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**Via Electronic Delivery:**
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

**Re: FINRA Regulatory Notice 20-02: FINRA Rule 4530 Retrospective Review; FINRA Requests Comment on the Effectiveness and Efficiency of Its Reporting Requirements Rule**

Dear Ms. Mitchell:

Lowenstein Sandler LLP ("**Lowenstein**"), on behalf of its clients and affected parties submits this comment in response to the Financial Industry Regulatory Authority Inc. ("**FINRA**") Request for Comment on the Effectiveness and Efficiency of Its Reporting Requirements Rule ("**Reg. Notice 20-02**").[1]

We represent a broad spectrum of broker-dealer clients of varying sizes and customer bases. Many of these clients are dynamic financial technology platforms that seek to utilize technological advancements such as smart phone and web-based applications to meet customer needs and demands and provide brokerage services through innovative means unlike anything that the industry has previously experienced.

Lowenstein believes the practical application of FINRA Rule 4530 (the "**Rule**") can be improved in several ways: (1) amend the duplicative and unnecessary prompt reporting requirement in provision (a)(1)(B) of the Rule; (2) narrow the reportable incidents to brokerage activities for which FINRA has a mandate and expertise; (3) clarify the meaning and scope of "Associated Person" as it is used in the Rule and throughout FINRA's Rulebook; and (4) increase the threshold amounts that trigger reporting requirements to adjust for inflationary effects and capture the Rule's intended information.

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1 See Regulatory Notice 20-02: FINRA Requests Comment on the Effectiveness and Efficiency of Its Reporting Requirements Rule (January 9, 2020) available at https://www.finra.org/sites/default/files/2020-01/Regulatory-Notice-20-02.pdf

## I. Background

The Rule was originally adopted in 1995 to enable FINRA to aggressively detect and investigate sales practice violations.[2] Adopted with noble causes, the Rule has not kept pace with the ever changing broker-dealer landscape. At the time of adoption, the broker-dealer marketplace was vastly different from the current environment. In the early nineties, traditional broker-dealers dominated the market by offering full service, high touch, high commission trading, while discount broker-dealers that offer self-directed trading made up approximately 8 percent of retail commissions.[3] The "online broker-dealer" market segment that now controls trillions of dollars of assets did not exist in 1995.[4] This changed marketplace was spurred-on by innovative approaches to providing broker-dealer services that have enhanced choice to the investing public. Additionally, technology has not only significantly enhanced investor access to the securities markets but has also given investors an unprecedented ability to interact with and communicate with broker-dealers. Unfortunately, the Rule has not matched this transformation and has left broker-dealers with an outdated and unclear reporting regime.

## II. Amend the duplicative and unnecessary prompt reporting requirement for 4530(a)(1)(B)

Since the Rule's adoption in 1995, broker-dealers have been required to promptly report to FINRA when a member or associated person of the member is the subject of *any* written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery. This well-intentioned requirement has imposed an undue burden and unnecessary reporting obligation on many technology driven brokerage platforms given: (1) the unanticipated technological changes that have fundamentally eroded traditional impediments to the submission of "written customer complaint"; (2) the resulting proliferation of false and inaccurate complaint submissions; and (3) the duplicative nature of reporting these incidents as a result of other required reporting within the Rule.

Customers' informal ability to communicate in written form to digitally native broker-dealers has vastly expanded the scope of provision (a)(1)(B) in the Rule beyond its original intent while not increasing investor protection. As mentioned above, the broker-dealer marketplace has changed significantly due in part to the adoption of disruptive technology. In 1995, broker-dealer

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2 National Association of Securities Dealers ("NASD"), a precursor to FINRA, originally proposed the rule change. See 60 FR 36838 ("Rule 4530 Proposing Release") and 60 FR 48182 ("Rule 4530 Adopting Release"). This legacy rule was incorporated into FINRA's consolidated Rulebook in 2010 as FINRA Rule 4530. See 75 FR 47863 (proposing release) and 75 FR 69508 (adopting release).

3 See Richard D. Hylton, "Now Fewer Firms are Chasing Small Investors", N.Y. Times, June 17, 1990, available at https://www.nytimes.com/1990/06/17/business/all-about-discount-brokers-now-fewer-firms-are-chasing-small-investors-discount.html.

4 See Tara Siegel Bernard and Matt Phillips, "Charles Schwab to Buy TD Ameritrade as Free Trading Takes over", N.Y. Times, November 25, 2019, available at https://www.nytimes.com/2019/11/25/business/dealbook/charles-schwab-td-ameritrade.html.

relationships were typically person-to-person, where orders were either phoned-in or carried out as part of a broader strategy that was agreed upon through in-person financial planning. Now, broker-dealers are app-native and in many instances provide brokerage services entirely through digital means. This technological advancement allows customers to have constant access to their broker-dealer and communicate effortlessly in ways that did not exist and were not contemplated when the provision of (a)(1)(B) in the Rule was adopted.

Text messaging and written app-based communication now predominate communication between customers and digitally native broker-dealers. This ability to be in constant contact with your broker-dealer wherever you have a smartphone or computer with an internet connection benefits customers and enriches their relationship with broker-dealers. Unfortunately, the uninterrupted ease and accessibility of these communication tools has increased informal written communication beyond the intended tone and scope of the (a)(1)(B) provision of the Rule.

The expanded scope of written communication has created more false and inaccurate complaint submissions increasing the reporting obligation on broker-dealers and rendering the reported information useless from an investor protection perspective. When the Rule was adopted, written communication was a formal process that required either physically writing and mailing or faxing a complaint. This process necessarily created an inherent burden on a customer wishing to submit a complaint, indicating, that provision (a)(1)(B) in the Rule was intended to capture only the most significant and grave complaint concerns. The time, effort and determination necessary for a customer to pursue a traditional written complaint deterred frivolity and focused broker-dealers' attentions on those customers with legitimate, meaningful grievances. This traditional filter no longer exists. With the ease of sending a text message through an app, a customer can draft and submit several complaints within a minute, a reality that provision (a)(1)(B) of the Rule clearly did not anticipate.

Through our clients, we have seen a massive number of frivolous, false, and inaccurate complaints submitted to broker-dealers, partially due to the ease of submission, and partially due to the near 24-hour access customers now have to their broker-dealers. Innocuous questions regarding why a deposit is not available that previously would become evident and settled during a single, formal complaint submission process now elicit numerous and escalating complaints. Given the ease with which a compliant can now be submitted, customers that are rash or rush to judgement often submit complaints alleging theft or fraud when it clearly is a case of a customer misunderstanding. It is often the case that after a short inquiry from the broker-dealer the complaint is revealed to be erroneous. Nonsensically, the quick resolution or discovery that the customer compliant is misguided does not relieve the broker-dealer's prompt reporting requirement. FINRA Staff has interpreted the requirement to report *any* complaint to mean broker-dealers have no discretion in assessing a complaint's validity or discarding complaints that are clearly erroneous. This interpretation and application of the Rule creates a burden on broker-dealers with absolutely no investor protection benefit.

Finally, the provision of (a)(1)(B) in the Rule that requires prompt reporting is duplicative and less efficient and effective than provision (d) in the Rule which requires that all written complaints be submitted on a quarterly basis. Since provision (d) of the Rule allows for a brief investigation by a broker-dealer it is designed to provide more accurate reporting reflective of legitimate complaints rather than customer communications demonstrating customer confusion, misunderstanding, or misguided frustration. Additionally, on balance the value of expediency in provision (a)(1)(B) is questionable given that complaints are only provided a few days sooner when compared to provision (d) of the Rule (30 days compared to quarterly) yet contain significantly more inaccurate information. As mentioned above, provision (a)(1)(B) of the Rule has been interpreted to prohibit an investigation or allowing the inclusion of contextual information regarding clearly false, frivolous or erroneous complaints. However, the quarterly customer complaint reporting required under provision (d) of the Rule allows a broker-dealer to amend and update a complaint that upon review is false, frivolous, or erroneous and affix the proper problem code reflective of the written complaint's nature. Since all written customer complaints are still submitted under provision (d) of the Rule, investor protection is not enhanced by reporting complaints twice. Further, since complaints submitted through provision (d) of the Rule follow a review of the complaint's information and its basis, they provide FINRA with more effective insight into the broker-dealers' operations and potential areas of concern while eliminating the inefficiency of reporting false or inapplicable events.

## III. Focus Reportable Incidents on narrowly scoped Brokerage Activities to center Rule on areas in which FINRA has a Mandate and Expertise

FINRA's mandate is to protect investors by overseeing the securities business of broker-dealers. The evolving landscape of broker-dealer service offerings has expanded to non-security services that are offered to investors through affiliates and third-parties of the broker-dealer. These attenuated non-security services are not, and should not, be subject to FINRA oversight and the reporting obligations of the Rule. FINRA is limited in its expertise to the securities business of broker-dealers, while broker-dealers' supervisory capabilities of third-parties is also limited.

The Rule's FAQs limit its application to "securities related" activity.[5] Further clarification regarding the scope of this unclear guidance is necessary given the expanding services offered by broker-dealers. De-regulation and technological advancements have expanded the offering of services provided through a broker-dealer and third-parties. Now, many broker-dealers offer banking services such as sweep accounts and connected debit cards, as well as non-security crypto-currency trading, along with integrated social media services. These services build on the broker-dealers services that were already being provided when the Rule was adopted and when the Rule's FAQs were published.

For example, a broker-dealer may offer a debit card option for customers through a third-party banking affiliate. This banking affiliate is subject to its own regulatory regime and oversight. Additionally, since it is a third-party, the broker-dealer has a limited ability to oversee its operations and complaints received. This third-party, separately regulated service over which

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[5] See Rule 4530 Frequently Asked Questions, Questions 2.3 and 2.4, available at https://www.finra.org/filing-reporting/regulatory-filing-systems/rule-4530-reporting-requirements/faq

FINRA and the broker-dealer have limited insight should not be subject to the Rule. It would be unwieldly and inappropriate to require a broker-dealer to learn and report issues for a business that is not overseen or operated by them.

Most convincingly, these activities are not securities related and therefore are beyond the scope and expertise of FINRA. While the activity, such as a debit card or crypto account, may be funded from, or related to, a securities brokerage account, the activity itself is not securities related. Subjecting these activities to the Rule is unduly burdensome for broker-dealers and does not provide any additional investor protection as these activities are typically overseen by a separate more specialized regulatory regime. Consistent with FINRA's securities industry mandate and its expertise, FINRA should take this opportunity to more clearly and narrowly define the scope of "securities related" activity given the evolving nature of broker-dealer services. Moving astray from its core mission and competencies will unnecessarily burden broker-dealers, FINRA staff and examiners.

## IV. FINRA should have a consistent definition of Associated Person and clarify the scope of this definition

The regulatory term "Associated Person" is defined in a number of instances, which causes confusion. There should be a uniform and consistent definition in FINRA's Rulebook or more clearly defined application of alternative definitions if, and when, one is used. Regardless of which definition is used, additional guidance on the scope of who should be included within the definition of Associated Person is necessary in light of modern broker-dealer operations where individuals carry out multiple roles.

The term Associated Person or "person associated with a member" is defined within FINRA's By-Laws of the Corporation,[6] FINRA's By-Laws of Regulation, Inc.,[7] and FINRA FINRA Rule 1011(b),[8] FINRA Rule 13100(u),[9] as well as twice defined in Section 3 of the Securities Exchange Act.[10] While FINRA Rule 0160 explicitly states that terms in the Rulebook shall have the By-Law's meaning there is still ambiguity within the definition and vagaries across the multiple definitions. First, it is unclear what it means to be "engaged in the securities business" and to be "controlled or controlling." In past enforcement cases an individual operating in "an essential part of the business" was deemed to be engaged in securities business.[11] There has not been clear guidance on what qualifies as an essential part of the business, especially in light of the

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6 See FINRA By-Laws of the Corporation, Article I(rr).

7 See FINRA By-Laws of Regulation, Inc., Article I(ee).

8 See FINRA Rule 1011(b).

9 See FINRA Rule 13100(u)

10 See 15 U.S.C. 78c(a)(18) and 15 U.S.C. 78c(a)(21).

11 Compliance personnel were determined to be "engaged in the securities business" because the compliance function and service was essential to the securities business. See Reichman (FINRA, 2009).

evolving broker-dealer landscape and service offerings. In modern broker-dealer operations many engineers, customer support staff, and back office operations personnel carry out functions that are essential to the securities business, but deeming these individuals as associated persons would lead to absurd results. A computer programmer who works on the broker-dealer user application programming interface ("API") or a customer service individual providing password assistance should not be considered "engaging in the securities business." Further confusing the definitional scope is the fact that some associated person definitions contain a "clerical and ministerial" carve out, while others do not. Whether the above listed functions would fall within the clerical and ministerial carve out itself is still open for interpretation and additional guidance is necessary to allow broker-dealers to properly scope their reporting obligations.

Whether an individual is controlling or controlled by a broker-dealer is also unclear given the varied ownership structure and advice provided to broker-dealers. For instance, it is unclear whether each investor in a venture fund that owns a significant portion (greater than 20 percent) of a broker dealer would be deemed to have de facto control of a broker-dealer. If so, then under the Rule a broker-dealer would then need to monitor and report all instances where underlying investors of the venture fund are subject to a regulatory filing. The bounds on who is controlling and controlled by a broker-dealer should be clearly defined and be narrow as to only capture those individuals who can affect the operations of a broker-dealer. Ownership through funds and other attenuated ownership structures lead to an unwieldy monitoring obligation with little effect on investor protection and should not be considered within scope of being an associated person for purposes of the Rule.

## V. Increase the Threshold Amount that Triggers FINRA Rule 4530 Reporting Requirements to Adjust for Inflationary Effects and Capture the Intended Information

The threshold reporting amounts provided in the Rule have not been updated since its adoption, which has caused the reporting requirements to now be over inclusive and overly burdensome for broker-dealers. As originally adopted in 1995, a broker-dealer was required to report when an associated person is a defendant in any securities or commodities-related civil litigation or arbitration for $15,000 or greater, or $25,000 or greater when the broker-dealer is named. Further, an associated person subject to $2,500 disciplinary action must be reported. Since these threshold amounts were enacted 25 years ago, significant inflationary effects have made the threshold amounts less on a real dollar basis. Computing for inflation the threshold reporting amounts are now 67 percent lower than what was originally adopted.[12] Outdated thresholds in other securities contexts are now being reexamined, such as the accredited investor definition.[13]

[12] Adjusting for consumer price index ("**CPI**") from 1995 to 2019 the values above ascribed in the Rule would now be $25,170, $41,951, and $4,195, respectively in 2019 dollars, available at https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator

[13] See "SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments", available at https://www.sec.gov/news/press-release/2019-265

The Rule is ripe to update its outdated reporting thresholds that have created a significantly higher reporting burden on FINRA member broker-dealers.

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If you have any questions about this letter or require any further information, please do not hesitate to get in touch with me at 212.419.5862.

Sincerely,

Ethan L. Silver