?

Additional Approaches Considered

16. Should FINRA consider a rule proposal that would provide it discretion to identify firms that pose significant concerns and impose tailored terms and conditions on a firm, similar to the IIROC's "terms and conditions" rule? If so, should FINRA consider adopting both proposed Rule 4111 and a "terms and conditions" rule, or just one of these kinds of rules? What would be the costs and consequences to member firms of a "terms and conditions" rule, and what kinds of limitations should be placed on such a rule?
17. FINRA's authority to seek temporary cease and desist orders is limited to alleged violations of specific Exchange Act provisions, specific Exchange Act rules, and specific FINRA rules. It is also limited to circumstances in which the alleged violative conduct is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding.[54] Should FINRA consider expanding its authority to seek temporary cease and desist orders?

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 proposed new rule establishing expedited proceeding procedures for regulating activities under proposed Rule 4111 would be new Rule 9559 (Procedures for Regulating Activities Under Rule 4111); current Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) would be renumbered as Rule 9560. References in this Notice to "new Rule 9559" are to the proposed new rule; references to "Rule 9560" or "the Hearing Procedures Rule" are to current Rule 9559.

2. 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* (Online Availability of Comments) (November 2003) for more information.

3. *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.

4. For example, in October 2018, FINRA announced plans to consolidate its Examination and Risk Monitoring Programs, integrating three separate programs into a single, unified program to drive more effective oversight and greater consistency, eliminate duplication and create a single point of accountability for the examination of firms. That effort is well underway, and FINRA expects the consolidation will bring those programs under a single framework designed to better direct and align examination resources to the risk profile and complexity of member firms.

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.

6. The number of disclosure events correspond to the number of Registered Person and Member Firm Events (defined in proposed Rule 4111(i)(12)) during the Evaluation Period (defined in proposed Rule 4111(i)(6)), as of December 31, 2018. As per the Evaluation Period definition, all final events are counted over the prior five years, and all pending events are counted if they were pending as of December 31, 2018.

7. *See* FINRA Rule 9800 Series (Temporary and Permanent Cease and Desist Orders).

8. *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).

9. *See Regulatory Notice 18-16*.

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10. The term "covered pending arbitration claim" is defined in proposed Rule 4111(i)(2) to mean an investment-related, consumer initiated claim filed against the member or its associated persons that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. The claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees. This term also is proposed in *Regulatory Notice 18-06* (February 2018). FINRA anticipates that the term would be amended in proposed Rule 4111(i)(2) to conform to any final definition adopted under the proposal in *Regulatory Notice 18-06*. For purposes of this *Notice*, the term "unpaid arbitration awards" also includes unpaid settlements related to arbitrations.

11. *See* IIROC Consolidated Rule 9208.

12. "Uniform Registration Forms" mean Forms BD, U4, U5 and U6.

13. *See* proposed Rule 4111(a) and (d).

14. This part of the *Notice* uses many terms that are defined in proposed Rule 4111(i). The terms used have the meanings as defined in proposed Rule 4111(i).

15. *See supra* note 12. One of the event categories, Member Firm Adjudicated Events, includes events that are derived from customer arbitrations filed with FINRA's dispute resolution forum.

16. "Registered Person Adjudicated Events," defined in proposed Rule 4111(i)(4)(A), means any one of the following events that are reportable on the registered person's Uniform Registration Forms: (i) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party, or was a "subject of" the customer arbitration award or civil judgment; (ii) a final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil judgment settlement or a settlement prior to a customer arbitration or civil litigation; (iii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (v) a criminal matter in which the registered person was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

17. "Registered Person Pending Events," defined in proposed Rule 4111(i)(4)(B), means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms: (i) a pending investment-related civil judicial matter; (ii) a pending investigation by a regulatory authority; (iii) a pending regulatory action that was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (iv) a pending criminal charge associated with any felony or any reportable misdemeanor. Registered Person Pending Events does not include pending arbitrations, pending civil litigations, or consumer-initiated complaints that are reportable on the registered person's Uniform Registration Forms.

18. "Registered Person Termination and Internal Review Events," defined in proposed Rule 4111(i)(4)(C), means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms: (i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations; or (ii) a pending or closed internal review by the member.

19. "Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D), means any of the following events that are reportable on the member firm's Uniform Registration Forms, or are based on customer arbitrations filed with FINRA's dispute resolution forum: (i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party; (ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (iv) a criminal matter in which the member was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

20. "Member Firm Pending Events," defined in proposed Rule 4111(i)(4)(E), means any one of the same kinds of events as the "Registered Person Pending Events," but that are reportable on the member firm's Uniform Registration Forms.

21. "Registered Persons Associated with Previously Expelled Firms," defined in proposed Rule 4111(i)(4)(F), means any registered person registered for one or more days within the year prior to the "Evaluation Date" (*i.e.*, the annual date as of which the Department calculates the Preliminary Identification Metrics) with the member, and who was associated with one or more previously expelled firms (at any time in his/her career).

22. For each of the six Preliminary Identification Metrics, proposed Rule 4111(i)(11) establishes numeric thresholds for seven different firm sizes. Firm sizes are based on the number of registered persons, and range from members that have 1-4 registered persons to members that have 500 or more registered persons. Thus, the proposal establishes 42 different numeric thresholds.

23. "Registered Person and Member Firm Events," a term defined in proposed Rule 4111(i)(12), means the sum of events in the following five categories: (i) Registered Person Adjudicated Events; (ii) Registered Person Pending Events; (iii) Registered Person Termination and Internal Review Events; (iv) Member Firm Adjudicated Events; and (v) Member Firm Pending Events.

24. The "Evaluation Date" is defined in proposed Rule 4111(i)(5) to mean the date, each calendar year, as of which the Department calculates the Preliminary Identification Metrics to determine if the member firm meets the Preliminary Criteria for Identification.

25. OCE has tested the Preliminary Criteria for Identification, including the Preliminary Identification Metrics Thresholds, in several ways. For example, OCE has compared the firms captured by the proposed criteria to the firms that have recently been expelled or that have unpaid arbitration awards. OCE also has consulted with Member Supervision staff and examiners about whether, based on their experience, the criteria identifies firms that appear to present high risks to investors.

26. *See supra* note 10, for an explanation of references in this *Notice* to the term "unpaid arbitration awards."

27. *See supra* note 1, for explanations of references in this *Notice* to "new Rule 9559" and references to "Rule 9560" or the "Hearing Procedures Rule."

28. Proposed new Rule 9559(a)(1) would define the "Rule 4111 Requirements" to mean the requirements, conditions, or restrictions imposed by a Department determination under proposed Rule 4111.

29. *See supra* note 1, for explanations of references in this *Notice* to "new Rule 9559" and references to "Rule 9560" or the "Hearing Procedures Rule."

30. Proposed amended Rule 9560 contains other related timing requirements for proceedings pursuant to proposed new Rule 9559.

31. *See* FINRA Rule 9560(q).

32. Attempts to collaterally attack final matters are also precluded in other FINRA proceedings. *Cf. Dep't of Enforcement v. Amundsen*, Complaint No. 2010021916601, 2012 FINRA Discip. LEXIS 54, at *21-24 (FINRA NAC Sept. 20, 2012) (rejecting respondent's attempt to collaterally attack a judgment that was required to be disclosed on Form U4), *aff'd*, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148 (Apr. 18, 2013), *aff'd*, 575 F. App'x 1 (D.C. Cir. 2014); *Membership Continuance Application of Member Firm*, Application No. 20060058633, 2007 FINRA Discip. LEXIS 31, at *51 (July 2007) (holding, in a membership proceeding, that a firm may not address its and its FINOP's past disciplinary history by collaterally attacking those past violations) (citing *BFG Sec., Inc.*, 55 S.E.C. 276, 279 n.5 (2001)); *Jan Biesiadecki*, 53 S.E.C. 182, 185 (1997) (describing, in eligibility proceedings, FINRA's long-standing policy of prohibiting collateral attacks on underlying disqualifying events).

33. *See* IIROC Consolidated Rule 9208; *see also* IIROC Notice 17-0010, at pp. 2, 14 (Jan. 12, 2017) (IIROC Compliance Priorities), available at *www.iiroc.ca/Documents/2017/2461049c-03b1-4bfa-ba16-2ac05bd59ab4_en.pdf*.

34. *See, e.g.*, Roland Strausz, *Delegation of Monitoring in a Principal-Agent Relationship*, Rev. Econ. Stud. 64(3):337-57 (July 1997). The paper shows that in a standard principal-agent framework, the delegation of monitoring by the principal (*e.g.*, a regulator) to the agent (*e.g.*, a firm) can be economically efficient for both parties.

35. *See supra* note 5.

36. Investors may also file claims in courts or other dispute resolution forums. Successful claimants in these forums may face similar challenges associated with collecting awards or judgments.

37. As discussed above, recent studies provide evidence of predictability of future regulatory-related events for brokers and firms with a history of past regulatory-related events. As a result, brokers and firms with a history of past regulatory-related events pose greater risk of future harm to their customers than other brokers and firms.

38. For example, for each of the six Preliminary Identification Metrics, the Preliminary Identification Metrics Threshold was chosen to capture 1% - 5% of the firms with the highest number of events per registered broker or the highest concentrations of Registered Persons Associated with Previously Expelled Firms, in respective firm-size categories.

39. 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.

40. For example, subjecting firms that are less likely to pose a risk to customers to the proposed Restricted Deposit Requirement or other obligations would impose additional and unwarranted costs on these firms, their brokers and their customers.

41. In order to evaluate the effectiveness of the proposed criteria at identifying firms that pose greater risks, FINRA examined the overlap between the firms that would have met the Preliminary Criteria for Identification each year during the review period and the firms that were subsequently expelled, associated with unpaid awards, or identified by Department staff as suitable candidates for additional obligations. Finally, as discussed below, FINRA also examined disclosure events associated with firms that would have met the Preliminary Criteria for Identification each year during the review period, subsequent to meeting the criteria, to assess the extent of risk posed by these firms.

42. Further, as discussed above, the Department would consider unpaid awards as one of the factors in determining the amount of the Restricted Deposit Requirement. As a result, Restricted Firms would have additional incentives to pay unpaid arbitration awards.

43. This analysis examines firms that would have met the Preliminary Criteria for Identification from 2013 until 2016, to allow sufficient time for the "new" events to resolve in the post-identification period.

44. Certain firms would have met the criteria in multiple years during the review period. The 183 firms discussed in the text correspond to the unique number of firms that would have met the criteria in one or more years during the review period.

45. Specifically, FINRA examined and counted all Registered Person and Member Firm Events that occurred any time after the firms were identified until March 15, 2019.

46. These costs would likely vary significantly across firms. Costs would depend on the specific obligations imposed specific to the firm and its business model. In addition, costs could escalate if a heightened supervision plan applied to brokers that serve as principals, executive managers, owners or in other senior capacities. Such plans may entail re-assignments of responsibilities, restructuring within senior management and leadership, and more complex oversight and governance approaches.

47. For example, firms may, conservatively, overestimate the amount of the required deposit, and withhold the use of additional funds, thereby losing out on economic opportunities associated with these excess funds, until FINRA informs these firms of their actual maximum Restricted Deposit Requirement.

48. The effect of the no-stay provision is that imposed obligations would apply immediately, even during the pendency of any hearing request. As a result, the no-stay provision would impose direct costs on misidentified firms.

49. 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 arbitrators or judges.

50. In order to assess the impact of removing pending events from the Preliminary Criteria for Identification and restricting the criteria solely to final events, FINRA examined the number of firms that would have met or exceeded at least one Preliminary Identification Metrics Threshold in the Registered Person Adjudicated Events, Member

Firm Adjudicated Events, or Registered Persons Associated with Expelled Firms categories, during the relevant period. This analysis showed that the number of firms identified by this alternative criteria would increase from 60-98 firms to 150-220 firms, each year, during the review period. Similarly, FINRA estimates the number of firms that would have met or exceeded at least two thresholds within these categories to be 50-75 firms, each year, during the review period.

51. Registered Persons In-Scope include all persons registered with the firm for one or more days within the one year prior to the Evaluation Date.

52. This is consistent with the time period used for counting "specified risk events" in *Regulatory Notice 18-16*.

53. These alternatives would have identified approximately the same number of firms as meeting the Preliminary Criteria for Identification, during the review period.

54. *See* FINRA Rules 9810(a), 9840(a).

Attachment A

Attachment A shows the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.[1]

* * * * *

4111. Restricted Firm Obligations

(a) General

A member designated as a Restricted Firm shall be required, except as provided in paragraphs (e) and (f), to establish a Restricted Deposit Account and maintain in that account deposits of cash or qualified securities with an aggregate value that is not less than the member's Restricted Deposit Requirement, and shall be subject to such conditions or restrictions on the member's operations as determined by the Department to be necessary or appropriate for the protection of investors and in the public interest.

(b) Annual Calculation by FINRA of Preliminary Criteria for Identification

For each member, the Department will compute annually (on a calendar-year basis) the Preliminary Identification Metrics to determine if the member meets the Preliminary Criteria for Identification.

(c) Initial Department Evaluation and One-Time Staff Reduction

(1) Initial Department Evaluation

If the member is deemed to meet the Preliminary Criteria for Identification, the Department shall conduct an internal evaluation to determine whether (A) the member does not warrant further review under this Rule because

[1] FINRA is proposing that current FINRA Rule 9559 be renumbered to Rule 9560. Additional rule amendments would be needed to conform to the renumbered rule.

the Department has information to conclude that the computation of the member's Preliminary Identification Metrics included disclosure events (and other conditions) that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. The Department shall also consider whether the member has addressed the concerns signaled by the disclosure events or conditions or altered its business operations such that the Preliminary Criteria for Identification calculation no longer reflects the member's current risk profile, or (B) except as provided in paragraph (c)(2), the member should proceed to a Consultation.

(2) One-Time Staff Reduction

If the Department determines that the member meets the Preliminary Criteria for Identification and such member has met such criteria for the first time, such member may reduce its staffing levels to no longer meet the Preliminary Criteria for Identification within 30 business days after being informed by the Department. The member shall provide evidence of the staff reduction to the Department identifying the terminated individuals. Once the member has reduced staffing levels to no longer meet the Preliminary Criteria for Identification, it shall not rehire in any capacity a person terminated to accomplish the staff reduction for a period of one year.

(3) Close-Out Review

If the Department determines that the member no longer warrants further review in accordance with paragraph (c)(1)(A) or (c)(2), the Department shall close out the review of the member for such year.

(d) Consultation

(1) General

If the Department determines that the member meets the Preliminary Criteria for Identification and should proceed to a Consultation, the Department shall conduct the Consultation to allow the member to demonstrate why it does not meet the Preliminary Criteria for Identification and should not be designated as a Restricted Firm. If the member is designated as a Restricted Firm, the Department may require it to maintain the Restricted Deposit Requirement or be subject to such conditions or restrictions as the Department in its discretion shall deem necessary or appropriate for the protection of investors or in the public interest, or both. The member bears the burden of demonstrating that it should not be designated as a Restricted Firm and should not be required to maintain the maximum Restricted Deposit Requirement.

(A) A member may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation that the member meets the Preliminary Criteria for Identification included events in the Disclosure Event and Expelled Firm Association Categories that should not have been included because for example, they are duplicative, involving the same customer and the same matter, or are not sales practice related; and

(B) A member may overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement by clearly demonstrating to the Department that the member would face significant undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement and that a lesser deposit requirement would satisfy the objectives of this Rule and be consistent with the protection of investors and the public interest; or that conditions and restrictions on the operations and activities of the member and its associated persons would address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

(2) Scheduling Consultation

The Department shall provide a written letter to each member it determines should proceed to a Consultation of the date, time and place of the Consultation and shall coordinate with the member to schedule further meetings as necessary.

(3) Consultation Process

In conducting its evaluation of whether a member should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement, the Department shall consider:

(A) information provided by the member during any meetings as part of the Consultation;

(B) relevant information or documents, if any, submitted by the member, in the manner and form prescribed by the Department, as shall be necessary or appropriate for the Department to review the computation of the Preliminary Criteria for Identification;

(C) a plan, if any, submitted by the member, in the manner and form prescribed by the Department, proposing in detail the specific conditions or restrictions that the member seeks to have the Department consider;

(D) such other information or documents as the Department may reasonably request in its discretion from the member related to the evaluation; and

(E) any other information the Department deems necessary or appropriate to evaluate the matter.

(e) Department Decision and Notice

(1) Department Decision

Following the Consultation, but no later than 30 days from the date of the letter provided to the member under paragraph (d)(2), the Department shall render a Department Decision as follows:

(A) If the Department determines that the member has rebutted the presumption set forth in paragraph (d)(1)(A) that it should be designated as a Restricted Firm, the Department's decision shall state that the firm shall not be designated as a Restricted Firm.

(B) If the Department determines that the member has failed to rebut the presumption set forth in paragraphs (d)(1)(A) and (d)(1)(B) that it should be designated as a Restricted Firm that must maintain the maximum Restricted Deposit Requirement, the Department's decision shall designate the member as a Restricted Firm and require the member to: (i) promptly establish a Restricted Deposit Account and deposit and maintain in that account the maximum Restricted Deposit Requirement; and (ii) implement and maintain specified conditions or restrictions, as the Department deems necessary or appropriate, on the operations and activities of the member and its associated persons to address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

(C) If the Department determines that the member has failed to rebut the presumption in paragraph (d)(1)(A) that it should be designated as a Restricted Firm but that it has rebutted the presumption in paragraph (d)(1)(B) that it must maintain the maximum Restricted Deposit Requirement, the Department shall designate the member as a Restricted Firm and shall: (i) impose no Restricted Deposit Requirement on the member or require the member to promptly establish a Restricted Deposit Account and deposit and maintain in that account a Restricted Deposit Requirement in such dollar amount less than the maximum Restricted Deposit Requirement as the Department deems necessary or appropriate; and (ii) require the member to implement and maintain specified conditions or restrictions, as the Department deems necessary or appropriate, on the operations and activities of the member and its associated persons to address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

(2) Notice of Department Decision, No Stays

No later than 30 days following the letter provided to the member under paragraph (d)(2), the Department shall issue a notice of the Department's decision pursuant to Rule 9559 that states the obligations to be imposed on the member, if any, under this Rule 4111 and the ability of the member under Rule 9559 to request a hearing with the Office of Hearing Officers. A timely request for a hearing shall not stay the effectiveness of the notice issued under Rule 9559, except that for a notice under Rule 9559(a) a member obligated to maintain a Restricted Deposit Requirement shall be required to maintain in a Restricted Deposit Account the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year, until the Office of Hearing Officers or the NAC issues a written decision under Rule 9560; provided, however, that a member that has been re-designated as a Restricted Firm as set forth in paragraph (f)(2) and is already subject to a previously imposed Restricted Deposit Requirement shall be required to maintain the full amount of its Restricted Deposit Requirement until the Office of Hearing Officers or NAC issues a written decision under Rule 9560.

(f) Continuation or Termination of Restricted Firm Obligations

(1) Currently Designated Restricted Firms

A member or Former Member that is currently designated as a Restricted Firm subject to the requirements of this Rule shall not be permitted to withdraw all or any portion of its Restricted Deposit Requirement, or seek to terminate or modify any deposit requirement, conditions, or restrictions that have been imposed pursuant to this Rule, without the prior written consent of the Department.

(2) Re-Designation as a Restricted Firm

Where a member has been designated as a Restricted Firm in one year and is determined to meet the Preliminary Criteria for Identification the following year in accordance with paragraph (b), the firm shall be re-designated as a Restricted Firm, and the obligations previously imposed on the member in accordance with this Rule shall remain effective and unchanged, unless either the member or the Department requests a Consultation in writing within 30 days of the date of the letter provided to the member under paragraph (d)(2), in which case the obligations previously imposed shall remain effective and unchanged unless and until the Department modifies or terminates them after the Consultation. If a Consultation is conducted, there shall be a presumption that the Restricted Deposit Requirement and conditions or restrictions, if any, previously imposed on the member shall remain effective and unchanged absent a showing by the party seeking changes that the previously imposed obligations are no longer necessary or appropriate for the protection of investors or in the public interest. If a Consultation is not timely requested, the member shall be subject to paragraph (f)(1).

(3) Previously Designated Restricted Firms

A member or Former Member that is a Restricted Firm in one year, but does not meet the Preliminary Criteria for Identification or is not designated as a Restricted Firm the following year(s), shall no longer be subject to any deposit requirement, conditions, or restrictions previously imposed on it under this Rule; provided, however, the member or Former Member shall not be permitted to withdraw any portion of its Restricted Deposit Requirement without submitting an application and obtaining the prior written consent of the Department. Such application shall:

(A) be made in such form and manner as FINRA may prescribe;

(B) be accompanied by a copy of a current account statement for the member or Former Member's Restricted Deposit Account;

(C) include a certification by the member's or Former Member's chief executive officer (or equivalent officer) stating the member's or Former Member's Restricted Deposit Requirement; the value of the cash or qualified securities on deposit in the member's or Former Member's Restricted Deposit Account; the value of cash or qualified securities on deposit in the member's or Former Member's Restricted Deposit Account that the member or Former Member is seeking the Department's consent to withdraw; and

(D) include evidence that there are no "covered pending arbitration claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding against the member or Former Member, or if there are any "covered pending arbitration claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding provide a detailed description of such.

After such review and investigation as it considers necessary or appropriate, the Department shall determine whether to authorize a withdrawal, in part or whole, of cash or qualified securities from the member's or Former Member's Restricted Deposit Account. There shall be a presumption that the Department shall require the member or Former Member to continue to maintain its Restricted Deposit Requirement if the member or Former Member has any "covered pending arbitration claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding. Within 30 days from the date the application is received by the Department, the Department shall issue a notice of the Department's decision pursuant to Rule 9559.

(g) Books and Records

Each member shall maintain records evidencing the member's compliance with this Rule and any Restricted Deposit Requirement or conditions or restrictions imposed in accordance with this Rule, including without limitation, records relating to the calculation of the Preliminary Criteria for Identification, Consultation, the Restricted Deposit Account, conditions or restrictions imposed, and agreements with bank(s) or clearing firm(s), for a period of six years from the date the member is no longer subject to the requirements of this Rule. In addition, a firm that is subject to a Restricted Deposit Requirement shall provide to the Department, upon its request, records, agreements and account statements that demonstrate the firm's compliance with the Restricted Deposit Requirement.

(h) Notice of Failure to Comply

FINRA may issue a notice pursuant to Rule 9559(b) directing a member that is not in compliance with the Restricted Deposit Requirement or the conditions or restrictions imposed by this Rule to suspend all or a portion of its business.

(i) Definitions

For purposes of this Rule, the following terms shall have the following meanings:

(1) The term "Consultation" means one or more meetings or consultations between the Department and a member that meets the Preliminary Criteria for Identification.

(2) The term "Covered Pending Arbitration Claim,"[2] means an investment-related, consumer initiated claim filed against the member or its Associated Persons that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. For purposes of this definition, the claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees.

(3) The term "Department" means FINRA's Department of Member Supervision.

(4) The term "Disclosure Event and Expelled Firm Association Categories" means the following categories of disclosure events and other information:

(A) "Registered Person Adjudicated Events" means any one of the following events that are reportable on the registered person's Uniform Registration Forms:

2 See Regulatory Notice 18-06 (April 2018). The term "covered pending arbitration claim" is proposed in Regulatory Notice 18-06. FINRA anticipates that the term would be amended in proposed Rule 4111 to conform to any final definition adopted under the proposal in Regulatory Notice 18-06.

(i) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party or was a "subject of" the customer arbitration award or civil judgment;

(ii) a final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil judgment settlement or a settlement prior to a customer arbitration or civil litigation;

(iii) a final investment-related civil judicial matter that resulted in a finding, sanction or order;

(iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(v) a criminal matter in which the registered person was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(B) "Registered Person Pending Events" means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms:

(i) a pending investment-related civil judicial matter;

(ii) a pending investigation by a regulatory authority;

(iii) a pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(iv) a pending criminal charge associated with any felony or any reportable misdemeanor.

(C) "Registered Person Termination and Internal Review Events" means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms:

(i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations; or

(ii) a pending or closed internal review by the member.

(D) "Member Firm Adjudicated Events" means any of the following events that are reportable on the member's Uniform Registration Forms, or are based on customer arbitrations filed with FINRA's dispute resolution forum:

(i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party;

(ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order;

(iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(iv) a criminal matter in which the member was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(E) "Member Firm Pending Events" means any one of the following events that are reportable on the member's Uniform Registration Forms:

(i) a pending investment-related civil judicial matter;

(ii) a pending investigation by a regulatory authority;

(iii) a pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(iv) a pending criminal charge associated with any felony or any reportable misdemeanor.

(F) “Registered Persons Associated with Previously Expelled Firms” means any registered person registered for one or more days within the year prior to the Evaluation Date with the member, and who was associated with one or more previously expelled firms (at any time in his/her career).

(5) The term “Evaluation Date” means the date, each calendar year, as of which the Department calculates the Preliminary Identification Metrics to determine if the member meets the Preliminary Criteria for Identification.

(6) The term “Evaluation Period” means the prior five years from the Evaluation Date, provided that for the Registered Person Pending Events and Member Firm Pending Events categories and pending internal reviews in the Registered Person Termination and Internal Review Events category, it would correspond to the Evaluation Date (and include all events that are pending as of the Evaluation Date).

(7) The term “Former Member” means an entity that has withdrawn or resigned its FINRA membership, or that has had its membership cancelled or revoked.

(8) The term “qualified security” has the meaning given it in SEA Rule 15c3-3(a)(6).

(9) The term “Preliminary Criteria for Identification” means meeting the following conditions:

(A) Two or more of the member’s Preliminary Identification Metrics are equal to or more than the corresponding Preliminary

Identification Metrics Thresholds, and at least one of these metrics is amongst the following metrics:

(i) Registered Person Adjudicated Event Metric;

(ii) Member Firm Adjudicated Event Metric; and

(iii) Expelled Firm Association Metric; and

(B) The member has two or more Registered Person and Member Firm Events during the Evaluation Period.

(10) The term "Preliminary Identification Metrics" means the following six metrics that are based on the number of disclosure events (defined above) per Registered Persons In-Scope or percent of Registered Persons In-Scope associated with previously expelled firms:

(A) "Registered Person Adjudicated Event Metric" would be computed as the sum of Registered Person Adjudicated Events that reached a resolution during the Evaluation Period, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(B) "Registered Person Pending Event Metric" would be computed as the sum of Registered Person Pending Events as of the Evaluation Date, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(C) "Registered Person Termination and Internal Review Event Metric" would be computed as the sum of Registered Person Termination and Internal Review Events that reached a resolution during the Evaluation Period and pending internal reviews by the member as of the

Evaluation Date, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(D) "Member Firm Adjudicated Event Metric" would be computed as the sum of Member Firm Adjudicated Events that reached a resolution during the Evaluation Period, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(E) "Member Firm Pending Event Metric" would be computed as the sum of Member Firm Pending Events as of the Evaluation Date, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(F) "Expelled Firm Association Metric" would be computed as the sum of Registered Persons Associated with Previously Expelled Firms, divided by the number of Registered Persons In-Scope.

(11) The term "Preliminary Identification Metrics Thresholds" means the following thresholds corresponding to each of the six Preliminary Identification Metrics.

		Preliminary Identification Metrics Thresholds					
		Thresholds for Registered Person Event Metrics:			Thresholds for Member Firm Event Metrics:		Threshold for Expelled Firm Association Metric:
Firm Size Category	Number of Registered Persons In-Scope in Firm Size Category	Registered Person Adjudicated Event Metric	Registered Person Pending Event Metric	Registered Person Termination and Internal Review Event Metric	Member Firm Adjudicated Event Metric	Member Firm Pending Event Metric	Expelled Firm Association Metric
		(1)	(2)	(3)	(4)	(5)	(6)
1	1-4	0.50	0.20	0.10	0.75	0.25	0.75
2	5-9	0.30	0.20	0.10	0.30	0.10	0.50
3	10-19	0.20	0.10	0.10	0.30	0.05	0.50
4	20-50	0.20	0.10	0.10	0.20	0.02	0.50
5	51-150	0.20	0.05	0.10	0.15	0.01	0.25
6	151-499	0.15	0.05	0.10	0.10	0.01	0.10
7	500+	0.10	0.05	0.10	0.05	0.01	0.05

(12) The term "Registered Person and Member Firm Events" means the sum of the following categories of defined events during the Evaluation Period:

(A) Registered Person Adjudicated Events;

(B) Registered Person Pending Events;

(C) Registered Person Termination and Internal Review Events;

(D) Member Firm Adjudicated Events; and

(E) Member Firm Pending Events.

(13) The term "Registered Persons In-Scope" means all persons registered with the firm for one or more days within the one year prior to the Evaluation Date.

(14) The term "Restricted Deposit Account" means an account in the name of the member:

(A) at a bank (as defined in Section 3(a)(6) of the Exchange Act) or the member's clearing firm;

(B) subject to an agreement in which the bank or the member's clearing firm, as applicable, agrees:

(i) not to permit withdrawals (other than withdrawals of interest or the withdrawal of qualified securities or cash after and on the same day as the deposit of cash or qualified securities of equal value) from the Restricted Deposit Account without the prior written consent of FINRA;

(ii) to keep the account separate from any other accounts maintained by the member with the bank or clearing firm;

(iii) that the cash or securities on deposit in the account will at no time be used directly or indirectly as security for a loan to the member by the bank or clearing firm and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm;

(iv) that if the member becomes a Former Member, the Restricted Deposit Requirement in the Restricted Deposit Account shall be maintained and the bank or clearing firm will not permit withdrawals from the Restricted Deposit Account without the prior written consent of FINRA as set forth in paragraph (f)(3); and

(v) that FINRA is a third-party beneficiary to such agreement and that such agreement may not be amended without the prior written consent of FINRA; and

(C) not subject to any right, charge, security interest, lien or claim of any kind granted by the member.

(15) The term "Restricted Deposit Requirement" means the deposit to be maintained by the member as follows:

(A) the specific maximum Restricted Deposit Requirement for a member, determined by the Department taking into consideration the nature of the firm's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any "covered pending arbitration claims," unpaid arbitration awards or unpaid settlements related to arbitrations, and concerns raised during FINRA exams. Based on a review of these factors, the Department would determine a maximum Restricted Deposit Requirement for the member that would be consistent with the objectives of this Rule, but would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months; or

(B) the amount, adjusted after the Consultation, determined by the Department; and

(C) with respect to a Former Member, the Restricted Deposit Requirement last calculated pursuant to paragraph (i)(15)(A) or (15)(B) when the firm was a member.

(16) The term "Restricted Firm" means each member that is designated as such in accordance with paragraphs (e)(1)(B) and (e)(1)(C).

(17) The term "Uniform Registration Forms" means the Forms BD, U4, U5 and U6, as applicable.

• • • Supplementary Material: --------------

.01 Net Capital Treatment of the Deposits in the Restricted Deposit Account

Because of the restrictions on withdrawals from a Restricted Deposit Account, deposits in such an account cannot be readily converted into cash and therefore shall be deducted in determining the member's net capital under SEA Rule 15c3-1 and Rule 4110.

.02 Compliance with Rule 1017

Nothing in this Rule shall be construed as altering in any manner a member's obligations under Rule 1017.

* * * * *

9559. Procedures for Regulating Activities Under Rule 4111

(a) Notices Under Rule 4111

(1) Notice of Requirements or Restrictions

FINRA's Department of Member Supervision ("Department") shall issue a notice of its determination under Rule 4111 that a firm is a Restricted Firm and the requirements, conditions or restrictions to which the Restricted Firm is subject (hereinafter, collectively referred to as the "Rule 4111 Requirements").

(2) Service of Notice

FINRA staff shall serve the member subject to a notice issued under this Rule (or upon counsel representing the member, or other person authorized to represent others under Rule 9141, when counsel or other person authorized to represent others under Rule 9141 agrees to accept service for the member) by facsimile, email, overnight courier or personal delivery. Papers served on a member, counsel for such member, or other person authorized to represent others under Rule 9141 by overnight courier or personal delivery shall conform to paragraphs (a)(1) and (3) and, with respect to a member, (b)(2) of Rule 9134. Papers served on a member by facsimile shall be sent to the member's facsimile number listed in the FINRA Contact System submitted to FINRA pursuant to Article 4, Section III of the FINRA By-Laws, except that, if FINRA staff has actual knowledge that a member's FINRA Contact System facsimile number is out of date, duplicate copies shall be sent to the member by overnight courier or personal delivery in conformity with paragraphs (a)(1) and (3) and (b)(2) of Rule 9134. Papers served on a member by email shall be sent to the member's email address listed in the FINRA Contact System submitted to FINRA pursuant to Article 4, Section III of the FINRA By-Laws and shall also be served by either overnight courier or personal delivery in conformity with paragraphs (a)(1) and (3) and (b)(2) of Rule 9134. Papers served on counsel for a member, or other person authorized to represent others under Rule 9141 by facsimile or email shall be sent to the facsimile number or email address that counsel or other person authorized to represent others under Rule 9141 provides and shall also be served by either overnight courier or personal delivery in conformity with paragraphs (a)(1) and (3) of Rule 9134. Service is complete upon sending the notice by facsimile or email, sending the notice by overnight courier or delivering it in person, except that, where duplicate service is required, service is complete upon sending the duplicate service.

(3) Contents of Notice

A notice issued under this Rule shall include the Department's determinations under Rule 4111 and state the specific grounds and include the factual basis for the FINRA action. The notice shall state when the FINRA action will take effect. The notice shall state that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9560. 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 the basis for eliminating any Rule 4111 Requirements. In addition, the notice shall explain that, pursuant to Rule 9560(n), a Hearing Officer may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the Department that issued the notice for further consideration of specified matters, but may not modify any of the Rule 4111 Requirements imposed by the notice or impose any other obligations or restrictions available under Rule 4111.

(4) Effectiveness of the Rule 4111 Requirements

The Rule 4111 Requirements imposed by a notice issued and served under paragraph (a) of this Rule are immediately effective; provided, however, that when a firm requests review of a Department determination under Rule 4111 that imposes a deposit requirement on the firm for the first time, the firm shall be required to deposit only 50% of its restricted deposit requirement or 25% of its average excess net capital over the prior year, whichever is less, while the hearing is pending. The Rule 4111 Requirements, and the partial deposit requirement required by Rule 4111 and this paragraph, shall remain in effect while the hearing is pending.

(5) Request for Hearing

A member served with a notice under paragraph (a) of this Rule may file with the Office of Hearing Officers a written request for a hearing pursuant to Rule 9560. A request for a hearing shall be made within seven days after service of the notice issued under this Rule. A request for a hearing must set forth with specificity the basis for eliminating any Rule 4111 Requirements.

(6) Failure to Request Hearing

If a member does not timely request a hearing, the notice under paragraph (a) of this Rule shall constitute final FINRA action.

(b) Notice for Failure to Comply with the Rule 4111 Requirements

(1) Notice of Suspension or Cancellation

If a member fails to comply with any Rule 4111 Requirements imposed under this Rule, the Department, after receiving authorization from FINRA's Chief Executive Officer or such other executive officer as the Chief Executive Officer may designate, may issue a suspension or cancellation notice to such member stating that the failure to comply with the Rule 4111 Requirements within seven days of service of the notice will result in a suspension or cancellation of membership.

(2) Service of Notice

FINRA staff shall serve the member subject to a notice issued under paragraph (b) in accordance with the service provisions in paragraph (a)(2).

(3) Contents of Notice

The notice shall explicitly identify the Rule 4111 Requirements with which the firm is alleged to have not complied and shall contain a statement of facts specifying the alleged failure. The notice shall state when the suspension will take effect and explain what the respondent must do to avoid such suspension. The notice shall state that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9560. 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 9560(n), a Hearing Officer may approve or withdraw the suspension or cancellation of membership, and may impose any other fitting sanction.

(4) Effective Date of Suspension or Cancellation

The suspension or cancellation referenced in a notice issued and served under paragraphs (b)(1) and (b)(2) shall become effective seven days after service of the notice, unless stayed by a request for hearing pursuant to Rule 9560.

(5) Request for a Hearing

A member served with a notice under paragraphs (b)(1) and (b)(2) may file with the Office of Hearing Officers a written request for a hearing pursuant to Rule 9560. A request for a hearing shall be made before the effective date of the notice, as indicated in paragraph (b)(4) of this Rule. A request for a hearing must set forth with specificity any and all defenses to the FINRA action.

(6) Failure to Request Hearing

If a member does not timely request a hearing, the suspension or cancellation specified in the notice shall become effective seven days after the service of the notice and the notice shall constitute final FINRA action.

(7) Request for Termination of the Suspension

A member subject to a suspension imposed after the process described in paragraphs (b)(1) through (6) of this Rule may file a written request for termination of the suspension on the ground of full compliance with the notice or decision. Such request shall be filed with the head of the Department. The head of the Department may grant relief for good cause shown.

• • • Supplementary Material: --------------

.01 Application to Former Members Under Rule 4111

For purposes of this Rule, the term member also shall include a "Former Member" as defined in Rule 4111(i) as applicable.

* * * * *

[9559]9560. Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series

(a) Applicability

The hearing procedures under this Rule shall apply to a member, person associated with a member, person subject to FINRA's jurisdiction or other person who is served with a notice issued under the Rule 9550 Series and who timely requests a hearing or who is served with a petition instituting an expedited proceeding under Rule 9556(h). For purposes of this Rule, such members or persons shall be referred to as respondents.

(b) Computation of Time

Rule 9138 shall govern the computation of time in proceedings brought under the Rule 9550 Series, except that intermediate Saturdays, Sundays and Federal holidays shall be included in the computation in proceedings brought under Rules 9556 through [9558]9559, unless otherwise specified.

(c) Stays

(1) Unless the Chief Hearing Officer or the Hearing Officer assigned to the matter orders otherwise for good cause shown, a timely request for a hearing shall stay the effectiveness of a notice issued under Rules 9551 through 9556 and 9559(b), except that: (A) the effectiveness of a notice of a limitation or prohibition on access to services offered by FINRA or a member thereof under

Rule 9555 with respect to services to which the member or person does not have access shall not be stayed by a request for a hearing; and (B) this paragraph has no applicability to a petition instituting an expedited proceeding under Rule 9556(h).

(2) A timely request for a hearing shall stay the effectiveness of a notice issued under Rule 9557 for ten business days after service of the notice or until the Office of Hearing Officers issues a written order under Rule [9559]9560(o)(4)(A) (whichever period is less), unless FINRA's Chief Executive Officer (or such other executive officer as the Chief Executive Officer may designate) determines that a notice under Rule 9557 shall not be stayed. Where a notice under Rule 9557 is stayed by a request for a hearing, such stay shall remain in effect only for ten business days after service of the notice or until the Office of Hearing Officers issues a written order under Rule [9559]9560(o)(4)(A) (whichever period is less) and shall not be extended.

(3) A timely request for a hearing shall not stay the effectiveness of a notice issued under Rule 9558, unless the Chief Hearing Officer or the Hearing Officer assigned to the matter orders otherwise for good cause shown.

(4) A timely request for a hearing shall not stay the effectiveness of a notice issued under Rule 9559(a).

(d) Appointment and Authority of Hearing Officer and[/or] Hearing Panel

(1) For proceedings initiated under Rules 9553, 9554, [and] 9556(h) and 9559, the Chief Hearing Officer shall appoint a Hearing Officer to preside over and act as the sole adjudicator for the matter.

(2) For proceedings initiated under Rules 9551, 9552, 9555, 9556 (except Rule 9556(h)), 9557 and 9558, the Chief Hearing Officer shall appoint a Hearing

Panel composed of a Hearing Officer and two Panelists. The Hearing Officer shall serve as the chair of the Hearing Panel. For proceedings initiated under Rules 9551, 9552, 9555, 9556 (except Rule 9556(h)) and 9558, the Chief Hearing Officer shall select as Panelists persons who meet the qualifications delineated in Rules 9231 and 9232. For proceedings initiated under Rule 9557, the Chief Hearing Officer shall select as Panelists current or former members of the FINRA Financial Responsibility Committee.

(3) Rules 9231(e), 9233 and 9234 shall govern disqualification, recusal or withdrawal of a Hearing Officer or, if applicable, Hearing Panelist.

(4) A Hearing Officer appointed pursuant to this provision shall have authority to do all things necessary and appropriate to discharge his or her duties as set forth under Rules 9235 and 9280.

(5) Hearings under the Rule 9550 Series shall be held by telephone conference, unless the Hearing Officer orders otherwise for good cause shown.

(6) For good cause shown, or with the consent of all of the parties to a proceeding, the Hearing Officer or, if applicable, the Hearing Panel may extend or shorten any time limits prescribed by this Rule other than those relating to Rule 9557.

(e) Consolidation or Severance of Proceedings

Rule 9214 shall govern the consolidation or severance of proceedings, except that, where one of the notices that are the subject of consolidation under this Rule requires that a hearing be held before a Hearing Panel, the hearing of the consolidated matters shall be held before a Hearing Panel. Where two consolidated matters contain different timelines under this Rule, the Chief Hearing Officer or Hearing Officer assigned to the matter has discretion to determine which timeline is appropriate under the facts and circumstances of the case. Where one of the consolidated matters includes an action brought under a Rule that does not permit a stay of the effectiveness of the notice or where FINRA's Chief Executive Officer (or such other executive officer as the Chief Executive Officer may designate), in the case of Rule 9557, or Hearing Officer, in the case of Rule 9558(d), determines that a request for a hearing shall not stay the effectiveness of the notice, the limitation, prohibition, condition, requirement, restriction, <u>obligation</u> or suspension specified in the notice<u>, or the partial deposit requirement specified in Rule 9559(a)(4),</u> shall not be stayed pending resolution of the case. Where one of the consolidated matters includes an action brought under Rule 9557 that is stayed for up to ten business days, the requirement [and/]or restriction specified in the notice shall not be further stayed.

(f) Time of Hearing

(1) A hearing shall be held within five business days after a respondent subject to a notice issued under Rule 9557 files a written request for a hearing with the Office of Hearing Officers.

(2) A hearing shall be held within ten days after a respondent is served a petition seeking an expedited proceeding issued under Rules 9556(h).

(3) A hearing shall be held within 14 days after a respondent subject to a notice issued under Rules 9556 (except Rule 9556(h))<u>,</u> [and] 9558 <u>or 9559(b)</u> files a written request for a hearing with the Office of Hearing Officers.

(4) A hearing shall be held within 30 days after a respondent subject to a notice issued under Rules 9551 through 9555 files a written request for a hearing with the Office of Hearing Officers.

(5) A hearing shall be held within 30 days after a respondent subject to a notice issued under Rule 9559(a) files a written request for a hearing with the Office of Hearing Officers.

([5]6) The timelines established by paragraphs (f)(1) through (f)(5[4]) confer no substantive rights on the parties.

(g) Notice of Hearing

The Hearing Officer shall issue a notice stating the date, time, and place of the hearing as follows:

(1) At least two business days prior to the hearing in the case of an action brought pursuant to Rule 9557;

(2) At least six days prior to the hearing in the case of an action brought pursuant to Rule 9556(h);

(3) At least seven days prior to the hearing in the case of an action brought pursuant to Rules 9556 (except Rule 9556(h)), [and] 9558 or 9559(b); and

(4) At least 21 days prior to the hearing in the case of an action brought pursuant to Rules 9551 through 9555 or 9559(a).

(h) Transmission of Documents

(1) Not less than two business days before the hearing in an action brought under Rule 9557, not less than six days before the hearing in an action brought under Rule 9556(h), not less than seven days before the hearing in an action brought under Rules 9556 (except Rule 9556(h)), [and] 9558 or 9559(b), and not less than 14 days before the hearing in an action brought under Rules 9551 through 9555 or 9559(a), FINRA staff shall provide to the respondent who

requested the hearing or the respondent who has received a petition pursuant to Rule 9556(h), by facsimile, email, overnight courier or personal delivery, all documents that were considered in issuing the notice unless a document meets the criteria of Rule 9251(b)(1)(A), (B), (C) or (b)(2). Documents served by facsimile or email shall also be served by either overnight courier or personal delivery. A document that meets the criteria in this paragraph shall not constitute part of the record, but shall be retained by FINRA until the date upon which FINRA serves a final decision or, if applicable, upon the conclusion of any review by the SEC or the federal courts.

(2) Not less than two business days before the hearing in an action brought under Rule 9557, not less than three days before the hearing in an action brought under Rules 9556, [and] 9558 or 9559(b), and not less than seven days before the hearing in an action brought under Rules 9551 through 9555 or 9559(a), the parties shall exchange proposed exhibit and witness lists. The exhibit and witness lists shall be served by facsimile, email, overnight courier or personal delivery. Documents served by facsimile or email shall also be served by either overnight courier or personal delivery.

(i) Evidence

Formal rules of evidence shall not apply to a hearing under this Rule Series. Rules 9262 and 9263 shall govern testimony and the admissibility of evidence.

(j) Additional Information

The Hearing Officer or, if applicable, the Hearing Panel may direct the Parties to submit additional information.

(k) Record of Hearing

Rule 9265 shall govern the requirements for the record of the hearing.

(l) Record of Proceeding

Rule 9267 shall govern the record of the proceeding.

(m) Failure to Appear at a Pre-Hearing Conference or Hearing or to Comply with a Hearing Officer Order Requiring the Production of Information

Failure of any respondent to appear before the Hearing Officer or, if applicable, the Hearing Panel at any status conference, pre-hearing conference or hearing, or to comply with any order of the Hearing Officer or, if applicable, Hearing Panel requiring production of information to support any defense to the notice or petition that respondent has raised, shall be considered an abandonment of the respondent's defense and waiver of any opportunity for a hearing provided by the Rule 9550 Series. In such cases:

(1) The notice issued under the Rule 9550 Series shall be deemed to be final FINRA action. The Hearing Officer or, if applicable, the Hearing Panel may permit the hearing to go forward as to those parties who appear and otherwise comply with this Rule.

(2) The Hearing Officer may issue a default decision against a respondent who is the subject of a petition filed pursuant to Rule 9556(h) and may deem the allegations against that respondent admitted. The contents of a default decision shall conform to the content requirements of Rule [9559]<u>9560</u>(p). A respondent may, for good cause shown, file a motion to set aside a default. Upon a showing of good cause, the Hearing Officer that entered the original order shall decide the motion. If the Hearing Officer is not available, the Chief Hearing Officer shall appoint another Hearing Officer to decide the motion. If a default decision is not

called for review pursuant to Rule [9559]9560(q), the default decision shall become the final FINRA action.

(n) Sanctions, Requirements, Costs and Remands

(1) In any action brought under the Rule 9550 Series, other than an action brought under Rule 9556(h), [or] Rule 9557 or Rule 9559, the Hearing Officer or, if applicable, the Hearing Panel may approve, modify or withdraw any and all sanctions, requirements, restrictions or limitations imposed by the notice and, pursuant to Rule 8310(a), may also impose any other fitting sanction.

(2) In an action brought under Rule 9556(h), the Hearing Officer may impose any fitting sanction.

(3) In an action brought under Rule 9557, the Hearing Panel shall approve or withdraw the requirements [and/]or restrictions imposed by the notice. If the Hearing Panel approves the requirements [and/]or restrictions and finds that the respondent has not complied with all of them, the Hearing Panel shall impose an immediate suspension on the respondent that shall remain in effect unless FINRA staff issues a letter of withdrawal of all requirements [and/]or restrictions pursuant to Rule 9557(g)(2).

(4) The Hearing Officer or, if applicable, the Hearing Panel may impose costs pursuant to Rule 8330 regarding all actions brought under the Rule 9550 Series.

(5) In any action brought under the Rule 9550 Series, other than an action brought under Rule 9556(h), or Rule 9557, the Hearing Officer or, if applicable, the Hearing Panel may remand the matter to the department or office that issued the notice for further consideration of specified matters.

(6) In any action brought under Rule 9559(a), the Hearing Officer may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the Department that issued the notice for further consideration of specified matters, but may not modify any of the Rule 4111 Requirements imposed by the notice or impose any other requirements, obligations or restrictions available under Rule 4111. In any action brought under Rule 9559(b), the Hearing Officer may approve or withdraw the suspension or cancellation of membership, and may impose any other fitting sanction.

(o) Timing of Decision

(1) Proceedings initiated under Rules 9553, [and] 9554 and 9559

Within 60 days of the date of the close of the hearing, the Hearing Officer shall prepare a proposed written decision and provide it to the National Adjudicatory Council's Review Subcommittee.

(2) Proceedings initiated under Rules 9556 and 9558

Within 21 days of the date of the close of the hearing, the Hearing Officer shall prepare a proposed written decision that reflects the views of the Hearing Panel, as determined by majority vote, and provide it to the National Adjudicatory Council's Review Subcommittee.

(3) Proceedings initiated under Rules 9551, 9552 and 9555

Within 60 days of the date of the close of the hearing, the Hearing Officer shall prepare a proposed written decision that reflects the views of the Hearing Panel, as determined by majority vote, and provide it to the National Adjudicatory Council's Review Subcommittee.

(4) Proceedings initiated under Rule 9557

(A) Written Order

Within two business days of the date of the close of the hearing, the Office of Hearing Officers shall issue a written order that reflects the Hearing Panel's summary determinations, as decided by majority vote, and shall serve the Hearing Panel's written order on the Parties. The Hearing Panel's written order under Rule 9557 is effective when issued. The Hearing Panel's written order will be followed by a written decision explaining the reasons for the Hearing Panel's summary determinations, as required by paragraphs (o)(4)(B) and (p) of this Rule.

(B) Written Decision

Within seven days of the issuance of the Hearing Panel's written order, the Office of Hearing Officers shall issue a written decision that complies with the requirements of paragraph (p) of this Rule and shall serve the Hearing Panel's written decision on the Parties.

(5) If not timely called for review by the National Adjudicatory Council's Review Subcommittee pursuant to paragraph (q) of this Rule, the Hearing Officer's or, if applicable, the Hearing Panel's written decision shall constitute final FINRA action. For decisions issued under Rules 9551 through 9556, [and] 9558 or 9559, the Office of Hearing Officers shall promptly serve the decision of the Hearing Officer or, if applicable, the Hearing Panel on the Parties and provide a copy to each FINRA member with which the respondent is associated.

(6) The timelines established by paragraphs (o)(1) through (5) confer no substantive rights on the parties.

(p) Contents of Decision

The decision, which for purposes of Rule 9557 means the written decision issued under paragraph (o)(4)(B) of this Rule, shall include:

(1) a statement describing the investigative or other origin of the notice issued under the Rule 9550 Series;

(2) the specific statutory or rule provision alleged to have been violated or providing the authority for the FINRA action;

(3) a statement setting forth the findings of fact with respect to any act or practice the respondent was alleged to have committed or omitted or any condition specified in the notice;

(4) the conclusions of the Hearing Officer or, if applicable, Hearing Panel regarding the alleged violation or condition specified in the notice;

(5) a statement of the Hearing Officer or, if applicable, Hearing Panel in support of the disposition of the principal issues raised in the proceeding; and

(6) a statement describing any sanction, requirement, obligation, restriction or limitation imposed, the reasons therefore, and the date upon which such sanction, requirement, obligation, restriction or limitation shall become effective, if they are not already effective.

(q) Call for Review by the National Adjudicatory Council

(1) For proceedings initiated under the Rule 9550 Series (other than Rule 9557), the National Adjudicatory Council's Review Subcommittee may call for review a proposed decision prepared by a Hearing Officer or, if applicable, Hearing Panel within 21 days after receipt of the decision from the Office of Hearing Officers. For proceedings initiated under Rule 9557, the National

Adjudicatory Council's Review Subcommittee may call for review a written decision issued under paragraph (o)(4)(B) of this Rule by a Hearing Panel within 14 days after receipt of the written decision from the Office of Hearing Officers. Rule 9313(a) is incorporated herein by reference.

(2) If the Review Subcommittee calls the proceeding for review within the prescribed time, a Subcommittee of the National Adjudicatory Council shall meet and conduct a review not later than 40 days after the call for review. The Subcommittee shall be composed pursuant to Rule 9331(a)(1). The Subcommittee may elect to hold a hearing or decide the matter on the basis of the record made before the Hearing Officer or, if applicable, the Hearing Panel. Not later than 60 days after the call for review, the Subcommittee shall make its recommendation to the National Adjudicatory Council. Not later than 60 days after receipt of the Subcommittee's recommendation, the National Adjudicatory Council shall serve a final written decision on the parties via overnight courier or facsimile. The National Adjudicatory Council may affirm, modify or reverse the decision of the Hearing Officer or, if applicable, the Hearing Panel. The National Adjudicatory Council also may impose any other fitting sanction, pursuant to Rule 8310(a), and may impose costs, pursuant to 8330. In addition, the National Adjudicatory Council may remand the matter to the Office of Hearing Officers for further consideration of specified matters.

(3) For good cause shown, or with the consent of all of the parties to a proceeding, the Review Subcommittee, the National Adjudicatory Council Subcommittee or the National Adjudicatory Council may extend or shorten any time limits prescribed by this Rule other than those relating to Rule 9557.

(4) The National Adjudicatory Council's written decision shall constitute final FINRA action.

(5) The National Adjudicatory Council shall promptly serve the decision on the Parties and provide a copy of the decision to each FINRA member with which the respondent is associated.

(6) The timelines established by paragraphs (q)(1) through (5) confer no substantive rights on the parties.

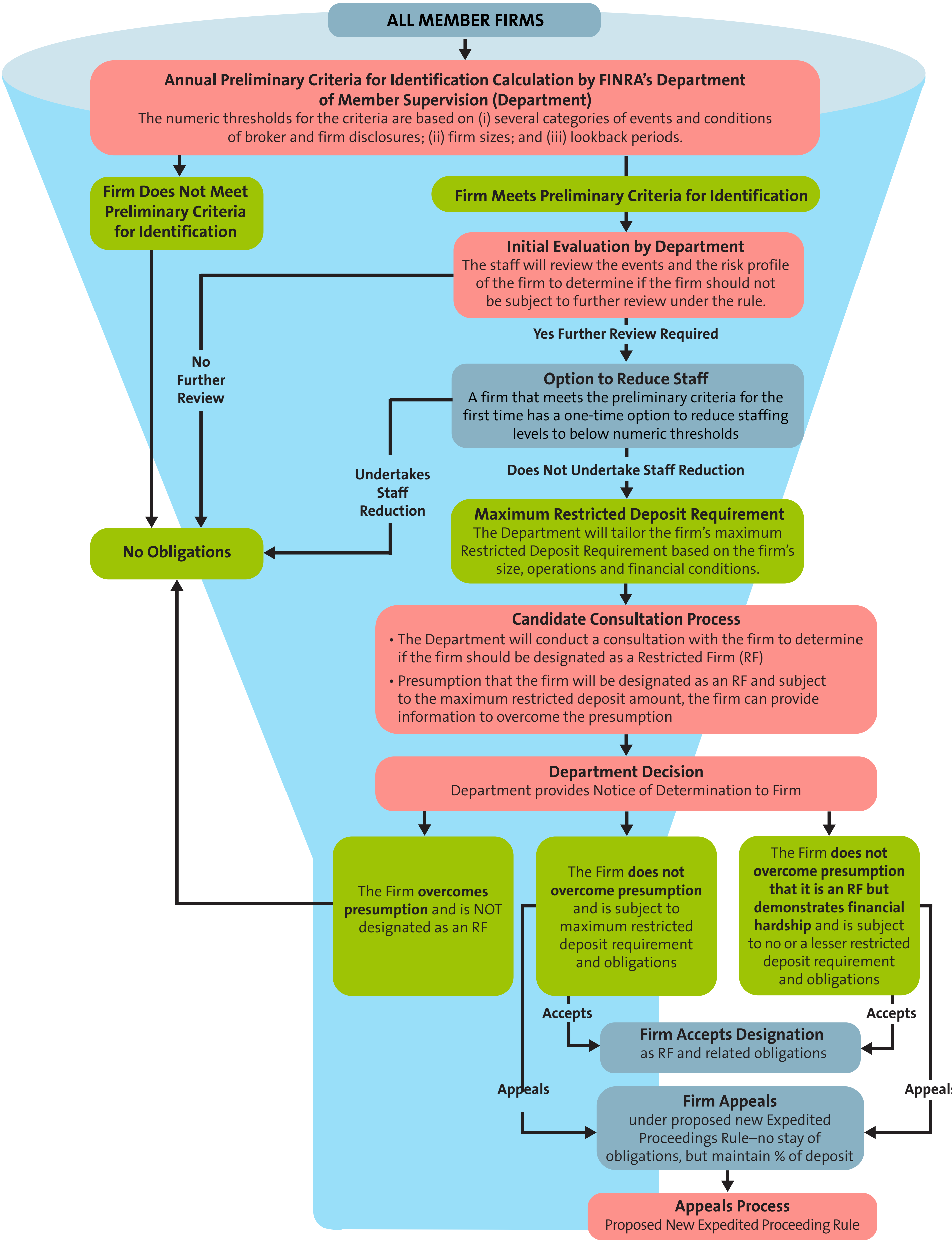
(r) Application to SEC for Review

The right to have any action pursuant to this Rule reviewed by the SEC is governed by Section 19 of the Exchange Act. The filing of an application for review by the SEC shall not stay the effectiveness of final FINRA action, unless the SEC otherwise orders.

* * * * *

Attachment B

Proposed Rule 4111 (Restricted Firm Obligations)



Attachment C

Examples of Maximum Restricted Deposit Requirements

Firm A

Firm Description: Firm A is a mid-sized member firm with an independent contractor model. It engages primarily in retail-focused business. A large percentage of the member's revenues is derived from self-offerings and private placements. A small percentage of its customers are foreign.

Financial Information: Firm A earned $25 million in gross revenues, including $10 million in commissions, over the last 12 months; has a $100,000 net capital requirement; and has maintained $550,000 in excess net capital (average over 12 months). Over the past five years, Firm A paid an average of 2% of total revenue in arbitration and customer settlements and litigations. The member has no unpaid arbitrations or settlements.

Aggravating Circumstances: Firm A meets the Preliminary Identification Metrics Thresholds for the Registered Person Adjudicated Events Metric and the Registered Person Termination and Internal Review Events Metric, and 25% of its registered representatives have adjudicated event disclosures. Over the last four years, Firm A has doubled in size by hiring registered representatives and principals who have disciplinary histories or previously worked at heavily disciplined firms. Its primary products are of higher risk, and its recent examinations have shown ongoing supervisory deficiencies.

Mitigating Factors: None.

Maximum Restricted Deposit Requirement: In light of the above facts and circumstances, the Department would set Firm A's maximum Restricted Deposit Requirement between $500,000 and $1,250,000. Considering the member firm's recent rapid growth through the hiring of persons with disciplinary histories, its primary focus on selling high-risk products, and its ongoing supervisory deficiencies as identified in recent examinations, Firm A's maximum Restricted Deposit Requirement would be set in the high end of the range ($750,000 - $1,250,000).

Firm B

Firm Description: Firm B is a large member firm, with more than 500 registered representatives and more than 10 branch offices. It operates as an independent contractor model, with a decentralized management structure. Its predominant business lines are retail sales of OTC equities, underwriting, proprietary trading, and market making. A large percentage of its accounts are retail, and many accounts are owned by seniors.

Financial Information: Firm B earned $125 million in gross revenues, including $40 million in commissions, over the last 12 months; its minimum net capital requirement is $100,000; it has maintained excess net capital of $2 million (average over 12 months). Over the past five years, Firm B has paid an average of 2% of total revenue in arbitration and customer settlements and litigations. The member has no unpaid arbitrations or settlements.

Aggravating Circumstances: Firm B meets the Preliminary Identification Metrics Thresholds for the Registered Person Adjudicated Event Metric and the Expelled Firm Association Metric. More than 5% of its public-facing registered representatives have adjudicated disclosure events; more than 25% of its registered representatives are from disciplined member firms; and 10 of its registered representatives have a history of significant misconduct. It hires representatives and principals from disciplined member firms. Firm B has high turnover at the control function level. FINRA's last several cycle examinations have identified supervisory weaknesses, including inconsistencies in how branch offices are overseen and in oversight of registered representatives' outside business activities.

Mitigating Factors: Firm B has recently appointed a new chief executive officer, and it has a substantial errors and omissions policy.

Maximum Restricted Deposit Requirement: In light of the above facts and circumstances, the Department would set Firm B's maximum Restricted Deposit Requirement between $1,725,000 - $5,750,000. Considering the aggravating and mitigating factors, Firm B's maximum Restricted Deposit Requirement would be set above the midpoint of the range (>$3,737,500), but not at the high end of the range.

Firm C

Firm Description: Firm C is a small member firm. It introduces accounts on a fully-disclosed basis. Its business lines are sales of equities (including low-priced securities), options, and advisory services. Its accounts are retail accounts. Firm C's owner is the chief executive officer, chief financial officer, and chief compliance officer.

Financial Information: Firm C earned $175,000 in gross revenues (including $130,000 in commissions) over the past 12 months; its minimum net capital requirement is $5,000; it has maintained excess net capital of $9,000 (average over 12 months). It has no unpaid customer arbitration awards or settlements.

Aggravating Factors: Firm C meets the Preliminary Identification Metrics Thresholds for the Registered Person Adjudicated Event Metric and the Expelled Firm Association Metric. Firm C's owner has 25 disclosure events, including several formal actions, regulatory actions, and suspensions. All of the member's registered representatives have adjudicated events. Firm C sells penny stocks.

Mitigating Factors: Firm C earns a low amount of revenue. It has not been required to pay any arbitration and customer settlements over the last five years. The firm's most recent FINRA cycle examination resulted in no findings.

Maximum Restricted Deposit Requirement: In light of the above facts and circumstances, the Department would set Firm C's maximum Restricted Deposit Requirement between $0 - $17,000. Considering the aggravating and mitigating factors, Firm C's maximum Restricted Deposit Requirement would be set within the lower end of the range (<$6,000).

Attachment D-1: Number of Firms Meeting the Preliminary Criteria for Identification*

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification	
		Number of Firms	Percentage of FINRA Registered Member Firms
2013	4,140	89	2.1%
2014	4,068	98	2.4%
2015	3,941	86	2.2%
2016	3,835	67	1.7%
2017	3,721	60	1.6%
2018	3,582	61	1.7%

* The statistics correspond to the number of firms that would have met the Preliminary Criteria for Identification as of year-end (December 31st) of the identification year.

Attachment D-2: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size*

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification						
		Number of Firms				Percent of Total		
		Small	Mid-Size	Large	Total	Small	Mid-Size	Large
2013	4,140	84	4	1	89	94%	4%	1%
2014	4,068	92	4	2	98	94%	4%	2%
2015	3,941	79	5	2	86	92%	6%	2%
2016	3,835	61	5	1	67	91%	7%	1%
2017	3,721	54	6	0	60	90%	10%	0%
2018	3,582	55	6	0	61	90%	10%	0%

* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st.
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.

Attachment D-3: New Events (after identification) Associated with Firms Meeting the Preliminary Criteria for Identification

Identification Year	Number of Firms Meeting the Preliminary Criteria for Identification	Post-Identification Period	Number of "New" Registered Person and Member Firm Events in the Post-Identification Period
2013	89	2014-2018	1,859 (6.3x)**
2014	98	2015-2018	1,671 (7.5x)**
2015	86	2016-2018	1,287 (8.2x)**
2016	67	2017-2018	636 (9.2x)**
2013-2016	183***	2014-2018	2,793

* "New" events correspond to Registered Person and Member Firm Events that were identified or occurred after the firm's identification, 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 (on a per registered person basis) for firms that would have met the Preliminary Criteria for Identification relative to other firms. For example, the factor of 6.3x for 2013 shows that firms that met the Preliminary Criteria for Identification in 2013 had 6.3 times more new disclosure events (per registered person) in the years after identification (2014-2018) than other firms registered in 2013.

*** These 183 firms correspond to the unique number of firms that meet the Preliminary Criteria for Indentification in one or more years during this period. Some of these firms meet the criteria in multiple years during the 2013-2016 period.

Exhibit 2b

Alphabetical List of Written Comments
Regulatory Notice 19-17

1. Matthew Alex, Raphaella Arnaud, Karoline Silva, & Elissa Germaine, Investor Rights Clinic at Pace Law School ("PIRC") (July 1, 2019)
2. Charles R. Brettell, Brooklight Place Securities, Inc. ("Brooklight") (June 12, 2019)
3. Richard J. Carlesco Jr., IBN Financial Services, Inc. ("IBN") (June 6, 2019)
4. Kevin M. Carroll, Securities Industry and Financial Markets Association ("SIFMA") (July 1, 2019)
5. Kwok C. Chiu (June 11, 2019)
6. Colorado Financial Service Corporation ("Colorado FSC") (June 7, 2019)
7. Catherine M. Corrigan, Rockfleet Financial Services, Inc. ("Rockfleet") (July 1, 2019)
8. Jerry Dempsey, Jr., Dempsey Lord Smith, LLC ("Dempsey") (July 1, 2019)
9. Scott A. Eichhorn, University of Miami School of Law Investor Rights Clinic ("MIRC") (July 1, 2019)
10. Michael H. Ference & Richard J. Babnick Jr., Sichenzia Ross Ference LLP ("Sichenzia") (June 28, 2019)
11. William F. Galvin, The Commonwealth of Massachusetts ("Massachusetts") (June 28, 2019)
12. Michael P. Gilmore, Moss & Gilmore LLP ("Moss & Gilmore") (June 28, 2019)
13. Owen Harnett, HLBS Law ("HLBS") (July 1, 2019)
14. Christopher A. Iacovella, American Securities Association ("ASA") (August 6, 2019)
15. Julie E. Kamps, WestPark Capital Financial Services, LLC ("Westpark") (July 1, 2019)
16. Dennis M. Kelleher & Lev Bagramian, Better Markets ("Better Markets") (July 1, 2019)
17. Dochtor Kennedy, AdvisorLaw, LLC ("AdvisorLaw") (May 28, 2019)
18. Les Kern (May 3, 2019)

19. Clifford Kirsch & Eric Arnold, Committee of Annuity Insurers ("CAI") (July 1, 2019)

20. Christine Lazaro & Samuel B. Edwards, Public Investors Arbitration Bar Association ("PIABA") (July 1, 2019)

21. Damian Maggio, Joseph Stone Capital, LCC ("Joseph Stone") (June 28, 2019)

22. David Marron, Richard Mayer & Christine Lazaro, Esq., St. John's University School of Law Arbitration Clinic ("St. John's SOL") (July 1, 2019)

23. David D. McNally, McNally Financial Services Corporation ("McNally") (June 27, 2019)

24. Seth A. Miller, Cambridge Investment Research, Inc. ("Cambridge") (July 1, 2019)

25. Ken Norensberg, Luxor Financial Group, Inc. ("Luxor") (June 27, 2019)

26. Michael Pieciak, North American Securities Administrators Association, Inc., ("NASAA") (July 1, 2019)

27. Dan Pisenti, Whitehall-Parker Securities, Inc. ("Whitehall") (May 3, 2019)

28. Mark Quinn, Cetera Financial Group, Inc. ("Cetera") (July 1, 2019)

29. Matthew Rothchild, EFS Advisors ("EFS") (June 27, 2019)

30. Damon D. Testaverde, William R. Hunt, Jr. & Joseph C. Cascarelli, Esq., Network 1 Financial Securities, Inc. ("Network 1") (June 27, 2019)

31. Robin M. Traxler, Financial Services Institute ("FSI") (July 1, 2019)

32. Jamie John Worden, Worden Capital Management, LLC ("Worden") (June 30, 2019)

Exhibit 2c

Faculty Supervisors
JONATHAN BROWN
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MARGARET M. FLINT
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BRENDA THORNTON

July 1, 2019

VIA ELECTRONIC SUBMISSION

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

Re: Regulatory Notice 19-17, Protecting Investors from Misconduct

Dear Ms. Mitchell:

The Investor Rights Clinic at Pace Law School, operating through John Jay Legal Services, Inc. (PIRC),[1] welcomes the opportunity to comment on FINRA's proposed new Rule 4111 (Restricted Firm Obligations), which imposes additional obligations on firms with a significant history of misconduct. The proposed rule seeks to promote investor protection and market integrity by giving FINRA a tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards. To accomplish these goals, the proposed rule authorizes FINRA to identify firms that present a heightened risk of harm to investors through a multi-step process involving numeric-based threshold calculations. It then requires these firms to make deposits of cash or qualified securities that could not be withdrawn without FINRA's prior written consent and to adhere to other conditions or restrictions on the member's operations that FINRA deems necessary or appropriate to protect investors.

PIRC supports FINRA's efforts to protect investors from firms with a significant history of misconduct and views the rule as a positive step in this direction. However, we believe the rule should be refined, and we recommend broader measures to accomplish the goals set out in the Regulatory Notice. While the proposed numeric thresholds should identify many high-risk firms, we are concerned that some firms could try to mislead and underreport disclosures to stay below the numeric thresholds. Moreover, while the proposed financial obligations on Restricted Firms should help deter misconduct, we recommend that FINRA clarify the process for

[1] PIRC, which opened in 1997, is the nation's first law school clinic in which law students, for academic credit and under close faculty supervision, provide pro bono representation to individual investors of modest means in arbitrable securities disputes. *See* Barbara Black, *Establishing A Securities Arbitration Clinic: The Experience at Pace*, 50 J. LEGAL EDUC. 35 (2000); *see also* Press Release 97-101, Securities Exchange Commission, *SEC Announces Pilot Securities Arbitration Clinic To Help Small Investors – Levitt Response To Concerns Voiced At Town Meetings* (Nov. 12 1997), *available at* http://www.sec.gov/news/press/pressarchive/1997/97-101.txt.

determining and using the restricted funds and more fully detail the other potential conditions or restrictions. Finally, PIRC supports the creation of an industry-funded national investor recovery pool to address the larger issue of unpaid awards and recommends investor education to deter serial misconduct by requiring member firms and registered representatives to provide BrokerCheck reports to customers.

Identifying Restricted Firms Using Numeric-Based Thresholds

To identify the firms that expose investors to high risk because of their history of significant misconduct, FINRA proposes using a multi-step, “funnel” process which begins with an annual calculation, based on six categories of broker and firms disclosures,[2] to preliminarily identify firms that present a significantly higher risk to investors than a large percentage of the membership. FINRA proposes using numeric thresholds for seven different firm sizes to ensure that each member firm is compared to similarly sized peers. The identification process then involves an initial evaluation by FINRA to determine whether, despite preliminary identification, the member does not impose a sufficiently high level of risk to warrant further review. If further review is warranted, FINRA would provide a one-time option to reduce staffing levels to below the thresholds. FINRA also offers a consultation with the member firm to determine whether it should be considered Restricted, as well as the opportunity to appeal. Only after this thorough process would FINRA consider a member a Restricted Firm.

As detailed in the Regulatory Notice, it appears that FINRA is cognizant of the most problematic and consistent offenders in the industry. The proposed rule uses numeric thresholds based on individual and firm disclosure events to identify these firms, while giving firms sufficient opportunity to avoid being mistakenly or wrongly identified as Restricted. Additionally, the one-time option to reduce risky staff has the added bonus of lowering the number of representatives who have repeatedly harmed investors.

While PIRC supports the numeric-based threshold approach as a positive step towards identifying high-risk firms, we are concerned that firms may attempt to mislead and underreport required disclosures in an attempt to stay below the numeric thresholds. FINRA notes that the IIROC “terms and conditions” approach would capture member firms with substantial compliance failures that might not otherwise be captured by the threshold approach but declined to propose that approach at this time. We support any supplemental or alternative methods, such as the “terms and conditions” approach, that would identify high-risk firms that have evaded the numeric threshold approach.

We are also concerned that the firms identified by the numeric-based threshold approach may underrepresent the number of firms and individuals with numerous disclosure events that have been expunged. It has been well established that, despite FINRA’s position that expungement of customer dispute information is an extraordinary measure, expungement is granted in the majority of cases in which it is requested. Thus, the numeric-based threshold criteria may not capture all of the firms or individuals with a significant and disproportionate

[2] These six categories are: Registered Person Adjudicated Events, Registered Person Pending Events, Registered Person Termination and Internal Review Events, Member Firm Adjudicated Events, Member Firm Pending Events, and Registered Person Associated with Previously Expelled Firms.

history of misconduct. Moreover, we echo PIABA's concern that the numeric-based threshold approach could encourage unwarranted requests for expungement in an attempt to avoid the Restricted Firm designation.

Industry objections that the proposed rule would disproportionately affect small firms are unwarranted, as the rule accounts for different firm sizes in its threshold calculations and should only identify firms that persistently hire individuals who pose a high risk to investors.

Restricted Firm Financial Obligations

Proposed Rule 4111 would give FINRA the authority to impose financial obligations on designated Restricted Firms by requiring them to make deposits of cash or qualified securities into a Restricted Deposit Account and maintain a minimum balance called the Restricted Deposit Requirement. FINRA will tailor the Restricted Deposit Requirement based on, among other factors, the nature of the firm's operations and activities, annual revenue, net capital requirements, the number of offices and registered persons, the nature of the disclosure events captured by the numeric thresholds, and the amount of any covered pending arbitration claims or unpaid arbitration awards. Once funds are deposited in the restricted account, Restricted Firms could not withdraw them without FINRA's prior consent. In addition to the Deposit Requirement, the proposed rule anticipates additional potential "conditions or restrictions."

PIRC generally supports the Restricted Firm financial obligations aspect of the proposed rule and believes it should help deter misconduct. However, the additional potential "conditions and restrictions" seem ambiguous, and it is unclear if and how FINRA will adjust a member's Restricted Deposit Requirement if a member actually uses these funds to pay unpaid awards.

The proposed financial obligations should help FINRA rein in Restricted Firms that shut down and reconstitute themselves in an attempt to avoid paying settlements and awards because members would need FINRA's consent to withdraw funds from their Restricted Accounts. A member that becomes a former member would still have funds tied up in the previous firm's Restricted Account and thus have less capital to work with upon attempted reconstitution. Although this aspect of the proposal should have a positive deterrent effect, we echo the concern raised by PIABA President Christine Lazaro that it could encourage gamesmanship among member firms to keep operating capital low.[3]

Unpaid Arbitration Awards

The Restricted Deposit Requirement should help address the issue of unpaid arbitration awards. However, while the proposed rule suggests that the funds subject to the Restricted Deposit Requirement *should be used* by member firms to pay unpaid arbitration awards, it does not state that they *must be used* for this purpose. We recommend making this a requirement.

[3] Christine Lazaro, *FINRA Proposal to Restrict Recidivist Behavior a Good Start – But More Needs to be Done*, INVESTMENTNEWS: OUTSIDE-IN (May 14, 2019), https://www.investmentnews.com/article/20190514/BLOG09/190519967/finra-proposal-to-restrict-recidivist-behavior-a-good-start-x2014.

Additionally, because the funds generated by the Restricted Deposit Requirement likely will not be sufficient to cover all unpaid arbitration awards, PIRC supports the creation of a national investor recovery pool as a complementary method to address this issue. The pool should be maintained and administered by FINRA through the collection of fines on rule-breaking members, from its profits, or through a modest assessment on members. In addition to ensuring that all awards are paid to customers, such a pool should incentivize the industry to police itself and minimize the misconduct that has led to the need for such a pool.

Mandatory Disclosure of BrokerCheck Reports

To ensure that customers are aware of reported misconduct before choosing a broker, PIRC recommends an additional condition on Restricted Firms – requiring mandatory disclosure of BrokerCheck reports by these firms and their registered representatives. Specifically, we recommend that FINRA require members to provide both firm and individual BrokerCheck reports to new customers as part of the account opening process, as well as at periodic intervals (perhaps with year-end account statements). This type of simple investor education would empower investors to avoid working with, or to ask clarifying questions of, brokers with a history of significant misconduct, while deterring such misconduct in the first place. Despite FINRA's efforts to promote BrokerCheck, in our experience, customers who are victims of brokers with a significant history of misconduct are unaware of this tool until it is too late. FINRA should consider requiring this disclosure of all members and registered representatives, which would provide all investors with the ability to make informed decisions when choosing a broker.

Conclusion

While proposed Rule 4111 enhances the protection of investors from firms with a history of significant misconduct, the rule should be refined to avoid underreporting and gamesmanship, as well as explicitly to require the payment of unpaid arbitration awards. Finally, we encourage FINRA to address the larger problem of unpaid arbitration awards through a national investor recovery pool and to enhance investor education by requiring brokers to share BrokerCheck reports with customers.

Respectfully submitted,

Pace Investor Rights Clinic

Matthew Alex, Student Intern

Raphaella Arnaud, Student Intern

Karoline Silva, Student Intern

Elissa Germaine, Director

BY ELECTRONIC MAIL

Financial Industry Regulatory Authority (FINRA)
1735 K Street, NW
Washington, DC 20006-1506

RE: Comments on FINRA Proposed Rule 4111

Dear Sir or Madam:

I write today on behalf of Brooklight Place Securities, Inc. ("**BPSI**," "**Firm**," "**we**," **or** "**our**") in regard to Proposed Rule 4111 (the "**Proposed Rule**"). In summary, BPSI is of the opinion that the Proposed Rule should not be adopted for the reasons set out below.

Firm Overview

Located just outside of Chicago, IL, BPSI has been "lighting the way to a brighter tomorrow" for our registered representatives and clients since 1984. Our approach is straight-forward: support our Reps and clients to identify specific long-term goals and then develop and implement strategies to meet them. Our unique combination of the best Reps in the industry and convenient access to an extensive portfolio of mutual funds, variable products, stocks and bonds provides clients peace of mind when thinking about how to achieve their financial services goals.

In FINRA's nomenclature, BPSI is considered a "small firm" and it is from this position that our comments originate.

Discussion

In a highly regulated industry in a county as litigious as America, few financial services professionals will go their entire careers unscathed by a client complaint. In addition, for those unfortunate enough to simply associate with a firm that itself is sanctioned by FINRA for firm-level issues, wholly innocent representatives will be marked with the scarlet letter of having been so associated. Proposed Rule 4111 could effectively end the careers of many of these reps as their options for future association would be vastly diminished in an already shrinking pool of broker-dealers.

Further, small firms would be disproportionately impacted by the Proposed Rule, as FINRA's ratio test could hamper both their ability to continue as a going concern in the face of heightened regulatory cost, diminished recruiting potential and the requirement to essentially "post bail" through the Proposed Rule's financial obligations.

Rather than true protection for investors along the lines of preventative measures, the Proposed Rule simply segregates cash into a "pre-funded victims account" based on little evidence that such a fund is necessary and under the assumption that identified firms and their representatives are ravenous wolves waiting to pounce on unsuspecting clients. It would appear that if a financial reserve is what FINRA is really after, they could get there by other means than saddling the entire industry with additional regulatory burden – something like an increased SIPC tax or other insurance-type coverages come to mind.

FINRA reaches its conclusion that the Proposed Rule is necessary based on no publicly available data (though they reference having such data) and by referring to what sounds like a few known repeat offenders that for some inexplicable reason it can't seem to reach under its current powers. Rather than solving for whatever gap in enforcement powers it might need to resolve what sounds like a serious problem with a few bad actors, it turns the whole industry on its head and requires firms prove they aren't potential thieves by wrapping a reporting requirement around every single member premised on some formula that at best will lead to an increased regulatory burden with no discernible benefit and at worst sweep in wholly innocent firms that merely tripped an arbitrary trigger, the regulatory equivalent of using a sledgehammer to swat a fly.

What seems reasonably clear in reading the tea leaves is that FINRA would rather have the Canadian Rule it cites to at the end of the Background & Discussion section (IIROC Consolidated Rule 9208). That rule, which we have not reviewed, appears to allow for authority by the regulator to impose additional terms and conditions on "strategically target[ed] . . . problematic firms" which, frankly, sounds like a vastly better idea than casting the extraordinarily wide net FINRA has proposed in the Proposed Rule. So, why would FINRA not simply have proposed that solution; one can only wonder because FINRA never addresses that rather disclaiming that as something they're not "proposing at this time." Again, why not?

Finally, we note the hostile tone FINRA evidences in regard to what amount to cherished American rights – like due process and a constraint on ex post facto laws & regulation – in comments essentially venting their frustration at their inability to remove bad actors from the financial system (see, full paragraph 2 on page 4 and full paragraph 2 on page 8). Bad actors should be removed – forcefully, permanently and as swiftly as allowed by law or regulation. But in its zeal to do so, FINRA cannot simply brush aside the rights of accused to defend themselves or retroactively apply its tests (both of which it would likely be constrained from doing by the US court system).

<u>Summary</u>

In closing, we believe the Proposed Rule provides little (if any) actual customer protection, presents a grave potential threat to reps and small firms and is better dealt with by other means, some of which FINRA itself references.

Sincerely,

Charles R. Brettell
President

I believe this will again have a disproportionate effect on small firms. If FINRA wants small firms out of the industry, let us know now. Quit nickel and diming us. Small firms can't pay for register representatives (such as forgivable loans) like the larger firms can. So often times we have to take reps with minor nicks on their disclosure record. Such as financial disclosures. Please call me if you have questions.

Richard J. Carlesco Jr., LUTCF

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July 1, 2019

Via E-Mail to pubcom@finra.org

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

Re: Regulatory Notice 19-17 (Protecting Investors from Misconduct)

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on Notice 19-17 (the "Notice" or the "Proposal").[2] The Proposal would impose tailored obligations, including financial set-asides, on designated member firms that cross specified, numeric disclosure-event thresholds. The stated purpose of the Proposal is to give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards. We respectfully submit the following comments and recommendations for your consideration.

SIFMA supports targeted efforts to ensure firms pay their arbitration awards in full.

We applaud FINRA's continuing efforts to help ensure that arbitration claims, awards, and settlements are paid in full. At the same time, we have been careful to explain that the issue of unpaid awards is not an indictment of the current securities arbitration system, or of the various processes currently available to help collect an arbitration award. Nor does it justify calls to create some form of post-award collection pool, insurance, or guaranty. Such a pool would be unfair and inappropriate because, among

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. 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 19-17, available at https://www.finra.org/industry/notices/19-17.

other things, it would essentially require the many good actors (firms who pay their awards) to pay for the few bad actors (firms who do not).[3]

The issue of unpaid awards cannot be solved on the "back-end" as a matter of post-award collection because at that point the money is already gone. Rather, the issue needs to be addressed on the "front-end" – before an arbitration arises by ensuring that the firm maintains adequate resources to satisfy it. The Proposal appropriately embraces the "front-end" approach by seeking to identify those small number of firms with an extensive history of misconduct and/or relevant disclosure events, and as appropriate, requiring those firms to set aside cash deposits or qualified securities that could be applied to pay the firm's or its representatives' unpaid awards. SIFMA supports this approach.

FINRA should ensure that firms can independently self-evaluate and continuously monitor their status as a prospective Restricted Firm.

The Proposal would create a multi-step process for FINRA to identify whether a firm should be subject to additional obligations (e.g., a cash deposit set-aside, etc.). The first step is an annual calculation by the Department of Member Supervision (the "Department") of a firm's "Preliminary Identification Metrics",[4] which is the calculated metric for each of the following six categories of events or conditions:

1. "Registered Person Adjudicated Events"[5]
2. "Registered Person Pending Events"[6]
3. "Registered Person Termination and Internal Review Events"[7]
4. "Member Firm Adjudicated Events"[8]
5. "Member Firm Pending Events"[9]
6. "Expelled Firm Association"[10]

Next, the Department would compare the firm's six metrics numbers to the chart of "Preliminary Identification Metrics Thresholds"[11] and determine if the firm meets the "Preliminary Criteria for Identification."[12] If the firm meets that criteria, then the Department would continue its process,

[3] *See, e.g.,* SIFMA testimony before U.S. Senate Committee on Banking, Housing and Urban Affairs (June 28, 2018) (objecting to a bill that would have required FINRA to establish an industry-financed recovery pool to pay the full value of unpaid arbitration awards), available at https://www.sifma.org/resources/news/sifma-submits-testimony-raising-concerns-with-unpaid-arbitration-legislation-s-2499/.

[4] Proposed Rule 4111(i)(10) (Definitions).

[5] *Id.* at (i)(4)(A).

[6] *Id.* at (i)(4)(B).

[7] *Id.* at (i)(4)(C).

[8] *Id.* at (i)(4)(D).

[9] *Id.* at (i)(4)(E).

[10] *Id.* at (i)(4)(F).

[11] *Id.* at (i)(11).

[12] *Id.* at (i)(9).

ultimately determining whether the firm should be designated as a "Restricted Firm" required to establish a "Restricted Deposit Account."

The process proposed by FINRA is essentially FINRA-controlled, with the Department making the calculations and then informing the firm. Firms cannot readily duplicate the Department's calculations with precision because they don't know all of the required variables, including, for example: (i) the "Evaluation Date"[13] (the date on which the Department calculates the firm's Preliminary Identification Metrics); (ii) the "Evaluation Period"[14] (the five years prior from the Evaluation Date); and (iii) the "Registered Persons In-Scope"[15] (all persons registered with the firm for one or more days within the one year prior to the Evaluation Date). More importantly, firms cannot identify with certainty or precision what disclosures/reportable events the Department is counting as part of its calculation.

The better approach would be to allow firms to be more directly involved in the process. Firms should have the in-house ability to make the same exact calculation as FINRA to determine if the firm meets the Preliminary Criteria for Identification. This would allow a firm to monitor itself on a continuous basis, self-police, and address any issues before FINRA comes knocking on its door. It would encourage firms to focus greater attention on the Proposal's metrics and take proactive corrective measures and would thereby probably reduce the Proposal's regulatory burden on the Department.

Accordingly, we recommend that FINRA provide member firms with an electronic template or worksheet that firms could use to make the identical calculation as the Department. We further recommend that such template/worksheet be available on a year-round basis so that firms can periodically, or even continuously, monitor their metrics and take corrective action to avoid triggering the relevant thresholds.

FINRA should not designate clearing firms as potential custodians of the Restricted Deposit Account.

The Proposal states that the Restricted Deposit Account must be established at a bank or the member's clearing firm, and must be subject to an agreement in which the bank or clearing firm agrees to a number of requirements. A number of clearing firms expressed concern with serving the role of custodian of the Restricted Deposit Account.

These clearing firms believe it would be problematic to custody a Restricted Deposit Account given the clearing firm's unique role in the relationship between an introducing broker and its clients. Fulfilling this role would impose additional duties and responsibilities on clearing firms that are not part of their systems and procedures today, and that would require significant time and resources to develop. Moreover, custody by a clearing firm likely would not provide FINRA with the level of transparency that it would want regarding these funds. For these reasons, we recommend that the Proposal be revised to state that a Restricted Deposit Account must be established at a third-party bank or trust company.

[13] *Id.* at (i)(5).

[14] *Id.* at (i)(6).

[15] *Id.* at (i)(13).

FINRA should facilitate clearing firms' compliance with their due diligence obligation by sharing the identify of an introducing firm client designated as a Restricted Firm.

The Proposal states that firms designated as Restricted Firms: "present heightened risk of harm to investors and their activities may undermine confidence in the securities market as a whole"; "often act in ways that harm their customers and erode trust in the brokerage industry"; and "expose investors to real risk."

Pursuant to FINRA Rule 4311(b)(4), a clearing firm is required to conduct appropriate due diligence with respect to its introducing firm relationships to assess, among other things, the reputational risk that the relationship will have on the clearing firm. Pursuant to the Supplementary Material to Rule 4311, the clearing firm's due diligence may include, without limitation, "inquiring by the [clearing] firm into the introducing firm's … complaint and disciplinary history."

The Proposal is specifically targeted towards individuals and firms with a history of misconduct and FINRA's related view that such history "can be predictive of similar future events." As a result, FINRA's designation of a firm as a Restricted Firm is directly relevant to, and interrelated with, clearing firms' due diligence obligation. Accordingly, in the interest of investor protection and regulatory transparency, and in order to facilitate clearing firms' compliance with their due diligence obligation, we recommend that FINRA share with clearing firms the identify of their introducing firm clients, if any, that FINRA has designated as a Restricted Firm.

* * *

If you have any questions or would like to further discuss these issues, please contact the undersigned.

Sincerely,

Kevin M. Carroll

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: ***via e-mail to:***
Robert L.D. Colby, Chief Legal Officer, FINRA
Richard W. Berry, Executive Vice President and Director, FINRA-DR

Re: Proposed new Rule 4111 (Restricted Firm Obligations)

To Whom It May Concern:

Rule 4111 would be unfair on all FINRA member firms as well as some financial advisors who are looking to rebuild their lives. Secondly, what problem is FINRA looking to solve with the restricted firm deposit?

For small firms, every dollar is budgeted and planned to grow the firm either through acquisitions, technology, and/or personnel. The dollars small firms spend today must pay dividends in the near future. Having dollars tied up in a restricted firm deposit is not a good allocation of resources.

And asking for a waiver due to low financial resources is a nonstarter. A firm looking for a waiver would be a red flag for brokers. Not only would it deter recruitment, but brokers may leave the firm to avoid being the last person on a ‘sinking ship”.

I have a few disclosures and a termination. My boss gave me a chance to move my book and rebuild. Now with this proposed new rule, he will be making the difficult decision of letting people go in order to avoid the restriction or tie up more of his funds in a restricted firm deposit account. As a broker who has had to move a book of business several times, it is not easy. Again, those funds could be better used to recruit advisors, spend on technology, and improve compliance.

Even if rogue brokers or rogue firms are barred, people from those firms still wind up in other firms. They wind up in RIA dispensing “advice”. They wind up in unregistered firms. Why else would the SEC have a PAUSE list?

FINRA should focus more of their attention on investor education. Have investors be educated about their rights. Have investors be educated on researching the broker or the firm. Knowledge is the best way to combat bad sales practices. One initiative by FINRA is a success story, the Senior Helpline. The Senior Helpline is a good tool for people to call to ask questions. There should be other outreaches like that.

Ultimately, FINRA would be reducing the number of brokerage firms that are out there. Mid and large firms, who can afford the restricted firm deposit, will give investors less choice. It was not the small firms that caused the 2008 financial crisis. The small firms did not get any bailout from the 2008 financial crisis. But it was the large firms that got the bailout. It was the large firms that created these derivative products that nobody understood but sold to their customers. It was the large firms who are, mixing banking with investments, selling mortgages that were out of budget for the borrower. We need a few more “Bailey Building & Loans” to give investors options than having to crawl to “Mr. Potter.”

Kwok C. Chiu

Colorado Financial Service Corporation
MEMBER FINRA • SIPC

304 INVERNESS WAY SOUTH, SUITE 355
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303-962-7267

June 7, 2019

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

Re: Regulatory Notice 19-17
Proposed FINRA Rule 4111

Dear Jennifer Piorko Mitchell:

We submit this comment on behalf of Colorado Financial Service Corporation as it relates to the Proposed Rule 4111 by FINRA (the "Proposed Rule"). We believe the underlying basis for the Proposed Rule does not apply to the majority of member firms and it would place an undue financial and economic burden on smaller member firms that are operating in an honorable and respectable manner, who have chosen to onboard enough representatives with disclosures, enough to pass the obligation thresholds. Though FINRA states that they are aware that various members and representatives would "eventually be forced out of the industry", this is counter intuitive to the mission of FINRA 360 that has been at the forefront of the image campaign for several years now.

The Regulatory Notice 19-17 would give FINRA additional authority to impose tailored obligations, including possible financial requirements on designated member firms that cross specified numeric disclosure-event thresholds without having committed any misconducts or wrongdoings. The imposed "obligations" are merely based on analysis derived from a number factor that places firms on the list because they have registered representatives that have prior disclosures. The new Rule would only force the smaller sized firms to exit the industry because they have representatives who have disclosures that might not always be at fault but settled to avoid incurring more expenses with litigations or other legal costs. The reasons stated by FINRA do not mention how the changes would enhance investor confidence or promote investor protection and market integrity. Again, the New Rule only adds a financial constraint onto small and mid-sized firms that are being transparent and following the FINRA disclosure and filing requirements.

It is of our opinion that having a lesser variety of small firms for individuals and investors to choose from negatively impacts the industry as a whole, and that a better course of action

would be the provision and assignment of “Disciplinary training and behavior restructuring” in order to attempt to correct disclosure related issues and acknowledge issues presented with representatives before taking action to force them out of the industry.
Sincerely,

Colorado Financial Service Corporation

July 1, 2019

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

Dear Ms. Mitchell:

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

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

Unfair Impact

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

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

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

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

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

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

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

The Math

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

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

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

Targeted Firms

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

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

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

Bypassing Safeguards

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

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

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

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

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

Counterintuitive Principles

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

Exaggeration of the Issue

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

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

<u>Alternatives to Rule 4111</u>

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

<u>Summary</u>

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

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

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

Sincerely,

Catherine M. Corrigan
Chair, President & CEO

July 1, 2019

Via email: pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA Inc
1735 K Street, NW
Washington, DC 200006-1506

Re: Regulatory Notice 19-17
Proposed FINRA Rule 4111

Dear Ms. Mitchell:

Dempsey Lord Smith, LLC would like to respectfully submit comments on the new proposed FINRA Rule 4111. Our firm's principals fully support FINRA's efforts to protect the investing public from unethical and fraudulent activities of a minor subset of industry participants, but we are concerned about the effectiveness of this new proposed rule to prevent such activities. The firm would like to point out that by definition, harmful acts to clients such as fraud and/or unethical sales practices are only realized and/or discovered after the occurrence, and the use of big data to try to be predictive of an event that has not occurred is certainly not an exact science, and does nothing to prevent these acts. We are also extremely concerned about the use of highly questionable data quality with respect to customer complaints as one of the criteria to classify firms. Our firm's direct experience with FINRA arbitration is certainly less than an encouraging endorsement of merit of some customer complaints, and with the number of frivolous claims filed one would have to wonder how these would be counted against a firm or representative. It is also very important to note that a customer complaint does not mean that a representative has necessarily done anything fraudulent or unethical. Our firm and our advisors are in the "securities investment" business, and all investments contain risks, and it is a fact some investments do not perform as expected by the advisor and/or firm, but this in no way is indicative of harmful intent of the advisor and/or firm. The use of raw data that contains claim information of this nature to predict restricted firm status with no due process is un-American, and highly questionable.

Our firm's principals also believe this new proposed rule would have a disproportionate effect on smaller FINRA member firms, and immediate unintended consequences with respect to registered representatives with any kind of regulatory background. Advisors with any prior regulatory incidents regardless of harmful intent, would be in danger of being given notice to terminate just to reduce the firm's overall "risk rating". It is also important to note that many of these advisors would not be able to find a new broker/dealer for this very reason. Small member firms designated as a "restricted firm" would have a permanent death sentence as their advisors with clean records would leave not wanting to be associated with the restricted firm, and then no way to recruit new representatives. Surely, FINRA would not consider this a desired outcome as the small broker/dealers of this country do serve a large portion of the smaller clients which are allocated to call centers at the larger member firms.

The proposed additional capital reserve requirements would also disproportionately affect smaller firm as well in our opinion, and are not feasible for most small firms. The current financial environment for broker/dealers is extremely capital intensive with all of the regulatory and compliance pressures, and margins are already razor thin for smaller firms. The additional capital required to make any kind of real difference in unpaid arbitration claims would put extreme pressure on most small firms.

In short, we applaud the intent of the new rule to protect investors, but we have serous concerns about the methodology, the reliance on potentially poor data quality, and the potentially unnecessary reputational damage using predictive assumptions about events that have not occurred. We are requesting that this rule not be adopted in its current format.

Sincerely,

Jerry Dempsey, Jr
CEO, Dempsey Lord Smith, LLC

UNIVERSITY OF MIAMI
SCHOOL of LAW

Investor Rights Clinic
1311 Miller Drive, A312
Coral Gables, FL, 33146

Phone: 305-284-8234
Fax: 305-284-9368

July 1, 2019

Via E-mail: *pubcom@finra.org*
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506

RE: Comment on Regulatory Notice 19-17
Proposed New Rule 4111 (Restricted Firm Obligations)

Dear Ms. Piorko Mitchell:

The University of Miami School of Law Investor Rights Clinic ("the IRC")[1] appreciates the opportunity to comment on proposed new Rule 4111 (Restricted Firm Obligations) imposing additional obligations on firms with a significant history of misconduct. The IRC supports FINRA's ongoing regulatory efforts to enhance scrutiny of high-risk firms and brokers, including proposed Rule 4111. At the same time, the IRC advocates for modification and clarification of certain features of the proposed rule in order to increase investor protection.

The proposed rule draws on studies and data that suggest that member firms with a history of misconduct pose a far greater risk of ongoing and future harm to investors. The proposed new rule seeks to set objective criteria to identify firms that raise "investor-protection concerns substantial enough to require that it be subject to additional obligations."[2] FINRA may impose obligations that include a requirement to maintain a deposit of cash or qualified securities or conditions or restrictions on a firm's operations, subject to the firm's opportunity to consult with FINRA and to request a hearing on the imposed obligations in an expedited proceeding.

For more than seven years, the IRC has assisted unsophisticated investors who have suffered financial losses due to unscrupulous broker practices, often at firms that pose an unusually high-risk to the investing public. High-risk firms and their brokers harm investors represented by the IRC on a routine and disproportionate basis. The IRC addresses the implementation of Rule 4111, including its benefits and potential shortcomings, through discussion of IRC clients and potential impacts of the proposed rule.

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[1] Launched in 2012, the IRC provides *pro bono* representation to investors of modest means who have suffered investment losses as a result of broker misconduct but, due to the size of their claims, cannot find legal representation. The IRC is the only *pro bono* organization in Florida available to investors asserting claims in FINRA arbitration. To date, the IRC has recovered more than $1,100,000 on behalf of investors.

[2] *FINRA Regulatory Notice 19-17*, p. 7.

Restricted Firms and the Restricted Deposit Requirement

As one example of the potential impact of the proposed rule, the IRC represented a husband and wife in their 80s in connection with losses of almost $200,000 of their life savings resulting from their broker's recommendation of illiquid private placements and direct participation programs. At the time the clients retained the IRC, FINRA had expelled the small member firm that employed the broker (among other brokers with numerous disclosures) for its failure to pay a regulatory sanction. Because the expelled firm had insufficient assets, the senior clients had little choice other than to pursue their claim against the individual broker and to accept a settlement that represented around five percent of their losses. In this instance, the Preliminary Criteria for Identification (had proposed Rule 4111 been effective) may have resulted in Restricted Firm Obligations that may have prevented the investor harm in the first place or provided means for a greater recovery for the harmed investors.

However, it is unclear whether the Restricted Deposit Requirement would be available to aggrieved investors who obtain an award or a settlement against a Restricted Firm, including when the firm is no longer registered with FINRA. Indeed, Regulatory Notice 19-17 and proposed Rule 4111 provide little or no guidance on the relationship between the Restricted Deposit Requirement and the amount of pending arbitration claims or unpaid arbitration awards that FINRA would consider in determining the Restricted Deposit Requirement. At a minimum, the IRC urges FINRA to include as factors in this determination all pending claims (not limited to pending arbitration claims) and all unpaid settlements in addition to unpaid arbitration awards. The IRC also suggests that the proposed rule should provide clarity on the availability of funds from the Restricted Deposit Requirement to recover for pending claims, unpaid settlements, or arbitration awards, including when the firm is no longer a FINRA member.

Preliminary Criteria for Identification: Expungement and Product Lines

In other cases, it is less likely that the Preliminary Criteria for Identification would provide any enhanced protection against investor harm by high-risk member firms. For example, the IRC has recently represented different clients in two separate claims against the same member firm for investment losses related to unsuitable recommendations of non-traded REITs and BDCs, including two of the exact same securities in both claims. The brokers that recommended these high-commission products to the separate clients worked in different offices in different states. The clients in each claim also had different investment profiles. Yet, the separate brokers portrayed the same high-commission, illiquid securities as suitable for each of the clients. After the firm settled one of the IRC client's claims, the broker sought and obtained expungement of the claim.

The above example illustrates potential shortcomings in the Preliminary Identification Criteria in the proposed rule. First, the routine expungement of settlement disclosures from brokers' CRD records complicates implementation of proposed Rule 4111 and frustrates its stated purpose "to change firms' behavior – and therefore protect investors – through its direct financial impact."[3] Due to the expungement obtained in the above example, the settlement would not factor into the Registered Person Adjudicated Event category, despite the fact that it

[3] *FINRA Regulatory Notice 19-17*, p. 6.

evidences a history of misconduct in the form of investor harm and relates to a type of product that has also harmed other investors of the same firm. The IRC expresses concern that reliance on CRD disclosures in the threshold for Registered Person Event Metrics under the proposed rule will incentivize firms to increase pursuit of expungement of broker disclosures, which continues to be granted with far greater frequency than the "extraordinary" relief it is intended to be.

Second, as the member firm in this example has more than 600 brokers, at least 30 to 60 registered person events (depending on the category) would be necessary under the metrics in the proposed rule for FINRA to consider identifying the member firm as a Restricted Firm. While this may reflect an appropriate balance for general identification of high-risk firms, it may be less effective to address the increased risk of harm posed by a specific product or type of product. Moreover, due to the nature of non-traded securities in particular, investors may not observe harm for several years after investing and may or may not assert a claim for various reasons. One approach may be to include in the threshold criteria a category for measurement of disclosures related to specific products or types or products. In addition to the proposed Restricted Firm Obligations, FINRA may also consider imposing Restricted Firm Obligations tailored to the dangers of the products or types of products meeting the product-specific metric, including a Restricted Deposit Requirement sufficient to meet all unpaid awards and pending claims related to the products or product types, as well as other conditions and restrictions targeted to reform member firm behavior related to that product line. Given the difficulties posed by expungement of disclosures and accurate identification of products as reported in disclosures, a more effective approach may be to include consideration of the risk posed by specific products and the extent of the sales of those products relative to the member firm's overall business.

Support for Further Consideration of "Terms and Conditions" Rule

In Regulatory Notice 19-17, FINRA states that it considered, but rejected, a "terms and conditions" rule similar to Investment Industry Regulatory Organization of Canada ("IIROC") Consolidated Rule 9208, which permits the IIROC to impose terms and conditions on recidivist firms when it considers those terms and conditions appropriate to ensure the firm's compliance with IIROC requirements. The IRC supports further consideration of a "terms and conditions" rule because of the greater flexibility such a rule would provide in circumstances under which a firm does not the numerical metric for threshold identification as a Restricted Firm, especially when firms may seek to avoid meeting threshold metrics through expungement of disclosures that would otherwise impact threshold categories.

The IRC is committed to protecting investors and supports FINRA's efforts to impose more rigorous requirements on member firms that pose an increased risk of harm to investors. We thank FINRA for the opportunity to comment on this proposal.

Respectfully submitted,

Scott A. Eichhorn
Associate Director

SICHENZIA
ROSS
FERENCE LLP

June 28, 2019

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

Re: Proposed New Rule 4111

Dear Ms. Mitchell:

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

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

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

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority
June 28, 2019
Page 2

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Respectfully submitted,

Michael H. Ference

Richard J. Babnick Jr.

The Commonwealth of Massachusetts
Secretary of the Commonwealth
State House, Boston, Massachusetts 02133

William Francis Galvin
Secretary of the Commonwealth

June 28, 2019

Via email to pubcom@finra.org.

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

Re: Comments on Proposed Rule 4111. Restricted Firm Obligations

Dear Ms. Piorko Mitchell:

I am writing in my capacity as the chief securities regulator for Massachusetts regarding proposed Rule 4111 (the "Proposed Rule"), as explained in Regulatory Notice 19-17 (the "Notice"). The Proposed Rule is a good first step toward addressing the risk posed to Main Street investors by member firms and brokers with histories of serious misconduct. However, I believe that the Proposed Rule should be improved in order to truly protect investors from that risk and ensure that they will have meaningful recourse when they are harmed.

The Proposed Rule rightly places the burden of investor protection with the riskiest firms. The Proposed Rule will be stronger if it gives prevention of harm the highest priority, expands the substantive criteria used to identify risky member firms, and provides greater flexibility in when and how Restricted Firms are identified. Also, regardless whether FINRA makes information about Restricted Firms available to the public, FINRA should notify state regulators of Restricted Firms registered in their states.

I. The Proposed Rule rightly places the burden of investor protection at the feet of firms that hire bad brokers.

Main Street investors should be able to trust and rely on financial service providers to help safeguard and grow their hard-earned savings. Securities regulators across the country too often have seen the most vulnerable investors suffer grievous financial harm because of fraud, abuse, and troublesome incentives in the brokerage industry. In some instances, those investors are further victimized when their recourse via arbitration proves to be illusory because firms and brokers fail to pay arbitration awards.

Member firms who continue to hire brokers with histories of serious misconduct add to the risk of investor harm. It has been the experience of my office that many of these firms view investor protection measures as a punishment and a cost to be minimized. As a result, many firms that hire bad brokers fail to proactively subject these brokers to heightened supervision, and often fail to discharge their supervisory obligations at all.

We acknowledge that the Restricted Deposit Requirement will be a burden on member firms that want to hire bad brokers, but investors must come first. If a firm poses a risk to investors, that firm should bear the cost of appropriate measures to protect them. A preference for spending money elsewhere cannot be an excuse to leave investors holding the bag.

Again, the Proposed Rule rightly places the burden with these member firms to protect investors and ensure that they have meaningful recourse when harmed.

II. The Proposed Rule should give preventive measures the highest priority.

The Notice recognizes that the remedial tools available to regulators are sometimes limited and may allow unscrupulous member firms and brokers to stall efforts to make investors whole. The Proposed Rule should explicitly prioritize imposing conditions on Restricted Firms' continued membership that will prevent investors from being harmed in the first place.

In 2016, my office completed a sweep of select firms that hire brokers with past disciplinary histories.[1] My office found that the firms hiring these brokers were not taking steps to subject these brokers to heightened supervision. We urge that the regulators must be the ones to look out for investors and impose these conditions because the industry cannot be relied upon to do it themselves.

In the years since issuing the report, my office has continued to see member firms and brokers with histories of serious misconduct seeking to do business in Massachusetts. My office has worked hard to proactively impose heightened supervision and other conditions on the registrations of such firms and brokers in order to protect Massachusetts investors.

Implementation of the Proposed Rule should prioritize conditions and restrictions designed to prevent harm. This should include requiring heightened supervision of brokers with histories of misconduct, restricting the member firm's ability to sell risky and illiquid products, and restricting the member firm's ability to sell risky and costly products to retail investors.

III. The Proposed Rule should include additional criteria for identifying Restricted Firms.

The identification criteria in the Proposed Rule are missing key indicators of risk to investors. The Proposed Rule excludes financial issues,[2] "non-investment-related" civil matters,[3]

[1] Massachusetts Securities Division's Sweep of Select Broker-Dealers that Hire Bad Agents (December 1, 2016) (available at https://www.sec.state.ma.us/sct/sctpdf/HS-White-Paper-12-08-16.pdf)
[2] Notice at 32.
[3] Proposed Rule 4111(i)(4)(A)(i), (ii); 4111(i)(4)(D)(i), (ii).

and internal reviews of a broker by other member firms[4] from the criteria used to identify Restricted Firms. Neglecting these criteria prevents a complete assessment of the risk posed by a member firm and its brokers, and sends the message that member firms can ignore the risk that these events pose to investors.

Financial issues, such as judgments, liens, bankruptcies, and compromises resulting in outstanding debt should be included in the Proposed Rule. These matters are currently disclosed in Form BD and Form U4 for good reason. Financial distress is a powerful incentive for firms and brokers to behave recklessly with investor funds to increase commissions, or engage in outright theft.[5] In February, my office filed an enforcement action charging a former broker with fraudulently misappropriating funds from at least one longtime brokerage customer, and engaging in a nearly twelve-year scheme to cover up the theft. During this time, the broker was the subject of two IRS tax liens totaling more than $280,000 and foreclosure on his home when he failed to pay his mortgage. Until approximately five months before my office filed the enforcement action this year, this broker had only financial disclosures and the Proposed Rule would have been blind to the risk this broker posed to investors.

Even when ostensibly "non-investment-related," civil suits, judgments, arbitrations, and settlements that involve dishonesty, deceit, or reckless or intentional wrongdoing should be included in the Proposed Rule. These matters may indicate a lack of care in financial matters or a willingness to deceive or to bend the rules. By excluding these civil matters, the Proposed Rule will miss problematic conduct involving digital currencies, viaticals, reverse mortgages, structured finance, as well as payday lending. Misconduct in these supposedly "non-investment-related" businesses has caused serious economic harm to many vulnerable investors and must be considered as a sign of potential investor risk.

Although the Proposed Rule includes internal reviews of a member firm's brokers in the identification criteria, the Proposed Rule limits consideration of internal reviews to those done "by the member."[6] This is too narrow. The Proposed Rule should include internal reviews of a broker by a previous employer, regardless of whether they resulted in a termination disclosure on Form U5. On many occasions, my office has discovered that a purportedly voluntary termination was related to the results of, or broker's unwillingness to cooperate with, an internal review of questionable conduct. In April, FINRA fined and suspended a broker for removing nonpublic customer information from his previous member firm when he left for his current firm in January 2018. This broker resigned from the previous member firm instead of complying with

[4] Proposed Rule 4111(i)(4)(C)(ii).

[5] In January 2016, a broker was convicted of stealing more than $100,000 from one investor, after being permanently barred by FINRA. A subsequent arbitration revealed that the broker had sold two other investors unsuitable annuities and impersonated them on the phone in an effort to increase his commissions to pay back taxes to the IRS. The broker's record includes seven separate financial disclosures prior to his conviction, termination, and permanent bar. *See 'That's not me!' What happened when AXA played a recording in an arbitration*, Financial Planning (Jun. 13, 2019), available at https://www.financial-planning.com/news/finra-fines-axa-over-financial-advisor-arbitration-recording-on-annuities.

[6] Proposed Rule 4111(i)(4)(C)(ii).

the firm's internal review, yet this internal review would not have been considered under the Proposed Rule as currently drafted.

These issues need to be considered as criteria for identifying Restricted Firms under the Proposed Rule.

IV. **The Proposed Rule should include flexibility to designate Restricted Firms outside of annual calculations.**

Under the Proposed Rule, FINRA would identify Restricted Firms based on numerical thresholds calculated annually. While the numerical calculations in the Proposed Rule may be helpful to narrow the field, such a rigid approach risks failing to identify some member firms that pose serious risk to investors.

For example, a member firm may have compliance issues that are not disclosed, but are nonetheless brought to light in examination findings, regulatory enforcement actions, and the large-scale migration of brokers from expelled or troubled firms. Such serious issues demand immediate action, and investors should not be required to remain in harm's way until the next calendar year. Additionally, the predictable annual calculation based on rigidly defined metrics may provide an incentive for member firms to comply only enough to remain just below the triggering thresholds. Minimal compliance suggests a weak compliance culture, and these firms should be included within the scope of the Proposed Rule.

FINRA should supplement its calculations with a more flexible approach, similar to IIROC's "terms and conditions" rule. A more flexible approach would allow FINRA to impose obligations other than annually when new information comes to light that demands immediate action, instead of a wait-and-see approach. It would also allow FINRA to consider member firms within a certain range below the thresholds, thereby mitigating the problem of minimal compliance. Finally, a more flexible approach would allow FINRA to consider member firms with historical misconduct that is concentrated in certain branches or offices of supervisory jurisdiction. Concentrated or localized misconduct will be diluted in the context of a large firm, but may nonetheless be indicative of localized problems that demand additional attention.

V. **FINRA should notify state regulators of Restricted Firms registered in their states.**

My office and other state securities regulators have long been on the front lines in the fight to protect investors from fraud, abuse, and conflicted financial advice. While self-regulators play an important role in regulating the industry, the states have a strong and focused interest in being informed about the member firms that pose the most risk to our investors. State regulators can use that information to set examination priorities, and may pay extra attention to investor complaints regarding those firms. When a broker with a history of misconduct seeks state registration with a Restricted Firm, the state can consider whether investors in that state will be adequately protected under the Proposed Rule or whether the state will need to impose its own conditions and restrictions.

Both FINRA and the states owe it to investors to ensure that the Proposed Rule is as effective as possible. Notifying state regulators of Restricted Firms in their states will result in a stronger rule, better allocation of resources, and more eyes on the riskiest member firms. In the end, investors will benefit.

The Proposed Rule is a positive first step toward protecting investors from the riskiest corners of the brokerage industry. I strongly urge FINRA to consider these changes to the Proposed Rule in order to make it more effective for investors everywhere. Please contact me or Diane Young-Spitzer, Acting Director of the Massachusetts Securities Division, at (617) 727-3548, if you have questions or we can assist in any way.

Sincerely,

William Francis Galvin

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts

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June 28, 2019

Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
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Attn: Jennifer Piorko Mitchell

Re: <u>Comment on Proposed Rule 4111</u>

Dear Ms. Mitchell:

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

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

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

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

> (i) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party or was a “subject of” the customer arbitration award or civil judgment;
>
> (ii) a final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a “subject of” the customer arbitration settlement, civil judgment settlement or a settlement prior to a customer arbitration or civil litigation;
>
> (iii) a final investment-related civil judicial matter that resulted in a finding, sanction or order;
>
> (iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization

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

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

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

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

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

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

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

[2] "Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D), means any of the following events that are reportable on the member firm's Uniform Registration Forms, or are based on customer arbitrations filed with FINRA's dispute resolution forum: (i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party; (ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (iv) a criminal matter in which the member was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

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

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

> (A) the specific maximum Restricted Deposit Requirement for a member, determined by the Department taking into consideration the nature of the firm’s operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any “covered pending arbitration claims,” [“the claim amount includes claimed compensatory loss amounts”] unpaid arbitration awards or unpaid settlements related to arbitrations, <u>and concerns raised during FINRA exams</u>.” (Emphasis added.)

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

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

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

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

FINRA should not adopt Proposed Rule 4111.

Very truly yours,

Michael P. Gilmore

Michael P. Gilmore

MPG:eu

July 1, 2019

By Electronic Email (pubcom@finra.org)

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

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

Dear Ms. Mitchell,

Thank you for the opportunity to submit these comments on the proposed new rule to the Financial Industry Regulatory Authority ("FINRA") Financial and Operational Rules, Rule 4000 Series (FINRA Proposed Rule 4111) on behalf of HLBS Law.

HLBS Law appreciates FINRA's goal of enforcing measures to protect investors and maintaining an accurate and meaningful regulatory platform to inform the investing public. HLBS Law advocates for removal of meritless customer disclosures for Registered Representatives. HLBS utilizes FINRA's dispute resolution forum and follows FINRA Rules promulgated to provide a path to expunge false and misleading U4 and U5 disclosures, of which there are many. This common goal of making sure the public can make informed decisions is why Proposed FINRA Rule 4111 cannot be enacted.

FINRA has created 6 categories of events or conditions that will flag a registered member and potentially increase the risk a member firm will be designated as restricted:

1. Registered Person Adjudicated Events;
2. Registered Person Pending Events;
3. Registered Person Termination and Internal Review Events;
4. Member Firm Adjudicated Events;
5. Member Firm Pending Events; and
6. Registered Persons Associated with Previously Expelled Firms (also referred to as the Expelled Firm Association category).

To avoid designation, Proposed FINRA Rule 4111 has a one-time option to terminate Registered Persons to reduce staffing levels to below numeric thresholds. Proposed FINRA Rule 4111 is overbroad and violates the trust the public has placed in FINRA to report accurate and meaningful information. Rule 4111 would create the designation of a Restricted Firm when numeric thresholds of disclosures proposed by FINRA are met.

If a firm meets the restrictive status, the member firm is required to deposit a large sum of money pursuant to a grid created by FINRA. The purpose of FINRA Rule 4111 according to Regulatory Notice 19-17 is to protect investors from misconduct. In reality, FINRA Rule 4111 is a punitive measure without due process constraints. It is designed to punish Registered Persons and Registered Firms and does little more than spread unverified accusations and inhibit free trade.

1. A restricted status designation under Proposed Rule 4111 misleads the public because it is based on unverified misconduct.

Proposed Rule 4111 is not crafted to inform the public when misconduct occurs for several reasons:

- A Member firm's decision to settle is a business decision, not an admission of misconduct. In the vast majority of FINRA arbitrations, the costs to fully litigate a matter to conclusion far outweighs the costs to simply settle the case for pennies on the dollar, regardless of the merits of the case.
- A presumption of guilt is an anathema to fundamental principles of justice. FINRA has provided no evidence or support that shows pending claims are related to misconduct. FINRA is essentially adopting presumed guilty standard. As it stands, the Rule is a blanket measure that does not differentiate between meritorious and unmeritorious claims.
- Proposed FINRA Rule 4111 attempts to undermine what historically has been a business decision whether or not to terminate someone's employment or contractual relationship. The rule throws out a blanket category without addressing what language is on the registered member's Form U-5. FINRA has not tailored the designation to ensure a nexus between firm attrition and investor protection.

As drafted, this rule punishes mere suspicion of misconduct. It results in a disservice to the public, and a chilling effect on Member firms and Registered Persons. Why waste resources on anything more than a cursory investigation when the punishment is the same whether there is any wrongful conduct found or not? This rule does not result in a truthful disclosure to the public, only the branding of a scarlet letter on the chest of Member firms and Representatives.

2. The proposed rule inhibits free trade by allowing FINRA to insert itself in Member firms' day-to-day business decisions.

A fundamental principle of the American workforce economy is that business and people are free to choose with whom to associate in their employment relationship. With rare exception, States have acknowledged that an employer/employee relationship is at-will. The Proposed Rule allows FINRA to substantially influence Member firms' recruiting and termination decisions.

Proposed Rule 4111 is aimed at only small to mid-sized firms. These firms do not have the same resources for attracting and keeping experienced representatives as large firms do. To be blunt, there is significant business value in attracting experienced Registered Representatives who, but for a U4 or U5 disclosure, would not consider aligning with a smaller firm. Proposed Rule 4111 forces Member firms to prioritize disclosures over candidate attributes. In order to stay competitive, a Member firm must now factor in whether to retain a 30-year veteran with a 20-year old disclosure, or an untested recruit with a clean record. This is a gross intrusion on onboarding and retention decisions.

The most alarming and punitive measure of Proposed FINRA Rule 4111 is the one-time option to terminate Registered Persons to reduce staffing levels to below numeric thresholds. Layoffs are a regular occurrence on the employment landscape. However, under Rule 4111, Member firms would conduct a mass termination not because of independent business decision, but because the practical result of failing to do so is a regulatory designation that would essentially result in financial ruin.

Conclusion

FINRA has the privilege and burden of making sure the investing public is protected and informed. Proposed Rule 4111 does not align with this objective. 4111 is overbroad and employs strong-arm tactics that rely on the BrokerCheck public reporting system that is itself indisputably flawed. It is our hope that the SEC once again steps in like it did with Regulatory Notice 17-42 and object to this overbroad rule with sweeping consequences.

Once again, HLBS Law thanks you for the opportunity to submit these comments. If there is any further information or other assistance that we may be able to provide, or if there are any questions we may be able to answer, please contact me at owen.harnett@hlbslaw.com or 720-515-9069.

Respectfully,

Owen Harnett
Managing Attorney

August 6, 2019

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, D.C. 20006-1506

Re: Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct, Regulatory Notice 19-17

Dear Ms. Mitchell:

The American Securities Association (ASA)[1] appreciates the opportunity to comment on the proposed rule 4111 (Proposal) released for comment by the Financial Industry Regulatory Authority (FINRA). The Proposal seeks to address a very important issue in our industry, and we applaud FINRA and its leadership for bringing these issues into the public debate. While we strongly support FINRA promoting investor protection and market integrity, certain aspects of the Proposal seem contrary to FINRA's mission as a self-regulatory organization (SRO), they do not go far enough to remove the most egregious actors from our industry, and they could ultimately harm the Main Street investors and retirement savers it seeks to protect.

As an SRO, FINRA's mission is to "safeguard the investing public against fraud and bad practices." This obligates FINRA to use every tool at its disposal to remove brokers from our industry who repeatedly fail to comply with regulations and engage in egregious acts that harm the customers of brokerage firms. We fully support FINRA revoking the licenses of brokers and expelling firms that employ these types of business models.

As FINRA states in the Proposal, there continues to be an ongoing problem within the brokerage industry of certain firms hiring recidivist brokers who are known to be bad actors and then failing to properly supervise them. The Proposal notes that "such firms generally do not carry out their supervisory obligations to ensure compliance with applicable securities laws regulations and FINRA rules, and they often act in ways that harm their customers and erode trust in the brokerage industry."[2]

[1] The ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This advances financial independence, stimulates job creation, and increases prosperity. The ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantics, and Pacific Northwest regions of the United States.
[2] Proposal at 3

If FINRA determines that a specific firm does not carry out its supervisory obligations and acts in ways that harms their customers, then FINRA has an obligation to pursue the expulsion of that firm from the brokerage industry. Recidivist brokers should not be allowed to move from one firm to another with impunity, and firms that have a demonstrated track record of hiring them and failing to properly oversee them have no place in our industry.

Regrettably, instead of clarifying what criteria will necessitate penalty or expulsion, the Proposal creates a byzantine process that would marginally increase the financial obligations of bad actor firms and allow these firms to remain in practice and continue their abuse of Main Street investors. This outcome is unacceptable and contrary to FINRA's mission. FINRA is not an insurer responsible for pricing certain 'risks' in the market; it is an SRO that has an obligation to penalize and, if necessary, revoke the licenses of bad actors whether they are held by firms or by brokers. If FINRA believes it lacks the authority or the tools necessary to stop the most egregious abuses within the brokerage industry, then it should work with the Securities and Exchange Commission (SEC), Congress and the industry to correct the problem.

We also draw a parallel between provisions in the Proposal and a concept release by FINRA discussing unpaid arbitration awards. As the ASA noted with respect to this proposal – which would have affected only 2% of all arbitration awards granted – that the net result would be that innocent investors and brokerage firms will ultimately pay for the actions of bad actors who should be barred from operating in our industry in the first place.

We would also suggest that FINRA apply a capital charge in lieu of the proposed collection of funds. We are concerned about the precedent a rulemaking which requires firms to place funds into an account controlled by regulator will set and how such a precedent could be misused in the future.

We also strongly believe that there are certain acts, such as theft of customer funds, that are so egregious and reprehensible that they should be punished with an immediate lifetime ban from the industry. There is no place for this in our industry and we strongly encourage FINRA to move in this direction.

While we appreciate efforts by FINRA to hold bad actors accountable, we believe the Proposal can do better. We encourage FINRA to instead clarify how it can use its authority to penalize or remove recidivist brokers and those who commit certain violations from the brokerage industry. We welcome the opportunity to engage with FINRA as it moves forward on this initiative.

Sincerely,

Christopher A. Iacovella
Chief Executive Officer
American Securities Association

July 1, 2019

TO: pubcom@finra.org

FROM: Julie E. Kamps, Esq.
jkamps@wpcfs.com

I am writing regarding proposed Rule 4111 in response to Notice to Members 19-17. Proposed Rule 4111 should not be enacted because it will have a disparate impact on small firms, for the reasons set forth herein. While material changes to the Rule are also suggested herein, even if FINRA adopted all of the suggested changes, the Rule should still not be enacted.

The number of broker-dealers has declined from 5,892 in March 2007 to 3,989 in March 2017. This should cause policymakers grave concern. Proposed Rule 4111 will only exacerbate this downward trend. FINRA's true priority, as reflected in, among other things, this proposed Rule, is to force small firms out of the business.

In general, small firms and small businesses are the driving force of new employment and innovation in the United States. Congress has demonstrated that easing regulation, not increasing regulation, to encourage funding of small businesses, is a legislative priority. For instance, in 2012, Congress enacted the Jumpstart Our Business Startups Act with bipartisan support, to ease regulation and encourage the formation of small business.

FINRA, which purports to operate as a "not-for-profit" corporation, acts with unresolvable financial conflicts of interest in its regulatory activities. FINRA wants to put small firms out of business because it cannot make a profit regulating small firms. FINRA can only pay its executive management and employees the outsize salaries and bonuses it pays them if it collects significant fines and controls regulatory costs. The cost of regulating small firms exceeds the fines that FINRA can collect from small firms. As a result, FINRA is seeking to enact a rule that disparately impacts small firms and greatly enhances FINRA's ability to put them out of business.

To determine the true impact on small firms of the proposed rule, the FINRA Chief Economist should do an economic analysis of the true effect on small firms if the proposed rule is enacted. The FINRA Chief Economist should do an analysis of how many brokers who are licensed with FINRA and in good standing would become unemployable under proposed Rule 4111. For example, the FINRA Chief Economist should do an analysis of how many of the 66,477 registered representatives who worked at small firm in 2017 have worked at a firm that has been expelled at any time in their careers, which would render such representative virtually unemployable under the proposed Rule.

FINRA's Testing of the Metrics From 2013 to 2018 is Flawed

The back-testing of the impact of proposed Rule 4111 on FINRA Firms in Attachment D is flawed since it only includes the time period for a bull market (it does not consider the effect of a market correction, such as what occurred in 1987, 2001 or 2008) Historically, a significant number of "events," (as defined in the Notice) occur within a couple of years after a market correction, yet the analysis contained in Attachment D only goes back to 2013, which is five years after the 2008 correction. FINRA should review their customer complaints, terminations for cause, arbitration, etc. statistics for this period, which no doubt will bear out this concern.

Proposed Rule 4111 Should Be Abandoned Because It Lacks Transparency

While FINRA claims that proposed Rule 4111 has transparency, it in fact does not. For instance, proposed Rule 4111 encompasses a "flow chart" filtering process that permits FINRA to simply decline to enforce the Rule against some firms and to enforce the Rule against other firms. The flow chart filtering process gives FINRA unconstrained discretion to enforce, or not to enforce, proposed Rule 4111. The Rule also gives FINRA complete discretion to exempt a Firm from the restrictions after its Consultation. There should be specific, enumerated criteria that restricts and constrains FINRA.

FINRA also has unfettered ability to place "conditions or restrictions on the member's operations." This power again entirely lacks transparency. There are no guidelines or parameters on what "conditions or restrictions" FINRA can place on a firm in the event that FINRA decides to enforce proposed Rule 4111 against it. FINRA would be free to raise compliance costs at a small firm to a level that would exhaust a small firm's resources and force that firm to close its doors.

There is also no transparency in FINRA's ability to set the amount of the Restricted Deposit. The Restricted Deposit is a backdoor way of allowing FINRA to randomly increase the Net Capital requirements on firms it selects to do so or increase the amount of cash required to run a firm. There are no parameters or guidelines for how much the Restricted Deposit can be. Proposed Rule 4111(i)(15) states that a Restricted Deposit Amount "would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise…." This is just not true and as any CEO or CFO knows, taking away a significant amount of cash from the operations results in cashflow problems, increased borrowing, and layoffs. However, there is no maximum or cap on what FINRA could set as a Restricted Deposit Amount and FINRA has complete discretion over this that is not reviewable outside of FINRA.

Thus, FINRA can easily set a Restricted Deposit amount that would be far outside the reach of a small firm. However, large firms would undoubtedly not be subjected to Restricted Deposit Amounts that would threaten the existence of the firm.

For these reasons, among others, proposed Rule 4111 lacks transparency and should be abandoned.

Proposed Rule 4111 Is Too Subjective and Gives FINRA Too Much Discretion to Apply the Rule in a Manner That is Arbitrary and Capricious

Proposed Rule 4111 empowers FINRA to act in a manner that is arbitrary and capricious in numerous material ways. Rules of a self-regulatory organization cannot be "arbitrary and capricious." *See, e.g., Susquehanna International Group, LLP, et al., v. SEC*, 866 F. 3d 442 (D.C. Cir. 2017) (reviewing SEC Order approving rule of self-regulatory organization under the "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" standard of the Administrative Procedures Act).

For example, the proposed Rule gives FINRA unfettered ability to place "conditions or restrictions on the member's operations," to set the amount of the Restricted Deposit, and to exempt a firm from the Restricted Deposit requirement. There are no parameters as to what conditions or restrictions could be set.

Proposed Rule 4111(i)(15) states that a Restricted Deposit Amount "would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise…." However, there is no maximum or cap on what FINRA could set as a Restricted Deposit Amount and there is no safeguard preventing FINRA from setting a deposit that actually seriously impacts the viability of the firm. For example, at the very minimum, there should be a restriction in place that prevents a Restricted Deposit Amount from being greater than a certain percentage of required Net Cap or a percentage of average Net Income over the last three years. The use of the word "significantly" is vague and ambiguous and permits FINRA to apply the proposed Rule in a manner that is arbitrary and capricious.

Proposed Rule 4111 also gives FINRA arbitrary authority to set deadlines for things that could be different for different firms. For instance, proposed Rule 4111(e)(1)(B)(i) states that a Restricted Firm must "promptly establish a Restricted Deposit Account…." The use of the word "promptly" is vague and ambiguous and permits FINRA to apply the proposed Rule in a manner that is arbitrary and capricious. FINRA would have the discretion to set a timeline for the establishment of a Restricted Deposit that does not provide a small firm with enough time to raise the capital.

These are just three examples of why proposed Rule 4111 cannot be enacted because it gives FINRA too much discretion to apply it in a manner that is arbitrary and capricious.

Proposed Rule 4111 Exceeds FINRA's Authority Under the Securities and Exchange Act of 1934

Proposed Rule 4111 violates the Exchange Act and exceeds FINRA's authority under the Exchange Act and thus cannot be approved by the United States Securities and Exchange Commission (the "Commission"). A FINRA rule that violates the Securities and Exchange Act of 1934 (the "Exchange Act") is unenforceable. *See* 15 U.S.C. § 78s(b)(3)(C) (SRO rule "may be enforced … to the extent it is not inconsistent with the provisions of this title [15 U.S.C. §§ 78a *et seq.*], the rules and regulations thereunder, and applicable Federal and State law.").

The Exchange Act constricts FINRA's authority. FINRA only has authority to have rules that are "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, […] to remove impediments to and perfect the mechanism of a free and open market […], and are *not* designed to permit unfair discrimination between customers, issuers, brokers or dealers …." 15 U.S.C. § 78o-3(b)(6) (emphasis added). Here, proposed Rule

4111 exceeds FINRA's authority under the Exchange Act because it is designed and intended to permit unfair discrimination between brokers and dealers and otherwise serves no purpose.

The Rule will have, and is intended to have, a disparate impact on small and large broker-dealers. The draconian requirements that this proposed rule seeks to impose will essentially put many more small firms out of business by raising compliance costs, effectively raising the net capital requirement, and limiting and restricting firm operations that provide sources of revenue for small firms. And as FINRA's own analysis points out in Attachment D, discussed below, the proposed Rule will have an impact on small firms and almost no impact on large firms.

Congress has shown over and over again that the growth and development of small business in the United States is a public policy priority. The Exchange Act itself reflects this public policy. The Exchange Act does not authorize the Commission to approve any rule of a self-regulatory organization that imposes an undue burden on competition. *See, e.g.*, 15 U.S.C. § 78o-3(b)(9) ("An association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that […] (9) The rules of the association do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter.").

Moreover, under 15 U.S.C. § 78o-3(b)(5), "[a]n association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that – […] [t]he rules of the association provide for the equitable allocation of reasonable dues, fees, and other charges among members …." Effectively raising the net capital and cash requirements on certain firms on an arbitrary basis violates this law.

FINRA rules must "remove impediments to and perfect the mechanism of a free and open market […], and are not designed to permit unfair discrimination between […] brokers[] or dealers …." 15 U.S.C. § 78o-3(b)(6). Rather than "remove impediments to and perfect the mechanism of a free and open market," proposed Rule 4111 *is* an impediment to a free and open market.

Proposed Rule 4111 burdens small firms only. This is proven beyond any doubt by Attachment D-2, Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size. Attachment D-2 identifies the percentage of firms meeting the Preliminary Criteria for Identification by Firm Size. During the sample period of 2013 to 2018, 94% to 90% of the firms meeting the Preliminary Criteria for Identification were small firms. During this time, the percentage of the total of large firms meeting the Preliminary Criteria for Identification ranged from 0% to 2% of the firms.

In addition to being a result of the factors discussed herein, the fact that 90% of the firms meeting the criteria are small firms and 0% of the firms meeting the criteria are large firms is a direct result of, among other things, the bias in the Preliminary Identification Metric Thresholds. The thresholds are purposely set to punish small firms and to allow for wrongdoing at large firms with no consequences under the rule.

Proposed Rule 4111 also violates the Exchange Act and cannot be enacted because it is an end-run around the Exchange Act's requirement that there be a fair process for imposing discipline on a member firm or a representative. *See* 15 U.S.C. §780-3(b)(8). Rule 4111 allows FINRA to far exceed its disciplinary abilities, by monetarily sanctioning firms and by restricting their operations at FINRA's discretion with no protections for the firms or the representatives that the Rule would impact.

In the Notice to Members on page 4, FINRA explains its true basis for the rule. FINRA states that "examiners are not empowered to require a firm to change or limit its business operations" and that "these constraints on the examination process protect firms from potentially arbitrary or overly onerous examination findings" and that "enforcement actions can only be brought after a rule has been violated."

In the next paragraph, FINRA admits that with the proposed Rule it is trying to circumvent the laws, regulations, and rules that limit and restrict FINRA's ability to impose discipline. FINRA admits that enforcement actions can only be brought when a rule is violated and that firms and representatives are entitled to hearings and appeals. FINRA wants to enact a rule that simply circumvents the due process and fair procedure requirements that provide what limited restriction there is on FINRA's behavior and allow it to sanction firms with impunity. *See* 15 U.S.C. §78o-3(b)(8).

The true basis for proposed Rule 4111 is for FINRA to circumvent the due process guarantees for member firms and registered representatives in the Exchange Act and the Constitution. The true purpose to is to remove the "constraints" on the examination process that protect firms from potentially arbitrary or overly onerous examination findings and replace those constraints with unfettered and arbitrary discretion. It has nothing to do with "investor protection," "market integrity," or "arbitration awards."

Proposed Rule 4111 Cannot Be Enacted Because It Violates the United States Constitution

Proposed Rule 4111 cannot be enacted because it is unconstitutional. *See* 15 U.S.C. § 78s(b)(3)(C) (SRO rule "may be enforced … to the extent it is not inconsistent with the provisions of this title [15 U.S.C. §§ 78a *et seq.*], the rules and regulations thereunder, and applicable Federal and State law."). Proposed Rule 4111 would be unenforceable because it violates the Constitution and the Exchange does not permit it. Moreover, the Commission cannot issue an Order approving a rule of a self-regulatory organization such as FINRA that violates due process because all activities of the Commission are subject to the constraints of the Constitution. In addition, the constraints of the Constitution apply to FINRA's activities and its rules, because FINRA does not have rule-making authority and can only enact a rule with an order of the Commission,[1] to which the Constitution applies. Thus, all FINRA rules must be constitutional. Proposed Rule 4111 is not.

Because interested FINRA staff would rule on exemption requests, there is no meaningful appeals process of the Restricted Deposit Amount, there is no meaningful appeals process at all because, among other things, there is no stay during the appeals process, and two of the Preliminary Identification Metrics subject firms to the Restricted Deposit and conditions and limitations on their operations prior to any adjudication of fault, the rule is unconstitutional. It is also unconstitutional because it has no rational basis, is impermissibly vague and ambiguous, and is arbitrary and capricious.

While the limitation or restriction of a member firm's operations is appealable to the Commission, there is no stay during the appeal, meaning the firm could be forced out of business before the appeal is even heard. In addition, the amount of the Restricted Deposit is only appealable, also without a stay, within FINRA. Thus, interested FINRA staff would be free to set a firm's Restricted Deposit at such a level that a firm would be unable to pay it and would force the firm out of business. Such a firm would have no recourse outside of FINRA. The FINRA process for hearings and appeals favors FINRA nearly 100% of the time and does not provide for or protect due process. Indeed, reviewing five years of decisions of the National

[1] See 15 U.S.C. § 78s(b).

Adjudicatory Council shows that FINRA wins 99% of the time, *per se* evidence of bias. The Rule 9600 Series is subject to collateral attack because it is unconstitutional.

Two of the Preliminary Identification Metrics would subject firms to punitive deposit requirements and restrictions on their operations prior to any adjudication of fault. "Registered Person Pending Events," as defined in proposed Rule 4111(i)(4)(B), would permit FINRA to require firms to maintain deposits and enable FINRA to limit or restrict a firm's operations prior to any finding that the broker at issue violated any law, rule, or regulation. "Member Firm Pending Events," as defined in proposed Rule 4111(i)(4)(E), would have the same effect. In effect, it is "guilty until proven innocent."

Permitting FINRA to count pending events in the Preliminary Identification Metric makes a mockery of due process. "Pending" events by definition exclusively consist of allegations that have not been proven. Counting "Pending Events" in the Preliminary Identification Metric allows FINRA to circumvent the established enforcement procedures entirely without due process.

Proposed Rule 4111 has no rational basis. FINRA claims that the basis for the proposed rule is to "promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards." The proposed Rule does not accomplish this purpose and the stated purpose is a sham.

FINRA's own enforcement behavior belies any claim that a Restricted Deposit is necessary for the protection of investors or to encourage member firms to pay arbitration awards, as FINRA settles with representatives and supervisors and allows them to stay in the business while expelling the whole firm, causing the very problems they claim now to be seeking to fix.

If FINRA believes a representative is not suitable for the business, the regulator should revoke the representative's license and not punish a whole firm.

Moreover, a firm that does not pay an arbitration award or an arbitration settlement gets suspended. It is hard to imagine how a rule that permits FINRA to arbitrarily raise a small firm's capital requirements and limit a firm's operations would enhance a firm's ability to pay arbitration awards or "encourage" them to do so. There is no rational basis.

"Investor protection" and "market integrity" are completely meaningless generic terms that that this rule claims to support but does not. The real basis for proposed Rule 4111 is to enhance the ability to discriminate against small firms in favor of large firms and to use the backdoor to expel small firms and bar representatives that it otherwise cannot or will not under existing FINRA rules and the Constitution's and the Exchange Act's guarantees of due process and fair procedure protections.

As stated above, in the Notice to Members on page 4, FINRA explains its actual basis for the rule. FINRA states that "examiners are not empowered to require a firm to change or limit its business operations" and that "these constraints on the examination process protect firms from potentially arbitrary or overly onerous examination findings" and that "enforcement actions can only be brought after a rule has been violated."

There is no rational basis for proposed Rule 4111 because what it really does is allow FINRA to circumvent the due process and fair procedure guarantees for member firms and registered representatives in the Constitution and the Exchange Act. The true purpose to is to remove the "constraints" on the examination process that protect firms from potentially arbitrary or overly onerous examination findings and replace those constraints with unfettered and arbitrary discretion. It has nothing to do with "investor protection," "market integrity," or "arbitration awards."

In addition to the requirement that the proposed Rule be constitutional, FINRA's enforcement of the rule must also be constitutional. FINRA claims both to have "governmental immunity" exempting it from civil suits and to be a "private actor," exempting it from the application of the United States Constitution to its rules and actions. This leaves firms in the untenable position of having no recourse. It is an untenable position that is subject to attack. There is no such thing as a "private actor with sovereign immunity."

As a result, proposed Rule 4111 cannot be enacted because it is so vague and ambiguous that it gives FINRA free range to enforce the rule in an arbitrary and discriminatory fashion. There are no guidelines or constraints on how FINRA could limit or restrict a member firm's business. The language of the rule violates due process because it is impermissibly vague.

For instance, proposed Rule 4111(a) provides that a member "shall be subject to such conditions or restrictions on the members operations as determined by the Department to be necessary or appropriate for protection of investors and in the public interest." This language is irreparably vague, ambiguous, contentless, and meaningless. The rule is so standardless that it authorizes and encourages seriously discriminatory enforcement.

Proposed Rule 4111 Is Biased Against Small Firms

According to NTM 19-17, "as of year-end 2018, there were 20 small firms (i.e., firms with no more than 150 registered persons) with 30 or more disclosure events over the prior five years, 10 mid-size firms (i.e., firms with between 151 and 499 registered persons) with 45 or more disclosure events over the prior five years, and five large firms (i.e., firms with 500 or more registered persons) with 750 or more disclosure events over the prior five years." NTM 19-17, p.

4. The impact on a small firm of one disclosure event is enormous, while the impact on a large firm of any disclosure event has literally no impact. If a firm with 100 representatives is allowed to have 30 disclosures, how is a firm with 500 representatives allowed to have 750 disclosures?

FINRA is purposely insulating large firms with hundreds of disclosure events from proposed Rule 4111 while subjecting small firms with a tiny fraction of the disclosure events to draconian financial burdens. Permitting large firms to have 750 disclosure events while only permitting small firms to have 30 disclosure events reflects evident bias against small firms. The alleged wrongdoing of one representative at a small firm puts that small firm over the limit and has no impact on a large firm.

FINRA's Attachment D-2 chart shows that 0% of the large firms met the Preliminary Criteria for Identification in the last two years of the review period.

To demonstrate the flaws in the proposed Rule, one only has to compare the BrokerCheck reports of the small firms with the BrokerCheck reports of the large firms. Large Firm 1 has 1,174 Disclosures on its BrokerCheck Report, including 531 Regulatory Events, 4 Civil Events, and 639 Arbitrations. In 2018 alone, Large Firm 1 had at least 6 regulatory disclosure events, including making misstatements and omissions (resulting in a $6,500,000 fine), failure to supervise, failure to establish and maintain a supervisory system, and failure to supervise traders who were mismarking trades and engaging in unauthorized trading (resulting in a $5,750,000 fine). These violations include such systemic violations as, for example, the failure to establish and maintain a reasonable system to review for the accuracy of content in the firm's customer trade confirmations over 11 years pertaining to errors in 9.3 million of the firm's 12.5 million trade confirmations ($550,000 fine).

Large Firm 2 was sanctioned for having systems that allowed five representatives to steal more than $1 million out of customer accounts. Large Firm 2 paid a $4.5 million dollar fine to the SEC. Small firms have been expelled for far less egregious conduct.

Yet, somehow, according to FINRA's proposed metrics and thresholds, 0% of large firms met the test for a restricted firm.

On the other hand, one "disclosure event" regarding alleged "supervisory" violations relating to one representative where there are no customer complaints and no losses would count as the exact same thing at a small firm.

Attachment D-2, Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size, is *per se* evidence of the bias in proposed Rule 4111 against small firms. For the years 2013 through 2018, small firms accounted for more than 90% of all firms meeting the "Preliminary Criteria for Identification." Yet these small firms have a small number of disclosures relative to the enormous number of disclosures at large firms.

The Preliminary Identification Metric Exponentially Magnifies the Existing Regulatory Bias

FINRA does not enforce the rules against small and large firms, or the representatives who work in those respective firms, in the same way. FINRA also does not enforce the rules against firms in an evenhanded manner. There is no uniformity in FINRA sanctions for similar conduct across firm sizes. There is also no uniformity in the charges that FINRA brings.

The Preliminary Identification Metric Is Subject to Manipulation

The Preliminary Identification Metric is also subject to manipulation due to the bias in FINRA's process for expelling firms. With exceedingly rare example, FINRA does not expel large firms. However, FINRA expels small firms.

For example, FINRA never expelled Lehman Brothers, Bear Stearns, or Brookstreet Securities Corporation. Therefore, none of the representatives who worked at the two largest broker-dealers responsible for the near collapse of the U.S. economy in 2008 or a large firm that blew up when its dangerously leveraged collateralized mortgage obligation activities imploded have had their records marked with "being from an expelled firm." As a result, even if a representative worked at Lehman Brothers, Bear Sterns, or Brookstreet, that representative would not have a mark on his or her license. So, when those representatives go to work for other firms, also likely large firms, the hiring firms will avoid triggering the Preliminary Identification Metric.

Rather than be subject to FINRA sanctions and expulsion, Congress paid hundreds of billions of dollars to bail out the very entities that created the 2008 crisis. For example, AIG and its Chief Executive Officer were never sanctioned or expelled.

Brookstreet, a large firm that sold derivative securities that were over-leveraged and thus risky to its customers without proper disclosures, was never expelled. Its membership was "cancelled" by FINRA on September 3, 2008.

By contrast, FINRA expels small firms that are already out of business, exceeding its authority. For instance, FINRA expelled Small Firm 1 in July 2017. Small Firm 1 had 18 regulatory events on its BrokerCheck Report and had been in business since 1978 (compared to the hundreds if not thousands at large firms). Small Firm 1 filed Form BDW on December 9, 2016. FINRA did not expel the firm until July 2017, after the firm had already filed Form BDW and gone out of business. According to BrokerCheck, FINRA "expelled" Small Firm 1 for "failure to pay fines and costs" on July 31, 2017. As a result, every representative who ever worked at Small Firm 1 now bears the mark on his or her license as being from an expelled firm.

In 2017, there were more than half a million registered representatives working at large firms. By contrast, in 2017, there were only 66,477 representatives working at more than 3,000 small firms. According to FINRA's 2018 FINRA Industry Snapshot, 81% of the registered representatives worked at large firms. Yet, because FINRA does not expel large firms, with extremely rare exception, these representatives do not have a mark on their license as being from an expelled firm. Because FINRA expels small firms, the metrics disparately impact the representatives who work at small firms.

Proposed Rule 4111 Is a Backdoor Way of Expelling Firms and Barring Representatives from the Industry

Proposed Rule 4111 gives FINRA the discretion to put restrictions and limitations on firms and to require firms to put up a Restricted Deposit that will undoubtedly be out of reach for at least some small firms. Proposed Rule 4111 is intended to provide FINRA with a mechanism to force small firms out of business that it otherwise cannot with the bare minimum of protections that small firms have against FINRA as it is.

Proposed Rule 4111 is also intended to make it financially untenable for small firms to employ brokers with certain levels of disclosures, essentially making such brokers unemployable. This is a backdoor way of removing from the industry brokers whom FINRA has no grounds to bar. It permits FINRA to essentially bar from the industry brokers who have not violated any rule while further denying them any due process or appeals procedures. FINRA would not have to prove any violation of a rule, regulation, or law that could support the sanction of a bar from the industry, yet such brokers will be rendered unemployable. This is a backdoor way around the Exchange Act's requirements that FINRA cannot take away the license of a representative without a violation that is proven through a fair procedure and due process, as guaranteed by the Exchange Act and the Constitution. *See* 15 U.S.C. §780-3(b)(8).

Firms should be entitled to employ any broker who has a FINRA license. If FINRA believes that any certain broker has engaged in conduct that would warrant a bar from the industry, FINRA should be required to proceed under the established disciplinary rules and requirements to revoke his or her license.

There is an enormous range of disclosure items that would count towards a Registered Representative's Adjudicated and Pending Event Metrics. For example, many customers file arbitration complaints anytime they lose money and make allegations that are not true. Many customer arbitrations are entirely without merit. Nonetheless, a small award from an arbitration panel or the settlement of a meritless claim to reduce the cost of litigation would count towards a firm's Preliminary Identification Metric. On the other hand, a large meritorious claim against another representative with a million dollar award would count as the exact same thing. There is no method for a representative to have an opportunity to be heard regarding what is essentially a disciplinary mark on his/her license under Proposed Rule 4111. Moreover, if a claimant names every officer of the firm, which is common practice, each officer named in the arbitration would count towards the metric even if they were never involved with the customer.

This is also true as to a representative who once worked at a firm that was later expelled, even if they worked there years or decades before the expulsion. Such a representative would be unemployable. There is no method for a representative to have an opportunity to be heard regarding what is essentially a disciplinary mark on his or her license under Proposed Rule 4111.

The Proposed Ways That a Firm Can Affect the Outcome Are Unlikely to Work

FINRA is unlikely to exempt any firms from the Restricted Deposit Requirement based on a member's explanation of why it should not be subject to the Restricted Deposit Requirement. Member firms that are designated as Restricted Firms are also unlikely to get relief from a Hearing Officer from the FINRA Office of Hearing Officers. Member firms are also unlikely to get relief from the FINRA National Adjudicatory Council. The track record of the OHO and the NAC speaks for itself. This would subject firms to a long and expensive appeal, during which time the firm's resources are tied up in the Restricted Deposit Account and during which time there is no stay of the restrictions FINRA decides to impose. With regard to the amount of the Restricted Deposit, there is no appeal outside of FINRA and the internal FINRA appeals process is unconstitutional.

PROPOSED RULE 4111 SHOULD BE MATERIALLY CHANGED

The Formula for Computing the Preliminary Identification Metrics is Overinclusive

Persons registered with the firm for one day should not be counted towards the metric. There should be a minimum employment period of 180 days before the representative counts towards the metric.

The Preliminary Identification Metrics Should be Materially Changed

Adjudicated Events

"Registered Person Adjudicated Events," defined in proposed Rule 4111(i)(4)(A), should not include subsection (ii) regarding settlements of customer claims because representatives settle cases with false and unsupportable allegations to avoid legal fees, the distraction of arbitrations, and arbitration risk. The allegations are never proven and should not be counted against the representative or the firm.

Subsections (i) and (ii) should be narrowed because Claimants' lawyers often reflexively name all officers and directors as control persons or for failure to supervise regardless of the fact that such officers and directors never even had supervisory responsibilities or customer contact. Thus, one settlement implicating one representative could count as five or more events even when there is no fault.

Subsections (iii) and (iv) should not include "findings" because such findings are the result of settlements and are not the result of proven allegations. Representatives settle false accusations for many reasons, including the expense of litigating claims, the distraction of a proceeding, and the general risk attendant to a contested proceeding. In addition, events that do not involve any customer harm should not be included.

Subsection (v) should not include criminal matters in which the registered person pled nolo contendere (no contest) because there was no admission or proof of guilt.

"Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D), should not include "findings" because firms settle for many reasons even if there has not been a violation of the laws, rules, or regulations, including the decision to stop paying substantial legal fees, to put the matter behind the firm because it is distracting to management, and to avoid the FINRA disciplinary proceeding and appeal process, which is entirely biased in favor of FINRA. These "findings" in an AWC have not gone through a judicial process and there has not been any determination of factual or legal violations. A firm does not admit it engaged in any wrongdoing.

If findings are included it is highly likely that this compromise process will end as individuals and small firms will need to fight to the end to avoid the devastating consequences of Rule 4111. Such "findings" remain unproven allegations that were never subjected to the judicial process. Including "findings" in the Preliminary Identification Metric elevates "findings," in which the member firm does not admit the "findings," to the same level as what has been proven at a hearing. In addition, events that do not involve any customer harm should not be included.

Pending Events

"Registered Person Pending Events," as defined in proposed Rule 4111(i)(4)(B), and "Member Pending Events," as defined in proposed Rule 4111(i)(4)(E), should not be included in any final rule. Including "pending events" in the Preliminary Identification Metric is unfair and violates due process. Allegations are not proven and are often false. This allows FINRA to open an investigation into a member firm and, in conjunction with the biased metric thresholds for the other categories, automatically put a small firm over the Preliminary Identification Metric Threshold.

Including pending investigations in the Preliminary Identification Metric allows FINRA to simply sidestep its obligation to fairly conduct investigations. FINRA would be able to financially sanction a firm and restrict its activities without proving anything. According to FINRA in every 8210 letter, mere investigations "should not be construed as an indication that the Enforcement Department or its staff has determined that any violations of federal securities laws or FINRA, NASD, NYSE, or MSRB rules have occurred." However, under Proposed Rule 4111, FINRA would be able to immediately sanction a firm.

Criminal defendants are entitled to due process of law and are innocent until proven guilty. Sanctioning a firm because it or a representative had a pending criminal matter would deny such firm or person due process of law.

In addition, events that do not involve any customer harm should not be included.

Registered Person Termination and Internal Review Events

"Registered Person and Internal Review Events," as defined in proposed Rule 4111(i)(4)(C), should not be included in the Preliminary Identification Metric. Including any pending or closed internal review would have the obvious and perverse effect of discouraging firms from conducting internal reviews and lessening, not enhancing, internal compliance procedures. It is another example of the true basis for the Rule, to circumvent the disciplinary process and punish small firms. The proposed Rule has nothing to do with investor protection or market integrity.

Registered Persons Associated with Previously Expelled Firms

"Registered Persons Associated with Previously Expelled Firms," (also referred to as the Expelled Firm Association category), as defined in proposed Rule 4111(i)(4)(F), should be entirely removed as a category. In the alternative, representatives should not be counted who worked at an expelled firm "at any time in his/her career."

A high-ranking FINRA official admitted to the Wall Street Journal that "the fact that someone has worked for a high-risk or expelled firm 'doesn't mean they're necessarily a bad actor or guilty of anything."[2]

Representatives should not be counted who worked at an expelled firm "at any time in his/her career." There are representatives who worked at firms that were expelled years later. The representatives who once worked at a firm that was later expelled were not implicated in the enforcement actions in any way should not be counted. There should also be a time limit on when such representative worked at a firm that was expelled.

[2] "*FINRA program hasn't barred any brokers who worked at "Wolf of Wall Street" firm*," The Wall Street Journal, March 5, 2012, available at http://www.marketwatch.com/story/watchdogs-hunt-is-short-on-wolves-2015-03-05

In addition, representatives hired by a member firm before the prior firm was expelled should not be counted towards the threshold. Firms that hire representatives from firms that have not been expelled at the time of the hiring decision should not be counted towards the threshold. A FINRA rule should not be allowed to contain a "gotcha" provision.

However, the category should be entirely removed because if FINRA expels a firm, it would automatically make all of its representatives, even the ones who were completely uninvolved in the events leading to the expulsion, unemployable.

The "One-Time Staff Reduction" should be revisited due to this discrepancy. If a representative is currently employed at a firm during an "Evaluation" period and none of his former employer member firms was an "Expelled Firm," but during the next "Evaluation Period" one or more of his prior employers are so labelled, the Firm is arbitrarily penalized for something that was completely out of both the current firm's and the representative's control in a "gotcha."

The metric Registered Persons Associated with Previously Expelled Firms is biased against small firms. It is unfair and overbroad. FINRA's method for marking the licenses of representatives who once worked at a firm that was later expelled itself violates due process as there is no notice and opportunity to be heard for a representative whose license is being marked with what is at its essence a disciplinary item.

FINRA has virtually only expelled small firms. When a firm is "expelled," every representative who ever worked at the firm, no matter when or for how long, is branded with the mark of being from an expelled firm. There are instances of a representative working at a firm for 7 days, years before the firm was ever expelled, who now bears the mark on their BrokerCheck as being from an expelled firm and other representatives who worked at a firm 20 years before it was expelled and who, if they worked for a member firm for one day during the Evaluation Period, would count towards the firm's threshold.

Almost all of the representatives from "expelled" firms in the current time had nothing to do with whatever disciplinary proceeding got the firm expelled, yet they are tarnished with being from an expelled firm. However, there are instances of FINRA settling with the representatives and supervisors who were involved and allowing them to stay in the business while expelling the entire firm and marking the licenses of all of the innocent representatives.

Proposed Rule 4111 threatens the ability of representatives who work at small firms to obtain and retain continued employment because, even though they are entirely innocent, the mark on their license of having worked at an expelled firm will discourage firms from hiring them due to the financial penalties and threat of the imposition of conditions and restrictions on their operations. Such innocent representatives will be rendered unemployable.

On the other hand, no matter the conduct, large firms with significant financial resources are permitted to simply pay fines. When a small firm cannot pay a fine, the firm is expelled.

As even further evidence of the uneven application of the rules and the potential for abuse, as demonstrated above, FINRA does not expel large firms that engage in rampant wrongdoing, such as Brookstreet, Lehman Brothers, and Bear Stearns, leaving those representatives free to go to other large firms without the scarlet letter of having worked at a firm that was expelled, and leaving large firms free to hire these representatives without having to count anything towards their thresholds.

Depending on the length of time that an expelled firm was registered, this metric could count thousands of representatives as having been from an expelled firm. This is an example of

FINRA's disproportionate enforcement activities against small firms having an even more magnified effect here.

The Preliminary Identification Metric Thresholds Discriminate Against Small Firms

The Preliminary Identification Event Metric Thresholds are also strongly biased against small firms. For Member Firm Pending Events, for a firm up to 100 representatives, one pending event puts the firm at the threshold. For firms over 100 representatives, the thresholds are skewed in their favors. A firm with 500 representatives can have up to 4 pending events without triggering the threshold. In other words, under the proposed rule, a large firm with four pending criminal investigations would not have its activities restricted or have to put up a Restricted Deposit, but a small firm with one FINRA investigation that may have no merit would have its operations restricted or limited and their capital requirement arbitrarily raised with no due process protections, no fair procedure, and no meaningful appeal.

In addition, there is no provision made for actual harm to investors of the event. An event with no customer losses with a nominal fine would count the same as an event impacting millions of customers with a fine in the millions. FINRA disciplines member firms and individual representatives even when there is no harm to customers and such regulatory events should not be counted.

The One-Time Opportunity to Reduce Staffing Should Renew After Three Years

Proposed Rule 4111(c)(2) permits a firm that has triggered the Preliminary Identification Metric for the first time to reduce headcount to go below the threshold. The opportunity to reduce staffing should renew every three years. A lifetime bar on the opportunity to reduce staffing ignores, for instance, the reality of the cyclical nature of the financial markets.

The Five-Year Lookback is Too Long

The Evaluation Period of five years is too long. *See* Proposed Rule 4111(i)(6). For the adjudicated disclosure-event categories, under Proposed Rule 4111, the counts would include disclosure events that reached a resolution during the prior five years from the date of the calculation. The lookback period should be three years, as that would give a firm ample opportunity to resolve any issues.

Pending Arbitrations Should Not Impact the Size of a Restricted Deposit

No deposit should be required for pending arbitrations. On page 6 of the Notice, FINRA states that "pending arbitration claims" could impact the size of the required deposit. *See* NTM 19-17, at p. 6. Pending arbitration claims involve allegations that have not been proven. The proposed rule would give claimants' lawyers a gun to point at small firms in that the claimants' lawyers could simply inflate the damages claim, for instance, to force a firm to put up an enormous restricted deposit, essentially forcing a small firm to settle meritless cases prior to every Evaluation Period.

Small firms would also be forced to settle meritless cases before the Evaluation Period, regardless of when they were filed during the year, to get the case off the firm's books prior to any meaningful opportunity for discovery and disclosure and prior to any opportunity to make a motion to dismiss, to engage in legitimate settlement discussions, or to defend itself at a hearing. Proposed Rule 4111 eviscerates the Code of Arbitration Procedure and provides the claimant's securities bar with a potent weapon that will result in unfair results and violate firms' and representatives' due process rights, among other things.

There is Literally No Way For a Small Firm To Get Its Restricted Deposit Amount Back

At the next Evaluation Period after a firm is no longer determined to be a Restricted Firm, FINRA can still keep the Restricted Deposit for as long as it wants under the terms of proposed Rule 4111(f)(3). To get the Deposit back, a Firm must make an "application" to FINRA, who has complete discretion under the Rule to force the Firm to maintain the Deposit. FINRA will makes its determination "After such review as it considers necessary or appropriate…." This is another instance of the Rule being vague and ambiguous and allowing FINRA to apply the Rule in a manner that is arbitrary and capricious.

The proposed Rule also has a "presumption that the Department shall require the member or the Former Member to continue to maintain its Restricted Deposit Requirement if the member or the Former Member has any 'covered pending arbitration claims,' unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding." Rule 4111(f)(3)(D).

This allows FINRA to financially punish small firms against whom a claimant's lawyer has filed a meritless arbitration. It also punishes a small firm that is making settlement payments on a payment plan, even if that firm is paying as agreed. It also punishes small firms that have absolutely no history whatsoever of not paying arbitration awards in customer arbitrations.

It also materially alters a small firm's ability to settle an arbitration, because the claimants' bar will seek to obtain a settlement in the maximum amount of the funds available, just like they do with an insurance policy, not an amount that is actually reflective of the settlement value of the case.

The Proposed Rule Does Not Provide Firms With Adequate Time to Prepare For a Consultation or Implement Any Requirements

Proposed Rule 4111(d)(2) provides no protections to firms or restrictions on FINRA regarding the length of time between the written letter informing the firm that it is subject to a Consultation and the date and place of a Consultation. Proposed Rule 4111(e)(1)(B)(ii) also provides no timetable for firms to implement any conditions or restrictions that FINRA imposes or to fund a Restricted Deposit Account. Small firms do not have large amounts of extra capital and FINRA could suspend a firm if it cannot fund the Restricted Deposit Account in whatever time frame FINRA arbitrarily imposes.

There is No Meaningful Appeals Process

Proposed Rule 4111(e)(2) provides that there is no stay during the pendency of an appeal. This renders the appeals process, which is already largely meaningless, even more meaningless.

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In conclusion, Proposed Rule 4111 should not be enacted for all of the reasons set forth herein. Even if FINRA adopted all of the changes suggested herein, the Rule should still not be enacted for all of the reasons set forth above.

BETTER MARKETS

July 1, 2019

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

Re: Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct, Regulatory Notice 19-17

Dear Mrs. Mitchell:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Regulatory Notice ("Notice" or "Rule") released for comment by the Financial Industry Regulatory Authority ("FINRA"). The Notice proposes a convoluted, Rube Goldberg-type process[2] to identify and place new obligations on "predator wolf-pack" firms populated with recidivists brokers whose business model appears to be maximizing profits by targeting and ripping off unsuspecting and vulnerable investors in violation of FINRA and other rules.

While it is arguably better than nothing, trying to minimally regulate firms that specialize in recidivist brokers—by making it a little costlier for them to operate—is grossly insufficient and doomed to fail to achieve the purported objectives of the Notice. FINRA has the indispensable mission to protect investors and promote market integrity; it must do more to stop firms that specialize in recidivist brokers. Rather than, at best, half measures, FINRA must revoke the licenses and expel these firms that are based on a predator wolf-pack business model that specialize in harming investors.

[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] *See infra*, "Description of the Proposal." According to his entry in Wikipedia, Rube Goldberg "is best known for his popular cartoons depicting complicated gadgets performing simple tasks in indirect, convoluted ways." https://en.wikipedia.org/wiki/Rube_Goldberg.

Making matters worse, these predator firms are not just going after any investors; they are specifically targeting and harming the most vulnerable kinds of investors, including seniors, those with language barriers, and those who lack of basic financial literacy.[3] What possible service or good do predator firms provide to investors that cannot be offered by thousands of other FINRA members that actually follow FINRA's and Securities and Exchange Commission's (SEC) rules? What is the public interest, market integrity, and pro-investor rationale for permitting these predatory firms to use FINRA's seal-of-approval to continue to harm investors? This Notice fails to answer these threshold questions, which, in our view, is a disservice to millions of American investors who have to rely upon FINRA as the cop on the beat and the front-line regulator of the broker-dealer profession.

While it is tempting to say that the policies proposed in this Notice are steps in the right direction, we cannot say that in this comment letter. Investors, and particularly those harmed by such unscrupulous brokers and firms who retain them, deserve concrete, effective, swift and far-reaching consequences from FINRA for brokers that repeatedly violate FINRA's rules, and the firms that employ them, not convoluted and weak attempts at regulation. We do not believe FINRA is lacking authority under its current rules to more forcefully and effectively punish and expel predators, and to bar predator wolf-packs from ever forming. However, if FINRA feels it lacks such authority to properly reduce investor harm by effectively punishing and deterring high-risk firms, then it should have proposed a rule that would have authorized FINRA to become a more effective regulator.

Instead, FINRA chooses to do the bare minimum by proposing to make it marginally more expensive for the worst-of-the-worst broker-dealer firms, that have already proven that they will brazenly disregard FINRA rules, to continue hiring and rewarding brokers that give self-serving advice and sell unsuitable products that are harmful for investors' and their families' financial health. These are not close calls; these are not brokers with a blemish or violation here or there; these are not firms hiring a broker or two with isolated violations. These are predator wolf-pack firms whose business model is to maximize profits by breaking rules and ripping off unsuspecting and vulnerable investors. They need to be put out of business and barred from forming new ones. Investors need to be protected from the harmful practices of the wolf-packs and be better served by other, law-abiding FINRA members.

Investors need and deserve honest, qualified, and competent brokers and firms who respect and follow the rules when offering their services and financial products. Americans need these good broker firms and their 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—especially the unsophisticated, elderly, and less educated—are

[3] Broker misconduct, particularly among the recidivists, is more prevalent in counties and cities with a large proportion of retirees and a lower educated population. 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. *See* Mark Egan, Gregor Matvos &Amit Seru, *The Market for Financial Adviser Misconduct* at 27, J. OF POL. ECON. (forthcoming) (Sept. 1, 2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170. .

protected from predatory and unscrupulous broker firms who employ brokers who repeatedly break the law with impunity with little or nothing to fear from FINRA.

FINRA can and must do more to address and extinguish the predatory wolf-pack business model, and our comment letter will focus on ways FINRA must significantly improve this Notice and its oversight of the broker-dealer firms.

SUMMARY OF COMMENTS

- FINRA is falling far short of its regulatory duties by seemingly caring more about the economic viability of recidivist broker firms that are FINRA's members than about the investor clients they harm.

- The Proposal risks perpetuating the recidivist mills' business model and increasing moral hazard when permitting firms with a long history of investor harm to remain operational by depositing some funds into a segregated account.

- The Proposal should not be approved unless significantly improved by applying more stringent criteria in identifying high-risk firms, including at a minimum:

    - look-back or review period of 10 years, and not just 5.
    - The disclosure events should include all settlements, penalties, arbitration claims, etc., that are at or above $5,000, and not $15,000 as proposed.
    - The disclosure events should include all events that are harmful to investors, not just those that are discovered through consumer complaints (so called, "consumer-initiated events,"). FINRA should count with equal weights events that are discovered through, for example, whistleblower tips or regulatory examinations. The Proposal seems to be limited to only events that are consumer-initiated events.

- FINRA must not permit those who have been laid-off or terminated as part of the consultation process to be hired by other firms for at least one year, and never by another high-risk firm. The Proposal only inadequately prohibits the firm who has laid off the broker from rehiring the same person within a year. Additionally, during the consultation period, FINRA must require the termination or lay-off of brokers, starting with those with the most disclosure events regardless of their role within the organization or the revenue they generate.

- FINRA must prominently publicize the names of high-risk firms. At a minimum, FINRA must prominently publicize the names of the firms that have been designated high-risk **twice**. FINRA must also publicize the names of newly formed firms that are made-up of 20% or more brokers who were affiliated with previously twice-designated high-risk firm.

- FINRA must require brokers who are affiliated with twice-designated high-risk firms to disclose to their former, current and prospective clients the fact that they are employed by such a firm.

- At the end of the second year, if the firm is still a high-risk firm, FINRA must expel the firm, and de-license all current brokers who were employed by the firm at the time of initial designation.

- We support FINRA obtaining authority to impose specific "terms and conditions" on certain firms who either circumvent the obligations and restrictions placed upon them by the Proposed Rule 4111 (as amended by our comments herein) or otherwise refuse to significantly improve their compliance culture.

DESCRIPTION OF THE PROPOSAL

FINRA's proposed Rule 4111[4] creates an extraordinarily lengthy and complex process that would, eventually, impose financial obligations and other requirements on certain high-risk member firms that are identified through a complicated process and application of various criteria and metrics. The proposed Rule 4111 would annually evaluate FINRA's entire 3,580-plus broker-dealer membership through the following six different metrics (using information obtained from Uniform Registration Forms):

1. Registered Person Adjudicated Events;[5]
2. Registered Person Pending Events;[6]
3. Registered Person Termination and Internal Review Events;[7]
4. Member Firm Adjudicated Events;[8]
5. Member Firm Pending Events;[9] and
6. Registered Persons Associated with Previously Expelled Firms (also Referred to as the Expelled Firm Association category).[10]

For each of these "Preliminary Identification Metrics" categories, FINRA proposes to apply different thresholds, depending on the firm's size (as measured by number of registered persons in the firm); only once above these thresholds would a firm be designated as having met the "Preliminary Criteria for Identification.[11] The table below shows the different Preliminary Identification Metrics Thresholds that FINRA would apply as part of its annual computation and evaluation of disclosure events:

4 Proposed Rule text is available at http://www.finra.org/sites/default/files/notice_other_file_ref/Regulatory_Notice_19-17_Attachment_A.pdf.

5 "Registered Person Adjudicated Events," defined in proposed Rule 4111(i)(4)(A).

6 "Registered Person Pending Events," defined in proposed Rule 4111(i)(4)(B).

7 "Registered Person Termination and Internal Review Events," defined in proposed Rule 4111(i)(4)(C).

8 "Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D).

9 "Member Firm Pending Events," defined in proposed Rule 4111(i)(4)(E).

10 "Registered Persons Associated with Previously Expelled Firms," defined in proposed Rule 4111(i)(4)(F).

11 *See* Proposed Rule 4111(i)(11).

Firm Size Category	Number of Registered Persons In-Scope in Firm Size Category	Preliminary Identification Metrics Thresholds — Thresholds for Registered Person Event Metrics: Registered Person Adjudicated Event Metric (1)	Registered Person Pending Event Metric (2)	Registered Person Termination and Internal Review Event Metric (3)	Thresholds for Member Firm Event Metrics: Member Firm Adjudicated Event Metric (4)	Member Firm Pending Event Metric (5)	Threshold for Expelled Firm Association Metric: Expelled Firm Association Metric (6)
1	1-4	0.50	0.20	0.10	0.75	0.25	0.75
2	5-9	0.30	0.20	0.10	0.30	0.10	0.50
3	10-19	0.20	0.10	0.10	0.30	0.05	0.50
4	20-50	0.20	0.10	0.10	0.20	0.02	0.50
5	51-150	0.20	0.05	0.10	0.15	0.01	0.25
6	151-499	0.15	0.05	0.10	0.10	0.01	0.10
7	500+	0.10	0.05	0.10	0.05	0.01	0.05

Source: FINRA Proposed Rule 4111(i)(11).

For example, a firm with 10 registered persons would need to have more than two "Adjudicated Events" and more than one "Pending Event" to pass the thresholds of these categories. Additionally, a smaller firm would need to have, on average, more "Adjudicated Events" per capita compared to its peers than larger firms (again, compared to its peers). Or, smaller firms need to have a higher concentration of "Persons Associated with Previously Expelled Firms" among its brokers' ranks than larger firms to qualify. [12] Finally, a firm needs to pass the thresholds of at least two categories to be designated as having met the Preliminary Criteria for Identification. [13]

To assess the impact of the proposed Rule, FINRA evaluated its entire membership between the 2013-2018 period to analyze categories of events that would have caused firms to meet the Preliminary Criteria for Identification. According to this analysis, "there were 60-98 such firms at the end of each year during the review period" or 1.6-2.4% of all firms registered with FINRA in any year during the review period.[14] Furthermore, "approximately 90-94% percent of these firms were small, 4-10% percent were mid-sized and 0-2% percent were large at the end of each year during the review period."[15] The below table shows this analysis, separated by firm size (according to number of registered representatives).

[12] Within categories one-five, FINRA would calculate using simple averages: dividing the number of events over number of registered representatives. For the sixth category, the metric would show the percentage concentration of the firm with employees who were associated with previously expelled firms at any point in their career.

[13] A firm can be flagged Preliminarily for meeting just two or more of the set forth thresholds as compared to other firms their size. If a firm were to meet the threshold for two metrics (metrics one-five), one would have to be for adjudicated events, and the firm must have at least two events.

[14] *See* Notice at 25.

[15] *See* Notice at 25-26.

Attachment D-2: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size*

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification						
		Small	Mid-Size	Large	Total	Small	Mid-Size	Large
		Number of Firms				Percent of Total		
2013	4,140	84	4	1	89	94%	4%	1%
2014	4,068	92	4	2	98	94%	4%	2%
2015	3,941	79	5	2	86	92%	6%	2%
2016	3,835	61	5	1	67	91%	7%	1%
2017	3,721	54	6	0	60	90%	10%	0%
2018	3,582	55	6	0	61	90%	10%	0%

* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st. 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.

Source: Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct, Regulatory Notice 19-17, Attachment D-2. Available at http://www.finra.org/sites/default/files/notice_other_file_ref/Regulatory_Notice_19-17_Attachment_D.pdf.

Once a firm meets the Preliminary Criteria for Identification, there are several more steps before it is designated as a "Restricted Firm" and thus become subject to the new financial and other obligations. After the Criteria is met, FINRA will conduct a focused analysis of the firm's disclosure events to reduce the likelihood of misidentification. Once this analysis is complete, FINRA will preliminarily designate the firm as "Restricted Firm" and propose a "Restricted Fund" amount. After these preliminary decisions, FINRA will invite the firm to engage in consultations. During this consultation process, the firm will have the opportunity to rebut two presumptions: the presumption that it must be designated as a "Restricted Firm" and the presumption that the firm must maintain a "Restricted Fund" in the amount proposed by FINRA.[16]

If a firm successfully rebuts both presumptions, no further obligations are imposed. However, if FINRA decides that the firm has not rebutted the presumption that the firm should be a Restricted Firm but has rebutted the presumption of maintaining the maximum amount in the Restricted Fund, it will be designated as Restricted Firm, but will have either no Restricted Fund or will have appropriately reduced Restricted Fund. However, the firm would have to implement and maintain specific conditions or restrictions on operations at FINRA's discretion with the aim of addressing the Preliminary Criteria for Identification metrics.[17] Finally, if the firm has not rebutted either presumption, then the firm will be designated as a Restricted Firm for that year, be required to establish a Restricted Deposit Account, deposit and maintain in that account the maximum Restricted Deposit Requirement, and implement specific conditions identified by

16 *See* Proposed Rule 4111(e)(1).
17 *Ibid.*

FINRA to address the metrics indicating the firm meeting the Preliminary Criteria for Identification.[18]

Once a firm is designated as a "Restricted Firm," and after it fails to rebut the presumptions, the firm would be permitted to reduce its staffing levels so as to fall below the thresholds that had triggered the firm's identification.[19] If a firm satisfactorily reduces staffing, then the firm is no longer designated as a Restricted Firm for that year.

If a firm fails to adequately reduce staff, FINRA will finalize its designation the firm as a Restricted Firm, and require the firm to establish a bankruptcy-remote, segregated account Restricted Fund, and FINRA will determine a Maximum Restricted Deposit Requirement to be deposited into this fund.[20] This account "must be subject to an agreement in which the bank or the clearing firm agrees: not to permit withdrawals from the account absent FINRA's prior written consent; to keep the account separate from any other accounts maintained by the member with the bank or clearing firm; that the cash or qualified securities on deposit will not be used directly or indirectly as security for a loan to the member by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm; that if the member becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and withdrawals will not be permitted without FINRA's prior written consent; that FINRA is a third-party beneficiary to the agreement; and that the agreement may not be amended without FINRA's prior written consent. In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member."[21]

In setting the Restricted Deposit Requirement, FINRA will "tailor the member's maximum … amount to its size, operations and financial conditions" and consider the nature of "member's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any "covered pending arbitration claims" or unpaid arbitration awards, and concerns raised during FINRA exams."[22] The Notice explains that this Maximum Restricted Deposit is intended to be high enough to change the firm's behavior **but "not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement."**[23]

After FINRA designates the firm as Restricted Firm and requires the establishment of a "Restricted Fund," the firm can request a hearing with the Office of Hearing Officers in an expedited proceeding.[24] The proposed Rule would not permit any stay during the hearing

[18] *Ibid.*
[19] *See* in Proposed Rule 4111(d).
[20] *See* Proposed Rule 4111(i)(15).
[21] *See* Notice at 17.
[22] *See* Notice at 12.
[23] *See* Notice at 12 and 28, emphasis added.
[24] *See* Notice at 15.

proceedings. Additionally, if a firm is found to not have complied with the obligations of Rule 4111, FINRA **could** suspend or cancel the firm's membership, with FINRA's CEO's **consent**.

Finally, FINRA discusses but **does not** propose in the Notice a general authority to impose specific "terms and conditions" upon firms that either game the proposed Rule 4111 by staying just below the thresholds that would trigger their identification or otherwise do not change their behavior and fail to "demonstrate commitment to the development of strong compliance culture."[25] Unfortunately, other than a brief reference and discussion of a similar "terms and conditions" authority that a Canadian SRO has implemented, there is no further discussion regarding the contours and possible uses of such authority. In our comments below, we will support in concept granting such authority to FINRA to empower it with appropriate regulatory tools to stop and deter firms that have substantial and unaddressed compliance failures and seem impervious to obligations and restrictions envisioned by Rule 4111 (as amended by our comments herein).

COMMENTS

FINRA's Primary Mission Is to Protect Investors and the Integrity of the Securities Markets, Not Serve the Interests of Its Worst Members Who Repeatedly Violate the Law. The Proposal Risks Perpetuating the Recidivist Wolf-Packs Business Model.

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 and firms that hire and reward these brokers. As briefly described in the Notice, FINRA currently has several regulatory tools that aim to deter or punish misconduct by firms and brokers. These include the ability to not renew or deny membership applications, conduct firm-focused examinations and other monitoring for risks, and bring enforcement cases. But, as the Notice itself admits, "persistent compliance issues continue to arise in some FINRA member firms."[26]

There are multiple, peer-reviewed studies showing the disproportionate harm that firms that specialize in bad brokers inflict on investors.[27] As released, the Proposal fails to even remotely solve this fundamental challenge.

Instead of appropriately working to rid its membership ranks of firms that attract and pay brokers who have indisputable records of repeat misconduct and investor abuses, this Notice tinkers on the margins by essentially making it slightly costlier for firms to hire or retain brokers with checkered pasts by slightly raising the firm's regulatory costs. While some firms may indeed

[25] *See* Notice at 21-23.

[26] *See* Notice at 3.

[27] *See, e.g.*, Mark Egan, Gregor Matvos &Amit Seru, *The Market for Financial Adviser Misconduct*, J. OF POL. ECON. (forthcoming) (Sept. 1, 2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170. *See also* Benjamin Lesser & Elizaeth Dilts, *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/specialreport/usa-finra-brokers/.

decide to fire or not hire a broker with a long rap-sheet in order not to tie funds into the Restricted Fund and assume costs associated with heightened supervision (as proposed in the Notice) and potential liability, it would still permit firms that repeatedly choose to hire recidivist brokers to operate.

The Notice fails to make any persuasive public policy rationale for keeping these recidivist wolf-packs in business. Indeed, every FINRA member shares the reputational stain caused by such recidivist wolf-packs and should, in their own self-interest if not in the public interest, demand that such firms be shut down.

As FINRA detailed in the Notice, there is no dispute about these firms and brokers and the business practices:

> "Such firms expose investors to real risk. For example, FINRA has identified certain firms that have a concentration of individuals with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. These firms generally have a retail business with vulnerable customers and engage in cold calling to make recommendations of securities. FINRA has also identified groups of individual brokers who move from one firm of concern to another firm of concern. In addition, certain firms, along with their representatives, have substantial numbers of disclosures on their records."[28]

Others have exposed the prevalence of these recidivist wolf-pack firms more starkly. A recent Wall Street Journal investigation exposed a deeply troubling fact: There are **over 100 FINRA regulated 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."[29]

The Journal gave an example of one still operating and seemingly flourishing broker-dealer, Newbridge Securities Corp., in Boca Raton, FL, 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."

These are the firms that FINRA licenses and is legally mandated to regulate. And yet, the Notice fails to show what, if anything, do these firms do to deserve the privilege of carrying a FINRA license and engaging investors? What services or products do they provide to investors and the public that cannot be provided by other law-abiding firms and brokers? The Notice offers no description or explanation.

28 *See* Notice at 3.

29 *See* Jean Eaglesham & Coulter Jones, *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-behindsales-of-private-stakes-1529838000.

The pernicious practices described above cry out for a fundamental re-thinking of how brokerage firms that are designed for and specialize in investor harm are regulated by FINRA—a rethinking that should include expelling these firms so they cannot continue to cause investor harm. But, inexcusably, FINRA seems to be more concerned about the economic viability of these firms. In fact, several times in the Notice, FINRA argues that it does **not** want to drive-out these firms that seek and embrace recidivist brokers and engage in profitable yet harmful investor conduct. Because the Restricted Fund will be set at levels to ensure that the firm will continue to be economically viable and make profits despite the obligation to segregate some funds into the Restricted Fund, the proposal will perpetuate the recidivist mill business models. Whatever profits will need to be frozen in the segregated Restricted Fund, the firm would likely offset these by doubling-down on its predatory practices, all the while using FINRA's membership as an imprimatur to attract and mislead investors.

This Restricted Fund will increase moral hazard by allowing firms with a lax culture of compliance to essentially insure their business practices through the Restricted Fund. Instead of discouraging and reducing the number of recidivist wolf-pack firms that profit through investor harm and violation of FINRA rules, the Proposal runs the risk of actually increasing their numbers. If the Rule is adopted as proposed, FINRA would signal to firms that have a culture of non-compliance but are below the thresholds that would trigger their designation, that they can in fact become much more profitable, even if they go beyond the thresholds, so long as they are willing to set aside some funds and slightly increase the cost of doing business. This Rule, if approved as proposed, could serve as an acceptable on-ramp for firms that have a culture of non-compliance and are seeking to maximize profits to join the ranks of wolf-pack firms.

Allowing high-risk firms to remain operational is also unfair to the vast majority of FINRA's members who want to serve their clients honestly and well. High-risk firms sully the reputation of the 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. Investors who have been hurt by a recidivist wolf-pack 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 FINRA must serve, and all its regulatory actions and proposals should be designed for the maximal benefit of investors—and, by extension, the brokers who serve those investors honestly–and not the recidivist wolf-pack firms that have decided to cheat time and time again.

The Notice also fails to quantify the harm to investors caused by brokers who peddle unsuitable investments that generate high commissions for themselves and profits for their brokerage firms. The Notice further fails to analyze the additional harm to investors that will be realized when firms with a long history of misconduct are permitted to continue engaging investors. These costs are real, and FINRA must take them account as it debates the merits of this Proposal and its regulatory approach to high-risk broker firms.

FINRA has not been charged by Congress to ensure that recidivist brokers have gainful employment in the financial industry or that firms that specialize in hiring and unleashing them on unsuspecting and vulnerable investors maximize their profits. FINRA exists to protect investors and promote market integrity.[30] If FINRA indeed has investors' best interest in mind, it should not compromise that interest for the benefit of broker-dealer firms who are either unable or unwilling to comply with the letter and spirit of the law. Neither the employment prospects of recidivist brokers nor FINRA's concern for decreasing the number of small broker-dealers among its membership should outweigh what is best for the investing public.

The Measures in the Proposal Are Inexcusably Weak and Should Not be Approved Without Complete Overhaul.

FINRA Should Identify Firms Using More Stringent Criteria and Capture More High-Risk Firms. FINRA's Proposed Criteria and Metrics Risk Under-Identifying Many High-Risk Firms.

First, the Notice proposes to count towards the "disclosure event" 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."[31] FINRA must lower this monetary threshold to $5,000. With the median brokerage account balance of U.S. investors at only $6,200, setting the "disclosure event" threshold at $5,000 would better serve the investing public.[32] 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.

Second, FINRA should not exclude "disclosure events" that are harmful to investors but are not "consumer-initiated." There is no public interest, market integrity, or investor protection rationale for FINRA to overlook or discount harmful conduct simply based on who initiated the complaint. FINRA should include events that it has discovered through its regulatory activities (examinations and inspections, whistleblower tips, enforcement, sweeps, etc.). There is no reason why FINRA should exclude a "disclosure event" discovered at a broker-dealer firm that is training its recidivist brokers ways to churn, peddle unsuitable products, or engage in any other predatory conduct upon especially vulnerable investors who are either too intimidated or unsophisticated to lodge a complaint. These discovered, non-consumer-initiated events should count with equal weight as those that are consumer-initiated.

Third, FINRA should expand the review period to include the previous 10 years, instead of 5 as proposed in the Notice, but credit firms that have demonstrated record of improved compliance during the previous 5 years. A look-back period of 5 years risks under-identifying medium and large firms whose disclosure events (even if they are many) would still need to be

30 *See* About FINRA (last visited on June 21, 2019), *available at* http://www.finra.org/about.

31 *See* Proposed Rule 4111(i)(A)(i-ii).

32 *See* 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-accountsin-the-us.pdf.

divided by the large number of affiliated registered representatives for them to breach the proposed Preliminary Identification Metrics Thresholds. Expanding the look-back period to 10 years would mitigate the risk of under-identification. To alleviate concerns that a 10 year lookback period is unduly harsh, and to incentivize firms to actually reform, FINRA could consider crediting firms that have demonstrated improved compliance in the most recent 5-year period.

Fourth, FINRA must not permit those who have been laid-off or terminated as part of the consultation process to be hired by other firms for at least one year, and never by another high-risk firm. The Proposal only prohibits the firm who has laid off the broker from rehiring the same person within a year. But this leaves open the scenario where a recidivist broker who has been laid-off simply joins another recidivist wolf-pack that is either more brazen and unwilling to comply with FINRA rules or is just below the threshold to be identified as a high-risk firm. FINRA should not permit this unhealthy turnover.

Finally, as firms engage in consultations with FINRA to take advantage of the one-time opportunity to reduce the number of brokers to fall below the designation thresholds, FINRA must require that the firms begin their termination or laying-off process with those brokers who have the highest number of disclosure events. Alternatively, FINRA could require that the firm terminate or lay-off those brokers who would have had a harmful combination of frequent and severe violations of FINRA and SEC rules that have direct impact on investors. In all circumstances, FINRA should **prohibit** firms from retaining recidivist brokers due to their position within the firm or the amount of revenue they produce.

<u>FINRA Should Prominently Publicize the Names of the High-Risk Firms So Investors Are Maximally Empowered to Make More Informed Broker-Dealer Choice.</u>

First, FINRA must prominently publicize the names of the high-risk firms. If FINRA refuses to do what is right and necessary and expel firms who specialize in harming investors, then it must at least provide bold and unmistakable warnings that would empower investors to make more informed broker-dealer choices. FINRA's use of robust disclosures would help investors to better protect themselves. Blunt and prominent warnings have long been an effective technique for informing consumers of dangerous products, such as cigarettes.

At a minimum, FINRA must prominently publicize the names of the firms that have been **twice-designated** as high-risk. Similarly, FINRA must also publicize the names of newly formed firms that are made-up of 20% or more of brokers who were affiliated with of previously twice-designated high-risk firm.

Second, FINRA must require brokers who are affiliated with twice-designated high-risk firms to disclose to their former, current and prospective clients the fact that they are employed by such a firm. These registered representatives either clearly know or are willfully ignorant of the fact that they are affiliated with and paid by a broker-dealer that essentially has been running a multi-year boiler room. All investors who have been or are about to be solicited by these brokers deserve to know the fact that whichever firm is employing the broker has been twice-designated as a high-risk firm by the front-line SRO.

Finally, FINRA should engage in more investor education on the topic, clearly explaining the methods these recidivist wolf-packs employ and why they pose a threat to investors. FINRA should also 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.

FINRA Must Expel Firms at The End of the Second Year of Designation.

The Notice must be amended to authorize FINRA to expel firms that have not significantly changed their behavior at the end of the second year of designation, and de-license and bar all current brokers of the firm who were affiliated with the firm at the time of the initial designation. This expulsion order should not be appealable and should take immediate effect. The rationale for this swift and effective remedy is elegantly simple: firms that have been twice-designated and have not significantly improved their compliance culture prove that they are irredeemable, and they do not deserve to be permitted to serve, or more likely, harm **any** additional investors. It would be a disgrace for FINRA to continue to lend its imprimatur and the privilege of being a firm regulated by FINRA to twice-designated firms that specialize in fraud and misconduct. At the end of the second year of designation, FINRA should have the authority, and the will to exercise that authority, to solve this issue and send a strong signal to the brokerage industry that it will no longer tolerate boiler-rooms, predator wolf-packs, and fraud-houses.

FINRA Must Obtain Authority to Impose Specific and Effective Terms and Conditions on Firms That Game FINRA's Rules.

As noted above, the Notice briefly discusses but **does not** propose a general authority to impose specific "terms and conditions" upon firms that either game the proposed Rule 4111 by staying just below the thresholds that would trigger their identification or otherwise do not change their behavior and fail to "demonstrate commitment to the development of strong compliance culture."[33] While it is unclear to us why FINRA declined to actually propose such "terms and conditions" authority, we nonetheless support in concept granting such authority to FINRA to empower it with appropriate regulatory tools to stop and deter firms that have substantial and unaddressed compliance failures and that seem impervious to the obligations and restrictions envisioned by Rule 4111 (as amended according to comments in this letter). Given the extensive due process available to FINRA members, and their strong influence over FINRA's board and the advisory committees that guide FINRA's policymaking and examination priorities, it is extraordinarily unlikely that FINRA would abuse this "terms and conditions" authority. We therefore support FINRA obtaining authority to impose specific "terms and conditions" on certain firms who either circumvent the obligations and restrictions placed upon them by the Proposed Rule 4111 (as amended by our comments herein) or otherwise refuse to significantly improve their compliance culture.

CONCLUSION

[33] *See* Notice at 21-23.

We hope these comments are helpful. 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.

FINRA has the authority, duty, and competency to do what is in the best interest of investors: reduce the prevalence of recidivism and expel firms specializing in investor harm. Now FINRA must apply its resolve to achieve this goal. FINRA must go beyond the specifics of this Notice and fundamentally change its treatment of and tolerance for firms that specialize in harming investors.

Sincerely,

Dennis M. Kelleher
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Date: May 28, 2019

Sent: VIA E MAIL (pubcom@finra.org)

Re: FINRA Proposed New Rule 4111 Comment

Dear Ms. Mitchell,

Once again, FINRA is proposing new rules which will undoubtedly cost member firms and their registered representatives money and time. Not surprisingly, the determination of who will be required to pay is based upon disclosure items prominently displayed on BrokerCheck. FINRA has again chosen to extract money and resources from its members, based merely upon allegations, rather than adjudicated findings of fact. When implemented, the assessment of costs and resources is triggered by mere allegations. Policy which fails to consider the veracity of allegations prior to implementing this punitive measure is wholly irresponsible and tantamount to a gross abuse of authority.

BrokerCheck publishes unsubstantiated allegations related to investor complaints and customer disputes. It publishes information related to alleged Rule violations which have not yet been adjudicated or found to have occurred.

While the public benefits by having access to admitted, proven, and verified wrongdoing by financial professionals, the publication of false, misleading, erroneous, and potentially defamatory disclosures does nothing more than dilute the integrity of such reporting.

Yes, through FINRA's dispute resolution process, FINRA U4 expungement and U5 Termination expungement are possible. In fact, over the last few years, we have assisted our clients with disclosure removal in over 520 instances. In each one of these cases, all facts and evidence are considered by a neutral arbitrator or judge. Then, and only then, the neutral arbitrator or judge has made a finding that the facts and evidence fail to adequately support the allegations made. More specifically, these finders of fact apply the standards enumerated within FINRA's Rule governing which specific circumstances warrant expungement of the inadequate allegations.

In the current regulatory environment, both the falsely accused and the true "bad actors" are immediately branded by public disclosures on their BrokerCheck profile when allegations are made. The proposed Rule amounts to nothing more than FINRA broadening the scope of an ineffective and inefficient practice to punish both the guilty and the innocent.

Despite FINRA's attempt to pass this off as a measure aimed at protecting the investing public, the proposed Rule 4111 is merely another expensive obligation for firms that is based on the cauldron of true and untrue allegations within BrokerCheck. The purported goals of the imminent Rule appear to be honorable. However, FINRA completely undermines itself by choosing to rely upon a watered-down population of data containing both guilty and innocent individuals.

Sincerely,

More BS that you don’t Need
Les

EVERSHEDS SUTHERLAND

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July 1, 2019

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

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

Dear Ms. Mitchell:

We are submitting this letter on behalf of our client, the Committee of Annuity Insurers (the "Committee"),[1] in response to Regulatory Notice 19-17, *Protecting Investors from Misconduct* (the "Notice"), issued by the Financial Industry Regulatory Authority, Inc. ("FINRA") on May 2, 2019.[2] The Notice solicits comment on proposed new Rule 4111 (the "Proposed Rule"), as well as an additional proposed new rule to outline procedures for regulating activities and proposed amendments to existing rules to outline procedures for hearings.

Background

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

[1]The Committee was formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of securities, banking, and tax policies regarding annuities. For three decades, the Committee has played a prominent role in shaping government and regulatory policies with respect to annuities, working with and advocating before the SEC, CFTC, FINRA, IRS, Treasury, Department of Labor, as well as the NAIC and relevant Congressional committees. Today the Committee is a coalition of many of the largest and most prominent issuers of annuity contracts. The Committee's member companies represent more than 80% of the annuity business in the United States. A list of the Committee's member companies is attached as Appendix A.
[2] The Notice is posted at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-17.pdf.

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Overview of the Proposed Rule

FINRA notes, however, that challenges remain at the member firm level, particularly where a member firm has a concentration of brokers with past misconduct issues and without adequate supervision. To remedy these issues, the Proposed Rule seeks to impose tailored obligations on firms that have significantly higher levels of risk-related disclosures than their similarly sized peers ("Restricted Firms"). Under the Proposed Rule, any Restricted Firm would be subject to a requirement to hold a Restricted Deposit Requirement (described in more detail below), and may also be subject to additional obligations, including other conditions or restrictions on the Restricted Firm's business and operations.

The Proposed Rule would create a multi-step process to guide FINRA's determination of whether to impose additional obligations on a member firm. The first step in this process is to calculate the sum of disclosure events and persons for six categories for the firm, which include: (i) registered person adjudicated events; (ii) registered person pending events; (iii) registered person termination and internal review events; (iv) firm adjudicated events; (v) firm pending events; and (vi) registered persons associated with previously expelled firms. Next, FINRA would compute the firm's Preliminary Identification Metrics by standardizing each of the sums. The final step is to determine if the firm meets the Preliminary Criteria for Identification by evaluating whether: (i) two or more of the firm's Preliminary Identification Metrics are equal to or more than the corresponding Preliminary Identification Metrics Thresholds for the firm's size; (ii) at least one of those Preliminary Identification Metrics is the Registered Person Adjudicated Event Metric, the Member Firm Adjudicated Event Metric, or the Expelled Firm Association Metric; and (iii) the member firm has two or more Registered Person or Member Firm Events.

FINRA also identifies additional steps intended to guard against the risk of misidentification of firms that could result from using the process identified under the Proposed Rule. For example, once a firm is deemed to meet the "Preliminary Criteria for Identification," the Proposed Rule would require FINRA to conduct an initial evaluation to "determine whether it is aware of information that would show that the member—despite having met the Preliminary Criteria for Identification—does not pose a high degree of risk."[3]

FINRA would also permit firms who meet the Preliminary Criteria for Identification to reduce staffing levels in a manner such that the firm would no longer meet the criteria. However, this option is only available if it is the firm's first time meeting the criteria. The Proposed Rule permits FINRA to continue the review if FINRA determines that a firm still meets the Preliminary Criteria for Identification following any reduction in staffing levels, or if a firm is not eligible for or opts out of reducing staffing levels. The next step in the review process grants FINRA the discretion to determine the maximum amount of any deposit that a member could be required to maintain, in cash or qualified securities, in a segregated account at a bank or clearing firm, the so-called "Restricted Deposit Requirement." In addition to discouraging misconduct, FINRA notes that this additional financial requirement imposed on Restricted Firms aims to preserve firm funds for payment of arbitration awards.

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

[3] The Notice, at p. 11.

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General Comments

The Committee appreciates the opportunity to submit comments in response to the Notice. The Committee is generally supportive of FINRA's efforts and its attempts to enhance customer protection by imposing additional obligations on a targeted group of firms. Particularly, the Committee supports FINRA's transparency around how the Preliminary Identification Metrics are calculated. The Committee has several comments regarding the financial requirements and other specified conditions or restrictions that a Restricted Firm may be subject to under the Proposed Rule. The Committee also requests clarification on several aspects of the Proposed Rule. Set forth below are the Committee's specific comments.

Specific Comments

FINRA's Exercise of Discretion. The Committee has several comments regarding the Proposed Rule's broad grant of discretion to FINRA's Department of Member Supervision in determining who is a Restricted Firm and the financial requirements and other specified conditions or restrictions that a Restricted Firm may be subject to under the Proposed Rule. The Committee believes that the amount of discretion that would be permitted under the Proposed Rules may not be set up in a manner that promotes consistency and fairness in how the Proposed Rule is applied. While the Committee appreciates the need for discretion in some instances, we urge FINRA to consider striking an appropriate balance between discretion and consistency and fairness within the Proposed Rule.

Initial Evaluation by FINRA. As noted above, FINRA points to several steps that it states are intended to guard against the risk of misidentification, including an initial evaluation by FINRA. During the initial evaluation, the Proposed Rule would grant FINRA broad discretion to determine whether the firm was misidentified and therefore should not be subject to further review. The Proposed Rule prescribes that FINRA would base its decision on whether FINRA has information to conclude that the computation of the member's Preliminary Identification Metrics included disclosure events (and other conditions) that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. Additionally, FINRA would be required to consider whether the member already addressed the concerns that the Proposed Rule is intended to address, or whether the Preliminary Criteria for Identification no longer reflect the member's current risk profile.

The Committee understands the need to mitigate concerns of including firms who are not the target of the Proposed Rule. However, the Committee believes that this initial evaluation provides FINRA with broad discretion to decide whether a firm has been misidentified and therefore whether the firm should be subject to continued review under the Proposed Rule.

Member Consultation. As noted above, the Proposed Rule also provides that a member firm consultation with FINRA is intended to guide against misidentification. While the Proposed Rule outlines how a firm may overcome the presumption that it is a Restricted Firm and should not be subject to financial requirements and specified conditions or restrictions, it grants FINRA the discretion to make the final determination as to whether a firm has overcome the presumption. The Proposed Rule also grants FINRA the authority to request relevant information or documents that are "necessary or appropriate . . . to review the computation of the Preliminary Criteria for Identification."[4] Furthermore, the Proposed Rule grants FINRA the authority to request "other information or documents" that FINRA may "reasonably request in its discretion from the member related to the evaluation," as well as "any other information . . . deems necessary or appropriate to evaluate the matter."[5]

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[4] Proposed FINRA Rule 4111(d)(3)(B).
[5] Proposed FINRA Rule 4111(d)(3)(D)-(E).

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The Committee believes that the Proposed Rule's consultation provides FINRA with broad discretion to decide whether a firm should be designated as a Restricted Firm and whether it should be subject to financial requirements and specified conditions or restrictions. The Committee believes that a carefully tailored and objective structure in determining whether mis-identification has occurred would be preferred.

Maximum Restricted Deposit Requirement. The Notice requests comment on whether there should be a cap on the maximum Restricted Deposit Requirement. As noted above, the Proposed Rule grants FINRA the discretion to determine a Restricted Firm's maximum Restricted Deposit Requirement amount. FINRA notes that the maximum Restricted Deposit Requirement amount would be tailored to the firm's size, operations and financial conditions. FINRA further notes that it would consider a number of factors when determining the maximum Restricted Deposit Requirement, including "the nature of the firm's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any 'covered pending arbitration claims' or unpaid arbitration awards or unpaid settlements related to arbitrations, and concerns raised during FINRA exams."[6] Attachment C to the Notice contains several examples that are intended to demonstrate how FINRA might exercise its discretion in determining a maximum Restricted Deposit Requirement. However, the Notice states that "nothing in the examples is intended to suggest that the Department will follow specific formulas in determining a maximum Restricted Deposit Requirement or the weight that any specific circumstances carry."[7]

The Committee agrees that any obligations on a Restricted Firm should not significantly undermine the continued financial stability and operational capability of the firm.[8] The Committee also agrees that FINRA should consider a firm's size and other important factors when determining any conditions or restrictions that will be imposed.[9] However, the Proposed Rule merely provides guidance, and falls short of placing limitations on FINRA's ability to determine the maximum Restricted Deposit Requirement. Without a formula or limitations, this provision does not prevent FINRA from making an arbitrary determination of a firm's maximum Restricted Deposit Requirement, or the weight of any mitigating factors. We believe it should be possible to develop a formula for calculating the maximum Restricted Deposit Requirement, by, e.g., focusing on the correlation between revenues derived from penny stock sales and unpaid arbitration amounts. A formula of this type would seem to make more sense because, unlike excess net capital, there is a direct correlation between revenue and sales that give rise or may give rise to, unpaid arbitration awards. Similar to the transparency provided around how the Preliminary Identification Metrics are calculated, the Committee requests that FINRA also provide transparency around the calculation of and caps on the maximum Restricted Deposit Requirements.

Department Decisions. The Proposed Rule provides that FINRA may make one of three determinations:

- If FINRA determines that the firm has rebutted the presumption that it should be designated as a Restricted Firm, then the firm will not be subject to any additional obligations.
- Alternatively, FINRA may determine that the firm has failed to rebut both the presumption that the firm should be designated as a Restricted Firm and the presumption that it should be subject to the maximum Restricted Deposit Requirement, in which case the firm would be required to comply with the maximum Restricted Deposit Requirement and "specified conditions or restrictions, as necessary or

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[6] Proposed FINRA Rule 4111(i)(15)(A).
[7] The Notice, at p. 12.
[8] The Notice, at p. 12.
[9] The Notice, at p. 12.

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appropriate, on the operations and activities of the firm and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest."[10]

- Lastly, FINRA may determine that the firm failed to rebut the presumption that the firm should be designated as a Restricted Firm but that it has rebutted the presumption that it should be subject to the maximum Restricted Deposit Requirement. As a result, FINRA could choose to (1) impose no Restricted Deposit Requirement; or (2) require the member to maintain a Restricted Deposit Account with an amount less than the maximum Restricted Deposit Requirement and impose "specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the firm and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest."[11]

The Committee believes that this provision would grant FINRA broad discretion to determine any additional obligations, including the amount of a financial requirement and conditions or restrictions that may be imposed on a Restricted Firm. Furthermore, this provision does not provide examples of the types of conditions or restrictions that may be imposed. For example, FINRA could impose conditions or restrictions that have the same effect as sanctions. The Committee believes that granting FINRA too much discretion to impose conditions or restrictions on a firm circumvents the enforcement process and any level of due process afforded by formal proceedings. For these reasons, the Committee requests that FINRA limit the additional obligations to conditions or restrictions that are directly targeted to remedy the events of the Firm that constitute Preliminary Criteria for Identification, and will not have a materially adverse business impact on other aspects of the firm's operations.

Termination of Restricted Firm Obligations. The Proposed Rule anticipates that a firm may be designated as a Restricted Firm in one year, but not meet the Preliminary Criteria for Identification or otherwise is not designated as a Restricted Firm the following year. However, the Proposed Rule would restrict a previously designated Restricted Firm from withdrawing any amount from the Restricted Deposit Account, unless FINRA decides to authorize a withdrawal.

This provision appears to suggest that a previously designated Restricted Firm could always, at FINRA's discretion, be subject to additional obligations in the form of Restricted Deposit Requirements. This seems to be a possibility regardless of any changes in a previously designated Restricted Firm's staffing or behavior, or the passage of time. FINRA states that the Proposed Rule is "premised on a notion that the most effective tool to change the behavior of a member firm that presents a high degree of risk is a financial restriction."[12] However, the Committee has doubts that a member who may be subject to a financial restriction regardless of changed behavior will be motivated to change its behavior. The Committee urges FINRA to reconsider its position on maintaining Restricted Deposit Requirements for previously designated Restricted Firms. As you know, the maintenance of a Restricted Deposit Account imposes at least three direct costs on member firms: the charge for maintaining the account; the cost to maintain excess capital; and the cost imposed through the annual independent audit. A firm that is no longer designated a Restricted Firm should not be subject to these on-going costs.

Clarifying Questions. The Committee is seeking clarification on many aspects of the Proposed Rule that could have implications on other aspects of a firm's business.

"Good Standing." The Notice requests comment on whether "there are collateral consequences that could result from being designated as a Restricted Firm, even if FINRA does not publicly disclose the firm's designation."[13] The Committee believes that being designated as a Restricted

[10] Proposed FINRA Rule 4111(e)(1)(B).
[11] Proposed FINRA Rule 4111(e)(1)(C).
[12] The Notice, at p. 35.
[13] The Notice, at p. 36.

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Firm could have other collateral consequences. In particular, many selling agreements to which a firm may be a party typically include a covenant that a firm maintain its status as a FINRA member firm in "good standing." The Committee is requesting clarification on whether a firm's status as a Restricted Firm would impact whether the firm is viewed as being in good standing with FINRA.

Public Availability of Restricted Firm Status. As noted above, FINRA requests information on whether "there are collateral consequences that could result from being designated as a Restricted Firm, *even if* FINRA does not publicly disclose the firm's designation."[14] Given FINRA's choice of words, the Committee asks that FINRA clarify whether a firm's status as a Restricted Firm could be made publicly available by FINRA.

Calculation of Preliminary Criteria for Identification. The Proposed Rule anticipates that the Department would calculate, on an annual basis, a member firm's Preliminary Identification Metrics to determine if it meets the Preliminary Criteria for Identification. The Proposed Rule appears to require Restricted Firms to keep records relating to, among other things, the calculation of the Preliminary Criteria for Identification. The Committee is requesting clarification on whether a firm would be provided the necessary information to be able to calculate its Preliminary Criteria for Identification. In addition to a firm's calculation, the Committee requests clarification on whether FINRA will provide advance notice to firms that meet or come close to meeting the Preliminary Criteria for Identification.

CONCLUSION

The Committee appreciates the opportunity to provide these comments on the Proposed Rule. Please do not hesitate to contact Clifford Kirsch (212.389.5052 or CliffordKirsch@eversheds-sutherland.com) or Eric Arnold (202.383.0741 or EricArnold@eversheds-sutherland.com), if you have any questions regarding these comments.

* * *

Respectfully submitted,

EVERSHEDS SUTHERLAND (US) LLP

BY: Clifford Kirsch EA
Clifford Kirsch

BY: Eric Arnold
Eric Arnold

FOR THE COMMITTEE OF ANNUITY INSURERS

[14] The Notice, at p. 36 (emphasis added).

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Appendix A

COMMITTEE OF ANNUITY INSURERS

AIG
Allianz Life
Allstate Financial
Ameriprise Financial
Athene USA
AXA Equitable Life Insurance Company
Brighthouse Financial, Inc.
Fidelity Investments Life Insurance Company
Genworth Financial
Global Atlantic Financial Group
Great American Life Insurance Co.
Guardian Insurance & Annuity Co., Inc.
Jackson National Life Insurance Company
John Hancock Life Insurance Company
Lincoln Financial Group
Massachusetts Mutual Life Insurance Company
Metropolitan Life Insurance Company
National Life Group
Nationwide Life Insurance Companies
New York Life Insurance Company
Northwestern Mutual Life Insurance Company
Ohio National Financial Services
Pacific Life Insurance Company
Protective Life Insurance Company
Prudential Insurance Company of America
Sammons Financial Group
Symetra Financial Corporation
Talcott Resolution
The Transamerica companies
TIAA
USAA Life Insurance Company

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July 1, 2019

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

RE: Regulatory Notice 19-17: Request for Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct

Dear Ms. Piorko 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 arbitrations. 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 investor protection.

PIABA generally supports the adoption of FINRA Rule 4111 (Restricted Firm Obligations) as well as the accompanying new Rule 9559 (Procedures for Regulating Activities Under Rule 4111). As FINRA noted in Regulatory Notice 19-17: "The proposal would further promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards." This is consistent with PIABA's goals of promoting the interests of investors and investor protection. We applaud all steps that regulators take in furtherance of those goals, but the problem that high-risk firms and high-risk brokers create is enormous. While we generally support the rules for what they will do to strengthen the regulation and compliance of high-risk firms and brokers, with the noted exceptions below, Rules 4111 and 9559 will not cure the long-standing unpaid arbitration award issue and we are concerned it is misleading to those interested in the unpaid arbitration award issue to suggest otherwise.

The proposed rules would create a multi-step process to strengthen regulation of high-risk firms. First, the process identifies "Restricted Firms" that meet quantifiable Preliminary Identification Metrics. FINRA's threshold is based on firm size and number of disclosure events. After opportunity for further Department evaluation and consultation with the firm, the rule authorizes FINRA to require identified Restricted Firms to deposit cash or qualified securities that may not be withdrawn without FINRA's prior

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Joseph C. Peiffer, LA
Jeffrey R. Sonn, FL
Andrew J. Stoltmann, IL
Robin S. Ringo, *Executive Director*

written consent ("Restricted Deposit Account"). FINRA may also require adherence to other conditions or restrictions on the member's operations deemed necessary to protect investors and in the public interest.

Proposed FINRA Rule 4111 begins to address a number of issues affecting public investors unfairly harmed by bad actors in the industry, in particular recidivist individuals and firms. But it has significant shortfalls that should be corrected before adoption. We address the following, and additional comments, in further detail:

(1) The proposed rule does not come close to resolving the epidemic of unpaid FINRA arbitration awards;
(2) The threshold calculations used to designate "Restricted Firms" highlight the problems with expungement of customer dispute information – FINRA cannot deem a firm "High Risk" if the settled customer complaints are routinely erased from the CRD system;
(3) There are meaningful questions regarding the nature and extent of FINRA's discretion in applying and enforcing the proposed rules; and
(4) The predictive model used to identify "Restricted Firms" is unduly narrow insofar as it focuses exclusively on firm size and reporting history, and does not address the nature of the products being sold by the member. Accordingly, the proposed rule does not address the common problem of a single product (or product type) raising a host of arbitration claims, and awards, which serve to bankrupt the member.

Unpaid Arbitration Awards

As FINRA is aware, the problem of uncollectable firms and registered representatives is a significant one and something that PIABA has worked hard to address. As we have stated repeatedly, if FINRA arbitration is to promote confidence in the markets and be perceived as a fair alternative to jury trials, investors who go through the process and receive an award must be able to collect that award.

We therefore noted with interest the last sentence of Regulatory Notice 19-17, which reads:

The proposal would further promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and ***to pay arbitration awards.*** (Emphasis added).

Recent press surrounding the proposed rule goes even further. According to an Investment News editorial dated May 11, 2019, FINRA "finally may have come up with a fair way to ensure that investors who win arbitration awards actually receive them."[1] The editorial piece highlights the misleading nature of suggesting the rule is a mechanism to resolve the unpaid arbitration award issue.

While it is true that a small number of firms[2] would be required to set aside some sum of funds (so long as it would not cause an undue burden on the firms' operations), we do not see anything in the rule

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[1] "*FINRA plan to address unpaid arbitration award problem deserves fair hearing*" InvestmentNews, (May 11, 2019), available at: https://www.investmentnews.com/article/20190511/FREE/190519995/finra-plan-to-address-unpaid-arbitration-award-problem-deserves-fair

[2] In the Regulatory Notice, FINRA noted that "1.6-2.4% of all firms registered with FINRA in any year during the review period," or 60 – 98 firms, would have met the criteria subjecting the firms to the rule's coverage. Regulatory Notice 19-17, p. 25.

proposal that attempts to square the sums to be set aside with the unpaid arbitration award experience. Stated differently, we have seen no data that shows the sums set aside will be sufficient to cover anticipated arbitration awards. To the contrary, the language in the proposed rule limiting the amount FINRA can require a high-risk firm to set aside to a sum that will "not significantly undermine the continued financial stability and operational capability of the member as an ongoing enterprise over the next 12 months"[3] means that the more thinly capitalized a firm, the smaller amount FINRA would require the firm to put in the Restricted Deposit Account. Such a limiting feature would necessarily result in it having a very minimal impact on unpaid awards.

In further support of this conclusion, PIABA has reviewed the list of firms with unpaid awards between 2013 and 2017, available on FINRA's website, and calculated the unpaid award amount for each firm.[4] Half of the firms listed appear to have 2 or more unpaid awards. More than 85% of the firms have unpaid awards of $100,000 or more. Forty percent of the firms have unpaid awards in excess of $1 million. Requiring those firms to deposit small sums in a Restricted Deposit Account will simply not have a material impact on the issue of unpaid awards. Additionally, we see nothing in the rule proposal that explains why, exactly, the rule would incentivize member firms to pay awards.

While PIABA appreciates any effort to make sure wronged investors are appropriately compensated, to be more effective in combating the unpaid award problem, analysis must be completed to assess the nature and extent of harm that Restricted Firms have done in the past, and more quantifiably use that data in determining the amount of deposits to be required. It may be that the data shows that a restricted deposit size would need to be so significantly large that enhanced additional measures must also be taken for a particular individual or firm for there to be any meaningful impact on unpaid awards.

The proposed rule should also address how aggrieved investors could access those restricted deposits to satisfy the arbitration awards that the Restricted Firms refuse to pay themselves. The proposed rule must also clarify what will happen to a Restricted Deposit Account if a firm goes out of business, in particular if there are outstanding unpaid awards, but also considering that valid customer claims may not be identified until years afterwards. Finally, the proposed rule should clarify that Restricted Deposit Accounts can be used to pay not only unpaid arbitration awards, but unpaid arbitration *settlements* as well.[5]

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[3] Regulatory Notice 19-17, p. 12.

[4] PIABA assumed any awards issued following a firm's termination of membership or within a year prior to the firm's termination were unpaid.

[5] FINRA should be able to track data regarding breach of contract/breach of settlement agreement claims and/or customer communications that a member firm or associated person has failed to pay a settlement agreement in further violation of FINRA rules.

Expungement of Customer Dispute Information under FINRA Rules 2080 and 12805

Proposed FINRA Rule 4111 also calls into question the ongoing problem related to the pervasive nature of expungements. First and foremost, to the extent the threshold analysis to determine "restricted" status reviews a member firm's disclosure history, it is axiomatic that FINRA can only review the disclosures that exist in the record. If customer complaints are expunged, FINRA will be unable to consider those disclosures and potentially miss appropriately designating a recidivist firm as being "Restricted." As PIABA has pointed out a number of times, expungements are granted all too frequently, and in violation of FINRA's attempts to ensure expungement is an extraordinary remedy, rather than the norm as it exists today.

PIABA first reported on the issue on September 24, 2007, and found that expungement was granted in 98.4% of the cases. PIABA next reported on the issue in 2013 in a report titled "Expungement Study of the Public Investors Arbitration Bar Association."[6] The 2013 study found that, for awards issued from May 18, 2009, through December 31, 2011, expungement was granted 96.9% of the time it was requested in cases resolved by settlement or stipulated awards. PIABA then updated its analysis in 2015 in a report titled simply "Update to the 2013 Expungement Study of the Public Investors Arbitration Bar Association."[7] The update found that, for cases filed from January 1, 2012, through December 31, 2014, expungement was granted in 87.8% of the cases.

In short, despite FINRA's attempts to curb the problem of rampant expungements, the problem remains unabated with only very small progress having been made on this issue over the last decade. Which leads us to the second problem related to expungements: FINRA member firms can avoid being labeled "Restricted Firms" if they sanitize their records. The proposed rule therefore will have the likely and unintended consequence of further incentivizing member firms and registered representatives to pursue expungement of customer complaints. Accordingly, to the extent FINRA contemplates the proposed rule, PIABA urges FINRA to simultaneously pursue meaningful expungement reform.

FINRA Discretion

While PIABA understands the need for a certain amount of flexibility in the application of the proposed rule, we question the extent it should be allowed. For example, proposed FINRA Rule 4111(h) states that (emphasis added): "FINRA *may* issue a notice pursuant to Rule 9559(b) directing a member that is not in compliance with the Restricted Deposit Requirement or the conditions or restrictions imposed by this Rule to suspend all or a portion of its business." We question why the discretion is permitted in the event a member has failed to abide by the rules' strictures. The non-compliant member is, by definition, a high-risk one. Accordingly, we cannot conceive of a good reason a high-risk firm would be allowed to continue its business unabated despite its violation of the rule. Instead, a non-compliant firm should be subject to immediate suspension. Accordingly, this section of the rule should state that "FINRA shall … suspend all of its business."

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[6] Available at https://piaba.org/system/files/2018-01/REPORT%20-%20Expungement%20Study%20of%20the%20Public%20Investors%20Arbitration%20Bar%20Association.pdf

[7] Available at: https://piaba.org/sites/default/files/newsroom/2015-10/Update%20on%20the%202013%20Expungement%20Study%20of%20PIABA%20%28October%2020%2C%202015%29.pdf .

The Predictive Model Is Too Narrow

FINRA's proposed rule uses history as a guide to future performance by focusing the threshold analysis on member firm reported events as a trigger for application of Restricted Firm status. Despite the admonishment that past performance is not a guarantee of future performance, the data identified by FINRA *does* support the concept that the more bad actors employed by a member firm, the more likely sales abuses will take place in the future.[8] But limiting the analysis as the proposed rules would require ignores the all-too-common problem presented by product failures. High-risk firms will often focus a large percentage of their business on selling particular products, commonly non-publicly traded investments. A failure of such a product will bring a rash of claims. And, in the event the member firm bears culpability for the sale of the products (such as UBS with Puerto Rico municipal bonds or Securities America with Medical Capital), the resulting liabilities can destroy the firm and leave investors without recourse. Securities America threatened to do exactly that when it testified, in court, that the failure to approve a minimal class action settlement would result in its bankruptcy over the following weekend.[9] Any threshold analysis must therefore consider the nature of the products sold by the member firms, and the extent to which it sells said products. If FINRA is truly trying to protect against risky behavior, the member firms' actual ongoing sales behavior must be factored into the analysis.

Additional Comments

The proposed rule would allow a restricted firm to deposit cash or "qualified securities" to meet the firm's obligation. However, the proposed rule lacks a mechanism to address the changing value of those securities. If the securities drop in value, will the firm be required to supplement the value? If the securities increase in value, will the firm be allowed to withdraw the excess value? FINRA should address the frequency of the Restricted Deposit Account valuation and establish rules requiring the account replenishment.

It is clear that FINRA put considerable time, effort, and thought into proposed Rule 4111, and the particular metrics to determine "Restricted Firm" status. We question, however, what happens when the product of a particular metric applied to a particular firm size results in a fraction. For example, the "Registered Person Adjudicated Event Metric" is .3 for firms of between 5 and 9 people. Accordingly, if the firm was comprised of 6 registered representatives, the trigger would seem to be 1.8 (the product of .3 and 6). Would it take 1 event to satisfy that trigger, or will FINRA round up and require 2 events? Clarification is needed regarding how such rounding issues will be addressed.

Conclusion

Once again, PIABA acknowledges and appreciates the considerable time and effort FINRA put into RN 19-17 and its proposed rule changes. We urge FINRA to put the rule into context and acknowledge that it is

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[8] *See* McCann, Qin, and Yan *"How Widespread and Predictable is Stock Broker Misconduct?"* Journal of Index Investing, Summer 2017, Vol. 26, Issue 2, Pp. 6-25, available at: https://www.slcg.com/pdf/workingpapers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck%20Final.pdf;

[9] *See* Susanne Craig, "*Judge Backs Arbitration in Case Against Securities America*," Dealbook, March 18, 2011, available at: https://dealbook.nytimes.com/2011/03/18/judge-backs-arbitration-in-securities-america-case/

an incremental step toward protecting public investors from high-risk firms. However, despite its good intentions and FINRA's commendable efforts, absent meaningful changes, the proposed rule could well have the unintended consequence of making the expungement problem worse. Moreover, while the clear purpose of the proposed rule is to better regulate high-risk firms and brokers, we strongly urge FINRA to acknowledge that it is not likely to have a meaningful impact on resolving the unpaid arbitration award issue or, in the alternative, provide sufficient data to support the impact of the new rule on unpaid arbitration awards. PIABA simply does not want to see a well-intended rule be tainted or misused by those seeking to give it attributes it will not have. We thank you for the opportunity to comment on the proposed rule, and urge FINRA to consider the issues set forth above before any final version is adopted.

Sincerely,

Christine Lazaro
President

Samuel B. Edwards
Executive Vice-President

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

Re: Comment on Proposed Rule 4111

Dear Ms. Mitchell:

I respectfully share my comments to Rule 4111 proposal. I believe this rule needs to be completely rethought. It puts the livelihoods of good hard-working people at risk for the wrong reasons. The criteria of this rule are discriminatory and punitive against innocent brokers and small firms. To label a firm as proposed will hurt such a firm from a reputational standpoint, hurt their ability to grow and give it a stigma that will certainly be used unfairly against them in litigation. This will force small firms to put up monies for liabilities that don't exist and force firms to terminate persons for reasons that serve no purpose.

Because a firm has resources to dilute their concentration of brokers that fall into these criteria doesn't mitigate risk of misconduct. This is completely unfair and geared to benefit larger firms. Because a firm has a number of representatives that don't meet the criteria doesn't negate the fact these representatives exist. This shouldn't bring immunity to a firm from the rule. A firm can create a training program or hire a significant number of new representatives with no disclosures and potentially escape this categorization. If a small firm wanted to accomplish this it will have to allocate a significant budget away from supervision and move it to new broker hiring.

The focus should continue to be on the supervisory system over such brokers. Firms with a high percentage of representatives from disciplined firms or a number of disclosures are under constant audit. They are constantly improving their systems as a result. These firms are constantly being identified by risk metrics of FINRA which lead to constant never-ending audits, inquiry and scrutiny. Small firms are constantly proving audit after audit the viability of their supervisory systems. Some of these small firms that would meet the criteria have better supervisory systems than firms which wouldn't be selected. It seems counterproductive to me. The audit cycle is much more frequent on these firms. Now this proposed rule wants to force firms which are already spending enormous amounts of their budgets towards supervision to put up additional money for potential claims that don't even exist. That is unfair and unreasonable. What about the firms that are already spending significant capital to pay premiums to maintain errors and omissions insurance? That should resolve the concern of unpaid arbitrations which appears to be a major motivation behind this proposal.

The criteria to begin with is completely unfair. The rule will force firms to terminate brokers who may ultimately land at firms that are audited less frequently. That is counterproductive. This rule as is does not mitigate misconduct. I don't see any way it accomplishes that objective. It will force firm management to push quality and compliant representatives out of their firms.

There is a systemic problem in the industry starting with the disclosure and arbitration system and how it leads to unfair circumstances and an increase in disclosures for industry representatives and small firm owners.

America has more litigation than the rest of the world combined. The securities industry is the only industry in which a broker or member has to report every part of their business or personal history for the rest of the public to review, judge, and take advantage of. To label a broker or a firm as a risk for non-compliance for a disclosure or a series of disclosures over $15,000 is unfair. This is evidence of a clear disconnect between the persons proposing this rule and the real-life challenges the members face from disclosure system abuses, complaints and/or disputes. I am a believer in the need for transparency, However, the current disclosure and arbitration systems are broken and lead to more disclosures and more litigation. If this rule is looked at from the perspective of the members it would be realized that a disclosure or event over $15,000 is not an indicator of misconduct. It results from a reasoned decision to cut down on costs. An arbitration against a member costs the member FINRA arbitration fees. It costs on average between $4,000 and $7,000 in FINRA fees just to get sued. Then the member will have to pay an attorney a retainer between $10,000- $20,000 just to start a defense whether the case is valid or frivolous. To get a frivolous case expunged you have to first arbitrate and then go to court and spend at least another $7,500. Even a frivolous case filed costs the member significantly more money than $15,000 to the member just to defend. To say this $15,000 should be a marker to categorize a broker and a firm into such a detrimental category is unreasonable.

The FINRA broker check system is for public awareness. Predatory law firms are now violating FINRA terms of service of the broker check and disclosure system and using it for commercial purposes. If a person googles a brokerage firm, he or she will find more advertisements to sue the firm, and a statement that these law firms are "investigating" the firm/representatives, than you will see information about the broker dealer itself you are trying to find information about. These firms use aggressive tactics and know how expensive and difficult the arbitration system is for members and they exploit it so they can extract a settlement. Many claimant's attorneys work on contingency – yet members and brokers have to pay retainers and pay by the hour. It should be a no surprise to anyone why so many representatives have an increase in claims filed which settle for litigation costs which is substantially higher than $15,000. $15,000 is not an appropriate benchmark given the costs of litigation. **Disclosures of this nature are not evidence of risk for misconduct and should not be labeled as such.**

Just because a claim gets filed doesn't mean it should have any merit and place a bias against a representative. Pending arbitrations shouldn't be considered in a vacuum to infer liability to a firm and a resulting restricted deposit. Just because a claim is made doesn't mean a firm should put aside their needed capital when there is an abundance of frivolous cases. This is why firms have insurance policies.

A 20-year veteran representative who has conducted business with several hundred, if not thousands of customers and has 6 disclosures on their license doesn't mean this poses a risk for future misconduct. I believe regulatory actions for sales practice violations are more relevant.

6. Expelled firm representatives.

To label a firm as restricted because they hire a concentration of brokers from an expelled firm is unfair. Especially because the expulsion of their previous firm is more than likely caused by conduct of control persons behind a closed door and not from the brokers who had nothing to do with or any knowledge of the violation. This certainly should not add a risk metric to their new firm. Activities and failures at a previous firm made by management shouldn't follow innocent brokers in a way that will adversely affect their lives and the lives of the new firm owners when the new firm has its own supervisory systems and procedures. The firm should be judged for its own procedures to keep in compliance with rules and regulations. A representative's past firm history does not make the representatives more likely to engage in bad behavior.

For example: a firm gets expelled for penny stock liquidations. Why would FINRA propose labelling a broker a heightened risk because the owners made a bad decision and the broker had nothing to do with the conduct. In this example this broker who never transacted a penny stock in his 20-year career is not higher risk for misconduct. This rule will categorize this person for potential termination even though the representative did not have any violations within their own independent business that related to the firm going out of business. FINRA does thorough investigations and disciplines individuals who are responsible for violations. The proposal to consider individuals from expelled firms does not make the industry any safer. It's a punitive move against small firms and innocent brokers with limited resources. It benefits the larger firm rosters.

There are many firms with brokers with high concentrations of disclosures which have good systems in place for supervision. They are able to demonstrate the ability to supervise as evidenced by the constant audits they endure. Now staff wants to punish and potentially dismantle small firms. FINRA should not label the firm for anything other than what its control persons have done and should not label the individual broker for anything but the individuals' own conduct. This entire rule is misguided. Forcing firms to reduce staff and causing brokers to uproot their lives to move firms will be the ultimate result which does nothing for the industry and does nothing to increase customer protection. The concern over unpaid arbitrations can be overcome with an errors and omissions policy.

One-time opportunity (if available) is suspect. If available? Not sure what that means but it sounds like an option for staff to make a discretionary decision, if wanted, at any given time significantly affecting an organization. The proposed rule itself will cause major adjustments in a firm's operations since the firm won't be able to sustain a restricted firm deposit for liabilities that may not ever occur. If a firm decides to try to work with staff and make adjustments to their business and they make changes that somehow aren't good enough, the door shouldn't be closed on it. If a firm works expeditiously, it shouldn't be limited to one-time opportunity or else. It shouldn't be of the nature of a dictatorship. Firms should be given several opportunities or a reasonable time period to work with Staff to accomplish a major adjustment.

In closing, I am for regulation and rules that make sense to ultimately be fair to the investor but also the industry members. I believe this rule need to be rethought to accomplish the goals it seeks to address. The way this proposal is now is unfair to small firms.

In closing my suggested changes are as follows:

Criteria of Representatives from expelled firms should be removed in its entirety.

A firm with an errors and omissions insurance policy should be exempt.

Pending matters should be removed.

Customer complaints settled for $15,000 or more should be changed to $100,000 or, at the very least $75,000.

The one-time opportunity should be changed to a time frame with multiple consults and an expedited appeal process available without the restrictions in place until the outcome.

Respectfully

Damian Maggio

ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

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July 1, 2019

<u>Via Email To pubcom@finra.org</u>
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street NW
Washington, D.C. 20006-1506

Re: Regulatory Notice 19-17

Dear Ms. Mitchell:

The St. John's University School of Law Securities Arbitration Clinic (the "Clinic") would like to thank you for the opportunity to comment on the proposed rule change concerning the imposition of additional obligations on firms with a significant history of misconduct pursuant to proposed new rule 4111. The Clinic is a curricular offering where students represent public investors of limited means in disputes against their investment brokers.[1]

FINRA's rule proposal seeks to introduce FINRA rule 4111 to impose additional obligations on firms that have a history of misconduct or have hired employees with a history of misconduct. The new obligations are: the establishment of a "restricted deposit account" and additional conditions or restrictions that may be necessary to protect investors.

The rule proposal is an effort by FINRA to protect investors from predatory and harmful practices that some brokerage firms and brokers might employ. FINRA is attempting to not only promote investor protection, but also ensure that investors who have been harmed have access

[1] For more information, please see http://www.stjohns.edu/law/securities-arbitration-clinic.

to these “restricted deposit accounts” in their arbitration efforts. The Clinic commends FINRA’s efforts in increasing investor protection. However, the Clinic believes more must be done to prevent misconduct in the first place, as well as to ensure that recidivist brokers and firms are held accountable to investors they have harmed.

The Clinic believes that more stringent conditions should be adopted to ensure firms deemed to be “high-risk” are not harming investors. Under the proposal, FINRA contemplates that “additional conditions or restrictions” may be imposed on high risk firms, however, there are no specific additional conditions or restrictions set forth in the proposal. At a minimum, firms that are under the purview of the rule should be subject to heightened supervision obligations. Such a requirement would be beneficial and a step towards increased investor protection.

The Clinic also urges FINRA to include language in the proposed rule that would incentivize firms to maintain appropriate capital and operating account levels. Under the proposed rule, the firms have an incentive to reduce their capital levels because in the multi-factor review process they would end up not being required to deposit a large amount into the restricted deposit account due to their already low levels of capital. FINRA should ensure firms that are deemed high risk are not able to evade the obligations the rule imposes by being underfunded. Arguably, investors doing business with such a firm need even more protections. As discussed above, such firms should also be subjected to heightened supervision obligations, regardless of the deposit amount. Further, there may be other restrictions that are appropriate, such as restrictions on the types of products that the firm may sell to investors.

Additionally, firms are able to avoid coverage by the rule by firing problem employees, or undergoing a one-time staffing reduction. However, the firm was willing to hire high-risk brokers in the first place, and allowing the one-time staffing reduction will not ensure that such a firm does not remain a risk to investors. Accordingly, even if the firm is able to overcome the obligation to fund a restricted deposit account because of a one-time staffing reduction, FINRA should consider additional obligations or restrictions for the firm, such as heightened supervision obligations. Such obligations, at least in the short term, should ensure the firm has truly reduced its risk level.

Moreover, not every firm will comply with the spirit of the proposed rule. This may result in gamesmanship and evasion of reporting and disclosure requirements to feign compliance while actually falling under a “high-risk” determination. To minimize this, FINRA must be vigilant in reviewing firm regulatory filings to ensure the filings are complete and truthful. In addition, the Clinic believes that more information should be available through BrokerCheck in order to allow investors to fully vet brokers and firms before they invest. FINRA has established that disclosures may be predictive of future misconduct. Therefore, information such as the percentage of brokers at a firm who have disclosures should be included on a firm’s BrokerCheck. A firm’s designation as a “Restricted Firm” or “High-Risk Firm” should also be included. Additionally, information about the average number of disclosures that brokers and firms have will provide investors with better information by which to assess broker and firm disclosures.

In conclusion, the Clinic believes that the rule is a step forward in regulating those members of the industry who are at the highest risk of harming investors. However, the proposal should be expanded to include further obligations for members found to be "high-risk." Finally, FINRA should consider additional factors pursuant to which a firm may be deemed "high-risk."

Thank you for the opportunity to comment on these important proposals.

Respectfully submitted,

/s/
David Marron
Legal Intern

/s/
Richard Mayer
Legal Intern

/s/

Christine Lazaro, Esq.
Director of the Securities Arbitration Clinic
*And Professor of Clinical Legal Educatio*n

This rule seems to be overly burdensome and directed primarily at small firms with the intent of requiring capital in excess of the normal capital requirements. I am sure that my comment will fall on deaf ears.

David D. McNally, President
McNally Financial Services Corporation

VIA ELECTRONIC MAIL: pubcom@finra.org

July 01, 2019

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 19-17: Request for Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct

Dear Ms. Mitchell,

Cambridge Investment Research, Inc. ("Cambridge") appreciates the opportunity to comment on Regulatory Notice 19-17: Request for Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct. FINRA is seeking a broad range of commentary regarding all aspects of this proposal and hopes to obtain input regarding whether this proposed new rule will be effective and efficient in addressing the history of misconduct FINRA has observed among a small number of member firms. FINRA has proposed a rule which would impose tailored obligations, including possible financial requirements, upon a designated member firm when that firm's calculation results under this proposed new rule cross specified numeric thresholds. FINRA states that this proposed rule is prompted by the activities of a small number of member firms that continue to create a disproportionate number of compliance issues relative to their peers. FINRA believes these firms pose greater risk to the investing public due to the nature and number of regulatory-related events these firms have disclosed. FINRA holds that the remedies it has created under this proposal are intended to apply to that small number of member firms only.

Cambridge supports FINRA's goal of protecting the investing public and agrees that member firms which pose a heightened risk of harm to the investing public, and whose conduct undermines investor confidence, should be subject to additional scrutiny. As always, Cambridge supports the implementation of sensible, well-crafted, and clearly understandable rules and commends FINRA for its efforts to protect investors from misconduct.

Cambridge agrees that an objective data assessment coupled with a comprehensive and transparent review of that data will aid FINRA in identifying those high risk member firms and registered persons contemplated by this proposal. However, given the prospective impacts upon member firms, registered persons and their clients, Cambridge believes FINRA should revise certain aspects of the rule to accomplish its underlying goals.

Cambridge requests FINRA consider amending the prospective rule per the analysis below and hopes FINRA will consider the following comments as it further develops this proposed rule.

Calculation Metrics, Criteria, and Methodology

Considering FINRA's intent to identify those comparatively few firms that, in FINRA's view, present a heightened risk to the investing public, Cambridge believes the Calculation Metrics, Criteria, and Methodology described in Proposed Rule 4111 should be modified to focus on those investor-related events creating the high level of risk FINRA seeks to address.

As FINRA has noted, the vast majority of member firms do not pose the high degree of risk prompting this proposal. Thus, certain changes to these Calculation Metrics, Criteria, and Methodology would better align the application of Proposed Rule 4111 with the spirit behind it, that is, to identify those high risk member firms only and to impose measures to protect the investing public from the high risk activities of those member firms.

Preliminary Identification Metric Thresholds

Overall, Cambridge agrees that the employment of an iterative process, that includes phases of data assessment followed by a comprehensive and transparent review, makes the most sense and supports the structured process as portrayed in Attachment B of the proposal. Cambridge believes, given the novelty, breadth and depth of this proposed rule, coupled with the prospective impact of the attendant effects of its implementation upon member firms, that FINRA should implement various checks and balances throughout the process. These checks and balances should be measured and reasoned so as to lessen the number and impact of potential false positive results.

The proposed rule gives FINRA broad discretion to determine whether a firm is a Restricted Firm and should be subject to heightened financial requirements. Considering the significant impact this will have on certain member firms and the burden and harm placed on misidentified firms, Cambridge believes such firms should be notified if the threshold calculations causes them to be identified as high risk during the preliminary identification process and allow the firms to review and address any data points and calculations the firms do not believe are accurate prior to the Evaluation stage. In addition, Cambridge believes the initial review during the Evaluation stage should require FINRA to consult with the member firm and demonstrate its reasons for a continued review. Cambridge further believes FINRA should establish a fact-based, demonstrable and transparent process to conclude a firm is a Restricted Firm.

Arbitration and Civil Judgments

Proposed rule 4111(i)(4)(A)(i) includes disclosure of arbitration awards and civil judgments in which the registered person was a named party. This metric takes into account all customer arbitration awards and civil judgments regardless of the size of the award or judgment and without recognition of the registered person's specific involvement in the matter. As a result, this proposed metric could capture individuals who are in an ownership or leadership position or the chain of supervision and are simply a named party as a result of a zealous litigation strategy or tactic even though they are not involved in the conduct ultimately at issue in the award or judgment. Because these individuals may have no direct history of misconduct, but are otherwise caught up in an action that causes them to be included in the Preliminary Identification Metrics, Cambridge believes this does not further FINRA's purpose underlying the rule. Therefore, Cambridge suggests FINRA modify its definition to include named parties only to the extent the award or judgment concludes they were involved with the underlying conduct giving rise to the event.

Additionally, Cambridge believes FINRA should establish a minimum award threshold in an amount of no less than $50,000 for 4111(i)(4)(A)(i) to apply. This amount reflects an average minimum cost to defend investment-related, consumer-initiated actions that are otherwise not settled for legitimate business reasons and are not necessarily reflective of high risk behavior. For example, a small award or judgement for a loss in account value due to a market correction that the registered person or member firm refused to settle does not seem like the type of high risk behavior FINRA is seeking to eliminate. A more narrowly tailored rule with a minimum threshold dollar amount to account for such real-world examples would still accomplish FINRA's goals while not inhibiting sound businesses decisions to challenge zealous claims that may have little merit but result in some type of award or judgment.

Settlements

Proposed Rule 4111(i)(4)(A)(ii) contemplates capturing settlements as low as $15,000. Cambridge believes such a low threshold renders the proposed rule overly inclusive. Often matters are resolved merely to avoid the cost of litigation, without regard to the merit (or lack of merit) in the underlying claim. The cost associated with the defense of such matters could easily exceed $50,000 and thus a settlement at or below that figure does not necessarily reflect enhanced risk. Instead, settlement of a matter at or below $50,000 may simply reflect a sound business decision. Cambridge proposes the settlement threshold contemplated in this particular subparagraph be increased to at least $50,000. Failing to increase this minimum could result in an increased number of matters taken to a final award or judgment, thus increasing the burden on investors seeking relief as well as registered persons and member firms who desire to avoid the negative impacts of Proposed Rule 4111.

Criminal Felonies

Proposed Rule 4111(i)(4)(A)(v) includes any criminal felony for which the registered person was convicted, pled guilty or no contest. While criminal findings are relevant to a member firm's determination of whether to associate with a particular registered person, they do not necessarily reflect conduct indicating present-day high risk behavior concerning the investing public.

Cambridge recommends that this provision, along with Proposed Rule 4111(i)(4)(B)(iv), be limited in time to those events occurring within the 10 years prior to the calculation in order to align with the approach used for statutory disqualification.

Registered Person Pending Events

Proposed Rule 4111(i)(4)(B), Registered Person Pending Events, includes certain events associated with a registered person that are reportable on a Uniform Registration Form. Cambridge believes this provision should be amended with regard to time and scope. As FINRA is likely aware, member firms typically err on the side of reporting potential disclosure events, including those matters which are stale or moot given the age of the event. This conservative approach to the firm's reporting obligation, which arguably benefits the investing public in the form of additional information, also potentially harms well-intended firms by potentially erroneously increasing the pending events metric calculation in a manner not consistent with the specific focus of identifying member firms or registered persons who may pose a high risk of misconduct to the investing public.

Further, a matter may remain pending for an extended period of time through no fault of the firm or an individual. The mere pendency of a matter, without any adjudication of wrongdoing, adversely impacts both the firm and the registered person in the context of the calculation contemplated by this proposed rule. At the same time, the pending event in no way informs the question of the nature and extent of any particular risk presented by that firm or the registered person – presumably the question to which the proposed rules seeks information. It is not uncommon for certain pending matters to remain for years with no actions taken. Including these types of matters will likely inflate calculations, possibly pushing a member firm into the realm of Evaluation or even a Restricted Firm, when that member is not necessarily engaging in high risk behavior.

Thus, Cambridge believes this provision should be limited to those events occuring within the 10 year period prior to the calculation so as to eliminate old matters which will likely never come to fruition, but rather were reported as a matter of practice versus on a substantive basis. Additionally, this provision should include additional language to further define those specific matters, investigations, actions, or charges that FINRA is attempting to mitigate, which are more specifically relevant to this review.

Member Firm Internal Reviews

Proposed Rule 4111(i)(4)(C)(ii) includes pending or closed internal reviews by the member firm. Cambridge believes this provision should be amended to differentiate among the types of internal reviews conducted by member firms and should limit the reviews included in this calculation metric to those relating to the violations FINRA believes to be indicia of high risk behavior. Cambridge also believes this provision should be limited to reviews pending or closed within the 10 years prior to the calculation.

Additionally, Cambridge requests FINRA provide clarification and guidance regarding the scope and application of this provision. FINRA should include additional language to note the specific sales practice or investor-related disclosure events FINRA believes identify the improper behavior this metric is intended to capture. This clarification could include references to specific questions on forms U-4 and U-5; citations to certain rules, notices, or interpretive guidance; or newly created FAQs discussing how FINRA intends to identify and capture the type of information and data it considers relevant for evaluation under this provision.

Civil Judicial Matters

Proposed Rule 4111(i)(4)(E)(i) deals with member firm pending civil judicial matters. Often these matters involve conduct unrelated to the heightened risk posed to investors by member firms and registered persons with histories of misconduct. Cambridge suggests FINRA amend this provision to distinguish those investment-related matters from those that are administrative in nature, and exclude all matters that are not sales practice or investment-related from the calculation.

Pending Investigations

As currently drafted, Proposed Rule 4111(i)(4)(E)(ii) captures any pending investigation by a regulatory authority. Again, this provision potentially casts too broad a net and should provide a mechanism for distinguishing among various types of matters. Given the regularity with which FINRA, the SEC, and the various state securities agencies oversee and investigate the dealings of member firms, application of this metric as written will likely produce an inflated result and thus be less relevant to FINRA's inquiry. A more defined provision that distinguishes between the various types of matters subject to investigation by these agencies concerning to FINRA would more closely align with the objectives of this proposed rule.

Registered Persons Formerly Associated with Expelled Firms

Proposed Rule 4111(i)(4)(F), regarding Registered Persons Associated with Previously Expelled Firms, includes any registered person who (1) was registered with the member firm for one or more days during the prior year and (2) had been associated with a previously expelled firm at any time. Cambridge believes this metric is well intended but may create adverse results for both registered persons and member firms that pose little to no risk to the investing public. As a preliminary matter, there is no direct causal connection between a registered person's association with an expelled firm and the high risk behavior this proposal seeks to address. There are numerous examples where a registered person without disclosure history indicative of high risk behavior may have at one time associated with a member firm now expelled. In these instances, the registered person likely had nothing to do with the matter justifying the expulsion. In the event the registered person participated in high risk behavior or improper conduct at the expelled firm, this should evidence itself as a disclosure on that individual's form U-4 or U-5, which would be included in the metrics in Propose Rule 4111. It seems counter to FINRA's stated objective in the proposed rule to potentially penalize a member firm, now employing a registered person who has no sales practice violations or investor-related disclosure events but who was formerly registered with an expelled member for a brief time, because of the past affiliation of one of its registered persons with an expelled firm. The impending result is likely that member firms will refuse to register any registered persons leaving expelled firms, thereby driving such persons from the industry and creating investor harm by mass abandonment of client relationships. Including anyone associated with a previously expelled member in the metrics does not produce the focused risk based result FINRA seeks with this proposed rule.

If FINRA retains this provision, Cambridge believes FINRA should only include this metric for expelled firms that truly created investor harm. Cambridge recommends FINRA consider the facts underlying the events causing the member firm's expulsion. For instance, did the member firm violate net capital requirements or was the expulsion a result of investor harms? Application of this provision as defined will likely result in a chilling effect among member firms when considering registering a person with a history of affiliation with an expelled member firm. This could drive otherwise compliant registered persons out of the business, and could harm that person's clients as a result.

These proposed changes would allow for those registered persons who may have been associated with an unscrupulous former member, but did not engage in high risk behavior, to move on from an undesirable past association; however, it would allow FINRA to focus on trending high risk behaviors of those registered persons who seek to avoid scrutiny by changing firms.

Preliminary Criteria for Identification

Cambridge recommends FINRA modify the Preliminary Criteria for Identification defined in 4111(i)(9)(B). The criteria should be amended consistent with the comments and concerns noted above. For example, included in this calculation is whether a "member has two or more Registered Person and Member Firm Events during the Evaluation Period." Cambridge believes applying this criteria in such broad form likely will generate false positive results because it creates the potential that one event may be reflected in multiple disclosures and counted several times in the various criteria.

Discussing proposed rule 4111(c)(1), FINRA contemplates that a false positive result could be produced by duplicative events, non-sales related events, and events warranting a different regulatory response. FINRA recognizes that these events potentially giving rise to a false positive could all be removed in advance from the calculation criteria. A process to screen out erroneously included disclosure events that are "duplicative (involving the same customer and the same matter)"[1] or not indicative of any relevant pattern "reflective of a firm posing a high degree of risk"[2] would further FINRA's goal of identifying those events that "are associated with an emerging pattern of customer harm"[3] only; "and would capture timely information of potential ongoing or recent misconduct."[4]

Maximum Restricted Deposit Requirement

Cambridge believes the Maximum Restricted Deposit Requirement may trigger unintended consequences which result in harm to the investing public. If for example, the requirement of a deposit cannot be implemented because of minimum net capital requirements, will FINRA have

[1] *Regulatory Notice 19-17* at 11.
[2] *Id.*
[3] *Id.* at 32.
[4] *Id.*

additional impactful recourse? Member firms without significant retained earnings, subject to the Deposit Requirement, may receive an exception due to the lack of stability of the firm whereas a member firm with greater working capital subject to the requirement would not be granted an exception, and thus potentially placed at a competitive disadvantage.

In the Examples of Maximum Restricted Deposit Requirements provided on Attachment C of the Notice, FINRA, by way of example, shows that the Restricted Deposit Requirement will likely be greater than a member firm's excess net capital. This example of how this requirement will be calculated is problematic because a calculation based on gross revenues does not contemplate contractual obligations the member firm may have to vendors, service providers, staff and registered persons for which those revenues have already been allocated. Further, as it is likely these obligations do not rise to the level of a significant undue financial hardship under Proposed Rule 4111(d)(1)(B), it is possible that members who should be subject to this provision will act in advance to extract any excess net capital that could be exposed to this restriction. Thus, the only member firms likely to have dollars which could be subjected to this requirement are those who do not anticipate being subjected to this rule because they are not intentionally creating high risk to the investing public and are seeking to comply with FINRA rules and requirements.

Department Evaluation Process

The Initial Department Evaluation Process under Proposed Rule 4111(c)(1) outlines the steps FINRA staff would take "to determine whether it is aware of information that would show that the member – despite having met the Preliminary Criteria for Identification – does not pose a high degree of risk."[5] As noted above, FINRA staff would engage in review of multiple factors to, on its own, determine whether a false positive identification occurred as a result of the Preliminary Criteria for Identification Calculation.

Within the Notice, FINRA lists the type of information a member firm could provide to redefine or challenge a result. Nothing contained in this section, however, compels or obligates FINRA staff to consider this information in connection with its review during this evaluation process. Rather, the rule simply requires FINRA staff to conduct an evaluation to determine whether further review is warranted. As a result, FINRA's determination could be based on information not specifically contemplated for consideration by the proposed rule.

The potential lack of transparency is made more troublesome by the fact that FINRA's finding in this regard is subject to a rebuttable presumption adverse to the member firm. It would be more equitable for FINRA to give the member firm notice of the result of the calculation identifying the member firm as a potential Restricted Firm, provide the firm with a preliminary computation identifying which criteria produced the result, give an explanation of the components of the computation, and give the member firm a meaningful opportunity to challenge FINRA's preliminary computation.

[5] *Id.*

Proposed Additional and Alternative Measures and Means

In addition to giving those member firms who fall subject to the Evaluation process an opportunity to present evidence during the Evaluation stage in order address a potential false positive outcome as a result of the calculation, Cambridge suggest FINRA consider additional and alternative measures and means.

Additional Factors

The proposed rule contemplates a determination of risk based solely on a strict numerical basis derived from the number of disclosures and the number of registered persons. Though this consideration is bound to a five-year period, this means of measuring risk does not account for the fact that older and/or larger member firms may have more disclosure events because they serve more investors. To address this issue, Cambridge suggests FINRA consider weighting the Preliminary Identification Metric Thresholds to account for the length of time a member firm has existed along with the number of registered persons and customers served by that member firm.

To illustrate this point, consider which of the following scenarios presents the greater risk: (1) a member firm with 100 registered persons, serving 10,000 investors, with 21 Registered Person Adjudicated Events, or (2) a member firm with 100 registered persons, serving 100 investors, with 21 Registered Person Adjudicated Events. In both situations, the member firm's metrics place that member firm above the threshold of 0.20, however, on a per investor basis, the ratios change to 0.0021 and 0.21 respectively. As such, including a weighted metric based on the size of the member firm's investor base would provide a more accurate reflection of the risk that member firm may pose to the investors it serves and could assist in further identifying those member firms that pose a higher degree of risk to the investing public generally.

Additional Rule Amendment Proposal

In conjunction with the proposed rule, Cambridge urges FINRA to consider amending Rule 2080(a) to exclude from the requirement to obtain a court order those instances where a dispute with a customer was disclosed on a registered person's Uniform Disclosure Forms, but that registered person was not involved in the subject matter of the dispute, was not subject to any consequences as a result of the determination or settlement of the matter, or was removed or dismissed from the matter as a party after a review of the facts. As mentioned earlier, registered persons have often incurred disclosure events as a result of being named in a matter due to their position within a chain of supervision, their presence in an office, their role as a senior manager, officer or director of the member firm, or because the person bringing the matter named them in error. As these disclosures could potentially carry much greater weight, FINRA should allow for these types of events to be more readily removed from these registered person's Uniform Disclosure Forms.

Terms and Conditions

As stated above, Cambridge believes FINRA should give member firms additional opportunities to engage and cooperate with FINRA staff throughout this new process. While FINRA contemplates a one-time reduction of staff to remedy the result placing that member firm in a restricted firm status, FINRA could provide additional remedial options. FINRA contemplates a "terms and conditions" rule[6], but chose not to propose this approach at this time. Cambridge does not believe this should be an all or none proposition. Contemplation of new rule provisions is not a Sophie's choice. FINRA could incorporate "terms and conditions" measures during the Initial Evaluation and Consultation phases to deal with those member firms whose calculation results place them at or above the thresholds. These measures could include opportunities to appeal any findings or cooperatively remedy those pertinent issues. Cambridge urges FINRA to reconsider its approach in order to handle a potential dramatic increase in volumes of Preliminary Identification Metric Thresholds under the proposed new rule. For example, what will happen in instances of a widespread product collapse or market collapse resulting in a high number of new events occurring within both the Registered Person and Member Firm categories? Will FINRA adjust the thresholds or will many firms be swept up into the status of a Restricted Firm? Without factoring in such broad sweeping events, member firms on the cusp in a particular category may find themselves subject to this proposed new rule by no fault of their own, even though they are not participating in high risk activities detrimental to clients.

List of Firms and Registered Persons

To further assist firms with this new process, FINRA could compile and publish a comprehensive list of expelled member firms and provide member firms information as to whether prospective new registered persons desiring to associate with the member would trigger identification under this rule and subject the member firm to further scrutiny under the rule.

Additional Incentive for Compliance

As an additional incentive for greater compliance, FINRA could implement measures to protect member firms, not subject to a restriction under Proposed Rule 4111, who seek to assist those registered persons whose business practices did not contribute to another restricted member firm's negative disclosure history but who may become caught up in the potentially negative impacts of such restriction, and their clients in relocating their business to a member firm not subject to the punitive provisions of this proposed rule.

Under this additional measure, which could further incentivize member firms who may fall into a Restricted Firm status to greater compliance, FINRA could include language specifically limiting that Restricted Firm from bringing certain legal actions against other member firms. For example, registered persons departing Restricted Firms may subject their new member firm to certain legal actions if it were to accept registrations of a large number of registered persons from the Restricted Firm. Adding language to the proposed rule that would protect member firms from such legal actions could provide another powerful incentive for firms to avoid being identified as a Restricted Firm.

[6] *Id.* at 21-23.

Conclusion

In conclusion, Cambridge respectfully suggests that to achieve the intent articulated by FINRA in this proposed rule, FINRA should modify the rule as noted above. Cambridge believes the novelty and breadth of the proposed rule compels an extremely measured approach to its implementation. The potential for unintended consequences to firms and registered persons must be balanced against the need for such a strict, data-driven analysis. Cambridge strongly supports FINRA's efforts to protect investors, but also asks FINRA to balance the prospective harm to the reputations of honest member firms, registered persons and their clients.

Cambridge would be happy to further discuss any of the comments or recommendations in this letter with FINRA.

Respectfully submitted,

// Seth A. Miller

Seth A. Miller
General Counsel
Senior Vice President, Chief Risk Officer

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June 27th 2019

Via email: pubcom@finra.org

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

Re: Regulatory Notice 19-17
Proposed FINRA Rule 4111

Dear Ms. Mitchell:

I write this comment today on behalf of Luxor Financial Group, Inc and numerous small firms that we represent regarding Proposed Rule 4111 (the "Proposed Rule"). The spirit and substance of the Proposed Rule are a cause of deep concern, and are strikingly intrusive even to an industry accustomed to the intense scrutiny necessary to safeguard the public. In short, the Proposed Rule should not be adopted.

In Regulatory Notice 19-17, which requests comment on the Proposed Rule, several considerations are set forth to justify implementation of Rule 4111. The impetus at the heart of the matter is the desire to strengthen the controls FINRA has which previously prevented enforcement and sanction of misconduct until *after* such harm has occurred. While misconduct and sanction usually occur in that order, and represents the sort of causal relationship inherent in any regulatory schema, Regulatory Notice 19-17 describes it as an undue constraint on the enforcement process. Regulatory Notice 19-17 concedes that market forces will cause bad actors to "eventually be forced out of the industry" regardless Rule 4111 is necessary as a prophylactic measures. The logic here is perplexing and un-American. The Notice cites certain research that suggests that past behavior can be an indicator of future misconduct, but sociology is hardly the province of financial regulators; the tone is Orwellian.

FINRA provides no evidence, argument, or data to prove that the Proposed Rule will cure the problem that it has been invented to solve. FINRA provides no evidence, argument, or data to support the proposition that the Proposed Rule is what is minimally necessary to address the unknown degree of harm posed by the small group of repeat offenders, or why these offenders seemingly can't be reached under FINRA's current powers. There is no publicly available data to suggest whether public opinion aligns with the Proposed Rule. There is no consideration of how public opinion and trust may be affected by the Proposed Rule. FINRA concludes the background and discussion portion of the Notice by alluding to Consolidated Rule 9208 promulgated by the Investment Industry Regulatory Organization of Canada, which targets problematic firms. Perhaps a targeted solution would alleviate many of the concerns currently circulating among member firms about this rule, but FINRA only notes that are "not proposing it at this time".

Indeed, what is perhaps inadvertently conveyed as impetus for the rule is frustration with the rights currently exercised by member firms. FINRA reductively and summarily addresses these rights, and yet member firms are *entitled* to reasonable constraints on regulation, as well as the expectation that the regulatory system will not seek to impose rules that are overly broad and arbitrary. While it is in the best interest of FINRA, the investing public, and most member firms to remove bad actors- this escalation in enforcement compounds the frustration of small firms already cornered by a complex and layered web of rules. The Proposed Rule affects broker-dealers both preemptively and retroactively in a manner that the standard court system would surely limit. While surely the public trust is eroded when there is customer harm, public trust is also eroded when they are given cause to wonder why the current system of rules and regulations protecting them is inadequate as is.

Although unpaid arbitration awards and recidivist brokers may be inconsistent with FINRA's mission, this does not automatically warrant the imposition of a complicated series of thresholds and calculations that will, with virtual certainty, chill the rights of member firms to do business and to freely associate with brokers. Regulatory Notice 19-17 sends the clear message that the primary concern of FINRA is the "particular challenge" that it faces in examining and disciplining individual firms with a history of misconduct. It is a frankly astonishing admission that FINRA has begun to see the due-process rights of its member firms as an inconvenience that is superseded when member firms "take advantage of the limits" of legal constraints on enforcement activity. Regulatory Notice 19-17 explicitly states:

> **Enforcement actions in turn can only be brought after a rule has been violated-and any resulting consumer harm has already occurred.** In addition, these proceedings can take significant time to develop, prosecute, and conclude, during which time the individual or firm is able to continue misconduct.

The right of the individual or firm to forestall the imposition of disciplinary sanctions by exercising their right to a legal defense is not an inconvenience that can be circumvented as dictated by FINRA standing in the shoes of the investing public. There is some transparent frustration here with the legal constraints on their enforcement and the time it takes to pursue them to a conclusion and remedy, but this Proposed Rule would preemptively enforce economic sanctions and undermine the appeals process. This initiative is ill advised, and unfair to many of those doing business in the industry. Many FINRA member firms, especially smaller firms, will feel an outsized impact under this new proposed rule. Free access to cash-on-hand or qualified securities is critical to the now shrinking field of small firms. A restricted deposit requirement compromises a firm's ability to transact business that may be necessary to both maintain operations and cover payment of any pending arbitration claims. With access to both a smaller pool of potential employees marked with the "scarlet letter" of prior misconduct and with restricted access to funds, smaller firms will struggle to exist, while larger firms will view it as the cost of doing business.

Small firms budget carefully, and allot their dollars into acquisitions, technology, personnel and compliance. Under the Proposed Rule, some will be forced to tie up their funds in a restricted deposit account, or terminate employees who would trigger this requirement. These terminated employees would not simply exit the financial services industry; they have always migrated to "advice" based positions or to un-registered firms, where there is even less oversight. The proposed waiver to compensate for financial hardship is a perfunctory consideration; anyone with knowledge of the industry knows that to avail oneself of this waiver would deter recruitment and lead to brokers leaving the firm. The ripple effects of the Proposed Rule seem to have been deemed unworthy of consideration or description. When small to mid-sized firms are inadvertently crippled it gives the investing public less choice. Large firms will consolidate more of the market. These are the same firms that caused the 2008 financial crisis and who will far more easily absorb the impact of the Proposed Rule.

A cursory review of the BrokerCheck system reveals thousands of regulatory actions as well as client arbitrations against larger broker dealers, who often have thousands of disclosed incidents for their representatives. Yet due to the size and resources of larger firms, the numeric thresholds imposed would result in absorbable losses, while smaller firms would be faced with an existential crisis.

To mitigate the impact on smaller firms, we recommend that:

1. The threshold be raised on reportable settlements to the $50,000 - $100,00 range as the current amounts for reporting are extremely low and create a large amount of reportable events from settlements which are simply settled to avoid the high costs of litigation;
2. Association with a disciplined firm should be held against the actual ownership persons, rather than brokers who were simply affiliated as this makes brokers guilty by association as opposed to actual misconduct by the broker and consequently unfairly punishes the firm that hires that broker;
3. Nuisance arbitrations that are settled without admission of guilt be addressed;
4. Remove the requirement of placing funds on hold during proceedings as this is devastating to small Firms with limited resources. Moreover, this issue is resolved for Firms that have an E&O policy which should certainly eliminate the requirement for a cash reserve for firms who have a policy in place;
5. Pending actions should have no bearing as everyone is entitled to have issues adjudicated prior to being penalized;
6. Additional considerations need to be addressed as to the disproportionate impact the Proposed Rule will have on small firms.

Sincerely,

Ken Norensberg

Ken Norensberg,
Managing Director, Luxor Financial Group
& Former FINRA Governor

July 1, 2019

By email to pubcom@finra.org

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

Re: Regulatory Notice 19-17: Protecting Investors from Misconduct

Dear Ms. Mitchell:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in response to the request for comment by the Financial Industry Regulatory Authority ("FINRA") on *Regulatory Notice 19-17: Protecting Investors from Misconduct* (the "Proposal").[2] NASAA commends FINRA's attempt to strategically identify, and more strongly regulate, the limited number of FINRA member firms with histories of regulatory noncompliance. The Proposal represents another step in FINRA's recent multi-pronged effort to protect investors from the bad behavior of certain high-risk firms – an effort NASAA supports.

The Proposal is designed to proactively deter misconduct by the highest risk FINRA member firms and to mitigate the issue of nonpayment of arbitration awards. The Proposal would create a new category of "Restricted Firms," which are those firms that present high risks to investors because of demonstrated patterns of prior misconduct by the firms and their associated persons, and empower FINRA to require these firms to set aside additional monies for the protection of investors beyond the firms' existing minimum net capital requirements. The Proposal contains a robust process for evaluating these issues and, as demonstrated by FINRA data, should affect only a small number of broker-dealers. The Proposal thus should increase investor protection while imposing minimal burdens on the brokerage industry. NASAA supports the Proposal and encourages its adoption with changes as set out below to better align the Proposal with its investor protection goals.

[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] *See* Regulatory Notice 19-17: Protecting Investors from Misconduct, FINRA (May 2, 2019), *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-17.pdf.

1. Designation as a "Restricted Firm" Under New Rule 4111 Should be Public Information

FINRA does not propose to publicly disclose those firms receiving a Restricted Firm designation, however, publishing this information would strengthen both investor protection and transparency. Identification of Restricted Firms would be a valuable public service entirely consistent with FINRA's general standards for public disclosure of disciplinary information under FINRA Rule 8313. An appropriate analogy is to FINRA's treatment of so-called "Taping Firms." At a minimum, though, the names of Restricted Firms should be provided to state securities regulators so it can be included in NASAA members' regulatory oversight and risk analyses.

Designation as a Restricted Firm is closely analogous to being designated a Taping Firm under FINRA Rule 3170. FINRA allows for public disclosure to investors of a firm's Taping Rule status if requested via the BrokerCheck toll-free telephone listing.[3] This provides investors – and other regulators such as NASAA members – with access to this information. The underlying purposes of the Taping Rule are the same as those behind the Proposal: both rules seek to identify high risk FINRA member firms and to impose additional regulatory and compliance obligations on them.[4] For the same reasons that FINRA makes the identity of Taping Firms and those disciplined under the Taping Rule known to the public, it should make the identities of Restricted Firms under new Rule 4111 known as well.

Publicizing which firms have been designated as Restricted Firms would strengthen the Proposal immeasurably. Being designated under new Rule 4111 will have regulatory consequences for Restricted Firms (including the requirement to set aside additional money in Restricted Deposit Accounts), but these obligations only go so far. If investors do not have access to this information they will not be able to know they are doing business with a high risk firm. Investors cannot obtain the same level of information through BrokerCheck that FINRA will use in designating members as Restricted Firms. Making the identities of Restricted Firms public would serve as a clear, simple – and entirely warranted – notice to investors to tread carefully when doing business with these firms and their associated persons. At a minimum, the names of Restricted Firms should be provided to state securities regulators so NASAA members can include this information in their own regulatory oversight and risk analyses. Regulatory coordination and collaboration is an important mainstay of deterrence and oversight, and will be particularly relevant with respect to Restricted Firms.

[3] *See* FINRA Rule 3812(b)(2)(F). A recent FINRA proposal would also require this information be provided proactively on BrokerCheck, and NASAA supported this proposal. *See* Letter from Joseph Borg, NASAA President, to Jennifer Piorko Mitchell, Re: FINRA Regulatory Notice 18-16: High Risk Brokers (Aug. 1, 2018), *available at* https://www.finra.org/sites/default/files/18-16_NASAA_Comment.pdf.

[4] *See*, *e.g.*, Notice to Members 05-46: Taping Rule, NASD (July 2005) (describing the purpose of the Taping Rule), *available at* http://www.finra.org/sites/default/files/NoticeDocument/p014653.pdf.

2. Account for any Registered Person Adjudicated Events that have been Expunged Pursuant to FINRA Rule 2080 when Calculating and Evaluating the Preliminary Criteria for Identification

The Proposal would create an entirely new regulatory process for identifying and assigning Restricted Firm status.[5] A key step in this process will be FINRA's analysis of member firms according to certain "Preliminary Criteria for Identification."[6] These criteria, defined in great detail in proposed FINRA Rule 4111, correspond to many of the mandatory disclosures on Form BD and Form U4, including the disclosures required by Item 14I of Form U4. Item 14I requires registered individuals to disclose information regarding customer complaints and customer-initiated arbitration and civil litigation.[7] The information captured in Item 14I is particularly relevant in identifying patterns of misconduct at a firm that could present high risks to investors – *e.g.*, numerous customer complaints about a single representative or about multiple representatives related to the same issues could be indicative of a pattern of misconduct. But FINRA Rule 2080 allows associated persons to have Item 14I information expunged from CRD. Once such a disclosure has been expunged, it is no longer reported under Item 14I on the individual's subsequent Form U4 filings.[8] The Proposal does not address how or if expunged customer complaint information will be considered when determining and assessing the Preliminary Criteria for Identification.

How expunged customer complaints, arbitrations, and civil litigations are treated when determining whether a firm meets the Preliminary Criteria for Identification is an important question that must be addressed before the Proposal can be implemented. In NASAA's view, this is a critical issue. NASAA has consistently advocated for significant reform to the rules and processes related to expungement.[9] NASAA must again note that expungement was intended as

[5] This process can be visualized through a flowchart included as Attachment B to the Proposal.

[6] *See* Proposed Rule 4111(i)(9).

[7] Form U4 Item 14I(1)-(5).

[8] NASAA is unaware of any law, rule, regulation, or guidance dictating this result. However, the general understanding of what it means for something to "*be expunged*" could be the reason events that would otherwise be reportable pursuant to Item 14I but that have been expunged under Rule 2080 are not reported on subsequent Form U4 filings. Further, arbitration awards recommending expungement pursuant to Rule 2080 contain the following (or similar) language: "The Arbitrator recommends the expungement of all references to this matter from registration records maintained by the CRD." The use of "*all references"* and reference to *"registration records"* in such awards has resulted not only the removal from CRD of *existing* references to an expunged matter but in practice has also relieved individuals from disclosing the expunged matter in their future Form U4 filings, because these future filings are *registration records maintained by the CRD*.

[9] *See* Letter from Joseph Borg, NASAA President and Alabama Securities Director, to Marcia Asquith, FINRA Office of the Corporate Secretary, Re: FINRA Regulatory Notice 17-42, Proposed Amendments to the Codes of Arbitration Procedure Relating to Requests to Expunge Customer Dispute Information (Feb. 5, 2018) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comments-to-FINRA-Regarding-Reg-Notice-17-42-Expungement.pdf; *see also* Letter from William Beatty, NASAA President and Washington Director of Securities, to Barbara Black, FINRA Dispute Resolution Taskforce, Re: NASAA Comments on Expungement of Matters from the Central Registration Depository (Aug. 31, 2015), *available at* http://nasaa.cdn.s3.amazonaws.com/wpcontent/uploads/2011/07/NASAA-Expungement-Letter-enclosure.pdf.;

an extraordinary remedy to be granted in only limited circumstances. Today, however, expungement is anything but an extraordinary remedy.[10]

Because expungements are routinely granted and represent potentially valuable regulatory data in assessing patterns of misconduct, FINRA must account for expunged Registered Person Adjudicated Events when determining whether a firm should be designated a Restricted Firm. FINRA should revise the Proposal to add the number of expunged Registered Person Adjudicated Events to the Preliminary Criteria for Identification. The number of expunged Registered Person Adjudicated Events should be counted and assessed in the same manner as the other metrics in the Proposal when determining whether a firm satisfies the Preliminary Criteria for Identification. If FINRA fails to account for expunged Registered Person Adjudicated Events in its Restricted Firm analysis, it will be creating a powerful incentive for registered persons to seek even more expungements. More importantly, not counting the number of expungements in the Preliminary Identification Criteria could also lead to firms encouraging – or even facilitating – expungements for their associated persons in the hopes of avoiding designation as a Restricted Firm. These incentives would only make expungement more common and less extraordinary, moving it even further from its intended purpose.[11]

Letter from Joseph Borg, NASAA President, to Barbara Sweeney, Secretary NASD Regulation, Inc., Re: Request for Comments – 01-65 Proposed Rules and Policies Relating to the Expungement of Information from the Central Registration Depository (Dec. 31, 2001), *available at* http://www.nasaa.org/wp-content/uploads/2011/07/95-Letter.37262-47637.pdf; Letter from Deborah Bortner, NASAA CRD Steering Committee Co-Chair, to Margaret H. McFarland, Deputy Secretary, U.S. Securities and Exchange Commission, Re: File No. SR-NASD-2002-168; Proposed Rule 2130 Concerning the Expungement of Customer Dispute Information from CRD (Jun. 4, 2003) *available at* http://www.nasaa.org/wpcontent/uploads/2011/07/82-ProposedNASDRule-202130.37775-72237.pdf; Letter from Karen Tyler, NASAA President, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, Re: Release No. 34-57572; File No. SR-FINRA-2008-010, Notice of Filing of Proposed Rule Change Relating to Amendments to the Codes of Arbitration Procedure To Establish New Procedures for Arbitrators To Follow When Considering Requests for Expungement Relief (Apr. 24, 2008) *available at* http://www.nasaa.org/wpcontent/uploads/2011/07/31-Release-No34-57572SR-FINRA-2008-010NASAA.pdf; Letter from Andrea Seidt, NASAA President, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, Re: Release No. 34-71959, File No. SR-FINRA-2014-020 Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2081 Prohibited Conditions Relating to Expungement of Customer Dispute Information (May 14, 2014) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-ReleaseNo-34-71959-File-No-SR-FINRA-2014-020.pdf.

[10] In 2018, 684 expungements were granted – more than twice the number granted in 2016. In the current year-to-date, more than 350 expungements have been granted, indicating that 2019 is likely to see another record number of customer complaints being removed from CRD. It is important to note that these figures do not count individual customer complaints or arbitrations but instead only count the individual representatives that have been granted an expungement, many of whom are granted expungement for multiple customer complaints or arbitrations.

[11] NASAA's position on expungement is that it is an extraordinary remedy to be granted only in limited circumstances and the current process has failed to maintain the narrow scope of this remedy. If at such future time that expungement relief is awarded in the truly exceptional instances for which it was established, NASAA would be supportive of FINRA revisiting how it evaluates expunged information for purposes of proposed Rule 4111.

3. Include Additional Financial Disclosure Information from Form BD and Form U4 in the Preliminary Criteria for Identification

NASAA encourages FINRA to expand the Preliminary Criteria for Identification to include financial disclosure requirements from Form BD and Form U4. Specifically, Form BD questions 11I through 11K and Form U4 questions 14K through 14M require disclosure of information about bankruptcies, unsatisfied liens and judgments, and security bonds. The information contained in these disclosures is essential to the investor protection concerns underlying the Proposal as these questions demonstrate potential inability (or unwillingness) to satisfy one's financial obligations. FINRA has crafted the Preliminary Criteria for Identification to capture those firms most likely to pose harm to investors. Adding these additional financial disclosure questions to the Restricted Firm criteria would be consistent with this objective.

4. Include Examples of Potential Conditions or Restrictions that Reasonably May be Imposed on Restricted Firms

Proposed Rule 4111 would provide FINRA with authority to require Restricted Firms to maintain a Restricted Deposit Account and "be subject to such conditions or restrictions on the member's operations" as FINRA determines.[12] This broad authority would, in keeping with FINRA Rule 8310(a)(7), include the ability to "impose any other fitting sanction" as FINRA deems appropriate.[13] The Proposal is silent, though, on what such conditions or restrictions might entail. We encourage FINRA to provide greater guidance on this point and, in particular, to identify conditions or restrictions that generally may be appropriate, such as:

- Mandatory heightened supervision plans for every associated person of the Restricted Firm with a disciplinary disclosure on the person's Form U4;[14]
- Disclosure by the firm of its status as a Restricted Firm to the firm's existing customers in a format acceptable to FINRA;
- Requirement that the Restricted Firm obtain approval from FINRA before hiring any employee (or retaining any person on an independent contractor basis) who has any disciplinary disclosures on the person's Form U4 or unpaid arbitration awards;
- Requirement that the Restricted Firm retain an independent compliance consultant at its own expense to monitor its regulatory compliance and

[12] *See* Proposed Rule 4111(a).

[13] *See Sanctions for Violation of the Rules*, FINRA Rule 8310 (eff. Dec. 15, 2008).

[14] In this regard, heightened supervision plans should conform with the standards set forth in FINRA Regulatory Notice 18-15: Heightened Supervision (*available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-15_1.pdf).

report any material breaches of applicable securities laws and regulations to FINRA;

- Limitations on the menu of products maintained by the Restricted Firm, particularly with regard to products with known sales practice issues (or, in the alternative, limitations on the firm's ability to solicit certain products);
- Requirement that the Restricted Firm perform more frequent reviews of customer transactions as well as sales practice assessments of transaction volumes and products sold;
- Requirement for the Restricted Firm to obtain errors and omissions insurance coverage pursuant to terms acceptable to FINRA (if the firm does not already maintain such coverage); and
- Limitations on the Restricted Firm's solicitation of new clients.

In sum, we applaud the FINRA staff's work preparing the Proposal. Rule 4111 would, if adopted, serve as a bulwark against FINRA member firms that maintain cultures of regulatory noncompliance.

If you have any questions about these comments, please contact NASAA's General Counsel, A. Valerie Mirko (vm@nasaa.org or 202-737-0900), or NASAA's Broker-Dealer Section Chair, Leslie Van Buskirk (Leslie.VanBuskirk@dfi.wisconsin.gov or 608-266-3432).

Sincerely,

Michael Pieciak
NASAA President
Commissioner, Vermont Department of Financial Regulation

Dear FINRA:

FINRA has a lot of nerve pre-judging future behavior and demanding funds for itself. FINRA has a regular habit of exacting payment in circumstances where it has not suffered any harm or loss. And now FINRA wants to profile firms and use this crystal ball to force firms to set up prepaid accounts to cover FINRA's future shakedown interests. This is pathetic and unacceptable.

In its never ending examinations FINRA taxes firms' resources to track down the smallest little compliance issues that often pose no material risk to the investing public. FINRA then identifies these insignificant items to justify the massive waste of firms' resources in these unorganized and nearly endless audits. Are these little "infractions"(which often are disputed by firms) a basis for requiring restricted deposits from firms?

FINRA collects disclosures of allegations and traffics in them publicly, regardless of the damage it does to innocent firms and representatives. Are these unadjudicated allegations the basis for lifting money from firms? If a firm hires a representative who has some items on his/her Form U-4 over a lengthy career but now must submit to a new broker/dealer's system, is the new firm penalized for hiring this representative?

We do not trust the judgments of FINRA. This position is informed by years of enduring silly exercises over negligible issues with FINRA personnel. Who at FINRA is going to determine the necessity for and size of a required restricted deposit? Will there be a trigger and a formula described in an actual rule? What redress do firms have when the FINRA decision is disproportional or completely ridiculous?

Many firms do not have large amounts of cash available to be held as restricted deposits. Firms need these assets to handle their own responsibilities within their businesses and to grow their operations. And as with most regulation, such new requirements further reduce competition for the larger firms by pricing the smaller firms out of business. But more importantly, many of us are tired of FINRA treating us like opportunistic criminals and using us as bank accounts to expand the activities of a runaway self-regulator.

Dan Pisenti
Whitehall-Parker Securities, Inc.
477 Pacific Avenue, 2nd Floor
San Francisco, CA 94133

Cetera®
FINANCIAL GROUP

Mark Quinn
DIRECTOR OF REGULATORY AFFAIRS

VIA Email to:PUBCOM@FINRA.ORG

July 1, 2019

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

Re: Regulatory Notice 19-17 – Proposed Rules 4111 and 9559

Dear Ms. Mitchell:

Please allow this to serve as comments of Cetera Financial Group, Inc. ("CFG") with regard to Regulatory Notice 19-17 (the "Notice") and proposed FINRA Rules 4111 and 9559. CFG is the corporate parent of six FINRA member firms: Cetera Advisor Networks, LLC, Cetera Advisors, LLC, Cetera Investment Services, LLC, Cetera Financial Specialists, LLC, First Allied Securities, Inc., and Summit Brokerage Services, Inc. We submit these comments on behalf of all six firms.

Proposed Rule 4111 would create a framework under which FINRA could require certain member firms to make deposits of cash or marketable securities that could not be withdrawn or otherwise utilized by the member firm without consent from FINRA. The intent of the proposal is to enhance investor protection by establishing additional authority to enforce compliance with FINRA's rules and to ensure that the member firms are able to meet their financial obligations to both customers and FINRA.

We will offer comments with respect to specific provisions of the proposed rules below, but in general, we support both the concept and the manner in which FINRA has approached this effort. A small number of FINRA member firms have consistently demonstrated a lack of willingness or ability to comply with FINRA and other industry rules. This has resulted in a disproportionate expenditure of examination and enforcement resources by FINRA on these firms, often without achieving compliance. In some circumstances, it has allowed member firms to continue operating in ways that are detrimental to their customers and the industry as a whole. We support any initiative that promotes compliance with FINRA rules enhances investor protection and public confidence in the securities industry and public capital markets.

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We note that FINRA has also considered the possibility of a ruled modeled on Investment Industry Regulatory Organization of Canada ("IIROC") Consolidated Rule 9208 ("Rule 9208"). Rule 9208 gives IIROC more latitude than Rule 4111 would afford FINRA in identifying firms that may be engaged in problematic behavior and in tailoring conditions or limitations on their activities in order to promote compliance with applicable rules. FINRA has elected not to pursue the approach in Rule 9208. We believe that this is an appropriate choice, but we also believe that a process such as that set forth in Rule 9208 is worth further study by FINRA. As discussed in more detail below, the formulaic/quantitative approach set forth in Rule 4111 has limitations and may result in a significant number of "false positives", especially if it utilizes all of the identification criteria that are currently proposed. The framework for Rules 4111 and 9559 has built-in procedural safeguards that should address most of these issues, but may in some cases result in presumptions regarding certain firms that are not warranted and which are not soon forgotten. Especially with regard to smaller FINRA members, identification as a potential "Restricted Firm" and the need to respond may also strain scarce resources and divert time and attention from running their businesses. Subject to design and implementation of procedural safeguards, we believe that a system similar to that established in Rule 9208 could yield better outcomes for both investors and member firms.

Our comments below focus primarily on four issues: The manner in which potential Restricted Firms are identified, procedural safeguards that will make the system established by Rules 4111 and 9559 function more efficiently, public identification of Restricted Firms, and other methods that may accomplish the desired results in a more efficient way. In that order, we offer the following:

1. **<u>Criteria for Identification of Restricted Firms</u>**

   a. **Adjudicated vs. Pending Events**. Proposed Rule 4111(b) lists six categories of information ("Preliminary Identification Metrics") that would be used to perform the initial screening and determine which firms would be subject to further review. They can be separated into three general categories: "Adjudicated" and "Pending" events (for both firms and representatives), and employment-related events for representatives. We believe that Adjudicated events are appropriate criteria for inclusion, but that Pending events generally are not, and that employment-related events for representatives should be considered with great caution, if at all.

In determining whether to use any element of data in the evaluation process, two criteria should be applied: The degree to which the data is reliable and the degree to which it is predictive of future conduct. Determining whether or not past actions are reliable indicators of future conduct is an inherently difficult concept. A discussion of that is beyond the scope of this letter, but we believe that there are significant flaws in the methodology and conclusions reached by one of the academic studies that are cited in the Notice in support of the proposed criteria.

The merits of all adjudicated events have been determined by an independent body. The respondent (firm or representative) has had an opportunity to rebut the allegations and establish that no violations have occurred or whether mitigating circumstances exist. While there can never be certainty that a hearing panel or other adjudicative body has reached the correct conclusion, each side has had an opportunity to present evidence and their interpretation of the facts and law. The decision of a neutral fact-finder is inherently more reliable than any mere allegation, which is essentially all that any pending event can be. This raises questions of both accuracy and fairness.

With respect to all Pending events, no such process has occurred. Proposed Rule 4111(i)(4)(B) includes pending investment-related civil judicial matters, pending regulatory matters, and certain types of pending criminal charges. It is an unfortunate fact, but a significant percentage of civil judicial matters are frivolous and ultimately determined to be without merit, and are often filed for purely economic reasons. The motives of the individuals filing such claims must be taken into account in including information about them in the screening process contemplated by Rule 4111. Regulatory actions do not present the same set of economic incentives to pursue unsubstantiated claims, but a significant percentage of both regulatory investigations and criminal proceedings are ultimately either discontinued without action by the regulatory agency, dismissed by prosecutors prior to trial, or dismissed by a court or other fact-finding body. Allegations are fundamentally different from decisions of courts or hearing panels. Including unadjudicated events in the formula used to determine whether a firm may become subject to restrictions on its activities raises substantial questions about both reliability of the information and the fairness of the process. We would also note that regulatory and criminal proceedings often take long periods of time (multiple years in many cases) to resolve. Firms may become stuck in a "time warp" waiting for pending matters to be concluded. We suggest that the balance in this instance militates in favor of excluding all categories of pending or unadjudicated events from the screening criteria.

There is also a practical reason why unadjudicated events are best excluded from consideration. Rules 4111 and 9559 provide for an expedited hearing process of which Restricted Firms may avail themselves if they disagree with a FINRA determination about a requirement to post deposits of cash or securities. Even if FINRA does not rely on unadjudicated events in presenting its case at such hearings, the respondent/Restricted Firm may seek to introduce evidence regarding the criteria on which the firm ended up being designated a Restricted Firm in the first place, suggesting either bias in the process or that FINRA has not applied its own rules correctly. This will result in large amounts of time being devoted to introduction of evidence regarding facts that are not relevant to the proceeding and delay it's resolution. In situations such as those envisioned by Rule 4111, the appearance of fairness is as important as the substance of the procedural protections. The balance weighs in favor of excluding all unadjudicated events from the review process.

b. Termination and Internal Review Events

Section (i)(4)(C) of Proposed Rule 4111 provides that events relating to terminations of registered persons go into the initial determination of which firms meet the threshold for Restricted Firms. This raises two separate issues:

i. Situations in which individuals are terminated, resigned after allegations, or where there are pending or closed internal reviews by the member firm. Reporting of these events by member firms is mandated by FINRA rules, but member firms must balance their reporting obligations with concerns regarding claims for defamation or wrongful termination by representatives who may allege that their terminations were either unjust or motivated by improper motives on the part of the firm. The representative may have an opportunity to discuss the circumstances leading to their termination, but the firm often submits the information without the individual having an opportunity to change or contest it until after the fact. As discussed above, the most important criteria for including any category of events in determining which firms may be subject to restrictions is it's reliability. The process and considerations that go into termination of representatives and initiation and conclusion of internal reviews create issues in that regard.

ii. If member firms believe that they may be nearing the numerical threshold for events that could subject them to Restricted Firm status, they may not report adverse employee actions such as terminations for cause or internal reviews. These determinations are inherently based on the judgment of the individuals making them, and a justification for any action can generally be made after the fact. It is not in the interest of any of the constituents in this exercise to create incentives for member firms not to report employment-related actions accurately. We believe that this would create such an incentive.

c. Persons Associated with Previously Expelled Firms

Proposed Rule 4111 (i)(4)(f) includes as one of the criteria for determining Restricted Firm status the number of registered individuals who have been associated with firms that have previously been expelled from FINRA membership. We recognize that there have been instances in which FINRA members firms were run inappropriately and utilized sales practices or other practices that created risk for investors. Many of these firms have been expelled from FINRA membership with good reason, and many of their affiliated representatives deserved the same fate. However, many such firms have made a practice of recruiting representatives who had little or no prior background in the securities industry and were taught bad habits before they had enough experience to know better. If the firm with which a representative was formerly associated is expelled from FINRA membership, other FINRA members may be unwilling to hire them for fear that it will cause them to meet one or more of the criteria for becoming a Restricted Firm. This may create an unfair "guilt by association" for individuals who have been employed by bad firms in the past but have not engaged in wrongdoing themselves. This raises issues of both procedural fairness and restriction on the ability of individuals to make a living. Both should be considered carefully.

2. <u>Procedural Safeguards and Protections</u>

Rule 4111 would give FINRA a new and powerful ability to impose potentially far-reaching restrictions on the conduct of member firms. We support both the spirit and letter of this initiative.

That being said, in order for it to accomplish the desired results, the entire process must be viewed as striking the appropriate balance between investor protection and procedural fairness for member firms who meet the initial screening criteria. For these reasons, we suggest that Rule 9559 include the following provisions:

a. **Decision Makers -** All contested hearings should be conducted by a hearing panel consisting of both industry members and a Hearing Officer. Fairly or not, Hearing Officers are often viewed as extensions of FINRA Enforcement, and therefore not as objective as hearing panels. Requiring that all cases be decided by a panel including two industry members will mitigate this perception. It would also bolster confidence in the level of expertise available with respect to matters that are technical in nature. Three heads are better than one in this instance.

b. **Hearing Process -** Rule 9559 provides for expedited hearings in instances where the Restricted Firm disagrees with the initial determination of FINRA staff. This is a necessary provision because firms need certainty in order to operate their businesses and extended delays create uncertainty. However, Rule 9559 provides that hearings must be conducted in as little as five days after the firm receives a notice regarding having become subject to Restricted Firm status. This strikes us an unreasonably short period of time. Many firms that become subject to these proceedings are likely to be small and lacking the resources necessary to prepare for a hearing on such short notice. In many cases, they will require the assistance of legal counsel or other experts, all of whom require time to familiarize themselves with the factual and other background of the case. In order to promote the perception of fairness and give firms an opportunity to prepare, we suggest that Rule 9559 establish a presumption that a hearing would be conducted within a specified period of time after notice of the determination, but that it could be extended for a reasonable period of time (perhaps 30 days) upon a request from the firm and showing of reasonable cause.

3. Public Notice of Restricted Firm Status

There will certainly be instances in which member firms go through the process set forth in Rules 4111 and are required to post deposits or submit to other restrictions on their conduct. This is an appropriate result in most cases, but public disclosure of such status will have undesirable collateral consequences. Any determination of Restricted Firm status should not be publicly announced by FINRA or become subject to discovery by third parties in other proceedings. This is true for several reasons:

a. Rule 4111 is intended to create a mechanism to vindicate the rights of FINRA to impose appropriate restrictions on the conduct of members and enhance investor protection. These are both important and laudable goals. However, if decisions regarding restrictions on member firms' activities become known to the public, they may create a perception of financial weakness or a propensity for the firm to commit bad acts, and lead to a "run on the bank" scenario in which many customers of the firm decide to close their accounts. This will have the perverse effect of making the firm less financially viable and more likely to fail.

Many FINRA members operate with minimal excess net capital, especially if they do not hold customer funds or securities. The provisions of Rule 4111 establish limits on the amount of the deposit that FINRA may require after a finding that a firm become a Restricted Firm, but they may still be in excess of the practical ability of the firm to supply them. The ability of a firm to meet its obligations often depends on its ability to survive as a going concern. In some cases, the amount of the deposit will be insufficient to meet all prospective claims of customers or other creditors, and the only means by which to ultimately satisfy such claims is for the firm to remain in business. Anything that adversely impacts that ability should be considered carefully.

b. Many FINRA member firms have been subject to public campaigns from claimants representatives seeking to induce firm clients to bring claims for damages. These representatives, including attorneys, often post advertisements seeking individuals who have done business with firms and encourage them to contact the attorney and institute a claim against the firm.

If a Claimant's representative becomes aware that a firm has become a Restricted Firm, they may be more inclined to increase their advertising or other promotion in order to generate revenue for themselves or to make it more likely that the claims of their clients are satisfied before the assets of the firm are dissipated. This may lead to the "run on the bank" scenario mentioned above. In addition, claimants' representatives may use the fact that a firm has been designated a Restricted Firm to suggest that the firm has engaged in wrongful conduct for which the customer may be entitled to compensation. This raises questions of both fairness and the effectiveness of Rule 4111. If it promotes more claims, it may well diminish the pool of assets available to satisfy customer claims rather than increasing it and undermine its own aims.

It can be argued that the determination that a FINRA member become a Restricted Firm would be material to a current or prospective customer. However, if disclosure of that fact makes it more likely that a firm will fail or otherwise be less likely to meet its obligations to customers, it fails to strike the correct balance between investor protection and the right of the public to know.

4. <u>Other methods to accomplish the goals of Rule 4111</u>

We agree with the intent and the general methodology of Rules 4111 and 9559. We believe that they represent a reasonable approach to a persistent problem that has negative effects on both investors and the securities industry in general. However, we believe that FINRA should also consider other means by which to accomplish these objectives. They include:

a. **IIROC Consolidated Rule 9208**. Subject to our comments about the need for procedural fairness, we believe that FINRA should consider the approach taken by IIROC Consolidated Rule 9208 as an alternative to that of Rule 4111. The circumstances that Rule 4111 is intended to address are sufficiently severe and arise infrequently enough that they may justify the use of such authority by FINRA. Substituting the expertise and discretion of FINRA staff for the more quantitative approach set forth in Rule 4111 strikes us as reasonable in these limited circumstances, and perhaps ultimately more fair and efficient for the process as a whole. We suggest that additional study of the merits and burdens of such an approach be undertaken.

b. **Financial responsibility.** Rule 4111 gives FINRA authority to require firms to post cash or other assets, with the goal of modifying their behavior and demonstrating their ability to meet their obligations to customers and others. This has benefits, but some firms may not have immediate access to cash or other acceptable assets and may need an interim or other method to satisfy these requirements. We therefore suggest that FINRA consider additional means by which Restricted Firms can satisfy these obligations through third-party guarantees such as performance bonds or insurance. These would have to be subject to appropriate terms and conditions, but may offer flexibility that is lacking in the current version of Rule 4111.

c. **Ongoing review.** The terms of Rule 4111 create extraordinary and unprecedented authority for FINRA. While we believe that this is necessary and justified, FINRA is embarking on an uncharted journey that may have unanticipated effects. We therefore suggest that Rules 4111 and 9559 include requirements that they be at reviewed at specified intervals (every three or five years, for example) to determine whether or not they are meeting their objectives in the most efficient way. While we are not aware of similar provisions in any current FINRA rule, we submit that such a requirement is justified in this instance.

****

Thank you for providing us the opportunity to submit these comments. If you have questions or I may offer any further information, I can be reached at 619/702-9735 or mark.quinn@cetera.com.

Sincerely,

Mark Quinn

We have net capital requirements. We have the U4 disclosures. We have Brokercheck. And now FINRA wants to enact this Rule 4111, which reads like a highly passive-aggressive piece of rulemaking. If there are people FINRA wants out of the industry, just bar them and be done with it. Stop playing these games where firms are “incentivized” to do FINRA’s dirty work by imposing a glass wall de-facto bar by giving firms another not so subtle wink and a nudge to refuse association to certain people.

I recommend that the rule not be enacted.

EFS ADVISORS | Navigating Your Financial Future.

Matthew Rothchild
Compliance Officer
EFS Advisors

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Thursday, June 27, 2019

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 19-17
Proposed Rule Amendments Relating to Protecting Investors from Misconduct

Dear Ms. Mitchell:

This letter is being timely filed with FINRA in response to certain proposed amendments identified in FINRA Regulatory Notice 19-17.

Regulatory Notice 19-17 proposes to create a new Rule 4111 that would impose "tailored obligations, including financial requirements, on designated member firms that cross specified numerical disclosure-event thresholds". The expressed aim of proposed new Rule 4111 is to "promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards."

Regulatory Notice 19-17 also proposes to create one new rule, Rule 9559, and to amend an existing rule, Rule 9549, to be renumbered as Rule 9560. Both the new rule and amendments aim at creating an expedited proceeding for review of determinations under new Rule 4111, including granting a member the right to challenge any obligation imposed on the member.

FINRA states it "has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily identify the member firms that are motivating this rule proposal." Network 1 concurs in this assessment: FINRA's analysis is indeed thorough. Network 1 also adjudges that FINRA's intention has been to be fair in its reach for solutions to thorny problems that plague our securities industry.

It is with respect for FINRA's comprehensive effort that Network 1 Financial Securities expresses genuine appreciation for this opportunity to offer its assessment of the proposals set forth in Regulatory Notice 19-17. Accordingly, this Comment Letter will analyze these proposals: first, from the perspective of consistency with FINRA's mission; secondly, from the perspective of consistency

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with principles of jurisprudence and other criteria higher than this mission; and lastly, from the perspective of an industry member's concerns. With these concerns in mind, Network 1 will offer recommendations to address what we have identified as shortcomings that have come to light as a result of our analysis.

Network 1 Financial Securities is an industry member that has been engaged primarily in investment banking and secondarily in securities brokerage, since 1983. Network 1's predominant business lines are underwriting, retail sales of OTC equities, proprietary trading, and market making.

1. Whether Proposed Rule 4111 (relating to Restricted Firm Obligations) is Consistent with FINRA's Mission.

Under proposed new Rule 4111, member firms that present heightened risk of harm to investors, meeting the criteria for the definition of, and deemed, in the final analysis, to be a "Restricted Firm", would be subject to:

- A "Restricted Deposit Requirement" – a "Restricted Firm" would be obligated to maintain a in a Restricted Deposit Account a Restricted Deposit Requirement calculated at the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year.[1]

- A deposit of cash and/or qualified securities in a segregated account at a bank or clearing firm from which the "Restricted Firm" could make withdrawals only with FINRA's approval.[2]

In support of this proposal, FINRA has set up a well-thought-out process for evaluating whether a potentially problem member firm is actually a firm that presents heightened risk of harm to investors, and therefore is firm that should be classified as a "Restricted Firm". It is quite apparent that the various "numeric, threshold-based criteria and several additional steps"[3] – a multi-step process – utilized by the Rule 4111 process, is aimed at "guard[ing] against misidentification"[4] of a member firm as a "Restricted Firm".

[1] Regulatory Notice 19-17, pp. 15, 19.

[2] Regulatory Notice 19-17, p. 6.

[3] Regulatory Notice 19-17, p. 6.

[4] Regulatory Notice 19-17, p. 6.

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Given that FINRA's mission is "to provide investor protection and promote market integrity";[5] and, because this proposed new Rule 4111 attempts to "identify members that present a high risk" while at the same time "limiting itself from improperly imposing obligations on firms whose risk profile and activities do not warrant such obligations", proposed Rule 4111 is consistent with FINRA's mission and, on the whole, appears to be both balanced and fair on the basis of these two perspectives.

2. Whether Proposed Rule 4111 is Consistent with Principles of Fundamental Law.

To answer the question whether these proposals are, *objectively*, truly fair and balanced as defined by higher principles – as distinct from FINRA's stated mission – these proposed amendments must be judged by principles that are fundamental to American jurisprudence.

Perhaps not appreciating the consequences of admitting so, FINRA makes this revealing statement:

> "FINRA has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily *identifying the member firms that are motivating this rule proposal.*"[6] (Emphasis supplied)

Elsewhere, FINRA reaffirms the genesis of *what motivates* FINRA to propose this new Rule 4111:

> " . . . as of year-end 2018, there were 20 small firms (i.e., firms with no more than 150 registered persons) with 30 or more disclosure events over the prior five years, 10 mid-size firms (i.e., firms with between 151 and 499 registered persons) with 45 or more disclosure events over the prior five years, and five large firms (i.e., firms with 500 or more registered persons) with 750 or more disclosure events over prior five years."[7]

And finally, FINRA explains *for whom* this new Rule 4111 is *specifically targeted*:

> ". . .based on recent history FINRA *expects* that its annual calculations *will identify* between 60-98 members that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]."[8]

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[5] https://www.finra.org/about/our-mission.

[6] Regulatory Notice 19-17, p. 11.

[7] Regulatory Notice 19-17, p. 3-4.

[8] Regulatory Notice 19-17, p. 9.

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In other words, the proposed new Rule 4111 is not motivated so much to be a generic rule for the entire membership as it is motivated to be a carefully tailored rule targeted for – indeed, *restricted* to – a specific subset of the membership, intended to solve a regulatory crisis for which traditional enforcement now (apparently) no longer works (according to FINRA).[9] Appropriately enough, this proposed new Rule 4111 is called the "*Restricted* Firm Obligations" rule.

This proposed new Rule is motivated to *identify that specific subset* of the membership that, even before the proposed new rule is submitted to the Securities and Exchange Commission (SEC) for review and approval, FINRA *already* knows falls into the "restricted firm" category.

In short, FINRA *knows as of this writing* which members (those "60-98 members that meet the Preliminary Criteria for Identification") *are already "guilty" of being "Restricted Firms".*

This "governmental"[10] motivation in targeted rule-making, limited to a very specific group, meets the classic definition of a Bill of Attainder, a legislative act that violates constitutional and therefore fundamental law.

3. <u>What a Bill of Attainder Is</u>

A Bill of Attainder is a "legislative act which inflicts punishment without a judicial trial."[11]

It was common in early English history that Bills of Attainder – generally originating in Parliament in the sixteenth century – were aimed at "inflict[ing] their deprivations upon relatively large *groups* of people."[12]

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[9] *See e.g.*, Regulatory Notice 19-17, p. 4, where FINRA states: "Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council (NAC), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel imposes a significant sanction, the firm can forestall its effectiveness through the appeals process, because sanctions are stayed during appeals to the NAC and potentially the SEC. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership, limiting FINRA's jurisdiction and *eliminating the leverage that FINRA has to incent the firm to comply with the sanction, including making restitution to customers.*" (Emphasis supplied)

[10] It is understood and fully appreciated that FINRA maintains that it is not a "governmental" agency. This issue is analyzed in depth in Section 9 of this Comment Letter. For the time being, it will be assumed for the sake of argument that FINRA is a "governmental" agency as we work our way through the analysis of the issue, whether proposed new Rule 4111 is a Bill of Attainder.

[11] <u>Cummins v. Missouri</u>, 71 U.S. (4 Wall.) 277, 323 (1866). A bill of attainder includes "legislative acts which take away the life, liberty, or property of particular names [or easily ascertainable] persons [or group of persons] because the legislature thinks them guilty of conduct which deserves punishment." <u>U.S. v. Lovett</u>, 328 U.S. 303, 317 (1946).

[12] <u>U.S. v. Brown</u>, 381 U.S. at 461. (Emphasis supplied)

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Some early English Bills of Attainder "named the parties to whom they were to apply", while "*some simply described them.*"[13]

During the American Revolution, several state legislatures resorted to bills of attainder to punish Tories for their loyalty to the British Crown and, in the course of scrupulously *disregarding* due process rights, confiscated Tory property.[14]

It bears noting that some of these early English Bills of Attainder left the targeted parties a way to escape the penalty, while others did not.[15] That said, the U.S. Supreme Court has held from-the-get-go that "escapability" is not an "absolute prerequisite" to a finding of attainder because "[s]uch an absolute rule would have flown in the face of explicit precedent [referring to *Cummins v. Missouri*] as well as the historical background of the constitutional prohibition."[16]

In *Cummins v. Missouri,*[17] the U.S. Supreme Court decided a pair of cases that establish present day precedent for what constitutes a violation of the constitutional prohibition against Bills of Attainder. In *Cummins,* the Court took up the issue whether the requirement of an oath of loyalty as a prerequisite to practicing one's profession constitutes a violation of the constitutional prohibition against Bills of Attainder. Reaching its decision, the Court found that the fundamental and unusual characteristics of a bill of attainder consists in (1) the deprivation livelihood in connection with one's profession (2) this deprivation being imposed on a person or *group* of persons, and (3) this deprivation being imposed without the safeguards of a judicial trial.[18]

In *United States v. Lovett,*[19] the U.S. Supreme Court took up the issue of the legislature's attempt to weed out "subversives". The Court reviewed the Urgent Deficiency Appropriation Act of 1943[20] and

[13] U.S. v. Brown, 381 U.S. at 442. (Emphasis supplied)

[14] U.S. v. Brown, 381 U.S. at 442.

[15] Cummins v. Missouri, 71 U.S. (4 Wall.) 277, 324 (1866): "A number of ante-Constitution bills of attainder inflicted deprivations upon named or described persons or groups, but offered them the option of avoiding the deprivations."

[16] U.S. v. Brown, 381 U.S. 437, at 457 n.32.

[17] Cummins v. Missouri, 71 U.S. (4 Wall.) 277, 324 (1866).

[18] Cummins v. Missouri, 71 U.S. (4 Wall.) at 315, the Court holding that an oath of loyalty has "no possible relation to fitness ***"

[19] U.S. v. Lovett, 328 U.S. 303 (1946).

[20] Specifically, The Urgent Deficiency Appropriation Act of 1943 permanently prohibited specifically named individuals from receiving any further compensation from their government jobs, and prevented them from further employment in government service, other than as jurors or soldiers.

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found an extensive legislative history that revealed the true purpose of this piece of legislation: To "*purge*" government agencies of government employees that Congress deemed "*unfit*". In the end, the Court held that the Act was a bill of attainder prohibited by the Constitution.

In *United States v. Brown*,[21] the U.S. Supreme Court reviewed §504 of the Labor-Management Reporting and Disclosure Act of 1959,[22] which made it a crime for a member of the Communist Party to serve as an officer or employee of a labor union. *Brown* utilized a combination of factors to determine that Section 504 of the Act constituted a prohibited bill of attainder. The following two (2) propositions in *Brown* are relevant to Regulatory Notice 19-17:

- "[T]he legislature made a judgment, undoubtedly *based largely on past acts* and associations ... that a given person or group was *likely to cause trouble* ... and *therefore inflicted deprivations* upon that person or group in order *to keep it from bringing about the feared event*."[23]
- The Court, believing that it would be antiquated to limit punishment to only a retributive purpose, found it appropriate to expand the meaning of "punishment" in order to "serve several purposes; retributive, rehabilitative, deterrent – and *preventative*."[24]

Summing things up so far, a Bill of Attainder exists when a law:

A. Passes judgment about who is "*unfit*" to engage in a profession.
B. Bases this judgment largely on the group's "*past acts*" of *causing trouble*.
C. Creates criteria to define who is "unfit" and then targets a "*group*", especially a subset within a given profession, to match such criteria.
D. Deems punishment[25] – e.g., *deprivation of livelihood* – absolutely necessary to keep that group from bringing about events that the legislator fears will recur, again and again– e.g., past acts of causing trouble – *if not prevented*.
E. Punishes without a judicial trial.

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[21] U.S. v. Brown, 381 U.S. 437 (1965).

[22] 29 U.S.C. §504 *1958 & Supp. IV).

[23] U.S. v. Brown, 381 U.S. at 458-59.(Emphasis supplied)

[24] U.S. v. Brown, 381 U.S. at 458.(Emphasis supplied)

[25] *See* Nixon v. Adm'r of Gen. Serv., 433 U.S. 425, at 538 (1977) (Burger, C.J., dissenting ("Those two cases [*Cummins v. Missouri* and *Ex Parte Garland*] established more broadly that 'punishment' for purposes of bills of attainder is not limited to criminal sanctions.")

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Any legislation that encompasses these elements is, as per *Cummins v. Missouri, United States v. Lovett,* and *United States v. Brown,* a bill of attainder whenever it inflicts punishment without a judicial trial. All these elements will be discussed in this Common Letter in relation to the elements of proposed new Rule 4111.

4. Elements of Proposed New Rule 4111 that Trigger Bill of Attainder Considerations

4.A Background Discussion to Proposed New Rule 4111 and the First Element[26] of Bills of Attainder:

FINRA has expressly judged a subset of member firms and their brokers who have engaged in a certain *history of misconduct* to be, by implication, *unfit* to participate in the securities industry:

> "FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and member firms that have *a history of misconduct*. * * * While these firms may eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with *a history of misconduct* that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers. * * * Such firms *expose investors to real risk.* For example, FINRA has identified certain firms that have a concentration of individuals with *a history of misconduct*, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. * * * [I]ndividuals and firms with *a history of misconduct* can pose a particular *challenge for FINRA's existing examination and enforcement programs*. * * *"[27]

No one can within reason dispute that firms and brokers who exhibit a history of misconduct should be disciplined, even severely when facts surrounding this misconduct support severe measures.

What is disputed is that a new rule that amounts to a Bill of Attainder should be allowed to replace the existing disciplinary process, even when that system evidences difficulties in being as effective as it could be.

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[26] That is, when a Legislator passes judgment about who is "*unfit*" to engage in a profession.

[27] Regulatory Notice 19-17, p. 3, 4. (Emphasis supplied)

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In Regulatory Notice 19-17, FINRA appears to be saying that its disciplinary process is presently experiencing ineffectiveness, and thus justifying proposed new Rule 4111:

> "Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby *effectively forestalling the imposition of disciplinary sanctions for an extended period.* * * * Temporary cease and desist proceedings *do not always provide an effective remedy* for potential ongoing harm to investors during the enforcement process. [citation omitted] * * * When FINRA is ready to pursue enforcement action against such a firm, a temporary cease and desist order *may not be available* (since many circumstances are not within the scope of that authority) or *may not enable more rapid intervention* (since the disciplinary complaint must be ready to be filed at the same time). While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm *can further prolong the disciplinary action* by litigating through the stages described above. * * *"[28]

Because this ineffectiveness or inefficiency (if this is what FINRA is saying) of the present disciplinary process is at the point where no-return-to-"good order and discipline" is possible without imposing an extreme remedy, one gets the sense that FINRA desires this proposed new Rule 4111 to, not only "fix", but to go one step further and *replace* the existing FINRA disciplinary process. The disciplinary problem for which FINRA seeks a practical, albeit draconian, solution is stated succinctly by FINRA:

> "Enforcement actions in turn can *only* be brought *after a rule has been violated*—and any resulting customer harm has already occurred. * * *"[29]

FINRA believes the present disciplinary crisis justifies creating an alternative (emergency?) process for *preventing misconduct before it happens in the future*. But this way of going about righting a wrong violates every established canon in American jurisprudence.

These considerations support the conclusion that proposed new Rule 4111 satisfies the 1st element of a Bill of Attainder, namely, the legislator passing judgment as to who is "unfit" to engage in a

[28] Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[29] Regulatory Notice 19-17, p. 4. (Emphasis supplied)

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profession. Adjudging an individual or group as unfit for employment – here, employment in the securities industry – is a punitive measure[30] that opens the door for Bill of Attainder consideration.

According, we turn to the second element, legislation that is based largely on a particular group's "past acts" of causing trouble.

4.B <u>Annual Calculation of Preliminary Criteria for Identification as "Restricted Firm [Proposed New Rule 4111(b)]; Initial Department Evaluation [Proposed Rule 4111(c)(1)]and the Second Element[31] of Bills of Attainder:</u>

Proposed new Rule 4111 will allow FINRA to determine whether certain "past acts" giving rise to a "history of misconduct" – in other words, acts of causing trouble – give FINRA just cause to judge a member firm to be a Restricted Firm, a least preliminarily.

Under the proposed new Rule, FINRA can include nineteen (19) factors in its "preliminary identification" formula: Eleven (11) acts of causing trouble committed by registered representatives[32]

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[30] Such judgment is punitive in nature in the case at hand precisely because the misconduct supporting this regulatory "judgment" is *superimposed* on an individual or group who has already been subjected to an enforcement process that has concluded and has resulted in a punishment (e.g., censure, suspension, fine, etc.) imposed. When misconduct continues, indeed to such level of severity, the appropriate next step, logically, should be proceeding in a *separate* enforcement action against the firm and/or the broker *for termination*. This is the sacrosanct due process path long-established in American jurisprudence. Instead (and we are admittedly jumping ahead of ourselves here) the proposed new Rule 4111 seems to be a substitute for "this logical next step". Indeed, in place of additional fines and even termination, the proposed new Rule 4111 intends to place on those firms having a "history of misconduct" *extraordinary* compliance and financial burdens (beyond existing compliance and financial requirements) that aim at producing the desired effect of motivating firms to take it upon themselves to simply leave the securities industry. This is a kind of "soft" punishment. *See* Alexis de Tocqueville, <u>Democracy in America</u>, "If despotism were to be established among the democratic nations of our days, it might assume a different character; *it would be more extensive and more mild*; it would degrade men without tormenting them." (New York: Alfred Knopf, 1966), vol. 2, book fourth, Ch. 6 (Emphasis supplied). This kind of "soft" punishment opens the door for Bill of Attainder consideration because Rule 4111 appears to be a "legislative act which inflicts punishment without a judicial trial" as per <u>U.S. v. Brown</u>. All elements of the definition of Bill of Attainder will be addressed at length throughout this Comment Letter.

[31] That is, when a Legislator basing its judgment (that a particular subset of a member group is "*unfit*" to engage in a profession) largely on the subset group's "*past acts*" of *causing trouble*.

[32] Registered Representative disclosure events include <u>all</u> of the following:

(i) A final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party or was a "subject of" the customer arbitration award or civil judgment.

(ii) A final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil judgment settlement or a settlement prior to a customer arbitration or civil litigation.

(iii) A final investment-related civil judicial matter that resulted in a finding, sanction or order.

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and eight (8) acts of causing trouble committed by the member firm[33] in question, regardless whether the acts of trouble in question are adjudicated (final, in other words) or pending.

This is but a partial list of criteria -- acts of causing trouble -- that proposed new Rule 4111 will allow, indeed will compel -- FINRA to include in its "preliminary identification" formula so that FINRA can comply with all the requirements, including the punitive directives, of this proposed new Rule.

In addition to the nineteen (19) acts of causing trouble just mentioned, FINRA can -- indeed, "must", in order to comply with the spirit of proposed new Rule 4111 -- include two (2) internal review

(iv) A final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(v) A criminal matter in which the registered person was convicted of or pled guilty or *nolo contendere* (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(vi) A pending investment-related civil judicial matter.

(vii) A pending investigation by a regulatory authority.

(viii) A pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(ix) A pending criminal charge associated with any felony or any reportable misdemeanor.

(x) A termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations.

(xi) A pending or closed internal review by the member.

[33] Member firm disclosure events include all of the following:

(i) A final investment-related, consumer-initiated customer arbitration award in which the member was a named party.

(ii) A final investment-related civil judicial matter that resulted in a finding, sanction or order.

(iii) A final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(iv) A criminal matter in which the member was convicted of or pled guilty or *nolo contendere* (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(v) A pending investment-related civil judicial matter.

(vi) A pending investigation by a regulatory authority.

(vii) A pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(viii) A pending criminal charge associated with any felony or any reportable misdemeanor.

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events[34] as well as an admittedly open-ended "Registered Person Associated with Previously Expelled Firms" category.[35]

But there is a significant proverbial fly-in-the-ointment. Consider, in regards to this category, "Registered Person Associated with Previously Expelled Firms", a hypothetical Compliance Analyst:

(a) Having no personal history of misconduct on his personal CRD BrokerCheck record who gets hired in "year 1" by a broker/dealer that gets expelled within five months of hire; and,

(b) Who is then hired by a second broker/dealer within the same "year 1" – again, having no personal history of misconduct – finds himself again unemployed because his second firm is expelled within the of the same "year 1" * * *

This Compliance Analyst will in the new year bring with him to his new firm (the third broker/dealer in this hypothetical) two (2) acts of causing trouble – his association with two (2) expelled firms – that can be counted in FINRA's "preliminary identification" formula against the third broker/dealer.[36]

This conceivably could happen even though this individual is just a "compliance person" (as opposed to salesman/broker), having a lily white clean record, having never sold a securities product to a securities customer, and therefore never having experienced a customer complaint or customer related arbitration.

Thus, all told, FINRA can – perhaps, "must" – call into play the "twenty-one-plus (21+) acts of causing trouble" when calculating FINRA's "preliminary identification" formula[37] of a potential "Restricted Firm".[38]

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[34] *See* proposed new Rule 4111(i)(C): "Registered Person Termination and Internal Review Events" means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms:

(i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations; or

(ii) a pending or closed internal review by the member.

[35] *See* proposed new Rule 4111(i)(F): "Registered Persons Associated with Previously Expelled Firms" means any registered person registered for one or more days within the year prior to the Evaluation Date with the member, and who was associated with one or more previously expelled firms (at any time in his/her career).

[36] True, the firm for this hypothetical Compliance Analyst can engage in the "rebuttal" process – the Consultation process – of Proposed Rule 4111(d)(1)(A). But it is anything but clear that FINRA has presented in Regulatory Notice 19017 an Economic Impact and Cost Impact *for the member firm*, especially if the member firm finds itself being aggressively, if not unfairly, treated and needing to hire outside legal counsel to represent its interests in this Consultation process. The potential for unfair treatment in the overall process posed by proposed new Rule 4111 is elsewhere treated in this Comment Letter.

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These considerations support the conclusion that proposed new Rule 4111 satisfies the 2nd element of a Bill of Attainder, namely, the legislator passing judgment on a group's "past acts" of causing trouble.

Accordingly, we turn now to the third element of a Bill of Attainder, targeting a Group as being "unfit" to participate in a profession.

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[37] There is a very important concern that should be a legitimate concern for the SEC and member firms, alike, as well as for the SRO attempting to arrive at a solution consistent with constitutional principles and principles of natural justice when the formula being created to determine who is and who is not a bad broker lacks identification of the algorithm being employed in the process. FINRA admits that "[i]n developing the proposal, FINRA considered the possibility of having a transparent formula, based on some of these factors, to determine a maximum Restricted Deposit Requirement. However, given the range of relevant factors and differences in firms' business models, operations, and financial conditions, FINRA decided not to propose a uniform, formulaic approach across all firms." (*See* Regulatory Notice 19-17 at 29). Let's use the example of the just-mentioned Compliance Analyst from an expelled firm. If the algorithm is known only to FINRA, then FINRA is at liberty to assign this Compliance Analyst a "10" (on a scale of 1 to 10, where a 10 is a "really bad" actor) if the Compliance Analysis takes a position with one of the firms that FINRA has already identified as a "high risk" member firm; but if the Compliance Analyst takes a position at a large firm, FINRA is also at liberty to assign this same Compliance Analyst a "1" (We already know from FINRA's Exhibit D-2 to Regulatory Notice 19-17 that no Large Firms have been deemed, preliminarily, to be a "high risk" firm.) The issue here is not so much what FINRA states in the above quoted passage – namely, that relevant factors and differences in firm's business models, operations, and financial conditions prevent the possibility of a uniform formulaic approach – as it is the fact that FINRA justifies this obstacle as *justification* for *not needing* to be transparent to a subject firm about the algorithms employed by FINRA either before or after a preliminary or final determination that the subject firm is deemed by FINRA to be a "Restricted Firm". Not having this information, certainly prior to a subject firm's decision to exercise its right of expedited appeal to the Hearing Officer, will invariably adversely affect the firm's ability to prepare itself and its legal defense team for a hearing on the "expedited appeal". Equally if not more importantly, not having this information will invariably "act as a prior restraint" on the subject firm's decision to exercise its right of expedited appeal – this decision will invariable rest on firm's assessment of the high costs of legal defense, an assessment that needs to be made in conjunction with the firm's being precluded from using a considerable amount of its otherwise available net capital to pay these defense costs because the "deposit" required during the pending appeal will prevent the firm from using all of its net capital resources. If FINRA had not anticipated these possibilities, this alone should be sufficient reason for withdrawing proposed new Rule 4111 at this time. If FINRA has anticipated these possibilities, but built this "chilling effect" into the Rule 4111 process in order to accomplish the regulatory mission of ridding the membership of the problematic firms outside the regular course of Enforcement Proceedings in order to remove "significant time" element that these proceedings involve (e.g., see page 4 of Regulatory Notice 19-17), then this *specific intent* is even more disconcerting.

[38] There is an equally troubling concern that does not appear to be addressed in the "formula" or in Regulatory Notice 19-17: How is the member firm going to be looked at by FINRA when: (1) a broker has "skeletons in the closet" that do not become revealed until the tail end of the running of the six (6) year statute of limitations; (2) the broker has been hired by a member firm that is not otherwise a "high risk" firm; (3) the member firm hired the broker five (5) years prior to the running of the six-year statute of limitations; and (4) the broker has no customer complaints or other red flags during his tenure with the member firm that may now become a subject firm for purposes of proposed new Rule 4111? Will this member firm be penalized under the regime of proposed new Rule 4111 by operation of "looking backwards" instead of "looking forward" in regards to the several DRPs (i.e., Disclosure Reporting Pages) that are at play in Rule 4111?

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4C. Annual Calculation of Preliminary Criteria for Identification [Proposed Rule 4111(b)]; FINRA's Exhibit "D-2" and the Third Element[39] of Bills of Attainder:

As stated previously, FINRA is clear *for whom* this new Rule 4111 is specifically targeted:

> ". . .based on recent history FINRA expects that its annual calculations will identify *between 60-98 members* that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]." [40]

The Preliminary Criteria referenced above is justified on an annual calculation of a member firm's "Preliminary Identification Metrics", which, in turn, is itself built on quantitative risk-based thresholds. [41]

These thresholds are indeed "quantitative"; they consist of "the sum of pertinent disclosure events or, for the Expelled Firm Association category, the sum of Registered Persons Associated with Previously Expelled Firms."[42]

"Quantitative" is something that is susceptible of measurement[43] and therefore "quantitative", in the context of proposed Rule 4111, refers to data that FINRA has already collected on its member firms and their brokers in connection with *past events*, even if some of these past events are still *pending*.[44]

Stated differently, FINRA is crafting a new rule that is tailor-made to fit a particular segment of the FINRA member firm population that FINRA intends to identify as "meet[ing] the Preliminary Criteria for Identification" on the path to being ultimately identified as a "Restricted Firm".

FINRA (via proposed new Rule 4111) knows *today* which members (those "60-98 members that meet the Preliminary Criteria for Identification") are already "guilty" of being "Restricted Firms" ... once the rule is *in the future approved* (if approved) by the SEC.

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[39] That is, when a Legislator creates criteria to define who is "unfit" and then targets a "*group*", especially a subset within a given profession, to match such criteria the criteria to convict or find a violation of the rule created by the Legislator.

[40] Regulatory Notice 19-17, p. 9.

[41] Regulatory Notice 19-17, p. 7.

[42] Regulatory Notice 19-17, p. 8.

[43] https://www.vocabulary.com/dictionary/quantitative

[44] Regulatory Notice 19-17, p. 8, 9, 33, 38.

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This assumption is made quite clear in FINRA's Exhibit "D-2" to Regulatory Notice 19-17, which is reproduced immediately below:

Attachment D-2: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size*

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification						
		Small	Mid-Size	Large	Total	Small	Mid-Size	Large
		Number of Firms				Percent of Total		
2013	4,140	84	4	1	89	94%	4%	1%
2014	4,068	92	4	2	98	94%	4%	2%
2015	3,941	79	5	2	86	92%	6%	2%
2016	3,835	61	5	1	67	91%	7%	1%
2017	3,721	54	6	0	60	90%	10%	0%
2018	3,582	55	6	0	61	90%	10%	0%

* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st. 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.

Based on this graphic that FINRA has incorporated into Regulatory Notice 19-17, FINRA has already identified, as of May 2nd 2019,[45] fifty-five (55) small firms and six (6) medium-sized firms being "Restricted Firms", of course subject to all the protections that FINRA sets forth in proposed new Rule 4111 that FINRA believes in earnest cuts constitutional muster.

The constitutional question is this: Did FINRA *blindly* craft proposed new Rule 4111 with its "numeric threshold based criteria and several additional steps that would guard against misidentification"?[46] That is, did FINRA craft its proposed new rule first, *and then after the final draft was completed* undertook an analysis to determine which member firms would be adversely affected by the elements set forth in proposed new Rule 4111? *Or*, was the proposed new Rule crafted with these sixty-one (61) small and medium sized firms *specifically in mind* during the drafting of this Rule?

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[45] That is, the date of Regulatory Notice 19-17.

[46] Regulatory Notice 19-17, at 6.

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As an aside, one thing is very clear from FINRA's Exhibit "D-2" to Regulatory Notice 19-17: ***Every large FINRA member firm avoids the enhanced regulatory and financial challenges*** of proposed new Rule 4111. The important and fair question is: Was this outcome ***intentional or serendipitous***?

Meaningful discussion of Bills of Attainder always begins with the seminal U.S. Supreme Court decision, United States v. Brown.[47] Right out of the gate, the Court quotes Alexander Hamilton, that constitutionalist par excellence and author of the majority of essays in The Federalist Papers:

> "Nothing is more common than for a free people, *in time of heat* and violence, *to gratify momentary passions* by letting into the government *principles and precedents* which afterwards prove fatal to themselves. Of this kind is the doctrine of disqualification, *disfranchisement*, and *banishment* by the acts of the legislature. The dangers consequences of this power are manifest. If the legislature can *disfranchise* any number of citizens at pleasure by *general descriptions*, it may soon confine all the votes to a small number of partisans, and *establish* an aristocracy or *an oligarchy*; it if may banish at discretion all those whom particular circumstances render obnoxious, without hearing or trial no man can be safe, nor known when he may be the innocent victim of *a prevailing faction*. * * *"[48] (Emphasis supplied)

Hamilton's insight has relevance for what small broker/dealer FINRA member firms have been intuiting for quite some time, namely, that the ultimate objective of Regulatory Notice 18-16 and now Regulatory Notice 18-17 as well as other previous rule making efforts, are part of an conscious attempt to eventually drive smaller firms out of the securities business[49] (read: Hamilton's reference to *disenfranchisement*) leaving the large broker/dealers – fewer in number (read: Hamilton's reference to

[47] 381 U.S. 437 (1965).

[48] 381 U.S. at 444, citing The Federalist Papers, No. 48, pp. 383-384 (Hamilton ed. 1880).

[49] *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "* * ****more troubling is the continuing decline in the number of FINRA member firms***. The [2018 FINRA Industry] Snapshot contains data only going back to 2013, and they show a drop in the total number of firms in excess of 10%. If you think that's scary, how about going back ten years, to 2017. In that ten-year period, FINRA lost 1,273 firms, or fully 25.5% of its members. The oldest figures available are from 2003, when FINRA had 5,261 members. By 2017, that number fell by over 29%. ***There have been lots of articles written about the difficulty of running a small broker-dealer today, what with the high cost of compliance and the sheer number of man-hours required each year just to deal with FINRA and its seemingly incessant requests for documents and information. The resultant migration away from FINRA to the investment advisory world is amply demonstrated by the data in the Snapshot.*** From 2008 – 2017, the number of BD-only firms, i.e., firms only registered with FINRA as broker-dealers, dropped 21.1%, from 3,969 to 3,132. Not surprisingly, the number of dually registered BD/IA firms also fell, and by an even greater percentage, 35.9%. During that same time period, however, the number of investment advisor-only firms, i.e., firms registered with the SEC or with the states only as investment advisors (and not registered with FINRA as BDs), increased 22.6%, from 24,147 to 29,599." (Emphasis Supplied) Source: https://www.bdlawcorner.com/2018/08/finra-stats-reveal-horribly-kept-secret-small-firms-are-the-heart-and-soul-of-the-brokerage-industry-but-dying-off-nevertheless/

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oligarchy) than the smaller firms[50] – to become the sole universe with whom investors can choose to invest, making it so much easier for self-regulatory organizations to draft "one-size-fits-all" rules, eliminating the frustration of devising rules that don't (read: Hamilton's reference to *heat of times* and *gratify momentary passions* that become the source of *principles and precedents* as for example Regulatory Notices 18-17 and now 19-17), leading to a membership organization that will finally be one with itself – when the natural synergy between large firms and regulators will become realized.[51]

Hamilton's observation in Federalist No. 44 is the classic statement about the danger that Bills of Attainder pose for representative government, not just at the federal and state level, but also in FINRA governance of its members.

At this point, it is evident that that proposed new Rule 4111 fits the 3rd element of a Bill of Attainder: Targeting a "*group*", especially a subset within a given profession, for punishment.[52]

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[50] *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "Yesterday, FINRA went one better and released what it called the 2018 FINRA Industry Snapshot, basically, an enhanced version of the data already available on the website. There are no real surprises here, especially to those who, well, to anyone who knows anything about FINRA and its history. But, for the few readers who need some reminding, here are the central themes of the new report. ***First, the membership of FINRA is predominantly made up of small firms.*** In 2017, there were a total of 3,726 broker-dealers. Of that total, almost half – 48.3% – had ten or fewer registered reps. If you look at firms with 20 or fewer RRs, then it goes up to 65.4% of the total. Using FINRA's own criteria for firm size, the number of small firms relative to the total is even more telling:

Small Firms (defined as 1 – 150 RRs):	90.00%
Mid-Size Firms (151- 499 RRs):	5.20%
Large Firms (500+ RRs):	4.80%"

(Emphasis Supplied) Source: https://www.bdlawcorner.com/2018/08/finra-stats-reveal-horribly-kept-secret-small-firms-are-the-heart-and-soul-of-the-brokerage-industry-but-dying-off-nevertheless/

[51] *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "* * *But, this is not news. FINRA has always looked like this. It has always been dominated by small firms. Unfortunately, despite their numbers, the revenues they generate for FINRA, even in the aggregate, cannot come close to matching those of the large firms. Thus, while FINRA technically remains a one-firm/one-vote organization, don't delude yourself into thinking it's truly democratic. ***The voices of large firms are heard way more loudly than the small firms because that's where FINRA gets its money from.*** It is no surprise, therefore, that when this report discloses the "Aggregate Financial Information" for the member firms, FINRA does not bother to break the numbers down by firm size. Instead, all we are shown is the total revenue for all firms, the total expenses, and the total pre-tax net income. If FINRA were to publish these data points separately for small firms, mid-size firms and large firms, it would demonstrate ***that the top 5% or so of broker-dealers are responsible for the lion's share of the revenues and the profits, as well as FINRA's own revenues. And that is not something FINRA is comfortable revealing."*** (Emphasis Supplied) Source: https://www.bdlawcorner.com/2018/08/finra-stats-reveal-horribly-kept-secret-small-firms-are-the-heart-and-soul-of-the-brokerage-industry-but-dying-off-nevertheless/

See also Benjamin P. Edwards, The Dark Side of Self-Regulation, 85 University of Cincinnati Law Review 573 (2017): "This Article examines the purportedly public representative serving on FINRA's Board of Governors. It finds that these public representatives often simultaneously serve on the boards of corporate financial intermediaries, giving rise to conflicts of interest between loyalties to market participants and industry lobbying groups and their roles as protectors of the public interest."

[52] Cummins v. Missouri, 71 U.S. (4 Wall.) 277, 315, 324 (1866).

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4D. <u>One-Time Opportunity to Reduce Staffing Levels [Proposed Rule 4111(c)(2)]; Determination of Maximum Restricted Deposit Requirement [Proposed Rule 4111(i)(15)] and the Fourth Element[53] of Bills of Attainder:</u>

FINRA proposes to give a member firm a one-time opportunity to "reduce its staff levels to no longer meet [the Preliminary Criteria for Identification] criteria [as a potential Restricted Firm], within 30 days after being informed by [FINRA's Department of Member Supervision]"[54] that the member firm is at risk for being determined to be a Restricted Firm.

At first glance, this looks like an act of magnanimity on FINRA's part. But as we read later on:

> "If, on the other hand, the Department determines that the member *still* meets the Preliminary Criteria for Identification *even after its staff reductions*, or if the member elects not to use its one-time opportunity to reduce staffing levels, the Department would *proceed to determine the member's maximum Restricted Deposit Requirement*, and the member would proceed to a Consultation with the Department."[55]

In other words, "staff reductions" does <u>not</u> amount to a safe harbor that gives the member firm sanctuary from the "soft" punishments described in footnote 30 to this Comment Letter:

> " . . . in place of additional fines and even termination, the proposed new Rule 4111 intends to place on those firms having a "history of misconduct" *extraordinary* compliance and financial burdens (beyond existing compliance and financial requirements) that aim at producing the desired effect of motivating firms to take it upon themselves to simply leave the securities industry. . ."

And so, even if the member firm timely exercises its "one-time" option and reduces its staff, the member firm does not necessarily avoid this "extraordinary financial burden" that FINRA calls the "maximum Restricted Deposit Requirement".

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[53] That is, when a Legislator deems punishment (e.g., deprivation of livelihood) as being absolutely necessary to prevent a group from bringing about events that the Legislator fears (e.g., past acts of "causing trouble") will recur, if not prevented but will be prevented if this proposed new Rule 4111 is adopted.

[54] Regulatory Notice 19-17, at 11.

[55] Regulatory Notice 19-17, at 12. (Emphasis supplied)

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While the maximum Restricted Deposit Requirement may be barely make an impact to the business of a large firm, it would necessarily be crushing for the small and medium sized firm. Demonstration of this is set forth in FINRA's Exhibit "C" to Regulatory Notice 19-17:

> "* * * the Department would set Firm A's maximum Restricted Deposit Requirement between $500,000 and $1,250,000. Considering the member firm's recent rapid growth through the hiring of persons with disciplinary histories, its primary focus on selling high-risk products,[56] and its ongoing supervisory deficiencies as identified in recent examinations, Firm A's maximum Restricted Deposit Requirement would be set in the high end of the range ($750,000 - $1,250,000)."[57]

While underlying revenue, minimum net capital requirements, and excess net capital will be variable from firm to firm; and while underlying applicable arbitrations awards and settlement may each in their turn may go up, down, or remain steady for any particular firm; and therefore, while these variables may change the maximum Restricted Deposit Requirement outcome for each small to mid-sized firm, the formula of the maximum Restricted Deposit Requirement – "50 % of its restricted deposit requirement or 25% of its average excess net capital over the prior year, whichever is less" – will, in any of these variable scenarios, likely be crushing for a small or mid-sized firm.[58]

In a word, FINRA's Determination of a Maximum Restricted Deposit Requirement (Proposed Rule 4111(i)(15) opens the discussion to whether this proposal serves a legitimate coercive purpose and becomes, instead, punitive in character, giving rise to the argument that proposed new Rule 4111 falls squarely in the category of "vindictive legislation", prohibited by the Constitution[59] and the Courts.[60]

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[56] That is, a broker/dealer whose "predominant business lines are retail sales of OTC equities, underwriting, proprietary trading, and market making."

[57] It is true that in FINRA's example, Firm A's maximum Restricted Deposit Requirement is premised on multifarious factors that may vary from other mid-sized firms. In this scenario, FINRA assumes "revenues [are] derived from self-offerings and private placements. A small percentage of its customers are foreign" and "$175,000 in gross revenues (including $130,000 in commissions) over the past 12 months; ... minimum net capital requirement is $5,000; . . . has maintained excess net capital of $9,000 (average over 12 months). [And] has no unpaid customer arbitration awards or settlements."

[58] This will be true for this sized firm, even after having exercised the "one-time" / "staffing reduction" option, thinking that its Rule 4111 problems will go away.

[59] Article I, Section 9, paragraph 3 provides that: "No Bill of Attainder or ex post facto law will be passed."

[60] Weaver v. Graham, 450 U.S. 24, at 29 (1981): "The ban also restricts governmental power by restraining arbitrary and potentially ***vindictive legislation***. Malloy v. South Carolina, 237 U. S. 180, 237 U. S. 183 (1915); Kring v. Missouri, 107 U.S. 221, at 229 (1983); Fletcher v. Peck, 6 Cranch 87, 10 U. S. 138 (1810); Calder v. Bull, 3 U.S. 386, 395, 396 (Paterson, J.); The Federalist No. 44 (J. Madison), No. 84 (A. Hamilton)." (Emphasis supplied)

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It bears repeating here FINRA's *motivation* for justifying proposed new Rule 4111:

> "Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and *multiple rounds of appeals*, thereby *effectively forestalling the imposition of disciplinary sanctions for an extended period.* * * * While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm *can further prolong the disciplinary action* by litigating through the stages described above. * * *"[61]

In other words, FINRA appears to be saying that it has lost patience with member firms and their brokers who exercise their legitimate rights, as for example taking appeal from adverse enforcement decisions. But the Supreme Court has weighed in on this, stating that:

> "Motives are complex and difficult to prove. As a result, in certain cases in *which action detrimental to the defendant has been taken after the exercise of a legal right,* the Court has found it necessary to *'presume'* an improper *vindictive motive*."[62]

To this general rule, the Court adding the condition: "Given the severity of such a presumption, however — which may operate in the absence of any proof of an improper motive and thus may block a legitimate response to criminal conduct — the Court has done so only in cases in which a *reasonable likelihood* of vindictiveness exists". Responding to this condition, Justice Brennan forcefully writes:

> " ... [in Blackledge v. Perry, 417 U. S. 21 (1974)] we held that the Due Process Clause is violated when situations involving increased punishment "pose a realistic likelihood of vindictiveness,'" Id. at 417 U. S. 27. In such situations, the criminal defendant's apprehension of retaliatory motivation does not amount to an unreal or technical violation of his constitutional rights. On the contrary, as we recognized in North Carolina v. Pearce, 395 U. S. 711, 395 U. S. 725 (1969), "the *fear of such vindictiveness may unconstitutionally deter a defendant's exercise" of his rights*." [63]

In other words, vindictiveness in the wake of the exercise of one's rights is unconstitutional.

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[61] Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[62] United States v. Goodwin, 457 U.S. 368, at 373 (1982). In other words, the Supreme Court would say that proposed new Rule 4111 is very likely vindictive, as evidences by the motive set forth in Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[63] United States v. Goodwin, 457 U.S. 368, at 389 (1982). (Emphasis supplied)

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FINRA's express motive in crafting proposed new Rule 4111 avoids the necessity to discuss whether the Court's "condition" might apply because, for FINRA, some solution – FINRA's proposed new Rule 4111, which is different from traditional enforcement solution – is needed, because

- "While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm *can further prolong the disciplinary action* by litigating through the stages described above."[64]

- "Enforcement actions in turn can *only* be brought *after a rule has been violated*—and any resulting customer harm has already occurred."[65]

FINRA seems to be saying that, because member firms and their brokers exercise their legal rights of appeal, FINRA has no choice but to take action detrimental to defendants / respondents in enforcement proceedings who exercise their appellate rights. The solution for righting this injustice is the proposed new Rule 4111(i)(15): Determination of a Maximum Restricted Deposit Requirement.

FINRA's justification is that something is needed *beforehand – before violations occur*. The problem, however, is of a constitutional nature.

Proposed new Rule 4111 is a Bill of Attainder, especially because it is legislation that intentionally targets a subset of the FINRA membership, aims at repairing the injustices that (in FINRA's view) comes about when legitimate rights (e.g., taking of an appeal) are exercised by brokers and their firms.

Proposed new Rule 4111 meets the 4th element of a Bill of Attainder: when the Rule-Maker deems punishment (e.g., deprivation of livelihood) as being absolutely necessary to prevent a group from bringing about events that the Legislator fears (e.g., past acts of "causing trouble") will recur, if not prevented but will be prevented if this proposed new Rule 4111 is adopted.

This kind of rule-making, while surely intended to bring about justice, amounts to *legislation* and, as will be shown in the sections that follow, it is legislation that circumvents constitutional due process.

[64] Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[65] Regulatory Notice 19-17, p. 4. (Emphasis supplied)

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5. Rule-Making as Legislation

We anticipate FINRA's objections: FINRA is engaged in Rule-Making (as for example rules made by the SEC and, especially, FINRA); but FINRA Rule-making is not "legislation" – as the layperson understands to be associated with a statute created by a state legislative body or by the Congress of the United States.

But there is ample precedent that supports the proposition that rule-making and legislation are one and the same.
There are two (2) seminal U.S. Supreme Court decisions that support the proposition that rule-making can be tantamount to legislation. The first case is the *Chevron*[66] decision. The second case is the *Mead* decision.[67] When determining whether a rule created by an administrative agency has the "force of law", the courts apply the Supreme Court's *Chevron-Mead* analysis. When all the stars align in this analysis, "force of law" deference is given to the administrative agency's rule-making, and the rules and regulations that result. In short, when an agency's rule has the "force of law" that rule is tantamount to legislation.

For example, when the Supreme Court employed the *Chevron-Mead* analysis to the Internal Revenue Service, the Court held that Internal Revenue rules carry the force of law.[68]

In *Chevron*, the Supreme Court was asked to decide whether an agency's construction of a statute of Congress should be given deference as having the "force of law". The issue centered on silence of a statute and Congressional delegation:

- Whenever a statute "is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[69]

- If there is an express delegation, "[s]uch *legislative* regulations [i.e., the agency's rule-making] are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."[70]

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[66] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

[67] United States v. Mead Corp., 533 U.S. 218 (2001).

[68] Mayo Foundation for Medical Education & Research v. United States, 131 S.Ct. 704, 714 (2011). *Accord* Swallows Holding, Ltd. v. Comm'r, 515 F.3d 162, 168-170 (3rd Cir. 2008)(finding general grant of power to Secretary of Treasury to promulgate rules with force of law.)

[69] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. at 844 (1984).

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- If there is an implicit delegation, "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency."[71]

In *Mead*, the Supreme Court held that when "it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority",[72] then the agency's exercise of rule-making has the force of law. But in reaching this conclusion, the Court set forth the following very relevant guidance:

> "Delegation of such authority may be shown in a variety of ways, as by an agency's *power to engage in adjudication*[73] or *notice-and-comment rule making*, or by some other indication of comparable congressional intent."[74]

The author of an important law review article has made a compelling case for this proposition that Rule-Making equates with Legislation. In *The Bill of Attainder Clauses: Protections From the Past in the Modern Administrative State*[75] the author recites the obvious:

> "It is widely acknowledged that Congress now delegates a significant amount of lawmaking power to executive and other administrative agencies,[76] deferring to an

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[70] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc ., 467 U.S. at 844 (1984). Note the Court's reference to the agency's regulations as "legislative" regulations.

[71] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc ., 467 U.S. at 844 (1984).

[72] United States v. Mead Corp., 533 U.S. 218, at 226-227 (2001).

[73] This element [the power to engage in adjudication] will be addressed separately, elsewhere in this Comment Letter. For our purposes here, there is no disputing that FINRA has (1) an adjudicatory process and (2) proposes rules subject to notice-and-comment and therefor fits squarely within the parameters of *Mead*.

[74] United States v. Mead Corp., 533 U.S. 218, at 227 (2001) (Emphasis supplied).

[75] John J. Cavaliere, III, The Bill of Attainder Clauses: Protections From the Past in the Modern Administrative State, 12:1 Ave Maria Law Review 149 (Winter, 2014).

[76] In support of this proposition, the author cites Humphrey's Ex'r v. United States, 295 U.S. 602, 628–31 (1935) describing Federal Trade Commission as an agency created to exercise "quasi legislative" and "quasi-judicial" functions, and is therefore outside the executive branch); Mistretta, 488 U.S. at 368, 371 (recognizing sentencing commission as an "independent commission in the Judicial Branch of the United States" via 28 U.S.C. § 991(a) (1982) and not finding excessive delegation); cf. id. at 427 (Scalia, J., dissenting) (calling recognition of the independent commission within the Judicial Branch the creation of another branch entirely or a "junior-varsity Congress"); *accord* FTC v. Ruberoid Co., 343 U.S. 470, 487 (1952) (Jackson, J., dissenting) (dubbing agencies "a veritable fourth branch of the Government").

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> agency's expertise in a particular field in order to promote efficient policy outcomes.[77] Often, these administrative rules represent the real substance of legislative action because the statute provides on the most minimal standards for an agency to follow while the administrative action is found to enjoy 'the force of law'. "[78]

As this author points out, the Supreme Court has already concluded that the regulations of the U.S. Treasury and the rules of the Internal Revenue Service – administrative agencies of the federal government – have the "force of law".

As for regulations of the Securities and Exchange Commission, there is likewise no question – at least in the mind of the SEC – that "federal statutes and the *SEC rules and regulations* have the force of law."[79]

According to SEC Chairman Jay Clayton:

> "The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. In furtherance of this mission, the Commission promulgates rules and regulations, which generally have the *force and effect of law*, and enforces compliance with its rules and regulations."[80] (Emphasis supplied)

To this statement, the Chairman adds the following footnote: "Such rules and regulations generally take effect only after the Commission publishes a notice of proposed rulemaking in the Federal Register, and adopts a final rule which considers public comments on the proposal in accordance with the Administrative Procedure Act."[81]

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[77] In support of this proposition, the author cites Chevron, 467 U.S. at 843–44 (discussing Congress' explicit or implicit gaps left open in legislation for agency to fill, which "necessarily requires the formulation of policy and making of rules" by the agency).

[78] John J. Cavaliere, III, The Bill of Attainder Clauses: Protections From the Past in the Modern Administrative State, 12:1 Ave Maria Law Review 149, at 165 (Winter, 2014). In support of this proposition, the author cites United States v. Mead Corp., 533 U.S. 218, 231–32 (2001) (finding no delegation to Customs to "issue classification rulings with the force of law"), [compare] with Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 714 (2011) (finding Internal Revenue rule to carry force of law), and Swallows Holding, Ltd. v. Comm'r, 515 F.3d 162, 168–70 (3d Cir. 2008) (finding general grant of power to Secretary of Treasury to promulgate rules with force of law).

[79] Researching the Federal Securities Laws Through the SEC Website (4 December 2012). https://www.sec.gov/reportspubs/investor-publications/investorpubssecuritieslawshtm.html.

[80] Statement Regarding SEC Staff Views (13 September 2018). Source: https://www.sec.gov/news/public-statement/statement-clayton-091318#_ftn1

[81] Statement Regarding SEC Staff Views (13 September 2018). Source: https://www.sec.gov/news/public-statement/statement-clayton-091318#_ftn1

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To make binding law through actions in the nature of rulemaking, the agency must use legislative rules, which ordinarily must be made in accordance with the notice-and-comment procedures specified by section 553 of the Administrative Procedure Act (APA).

Although not necessarily bound to follow the APA, FINRA does follows the "notice-and-comment rule making" procedure. Case at hand is Regulatory Notice 19-17.[82] When combined with FINRA's power to engage in adjudications (such as in FINRA's Office of Hearing Office and National Adjudicatory Council enforcement proceedings), it becomes very persuasive that FINRA's rule-making has the "force of law".

Therefore, to resolve any doubt, our analysis proceeds to the next question, which is whether FINRA's rule-making has lineage that traces back to Congress.

If it does, either directly or indirectly, then FINRA's rule-making has the "force of law", and this has implications for the ultimate question, whether proposed new Rule 4111 and amendments to Rule 9559 et al implicates the constitutional prohibition against Bills of Attainder.

6. FINRA and Congressional Delegation

In 1934, Congress established the system of regulation over the securities industry through the passing of the Exchange Act signed by President Franklin D. Roosevelt. The Exchange Act included

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[82] Regulatory Notice 19-17: "As part of FINRA's ongoing initiatives to protect investors from misconduct, FINRA is *requesting comment* on proposed new Rule 4111 (Restricted Firm Obligations) * * * FINRA is *requesting comment* on: 1. proposed new Rule 4111 (Restricted Firm Obligations), which would authorize FINRA to require "Restricted Firms," identified by a multistep process involving threshold calculations, to make deposits of cash or qualified securities that could not be withdrawn without FINRA's prior written consent, adhere to other conditions or restrictions on the member's operations that are necessary or appropriate for the protection of investors and in the public interest, or be subject to some combination of those obligations; and 2. proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111) (new Rule 9559) and amendments to existing Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) to be renumbered as Rule 9560 (Rule 9560 or the Hearing Procedures Rule) to create an expedited proceeding that allows a prompt review of the determinations under the Restricted Firm Obligations Rule and grants a member a right to challenge any obligations imposed. * * * FINRA encourages all interested parties to *comment. Comments* must be received by July 1, 2019. * * * FINRA *welcomes comments* on alternative ways of calculating the Restricted Deposit Requirement that would be more predictable while remaining impactful but avoiding disproportionate effects on different types of firms. * * * 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 and firm misconduct than the proposed amendments. * * * FINRA *specifically seeks comments* on alternatives FINRA should consider for the Expelled Firm Association Metric and why these alternatives may be more effective and efficient for identifying the firms that this proposal seeks to address. * * * FINRA *requests comment on all aspects of the proposal.* FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues. * * * 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." At pp. 1, 2, 12, 30, 33, 34, and 37.

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provisions for administration of markets and oversight of industry participants by private organizations, such as the New York Stock Exchange.

In 1938, Congress amended the Exchange Act by including provisions to authorize the formation and registration of National Securities Associations (NSAs) that would address conduct of their members under the supervision of the Securities and Exchange Commission (SEC). The amendment authorized the SEC to delegate to NSAs regulatory oversight of broker-dealers that were not members of a national securities exchange.[83] This amendment has come down to us as The Maloney Act.

The Maloney Act added the new section 15A to the Exchange Act to allow any association of brokers or dealers meeting certain statutory requirements to register with the SEC as a national securities association.[84]

In 1964 Congress amended section 15A of the Exchange Act to require, for the first time, that National Securities Associations (NSAs) have standards of financial responsibility for member firms and standards of training, experience, and other qualifications for associated persons.

This amendment also permitted the then sole NSA – the National Association of Securities Dealers (NASD), now the Financial Industry Regulatory Authority (FINRA) – to bring disciplinary proceedings against associated persons without proceeding against their firms.

Preliminary to the 1964 amendment to 15A of the Exchange Act, extensive hearings were held before Senate Committee on Banking and Currency. The Senate issued Report of the Committee on Banking and Currency to Accompany S. 1642, S. Rep. No. 88-379 (1963) ("Committee Report"). The Committee Report emphasized NASD as a regulator acting pursuant to authority delegated to it by Congress:

> "Registered securities associations are no private clubs. They are *organized under statutory authority* to perform, under governmental oversight, regulatory functions in the over-the counter securities market."[85]

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[83] Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o-3 (2006)); Id. § 15A(a) (codified as amended at 15 U.S.C. § 78o-3(a)); *see also* VI Securities Regulation (Louis Loss, Joel Seligman & Troy Paredes) 194-95 (4th ed. 2011).

[84] 15 U.S.C. § 78o-3 (2012).

[85] Securities and Exchange Commission Legislation 1963, S. Rep. No. 88-379, at 42 (1963).

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According to the Committee Report accompanying this legislation, these amendments:

- "[C]ontemplate[d] an even greater degree of reliance upon self-regulation, although under somewhat more intensive [SEC] supervision."[86]

- Essentially repudiated the Maloney Act's concept of a voluntary membership association enforcing through contract its business and ethical standards on its members and instead emphasized that the association was a regulator acting *pursuant to delegated authority*.[87]

This emphasis on delegated government power becomes the dominant theme in subsequent congressional consideration of the concept of securities self-regulation, although lip service is still paid to the Maloney Act's concept of self-regulation.[88]

In an early federal district court decision, shortly following the 1964 Amendments to the Maloney Act, investors instituted a class action for breach of contract against various broker-dealers and the NASD. The NASD and SEC decided that the particular investment program involved was harmful to public investors and, "after extensive consultation with and the express approval of" the SEC, the NASD issued an interpretation barring NASD member securities dealers from participating in the program. The defendant broker-dealers complied, thus repudiating their existing contracts with the plaintiff investors. Plaintiffs argued that the NASD's action was an interference with their contract, a violation of the antitrust laws, and a violation of due process of law.[89] In this case, the issue of Congressional delegation held center stage.

- NASD argued that any interference with plaintiffs' contracts was not wrongful because it *was properly exercising its delegated authority pursuant to the Maloney Act*, that its Interpretation was valid and that it was not retroactive because it merely interpreted a Rule which had been in effect for approximately 26 years, that plaintiffs showed no violation of the antitrust laws and that in any event the antitrust laws do not apply to this situation, and that there was no constitutional infirmity in the Association's actions. NASD disclaimed any position as to liability of Growth Programs or Supervised Investors to the plaintiffs for breach of contract.

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[86] Securities and Exchange Commission Legislation 1963, S. Rep. No. 88-379, at 42 (1963).

[87] Securities and Exchange Commission Legislation 1963, S. Rep. No. 88-379, at 42 (1963).

[88] Barbara Black, Punishing Bad Brokers: Self-Regulation and FINRA Sanctions, 8 Brook. J. Corp. Fin. & Com. L. at 33 (2013). https://brooklynworks.brooklaw.edu/bjcfcl/vol8/iss1/2.

[89] Harwell v. Growth Programs, Inc., 315 F. Supp. 1184 (W.D. Tex. 1970), *rev'd on other grounds*, 451 F.2d 240 (5th Cir. 1971), *modified per curiam*, 459 F.2d 461 (5th Cir.), *cert. denied*, 409 U.S. 876 (1972).

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- The Securities and Exchange Commission has filed an amicus curiae brief in which it defended the NASD Interpretation as being *clearly within its power under the Maloney Act* and not promulgated in violation of due process of law. The SEC argued that the issuance of the Interpretation of existing Rules of Fair Practice by NASD, with SEC concurrence, did not constitute a violation of the antitrust laws, and took no position as to the liability of Growth Programs or Supervised Investors to plaintiffs on the breach of contract action.

In its ruling, the Court wrote:

> "It is of course hornbook law that Congress can and often does permissibly delegate "public policy determination" to an administrative agency. *It is quite clear that the Maloney Act empowered the NASD to act subject to pervasive supervision by the SEC* as a quasi-governmental agency[90] charged with the responsibility of promoting, and enforcing, "just and equitable principles of trade" in the over-the-counter markets. *This Congressional delegation of policy-making power to the NASD has been upheld in* both <u>R. H. Johnson & Co. v. S.E.C.</u>, 198 F.2d 690 (2nd Cir. 1952), cert. denied 344 U.S. 855, 73 S. Ct. 94, 97 L. Ed. 664 (1952) and in <u>Nassau Securities Service v. S.E.C.</u>, 348 F.2d 133 (2nd Cir. 1965)."[91] (Emphasis supplied)

The issue of Congressional delegation of authority to NASD was again raised in 1977.

In *Todd & Co., Inc. v. SEC*,[92] the Third Circuit considered whether Congress's delegation of authority to the National Association of Securities Dealers (NASD) constituted an unconstitutional delegation to a private entity.[93] The plaintiff, a broker/dealer, contested an NASD investigation of its activities on the ground that the Maloney Act constituted an undue delegation to a private entity. The Court found that the Maloney Act *authorized* the self-regulatory entity to *promulgate rules* protecting against

[90] Network 1 is well aware that FINRA has consistently maintained that it is not a "quasi-governmental agency". This question was extensively addressed in Network 1's Comment Letter to Regulatory Notice 18-16 (relating to High Risk Brokers), and will be revisited elsewhere in today's Comment Letter. For the time being, it bears noting that *Harwell* is <u>not</u> being offered for the proposition that FINRA is a "quasi-governmental agency"; *Harwell* is, instead, offered to demonstrate that, as far back 1970, the federal courts have recognized that FINRA (formerly, NASD) ***holds rule-making powers that have been delegated to it by Congress from the time that "National Securities Associations" were created through the Maloney Act, and that this delegation has been reinforced by subsequent amendments to the Maloney Act.***

[91] <u>Harwell v. Growth Programs, Inc.</u>, 315 F. Supp. 1184, 1188 (W.D. Tex. 1970). The court entered summary judgment against plaintiffs on all claims. Id. at 1192. The plaintiffs appealed to the Fifth Circuit. While the Fifth Circuit reversed on the grounds that the district court had not fully considered certain factual issues and that parties are not always free from liability on contracts that government regulation renders impossible to perform, the Fifth Circuit did not abrogate the "delegation of authority by Congress" issue raised by both the NASD and SEC.

[92] 557 F.2d 1008 (3d Cir. 1977).

[93] 557 F.2d 1008, at 1011–12.

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fraudulent and unethical practices, and to *discipline members* who failed to conform to the standards promulgated.[94] The Court also found that Congress authorized the SEC to review the NASD's findings upon appeal.[95] But the Court rejected the plaintiff's challenge because the Securities and Exchange Commission (SEC) retained the power "to approve or disapprove the Association's rules," to make additional findings if necessary, and "make an independent decision on the violation and penalty,"[96] and on these grounds found no impermissible exercise of authority by NASD. In other words, the Court agreed that NASD held authority delegated to it by Congress via the Maloney Act, and that this delegation of authority was not unconstitutional.

In addition to direct delegation of powers from Congress, FINRA has been delegated powers by the SEC, which the SEC has directly received from Congress. These two sources of delegation, direct and indirect sources, form the very basis of FINRA's position that it is entitled to absolute immunity in lawsuits. The Second Circuit, as recently as 2011, has affirmed this:

> "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. This immunity extends both to affirmative acts as well as to an SRO's omissions or failure to act.... It is patent that the consolidation that *transferred NASD's and NYSE's regulatory powers to the resulting FINRA* is, on its face, an exercise of the SRO's *delegated regulatory functions* and thus entitled to absolute immunity.... 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* and underscore our conviction that immunity attaches to the proxy solicitation here."[97] (Emphasis supplied)

There is no disputing that Congress has authorized self-regulatory organizations, such as the National Association of Securities Dealers, now the Financial Industry Regulatory Authority (FINRA), to investigate and prosecute violations of federal law.[98] Indeed, various attacks on the NASD's

[94] 557 F.2d 1008, at 1012.

[95] 557 F.2d 1008, at 1012.

[96] 557 F.2d 1008, at 1012.

[97] Standard Investment Chartered Inc. v. National Association of Securities Dealers, 637 F.3d 112 (2d Cir. 2011), *cert. denied* January 17, 2012.

[98] *See, e.g.*, 15 U.S.C. § 78o-3(b)(7) (2006). Firms wishing to trade securities have no choice but to join a self-regulatory organization. Id. § 78o(b)(8). Firms and individuals disciplined, whether through fines or withdrawal of trading privileges, have a right of appeal to the SEC, but the SEC cannot add any findings to the record. Id. § 78s(e)(1), (f).

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disciplinary authority based on a theory of unconstitutional delegation of legislative authority by Congress have been unsuccessful.[99]

Because this delegation of authority is so amply demonstrated by FINRA's notice-and-comment rule-making in support of enforcing federal securities laws, not to mention the power of FINRA to engage in adjudication of violations of federal securities laws, *FINRA rules enjoy the "force of law"*.

An important comment needs to be inserted here. It is often remarked at the various industry conferences that FINRA is not the only SRO, as if to imply that, because FINRA is but one of forty-one (41) Self-Regulatory Organizations or SROs, the force of FINRA's "laws" (i.e., rules) is no more powerful, and therefore no more invasive of the capitalist spirit, than any of the other SRO rules.

It is true that FINRA is "only one" of 41 SROs.[100] There are twenty-two (22) SROs that are "exchanges".[101] There are five (5) registered securities futures products exchanges.[102] There are eleven (11) registered clearing agencies.[103] The Municipal Securities Rulemaking Board is in a class of its own.[104] And there are two (2) national "registered securities associations": The National Futures

[99] *See, e.g.,* Sorrell v. SEC, 679 F.2d 1323, 1325 (9th Cir. 1982); First Jersey Securities, Inc. v. Bergen, 605 F.2d 690, 697 (3d Cir. 1979), cert. denied, 444 U.S. 1074 (1980); Todd & Co., Inc. v. SEC, 557 F.2d 1008, 1012 (3d Cir. 1977); R. H. Johnson & Co., v. SEC, 198 F.2d 690, 695 (2d Cir.), cert. denied, 344 U.S. 855 (1952).

[100] 15 USC §78c(a)(26): "The term 'self-regulatory organization' means any national securities exchange, registered securities association, or registered clearing agency, or (solely for purposes of sections 78s(b), 78s(c), and 78w(b)[1] of this title) the Municipal Securities Rulemaking Board established by section 78o–4 of this title."

[101] These include: (1) BOX Exchange LLC; (2) CBoe BYX Exchange, Inc.; (3) Cboe BZX Exchange, Inc.; (4) Cboe C2 Exchange, Inc.; (5) Cboe EDGA Exchange, Inc.; (6)Cboe EDGX Exchange, Inc.; (7) Cboe Exchange, Inc.; (8) Investors Exchange LLC; (9) Miami International Securities Exchange LLC; (10) MIAX Emerald, LLC; (11) MIAX PEARL, LLC; (12) Nasdaq BX, Inc.; (13) Nasdaq GEMX, LLC; (14) Nasdaq ISE, LLC; (15) Nasdaq MRX, LLC; (16) Nasdaq PHLX LLC; (17) The Nasdaq Stock Market LLC; (18) New York Stock Exchange LLC; (19) NYSE Arca, Inc.; (20) NYSE American LLC; (21)NYSE Chicago, Inc.; (22) NYSE National, Inc. Source: https://www.sec.gov/rules/sro.shtml.

[102] These include: (1) CBOE Futures Exchange; (2) Chicago Board of Trade; (3) Chicago Mercantile Exchange; (4) OneChicago; and (5) NQLX. Source: https://www.sec.gov/rules/sro.shtml.

[103] These include: (1) Banque Centrale De Compensation; (2) Boston Stock Exchange Clearing Corporation; (3) Chicago Mercantile Exchange LLC; (4) Fixed Income Clearing Corporation; (5) ICE Clear Credit LLC; (6) ICE Clear Europe Limited; (7) National Securities Clearing Corporation; (8) The Options Clearing Corporation; (9) Stock Clearing Corporation of Philadelphia; (10) The Depository Trust Company; and (11) Fixed Income Clearing Corporation. Source: https://www.sec.gov/rules/sro.shtml.

[104] The MSRB was created under §78o–4of the Exchange Act of 1934. The SEC classifies the MSRB as "Other" in its list of Self-Regulatory Organizations. Source: https://www.sec.gov/rules/sro.shtml.

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Association[105] and FINRA. What is often overlooked is the fact that FINRA, formerly NASD (which is the original "registered national securities association" following passage of the Maloney Act), is the only SRO that is a Registered *Securities* Association. A "registered securities association" is "an association of broker dealers" registered as a "national securities association" under Section 15(A) of the Exchange Act.[106]

Being a "registered securities association" is significant:

- *Congress* gives "registered securities associations" the authority and power to deny membership to its association to any person who is not a registered broker or dealer.[107]

- *Congress* gives "registered securities associations" the authority and power to 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.[108]

- *Congress* gives "registered securities associations" the authority and power to deny membership or make membership conditional to a broker or dealer that does not meet standards of financial responsibility.[109]

- *Congress* gives "registered securities associations" the authority and power to deny membership or make membership conditional to a broker or dealer that does not meet standards of training, experience, and competency.[110]

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[105] In 1974 Congress established the Commodity Futures Trading Commission (CFTC), a federal regulatory agency with jurisdiction over futures trading. Section 17 of the Commodity Exchange Act (7 U.S.C. 21) authorized the creation of "registered futures associations," giving the futures industry the opportunity to create a nationwide, self-regulatory organization. The National Futures Association (NFA) is the self-regulatory organization (SRO) created pursuant to this mandate. The NFA is the SRO for the U.S. derivatives industry, including on-exchange traded futures, retail off-exchange foreign currency (forex) and OTC derivatives (swaps). The NFA has jurisdiction over "security futures products", but not "securities" - as "securities" is defined under the Section 78c(a)(10) of the Exchange Act. The term "security futures product" means a security future or any put, call, straddle, option, or privilege on any security future. 15 USC §78c(a)(56). The NFA began operations in 1982.

[106] 15 USC §78o-3(b).

[107] 15 USC §78o-3(g)(1).

[108] 15 USC §78o-3(g)(2).

[109] 15 USC §78o-3(g)(3)(A)(i).

[110] 15 USC §78o-3(g)(3)(A)(i).

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- *Congress* gives "registered securities associations" the authority and power to deny membership or make membership conditional when a broker or dealer "has engaged and there is a reasonable likelihood he will again engage in acts or practices inconsistent with just and equitable principles of trade."[111]

- *Congress* gives "registered securities associations" the authority and power to bar a natural person (i.e.,"broker") from associating with a broker or dealer when the "broker" has "engaged and there is a reasonable likelihood he will again engage in acts or practices inconsistent with just and equitable principles of trade."[112]

- *Congress* gives "registered securities associations" the authority and power to restrict its members (brokers and dealers) from dealing with non-members.[113]

For all intents and purposes, because FINRA is the only "registered *securities* association", no broker/dealer or "broker" can professionally buy and securities for another person without being a member of FINRA and without being associated with a member of FINRA. The official comment to Cornell University's Legal Information Institute puts it this way:

> "In addition to securities exchanges, broker-dealer firms who must register under the Exchange Act can only transact in the over the counter market (i.e. securities traded outside of an exchange) if they are members of a registered securities association. (*See* Exchange Act §§ 5(b)(8) and 5(b)(9).) <u>Given that the vast majority of securities are traded over-the-counter and that a securities association can require its</u>

[111] 15 USC §78o-3(g)(3)(A)(ii). At first glance, this Congressional mandate appears to support FINRA's proposed new Rule 4111. It does – broadly speaking, but with this historic qualification: If this Congressional mandate supports Rule 411, then there is no escaping the conclusion that Rule 4111 has the "force of law"; and, because Rule 4111 has the "force of law", <u>then FINRA Rules both generally speaking and this proposed new Rule 4111 in particular are subject to the same constitutional constraints to which all Congressional statutes are subject.</u> In other words, just as a Congressional statute is subject to the constitutional prohibition against Bills of Attainder, then so also are FINRA Rules in general – and this proposed new Rule 4111 – subject to the constitutional prohibition against Bills of Attainder. Indeed, as the balance of Section 6 of this Comment Letter (relating to FINRA and Congressional Delegation) demonstrates, proposed new Rule 4111 is a Bill of Attainder under the *Chevron-Mead* analysis precisely because FINRA rules have the "force of law" as a result of Congressional delegation.

[112] 15 USC §78o-3(g)(3)(B)(ii). The explanation rendered in footnote 113 applies likewise to this provision.

[113] 15 USC §78o-3(e)(1): "The rules of a registered securities association may provide that no member thereof shall deal with any nonmember professional (as defined in paragraph (2) of this subsection) except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public."

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members to trade only with other members, this provision effectively require[s] almost all broker-dealers to register with a securities association [read: NASD, now FINRA]."[114]

Since Exchange Act §§ 5(b)(8) and 5(b)(9) "effectively require[s] almost all broker-dealers to register with a securities association"; and because FINRA is the *only* SRO that is a "registered *securities* association", FINRA ***is*** the only "game in town" when a broker or dealer or an associated person wants to engage in the securities and investment banking business in the United States.

In other words, the FINRA membership agreement that a broker or dealer obtains via the Rule 1013 Membership Application Process, and the "registration" that an associated person obtains when he passes the Series 7 or Series 79 or other FINRA examinations, are, *in effect*, "federal licenses" to engage in the securities or investment banking business – precisely because of the aforementioned *Congressional* delegation of powers to "registered securities associations".

For these reasons, FINRA rules ***do*** have the "force of law"; and, because FINRA ***is*** the only "game in town" – the Keeper of these "federal licenses" - no other SRO rules are more powerful, and therefore potentially more invasive of the capitalist spirit, than FINRA's rules.

And because FINRA rules enjoy the "force of law", FINRA rule-making (as set forth in Regulatory Notice 19-17 (relating to Protecting Investors from Misconduct) is arguably "legislation". And because FINRA rule-making is a legislative act, FINRA rules are subject to the constitutional prohibition against Bills of Attainder under the *Chevron-Mead* analysis.

7. **Proposed Amendments to Rule 9550 – Expedited Proceedings to Implement Proposed Rule 4111 and the Fifth Element[115] of Bills of Attainder:**

FINRA is proposing to establish a new "expedited" proceeding in the Rule 9550 Series (Expedited Proceedings). Under proposed new Rule 9559 (Procedures for Regulating Activities Under Rule

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[114] Cornell University's Legal Information Institute: Self regulatory organization. Source: https://www.law.cornell.edu/wex/self_regulatory_organization.

[115] The fifth element is "punishment without a judicial trial". To restate the definition, a Bill of Attainder is a law that:

A. Passes judgment about who is "unfit" to engage in a profession.
B. Bases this judgment largely on the group's "past acts" of causing trouble.
C. Creates criteria to define who is "unfit" and then targets a "group", especially a subset within a given profession, to match such criteria.
D. Deems punishment – e.g., deprivation of livelihood – absolutely necessary to keep that group from bringing about events that the legislator fears will recur, again and again– e.g., past acts of causing trouble – if not prevented.
E. Punishes without a judicial trial.

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4111), member firms can request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and challenge the Restricted Deposit Requirement imposed on the member firm as well as any of the "Rule 4111 Requirements".[116] The new expedited proceeding grant affected member firms the right to seek a Hearing Officer's review of those determinations.[117]

Proposed new Rule 9559(a) has a notice provision, but the more significant aspect of Rule 9559(a) for purposes of this Comment Letter's discussion of Bills of Attainder is the "immediate effective[ness]" of any and all Rule 4111 Requirements imposed by FINRA once the member firm has passed from Preliminary Identification to Consultation to Restricted Firm determination by the Department of Member Supervision.

In other words, even when a member firm essentially "appeals" the determination of the Department to a "higher" authority within FINRA, namely, the Hearing Officer, there is *no postponement or deferment*[118]of the "soft punishments" – the Restricted Deposit Requirement as well as any of the other "Rule 4111 Requirements" imposed on the member firm by the Department of Member Supervision. It bears mentioning here that, even if the member firm timely exercises its "one-time" opportunity under Proposed Rule 4111(c)(2) and reduces its staff, the member firm does not necessarily avoid this "extraordinary financial burden" that FINRA calls the "maximum Restricted Deposit Requirement".

It is true that proposed new Rule 9559(a) allows the member firm to request for a hearing in an expedited proceeding within seven (7) days after service of Department's notice. But there is a quid pro quo for requesting an expedited hearing: When a member requests expedited review of the Department determination that imposes a Restricted Deposit Requirement on the member for the first time, the member is required to deposit while the expedited proceeding is pending, the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year.

Again, another "soft punishment".

The point is this: Even though a member firm is afforded the right to "appeal" to the Hearing Officer, and even "request expedited hearing" on the decision of the Department of Member Supervision, Rule

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[116] Proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111) (new Rule 9559) and amendments to existing Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) to be renumbered as Rule 9560 (Rule 9560 or the Hearing Procedures Rule) to create an expedited proceeding that allows a prompt review of the determinations under the Restricted Firm Obligations Rule and grants a member a right to challenge any obligations imposed. Regulatory Notice 19-17, p. 2.

[117] Regulatory Notice 19-17, p. 18.

[118] " * * *Rule 4111 Requirements imposed in a notice issued under proposed new Rule 9559(a) are immediately effective. In general, a request for a hearing would not stay those requirements." Regulatory Notice 19-17, p. 18.

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9559 (Procedures for Regulating Activities Under Rule 4111) is, in fact, not so member-friendly, but instead is crafted with a silent expectation that the member firm will simply throw its towel into the ring as a token of defeat.

But the constitutional problem that arises from the proposed Rule 9559 structure is twofold:

- Proposed Amendments to Rule 9550 triggers due process concerns.
- Proposed Amendments to Rule 9550 fails to meet the Bill of Attainder test for protections afforded by a "judicial trial".

7.A Proposed Rule 9559 (Expedited Proceedings to Implement Proposed Rule 4111) and Due Process Concerns

Proposed amendments to Rule 9559 are built on the quasi-judicial device of having a FINRA Hearing Officer *review*, even on an expedited basis, the "Restricted Firm" determination by the Department of Member Supervision.

But the constitutionality of this device stands or falls on the question whether the FINRA Hearing Officer – as an *Institution Charged with Adjudication* – is without conflict of interest and therefore can be, and in fact is, neutral.[119]

7.A.1 Whether Impartiality Is Built into the Institution?

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."[120]

This statement about impartiality claimed by FINRA as well as FINRA's assertion about separation of powers (i.e., judiciary and enforcement powers) notwithstanding,[121] it must still be asked: Does the

[119] *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)

[120] FINRA, Office of Hearing Officers, http://www.finra.org/industry/oho.

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soil from which Hearing Officers are appointed support a presumption of impartiality in the Hearing Officer? It is in the light of this question that proposed new Rule 9559 – the Hearing Officer's review of the "Restricted Firm" determination by the Department of Member Supervision – must be judged in light of well-established principles of fundamental justice that are fixed in American jurisprudence.[122]

Therefore, who qualifies to be a Hearing Officer? Stated differently, are their conflicts of interest grounded in the very eligibility requirements qualifying an individual to become a Hearing Officer?

7.A.2 Whether Conflicts of Interest are Ingrained in the Institution?

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, *but now also plays a very special role in the operation of proposed new Rule 4111 (relating to Restricted Firm Obligations).*

It is not be unreasonable or unfair to question the impartiality of a Hearing Officer who will be charged with the vital role of reviewing, *impartially*, the "Restricted Firm" determination by the Department of Member Supervision.

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[121] 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." Source: http://www.finra.org/industry/guide-disciplinary-hearing-process.

[122] The following constitutionally recognized principles need to be in play in order for proposed amendments to Rule 9550 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. 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). (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. *See, e.g.*, Morrissey v. Brewer, 408 U.S. 471, 486 (1972). (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. 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"). (Emphasis supplied)

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The reason for asking this question should be self-evident: For the small and medium sized member firm, the decision of the Hearing Officer has enormous financial consequences for these firms and their ability to continue to meet net capital requirements because, whenever a broker-dealer's net capital drops below its minimum net capital requirements, SEC requires the broker-dealer to cease operations immediately and get additional capital to come into capital compliance or liquidate its operations.[123]

It is noted that Regulatory Notice 19-17 does not specifically address whether the Restricted Deposit Requirement of proposed new Rule 4111 impacts the net capital requirements of the SEC's uniform net capital rule (15c3-1).[124] Hence, the consequence of the Hearing Officer's review and upholding of

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[123] The "early warning notice" levels that require the broker-dealer to give notice to the SEC are as follows:

- Under the basic method, the broker-dealer's ratio of aggregate indebtedness to net capital is greater than 1,200 percent.
- Under the alternative method, the broker-dealer's net capital is less than 5 percent of customer-related receivables.
- The broker-dealer's net capital is less than 120 percent of its required minimum dollar net capital.

Source: https://www.sec.gov/about/offices/oia/oia_market/key_rules.pdf

[124] *See* Regulatory Notice 19-17, at 17: "These account restrictions would impact how a Restricted Firm calculates its net capital levels. As explained in proposed Rule 4111.01, a deposit in the Restricted Deposit Account would be an asset of the member firm that could not readily be converted into cash, due to the restrictions on accessing it. Accordingly, the member would be required to deduct deposits in the Restricted Deposit Account when determining its net capital under Exchange Act Rule 15c3-1 and FINRA Rule 4110." This is the extent of FINRA's guidance. It is almost seems as if FINRA saying to broker/dealers: "we here at FINRA approved this rule impacting your net capital, now you member firms figure out *how* it impacts your net capital computation and *what* you must do to avoid giving "early warning notice" to the SEC; and, if you have to shut down your securities business, then so be it." In other words, "tag ... you're it." There is no hint that the SEC had any a priori input on the FINRA mandate that member firms "deduct deposits in the Restricted Deposit Account when determining its net capital" and whether this mandate is consistent with the letter and spirit of Rule 15c3-1. For example, a ***broker/dealer could maintain errors and omissions insurance that cover the liability equal to the Restricted Deposit Account amount; in such a scenario, a broker/dealer arguably should not need to deduct deposits in the Restricted Deposit Account when determining its net capital.*** Errors and Omissions insurance as an alternative to "deducting deposits in the Restricted Deposit Account amount when determining net capital" is ignored in Regulatory Notice 19-17. There is another important scenario that is relevant but has gone unnoticed by Regulatory Notice 19-17. When a member firm is subject to a civil litigation, the member firm is required by SEC Regulation 17 CFR 240.15c3-1(c)(2) to secure a "reasoned opinion", i.e., a written expression of an independent lawyer's professional judgment that addresses the facts of the member firm's business and regulatory circumstances with respect to the lawsuit at issue, and its potential effect on the firm's financial condition. Based the independent professional's assessment, the member firm sets aside a dollar amount – deducts this amount – from the firm's assets otherwise available for net capital computation. FINRA is proposing through rule 4111 to use as part of its quantitative analysis to determine a potential "Restrictive Firm" pending civil cases. This could lead to classifying the member firm as a "preliminarily" determined firm to be a "Restricted Firm" and therefore decides to take an expedited appeal, the member firm "would be required to deposit [in the Restricted Account that the member firm cannot use for business purposes], while the expedited proceeding was pending, the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year." But the member firm has *already* "reserved" the amount that the independent professional (independent law firm) has assessed pursuant to SEC Regulation 17 CFR 240.15c3-1(c)(2). Proposed new Rule 4111 does not appear to account for this 15c3-1(c)(2) assessment. In other words, it does not appear that the member firm is allowed to deduct the 15c3-1(c)(2) assessment against the "the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year." Accordingly, proposed new Rule 4111, as currently drafted, amounts to a "double penalty" against the firm.

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the Department of Member Supervision's determination that a member firm is a "Restricted Firm" can be mammoth for the small to mid-sized member firm.

Therefore, what is the soil from which conflicts of interest might spring?

Hearing Officers are employees of FINRA.[125]

Right out of the gate, the Hearing Officer has a "financial interest" in being loyal and continuing to be loyal to FINRA's mission, which is "to provide investor protection and promote market integrity":

> "Our Mission
>
> "We're *one team with one mission.*
>
> "Our mission is clear—to provide investor protection and promote market integrity * * * ") [126]

The Hearing Officer must be one who is committed, first and foremost, to FINRA's mission – as distinct from being committed, first and foremost, to member issues in the competitive market place, as originally conceived by the Maloney Act, as amended,[127] that gave rise to National Securities Associations, followed by the National Association of Securities Dealers, and finally the Financial Industry Regulatory Authority.

While both commitments should and must ultimately center on justice,[128] the immediate question that is the concern in this Comment Letter is whether the soil from which a Hearing Officer is cultivated[129] and appointed truly lends itself to the appointment of one who is without conflict of interest.

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[125] *See* FINRA, Revolving Door Rules, FAQs, General Questions, Question & Answer No. 1, http://www.finra.org/about/revolving-door-rules#general.

[126] http://www.finra.org/about/our-mission (Emphasis supplied)

[127] The Maloney Act required, as a condition for registration of a securities association, that the association's rules be designed "to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." 15 U.S.C. § 78o-3(b)(8) (1970), as amended, 15 U.S.C.A. § 78o-3(b)(6) (Supp. 4, 1975). The Maloney Act "limits a securities association's authority to promulgate restrictive regulations and provides that a securities association shall not be registered by the SEC if its rules regulate 'matters not related to the purposes of this chapter or the administration of the association.' " Securities Exchange Act of 1934 § 1SA(b)(6), 15 U.S.C.A. § 78o-3(bX6) (Supp. 4. 1975). Finally, pursuant to the Maloney Act as amended by Congress, "the SEC may not register a securities association whose rules "impose any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter." Id. § 15A(bX9), 15 U.S.C.A. § 78o-3(b)(9) (Supp. 4, 1975).

[128] 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,

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In 2011, the U.S. Supreme Court emphasized in *Free Enterprise Fund v. Public Co. Accounting Oversight Board* that at-will removal directly affects whether an official is in fact independent: "[O]ne who holds his office only during the pleasure of another cannot be depended upon to maintain an attitude of independence against the latter's will."[130] Stated otherwise, the ability to discipline, remove, or affect the salary of an adjudicator also creates an unconstitutional appearance of partiality.

We have scoured the FINRA website and could find nothing that dispels the assumption that Hearing Officers are at-will employees of FINRA. The only item referencing termination of Hearing Officers on the FINRA website is that they can only be terminated by the FINRA Chief Executive Officer.[131] This only serves to drive home the point that the Hearing Officer is not simply an employee of an ordinary not-for profit organization – the Hearing Officer is an employee whose bias is, naturally, tied-at-the-hip with its very important, very focused mission: FINRA's mission being "to provide investor protection and promote market integrity".[132]

This opens the discussion to whether the Hearing Officer – charged with the responsibility of independently reviewing the "Restricted Firm" determinations by the Department of Member Supervision - can truly be independent and neutral and impartial when the Hearing Officer reviews the Department's determination of a member firm's preliminary status as a "Restricted Firm"?

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'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.

[129] FINRA's espoused purpose in keeping the Hearing Officer 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" 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." 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.

[130] 561 U.S. 477, 493 (2010) [quoting Humphrey's Ex'r v. United States, 295 U.S. 602, 629 (1935)].

[131] *See* FINRA, Office of Hearing Officers: "Employment protections exist for hearing officers to further ensure their independence; they may not be terminated except by the FINRA Chief Executive Officer, with a right to appeal to the Audit Committee of FINRA's Board of Governors." https://www.finra.org/industry/oho.

[132] https://www.finra.org/about/our-mission.

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Like the Hearing Officer, the members of the Department of Member Supervision are likewise *employees* (as opposed to independent contractors) of FINRA. And like the Hearing Officer, the member of the Department of Member Supervision is not simply an employee of an ordinary not-for profit organization – the members of the Department of Member Supervision are employees whose bias is, naturally, tied-at-the-hip with its very important, very focused mission: FINRA's mission being "to provide investor protection and promote market integrity".

In a word, financial interest derived from employment, itself rooted in the desire to avoid termination, are all ultimately united in "all ships sailing in the same direction" of FINRA's mission.[133]

Consider the recent controversy involving a former SEC administrative law judge who came under fire for ruling against the SEC.[134]

True, FINRA will contest that FINRA is not the SEC; but then again, FINRA's adjudicatory system so much closer to the SEC adjudicatory system than it is to the judiciary or "court system", where the judiciary is truly separated from the legislative and executive branches of government.

Additionally, if the SEC administrative proceedings have been challenged successfully in the courts on separation-of-powers grounds, where the complaint is that regulated parties are afforded limited protections and procedures at that those proceedings, how much more compelling is the case against FINRA's adjudicatory system? FINRA has consistently maintained that, while it may do so, it is *not* compelled as a matter of law to recognize constitutional protections because FINRA is a non-profit organization and is not a government or quasi-government agency and therefore is immune from these obligations.[135]

But we have strayed from the main point. The appointment of a Hearing Officer whose employment is essentially guaranteed unless he/she runs afoul of FINRA's Chief Executive Officer reinforces the

[133] https://www.finra.org/about/our-mission.

[134] *See* Jean Eaglesham, SEC Wins with In-House Judges, WALL ST. J. (May 6, 2015, 10:30 PM), (referring to former SEC ALJ Lillian McEwen, who complained of coming "under fire" *for finding in favor of regulated parties*). http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[135] 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.")."

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"common perception [that] administrative adjudicators [read: Hearing Officers] are likely to be *too committed* to the agency's [read: FINRA's] positions" and "imbued with the agency's [read: FINRA's] *culture,*" according to the highly respected Law Professor and former attorney at the U.S. Department of Agriculture, the Antitrust Division of the Department of Justice and the Federal Trade Commission, Charles H. Koch, Jr. [136]

In light of Professor Koch's important insight into the danger to justice posed by conflicts of interest that impact impartiality, consider the analogous situation of a prosecutor; and, in view of that situation, 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, demonstrating *why it became so easy for him to become too committed to his agency's position*:

> "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."[137] (Emphasis supplied)

And, being so *imbued with his agency's culture*, the same former prosecutor pointedly explains how agency culture informs and eventually directed his work ethic:

> "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 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

[136] Charles H. Koch, Jr., Policymaking by the Administrative Judiciary, 56 ALA.L.REV. 693, 702-703 (2005); 25 J. Nat'l Ass'n Admin. L. Judges (2005) *available at* https://digitalcommons.pepperdine.edu/naalj/vol25/iss1/2. William & Mary Law School Bill of Rights Journal Bio: http://wm.billofrightsjournal.org/wp-content/uploads/2012/11/Koch_bio.pdf

[137] 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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me that *explicitly*—nobody had to." [138] (Emphasis via underlining, supplied; italics in original)

Conflicts of interest of a material nature – financial interest, job security, compliance with organizational culture – exist for the Hearing Officer, and these may not be overcome by institutional devices such as physical separation from other FINRA departments. The "ability to discipline, remove, or affect the salary of an adjudicator also creates an unconstitutional appearance of partiality"[139] will eventually prove stronger than physical barriers:

> "This is a significant problem for regulated parties and agencies because, in light of one of the Supreme Court's most recent impartiality decisions (*Caperton v. A.T. Massey Coal Co.*) and one of its most recent separation-of-powers decisions (*Free Enterprise Fund v. PCAOB*), there is a compelling, unacknowledged argument that agency control over AJs [read: Hearing Officer] creates an unconstitutional appearance of partiality under the Due Process Clause and thereby renders invalid tainted agency proceedings. Moreover, even without a due process violation, the perception of partiality — as the SEC's current litigation demonstrates[140] — leads to wholesale resistance from regulated parties and perhaps even courts (as partiality concerns over Immigration Judges did in the mid-2000s) and Congress for agency initiatives."[141] (Emphasis supplied)

These legitimate concerns give rise to a serious doubt that the proposed new Rule 9559 (relating to Expedited Proceedings to Implement Proposed Rule 4111) is consistent with *fundamental law* – Due Process, in other words. *Free Enterprise Fund* establishes the following: (1) the agency's [read:

[138] 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).

[139] Kent H. Barnett, Why Bias Challenges to Administrative Adjudication Should Succeed, 81 Mo. L. Rev. 1023, at 1027 (2016).

[140] The New York Times and The Wall Street Journal have reported that the Securities and Exchange Commission ("SEC") prevails much more frequently — sometimes 100% of the time in a given year — in its in-house enforcement proceedings than in court. Jean Eaglesham, SEC Wins with In-House Judges, WALL ST. J. (May 6, 2015, 10:30 PM), http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803. Gretchen Morgenson, At the S.E.C., a Question of Home-Court Edge, N.Y. TIMES (Oct. 5, 2013), http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-ofhome-court-edge.html. (contrasting SEC's 88% win rate in ALJ hearings to its 63% win rate in district courts). For instance, the SEC prevailed in all agency proceedings in 2012, and in more than 75% in 2011, 2013, and 2014. In comparison, it prevailed in less than 75% of similar judicial proceedings. *See* id. In several recent judicial proceedings, defendants have challenged — and have had enjoined — those SEC administrative proceedings on separation-of-powers grounds, complained of the limited protections and procedures that those proceedings afford them, and emphasized the *partiality concerns* that arise from the SEC's higher win rate before its own judges than before Article III courts. See, e.g., Gray Fin. Group, Inc. v. SEC, No. 1:15-cv-00492-LMM (N.D. Ga. Aug. 4, 2015); Timbervest v. SEC, No. 1:15-cv-02106-LMM (N.D. Ga. Aug. 4, 2015); Tilton v. SEC, No. 15-cv-02472-RA (S.D.N.Y. June 30, 2015); Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014); Hill v. SEC, 114 F. Supp. 3d 1297, 1320-21 (N.D. Ga. 2015) (granting preliminary injunction based on substantial likelihood of Appointments Clause violation); *accord* Duka v. SEC, No. 1:15-cv-00357, 2015 WL 4940083, at *1 (S.D.N.Y. Aug. 12, 2015).

[141] Kent H. Barnett, Against Administrative Judges, 49 University of California, Davis 1643, at 1649-50 (2016). Kent Barnett is Assistant Professor, University of Georgia School of Law.

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FINRA?] power to remove (or transfer) and affect AJs' [read: FINRA Hearing Officer?] pay gives agencies [read: FINRA] *control*, and (2) that control *impacts impartiality* [read: impartiality of the Hearing Officer].[142]

Elsewhere 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.[143]

On the basis of these factors, proposed new Rule 9559 (relating to Expedited Proceedings to Implement Proposed Rule 4111) triggers serious Due Process concerns – the concern for *material* conflicts of interest (financial interest, job security, and pressure to comply with organizational culture) giving rise to a strong suspicion of a real likelihood of *partiality* in favor the employer's mission.[144]

The matter of conflict of interest created by *financial interest for* FINRA when a Hearing Officer decides *in favor of* the Department of Supervision Management and *against* the "Restricted Firm" in the "appeal" process[145] cannot reasonably be discounted.

FINRA's budget is largely supported by fines imposed on its member firms. According to ***Investment News***:

> "The Financial Industry Regulatory Authority Inc. will not raise member fees for the sixth straight year, *but depending how much it raises through fines* and market performance, the broker-dealer regulator could draw up to $185 million from its cash reserves this year. That aspect of the 2019 Finra budget summary released Thursday was a sticking point to some critics of the strategy. While Finra members might be able to appreciate the fee news, Todd Cipperman, principal at Cipperman Compliance Services,

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[142] Kent H. Barnett, Against Administrative Judges, 49 University of California, Davis 1643, at 1667 (2016).

[143] Turney 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").

[144] https://www.finra.org/about/our-mission.

[145] *See* Regulatory Notice 19-17, at 18: "FINRA is proposing to establish a new expedited proceeding in the Rule 9550 series (Expedited Proceedings), specifically proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111), that would allow member firms to request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and grant a right to challenge any of the "Rule 4111 Requirements," including any Restricted Deposit Requirements, imposed. [citation omitted] The new expedited proceeding would govern how the Department provides notice of its determinations and afford affected member firms the right to seek a Hearing Officer's review of those determinations."

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said *members should be wary of an increased focus on revenue through fines*. The potential budget shortfall of $185.8 million, up from $138.1 million a year ago, is 'problematic for members,' Mr. Cipperman said. '*Finra has a significant financial incentive to bring enforcement cases and impose fines in order to close its budget shortfall*,' he said. 'In 2017, Finra assessed over $170 million in fines, an 82% increase over the prior year. Finra needed these fines to close a significant funding gap.' * * * Daniel Nathan, partner at Orrick, Herrington & Sutcliffe and *a former Finra vice president and director of regional enforcement*, also cited the *potential incentive to rely on fines for revenue*. 'There appears to be some inconsistency,' he said. 'On one hand, they say they are excluding fine monies from budgetary needs, but on the other hand *Finra's stated guiding principles are that the fines will be used to promote compliance and improve markets. It does appear to create an incentive to collect fines, notwithstanding their claims otherwise*.' "[146]

If fines are in fact the driving force behind determining whether a member firm does or does not meet the criteria for "preliminarily" being a "Restricted Firm", then ***the***[147] Hearing Officer charged with reviewing the challenge brought by a member firm against the Department of Supervision Management must be presumed to be conflicted for all the reasons enumerated throughout this Section 7.A.2 (relating to Whether Conflicts of Interest are Ingrained in the Institution?)

The Hearing Officer in an expedited hearing can, out of loyalty to FINRA's mission, unwittingly become the instrument of targeting a broker/dealer for effective termination of membership; when lacking independence in the determination that a member firm should be a "Restricted Firm", the Hearing Officer is participating in a Bill of Attainder targeting the member firm for draconian "soft" punishment that is the *enhanced regulatory and financial challenges* of proposed new Rule 4111.

The Hearing Officer holding the office of adjudicator in an expedited hearing unites, in his person, both the power of the sword and the power of the purse.[148] This power is literally the power of life

[146] Jeff Benjamin, Finra budget to keep fees steady in 2019: Critics worry the regulator might be sending mixed messages about any dependence on fines, (Investment News - Mar 21, 2019 @ 2:30 pm). (Last visited Monday, June 24, 2019 @ 2:21:17 PM) (Emphasis supplied) Source: https://www.investmentnews.com/article/20190321/FREE/190329981/finra-budget-to-keep-fees-steady-in-2019.

[147] It is especially noted that "Hearings in expedited proceedings under proposed new Rule 9559 would be presided over by ***a*** Hearing Officer * * * ***instead of a Hearing Panel***." Regulatory Notice 19-17, p. 37 (Emphasis supplied) In other words, adjudication by a single Hearing Officer, not a panel of Hearing Officers.

[148] *Compare* James Madison, Helvedius No. 1: " * * * [It is that] great principle in free government * * *which ***separates the sword from the purse, or the power of executing from the power of enacting laws***." (24 August 1793)

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and death over a broker/dealer. But it was never the intent of Congress to give this kind of power to a regulator that claims to be a "not for profit organization".[149]

The membership is therefore very reasonably concerned that the Hearing Officer, being imbued with FINRA's culture, will give automatic approval or authorization to the decisions of others, without proper consideration, because of the pressure to be committed to the FINRA mission. Accordingly, the membership is legitimately hesitant to agree with FINRA that its Hearing Officer can and should review the Department of Member Supervision's determination that a firm is a "Restricted Firm". The consequences of the Hearing Officer's decision in this determination is, as we have stated, *mammoth* especially for the small to mid-sized member firm because of the "soft" financial punishment that these firms will suffer if the Hearing Officer is not impartial: The member is required to deduct deposits[150] in the Restricted Deposit Account when determining its net capital under Exchange Act Rule 15c3-1, potentially causing the member to go under net capital, triggering "early warning notice" to the SEC, effectively forcing the member to go out of business within three days. This is too important to ignore these Due Process concerns.

This brings this Comment Letter back to the point of origin, concern that Regulatory Notice 19-17 and its proposed new and amended rules, amount to Bills of Attainder.

7.B. <u>Rule 9550 (Expedited Proceedings to Implement Proposed Rule 4111) and the Prohibition against Bills of Attainder Not Protected by "Judicial Trials"</u>

It is expected that FINRA will say that its adjudicatory system is equivalent to a "judicial trial". But, before we address this point, let's summarize the relevant points of law.

The Constitution of the United States, Article I, Section 9, Paragraph 3 provides that: "No Bill of Attainder or ex post facto Law will be passed."

Chief Justice William H. Rehnquist writes:

[149] FINRA's standard disclosure is: "FINRA is a not-for-profit organization dedicated to investor protection and market integrity. It regulates one critical part of the securities industry – brokerage firms doing business with the public in the United States." *See e.g.*, http://www.finra.org/newsroom/2019/report-finra-board-governors-meeting-may-2019.

[150] It bears noting that the requirement to deduct deposits in the Restricted Deposit Account when determining net capital has another consequence: It amounts to freezing the firm's assets that, in turn, can prevent the firm's ability to finance an appeal from the Hearing Officer's negative finding. In short, "deducting deposits" is likely to obstruct a Smaller Firm ability to finance its appeals during the expedited hearing process and, if necessary, thereafter to the National Adjudicatory Council. In short, Rule 4111 operates to take away the firm's ability to defend itself.

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"These clauses of the Constitution are not of the broad, general nature of the Due Process Clause, but refer to rather precise legal terms which had a meaning under English law at the time the Constitution was adopted. A bill of attainder was a legislative act that singled out one or more persons and imposed punishment on them, *without benefit of trial*. Such actions were regarded as *odious* by the framers of the Constitution because it was *the traditional role of a court, judging an individual case, to impose punishment*."[151]

To restate Chief Justice Rehnquist, a Bill of Attainder is a law by means of which the Legislator punishes a targeted individual or group of individuals without the protection of a judicial trial.

Long before Chief Justice Rehnquist stated this classic statement about the nature of a Bill of Attainder, earlier justices of the Supreme Court had written:

"The Bill of Attainder Clause was not intended as a narrow, technical and soon to be outmoded prohibition, but rather as an implementation of the doctrine of "separation of powers," a safeguard against legislative exercise of the judicial function as to prevent trial by legislature."[152]

In short, the prohibition against a Bill of Attainder is centered on preventing the Legislator from acting as judge, jury, and executioner. It should now be clear from the discussion above, especially in Sections 7.A., 7.A.1, and 7.A.2 of this Comment Letter, that the *impartiality* of the Hearing Officer as final arbiter of the "Restricted Firm" determinations of the Department of Member Supervision is highly suspect, if not compromised, because of the *conflicts of interest* inherent in the FINRA adjudication system.

Because of this, the "separation of powers" function that is so fundamental to "preventing trial by legislature", and so clearly evident in the federal and state governmental systems of checks and balances, is plausibly absent in the FINRA system.

Member firms, especially small to mid-sized firms are hard pressed to take it on FINRA's word that there is a wall of separation between the rule-making body of FINRA and the adjudicatory body, i.e., the Office of Hearing Officers, that will be charged with reviewing the "Restricted Firm" determination of FINRA Department of Member Services, which, in the context of proposed new Rule

[151] William H Rehnquist, The Supreme Court: How It Was, How It Is, at p. 82, New York: William Morrow & Co. (1987). (Emphasis supplied)

[152] United States v. Brown, 381 US 437, 442 (1965).

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4111 is itself actually functioning as a quasi-judicial body. For example, in the "consultation" process that is part of the Preliminary Criteria for Identification process:

> "The proposed rule would give each affected member firm several ways to affect outcomes, including * * * a consultation with the Department at which the member could *explain why it should not be subject* to a Restricted Deposit Requirement * * * "[153]

In other words, the member firm goes before the Department of Member Services to argue its case as to why a "Restricted Firm" case should not be brought against the member firm. The Department, then, makes its determination (which, of course, the member firm can appeal to the Hearing Officer). This consultation with the Department is a hearing in its own right – a kind of preliminary hearing, to borrow a term from criminal procedure. This gives the Department of Member Services a quasi-judicial function.

At the same time, the Department of Member Services operates as "internal investigator", *in addition to* being a quasi-judge, in this "preliminary hearing":

> "For each member firm that meets the Preliminary Criteria for Identification, the Department would conduct, pursuant to proposed Rule 4111(c)(1), an initial internal evaluation to determine whether the member does not warrant further review under Rule 4111."[154]

Significantly, the Department is the "internal investigator" that decides for itself whether its assessment that the member firm preliminarily meets the criteria of being a "Restricted Firm" was a correct determination; and, if the member firm throws in the towel deciding not to appeal to the Hearing Officer,[155] then the Department is the single – *investigatory and adjudicatory* – body having the final say.

The equivalent in the court system goes something like this: The judge who sits in a preliminary hearing gets to decide whether there is a *prima facia* (a more likely than not likely) case against the

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[153] Regulatory Notice 19-17, p. 7.

[154] Regulatory Notice 19-17, p. 11.

[155] It may seem obvious but the following does need to be said. Notwithstanding FINRA's expressed intent is not to burden member firms when they claim the right to an expedited hearing – "the proposed rule is anticipated to reduce the costs associated with obligations imposed on misidentified firms by the proceeding's expedited nature" – the fact is that the cost of taking an appeal to the Hearing Officer in the expedited process is a significant and expensive burden that can bankrupt a Smaller Firm. (The quotation cited in this footnote is taken from page 30 of Regulatory Notice 19-17.)

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defendant; the judge holds the defendant for trial; and then this preliminary hearing judge is the same judge who sits in a bench trial on the merits of the case.

There is no material "separation of powers" here, any more than there is a material "separation of powers" when the Hearing Officer reviews the "Restricted Firm" determination of the Department of Member Supervision.

Because of this, the FINRA adjudication system – from which the Hearing Officer would serve as "appeals judge" from "Restricted Firm" determination made by the Department – is plainly not a "judicial trial" or any process equivalent to a "judicial trial".

Accordingly, proposed new Rule 4111 meets the 5th element of a Bill of Attainder: legislation lacking the benefit of a judicial trial.

8. <u>Other Constitutional Concerns: Rule 4111(i)(14) Constitutes a Regulatory Taking in Violation of the Fifth Amendment</u>

Proposed new Rule 4111(i)(14) would require the previously discussed Restricted Deposit Account to deposit a Restricted Deposit Requirement calculated at the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year;[156] this deposit account will be subject to the member firm's bank or clearing firm agrees:

> "*not to permit withdrawals from the account absent FINRA's prior written consent*; to keep the account separate from any other accounts maintained by the member with the bank or clearing firm; that the cash or qualified securities on deposit will *not be used directly or indirectly as security* for a loan to the member by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien or claim of any kind in favor of the bank, clearing firm, or any person claiming through the bank or clearing firm; that if the member becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and *withdrawals will not be permitted without FINRA's prior written consent*; that F*INRA is a third party beneficiary to the agreement*; and the agreement may *not be amended without FINRA's prior written consent.* In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member."[157]

[156] Regulatory Notice 19-17, pp. 15, 19.

[157] Regulatory Notice 19-17, pp. 17.

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The aforementioned *restrictions on a member firm's assets* need to be read in light other restrictions set forth in proposed new Rule 4111.01:

> " * * * a deposit in the Restricted Deposit Account would be an asset of the member firm that could *not readily be converted into cash,* due to the restrictions on accessing it. Accordingly, the member would be required to *deduct deposits* in the Restricted Deposit Account when *determining its net capital* under Exchange Act Rule 15c3-1 and FINRA Rule 4110."[158]

These restrictions, simply stated, amount to a "taking" – specifically, a "non-categorical regulatory taking", to use the language of the Courts.[159]

A "regulatory taking" is one in which a government regulation is "so onerous that its effect is tantamount to a direct appropriation or ouster."[160]

According to the Second Circuit U.S. Court of Appeals: "The gravamen of a regulatory taking claim is that the state regulation goes too far and in essence 'effects a taking.' "[161]

When determining whether a regulation "goes too far", Courts utilize the so-called *Penn Central*[162] factors:

(1) Economic impact of the regulation on the party claiming a "taking" of his property.[163]

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[158] Regulatory Notice 19-17, at 17.

[159] Sherman v. Town of Chester, 752 F.3d 554 (2nd Cir. – 2014): "Regulatory takings are further subdivided into categorical and non-categorical takings. * * * regulatory taking * * * occurs "when the government acts in a regulatory capacity * * *"

[160] Lingle v. Chevron U.S.A. Inc., 544 U.S. 528, 537 (2005).

[161] Buffalo Teachers Fed'n v. Tobe, 464 F.3d 362, 374 (2d Cir.2006) cited in Sherman v. Town of Chester, 752 F.3d 554 (2nd Cir. – 2014).

[162] Penn Central Transportation Co. v. New York City, 438 U.S. 104 (1978). *See* Ruckleshaus v. Monsanto Co., 467 U.S. 986, 1000–01, 1005 (1984). In determining how far is too far, we consider several factors, including "the character of the governmental action, its economic impact, and its interference with reasonable investment-backed expectations." Id. at 1005 (quoting PruneYard Shopping Ctr. v. Robins, 447 U.S. 74, 83 (1980). *But see* Gary Lawson, Katharine Ferguson & Guillermo A. Montero, "Oh Lord, Please Don't Let Me Be Misunderstood!": Rediscovering the Matthews v. Eldridge and Penn Central Frameworks, 81 NOTRE DAME L. REV. 1, 32 (2005): "[T]o the extent that the Court in *Penn Central* identified discrete factors for consideration, it identified two, rather than three, such factors: (1) the impact of the challenged regulation on the claimant, viewed in light of the claimant's investment-backed expectations and (2) the character of the governmental action, viewed in light of the principle that actions that closely resemble direct exercises of eminent domain are more likely to be compensable takings than are garden-variety land use regulations. Someone who knew nothing of modern takings law would be, to say the least, hard pressed to distill a discrete three-factor analysis from the opinion in *Penn Central*." (Emphasis supplied)

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(2) Character of the governmental action.[164]

8.A <u>"Economic Impact" of Rule 4111(i)(14) on a Member Firm's Assets</u>

Because the Restricted Deposit Account amount must be *deducted* from the member firm's available assets for calculating net capital, the member firm will need to *increase sales in order to increase profitability in order to increase capital* just to make up the "difference" – i.e. the amount placed into reserve in the Restricted Deposit Account – in order to meet the firm's SEC net capital requirements.

But, proposed new Rule 4111(i)(14) creates a kind of Scarlet Letter once FINRA identifies a member as a "Restricted Firm" that will adversely affect the firm's ability to make up this "difference":

- The "Restricted Firm's" salesmen that are not "bad brokers" will leave the firm.
- The "Restricted Firm's" customers will transfer their accounts out of the firm to a new broker/dealer.
- The "Restricted Firm" will find it difficult, if not nearly impossible, to recruit new brokers to replace the brokers – both "good" and "bad" – that leave the firm.

Consider these additional restrictions piled onto the member firm's burden:

- The assets in the Restricted Deposit Account – it needs to be <u>emphasized</u> here, these are the *member firm's assets* – cannot be used by the member firm for otherwise routine business purposes, namely, used as collateral for financing day-to-day business operations.
- The assets in the Restricted Deposit Account – again, it needs to be <u>stressed</u> here, these are the *member firm's assets* – are now ultimately controlled by FINRA because withdrawal of funds from this Account cannot be effected without FINRA's prior written approval.

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[163] <u>Buffalo Teachers Fed'n v. Tobe</u>, 464 F.3d at 375 (2d Cir.2006).

[164] <u>Buffalo Teachers Fed'n</u>, 464 F.3d at 375.

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- The legal ownership of assets in the Restricted Deposit Account – and once again, it needs to be underscored that these assets are, at law, supposed to be the *member firm's assets* – can pass to FINRA by virtue of the "third party beneficiary" requirement – a contract of adhesion[165] precisely because this is "third party beneficiary" contract is not an arms-length meeting of the minds agreement between two equal parties. Indeed, "the agreement may *not be amended without FINRA's prior written consent.*" [166]

- FINRA requires the "Restricted Firm" to reserve money for pending lawsuits – despite the fact that many firms do have Errors and Omissions (E&O) insurance that covers customer civil lawsuits (as well as arbitrations); yet, FINRA appears to be silent on the question whether E&O insurance can be taken into account when calculating the amounts needed to be set aside in the Restricted Deposit Account.

Surely FINRA appreciates the business reality that the member firm is deliberately being placed on the horns of a dilemma: *Either increase sales in order to increase profitability in order to increase capital* to meet SEC net capital and increase even more regulatory scrutiny by FINRA. *Or* allow sales to run flat, risk failing to meet net capital, and go out of business.

In a word, proposed new Rule 4111(i)(14) therefore operates as a self-fulfilling prophecy that decidedly has an "economic impact" on a firm that FINRA identifies as a "Restricted Firm".

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[165] Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991). Courts traditionally have reviewed with ***heightened scrutiny*** the terms of ***contracts of adhesion***, form ***contracts offered on a take-or-leave basis by a party with stronger bargaining power to a party with weaker power.*** Some commentators have ***questioned whether contracts of adhesion can justifiably be enforced at all*** under traditional contract theory because the adhering party generally enters into them without manifesting knowing and voluntary consent to all their terms. See, e. g., Rakoff, Contracts of Adhesion: An Essay in Reconstruction, 96 Harv.L.Rev. 1173, 1179-1180 (1983); Slawson, Mass Contracts: Lawful Fraud in California, 48 S.Cal.L.Rev. 1, 1213 (1974); K. Llewellyn, The Common Law Tradition 370-371 (1960). *See also* Monsanto Company v. McFarling, No. 01-1390 (U.S. Court of Appeals, Federal Circuit – 2002): "To be sure, the Supreme Court has yet to hold that adhesion contracts are ineffective to surrender rights granted by the Due Process Clause. ***But the Court's assessment of such surrenders has hardly been favorable.*** In Fuentes v. Shevin, 407 U.S. 67, 92 S.Ct. 1983, 32 L.Ed.2d 556 (1972), the Court considered an alleged waiver by an adhesion contract of the right to a prior hearing, another aspect of the personal liberty conferred by the Due Process Clause."

[166] Not even the SEC can do this. In order to get its hands on a bad party's assets (e.g., disgorgement of profits), the SEC must go to federal court in a preliminary injunction proceeding, obtain a temporary order that effectively places the party's assets in escrow, subject to a permanent injunction hearing. Only then, with a permanent Order of the Court in hand can the SEC take possession of its opponent's property. Even then, the SEC only acts as temporary custodian of these funds, holding the funds for injured investors and wait for these investors to come forward to reclaim their property. The SEC never becomes a "third party beneficiary" of these funds. Indeed, not even the Courts can take possession of a citizen's property *for the Court's own purposes*. In other words, no federal, state, or local court can sue a civilian in the court's name for the court's purpose. That is, no court has the power to become a "third party beneficiary" of any civilian's property. At best, a court can only hold contempt proceedings, criminally and civilly, against a party who has submitted to the court's jurisdiction. Even then, the court does not become a "third party beneficiary" of the civilian's property.

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The "economic impact" of proposed new Rule 4111(i)(14) is self-evident: Close the Doors – in the first instance, down the road; in the second instance, immediately. It is inconceivable that the Courts would not judge this to be a "taking" of a broker/dealer's private property.

That said, we move on to the element of "character of governmental action".

8.B **<u>"Character of Government Action" and Rule 4111(i)(14) and Regulatory Taking:</u>**

In determining "character of governmental action", Courts have considered these factors:

(1) Reciprocity of Advantage.

(2) Retroactivity.

8.B.1 **<u>"Reciprocity of Advantage" and Rule 4111(i)(14) and Regulatory Taking:</u>**

Reciprocity of advantage focuses on the distributional impact of the challenged governmental action. Regulations that impose burdens and confer benefits on all property owners generally have a neutral distributional impact. Everyone loses but everyone gains.[167] In contrast, regulations that impose burdens exclusively on some owners while generating benefits for others have a skewed distributional impact. The most extreme form would be a law that takes from A and gives to B, often cited as something that would violate the public use requirement of the Takings Clause.[168]

As we have previously pointed out, FINRA explains *for whom* this new Rule 4111 is *specifically* targeted:

> ". . .based on recent history FINRA *expects* that its annual calculations *will identify between 60-98 members* that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]."[169]

The motivation behind identifying these member firms for the Restricted Deposit Account is evidenced in the following FINRA statement:

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[167] Mark W. Cordes, <u>The Fairness Dimension in Takings Jurisprudence</u>, 20 KAN. J.L. & PUB. POL'Y 1, 21 (2010).

[168] <u>Kelo v. City of New London</u>, 545 U.S. 469, 477 (2005).

[169] Regulatory Notice 19-17, p. 9.

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> "The underlying policy for the proposed account requirement is that, to make a deposit requirement effective in creating appropriate incentives to members that pose higher risks to change their behavior, the member must be restricted from withdrawing any of the required deposit amount, even if it terminates its FINRA membership."[170]

Courts favor broad-based laws that offer reciprocity of advantage but find suspect laws that *single out* particular owners for *severe burdens* while conferring benefits on others.[171]

Proposed new Rule 4111 – particularly, subsection (i)(14) creating restrictions on the assets of "members that pose higher risks" – is suspect because it *singles out* these member firms. But upon closer inspection, this "singling out" is not broad-based at all and appears to be "class based", that is based on the three (3) categories of firm size: Small, Mid-Size, and Large.

This is amply demonstrated in the matrix in FINRA's Exhibit "D-2" to Regulatory Notice 19-17. For convenience, this matrix is (again) produced below:

Attachment D-2: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size*

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification						
		Small	Mid-Size	Large	Total	Small	Mid-Size	Large
		Number of Firms				Percent of Total		
2013	4,140	84	4	1	89	94%	4%	1%
2014	4,068	92	4	2	98	94%	4%	2%
2015	3,941	79	5	2	86	92%	6%	2%
2016	3,835	61	5	1	67	91%	7%	1%
2017	3,721	54	6	0	60	90%	10%	0%
2018	3,582	55	6	0	61	90%	10%	0%

* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st. 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.

170 Regulatory Notice 19-17, p. 9.

171 Hendler v. United States, 36 Fed. Cl. 574, 588 (1996).

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While there are fifty-five (55) small and six (6) mid-size firms that FINRA has preliminarily identified as "members that pose higher risks", there are zero (0) large firms so identified. FINRA's Exhibit "D-2" to Regulatory Notice 19-17 throws into question that proposed new Rule 4111 is a broad-based regulation that offers reciprocity of advantage precisely because *every large FINRA member firm avoids the enhanced regulatory and financial challenges* of proposed new Rule 4111.

At the same time, these enhanced regulatory and financial challenges create a burden that is *severe* for the smaller firms (small to mid-sized firms). As we previously stated in Section 8.A (relating to "Economic Impact" of Rule 4111(i)(14) on a Member Firm's Assets), the "economic impact" of proposed new Rule 4111(i)(14) on these smaller firms is self-evident: The only option is to shut down the business – either immediately or down the road.

Proposed new Rule 4111 – particularly, subsection (i)(14) creating restrictions on the assets of "members that pose higher risks" [read: small to mid-sized firms only] – imposes burdens on the smaller firm that work (wittingly[172] or unwittingly, it does not matter) to confer benefits on large firms.

"Reciprocity of advantage" is akin to equal protection under the law because, in implementing limitations to freedom for the benefit of the common good (which is what regulations do), a regulation is "just" when it creates a "*neutral* distributional impact" where *everyone* loses but *everyone* gains. This concept – "reciprocity of advantage" – is at the heart of the meaning of "just laws".[173]

But, singling out or targeting an individual or class of individuals or groups within the universe of membership members in order to impose a burden on that individual or group thereby benefiting the rest removes equality from the equation. Proposed new Rule 4111(i)(14), if adopted, will do precisely this: remove equality among member firms.

"Reciprocity of advantage" therefore has no play in proposed new Rule 4111(i)(14); and, for this reason, proposed new Rule 4111(i)(14) violates the public use requirement of the Takings Clause of the Fifth Amendment.

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[172] There is a strong suggestion that conferring this benefit to large firms may be intentional. *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "****The voices of large firms are heard way more loudly than the small firms because that's where FINRA gets its money from.* ***"

[173] "[J]ust laws * * *promise *equal protection* to all who abide by them." Ex Parte Kumenzo Kawato, 317 U.S. 69, 72 (1942).

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8.B.2 "Retroactivity" and Rule 4111(i)(14) and Regulatory Taking:

Lower court cases hold that *retroactive* regulations are to be assessed with greater skepticism under the character factor.[174]

One court, interpreting the character factor adopted by Justice O'Connor's plurality opinion in *Eastern Enterprises v. Apfel*,[175] specifically stated that where "the action is retroactive in effect" and "is targeted at a particular individual," this supports a finding of a "taking".[176]

We have already amply demonstrated that proposed new Rule 4111 is "action [that] is retroactive in effect".

By its own admission, FINRA has looked to historical past conduct of member firms[177] during the process of drafting regulatory criteria that will line-up with histories of misconduct so that FINRA can, once Rule 4111 is implemented, "convict" those "members that pose higher risks" – who have already been identified even before the comment period for Regulatory Notice 19-17 has expired – so that, in the end, *the enhanced regulatory and financial challenges* of proposed new Rule 4111 can be imposed on these "members that pose higher risks" in order to bring about the end game: Shut down the business of these firms – either immediately or down the road.

We have previously pointed out that FINRA explains *for whom* this new Rule 4111 is *specifically* targeted:

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[174] Lost Tree Vill. Corp. v. United States, 100 Fed. Cl. 412, 438 (2011); Brace v. United States, 72 Fed. Cl. 227, 356 (2006); Carolina Power & Light Co. v. United States, 48 Fed. Cl. 35, 49 (2000).

[175] E. Enters. v. Apfel, 524 U.S. 498 (1998) (plurality opinion).

[176] Am. Pelagic Fishing Co. v. United States, 49 Fed. Cl. 36, at 50 (Fed. Cl. 2001) rev'd on other grounds, 379 F.3d 1363 (Fed. Cir. 2004).

[177] See Regulatory Notice 19-17 p. 3, 4: "FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and member firms that have *a history of misconduct*. * * * While these firms may eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with *a history of misconduct* that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers. * * * Such firms *expose investors to real risk.* For example, FINRA has identified certain firms that have a concentration of individuals with *a history of misconduct*, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. * * * [I]ndividuals and firms with *a history of misconduct* can pose a particular *challenge for FINRA's existing examination and enforcement programs*. * * *"(Emphasis supplied)

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> ". . .based on recent history FINRA *expects* that its annual calculations *will identify between 60-98 members* that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]."[178]

In 2014, the Second Circuit found "targeting" to be a critical factor when determining whether a regulatory taking did take place. The Court stated:

> "[T]the Town *singled out* Sherman's development, *suffocating him with red tape to make sure he could never succeed in developing* MareBrook [Sherman's real estate and proposed development]. The Town's alleged conduct was *unfair, unreasonable, and in bad faith.* Though the precise contours of the "character" factor may be blurry, we can nevertheless conclude that the Town's conduct in this case falls safely within its [i.e., regulatory taking] ambit."[179] (Emphasis supplied)

Paraphrasing the Court's decision in *Sherman v. Town of Chester*, it is easy to see how proposed new Rule 4111 fits squarely within the Second Circuit's description of "regulatory taking":

> "[T]the Town [read: FINRA] *singled out* Sherman's development [read: smaller member firms], *suffocating him* [read: smaller member firms] *with red tape* [read: Rule 4111, and especially subsection (i)(14)] *to make sure he* [read: smaller member firms] *could never succeed in developing* MareBrook [read: smaller member firms developing their businesses]."

Because proposed new Rule 4111(i)(14) violates *Eastern Enterprises'* prohibition against "retroactivity" in conjunction with "targeting", Rule 4111, and especially subsection (i)(14), "falls safely within the 'regulatory taking' ambit" formula set forth in *Sherman v. Town of Chester.*

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[178] Regulatory Notice 19-17, p. 16.

[179] Sherman v. Town of Chester, 752 F.3d 554 (2nd Cir. – 2014) finding that regulatory taking had taken place: "Regulatory takings are further subdivided into categorical and non-categorical takings. * * * regulatory taking * * * occurs "when the government acts in a regulatory capacity * * * Balancing the Penn Central factors, we conclude that Sherman stated a non-categorical [regulatory] takings claim."

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8.B.3 Regulatory Taking & Rule 4111(i)(14)

To sum things up thus far, proposed new Rule 4111(i)(14) amounts to "government action" [180] that amounts to a "taking" of a broker/dealer's private property because FINRA's action "goes too far" and also because the "character" of FINRA's action:

- Violates the principle of "Reciprocity of advantage" because proposed new Rule 4111(i)(14) create restrictions on the assets small to mid-sized firms, imposing burdens on the smaller firm that work to confer benefits on large firms, thereby removing equality among member firms; and,

- Is "retroactive in effect" and "targeted at a particular" members firms – firms that FINRA has prejudged to be a "Restricted Firm" even before the comment period for Regulatory Notice 19-17 has expired and before proposed new Rule 4111(i)(14) has been reviewed and approved by the SEC and implemented and officially imposed on member firms.

Justice Holmes, writing for the majority in Pennsylvania Coal Co. v. Mahon,[181] 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."* This "going too far" in regards to proposed new Rule 4111(i)(14) is demonstrated by:

- FINRA's deliberate decision to craft a regulation with criteria that is not general in nature but instead specifically lines up with the history of misconduct of certain smaller firms that FINRA has targeted for voluntary or involuntary termination from membership *by operation of the "economic impact"* of proposed new Rule 4111, is a regulation that "goes too far".

- FINRA's deliberate decision to "single out" or "target" a small segment of the FINRA membership population that FINRA knows or reasonably knows *in advance of implementation* will be identified as a "Restricted Firm" ("preliminarily" and ultimately "determined" and even "re-determined" to be a "Restricted Firm"), is a regulation that "goes too far".

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[180] Network 1 is aware that FINRA takes the position that FINRA is a private non-profit, not a government agency or a "state actor". Proposed rule changes, both in Regulatory Notice 18-16 and again here in Regulatory Notice 19-17, stretch the limits of this stance. Network 1 has amply demonstrated that the proposed rule changes in Regulatory Notice 18-16 "crossed the line" into "state action". In Section 9 of this Comment Letter, Network 1 will demonstrate that Regulatory Notice 19-17 likewise crosses the line into "state action". With that in mind, we hold firm that the statement that proposed new Rule 4111 constitutes, FINRA's "government action" on FINRA's part and, as such, amounts to a "taking" of a broker/dealer's private property.

[181] 260 U.S. 393 (1922) (Emphasis added).

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- FINRA's deliberate decision to *retroactively* apply this "Restricted Firm" criteria to certain smaller firms in order to impose the *enhanced regulatory and financial challenge*s of proposed new Rule 4111, *before the proposed rule has been reviewed and approved by the SEC*, is a regulation that "goes too far".

- FINRA's deliberate decision to "single out" or "target" a small segment of the FINRA membership population that FINRA knows or reasonably knows in advance will fit the category of being "preliminarily" and ultimately "determined" and even "re-determined" to be a "Restricted Firm" so that the "Restricted Firm" will be subject to the *enhanced regulatory and financial challenge*s of proposed new Rule 4111 likewise "goes too far".

- FINRA's deliberate plan to impose these burdens on member firms that FINRA alone judges, without review by either the SEC or the Courts, to be "members that pose higher risks", is a regulation that "goes too far".

- FINRA's deliberate plan to craft a regulation that has as its "end game" the goal of encouraging these firms to simply shut their doors because the cost of compliance and over-regulation makes staying in the securities business no longer desirable or profitable, is a regulation that "goes too far".

- FINRA's deliberate plan to single out smaller firms with *enhanced regulatory and financial* burdens in order to benefit larger firms, is a regulation that simply "goes too far".[182]

For these reasons, proposed new Rule 4111(i)(14) "falls safely within the 'regulatory taking' ambit" formula set forth in *Sherman v. Town of Chester*. It is inconceivable that, with this targeted

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[182] Consider this interesting omission from Regulatory Notice 19-17. At page 10, FINRA displays a matrix that gives examples of "the point at which a member firm's Preliminary Identification Metrics would meet the Preliminary Identification Metrics Thresholds in proposed Rule 4111(i)(11)". In this matrix, FINRA sets for examples for (A) member firms that have 1 to 4 registered persons; (B) member firms that have 20 to 50 registered persons; and (C) member firms that have 51 to 150 registered firms. ***Noticeably absent is any demonstration of the point at which a Large Firm would meet the Preliminary Identification Metrics Threshold.*** Is the inference that FINRA does not elaborate on Preliminary Identification risk to Large Firms because this risk does not exist for Large Firms? That said, if we attempt to imagine this risk to Large Firms, might we see something like the following: Large Firms with 3,000 brokers can have 400 brokers and hundreds of adjudicated and pending events, but there is either no triggering event for the Large Firm worth analyzing because the Large Firms have sufficient capital to handle the "Maximum Restricted Deposit Requirement" or Large Firms are simply "too big to fail" - or, that Rule 4111 was created, with such understanding of Large Firm broker histories of misconduct that the criteria of Rule 4111 would never trigger a Preliminary Identification Metrics Threshold for Large Firms. In contrast, a Smaller Firm with 100 brokers and 25 restricted brokers invariably risks "the death penalty". Hypothetically speaking, Large Firms can have pending arbitrations with potential losses of $500 million and without needing to set up a reserve, whereas Smaller Firms with $100 thousand in losses or potential losses will have to set up a reserve, effectively forcing the Smaller Firm out of business. If this is the reality, then this reality strongly points to the conclusion that the ultimate objective of Rule 4111 is to favor the Large Firm at the expense of the Smaller Firm, eventually eliminating the Smaller Firms.

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deliberation on the part of a regulator that claims not to be a "government agency" yet possess the "force of law" every day, the Courts would not judge FINRA's "government action" to be a "taking" of a broker/dealer's private property.

9. Whether the Proposed New Rule 4111 That Amounts to a Bill of Attainder and a Regulatory Taking of Member Property Makes 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."[183]

Previously in Regulatory Notice 18-16, FINRA proposed to amend NASD Rule 1010 Series affecting the MAP rules, that amounted to dictating *whom* member firms are permitted hire, and also *how many* brokers a firm may hire.[184]

The "employment" initiative set forth in Regulatory Notice 18-16 appears, at this time, to be put on hold for the time being. That said, FINRA appears to be revisiting this "employment" issue through an alternative strategy in proposed new Rule 4111(c)(2) (relating to the One-Time Opportunity to Reduce Staffing Levels).

The One-Time Opportunity to Reduce Staffing Levels is explained in Regulatory Notice 19-17 as follows:

> "If the Department determines, after its initial evaluation, that a member that meets the Preliminary Criteria for Identification warrants further review under Rule 4111, such member—if it would be meeting the Preliminary Criteria for Identification for the first time—*would have a one-time opportunity to reduce its staffing levels to no longer meet these criteria*, within 30 business days after being informed by the Department. The member would be required to demonstrate the staff reduction to the Department by *identifying the terminated individuals. The proposed rule would prohibit the member from rehiring any persons terminated pursuant to this option, in any capacity, for one year*. A member that has reduced staffing levels at this stage may not use that staff-

[183] *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.

[184] *See* Network 1 Financial Securities Comment Letter (29 June 2018), Section 4.B (relating to "Whether the Proposal to Amend the NASD Rule 1010 Series [MAP Rules] Amounts to Taking of Property Making FINRA a "State Actor") at pp. 28-41. Source: https://www.finra.org/sites/default/files/notice_comment_file_ref/18-16_Netw1_Comment.pdf. The legal arguments made in the 29 June 2018 Comment Letter are hereby incorporated by reference into Network 1's Comment Letter of 1 July 2019 because of the close interworking between the proposals in Regulatory Notice 18-16 and Regulatory Notice 19-17.

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> reduction opportunity again * * * If * * * the Department determines that the member still meets the Preliminary Criteria for Identification *even after its staff reductions*, or if the member elects not to use its one-time opportunity to reduce staffing levels, *the Department would proceed to determine the member's maximum Restricted Deposit Requirement*, and the member would proceed to a Consultation with the Department."[185]

Notwithstanding the previous attempt in Regulatory Notice 18-16 to dictate *whom* member firms are permitted hire and how many brokers a firm may *hire*, FINRA does not, as yet, interfere with whom a member hires and fires. But proposed new Rule 4111(c)(2) will change this. This time FINRA's focus is not on hiring, but on *firing*.

Traditionally, both hiring and especially *firing* – "reducing staff", to use FINRA parlance – has been a business decision that belongs exclusively to the employer. To date, no government (state, federal, or municipal) or its agencies *or its delegates* have ever crossed the line to presume the power to dictate when and under what circumstances an employer must *fire* its employees *or else face economic / financial consequences*.[186]

At common law, the role of government is to enforce, not interfere, with contracts. This means that, at common law, an employer should not be prohibited from hiring, firing, promoting, or demoting whomever he wants and for whatever reason he wants.[187] 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

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[185] Regulatory Notice 19-17, p. 11-12 (Emphasis supplied).

[186] Regulatory Notice 19-17, p. 12: "* * * If * * * the Department determines that the member still meets the Preliminary Criteria for Identification *even after its staff reductions*, or if the member elects not to use its one-time opportunity to reduce staffing levels, *the Department would proceed to determine the member's maximum Restricted Deposit Requirement*, and the member would proceed to a Consultation with the Department." (Emphasis supplied) There is another important consequence that appears to have been overlooked, wittingly or unwittingly. And that is this: Not only can the Department proceed to determine the member's maximum Restricted Deposit Requirement, but the Department can utilize the proposed new Rule 4111 system to start further investigations from which FINRA could then institute an enforcement action.

[187] *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/volumc3/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.

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property".[188] That said, today we know that this principle has been whittled away by the condition, "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 when an employer discriminates, at hiring, based on race, color, religion, sex, or national origin.[189] 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.[190] Employers can suffer liability for damages when failing to promote an employee because of her gender, despite qualifications.[191] And more recently, state governments have entered into the "hiring, firing, promoting, or demoting" arena, with at least 25 States having passed one form or another of "right-to-work" laws.[192]

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. It is "state action" pure and simple.

Thus, proposed new Rule 4111(c)(2) has ramifications that 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".

One Law Commenter, who is now a Commissioner for the U.S. Securities and Exchange Commission, states the case better than anyone to date has stated 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."[193]

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[188] *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

[189] 42 U.S.C. Section 200003-2 (1982).

[190] Drazewski v. Waukeegan Dev. Center, 651 F.Supp. 754 (N.D. Ill. 1986).

[191] 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).

[192] *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.

[193] 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

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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 ..."[194] (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".[195]

But the proposed new Rule 4111(c)(2) would change this, decisively.

Until now, hiring, *and most especially firing*, has been the exclusive province that belongs to the private sector. Right now it is the member firm that is in charge of *whom* it fires. If the SEC approves the proposed new Rule 4111(c)(2), FINRA – not the member firm – will hold the *effective* power to fire. This makes FINRA "it will look even less like an SRO and more like a governmental regulator".[196]

Commissioner Peirce is not the only SEC Commissioner who has expressed concerns over FINRA ventures into "government action" territory. Former SEC Commissioner Daniel M. Gallagher raised similar concerns about the true nature of today's FINRA, as well as its perhaps too-close-relationship with the SEC. Former Commissioner Gallagher writes:

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[194] 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)

[195] *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).

[196] 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

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"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."[197] (Emphasis supplied)

Respected law commenters like Professor Roberta S. Karmel have correctly assessed:

"Although FINRA may not be a government entity,[198] in all or virtually all of its activities, it can be viewed as exercising powers delegated to it by the SEC."[199]

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."[200]

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[197] 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. Source: 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.

[198] It is worth mentioning that another federal government agency – the Internal Revenue Service of the U.S. Treasury Department – concurs that "***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)

[199] 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

[200] *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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Former SEC Commissioner Gallagher has, on a separate occasion, asked the incisive question: *Is FINRA becoming a "deputy SEC"?*[201] Regulatory Notice 19-17 in conjunction with Regulatory Notice 18-16 answers this question in the affirmative.

As a "deputy SEC" having power and authority to dictate whom member firms are permitted hire (assuming FINRA goes forward with proposed new Rule 4111, especially subsections (c)(2) and (i)(14) discussed extensively elsewhere in this Comment Letter, and assuming the SEC approves these rule proposal), FINRA arguably crosses the threshold of "Becoming a Fifth Branch" of government[202] - the Fourth Branch being the administrative agencies (as for example, the SEC) of the federal government.

There is no debating whether the proposed new Rule 4111 and the proposal to create one new rule, Rule 9559, amending existing rule Rule 9549 to be renumbered as Rule 9560 are consistent with FINRA's mission.

The debate 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.

One State Securities Administrator hits 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."[203]

This "state actor" issue was brought to a head by Regulatory Notice 18-16 and is again resurrected in Regulatory Notice 19-17. Interfering with employment relationships between employer and employee crosses that line that separates "private sector" from "state action", transforming private club

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[201] 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/

[202] *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).

[203] 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 (Emphasis supplied)

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membership rulemaking into "government action". When it does, constitutional prohibitions against Bills of Attainder and Regulatory Taking are triggered.

10. <u>Factors Important to Smaller Firms but Overlooked by FINRA in Crafting Regulatory Notice 19-17 and Proposed New Rule 4111:</u>

10.A <u>FINRA's Determination of a Maximum Restricted Deposit Requirement [Proposed Rule 4111(i)(15)] without regard for E&O Insurance</u>

FINRA writes:

> "* * * As provided in proposed Rule 4111(i)(15), the Department would consider the nature of the member's operations and activities, *annual revenues*, *commissions*, *net capital requirements*, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, *the amount of any "covered pending arbitration claims" or unpaid arbitration awards*, and concerns raised during FINRA exams. * * * FINRA's intent is that the maximum Restricted Deposit Requirement should be significant enough to change the member's behavior *but not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement*."[204]

Network 1 accepts as true and believes to be genuine FINRA's representation that its intent in crafting proposed Rule 4111(i)(15) is be "not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement."

Therefore, Network 1 believes that it is must be an oversight that the matter of Errors and Omissions (E&O) Insurance was not included in the discussion about "annual, commissions, net capital requirements" in connection with "the amount of any 'covered pending arbitration claims' or unpaid arbitration awards".

Accordingly, Network 1 respectfully requests that FINRA take into account that many firms have E&O insurance that covers a broker/dealer's payment of awards entered in favor of customers by FINRA arbitrators. Yet this "insurance" factor has not been taken into account by FINRA when

[204] Regulatory Notice 19-17, p. 12.

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considering the amount that FINRA requires to be set aside for either the minimum or maximum Restricted Deposit Requirement in proposed new Rule 4111(i)(15). Network 1 respectfully requests that E&O Insurance reduce, dollar for dollar, the amount that a member firm would be required to segregate from its net capital and deposit into the Maximum Restricted Deposit Requirement.

10.B FINRA's Determination of a Maximum Restricted Deposit Requirement [Proposed Rule 4111(i)(15)] without regard for "Bona Fide" Nuisance Claims Brought in Arbitration

Again, FINRA writes:

> "* * * As provided in proposed Rule 4111(i)(15), the Department would consider * * * the nature of the disclosure events counted in the numeric thresholds, *the amount of any "covered pending arbitration claims"*[205] * * *"[206]

In its Comment Letter to Regulatory Notice 18-16, Network 1 devoted three (3) sections[207] to the issue of "nuisance value" lawsuits and arbitrations brought by customers, especially through the aegis of non-attorney representatives.[208] As an appendix to these two sections, Network 1 presented a ten (10) page matrix summarizing the fact that an overwhelming number - **71.428%** - of these arbitration cases brought by these non-attorney representatives were "nuisance value" cases.

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[205] Footnote 10 to Regulatory Notice 19-17: "The term 'covered pending arbitration claim' is defined in proposed Rule 4111(i)(2) to mean an investment-related, consumer initiated claim filed against the member or its associated persons that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. The claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees. This term also is proposed in Regulatory Notice 18-06 (February 2018). FINRA anticipates that the term would be amended in proposed Rule 4111(i)(2) to conform to any final definition adopted under the proposal in Regulatory Notice 18-06. For purposes of this Notice, the term "unpaid arbitration awards" also includes unpaid settlements related to arbitrations."

[206] Regulatory Notice 19-17, p. 12.

[207] *See* Network 1 Financial Securities Comment Letter (26 June 2018): Section 4.A (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]) and Section 6.B (FINRA Should Exclude Certain Arbitration Settlements Entirely From "Materiality" Considerations in the Proposal to Amend the NASD Rule 1010 Series [MAP Rules]) and Section 6.C (relating to 6.C FINRA Should Exclude Certain Arbitration Settlements Entirely BrokerCheck Disclosure.) Source: https://www.finra.org/sites/default/files/notice_comment_file_ref/18-16_Netw1_Comment.pdf

[208] As of this writing, FINRA has communicated that in December 2018, the Board of Governors has approved The Board approved two rule proposals to be published by FINRA for comment or filed with the SEC, one of which is the proposal to prohibit compensated Non-Attorney Representatives (NARs) in arbitration and mediation: " The Board approved filing with the SEC proposed amendments to the Codes of Arbitration and Mediation Procedure relating to prohibiting compensated non-attorney representatives from practicing in the FINRA arbitration and mediation forum." Source: http://www.finra.org/newsroom/2018/report-from-finra-board-of-governors-meeting-december-2018. That said, as of the date of composition of the instant Comment Letter, this rule proposal appears not to have been submitted to the SEC for review.

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Accordingly, Network 1 respectfully requests that FINRA take into account this disproportionate percentage of arbitration cases as being bona fide "nuisance value" in nature.

On a related note, proposed new Rule 4111 would allow law firms, acting on a contingency fee basis when engaging in "barratry",[209] knowing the impact on the firm's net capital, to effectively hold smaller firms hostage to the repercussions of "Restricted Firm" status, by threatening arbitration in "nuisance value" cases in hope for "quick and quiet resolution".

Once again, proposed new Rule 4111(i)(14) operates as a self-fulfilling prophecy. By identifying a member firm as a "Restricted Firm", proposed new Rule 4111(i)(14) puts a target on the backs of these member firms, drawing these firms to the attention of law firms engaged in "barratry", encouraging even more "nuisance value" arbitrations to be brought against such member firms, resulting in a downward spiral that never ends.

Accordingly, Network 1 respectfully requests that FINRA take into account the unethical practice bringing "nuisance value" lawsuits and exclude – not include - *pending* arbitration claims when considering the amount that FINRA requires to be set aside for either the minimum or maximum Restricted Deposit Requirement in proposed new Rule 4111(i)(15).

11. Conclusion

No one can reasonably dispute that a workable solution to the problem of dealing with "bad brokers" in the securities industry is needed.

At the same time, everyone who is reasonable can appreciate the frustration that FINRA is experiencing, and has experienced for years, in attempting to deal with "bad brokers" on a day-to-day basis while at the same time coming up with an enduring solution that (1) protects the investing public from "bad actors"; (2) curbs bad behavior of repeat offenders who cannot be so easily terminated; (3) preventing "bad actors" from the jumping from one firm to another, if not outright remove them from the securities industry; and (4) does so in a practical way that is in consonance with fundamental principles of justice and in compliance with constitutional prohibitions that limit the extent to which power can be exercised consistent with liberty in the marketplace. Economic freedom working in

[209] *See* footnote 164, Network 1 Financial Securities Comment Letter (26 June 2018).

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tandem with virtue[210] or virtuous behavior has been the hallmark of what, traditionally, made America uniquely what it is and the envy of all other nations. Keeping virtue in the market place – the goal of

[210] This question – What is Virtue? – is so fundamental, to both the analysis and coming up with an ultimate solution to the real or perceived problem of bad behavior especially in the market place, that it deserves serious dedication of time and effort. Philosophy does have consequences. In this footnote we will present some background to how the philosophy of law has looked at virtue as pertains to the market place. But let's start with a practical 21st century scenario and potential ethical problem. A financial advisor sells a variable annuity to an 80 year old senior citizen. Or a stock broker engages in active trading for a customer of no particularly relevant age. Today, we conduct the analysis through the prism of suitability or very recently through the prism of "best interests" of the customer. Today's regulatory analysis – suitability / best interest – is actually the logical conclusion to the long search for justice in the market place whose problem was created by the shift in, or more accurately, towards contract law that began in Reformation Europe in the 1500s. Prior to that time, the law of the market place was governed by Roman law and natural law principles. In the days when Roman and natural law principles prevailed, an agreement between parties needed to have a *causa* in order to become a contract enforceable by the strong arm of the law. As the Roman jurist Ulpian explained: "If there is no additional ground [*causa*], in that case it is certain that no obligation can be created on the mere agreement; so that a bare agreement does not produce an obligation." Natural Law jurists built on this fundamental principle of *causa*, concluding that a "morally binding promise should also be legally binding if it is part of an agreement (a *pactum*, or consensual obligation) that is itself morally justified. The object or purpose (*causa*) of the contract had to be reasonable and equitable." This led to two significant restraints on the freedom of contracts that went beyond Roman law: the prohibition against enforcing usurious contracts and the requirements that contracts must be made at a just price. The Natural Law jurists' reliance on an objective standard of justice determined which agreements created an obligation as determined by civil law. Things changed in post-Reformation Europe created by the new theology that emphasized *individual* and *subjective* determination (in contrast to the former emphasis being on the common good). The Roman Law concept of *causa*, supplemented by the Natural Law requirement that the *causa* be both reasonable and equitable, was supplanted in Reformation England by the concept of *consideration*. Every first year law student learns that, in the absence of *consideration*, there is no binding contract at law *Consideration* is the "bargained for exchange". Whereas in pre-Reformation Europe only contractual promises supported by a *causa* were legally enforceable and enforced, in post-Reformation England the courts developed the practice of only enforcing *bargains* – that is, contractual promises supported by *consideration* – again, an exchange of bargained-for promises. In Natural Law jurisdictions, parties were always free to contract, but only *just* contracts – that is, contracts supported by *causa* – were enforceable by the law; in other words, obligation of the parties to fulfill their promise rested on the cause or *justness of the transaction*. Post-Reformation English courts rejected this Natural Law understanding of law in favor of *strict liability*. One of the oldest English court decisions, *Paradine v. Jane*, 82 E.R.519 (Kings Bench, 1647), set the trend for this shift away from contracts supported by *causa* replaced by contracts supported by *consideration*, creating *strict liability* for freely made covenants, leaving each party to bear the risk of unforeseen circumstances. Although modern English and American courts have, over the years, attempted to temper the purity of strict liability by introducing concepts like "mistake", "frustration of purpose", etc., the starting point in every judicial review of a transaction is (1) inviolability of the bargain and (2) strict liability for each party to bear the risk of unforeseen circumstances (e.g., volatility in the markets). Now let us apply these Roman Law/Natural Law and Post-Reformation Contract Law principles to the two scenarios postulated at the beginning of this footnote. Under Roman/Natural Law principles, the transaction (selling a variable annuity to an 80 year old senior citizen) lacks a *causa* because the transaction objectively lacks, not just reason, but equity. At Roman Law, and in Natural Law jurisdictions, it is the right of the state or government to step in between the parties in order to protect the common good from the immorality of the transaction – it does not matter whether the 80 year customer wants, needs, or thinks he needs a variable annuity; the individual's wants and needs are subordinate to the best interests of the common good. In Natural Law jurisdictions, this transaction would not be legally enforceable contract because the transaction lacks *causa*. A law-giver and the courts in a Natural Law jurisdiction would be free to declare this transaction and similar transaction as against the common good. A different conclusion is reached under contract law principles that started in post-Reformation Europe. These principles are the foundation of American capitalism and are the principles that are at play in the securities industry, today. In our scenario, even though the customer may be 80 years old, the "bargain" (i.e, the purchase of the variable annuity) is *inviolable*; and because the bargain is inviolable, each party – here especially the 80 year old customer – *bears his own risk* of unforeseen circumstances: *consideration* has replaced *causa* (with its concern for reasonableness and equity and morality). And because the contract is enforceable, there can be no imputation of wrongdoing to the financial advisor, at least under principles of American capitalism. The same respective conclusions would apply for the customer engaged in active trading of his account. Under Roman and Natural Law principles, *causa* (with its concern for reasonableness and equity and morality) is lacking because of the state's concern for the practical effect that gambling and other considerations ultimately have on the common good. But under post-Reformation contract of law principles, *causa* (with its concern for reasonableness and equity) is no longer legally relevant; concern for the common good is replaced by the new theology's emphasis on *individual* and *subjective* determination of what is good for himself – and in this scenario for *this* particular customer. The customer is free to engage in any covenant he wants without any interference by government (or its administrative agencies or their delegates) and the quid pro quo for this freedom of contract is that the customer bears, on his own, the risk of loss caused by the market place. Under

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FINRA Rule 2010's requirement that members firms and their brokers "observe high standards of commercial honor and just and equitable principles of trade" – is the ultimate objective, we believe, of FINRA's efforts in Regulatory Notice 19-17.

Unfortunately, proposed new Rule 4111 "goes too far", to use Justice Holmes' phrase.[211]

Arguably, proposed new Rule 4111 is, as a result of powers directly delegated by Congress to FINRA and indirectly by the SEC, the product of Rule-Making that has the "force of law"[212] and is therefore Legislation as this term is meant in the context of the definition of a Bill of Attainder.[213]

Proposed new Rule 4111 is a Bill of Attainder precisely because, prior to rolling out this rule proposal for comment by the membership and review and approval by the SEC, FINRA has already identified a subset of FINRA membership - sixty-one or so member firms - that FINRA has targeted to be identified as "high risk firms" so that FINRA can employ the criteria crafted into Rule 4111 with these firms in mind, in order to formally adjudge (through a non-judicial process) these same firms to be "Restricted Firms", thereby triggering limitations on how these firms can utilize their assets for net capital calculation – with the ultimate objective of pressing these firms to voluntarily "close their doors" – some sooner, others later – without needing to undertake termination of membership through the normal course of enforcement proceedings.

Roman and Natural Law principles, the contract, though not legally enforceable, is also not morally justifiable; therefore, the broker, having encouraged the customer to engage in immoral conduct (i.e, active trading), could be deemed a "bad broker". The opposite is true under American capitalist principles founded in post-Reformation contract law: the same broker is not a "bad broker" because: (1) the broker is nothing more than one of the parties to the bargain (the customer, the other party, wants to actively trade and the broker, because of his FINRA registrations, has the power to execute his customer's trading orders); (2) the bargain is supported by consideration (e.g., commissions in exchange for services to the customer); and (3) because the transaction (active trading) is *morally neutral* (i.e., *causa* in its concern for reason and equity is replaced by *consideration*); thus, the broker cannot be deemed a "bad broker". Things like cost-to-equity, or profit-and-loss, and commission-to-equity ratios are, in principle, legally meaningless in fundamental post-Reformation/American capitalism. As we said at the outset, Philosophy has consequences. This is why it is, and will continue to be, so very difficult to reasonably arrive at defining who is, and who is not, a "bad broker". So long as a broker conducts securities business *consonant with the principles of American contract law*, whose principles derive ultimately from the English courts of the post-Reformation, any criteria attempting to define a broker as a "bad broker" will ultimately struggle to survive scrutiny under the weight of objective reasoning whenever "bad broker" criteria contradicts the fundamental principles of contract law that leaves no room for *causa* (with its focus on reason, equity – and, under the operation of natural law – morality) because, in the final analysis, declaring a broker to be a "bad broker", under any criteria, is a moral judgment. – jcc

[211] Justice Holmes, writing for the majority in Pennsylvania Coal Co. v. Mahon, 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*."

[212] Pursuant to the Supreme Court's *Chevron-Mead* analysis, rules of such administrative agencies as the Internal Revenue Service and the Treasury Department and the Federal Trade Commission have been deemed by the Court to have the "force of law".

[213] Section 5 of this Comment Letter (relating to Rule-Making as Legislation); Section 6 of this Comment Letter (relating to FINRA and Congressional Delegation).

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In other words, through proposed new Rule 4111, FINRA hopes to accomplish indirectly that which it has been struggling, if not failing (according to FINRA's implied admissions), to accomplish directly through enforcement proceedings – the accepted course that at least has some modicum of due process.

And because proposed new Rule 4111 "goes too far", FINRA has triggered another constitutional prohibition, namely, the prohibition against "regulatory taking" of private property:

- In Regulatory Notice 18-16, FINRA triggered regulatory taking because it aimed at controlling a member's property right to *hire* whom it so chooses;

- In Regulatory Notice 19-17, FINRA triggers regulatory taking because it aims at controlling a member's property right, as an employer, to *fire* employees.

Because of these principles of law, arguably (from our perspective, but not FINRA's perspective), FINRA is a "state actor". Because FINRA is a "state actor", prohibitions against "attaint of persons" and "taking of property", as set forth in the U.S. Constitution, apply.

Proposed new Rule 4111 is a Bill of Attainder that violates the constitutional prohibition against "regulatory taking" of property by "government action", whether at the hands of agencies or deputies of government agencies.[214]

That said, it is worthy of consideration that proposed new Rule 4111 may not even be necessary, based on statistics provided by FINRA.[215]

Proposed new Rule 4111 is premised on the need to "creat[e] appropriate incentives to members that pose higher risks to change their behavior."

[214] As Network 1 has argued, and we believe amply demonstrated in its June 26th 2018 Comment Letter to Regulatory Notice 18-16, FINRA is in the many functions that it performs a "deputy" of the SEC, and for this reason triggers "state action", making FINRA a "state actor". https://www.finra.org/sites/default/files/notice_comment_file_ref/18-16_Netw1_Comment.pdf, at pp. 15, 16, 28, 30, 37-38, 40, 41, 46.

[215] *See* the FINRA Exhibit D-2 attachment to Regulatory Notice 19-17.

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But the percentage of *decline in the number of Bad Brokers*, from 2013 to 2018, *has decreased by* **20.50%.** Based on these statistics, arguably, FINRA is already accomplishing its objective without the need for proposed new Rule 4111.

Year	Percentage of 'Preliminarily' Identified Bad Firms	Number of "Bad Firms" divided by Total Number of Firms
2013	2.14%	89 / 4,140
2014	2.40%	98 / 4,068
2015	2.18%	86 / 3,941
2016	1.70%	67 / 3,835
2017	1.60%	60 / 3,721
2018	1.70%	61 / 3,582

- The percentage of "Bad Firms" declined from 2.14% in 2013 to 1.7% in 2018.
- The difference (2.14% minus 1.7%) is a decline of 0.44% over a period of six (6) years (i.e., 2013 through 2108).
- The percentage of decline from 2013 to 2018 is 20.50% (0.44% / 2.14%).
- Data is taken from FINRA's Attachment D-2 to Regulatory Notice 19-17.

It is also worthy of consideration that proposed new Rule 4111 may not even be necessary because of the performance of FINRA's Enforcement Program:

Regulatory Actions 2014 – 2018: [216]

Regulatory Actions	2018	2017	2016	2015	2014
Investor Complaints Received	3,136	3,002	3,070	3,250	2,802
New Disciplinary Actions Filed	921	1,369	1,434	1,512	1,397
Fines (in millions)	$61.0	$64.9	$173.8	$93.8	$132.6
Restitution (in millions)	$25.5	$66.8	$27.9	$96.6	$32.3
Firms Expelled	16	20	24	31	18
Firms Suspended	23	29	26	25	5

[216] https://www.finra.org/newsroom/statistics

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Individuals Barred	386	492	517	496	481
Individuals Suspended	472	733	727	736	705

FINRA's angst notwithstanding,[217] FINRA is blessed with a coterie of skilled trial attorneys who have served, and continue to serve, FINRA and investors well.[218] The above statistics speaks for itself.

The delay caused by the enforcement process is the natural consequence of due process considerations guaranteed by our Constitution, and therefore should not be taken lightly or even disregard in order to justify an end that, ultimately, is illusory.

We use the word "illusory" because the intended "end" – namely, ridding the securities industry of every "bad broker" and every "high risk" firm – is wished for in an environment (namely, the securities market place) where customer and broker each in their turn willingly bargain for the opportunity for profit in arena where "high risk of unforeseen consequences" is an *essential* component of making a profit, and of course its opposite, incurring a loss. This is extensively discussed in footnote 210.

Some brokers truly are or will be "bad" brokers. At the same time some customers are experienced investors who play "dumb like a fox" when the market goes against them because they know there will be lawyers who engage in "barratry" and will take "nuisance value" claim against a broker on a contingent-fee basis, costing the investor nothing unless the investor wins at arbitration.

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[217] FINRA writes: "Enforcement actions in turn can only be brought after a rule has been violated—and any resulting customer harm has already occurred. In addition, these proceedings can take significant time to develop, prosecute and conclude, during which time the individual or firm is able to continue misconduct, perpetuating significant risks of additional harm to customers and investors. Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council (NAC), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel imposes a significant sanction, the firm can forestall its effectiveness through the appeals process, because sanctions are stayed during appeals to the NAC and potentially the SEC. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership, limiting FINRA's jurisdiction and eliminating the leverage that FINRA has to incent the firm to comply with the sanction, including making restitution to customers. Temporary cease and desist proceedings do not always provide an effective remedy for potential ongoing harm to investors during the enforcement process. Temporary cease and desist proceedings are available only in narrowly defined circumstances. Moreover, initiation by FINRA of a temporary cease and desist action does not necessarily enable more rapid intervention, because FINRA must be prepared to file the underlying disciplinary complaint at the same time." *See* Regulatory Notice 19-17 at 4.

[218] On a personal note: As a former trial lawyer myself, I hold in high regard the attorneys at NASD and FINRA Enforcement with whom I have dealt over the last 20 years since I crossed over from private practice to securities regulation and broker/dealer compliance practice both at various law firms and as in-house counsel. I regard the attorneys with whom I have dealt as worthy adversaries, which is the highest compliment that a trial lawyer can give to a colleague. - jcc

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In the final analysis, Who is a "bad broker"?, is in no way easily capable of being determined.

Our Country's history of constitutional law teaches us the important lesson that making a judgment about who is or is not a "bad" person is better left to adjudicators (who apply facts-of-record to principles of law and vice versa), rather than to rule-makers (who make judgments, in advance, as to who is a "bad" person and who should effectively be exited from the industry without the benefit of a forum offering traditional protections Star Chamber verdicts).

Proposed new Rule 4111 would shift this judgment process, first and foremost to the rule-maker and its executors (i.e. the Department of Supervision Management). The employment of a Hearing Officer in the expedited hearing protocol is of no constitutional consequence because of the significant material conflicts of interest that exist (as we have already amply demonstrated). Moreover, there is no hint that due process would exist in a meaningful way in this expedited hearing process, under Proposed new Rule 4111. The "formula" for judging which member firm is, at least preliminarily and eventually permanently, determined to be a "Restricted Firm" is so fluid and so obscure as to evoke images of the notorious Star Chamber.

Proposed new Rule 4111 is constitutionally defective. It is a Bill of Attainder. It does trigger Regulatory Taking that is in violation of Amendment V of the Constitution. FINRA may continue to argue that it is not a "state actor" and therefore constitutional considerations do not apply to FINRA. Aside from the fact that both Regulatory Notice 18-16 and now Regulatory Notice 19-17 have inched FINRA ever so convincing close to "state action" enticing several courts to be willing to take up this question "of first instance", FINRA should be concerned about the court of public opinion that grows ever more suspicious of a governing body that has so much power – more power than the SEC – and yet is so privileged that every protection that Americans are accustomed to having on his and her side, simply does not apply to it (namely, FINRA).

Again, FINRA already has a practical solution to the problem of "bad brokers". It is FINRA's excellent Enforcement Program. It may not be as "efficient" as FINRA may desire (that is, the right of appeal delays the final outcome of cases). But, the FINRA Enforcement Program certainly is effective – in 2018, through the efforts of the FINRA enforcement attorneys 386 individual brokers were barred and 472 brokers were suspended. The trade-off for "efficiency" is constitutional protections. We are therefore encouraging FINRA to give as much, if not greater, weight to constitutional protections as it desires to give a first place to "efficiency".

Again, the intended "end" – namely, ridding the securities industry of every "bad broker" and every "high risk" firm in the securities market place – is "illusory" because "risk" and the "opportunity for

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profit" is the essence of the securities market place. It is the nature of the beast. There will always be "bad" brokers just as there will always be "bad" customers. Accordingly, pursuing this "end" at the expense of constitutional protections is dangerous to our Country's founding principles.

An important lesson can be taken James Madison, who, in Federalist 10, writes the prophecy:

> "There are two methods of curing the mischiefs of faction [read: investors vs. brokers vs FINRA]: the one, by removing its causes; the other, by controlling its effects.
>
> "There are again two methods of removing the causes of faction: the one, by destroying the liberty which is essential to its existence; the other, by giving to every citizen the same opinions, the same passions, and the same interests.
>
> "It could never be more truly said than of the first remedy, that it was worse than the disease. Liberty is to faction what air is to fire, an aliment without which it instantly expires. But it could not be less folly to abolish liberty, which is essential to political life, because it nourishes faction, than it would be to wish the annihilation of air, which is essential to animal life, because it imparts to fire its destructive agency.
>
> "The second expedient is as impracticable as the first would be unwise. As long as the reason of man continues fallible, and he is at liberty to exercise it, different opinions will be formed. As long as the connection subsists between his reason and his self-love, his opinions and his passions will have a reciprocal influence on each other; and the former will be objects to which the latter will attach themselves."

A regulator can remove the "cause" of investor harm: Search out and remove all "bad brokers" without a bona fide adjudicatory process. But in doing so, the consequence will be "destroying liberty of the market place".

If James Madison were writing today, he would say that the first remedy - searching out and removing all "bad brokers" without a bona fide adjudicatory process – is worse than the disease that FINRA is attempt to heal within the market place.
James Madison would also very likely write that the second solution – making everyone fall in, "lock, stock, and barrel", with FINRA's determination as to who is and who is not a "bad broker" – would be impracticable because, as Madison writes, the reason of man continues fallible, and [because] he is at liberty to exercise it, different opinions will be formed".

We need only point to the example of the Compliance Analyst with a lily-white history who leaves his employment with an expelled firm and hired by a smaller firm or a larger firm: Is he or is he not to be

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counted as a "bad broker" towards FINRA's "preliminary" determination of "Restricted Firm" status? Similarly, we need only point to the likelihood of a member firm being transformed into a "Restricted Firm" simply because it hired a broker who was (apparently) lily-white at the time of hire but whose skeletons came out of the closet years later when the statute of limitations come close to expiration.

Setting aside interpreting the technical applications and limitless scenarios of the various provisions in proposed new Rule 4111, reasonable minds will invariably differ on the question whether a member firm, determined by FINRA to be a "Restricted Firm", really is a "bad firm", morally speaking. For, as James Madison explains, "the reason of man continues fallible, and [because] he is at liberty to exercise it, different opinions will be formed".

It is doubtful that James Madison would agree that a regulator – whether we agree that it is a "state actor" or not – should have the final say on this question.

As James Madison writes, in concluding the point being made above:

> "The diversity in the faculties of men, from which the rights of property originate, is not less an insuperable obstacle to a uniformity of interests. The protection of these faculties is the first object of government. From the protection of different and unequal faculties of acquiring property, the possession of different degrees and kinds of property immediately results; and from the influence of these on the sentiments and views of the respective proprietors, ensues a division of the society into different interests and parties."

To paraphrase James Madison: The securities market place is the premier forum for acquiring property through man's fallible, different and unequal faculties. This applies to customer and broker alike. There are already plenty of rules on the record books that adhere to and safeguard constitutional protections; and, there already exists a well-functioning enforcement process that has demonstrated effectiveness, even if not satisfactory to FINRA in regards to the "significant time" – delay, in other words – invariably involved in the enforcement process.

Far better, James Madison would argue, that the determination who is and who is not a "bad broker" or a "bad firm" should be left to an enforcement process that is not tainted by Bills of Attainder, Regulatory Taking, and supported by at least some semblance of due process, than to be left into the hands of the Rule-Maker's and those who (i.e the Department of Member Supervision and its cooperating Hearing Officer) would execute the provisions of proposed new Rule 4111.

For all these reasons, we respectfully request that proposed new Rule 4111 and the other amendments to the Rule 9500 Series not be submitted to the SEC for consideration.

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Respectfully submitted,

NETWORK 1 FINANCIAL SECURITIES, Inc.

BY: ______________________
Damon D. Testaverde
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BY: ______________________
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BY: ______________________
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VIA ELECTRONIC MAIL

July 1, 2019

Submitted electronically to pubcom@finra.org

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

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

Dear Ms. Mitchell:

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

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

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

Background on FSI Members

The Financial Services Institute[2] (FSI) appreciates the opportunity to comment on this proposal. The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the U.S., there are approximately 167,000 independent financial advisors, which account for approximately 64.5% percent of all producing registered representatives.[3] These financial advisors are self-employed independent contractors, rather than employees of Independent Broker-Dealers (IBD).

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

Overview of the Proposed Rule

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

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

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

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

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

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

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

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

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

Discussion

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

[4] The Notice, at p. 11.

I. FINRA's Broad Use of Discretion

A. Preliminary Identification Metrics Thresholds

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

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

B. Initial Internal Review and Member Consultation

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

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

C. Maximum Restricted Deposit Requirement

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

[5] The Notice, at p. 9.
[6] The Notice, at p. 9.
[7] The Notice, at pp. 32-33.
[8] Proposed FINRA Rule 4111(d)(3)(B), (D)-(E).
[9] *See, e.g.*, The Notice, at p. 25.

consider "the nature of the firm's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any 'covered pending arbitration claims' or unpaid arbitration awards or unpaid settlements related to arbitrations, and concerns raised during FINRA exams" when determining a firm's maximum Restricted Deposit Requirement."[10] The Notice states that the "maximum Restricted Deposit Requirement should be significant enough to change the member's behavior but not so burdensome that it would force the member out of business."[11] Further, the Notice invites comments on "alternative ways of calculating the Restricted Deposit Requirement that would be more predictable while remaining impactful."[12]

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

D. <u>Department Decisions</u>

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

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

II. <u>Net Capital Requirements</u>

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

[10] Proposed FINRA Rule 4111(i)(15)(A).
[11] The Notice, at p. 12.
[12] The Notice, at p. 12.

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

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

III. <u>Impact on Small Firms</u>

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

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

IV. <u>Transparency and Retrospective Review</u>

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

[13] Exchange Act Rule 15c3-1(c)(2)(iv).
[14] FINRA defines a small firm as a member with at least one and no more than 150 registered persons, a mid-size firm as a member with at least 151 and no more than 499 registered persons, and a large firm as a member with 500 or more registered persons. *See* FINRA By-Laws, Article I.
[15] *See* FINRA, The Small Firm Report (July 23, 2018), https://www.finra.org/industry/small-firm-report.

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

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

Conclusion

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

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

Respectfully submitted,

Robin M. Traxler

Robin M. Traxler, Esq.
Senior Vice President, Policy & Deputy General Counsel

[16] *See* The Notice, at p. 35 (noting that the proposed rule "includes several processes, including qualitative reviews and consultations, to *minimize* potential sources of misidentifications.") (emphasis added).
[17] The Notice, at p. 18.

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WORDEN CAPITAL MANAGEMENT

Via email submission to pubcom@finra.org

June 30, 2019

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

Dear Ms. Mitchell:

Worden Capital Management, LLC ("WCM") is filing this response to certain proposed rule amendments and changes identified in FINRA's Regulatory Notice 19-17 ("the Notice"), during the comment period.

Regulatory Notice describes FINRA's proposed Rule 4111, which would create a classification of broker/dealers who would be so-called "Restricted Firms". The aim of this rule, as described in the Notice, is to "promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards." Respectfully, WCM submits that this proposed rule will do neither; instead this rule will cost broker/dealers and their representatives both money and time, which are already stretched thin for many member firms.

FINRA created BrokerCheck as a checks and balances tool, allowing the public to have access to CRD history, including regulatory actions, complaints and arbitrations, and past workplace transgressions. However, the process is allegation driven, forcing members to report items against their representatives without a scintilla of evidence being presented. In fact, FINRA currently requires that items be reported even if they have been able to determine that the allegations are FACTUALLY INACCURATE. This is astounding considering that we all live under a presumption of innocence under law until proven guilty. Basically, FINRA reporting requires a presumption of guilt until proven innocent. In a day and age where there are arbitration solicitation companies in existence, operating outside their jurisdiction, FINRA is looking to rely on the number of FINRA Dispute Resolution cases filed against member firms and their representatives as a determining factor for subjecting a member to this rule. It is commonly known throughout the industry, and within FINRA itself, that these companies act in an unscrupulous manner, as evidenced by FINRA's attempt to remove third-party non-attorney representatives from the Dispute Resolution process. In Regulatory Notice 17-34, FINRA describes in detail why it is proposing the prohibition of non-attorney third party representation (pp 2-3), including that these companies:

- Use the forum for inappropriate business practices;
- Require retainers of up to $25,000 for their services and are non-refundable;
- Represent parties in jurisdictions where state law prohibits such representations; and,
- Pursuing frivolous and stale claims to elicit settlements.

These concerns certainly indicate that FINRA is aware of the issues yet, seek to impose additional monetary and time requirements on member firms for these practices. It appears to be the height of hypocrisy.

Additionally, FINRA seeks to use pending regulatory proceedings as a metric for its determinations, even though they have not been adjudicated through any process. Again, FINRA is bypassing the presumption of innocence and any modicum of due diligence. If the member firm and its representatives are found to have done nothing wrong, they have been exposed to the inclusion of the metric prior to being found guilty of any wrong-doing.

Lastly, WCM is of the opinion that FINRA has devised an artificial metric to rely on determining if a firm meets the initial criteria. Using the size of a member firm as a determining factor is truly arbitrary, considering that a member with over 1,300 reported disclosures on BrokerCheck (Merrill Lynch) would not be subject to the new rule, but a member of a lesser size could be considered for inclusion with perhaps 1-5 reported events. It also seems that the member firms are policing the activity of representatives themselves based on Attachment D to Regulatory Notice 19-17. The number of members who would meet the initial determining factor has dropped from 89 to 61 (2.1% of the membership to 1.7% of the membership). This would point to member firms taking their hiring practices seriously and policing themselves.

WCM appreciates the opportunity to give comment on the proposed rule and hopes that FINRA will take into consideration our comments and others to find that this rule, as currently composed, is not in anyone's best interest.

Thank you.

Sincerely,

Jamie John Worden
CEO, Worden Capital Management, LLC

Exhibit 2d

Proposed Rule 4111 (Restricted Firm Obligations)

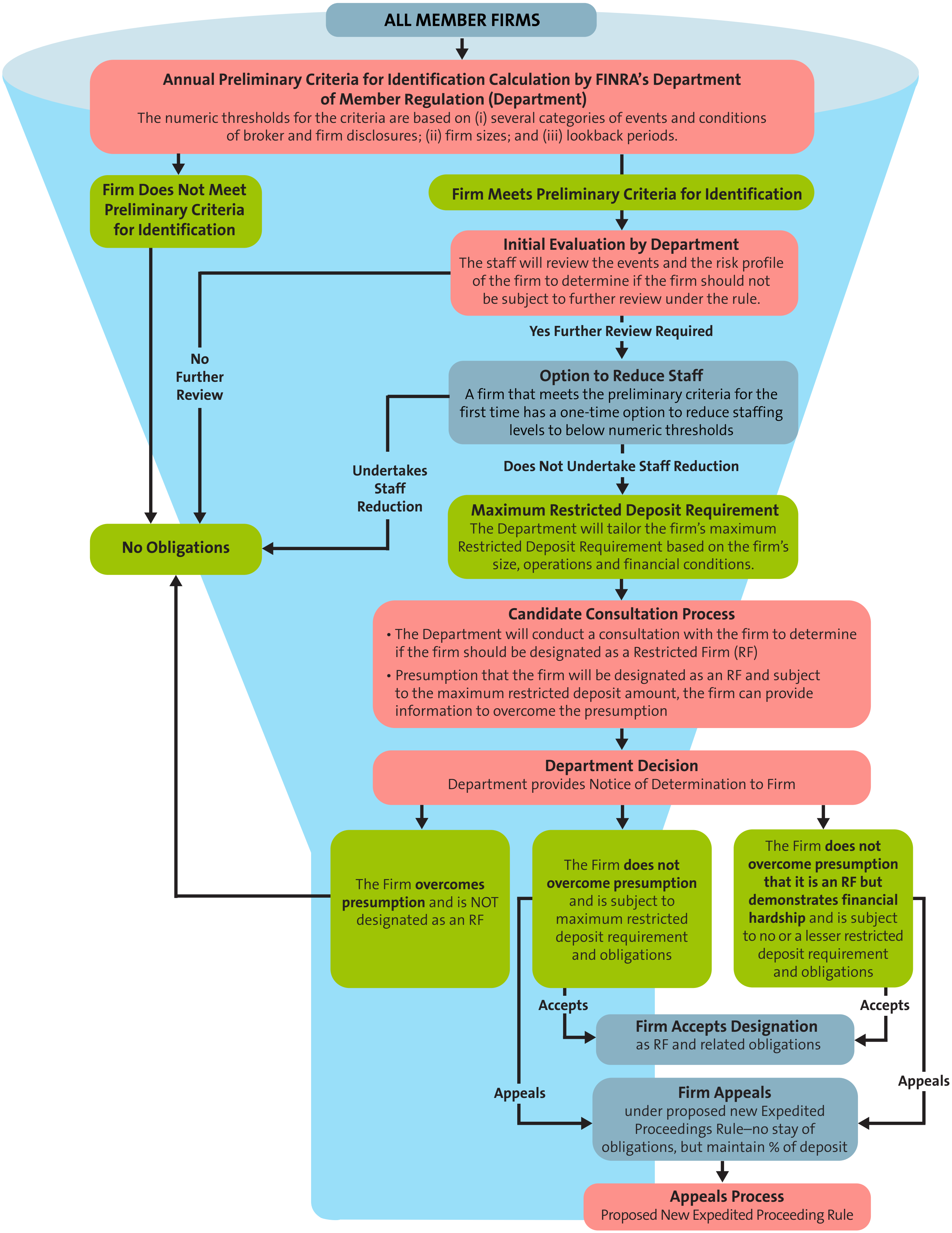

Exhibit 3a: Number of Firms Meeting the Preliminary Criteria for Identification*

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification	
		Number of Firms	Percentage of FINRA Registered Member Firms
2013	4,140	77	1.9%
2014	4,070	80	2.0%
2015	3,942	72	1.8%
2016	3,837	62	2%
2017	3,721	59	2%
2018	3,606	59	1.6%
2019	3,522	45	1.3%

* The statistics correspond to the number of firms that would have met the Preliminary Criteria for Identification as of year-end (December 31st) of the identification year.

Exhibit 3b: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size*

Identification Year	Number of FINRA Registered Member Firms	Firms Meeting the Preliminary Criteria for Identification						
		Small	Mid-Size	Large	Total	Small	Mid-Size	Large
		Number of Firms				Percent of Total		
2013	4,140	72	3	2	77	94%	4%	3%
2014	4,070	75	4	1	80	94%	5%	1%
2015	3,942	67	4	1	72	93%	6%	1%
2016	3,837	57	4	1	62	92%	6%	2%
2017	3,721	53	6	0	59	90%	10%	0%
2018	3,606	52	7	0	59	88%	12%	0%
2019	3,477	40	5	0	45	89%	11%	0%

* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st.
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.

Exhibit 3c: New Events (after identification) Associated with Firms Meeting the Preliminary Criteria for Identification

Identification Year	Number of Firms Meeting the Preliminary Criteria for Identification	Post-Identification Period	Number of "New" Registered Person and Member Firm Events in the Post-Identification Period*
2013	77	2014 – 2019	1,552 (6.1)**
2014	80	2015 – 2019	1,542 (10.5)**
2015	72	2016 – 2019	117900% (12.2)**
2016	62	2017 – 2019	107200% (17.8)**
2017	59	2018 – 2019	561 (19.9)**
2013 – 2017	180***	2014 – 2019	2,995

* "New" events correspond to Registered Person and Member Firm Events that were identified or occurred after the firm's identification and do not include events that were pending at the time of identification and subsequently resolved. Events associated with Registered Persons that are registered with multiple firms are counted for each firm they represent.

** The factors reported in parentheses represent a multiple for the average number of new events (on a per registered person basis) for firms that would have met the Preliminary Criteria for Identification relative to other firms. For example, the factor of 6.1x for 2013 shows that firms that met the Preliminary Criteria for Identification in 2013 had 6.1 times more new disclosure events (per registered person) in the years after identification (2014 – 2019) than other firms registered in 2013.

*** These 180 firms correspond to the unique number of firms that meet the Preliminary Criteria for Identification in one or more years during this period. Some of these firms meet the criteria in multiple years during the 2013 – 2017 period.

Exhibit 3d: New Events Associated with Firms No Longer Meeting the Preliminary Criteria for Identification after removing Pending Events*

Identification Year	Number of Firms No Longer Meeting the Preliminary Criteria for Identification	Subsequent Period	Number of "New" Registered Person and Member Firm Events in Subsequent Period**
2013	16	2014 – 2019	124 (8x)***
2014	21	2015 – 2019	226 (13.1x)***
2015	22	2016 – 2019	112 (11.2x)***
2016	17	2017 – 2019	74 (6.5x)***
2017	18	2018 – 2019	66 (10.3x)***
2013 – 2017	63***	2014 – 2019	390

* The statistics in this exhibit are based on firms that no longer meet the Preliminary Criteria for Identification after removing pending events. In addition, we conducted this analysis based on the Preliminary Criteria for Identification as proposed in Regulatory Notice 19-17 and found no material change in these statistics.

** "New" events correspond to Registered Person and Member Firm Events that were identified or occurred after the firm's identification and do not include events that were pending at the time of identification and subsequently resolved. Events associated with Registered Persons that are registered with multiple firms are counted for each firm they represent.

*** The factors reported in parentheses represent a multiple for the average number of new events (on a per registered person basis) for firms that would no longer meet the Preliminary Criteria for Identification after removing pending events relative to other firms. For example, the factor of 8x for 2013 shows that firms that would no longer meet the Preliminary Criteria for Identification in 2013 had 8 times more new disclosure events (per registered person) in the years after identification (2014 – 2019) than other firms registered in 2013.

**** These 63 firms correspond to the unique number of firms that no longer meet the Preliminary Criteria for Identification after removing pending events in one or more years during this period. Some of these firms no longer meet the criteria in multiple years during the 2013 – 2017 period.

Exhibit 3e: Variation in Financial Metrics for Firms Meeting the Preliminary Criteria for Identification*

Firm Size Category	Financial Metrics *(thousands of dollars, per Registered Person***)*											
	Revenues			Cash			Excess Net Capital			Ownership Equity		
	Min	Max	Factor**	Min	Max	Factor**	Min	Max	Factor**	Min	Max	Factor**
1	$11.40	$243.53	21	$0.03	$17.79	712	$0.89	$4.61	5	$2.56	$10.09	4
2	$0.63	$50.12	80	$0.60	$28.05	47	$0.58	$7.81	13	$2.09	$24.92	12
3	$109.65	$195.22	2	$0.0007	$21.08	30,442	$4.27	$72.79	17	$7.14	$122.72	17
4	$61.34	$1,095.75	18	$0.27	$1,191.47	4,472	$0.55	$1,981.36	3,571	$1.83	$2,345.09	1,282
5	$30.59	$466.21	15	$0.39	$58.42	149	$0.61	$1,208.06	1,996	$1.63	$655.85	403
6	$96.78	$318.36	3	$1.16	$10.38	9	$0.59	$50.53	85	$1.00	$60.62	60
All	**$0.63**	**$1,095.75**	**1,743**	**$0.0007**	**$1,191.47**	**1,721,017**	**$0.55**	**$1,981.36**	**3,571**	**$1.00**	**$2,345.09**	**2,338**

* The statistics are based on firms meeting the Preliminary Criteria for Identification in 2019. In addition, we conducted an analysis of firms meeting the Preliminary Criteria for Identification as proposed in Regulatory Notice 19-17 and found no material change in these financial metrics.

** Factor corresponds to the ratio of the Maximum to the Minimum.

*** Zeroes and negative values have been removed.

Exhibit 3f: Association between Revenues and Award & Settlement Amounts for Firms Meeting the Preliminary Criteria for Identification*

Award & Settlement Amounts x Revenues**

Award & Settlement Amounts***	Revenues: High****	Medium	Low	Total
High****	0.22	0.09	0.02	0.33
Medium	0.07	0.18	0.09	0.33
Low	0.04	0.07	0.22	0.33
Total	0.33	0.33	0.33	1.00

* The statistics are based on firms meeting the Preliminary Criteria for Identification in 2019 on a per registered person basis. In addition, we conducted an analysis of firms meeting the Preliminary Criteria for Identification as proposed in Regulatory Notice 19-17 and found no material change in the association between Revenues and Award & Settlement Amounts.

**Reported as a proportion of firms meeting the Preliminary Criteria for Identification.

*** Award & Settlement Amounts are based on total amount of awards and settlements per firm from 2013-2019.

**** 'High' refers to the top tercile group of firms (66-100th percentile), 'Medium' to the second tercile group of firms (33-66th percentile), and 'Low' to the bottom tercile (0-33rd percentile) group of firms.

Exhibit 5

Exhibit 5 shows the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

FINRA Rules

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4000. FINANCIAL AND OPERATIONAL RULES

* * * * *

4111. Restricted Firm Obligations

(a) General

A member designated as a Restricted Firm shall be required, except as provided in paragraphs (e) and (f) of this Rule, to establish a Restricted Deposit Account and maintain in that account deposits of cash or qualified securities with an aggregate value that is not less than the member's Restricted Deposit Requirement, and shall be subject to such conditions or restrictions on the member's operations as determined by the Department to be necessary or appropriate for the protection of investors and in the public interest.

(b) Annual Calculation by FINRA of Preliminary Criteria for Identification

For each member, the Department will compute annually (on a calendar-year basis) the Preliminary Identification Metrics to determine if the member meets the Preliminary Criteria for Identification.

(c) Initial Department Evaluation and One-Time Staff Reduction

(1) Initial Department Evaluation

If the member is deemed to meet the Preliminary Criteria for Identification, the Department shall conduct an internal evaluation to determine whether (A) the member does not warrant further review under this Rule because the Department has information to conclude that the computation of the member's Preliminary Identification Metrics included disclosure events (and other conditions) that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. The Department shall also consider whether the member has addressed the concerns signaled by the disclosure events or conditions or altered its business operations such that the Preliminary Criteria for Identification calculation no longer reflects the member's current risk profile, or (B) except as provided in paragraph (c)(2) of this Rule, the member should proceed to a Consultation.

(2) One-Time Staff Reduction

If the Department determines that the member meets the Preliminary Criteria for Identification and such member has met such criteria for the first time, such member may reduce its staffing levels to no longer meet the Preliminary Criteria for Identification within 30 business days after being informed by the Department. The member shall provide evidence of the staff reduction to the Department identifying the terminated individuals. Once the member has reduced staffing levels to no longer meet the Preliminary Criteria for Identification, it shall not rehire in any capacity a person terminated to accomplish the staff reduction for a period of one year.

(3) Close-Out Review

If the Department determines that the member no longer warrants further review in accordance with paragraph (c)(1)(A) or (c)(2) of this Rule, the Department shall close out the review of the member for such year.

(d) Consultation

(1) General

If the Department determines that the member meets the Preliminary Criteria for Identification and should proceed to a Consultation, the Department shall conduct the Consultation to allow the member to demonstrate why it does not meet the Preliminary Criteria for Identification and should not be designated as a Restricted Firm. If the member is designated as a Restricted Firm, the Department may require it to maintain the Restricted Deposit Requirement or be subject to such conditions or restrictions as the Department in its discretion shall deem necessary or appropriate for the protection of investors or in the public interest, or both. The member bears the burden of demonstrating that it should not be designated as a Restricted Firm and should not be required to maintain the maximum Restricted Deposit Requirement.

(A) A member may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation that the member meets the Preliminary Criteria for Identification included events in the Disclosure Event and Expelled

Firm Association Categories that should not have been included because for example, they are duplicative, involving the same customer and the same matter, or are not sales practice related; and

(B) A member may overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement by clearly demonstrating to the Department that the member would face significant undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement and that a lesser deposit requirement would satisfy the objectives of this Rule and be consistent with the protection of investors and the public interest; or that conditions and restrictions on the operations and activities of the member and its associated persons would address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

(2) Scheduling Consultation

The Department shall provide a written letter to each member it determines should proceed to a Consultation or that will proceed to a Consultation pursuant to paragraph (f)(2) of this Rule at least seven days prior to the Consultation, of the date, time and place of the Consultation and shall coordinate with the member to schedule further meetings as necessary. A Consultation shall begin at the time scheduled, unless the Department, for good cause shown by the member, provides a written letter that postpones the commencement of the

Consultation. Postponements shall not exceed 30 days unless the member establishes the reasons a longer postponement is necessary.

(3) Consultation Process

In conducting its evaluation of whether a member should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement, the Department shall consider:

(A) information provided by the member during any meetings as part of the Consultation;

(B) relevant information or documents, if any, submitted by the member, in the manner and form prescribed by the Department, as shall be necessary or appropriate for the Department to review the computation of the Preliminary Criteria for Identification;

(C) a plan, if any, submitted by the member, in the manner and form prescribed by the Department, proposing in detail the specific conditions or restrictions that the member seeks to have the Department consider;

(D) such other information or documents as the Department may reasonably request in its discretion from the member related to the evaluation; and

(E) any other information the Department deems necessary or appropriate to evaluate the matter.

(e) Department Decision and Notice

(1) Department Decision

Following the Consultation, but no later than 30 days from the date of the latest letter provided to the member under paragraph (d)(2) of this Rule, the Department shall render a Department Decision as follows:

(A) If the Department determines that the member has rebutted the presumption set forth in paragraph (d)(1)(A) of this Rule that it should be designated as a Restricted Firm, the Department's decision shall state that the firm shall not be designated as a Restricted Firm.

(B) If the Department determines that the member has failed to rebut the presumption set forth in paragraphs (d)(1)(A) and (d)(1)(B) of this Rule that it should be designated as a Restricted Firm that must maintain the maximum Restricted Deposit Requirement, the Department's decision shall designate the member as a Restricted Firm and require the member to: (i) promptly establish a Restricted Deposit Account and deposit and maintain in that account the maximum Restricted Deposit Requirement; and (ii) implement and maintain specified conditions or restrictions, as the Department deems necessary or appropriate, on the operations and activities of the member and its associated persons to address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

(C) If the Department determines that the member has failed to rebut the presumption in paragraph (d)(1)(A) of this Rule that it should be designated as a Restricted Firm but that it has rebutted the presumption in paragraph (d)(1)(B) of this Rule that it must maintain the maximum

Restricted Deposit Requirement, the Department shall designate the member as a Restricted Firm and shall: (i) impose no Restricted Deposit Requirement on the member or require the member to promptly establish a Restricted Deposit Account and deposit and maintain in that account a Restricted Deposit Requirement in such dollar amount less than the maximum Restricted Deposit Requirement as the Department deems necessary or appropriate; and (ii) require the member to implement and maintain specified conditions or restrictions, as the Department deems necessary or appropriate, on the operations and activities of the member and its associated persons to address the concerns indicated by the Preliminary Criteria for Identification and protect investors and the public interest.

(2) Notice of Department Decision, No Stays

No later than 30 days following the latest letter provided to the member under paragraph (d)(2) of this Rule, the Department shall issue a notice of the Department's decision pursuant to Rule 9561(a) that states the obligations to be imposed on the member, if any, under this Rule 4111 and the ability of the member under Rule 9561 to request a hearing with the Office of Hearing Officers. A timely request for a hearing shall not stay the effectiveness of the notice issued under Rule 9561(a), except that for a notice under Rule 9561(a) a member obligated to maintain a Restricted Deposit Requirement shall be required to maintain in a Restricted Deposit Account the lesser of 25 percent of its Restricted Deposit Requirement or 25 percent of its average excess net capital during the prior calendar year, until the Office of Hearing Officers or the NAC issues a written decision under Rule 9559; provided, however, that a member that has been re-designated as a Restricted Firm as set forth in paragraph (f)(2) of this Rule and is already subject to a previously imposed Restricted Deposit Requirement shall be required to maintain the full amount of its Restricted Deposit Requirement until the Office of Hearing Officers or NAC issues a written decision under Rule 9559.

(f) Continuation or Termination of Restricted Firm Obligations

(1) Currently Designated Restricted Firms

A member or Former Member that is currently designated as a Restricted Firm subject to the requirements of this Rule shall not be permitted to withdraw all or any portion of its Restricted Deposit Requirement, or seek to terminate or modify any deposit requirement, conditions, or restrictions that have been imposed pursuant to this Rule, without the prior written consent of the Department. There shall be a presumption that the Department shall deny an application by a member or Former Member that is currently designated as a Restricted Firm to withdraw all or any portion of its Restricted Deposit Requirement. An application under this paragraph for a withdrawal from a Restricted Deposit Requirement shall comply with the content requirements in paragraph (f)(3)(A)(i) through (iv) of this Rule.

(2) Re-Designation as a Restricted Firm

Where a member has been designated as a Restricted Firm in one year and is determined to meet the Preliminary Criteria for Identification the following year in accordance with paragraph (b) of this Rule, the Department shall provide a written letter to the member stating that it shall be re-designated as a Restricted Firm, and that the obligations previously imposed on the member in accordance with this Rule shall remain effective and unchanged, unless either the member or the Department requests a Consultation in writing within seven days of the date of the letter, in which case the obligations previously imposed shall remain effective and unchanged unless and until the Department modifies or terminates them after the Consultation. If a Consultation is conducted, there shall be a presumption that the Restricted Deposit Requirement and conditions or restrictions, if any, previously imposed on the member shall remain effective and unchanged absent a showing by the party seeking changes that the previously imposed obligations are no longer necessary or appropriate for the protection of investors or in the public interest. If a Consultation is not timely requested, the member shall be subject to paragraph (f)(1) of this Rule.

(3) Previously Designated Restricted Firms

(A) A member or Former Member that is a Restricted Firm in one year, but does not meet the Preliminary Criteria for Identification or is not designated as a Restricted Firm the following year(s), shall no longer be subject to any deposit requirement, conditions, or restrictions previously imposed on it under this Rule; provided, however, the member or Former Member shall not be permitted to withdraw any portion of its Restricted

Deposit Requirement without submitting an application and obtaining the prior written consent of the Department. Such application shall:

(i) be made in such form and manner as FINRA may prescribe;

(ii) be accompanied by a copy of a current account statement for the member or Former Member's Restricted Deposit Account;

(iii) include a certification by the member's or Former Member's chief executive officer (or equivalent officer) stating the member's or Former Member's Restricted Deposit Requirement; the value of the cash or qualified securities on deposit in the member's or Former Member's Restricted Deposit Account; the value of cash or qualified securities on deposit in the member's or Former Member's Restricted Deposit Account that the member or Former Member is seeking the Department's consent to withdraw; and

(iv) include evidence that there are no "Covered Pending Arbitration Claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding against the member, the member's Associated Persons or the Former Member, or if there are any "Covered Pending Arbitration Claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding, provide a detailed description of such.

(B) After such review and investigation as it considers necessary or appropriate, the Department shall determine whether to authorize a withdrawal, in part or whole, of cash or qualified securities from the member's or Former Member's Restricted Deposit Account. There shall be presumptions that the Department shall: (i) approve an application for withdrawal if the member, the member's Associated Persons, or the Former Member have no "Covered Pending Arbitration Claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding; and (ii) (a) deny an application for withdrawal if the member, the member's Associated Persons who are owners or control persons, or the Former Member have any "Covered Pending Arbitration Claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding, or if the member's Associated Persons have any "Covered Pending Arbitration Claims," unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding that involved conduct or alleged conduct that occurred while associated with the member; but (b) approve an application by a Former Member for withdrawal if the Former Member commits in the manner specified by the Department to use the amount it seeks to withdraw from its Restricted Deposit to pay the Former Member's specified unpaid arbitration awards or unpaid settlements relating to arbitrations outstanding. Within 30 days from the date the application is received by the Department, the Department shall issue a notice of the Department's decision pursuant to Rule 9561(a).

(g) Books and Records

Each member shall maintain records evidencing the member's compliance with this Rule and any Restricted Deposit Requirement or conditions or restrictions imposed in accordance with this Rule, including without limitation, records relating to the calculation of the Preliminary Criteria for Identification, Consultation, the Restricted Deposit Account, conditions or restrictions imposed, and agreements with bank(s) or clearing firm(s), for a period of six years from the date the member is no longer subject to the requirements of this Rule. In addition, a firm that is subject to a Restricted Deposit Requirement shall provide to the Department, upon its request, records, agreements and account statements that demonstrate the firm's compliance with the Restricted Deposit Requirement.

(h) Notice of Failure to Comply

FINRA may issue a notice pursuant to Rule 9561(b) directing a member that is not in compliance with the Restricted Deposit Requirement or the conditions or restrictions imposed by this Rule to suspend all or a portion of its business.

(i) Definitions

For purposes of this Rule, the following terms shall have the following meanings:

(1) The term "Consultation" means one or more meetings or consultations between the Department and a member that meets the Preliminary Criteria for Identification.

(2) The term "Covered Pending Arbitration Claim," for purposes of this Rule 4111, means an investment-related, consumer initiated claim filed against the member or its Associated Persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. For purposes of this definition, the claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees, and shall be the maximum amount for which the member or Associated Person, as applicable, is potentially liable regardless of whether the claim was brought against additional persons or the Associated Person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount.

(3) The term "Department" means FINRA's Department of Member Regulation.

(4) The term "Disclosure Event and Expelled Firm Association Categories" means the following categories of disclosure events and other information:

(A) "Registered Person Adjudicated Events" means any one of the following events that are reportable on the registered person's Uniform Registration Forms:

(i) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party or was a "subject of" the customer arbitration award or civil judgment;

(ii) a final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation;

(iii) a final investment-related civil judicial matter that resulted in a finding, sanction or order;

(iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(v) a criminal matter in which the registered person was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(B) "Registered Person Pending Events" means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms:

(i) a pending investment-related civil judicial matter;

(ii) a pending investigation by a regulatory authority;

(iii) a pending regulatory action that was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(iv) a pending criminal charge associated with any felony or any reportable misdemeanor.

(C) "Registered Person Termination and Internal Review Events" means any one of the following events associated with the registered person at a previous member that are reportable on the registered person's Uniform Registration Forms:

(i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign from a previous member after allegations; or

(ii) a pending or closed internal review by a previous member.

(D) "Member Firm Adjudicated Events" means any one of the following events that are reportable on the member's Uniform Registration Forms, or are based on customer arbitrations filed with FINRA's dispute resolution forum:

(i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party;

(ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order;

(iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(iv) a criminal matter in which the member was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(E) "Member Firm Pending Events" means any one of the following events that are reportable on the member's Uniform Registration Forms:

(i) a pending investment-related civil judicial matter;

(ii) a pending investigation by a regulatory authority;

(iii) a pending regulatory action that was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or

(iv) a pending criminal charge associated with any felony or any reportable misdemeanor.

(F) "Registered Persons Associated with Previously Expelled Firms" means any Registered Person In-Scope who was registered for at least one year with a previously expelled firm and whose registration with the previously expelled firm terminated during the Evaluation Period.

(5) The term "Evaluation Date" means the date, each calendar year, as of which the Department calculates the Preliminary Identification Metrics to determine if the member meets the Preliminary Criteria for Identification.

(6) The term "Evaluation Period" means the prior five years from the Evaluation Date, provided that for the Registered Person Pending Events and Member Firm Pending Events categories and pending internal reviews in the Registered Person Termination and Internal Review Events category, it would correspond to the Evaluation Date (and include all events that are pending as of the Evaluation Date).

(7) The term "Former Member" means an entity that has withdrawn or resigned its FINRA membership, or that has had its membership cancelled or revoked.

(8) The term "qualified security" has the meaning given it in SEA Rule 15c3-3(a)(6).

(9) The term "Preliminary Criteria for Identification" means meeting the following conditions:

(A) Two or more of the member's Preliminary Identification Metrics are equal to or more than the corresponding Preliminary

Identification Metrics Thresholds, and at least one of these metrics is among the following metrics:

(i) Registered Person Adjudicated Event Metric;

(ii) Member Firm Adjudicated Event Metric; and

(iii) Expelled Firm Association Metric; and

(B) The member has two or more Registered Person and Member Firm Events during the Evaluation Period.

(10) The term "Preliminary Identification Metrics" means the following six metrics that are based on the number of disclosure events (defined above) per Registered Persons In-Scope or percent of Registered Persons In-Scope associated with previously expelled firms:

(A) "Registered Person Adjudicated Event Metric" would be computed as the sum of Registered Person Adjudicated Events that reached a resolution during the Evaluation Period, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(B) "Registered Person Pending Event Metric" would be computed as the sum of Registered Person Pending Events as of the Evaluation Date, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(C) "Registered Person Termination and Internal Review Event Metric" would be computed as the sum of Registered Person Termination and Internal Review Events that reached a resolution during the

Evaluation Period and pending internal reviews by a previous member as of the Evaluation Date, across all Registered Persons In-Scope and divided by the number of Registered Persons In-Scope.

(D) "Member Firm Adjudicated Event Metric" would be computed as the sum of Member Firm Adjudicated Events that reached a resolution during the Evaluation Period, divided by the number of Registered Persons In-Scope.

(E) "Member Firm Pending Event Metric" would be computed as the sum of Member Firm Pending Events as of the Evaluation Date, divided by the number of Registered Persons In-Scope.

(F) "Expelled Firm Association Metric" would be computed as the sum of Registered Persons Associated with Previously Expelled Firms, divided by the number of Registered Persons In-Scope.

(11) The term "Preliminary Identification Metrics Thresholds" means the following thresholds corresponding to each of the six Preliminary Identification Metrics.

Firm Size Category	Number of Registered Persons In-Scope in Firm Size Category	Preliminary Identification Metrics Thresholds					
		Thresholds for Registered Person Event Metrics:			Thresholds for Member Firm Event Metrics:		Threshold for Expelled Firm Association Metric:
		Registered Person Adjudicated Event Metric	Registered Person Pending Event Metric	Registered Person Termination and Internal Review Event Metric	Member Firm Adjudicated Event Metric	Member Firm Pending Event Metric	Expelled Firm Association Metric
		(1)	(2)	(3)	(4)	(5)	(6)
1	1-4	0.50	0.20	0.10	0.75	0.25	0.30
2	5-9	0.30	0.20	0.10	0.30	0.10	0.25
3	10-19	0.20	0.10	0.10	0.30	0.05	0.20
4	20-50	0.20	0.10	0.10	0.20	0.02	0.15
5	51-150	0.20	0.05	0.10	0.15	0.01	0.03
6	151-499	0.15	0.05	0.10	0.10	0.01	0.01
7	500+	0.10	0.05	0.10	0.05	0.01	0.01

(12) The term "Registered Person and Member Firm Events" means the sum of the following categories of defined events during the Evaluation Period:

(A) Registered Person Adjudicated Events;

(B) Registered Person Pending Events;

(C) Registered Person Termination and Internal Review Events;

(D) Member Firm Adjudicated Events; and

(E) Member Firm Pending Events.

(13) The term "Registered Persons In-Scope" means all persons registered with the firm for one or more days within the one year prior to the Evaluation Date.

(14) The term "Restricted Deposit Account" means an account in the name of the member:

(A) at a bank (as defined in Section 3(a)(6) of the Exchange Act) or the member's clearing firm;

(B) subject to an agreement in which the bank or the member's clearing firm, as applicable, agrees:

(i) not to permit withdrawals (other than withdrawals of interest or the withdrawal of qualified securities or cash after and on the same day as the deposit of cash or qualified securities of equal value) from the Restricted Deposit Account without the prior written consent of FINRA;

(ii) to keep the account separate from any other accounts maintained by the member with the bank or clearing firm;

(iii) that the cash or securities on deposit in the account will at no time be used directly or indirectly as security for a loan to the member by the bank or clearing firm and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm;

(iv) that if the member becomes a Former Member, the Restricted Deposit Requirement in the Restricted Deposit Account shall be maintained and the bank or clearing firm will not permit withdrawals from the Restricted Deposit Account without the prior written consent of FINRA as set forth in paragraphs (f)(1) and (f)(3) of this Rule; and

(v) that FINRA is a third-party beneficiary to such agreement and that such agreement may not be amended without the prior written consent of FINRA; and

(C) not subject to any right, charge, security interest, lien or claim of any kind granted by the member.

(15) The term "Restricted Deposit Requirement" means the deposit to be maintained by the member as follows:

(A) the specific maximum Restricted Deposit Requirement for a member, determined by the Department taking into consideration the nature of the firm's operations and activities, revenues, commissions, assets, liabilities, expenses, net capital, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, insurance coverage for customer arbitration awards or settlements, concerns raised during FINRA exams, and the amount of any of the firm's or its Associated Persons' Covered Pending Arbitration Claims, unpaid arbitration awards or unpaid settlements related to arbitrations. Based on a review of these factors, the Department would determine a maximum Restricted Deposit Requirement for the member that would be consistent with the objectives of this Rule, but would not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the next 12 months; or

(B) the amount, adjusted after the Consultation, determined by the Department; and

(C) with respect to a Former Member, the Restricted Deposit Requirement last calculated pursuant to paragraph (i)(15)(A) or (15)(B) of this Rule when the firm was a member.

(16) The term "Restricted Firm" means each member that is designated as such in accordance with paragraphs (e)(1)(B) and (e)(1)(C) of this Rule.

(17) The term "Uniform Registration Forms" means the Forms BD, U4, U5 and U6, as applicable.

• • • Supplementary Material: --------------

.01 Net Capital Treatment of the Deposits in the Restricted Deposit Account. Because of the restrictions on withdrawals from a Restricted Deposit Account, deposits in such an account cannot be readily converted into cash and therefore shall be deducted in determining the member's net capital under SEA Rule 15c3-1 and FINRA Rule 4110.

.02 Compliance with Rule 1017. Nothing in this Rule shall be construed as altering in any manner a member's obligations under Rule 1017.

.03 Examples of Conditions and Restrictions. For purposes of this Rule, the conditions or restrictions that the Department may impose include, but are not limited to, the following:

(a) limitations on business expansions, mergers, consolidations or changes in control;

(b) filing all advertising with FINRA's Department of Advertising Regulation;

(c) imposing requirements on establishing and supervising offices;

(d) requiring a compliance audit by a qualified, independent third party;

(e) limiting business lines or product types offered;

(f) limiting the opening of new customer accounts;

(g) limiting approvals of registered persons entering into borrowing or lending arrangements with their customers;

(h) requiring the member to impose specific conditions or limitations on, or to prohibit, registered persons' outside business activities of which the member has received notice pursuant to Rule 3270; and

(i) requiring the member to prohibit or, as part of its supervision of approved private securities transactions for compensation under Rule 3280 or otherwise, impose specific conditions on associated persons' participation in private securities transactions of which the member has received notice pursuant to Rule 3280.

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9500. OTHER PROCEEDINGS

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9550. Expedited Proceedings

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9559. Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series

(a) No Change.

(b) Computation of Time

Rule 9138 shall govern the computation of time in proceedings brought under the Rule 9550 Series, except that intermediate Saturdays, Sundays and Federal holidays shall be included in the computation in proceedings brought under Rules 9556 through 9558 and 9561, unless otherwise specified.

(c) Stays

(1) Unless the Chief Hearing Officer or the Hearing Officer assigned to the matter orders otherwise for good cause shown, a timely request for a hearing shall stay the effectiveness of a notice issued under Rules 9551 through 9556 and 9561(b), except that: (A) the effectiveness of a notice of a limitation or prohibition on access to services offered by FINRA or a member thereof under Rule 9555 with respect to services to which the member or person does not have access shall not be stayed by a request for a hearing; and (B) this paragraph has no applicability to a petition instituting an expedited proceeding under Rule 9556(h).

(2) A timely request for a hearing shall stay the effectiveness of a notice issued under Rule 9557 for 10[ten] business days after service of the notice or until the Office of Hearing Officers issues a written order under Rule 9559(o)(4)(A) (whichever period is less), unless FINRA's Chief Executive Officer (or such other executive officer as the Chief Executive Officer may designate) determines that a notice under Rule 9557 shall not be stayed. Where a notice under Rule 9557 is stayed by a request for a hearing, such stay shall remain in effect only for 10[ten] business days after service of the notice or until the Office of Hearing Officers issues a written order under Rule 9559(o)(4)(A) (whichever period is less) and shall not be extended.

(3) No Change.

(4) A timely request for a hearing shall not stay the effectiveness of a notice issued under Rule 9561(a).

(d) Appointment and Authority of Hearing Officer and[/or] Hearing Panel

(1) For proceedings initiated under Rules 9553, 9554, [and] 9556(h) and 9561, the Chief Hearing Officer shall appoint a Hearing Officer to preside over and act as the sole adjudicator for the matter.

(2) through (6) No Change.

(e) Consolidation or Severance of Proceedings

Rule 9214 shall govern the consolidation or severance of proceedings, except that, where one of the notices that are the subject of consolidation under this Rule requires that a hearing be held before a Hearing Panel, the hearing of the consolidated matters shall be held before a Hearing Panel. Where two consolidated matters contain different timelines under this Rule, the Chief Hearing Officer or Hearing Officer assigned to the matter has discretion to determine which timeline is appropriate under the facts and circumstances of the case. Where one of the consolidated matters includes an action brought under a Rule that does not permit a stay of the effectiveness of the notice or where FINRA's Chief Executive Officer (or such other executive officer as the Chief Executive Officer may designate), in the case of Rule 9557, or Hearing Officer, in the case of Rule 9558(d), determines that a request for a hearing shall not stay the effectiveness of the notice, the limitation, prohibition, condition, requirement, restriction, obligation or suspension specified in the notice, or the partial deposit requirement specified in Rule 9561(a)(4), shall not be stayed pending resolution of the case. Where one of the consolidated matters includes an action brought under Rule 9557 that is stayed for up to 10[ten] business days, the requirement [and/]or restriction specified in the notice shall not be further stayed.

(f) Time of Hearing

(1) No Change.

(2) A hearing shall be held within 10[ten] days after a respondent is served a petition seeking an expedited proceeding issued under Rules 9556(h).

(3) A hearing shall be held within 14 days after a respondent subject to a notice issued under Rules 9556 (except Rule 9556(h)), [and] 9558 or 9561(b) files a written request for a hearing with the Office of Hearing Officers.

(4) No Change.

(5) A hearing shall be held within 30 days after a respondent subject to a notice issued under Rule 9561(a) files a written request for a hearing with the Office of Hearing Officers.

([5]6) The timelines established by paragraphs (f)(1) through (f)(5[4]) of this Rule confer no substantive rights on the parties.

(g) Notice of Hearing

The Hearing Officer shall issue a notice stating the date, time, and place of the hearing as follows:

(1) through (2) No Change.

(3) At least seven days prior to the hearing in the case of an action brought pursuant to Rules 9556 (except Rule 9556(h)), [and] 9558 or 9561(b); and

(4) At least 21 days prior to the hearing in the case of an action brought pursuant to Rules 9551 through 9555 or 9561(a).

(h) Transmission of Documents

(1) Not less than two business days before the hearing in an action brought under Rule 9557, not less than six days before the hearing in an action brought under Rule 9556(h), not less than seven days before the hearing in an action brought under Rules 9556 (except Rule 9556(h)), [and] 9558 or 9561(b), and not less than 14 days before the hearing in an action brought under Rules 9551 through 9555 or 9561(a), FINRA staff shall provide to the respondent who requested the hearing or the respondent who has received a petition pursuant to Rule 9556(h), by facsimile, email, overnight courier or personal delivery, all documents that were considered in issuing the notice unless a document meets the criteria of Rule 9251(b)(1)(A), (B), (C) or (b)(2). Documents served by facsimile or email shall also be served by either overnight courier or personal delivery. A document that meets the criteria in this paragraph shall not constitute part of the record, but shall be retained by FINRA until the date upon which FINRA serves a final decision or, if applicable, upon the conclusion of any review by the SEC or the federal courts.

(2) Not less than two business days before the hearing in an action brought under Rule 9557, not less than three days before the hearing in an action brought under Rules 9556, [and] 9558 or 9561(b), and not less than seven days before the hearing in an action brought under Rules 9551 through 9555 or 9561(a), the parties shall exchange proposed exhibit and witness lists. The exhibit

and witness lists shall be served by facsimile, email, overnight courier or personal delivery. Documents served by facsimile or email shall also be served by either overnight courier or personal delivery.

(i) through (m) No Change.

(n) Sanctions, Requirements, Costs and Remands

(1) In any action brought under the Rule 9550 Series, other than an action brought under Rule 9556(h), [or] Rule 9557 or Rule 9561, the Hearing Officer or, if applicable, the Hearing Panel may approve, modify or withdraw any and all sanctions, requirements, restrictions or limitations imposed by the notice and, pursuant to Rule 8310(a), may also impose any other fitting sanction.

(2) No Change.

(3) In an action brought under Rule 9557, the Hearing Panel shall approve or withdraw the requirements [and/]or restrictions imposed by the notice. If the Hearing Panel approves the requirements [and/]or restrictions and finds that the respondent has not complied with all of them, the Hearing Panel shall impose an immediate suspension on the respondent that shall remain in effect unless FINRA staff issues a letter of withdrawal of all requirements [and/]or restrictions pursuant to Rule 9557(g)(2).

(4) through (5) No Change.

(6) In any action brought under Rule 9561(a), the Hearing Officer may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the department that issued the notice for further consideration of specified matters, but may not modify any of the Rule 4111 Requirements

imposed by the notice or impose any other requirements, obligations or restrictions available under Rule 4111. In any action brought under Rule 9561(b), the Hearing Officer may approve or withdraw the suspension or cancellation of membership, and may impose any other fitting sanction.

(o) Timing of Decision

(1) Proceedings initiated under Rules 9553, [and] 9554 and 9561

Within 60 days of the date of the close of the hearing, the Hearing Officer shall prepare a proposed written decision and provide it to the National Adjudicatory Council's Review Subcommittee.

(2) through (4) No Change.

(5) If not timely called for review by the National Adjudicatory Council's Review Subcommittee pursuant to paragraph (q) of this Rule, the Hearing Officer's or, if applicable, the Hearing Panel's written decision shall constitute final FINRA action. For decisions issued under Rules 9551 through 9556, [and] 9558 or 9561, the Office of Hearing Officers shall promptly serve the decision of the Hearing Officer or, if applicable, the Hearing Panel on the Parties and provide a copy to each FINRA member with which the respondent is associated.

(6) No Change.

(p) Contents of Decision

The decision, which for purposes of Rule 9557 means the written decision issued under paragraph (o)(4)(B) of this Rule, shall include:

(1) through (5) No Change.

(6) a statement describing any sanction, requirement, obligation, restriction or limitation imposed, the reasons therefore, and the date upon which such sanction, requirement, obligation, restriction or limitation shall become effective, if they are not already effective.

(q) through (r) No Change.

9561. Procedures for Regulating Activities Under Rule 4111

(a) Notices Under Rule 4111

(1) Notice of Requirements or Restrictions

FINRA's Department of Member Regulation ("Department") shall issue a notice of its determination under Rule 4111 that a firm is a Restricted Firm and the requirements, conditions or restrictions to which the Restricted Firm is subject (hereinafter, collectively referred to as the "Rule 4111 Requirements").

(2) Service of Notice

FINRA staff shall serve the member subject to a notice issued under this Rule (or upon counsel representing the member, or other person authorized to represent others under Rule 9141, when counsel or other person authorized to represent others under Rule 9141 agrees to accept service for the member) by facsimile, email, overnight courier or personal delivery. Papers served on a member, counsel for such member, or other person authorized to represent others under Rule 9141 by overnight courier or personal delivery shall conform to paragraphs (a)(1) and (3) and, with respect to a member, (b)(2) of Rule 9134. Papers served on a member by facsimile shall be sent to the member's facsimile number listed in the FINRA Contact System submitted to FINRA pursuant to

Article 4, Section III of the FINRA By-Laws, except that, if FINRA staff has actual knowledge that a member's FINRA Contact System facsimile number is out of date, duplicate copies shall be sent to the member by overnight courier or personal delivery in conformity with paragraphs (a)(1) and (3) and (b)(2) of Rule 9134. Papers served on a member by email shall be sent to the member's email address listed in the FINRA Contact System submitted to FINRA pursuant to Article 4, Section III of the FINRA By-Laws and shall also be served by either overnight courier or personal delivery in conformity with paragraphs (a)(1) and (3) and (b)(2) of Rule 9134. Papers served on counsel for a member, or other person authorized to represent others under Rule 9141 by facsimile or email shall be sent to the facsimile number or email address that counsel or other person authorized to represent others under Rule 9141 provides and shall also be served by either overnight courier or personal delivery in conformity with paragraphs (a)(1) and (3) of Rule 9134. Service is complete upon sending the notice by facsimile or email, sending the notice by overnight courier or delivering it in person, except that, where duplicate service is required, service is complete upon sending the duplicate service.

(3) Contents of Notice

A notice issued under this Rule shall include the Department's determinations under Rule 4111 and state the specific grounds and include the factual basis for the FINRA action. The notice shall state when the FINRA action will take effect. 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 the basis for eliminating any Rule 4111 Requirements. In addition, the notice shall explain that, pursuant to Rule 9559(n), a Hearing Officer may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the Department that issued the notice for further consideration of specified matters, but may not modify any of the Rule 4111 Requirements imposed by the notice or impose any other obligations or restrictions available under Rule 4111.

(4) Effectiveness of the Rule 4111 Requirements

The Rule 4111 Requirements imposed by a notice issued and served under paragraph (a) of this Rule are immediately effective; provided, however, that when a firm requests review of a Department determination under Rule 4111 that imposes a deposit requirement on the firm for the first time, the firm shall be required to deposit only 25 percent of its restricted deposit requirement or 25 percent of its average excess net capital over the prior year, whichever is less, while the hearing is pending. The Rule 4111 Requirements, and the partial deposit requirement required by Rule 4111 and this paragraph, shall remain in effect while the hearing is pending.

(5) Request for Hearing

A member served with a notice under paragraph (a) of this Rule may file with the Office of Hearing Officers a written request for a hearing pursuant to Rule 9559. A request for a hearing shall be made within seven days after service of the notice issued under this Rule. A request for a hearing must set forth with specificity the basis for eliminating any Rule 4111 Requirements.

(6) Failure to Request Hearing

If a member does not timely request a hearing, the notice under paragraph (a) of this Rule shall constitute final FINRA action.

(b) Notice for Failure to Comply with the Rule 4111 Requirements

(1) Notice of Suspension or Cancellation

If a member fails to comply with any Rule 4111 Requirements imposed under this Rule, the Department, after receiving authorization from FINRA's Chief Executive Officer or such other executive officer as the Chief Executive Officer may designate, may issue a suspension or cancellation notice to such member stating that the failure to comply with the Rule 4111 Requirements within seven days of service of the notice will result in a suspension or cancellation of membership.

(2) Service of Notice

FINRA staff shall serve the member subject to a notice issued under this paragraph (b) in accordance with the service provisions in paragraph (a)(2) of this Rule.

(3) Contents of Notice

The notice shall explicitly identify the Rule 4111 Requirements with which the firm is alleged to have not complied and shall contain a statement of facts specifying the alleged failure. The notice shall state when the suspension will take effect and explain what the respondent must do to avoid such suspension. 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 may approve or withdraw the suspension or cancellation of membership, and may impose any other fitting sanction.

(4) Effective Date of Suspension or Cancellation

The suspension or cancellation referenced in a notice issued and served under paragraphs (b)(1) and (b)(2) of this Rule shall become effective seven days after service of the notice, unless stayed by a request for hearing pursuant to Rule 9559.

(5) Request for a Hearing

A member served with a notice under paragraphs (b)(1) and (b)(2) of this Rule may file with the Office of Hearing Officers a written request for a hearing pursuant to Rule 9559. A request for a hearing shall be made before the effective date of the notice, as indicated in paragraph (b)(4) of this Rule. A request for a hearing must set forth with specificity any and all defenses to the FINRA action.

(6) Failure to Request Hearing

If a member does not timely request a hearing, the suspension or cancellation specified in the notice shall become effective seven days after the service of the notice and the notice shall constitute final FINRA action.

(7) Request for Termination of the Suspension

A member subject to a suspension imposed after the process described in paragraphs (b)(1) through (6) of this Rule may file a written request for termination of the suspension on the ground of full compliance with the notice or decision. Such request shall be filed with the head of the Department. The head of the Department may grant relief for good cause shown.

• • • Supplementary Material: --------------

.01 Application to Former Members Under Rule 4111. For purposes of this Rule, the term member also shall include a "Former Member" as defined in Rule 4111(i) as applicable.

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Capital Acquisition Broker Rules

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400. FINANCIAL AND OPERATIONAL RULES

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412. Restricted Firm Obligations

All capital acquisition brokers are subject to FINRA Rule 4111.

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Funding Portal Rules

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900. Code of Procedure.

(a) Application of FINRA Rule 9000 Series (Code of Procedure) to Funding Portals

Except for the FINRA Rule 9520 Series, FINRA Rule 9557, FINRA Rule 9561, and the FINRA Rule 9700 Series, all funding portal members shall be subject to the FINRA Rule 9000 Series, unless the context requires otherwise, provided, however, that:

(1) through (9) No Change.

(b) No Change.

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