

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–90527; 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)

November 27, 2020.

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 November 16, 2020, 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 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 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 eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of

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.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b–4.

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”).

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.

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 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

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).

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

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

unpaid arbitration awards¹¹ 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 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

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").

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

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
2. Registered Person Pending Events;²⁰

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

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 ("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

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").

3. Registered Person Termination and Internal Review Events;²¹

4. Member Firm Adjudicated Events;²²

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

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-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-

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 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

Scope"). This proposed definition is narrower than the definition proposed in *Regulatory Notice 19–17*.

²⁵ See proposed Rule 4111(i)(13).

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

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 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).

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

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.

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):

| | 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 <i>two or more</i> . (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 <i>ten or more</i> . (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 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 <i>three or more</i> . (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, 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

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*.

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.

³² 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.

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 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.

➤ **One-Time Opportunity To Reduce Staffing Levels (Proposed Rule 4111(c)(2))**

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 maximum Restricted Deposit Requirement for the member firm that would be consistent with the objectives

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 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.

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.

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.

➤ 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

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.

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).

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 firm³⁷ 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 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 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

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.

³⁷ See proposed Rule 4111(i)(7) (definition of “Former Member”).

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.

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.

➤ 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 15c3-1⁴¹ 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 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.

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

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.

⁴⁰ See Exhibit 5.

⁴¹ 17 CFR 240.15c3-1.

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.

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.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 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

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

⁴⁴ See FINRA Rule 9559(q).

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

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.

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 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

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 SEC. 276, 279 n.5 (2001)); *Jan Biesiadecki*, 53 SEC. 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 proposed Rule 9561 as a rule to which funding portal members would not be subject.

⁴⁷ 15 U.S.C. 78o–3(b)(6).

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.

⁴⁹ See *supra* note 5.

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 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 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. 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 2013–2019 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.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 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

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.

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

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.

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.

➤ 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 2013–2017⁵⁸ (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 firms⁵⁹ 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 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

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.

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.

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.

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 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 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

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.

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.

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.

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 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

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.

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.

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

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

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.

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 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,

within these categories to be 32–57 firms, each year, during the review period.

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.

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 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

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

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 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.

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.

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 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 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.

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.

1. 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.

2. 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

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

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.

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.

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

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 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 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

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).

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

Several commenters predicted that, for a variety of reasons, the proposal will not achieve its intended goals⁸⁴ 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 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

situated parties is not necessarily either fair or unfair).

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

⁸⁵ ASA, Better Markets.

⁸⁶ Cetera, Dempsey, Luxor.

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.

⁷⁹ Dempsey, Joseph Stone.

⁸⁰ Brooklight, Dempsey, Joseph Stone.

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 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.

3. 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 Department would calculate a Restricted Deposit Requirement⁹¹ 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 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.

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

⁸⁸ 17 CFR 240.15c3-1.

⁸⁹ CAI, Cambridge, FSI, Sichenzia, Westpark.

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

⁹¹ CAI, Westpark, Whitehall.

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

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

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 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.

4. 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 settlements¹⁰⁰ and establish a minimum threshold for awards and judgments;¹⁰¹ (7) decrease the lookback period;¹⁰² (8) distinguish between events by recidivist and non-recidivist brokers;¹⁰³ (9) exclude all matters that are not sales-practice or investment-related¹⁰⁴ 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 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

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.

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.

¹¹⁴ Massachusetts, NASAA.

¹¹⁵ Massachusetts.

¹¹⁶ Massachusetts.

¹¹⁷ MIRC, PIABA.

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 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

¹¹⁸ NASAA.

¹¹⁹ Rockfleet, Worden.

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.

⁹⁴ See, e.g., FSI, NASAA, PIRC.

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

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.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 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 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.

5. 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

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-and-mediation/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).

¹²¹ AdvisorLaw, Cambridge, Moss & Gilmore, Worden.

¹²² AdvisorLaw, Cambridge, Moss & Gilmore, Worden.

¹²³ AdvisorLaw.

¹²⁴ MIRC, NASAA, PIABA, PIRC.

¹²⁵ MIRC, NASAA, PIABA, PIRC.

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).

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

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.

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.

6. One-Time Staffing Reduction

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.

7. 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 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

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).

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.

8. 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 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 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 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 capital¹⁴⁴—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

9. 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

¹³³ Cambridge.

¹³⁵ Cambridge.

¹³⁶ Westpark.

¹³⁷ Rockfleet.

¹³⁸ Chiu.

¹³⁹ Brooklight.

¹⁴⁰ Moss & Gilmore.

¹⁴¹ Moss & Gilmore.

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.

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.

¹³³ Cambridge.

“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 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 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.

10. 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

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

¹⁴⁷ Moss & Gilmore.

¹⁴⁸ Network 1, Sichenzia.

¹⁴⁹ Network 1, Rockfleet.

¹⁵⁰ MIRC, PIABA, PIRC.

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, 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.

11. 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.

12. 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."

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.

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

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. 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.

12. 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 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

13. 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.

14. Public Disclosure Issues

Several commenters addressed whether there should be public disclosure of a firm's status as a

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)).

¹⁵⁴ Brooklight, Luxor, Network 1, Rockfleet, Westpark.

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.

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

15. 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 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.

16. 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

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.

¹⁶⁰ See *supra* note 5.

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 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 receives¹⁶³ 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.

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 Markets’ suggestions essentially request that FINRA broaden the statutory definition of disqualified

persons, which is not within FINRA’s jurisdiction to do.¹⁷³

17. 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.

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 email 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 email is used. To help the

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 SEC. 668 (1981), and *Arthur H. Ross*, 50 SEC. 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.

¹⁶² Brooklight, Cetera, Rockfleet.

¹⁶³ PIRC.

¹⁶⁴ Sichenzia.

¹⁶⁵ ASA.

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.

¹⁷³ See 15 U.S.C. 78c(a)(39) (defining “statutory disqualification”).

¹⁷⁴ Chiu.

¹⁷⁵ AdvisorLaw.

¹⁷⁶ Moss & Gilmore.

¹⁷⁷ 17 CFR 200.30–3(a)(12).

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 10:00 a.m. and 3:00 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 December 28, 2020.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁷⁷

J. Matthew DeLesDernier,
Assistant Secretary.

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¹⁷⁷ 17 CFR 200.30-3(a)(12).