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March 4, 2021

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. SR-FINRA-2020-041 (Proposed Rule Change to Address Firms with a Significant History of Misconduct)

Dear Ms. Countryman:

This letter is being submitted by the Financial Industry Regulatory Authority ("FINRA") in response to comments received by the Securities and Exchange Commission ("SEC" or "Commission") regarding the above-referenced rule filing. The proposed rule change would:

(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.

The Commission published the proposed rule change for public comment in the Federal Register on December 4, 2020.[1] The Commission received seven comment letters directed to the rule filing.[2] The following are FINRA's responses, by topic, to the commenters' material concerns.

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1 See Securities Exchange Act Release No. 90527 (November 27, 2020), 85 FR 78540 (December 4, 2020) (Notice of Filing of File No. SR-FINRA-2020-041) ("Filing").

2 See Letter from Richard J. Carlesco Jr., CEO, IBN Financial Services, Inc., dated December 15, 2020 ("IBN"); Letter from Andrew R. Harvin, Partner, Doyle, Restrepo, Harvin & Robbins, LLP, to Secretary, SEC, dated December 21, 2020

General Support for the Proposal

Four commenters generally supported the proposal.[3] PIABA states that it is a firm supporter of FINRA's efforts to enhance its programs to address the risks posed to investors by individual brokers and member firms that have a history of misconduct and that the proposed changes in SR-FINRA-2020-041 are a step toward that end. SIFMA also expresses support for the proposal to the extent it has the ancillary effect of incentivizing firms and their associated persons to comply with their regulatory obligations and to pay their arbitration awards. NASAA states that the proposal has the potential to better protect investors from high-risk firms and commends the Commission and FINRA for expanding controls over high-risk firms. St. John's Clinic expresses support of FINRA's proposed adoption of Rule 4111 imposing additional obligations on firms with significantly higher levels of risk-related disclosures. Some of those commenters raise more detailed comments and requested modifications, as discussed below.

General Opposition to the Proposal

Three commenters were generally unsupportive.[4] Better Markets states that while the proposal is "better than doing nothing, it is nonetheless grossly insufficient" and does not go far enough. Harvin believes the proposal is "looking for a problem" and that FINRA's statistics do not support the creation of an elaborate system of additional

("Harvin"); Letter from Lev Bagramian, Senior Securities Policy Advisor, and Michael J. Hughes, Program & Research Assistant, Better Markets, Inc. to Vanessa A. Countryman, Secretary, SEC, dated December 28, 2020 ("Better Markets"); Letter from Lisa Hopkins, NASAA President, North American Securities Administrators Association, Inc., to J. Matthew DeLesDernier, Assistant Secretary, SEC, dated December 28, 2020 ("NASAA"); Letter from David P. Meyer, President, Public Investors Advocate Bar Association, to Vanessa Countryman, Secretary, SEC, dated December 28, 2020 ("PIABA"); Letter from Kevin M. Carroll, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Vanessa A. Countryman, Secretary, SEC, dated December 28, 2020 ("SIFMA"); and Letter from Ruben Huertero, Legal Intern, and Christine Lazaro, Director of the Securities Arbitration Clinic and Professor of Clinical Legal Education, Securities Arbitration Clinic at St. John's University School of Law, to Vanessa Countryman, SEC, dated December 28, 2020 ("St. John's Clinic").

3 See NASAA, PIABA, SIFMA, St. John's Clinic.

4 See Better Markets, Harvin, IBN.

regulation to address the issue of unpaid arbitration awards. IBN notes the proposal is a part of a "throng of new regulations that are burying small firms."

Resources to Help Firms Comply with Proposed Rule 4111

SIFMA and Harvin both request that FINRA provide resources to help facilitate firms' self-monitoring of their status with respect to the Preliminary Criteria for Identification and describe the burdens that firms will face without additional resources. For example:

- SIFMA requests that FINRA make a firm commitment to making resources available to firms, to allow firms to self-monitor and take proactive corrective measures. Specifically, SIFMA requests that FINRA commit to providing the three examples that FINRA described in the Filing: (1) resources that map the Disclosure Event and Expelled Firm Association Categories[5] to the relevant questions on the Uniform Registration Forms; (2) a worksheet that member firms can populate, year-round, 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; and (3) a list of expelled firms.

- Harvin comments about the burdens firms will face in calculating their Expelled Firm Association Metric, and requests that FINRA provide to every member firm a list of all associated registered persons who were associated with one or more previously expelled firms within the Expelled Firm Association Metric.

- Harvin also requests that FINRA be required to advise each member firm in writing, each year, what its six Preliminary Identification Metrics are.[6]

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5 This response to comments uses the same terms that are defined in the proposed rule change.

6 As part of his explanation of the burdens firms would face, Harvin comments that although FINRA reports arbitration awards on the Uniform Disciplinary Action Reporting Form (Form U6), those Form U6s are not available to member firms on their Central Registration Depository (CRD) file. The information on Form U6 is available in CRD for any specific employee of the firm. In addition, there are a variety of ways by which member firms can readily access such information and learn about Form U6 disclosures. Relevant Form U6 disclosure information is disclosed on BrokerCheck, to the extent required by the FINRA BrokerCheck Disclosure rule. See FINRA Rule 8312. Firms can request individual CRD snapshots that include Form U6 disclosures for persons who are current or former

FINRA appreciates SIFMA's and Harvin's comments about the burdens firms may face and, in the Filing, explained that additional guidance and resources could facilitate member firms' independent calculations.[7] FINRA notes Harvin's specific recommendation for annual, FINRA-generated notices to each firm of its status with respect to the Preliminary Criteria for Identification and will explore the feasibility of providing such a notice and its usefulness to firms if calculated other than on the annual Evaluation Date because, among other things, firm staff included in any calculations for such notice may change or disclosure events may age out. While FINRA continues to evaluate which resources can best assist member firms, including the examples FINRA described in the Filing and others, FINRA remains fully committed to developing resources and making them available to help facilitate firms' self-monitoring of their metrics.

Moreover, in light of the comments raised and understanding the time it may take FINRA to develop such resources, FINRA proposes to extend the effective date of the proposed rule change from no later than 60 days following publication of the Regulatory Notice announcing Commission approval to no later than 180 days following publication of the Regulatory Notice announcing Commission approval to allow FINRA sufficient development time.[8] It is important to reiterate, however, that any year-round tools that FINRA would provide to help member firms monitor their status in relation to the Preliminary Criteria for Identification would not be determinate ones, because whether a member firm will meet the Preliminary Criteria for Identification could only be definitely established as of the annual Evaluation Date.[9]

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associated persons of the member firm and persons whom the firm is considering for registration or association. Firms have the ability to subscribe to an automatic notification any time a Form U6 is filed against an individual registered with the firm. Firms also can use FINRA Gateway Reports to obtain a full list of individuals with disclosure events, including events reported on Form U6. See FINRA Gateway Reports, Individual Data Definition, Version 0.9 (November 5, 2020), at p. 6, https://www.finra.org/sites/default/files/2019-09/Individual-Data-Dictionary-for-Dynamic-Reporting.pdf (showing that the "form type" data field includes Forms U4, U5 and U6 as the type of form that first reported a disclosure).

7 See Filing, 85 FR 78562.

8 FINRA initially stated that the effective date would be no later than 60 days following publication of the Regulatory Notice announcing Commission approval. See Form 19b-4, SR-FINRA-2020-041, at https://www.finra.org/sites/default/files/2020-11/SR-FINRA-2020-041.pdf.

9 See Filing, 85 FR 78562 n.131.

Concerns that the Proposal Imposes Burdens on Small Firms

IBN comments that the proposed rule change will have unintended consequences for small firms, such as "increased costs to defend" and "reporting." As a general matter, FINRA acknowledged that some reporting and defense costs may be borne by a limited number of firms, of all sizes. For example, FINRA explained in the Filing that, to the extent 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.[10] FINRA also explained that costs would be borne by firms that choose to seek review via the proposed expedited proceeding.[11] As for IBN's comment about the potential disproportionate impact on small firms, FINRA believes that the proposed rule change is reasonably designed to impact a limited number of firms—across all firm sizes—that pose outlier-level risks. For example, each specific numeric threshold in the Preliminary Identification Metrics Thresholds grid (proposed Rule 4111(i)(11)) represents an outlier with respect to similar sized peers,[12] and the proposed Rule 4111 "funnel" process has numerous safeguards designed to protect firms of all sizes against misidentification. Similarly, FINRA does not anticipate that the Restricted Deposit Requirement or any required conditions and restrictions would disproportionately disadvantage firms of different sizes, because FINRA would consider firm size, among other factors, when determining the appropriate maximum Restricted Deposit Requirement or any conditions and restrictions. For these reasons, FINRA does not believe that the proposed rule imposes disproportionate costs or impacts on small firms.

Annual Calculation Date

FINRA explained in the Filing that FINRA would announce the first Evaluation Date no less than 120 calendar days before the first Evaluation Date, and that subsequent Evaluation Dates would be on the same month and day each year, except when that date falls on a Saturday, Sunday or federal holiday, in which case the Evaluation Date would be on the next business day.[13] Harvin comments that the proposed rule change should set a "date certain" for the Evaluation Date that should not fluctuate based on weekends or holidays.

FINRA believes this comment has merit and that establishing a fixed month and day as the Evaluation Date as suggested would provide even more clarity and

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10 See Filing, 85 FR 78553.

11 See Filing, 85 FR 78554.

12 See Filing, 85 FR 78558.

13 See Filing, 85 FR 78544.

predictability. For this reason, FINRA would announce the first Evaluation Date no less than 120 calendar days before the first Evaluation Date, and FINRA intends that subsequent Evaluation Dates would be on the same month and day each year, whether that date certain falls on a business day, a weekend day, or a holiday.

FINRA also believes additional aspects of the Evaluation Date would benefit from further explanation. The "Evaluation Date" would establish the date as of which all specified *events* that are reportable on the Uniform Registration Forms, or otherwise included in the proposed rule, would be included in the annual calculation of the Preliminary Criteria for Identification, not the date as of when the events that are *reported* would be counted. Thus, if a relevant final regulatory action against a registered person occurred just prior to the Evaluation Date but was reported on Form U4 promptly after the Evaluation Date, the annual Preliminary Criteria for Identification calculation would count that disclosure. Furthermore, the Evaluation Date is not the date when FINRA would actually perform the annual calculation. Rather, FINRA plans to actually perform the annual calculation at least 30 days after the Evaluation Date, to account for the time between when relevant disclosure events occurred and when firms must report those events on the Uniform Registration Forms.[14]

Preliminary Criteria for Identification

Several commenters express concern regarding the scope of certain disclosure events included in the proposed Preliminary Criteria for Identification and requested clarification. In opposing the proposed rule change, IBN describes how seven of its representatives were "at expelled firms during their career," two have "1 customer complaint," one has a "financial disclosure," and one "has three disclosures." IBN also comments that "lawyers are recruiting clients to arbitrate against reps and firms, due to no fault of their own." FINRA believes the events that IBN described, however, are much broader than the events covered by the Preliminary Criteria for Identification, and without more information and context regarding these events it is unclear if they would be captured by the proposed criteria.

The Registered Person and Member Firm Events count some disclosures on the Uniform Registration Forms—not all—and only those disclosures that occurred within the specified lookback periods. For example, a registered person's "financial disclosures"

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[14] FINRA notes that although the annual calculation will be performed after the Evaluation Date, it will not include new specified events (or updates to existing specified events) that occurred after the Evaluation Date. For example, a termination disclosure that occurred after the Evaluation Date will not be counted towards the annual calculation. Similarly, a customer arbitration that was pending as of the Evaluation Date and resulted in an award afterwards will not be included in the annual calculation.

(e.g., compromises with creditors, bankruptcy petitions, bond-related questions, unsatisfied judgments, unsatisfied liens)[15] are not included in any of the Registered Person and Member Firm Events and have no impact on the calculation of the Preliminary Criteria for Identification. Similarly, pending arbitrations and written consumer-initiated complaints, such as those disclosed in response to Form U4 Question 14I,[16] are not counted in the Preliminary Criteria for Identification; only awards and settlements in specified investment-related, consumer initiated arbitrations and complaints are counted.[17] The proposed "Registered Persons Associated with Previously Expelled Firms" category does not include representatives who were at an expelled firm at any time during their career; rather, it includes any Registered Person In-Scope who was registered with the previously expelled firm for at least one year "and whose registration with the previously expelled firm terminated during the Evaluation Period," meaning the prior five years from the Evaluation Date.[18] Moreover, by itself, the mere number of a firm's and its registered persons' relevant disclosure events would have no independent meaning under proposed Rule 4111; rather, the number of aggregate disclosure events would be viewed in relation to the relevant Preliminary Identification Metrics Thresholds for the firm's size.[19] As explained in the Filing, the proposed metrics thresholds would be ones that are intended to identify only outlier-level amounts of disclosures based on the seven proposed firm-size tiers.

Harvin suggests that proposed Rule 4111 should reference or incorporate the specific disclosure questions on the Uniform Registration Forms that are counted when calculating a firm's metrics. As FINRA responded to Harvin's similar comment in SR-FINRA-2020-011, we understand the need for clarity but believe the proposed definitions should not list specific form questions in the rule text. The definitions include disclosures from multiple Uniform Registration Forms, and FINRA believes listing questions from each relevant form will be more confusing in the rule text and could lead to ongoing amendments to the definitions as the forms are amended. Defining the Registered Person and Member Firm Events with substantive descriptions of the included disclosure events, instead of references to specific disclosure questions and fields on the Uniform Registration

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15 See, e.g., Form U4, Questions 14K, 14L, 14M.

16 See Form U4 Questions 14I(1)(a), 14I(3), 14I(5).

17 See proposed Rule 4111(i)(4)(A)(i) and (ii), 4111(i)(4)(D)(i).

18 See proposed Rule 4111(i)(4)(F), (i)(6). FINRA narrowed the proposed definition of "Registered Persons Associated with Previously Expelled Firms," in response to comments on Regulatory Notice 19-17 (May 2019).

19 See proposed Rule 4111(i)(9) (defining the "Preliminary Criteria for Identification"), Rule 4111(i)(11) (defining the "Preliminary Identification Metrics Thresholds").

Forms, is a plain-English approach that will make the definitions easier for firms and individuals to read, understand, and use. This approach is also consistent with FINRA's rulemaking to address brokers with a significant history of misconduct.[20] Moreover, as explained above, FINRA commits to providing resources to firms to help facilitate their self-monitoring of their metrics, and is considering providing guidance that would map the Registered Person and Member Firm Events to the relevant disclosure questions on the Uniform Registration Forms.[21]

Regarding proposed Rule 4111(i)(4)(D)(i), which defines "Member Firm Adjudicated Events" to include "[a] final investment-related, consumer-initiated customer arbitration award in which the member was a named party," Harvin comments that while summary information about certain arbitration awards against a firm involving a securities or commodities dispute with a public customer is published on BrokerCheck and in Arbitration Awards Online, the awards are not identified using the terms "investment-related" or "consumer-initiated." Harvin asks that FINRA confirm whether the arbitration awards that are counted for purposes of proposed Rule 4111(i)(4)(D)(i) include the awards reported by FINRA on BrokerCheck and to make appropriate reference in the proposed rule.[22] FINRA believes that additional clarity about proposed Rule 4111(i)(4)(D)(i) is warranted, and agrees that proposed Rule 4111(i)(4)(D)(i) is intended to capture all BrokerCheck disclosures of arbitration awards against firms. For the reasons discussed above, however, FINRA does not believe adding specific rule text to reference BrokerCheck is appropriate.

Harvin writes that it is unclear how, in proposed Rule 4111(i)(4)(E) (Member Firm Pending Events), the events described in proposed Rule 4111(i)(4)(E)(ii) differ from those described in Rule 4111(i)(4)(E)(iii). Proposed Rule 4111(i)(4)(E)(ii) includes "a pending investigation by a regulatory authority" reportable on the member's Uniform Registration Forms. Proposed Rule 4111(i)(4)(E)(iii) includes a "pending regulatory action that was

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20 See Securities Exchange Act Release No. 90635 (December 10, 2020), 85 FR 81540, 81543 (December 16, 2020) (Order Approving File No. SR-FINRA-2020-011).

21 Harvin attached to his comment letter what he described as a "tabular representation of the proposed definitions with cross references to the assumed Disclosure Question in Form U4, U5, and U6 or item numbers in Form BD." FINRA does not endorse or accept Harvin's tabular representation.

22 Harvin also comments that FINRA reports arbitration awards against member firms on Form U6. The Form U6 for CRD/IARD Organizations, however, contains no Disclosure Reporting Pages (DRP) for reporting arbitration awards against firms. See Form U6 for CRD/IARD Organization, https://www.finra.org/sites/default/files/AppSupportDoc/p116977.pdf.

brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization." To support his comment, Harvin notes that the Form U6 DRP refers to a matter as an "action" and does not mention "investigation." Although the Form U6 Regulatory Action DRP includes no fields for reporting a pending investigation, Forms U4 and U5 contain questions that require disclosure of pending "investigation[s]" that are distinct from other questions that ask about pending regulatory complaints or proceedings.[23] Moreover, FINRA notes that member firms and registered persons are already familiar with the reporting regime and the differences between these questions on the Uniform Registration Forms as they are longstanding disclosure questions on the forms. Including proposed 4111(i)(4)(E)(ii) was intended to parallel proposed Rule 4111(i)(4)(B)(ii) concerning registered persons, but FINRA acknowledges that, as a technical matter, Form BD contains no disclosure questions or DRP fields about pending investigations by a regulatory authority concerning firms, and FINRA plans to propose a technical correction to the proposed rule text.[24]

PIABA, citing concerns with "product failures," comments that any threshold analysis should consider the nature of the products sold by the member firms and the extent to which a firm sells those products, so that the member firms' actual ongoing sales behavior is factored into the threshold analysis. As FINRA explained in the Filing, proposed Rule 4111 uses Preliminary Criteria for Identification that are intended to, among other things, be replicable, objective and transparent (to FINRA and affected member firms).[25] As a result, the Preliminary Criteria for Identification are almost entirely based on disclosures on the Uniform Registration Forms that do not distinguish disclosures associated with product failures from other disclosures. Nevertheless, FINRA can take into account the products a firm sells and the extent to which disclosures may be associated with product failures when making a determination under Rule 4111 or during the consultative process. Moreover, proposed Rule 4111(i)(15) would expressly provide that the Department's determination of the Restricted Deposit Requirement would take into consideration, among other things, "the nature of the firm's operations and activities."

Better Markets comments that the proposal should have "more stringent criteria in identifying high risk firms," including at a minimum: (1) increasing the look-back period from five years to ten years; (2) decreasing the threshold for settlements from $15,000 to

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23 See Form U4, Questions 14G(1) (regulatory complaint or proceeding) and 14G(2) (investigation); Form U5, Questions 7A (investigation disclosure) and 7D (regulatory action disclosure).

24 Such amendment will not impact the number of firms that meet the Preliminary Criteria for Identification.

25 See Filing, 85 FR 78542.

$5,000;[26] and (3) including all disclosure events that are harmful to investors, not just those events that are "consumer-initiated." As FINRA explained in the Filing, commenters on Regulatory Notice 19-17 proposed numerous alternative definitions and criteria concerning issues—such as the length of the look-back periods—that FINRA already considered and addressed in the economic assessment in Regulatory Notice 19-17. In the Filing, FINRA explained why it believes the proposed definitions and criteria are appropriate at this time and that those comments did not identify issues with the proposal that persuaded FINRA that any changes were necessary or appropriate at this time.[27] With respect to Better Markets' suggestion to decrease the $15,000 settlements threshold to $5,000, FINRA notes that this approach would not be consistent with how the proposal is based on events disclosed on the Uniform Registration Forms, which establish the $15,000 threshold for reporting purposes.[28] A $5,000 threshold would be below the Form U4 and Form U5 reporting threshold, and as such FINRA would not have useful information on the Uniform Registration Forms from which to make its objective analysis.[29] Furthermore, Better Markets' statement that the proposal "seems to be limited to only events that are 'consumer-initiated'" is incorrect. Only awards, civil judgments, and settlements in arbitrations and civil litigations (and similar settlements prior to a customer arbitration or civil litigation) would be qualified by the "consumer-initiated" term, and these criteria are limited thus to track the relevant disclosure questions in the Uniform Registration Forms.

Better Markets objects to how FINRA has narrowed the Expelled Firm Association Metric, writing that commenters on Regulatory Notice 19-17 made "overblown" objections that the originally proposed metric would discourage firms from hiring brokers who had merely worked for expelled firms and unfairly punish brokers who may not themselves have violated any rules. FINRA believes, however, that the revised Expelled Firm Association Metric—in combination with the revised Expelled Firm Association Metrics Thresholds—appropriately serves the goal of preliminarily identifying firms that present a higher risk.

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26 Better Markets' specific request is to decrease the $15,000 dollar threshold for all "settlements, penalties, arbitration claims, etc." The only $15,000 threshold in the proposed rule, however, is the $15,000 threshold specified in proposed Rule 4111(i)(4)(A)(ii) for settlements of consumer-initiated matters in which the registered person was a named party or was a subject of the settlement.

27 See Filing, 85 FR 78560-61; see, e.g., Regulatory Notice 19-17 (explaining that FINRA considered alternative criteria for the time period over which the disclosure events or conditions would be counted).

28 See Filing, 85 FR 78561.

29 See Form U4, Question 14I; Form U5, Question 7E.

In Regulatory Notice 19-17, FINRA proposed a definition of Registered Persons Associated with Previously Expelled Firms that had an unlimited lookback over a registered person's entire career and no limitations on the duration of the person's registration with the expelled firm. Based on comments received to Regulatory Notice 19-17, FINRA narrowed the category. Specifically, the revised definition proposed in the Filing would limit this category to include only those registered persons who were registered with a previously expelled firm for at least one year and within a five-year lookback period.[30] FINRA explained that it believes that using a five-year lookback would be consistent with the lookback periods for the other proposed metrics.[31] FINRA also explained that, based on staff experience, it 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.[32]

To ensure that the proposed Expelled Firm Association Metric continues to serve its intended purposes, FINRA counterbalanced the revision of the "Registered Persons Associated with Previously Expelled Firms" term by lowering all of the proposed thresholds for the Expelled Firm Association Metric, which are in the form of a percentage concentration at the member firm of Registered Persons Associated with Previously Expelled Firms.[33] As a result, this lowered the percentages of such registered persons that would cause a firm to meet the Expelled Firm Association Metric Thresholds.[34]

Finally, FINRA validated whether the revised Expelled Firm Association Metric (along with the revised metrics thresholds) continued to serve its intended purpose. As explained in the Filing, based on staff review and validations, FINRA believes the proposed Expelled Firm Association Metric preserves the usefulness of the Preliminary

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30 See Filing, 85 FR 78560.

31 See Filing, 85 FR 78560.

32 See Filing, 85 FR 78555-56.

33 FINRA recalculated the thresholds for the revised Expelled Firm Association Metric to ensure that it continues to identify firms that are at the "far tail" of the distribution of the revised metric, which is intended to preliminarily identify firms that present significantly higher risk than a large percentage of the membership.

34 In Regulatory Notice 19-17, FINRA originally proposed Expelled Firm Association Metrics Thresholds, for the seven firm-size categories, that ranged from 0.05 to 0.75. See Regulatory Notice 19-17, Attachment A. FINRA's current proposal would establish lower Expelled Firm Association Metrics Thresholds ranging between 0.01 to 0.30. See proposed Rule 4111(i)(11) (definition of "Preliminary Identification Metrics Thresholds").

Criteria for Identification and continues to identify firms that pose greater risks to their customers.[35]

Restricted Deposit Requirement

Harvin comments that the impact of a Restricted Deposit Requirement is "to require additional net capital," and that FINRA Rule 4110(a) would appear to provide FINRA ample authority to impose greater net capital on a firm that is not paying customer arbitration awards.[36] As an initial matter, 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.[37] In addition, FINRA considered an alternative approach of increasing the capital requirements on identified firms and, as FINRA explained in the Filing, determined that such an approach would be accompanied by "several drawbacks with respect to economic incentives and anticipated impacts":

> 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,

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35 See Filing, 85 FR 78556.

36 FINRA Rule 4110(a) provides, in pertinent part, that "[w]hen necessary for the protection of investors or in the public interest, FINRA may, at any time or from time to time with respect to a particular carrying or clearing member or all carrying or clearing members, . . . prescribe greater net capital or net worth requirements than those otherwise applicable, including more stringent treatment of items in computing net capital or net worth, or require such member to restore or increase its net capital or net worth."

37 See Filing, 85 FR 78559.

> FINRA would not be able to ensure that any funds would be available for satisfying unpaid arbitration awards.[38]

In light of these considerations, FINRA decided to propose a Restricted Deposit Requirement approach, rather than changes to the capital requirements on identified firms.[39]

Restricted Deposit Amount

Harvin suggests that the imposition of a Restricted Deposit Requirement on a firm that has no Covered Pending Arbitration Claims or unpaid arbitration awards would appear to be contrary to the purpose of the proposed rule. In support, Harvin cites proposed Rule 4111(i)(15), which sets forth factors that the Department would consider when evaluating the amount of a Restricted Deposit Requirement, including "Covered Pending Arbitration Claims" and "unpaid arbitration awards." FINRA disagrees with Harvin's comment. The proposal's primary purpose is to create incentives for members that pose outlier-level risks to change behavior.[40] Under proposed Rule 4111, the Department could impose a Restricted Deposit Requirement on a Restricted Firm regardless of whether it has any unpaid arbitration awards or Covered Pending Arbitration Claims. Nothing in proposed Rule 4111(i)(15) indicates otherwise.

In a related comment, Harvin notes that the proposed factors in Rule 4111(i)(15) do not include the "average of total revenue paid out in the past five years in arbitration and customer settlements and litigation." FINRA believes the proposed factors would permit FINRA to consider relevant information because the proposed rule is both specific enough to set forth the factors that would be relevant to the Department's determination of the maximum Restricted Deposit Requirement and flexible enough to facilitate an evaluation of the weight those factors should have in light of different facts and circumstances at different firms. For example, one of the factors in proposed Rule 4111(i)(15) is "the nature of the firm's . . . expenses," and a firm would be permitted to present at a Rule 4111 Consultation why the maximum Restricted Deposit Requirement amount does not properly

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38 See Filing, 85 FR 78556-57.

39 See Filing, 85 FR 78558.

40 FINRA notes that it has recently (and separately) adopted rule changes to help further address the issue of unpaid customer arbitration awards. See Regulatory Notice 20-15 (May 2020) (FINRA Amends Rules Governing its Membership Application Program to Incentivize Payment of Arbitration Awards). See also Regulatory Notice 20-11 (April 2020) (FINRA Amends Arbitration Code to Expand Options Available to Customers if a Firm or Associated Person Is or Becomes Inactive).

account for the nature of its expenses.[41] However, just because a Restricted Firm has a recent history of paying arbitration awards and settlements does not mean that a Restricted Deposit Requirement would not be appropriate to address the risks that that Restricted Firm presents to investors and the public interest.[42]

Harvin comments that it is "interesting to note" that the examples of restricted deposits that FINRA provided in Regulatory Notice 19-17 used the terms "aggravating" circumstances and "mitigating" factors, and he opines that "[t]he aggravating circumstances are that each firm meets Preliminary Identification Metric Thresholds."[43] FINRA believes firms that meet the Preliminary Criteria for Identification present different levels of risks to the public and therefore has proposed the consultative process. As part of that process, FINRA believes it is appropriate that the Department's determination of a Restricted Deposit Requirement would consider each Restricted Firm's unique characteristics, including factors that may suggest a higher deposit requirement is needed and factors that suggest a lower deposit requirement would be appropriate.

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41 Prior to the Consultation, the Department would determine a "maximum" Restricted Deposit Requirement. See proposed Rule 4111(i)(15). Pursuant to proposed Rule 4111(d), at the Consultation the firm would "bear[ ] the burden of demonstrating that it . . . should not be required to maintain the maximum Restricted Deposit Requirement" and would have to overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement. Where the firm does not overcome that presumption and the presumption that it is a Restricted Firm, the firm would be required to maintain the maximum Restricted Deposit Requirement. See proposed Rule 4111(e)(1)(B). Where the firm does not overcome the presumption that it is a Restricted Firm but does overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement, the Department would either impose no Restricted Deposit Requirement or would impose a Restricted Deposit Requirement that is less than the maximum Restricted Deposit Requirement. See proposed Rule 4111(e)(1)(C).

42 For example, a firm that has a higher amount of payments of arbitration awards and settlements could suggest that the firm has had greater awards and settlements and poses a greater risk of harm.

43 In Regulatory Notice 19-17, FINRA provided three examples of maximum Restricted Deposit Requirements. For each example firm, the examples set forth a firm description, financial information, "aggravating circumstances," "mitigating factors," and a maximum Restricted Deposit Requirement that indicated a potential range of deposit requirements and where in the range the deposit requirement would be set (e.g., high end, midpoint, low end). FINRA did not submit similar examples with the Filing.

Restricted Deposit Value

PIABA comments that there is no guarantee that "qualified securities" deposited to satisfy a Restricted Deposit Requirement will maintain their value. PIABA recommends that the proposal address the frequency of the Restricted Deposit valuation and establish rules requiring account replenishment as necessary.

Proposed Rule 4111(a) would permit a Restricted Firm to satisfy a Restricted Deposit Requirement only with the same assets that the SEC permits a broker-dealer to use to satisfy its reserve deposit obligations under Exchange Act Rule 15c3-3(e).[44] In addition to cash, a Restricted Firm would be able to satisfy a Restricted Deposit Requirement with "qualified securities," which would have the meaning given it in Exchange Act Rule 15c3-3(a)(6): "a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States."[45] FINRA believes that these securities are of relatively stable value and, therefore, the direct financial impact of the Restricted Deposit Requirement—and the resulting incentive for the Restricted Firm to reform—will not be impacted by any fluctuations after the date of the deposit in the value of qualified securities used to satisfy that requirement.

Conditions and Restrictions

Better Markets expresses concern that by setting out in proposed Rule 4111.03 an illustrative list of conditions and restrictions that the Department could impose on a Restricted Firm, FINRA may be limiting its options in dealing with noncompliant and exceptionally high-risk firms. Better Markets further comments that FINRA should make clear that FINRA does not cede its authority to take punitive action against predatory firms that violate FINRA's rules and the rights of their customers.

In FINRA's view, the proposed rule does not expressly or impliedly limit the kinds of conditions and restrictions that FINRA could impose. Proposed Rule 4111.03 expressly provides that the examples of conditions and restrictions "are not limited to" the ones listed in that proposed Supplementary Material. FINRA also disagrees with Better Markets' suggestion that the conditions and restrictions that would be imposed would be "punitive." Rather, proposed Rule 4111(e) would allow the Department to impose conditions and restrictions 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. Conditions and restrictions

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44 See 17 CFR 240.15c3-3(e).

45 See proposed Rule 4111(i)(8) (defining "qualified security"); 17 CFR 240.15c3-3(a)(6).

are not intended to be punishment for having outlier levels of disclosures; rather, they incent firms to change behavior and protect investors.[46]

However, FINRA understands the concern raised by Better Markets and the need to act when appropriate against predatory firms. FINRA fully intends to continue using its existing authority to take action against predatory firms that violate FINRA's rules and the rights of their customers, and does not believe the proposed rule change would undermine FINRA's ability to discipline firms. The proposed rule change strengthens FINRA's tools to respond to firms and brokers with a significant history of misconduct, without supplanting our existing tools. Nothing in proposed Rule 4111 by its express terms or otherwise limits FINRA's authority to bring disciplinary action against firms and persons within its jurisdiction for violations and impose remedial sanctions for violations, including expulsions and bars where appropriate. Moreover, FINRA also is proposing to adopt Rule 9561(b), which would permit FINRA to bring an expedited proceeding against a firm that fails to comply with any of the Rule 4111 Requirements imposed on a Restricted Firm, and seek the imposition of a suspension or cancellation of membership.

Disclosure of Restricted Firms

Several commenters propose that FINRA disclose a firm's status as a Restricted Firm to the public.[47] Better Markets further comments that FINRA must, at a minimum, disclose the names of firms that have been twice designated as a Restricted Firm, publicize the names of newly formed firms that are made up of 20% or more brokers who were affiliated with previously twice-designated Restricted Firms, and require that brokers who are affiliated with twice-designated Restricted Firms disclose to their former, current and prospective clients the fact that they are employed by such a firm.

As FINRA explained in the Filing, 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). Publicly disclosing a firm's Restricted Firm status may potentially interfere with those purposes. Therefore, at this time FINRA is not proposing to require the public disclosure of a firm's status as a Restricted Firm. FINRA continues to believe that it should first gain meaningful experience with the proposed rule to evaluate the impact of creating an

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46 Cf. *Saad v. SEC*, 980 F.3d 103, 106 (D.C. Cir. 2020) (holding that the Exchange Act requires that FINRA's selection of appropriate relief "avoid 'excessive or oppressive' sanctions, . . . by acting 'for a remedial purpose, [and] not for punishment'") (citing *Siegel v. SEC*, 592 F.3d 147, 157 (D.C. Cir. 2010)).

47 Better Markets, NASAA, PIABA.

affirmative disclosure program.[48] Nevertheless, FINRA appreciates the potential value of public disclosure and will be considering it and other approaches, such as the approaches suggested by Better Markets, going forward. As FINRA noted in the Filing, FINRA plans to conduct a review of proposed Rule 4111 after gaining sufficient experience with the rule, and FINRA will consider the disclosure issues at that time.

NASAA further comments that, at a minimum, FINRA should disclose a firm's Restricted Firm status to other regulators. NASAA expresses concern that if regulators do not have information about which firms are Restricted Firms, it would lead to regulatory confusion and wasted resources, and could adversely impact regulators' risk evaluation and examination functions. In particular, NASAA comments that withholding the fact that a firm is subject to a Restricted Deposit Requirement could skew an examiner's review of a firm's compliance with net capital requirements, because the funds would not be readily available to meet creditors' calls or liquidity requirements. FINRA appreciates NASAA's concerns. FINRA will explore ways in which it and NASAA can continue to share information regarding risks presented by firms, in a manner consistent with the purpose of the proposed rule change.[49]

Unpaid Arbitration Awards

PIABA makes several comments concerning unpaid arbitration awards. PIABA comments that the proposed rule change fails to remedy the issue of unpaid arbitration awards and settlements, and suggests that Restricted Firms be required to pay unpaid arbitration awards prior to depositing funds in a Restricted Deposit Account.

In situations where a Restricted Deposit Requirement is imposed on a firm that has one or more unpaid arbitration awards, that firm would have the dual obligation to pay its

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48 See Filing, 85 FR 78567.

49 In a related comment, NASAA states that it does not believe that firms would disclose their Restricted Firm status on Form BD or Form CRS without being required to do so through changes to those forms' existing requirements. Question 11E on Form BD asks, "Has any self-regulatory organization . . . ever: . . . (3) found the applicant . . . to have been the cause of an investment-related business having its authorization to do business . . . restricted?" Form CRS, Item 4 requires firms to disclose "[l]egal or disciplinary events in your Form BD (Items 11 A-K) (except to the extent such information is not released to BrokerCheck, pursuant to FINRA Rule 8312). Because Forms BD and CRS are SEC forms, FINRA cannot provide interpretative guidance concerning whether a Restricted Firm that is subject to a Restricted Deposit Requirement or conditions and restrictions would be required to provide an affirmative answer to Form BD Question 11E or disclose such events in response to Form CRS Item 4.

unpaid arbitration awards *and* deposit and maintain the full amount of the Restricted Deposit Requirement in a Restricted Deposit Account. Both obligations would be mandatory and serve important, but different, regulatory purposes.

Moreover, as FINRA explained in the Filing, FINRA currently suspends member firms or registered representatives who do not pay arbitration awards in a timely manner from membership or association, thus precluding them from continuing to engage in the securities business with customers.[50] FINRA further explained that the proposed rule was designed to address not just unpaid awards, but a broader range of investor protection concerns posed by firms and individuals with a significant history of misconduct. Specifically, proposed Rule 4111 would apply to firms that, 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.[51]

At the same time, as also explained in the Filing, FINRA believes proposed Rule 4111 may have important ancillary effects in addressing unpaid customer arbitration awards. The proposed rule may deter behavior that could otherwise result in unpaid arbitration awards by incentivizing firms to reduce their risk profile and violative conduct to avoid being deemed a Restricted Firm and becoming subject to a Restricted Deposit Requirement or other conditions or restrictions for a year or more. The proposed rule may incentivize firms to obtain insurance coverage for potential arbitration awards, because such coverage would be taken into account in determining a Restricted Deposit Requirement. The proposed rule also 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.[52]

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50 See Filing, 85 FR 78565 & n.151; Rule 12904(j) (providing that "[a]ll monetary awards shall be paid within 30 days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction"); Rule 9554 (expedited proceeding for failure to comply with an arbitration award or related settlement); see also Notice to Members 00-55 (August 2000) (describing defenses to non-payment of a customer arbitration award, including, inter alia, that the member or associated person has a bankruptcy petition pending in U.S. Bankruptcy Court or the award has been discharged by a U.S. Bankruptcy Court).

51 See Filing, 85 FR 78565. As noted above, FINRA recently (and separately) adopted rule changes to help further address the issue of unpaid customer arbitration awards. See note 40, supra.

52 See Filing, 85 FR 78565. In a related comment, Harvin suggests that the issue of unpaid arbitration awards is not a problem that FINRA needs to address through the

Suggesting that it is "axiomatic" that the maximum Restricted Deposit Amount should "at the very least" cover unpaid awards and "anticipated awards," PIABA also comments that the proposed limitation that a Restricted Deposit Requirement "not significantly undermine the continued financial stability and operational capability of the member as an ongoing enterprise over the next 12 months"[53] means that the more thinly capitalized firms may not be required to deposit funds sufficient to cover outstanding arbitration awards or Covered Pending Arbitration Claims. FINRA reiterates that the proposed rule change would not absolve firms from paying unpaid arbitration awards. Moreover, as FINRA explained in the Filing, a member's thin capitalization at the time of the Consultation would be only one factor of many that the Department would consider when determining a Restricted Deposit Requirement, and a thin capitalization would not necessarily result in a lower requirement.[54] Indeed, a key reason why FINRA has proposed a factor-based approach to determining a Restricted Deposit Requirement, and not a formulaic one, is because it is less susceptible to the risk of firms manipulating their financial-related factors, such as preemptively withdrawing net capital.[55] FINRA also notes that while a member's unpaid arbitration awards and Covered Pending Arbitration Claims would be factors to consider, nothing in proposed Rule 4111 establishes a floor for the amount of a Restricted Deposit Requirement based on those factors or others.

PIABA also comments that the proposed rule change should address how aggrieved investors can access restricted deposits when a firm refuses to pay an arbitration award in favor of the investor, when a former firm refuses to apply for a withdrawal, or when no one from the former firm is available to make such a request on behalf of the investor. While FINRA understands the basis for this comment, FINRA reiterates that proposed Rule 4111 is intended to address the risks posed to investors by individual brokers and member firms that have a history of misconduct. Although proposed Rule 4111 has features that further incentivize firms to pay unpaid arbitration awards beyond the incentives that already exist (e.g., the amount of such unpaid arbitration awards would be considered in determining the

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proposed rule change. FINRA, however, has long been concerned about non-payment of arbitration awards. See, e.g., FINRA, *Discussion Paper – FINRA Perspectives on Customer Recovery*, at pp. 1, 19 (February 8, 2018), https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf. FINRA issued the *Discussion Paper* to encourage a continued dialogue about addressing the challenges of customer recovery across the financial services industry while directly informing the further enhancement of recovery in FINRA's forum.

53 See proposed Rule 4111(i)(15)(A).

54 See Filing, 85 FR 78565.

55 See Filing, 85 FR 78564.

size of the firm's Restricted Deposit Requirement; the ability of a previously designated firm to seek approval for withdrawals from its Restricted Deposit when it commits to use the amount to pay the firm's specified unpaid arbitration awards, etc.), it is not intended to alter how aggrieved investors currently may proceed to collect on an arbitration award.[56]

Expungement

PIABA comments that the expungement of customer disputes from firms' and brokers' industry records will adversely affect FINRA's ability to determine whether a firm should be deemed a Restricted Firm, and that the proposed rule change will have the likely and unintended consequence of further incentivizing member firms and registered representatives to pursue expungement of customer complaints. The Filing, however, explained why FINRA believes that the data reported on the Uniform Registration Forms is a reliable source on which to base proposed Rule 4111.

In this regard, FINRA explained that FINRA rules require firms and individuals to make accurate disclosures, and that firms and individuals could be subject to disciplinary action and possible disqualification if they fail to do so. FINRA also explained that regulators are the source of disclosures on Form U6, and that FINRA's Department of Credentialing, Registration, Education and Disclosure conducts a public records review to verify the completeness and accuracy of criminal disclosure reporting.[57] Moreover, while the number of expungement requests may increase as a result of the proposed rule change, the existing regulatory framework and FINRA rules are designed to ensure that expungements are granted only after a court of competent jurisdiction has entered an order directing expungement or confirming an arbitration award containing expungement relief.[58] FINRA also explained in the Filing that FINRA's Office of the Chief Economist has tested the proposed thresholds based on existing CRD data in several ways, 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. Based on these validations and

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56 Customers who obtain a monetary award in arbitration can have the award confirmed in court, putting them in the same position—in terms of their ability to collect on that award—as if they had initially obtained the award through court proceedings. Thus, a customer's recovery depends on factors such as the ability of the respondent to pay, not on whether the customer obtained the award in arbitration or in court. See Discussion Paper, supra, at p. 2.

57 See Filing, 85 FR 78561.

58 See Filing, 85 FR 78561.

staff review, FINRA believes that the existing CRD data and the proposed criteria using this data are effective at identifying firms that pose greater risks to customers.

Moreover, while the proposed rule change is not intended to address concerns with the current expungement process, FINRA notes that it is actively engaged in rulemaking to substantially strengthen the current process and welcomes continued engagement with interested parties on expungement.[59] FINRA appreciates PIABA's comment that "FINRA has made strides to reform the expungement process and supports FINRA's continuing efforts to address" the expungement issue.

One-Time Staff-Reduction Option

Several commenters address the proposed one-time staff-reduction option. Under proposed Rule 4111(c)(2), if the Department determines, after its initial evaluation, that a member firm that meets the Preliminary Criteria for Identification warrants further review under proposed Rule 4111, such a member firm—if it would be meeting the Preliminary Criteria for Identification for the first time—would have a one-time option to reduce its staffing levels to no longer meet the criteria.

PIABA comments that the proposed one-time staff-reduction option incentivizes firms that meet the Preliminary Criteria for Identification to discharge the "low hanging fruit" and continue business as usual, and does not incentivize firms to diligently monitor and supervise their brokers. In a similar comment, Better Markets suggests that firms exercising the one-time staff-reduction opportunity should be required to "start[ ] with those with the most disclosure events regardless of their role within the organization or the revenue they generate" or, alternatively, with brokers who have a "harmful combination of frequent and severe violations of FINRA and SEC rules that have a direct impact on investors," and "prohibit firms from retaining recidivist brokers due to their position within the firm or the amount of revenue they generate."

FINRA agrees with the investor-protection objectives of these comments, and believes that the proposed one-time staff reduction option strikes the appropriate balance by incentivizing potential Restricted Firms to materially reduce their risk profile while providing a procedural protection to a firm that meets the Preliminary Criteria for Identification for the first time a single opportunity to reduce staff within the required timeframe so as to fall below the criteria's thresholds. To exercise the staff-reduction option, a firm would need to terminate representatives who have the kinds of disclosures that count for purposes of the Preliminary Criteria for Identification and in sufficient

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59 See Filing, 85 FR 78561 & n.130 (describing FINRA's recent efforts). See also Securities Exchange Act Release No. 90734 (December 18, 2020), 85 FR 84396 (December 28, 2020) (Order Instituting Proceedings to Determine Whether to Approve or Disapprove File No. SR-FINRA-2020-030).

numbers that cause the firm to fall below the Preliminary Criteria for Identification, and not rehire such representatives in any capacity for a period of one year. That the firm could otherwise become subject to a Restricted Deposit Requirement or conditions and restrictions for a significant period of time would be a strong incentive for the firm to exercise the staff-reduction option in ways that materially reduce the risks it poses to investors.[60] Moreover, the fact that a firm would not be able to use the staff-reduction option a second time would deter the firm from hiring larger numbers of individuals with a record of disciplinary issues after a staff reduction, and incentivize it to improve compliance so as to avoid a Restricted Firm designation.[61]

Better Markets also comments that prohibiting a firm that has used the staff-reduction option only from rehiring the same persons within a year is "inadequate[ ]," and that persons who have been terminated or laid-off should not be permitted to be hired by other firms for at least one year and never by another "high risk firm." FINRA believes a one-year restriction from being rehired at the firm from which such persons were terminated strikes the appropriate balance. Moreover, FINRA agrees with the concerns raised by the commenter and believes that FINRA's new rules related to brokers with a significant history of misconduct will play an important complementary role in protecting investors. The SEC recently approved rule changes that, as FINRA explained in the Filing, will potentially impact persons who would be terminated pursuant to the proposed staff-reduction option and seek to join another firm.[62]

Better Markets asserts that the newly approved rule, Rule 1017(a)(7), "merely requires that the hiring firm impose an additional supervisory regime over troublesome brokers." However, that is not an accurate description. Rule 1017(a)(7) will generally require a member firm to submit a written request to FINRA seeking a materiality consultation when a person who has, in the prior five years, one "final criminal matter" or two "specified risk events" seeks to become an owner, control person, principal or

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60 FINRA notes that any member firm that seeks to hire such persons would need to consider and comply with Rule 9522 (Initiation of Eligibility Proceeding; Member Regulation Consideration) to the extent any such persons are subject to a "statutory disqualification" as defined in Section 3(a)(39) of the Exchange Act.

61 See Filing, 85 FR 78562.

62 See Filing, 85 FR 78562 & n.132 (citing SR-FINRA-2020-011); see also Securities Exchange Act Release No. 90635 (December 10, 2020), 85 FR 81540 (December 16, 2020) (Order Approving File No. SR-FINRA-2020-011). FINRA will announce in a Regulatory Notice the effective date of the rules approved in SR-FINRA-2020-011.

registered person of the member.[63] Pursuant to Rule 1017(a)(7), as part of the materiality consultation, the Department of Member Regulation shall determine in the public interest and the protection of investors that either (A) the member is not required to file a Form CMA in accordance with Rule 1017 and may effect the contemplated activity; or (B) the member is required to file a Form CMA in accordance with Rule 1017 and the member may not effect the contemplated activity unless the Department approves the Form CMA. Rule 1017(a)(7) does not mandate, as Better Markets implies, that all proposed associations with terminated persons be approved.[64] FINRA further notes that the examples of conditions and restrictions in proposed Rule 4111.03 include "limitations on business expansions," which could include limitations on the kinds of persons that a Restricted Firm might hire.

"Covered Pending Arbitration Claims"

Several commenters address the proposed definition of Covered Pending Arbitration Claim in proposed Rule 4111(i)(2). PIABA states that the proposed definition improperly excludes arbitration claims "that are less than a firm's excess net capital yet may still remain unpaid by the firm." The term "Covered Pending Arbitration Claim" does not include, however, final arbitration matters that have resulted in an award or settlement. Moreover, regardless of a firm's excess net capital, if a final arbitration award or settlement is unpaid, that would be a factor for FINRA to consider when determining a Restricted Deposit Requirement and reviewing a firm's request for a withdrawal from a Restricted Deposit.[65]

PIABA also states that a firm may be able to manipulate whether a pending arbitration claim is included in the "Covered Pending Arbitration Claim" definition simply by adjusting its excess net capital while the Department is determining the Restricted Deposit Requirement. However, proposed Rule 4111(i)(15), which describes the factors that would be relevant to the Department's determination of a firm's Restricted Deposit

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63 See Rule 1017(a)(7) and Rule 1011(h) and (p) (definitions of "final criminal matter" and "specified risk event").

64 FINRA also reiterates that some of Better Markets' requests to restrict or prohibit the rehiring by member firms of persons who were terminated pursuant to the proposed one-time staff reduction option are tantamount to a request that FINRA broaden the statutory definition of disqualified persons under Exchange Act, which is not within FINRA's jurisdiction to do. See Filing, 85 FR 78568.

65 See proposed Rule 4111(f) and (i)(15). Moreover, as FINRA explained in the Filing and above, 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.

Requirement, is flexible enough to allow the Department to take into account attempts by a firm to manipulate financial-related factors. Under proposed Rule 4111(i)(15) the Department would review a firm's financial factors, including its net capital levels for relevant periods. Thus, for example, if the Department sees that a firm has materially changed its net capital levels either while it is under review pursuant to Rule 4111 or in anticipation of a possible review, the Department can take that into account, including considering how such changes in net capital may also impact assessment of the Covered Pending Arbitration Claims factor.

Harvin comments that the Covered Pending Arbitration Claims definition should refer not to the "claim amount" but to accounting standards codified in Financial Accounting Standards Board (FASB) standards concerning "loss contingencies."[66] Harvin suggests that the definition should account for whether it is probable that a loss has been incurred as a result of a pending arbitration claim and for whether that loss can be reasonably estimated, and that absent such change the rule "could impose a severe hardship on a firm." As an initial matter, all Covered Pending Arbitration Claims need to be considered in setting the requirements because, in our experience, firms do not necessarily recognize a "loss contingency" for a Covered Pending Arbitration Claim prior to the conclusion of a proceeding. To the extent that Harvin's comment presumes that the Restricted Deposit Requirement amount would establish a floor based on the amount of the firm's Covered Pending Arbitration Claims, such a presumption is incorrect. Proposed Rule 4111(i)(15) explains that a firm's Covered Pending Arbitration Claims would be a factor, among many others, that the Department would consider when determining a Restricted Deposit Requirement. Further, nothing in proposed Rule 4111(i)(15) requires that any such factors would establish or require a floor amount. Moreover, FINRA believes that proposed Rule 4111(i)(15) is already flexible enough to address Harvin's concerns related to loss contingencies. In this regard, nothing would preclude a firm, during a Rule 4111 Consultation, from asserting that the weight of the Covered Pending Arbitration Claims factor should be evaluated in relation to the probability that those pending claims would evolve into actual liabilities and that the size of such actual liabilities would be less than the stated amount of the claims.[67]

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66 Harvin cites FASB ASC 450-20 (Loss Contingencies), ASC 450-20-25 (Recognition), ASC 450-20-25-2, ASC-450-20-20 (Glossary), and ASC 20-55-13.

67 Harvin makes a related comment that appears to be about provisions in IM-1014-1 that relate to an applicant firm providing a "written opinion of an independent, reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claims." IM-1014-1 concerns providing evidence in a membership application of an ability to satisfy unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements or, for new member applications, pending arbitration claims. Nothing in the proposed rule change, however, references IM-1014-1,

Expedited Proceeding

Harvin comments that the proposed expedited proceeding rule[68] should be amended to require that FINRA provide each member firm notice of its Preliminary Identification Metrics. FINRA declines this recommendation. The purpose of the proposed expedited proceeding rule—including proposed Rule 9561 and the related proposed amendments to Rule 9559—is to establish procedures for when the Department determines, after the Rule 4111 process, that a firm is a Restricted Firm and seeks to impose requirements, conditions, or restrictions on the Restricted Firm. The proposed expedited proceeding is not intended to provide notice of Preliminary Identification Metrics to numerous firms that are not deemed to be Restricted Firms. Alternatively, if Harvin's comment was not about amending the expedited proceeding process, but intended to suggest that FINRA provide all firms notice of their Preliminary Identification Metrics, then FINRA reiterates its commitment to providing resources to help firms comply with proposed Rule 4111 as described earlier in this letter.

Economic Impact Analysis

Better Markets contends that FINRA should conduct an economic assessment that takes into account consumer harm beyond the "baseline scenario where FINRA takes no action to monitor or control predatory wolf-pack firms," and that "assumes the improvements offered" by the commenter. FINRA disagrees with this assertion. As stated in the Filing, the economic baseline used to evaluate the economic impacts of the proposed rule 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 also includes FINRA's current risk monitoring and focused examination programs that are designed to monitor and address the risks posed by high-risk firms and high-risk brokers. FINRA used this baseline as the primary point of comparison for assessing economic impacts of the proposed rule, including incremental benefits and costs. Moreover, FINRA has conducted a thorough analysis of the economic impact of the proposed rule change. As part of its development of the proposed rule change and assessment of the potential impacts, FINRA analyzed the number of firms that would have met the Preliminary Criteria for Identification if it had been in place during the 2013-2017 review period and the number of "new" Registered Person and Member Firm Events in the 2014-2019 Post-Identification Period. That analysis demonstrated that for firms that would

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proposes changes to IM-1014-1, or proposes any rule changes that relate to the provision of a written opinion of an independent, reputable U.S. licensed counsel.

68 Although Harvin requests a change to "Rule 9559(a)," which describes the applicability of hearing procedures for FINRA's expedited proceeding, FINRA assumes that Harvin intended to request a change to proposed Rule 9561(a).

have met the Preliminary Criteria for Identification in the years 2013-2017, those firms were associated with 2,995 "new" Registered Person and Member Firm Events in the Post-Identification Period.[69] It also demonstrated that such firms had between 6.1 and 19.9 times more "new" disclosure events (per registered person) in the years after identification than other firms registered during the 2013-2017 period. FINRA believes this provides appropriate information about the economic baseline and effectiveness of the proposed rule in identifying firms that may be associated with additional events after identification.

With respect to Better Markets' suggestion that FINRA conduct an economic assessment that assumes the rule changes that Better Markets suggests, FINRA believes that its economic impact analysis thoroughly addresses how FINRA's proposed rule change addresses a regulatory need better than reasonable alternatives,[70] and that its economic assessment is consistent with the framework for FINRA's approach to economic impact assessments in proposed rulemakings.[71]

Other Measures Suggested by Commenters

Better Markets comments that the proposal is insufficient because it allows "high risk firms to remain operational" and will "increase moral hazard." It proposes that firms that are twice-designated as a Restricted Firm and still designated as such at the end of the second year: (1) be expelled; (2) that current brokers of such firms who were employed at the time of the initial designation be de-licensed and barred; and (3) that such expulsion orders should not be appealable. As explained in the Filing, Better Markets' suggestions essentially request that FINRA broaden the definition of statutory definition of disqualified persons, which is not within FINRA's jurisdiction to do.[72] Moreover, FINRA believes that Better Markets' suggestion that firms and individuals be expelled and barred with no

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69 See Form 19b-4, Exhibit 3c, SR-FINRA-2020-041.

70 For example, FINRA considered several alternative specifications to the numeric threshold based-approach, including alternative categories of reported disclosure events and metrics, alternative counting criteria for the number of reported events or conditions, and alternative time periods over which the events or conditions are counted.

71 See Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking (September 2013), https://www.finra.org/sites/default/files/Economic%20Impact%20Assessment_0_0.pdf.

72 See Filing, 85 FR 78568.

appeal rights would be inconsistent with the fair procedure requirements in Section 15A(b)(8) of the Securities Exchange Act of 1934.[73]

Better Markets comments that it would support FINRA obtaining authority to impose "terms and conditions" on certain firms that either circumvent the obligations and restrictions placed upon them under Rule 4111 or otherwise refuse to significantly improve their compliance culture. In the Filing, FINRA explained that one alternative approach it considered is an approach similar to the Investment Industry Regulatory Organization of Canada's (IIROC) "terms and conditions" rule, IIROC Consolidated Rule 9208.[74] FINRA appreciates Better Markets' comment and, as explained in the Initial Notice, FINRA will continue to explore a broader terms and conditions approach.[75] At the same time, FINRA notes that proposed Rule 9561(b), which would permit FINRA to bring an expedited proceeding against a member that fails to comply with any Rule 4111 Requirements imposed under Rule 9561, already addresses some of Better Markets' concerns.

In a related comment, Better Markets writes that FINRA must prevent firms from gaming the Preliminary Identification Metric Thresholds, and that Better Markets would support any "reasonable and appropriate amendments or future proposals that would allow FINRA to address firms with substantial compliance issues that cannot be captured by the proposed numerical framework." FINRA appreciates this comment, and notes that these kinds of concerns are one reason why FINRA will continue to explore a terms and conditions approach. FINRA also notes that the proposed rule change has been designed to make it more difficult for firms to manipulate their Preliminary Identification Metrics. In this regard, proposed Rule 4111(i)(13) defines "Registered Persons In-Scope" to mean all persons registered with the firm for one or more days within the year prior to the Evaluation Date. This proposed definition would prevent a firm from manipulating its metrics by reducing staff immediately before the annual calculation of the Preliminary Criteria for Identification. Likewise, FINRA would plan to perform the annual calculation of a firm's Preliminary Criteria for Identification at least 30-45 days after the Evaluation Date, to account for the lag time between when relevant disclosure events occurred and when they are required to be reported on the Uniform Registration Forms. This would

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73 See 15 U.S.C. 78o-3(b)(8).

74 See Filing, 85 FR 78554.

75 See Filing, 85 FR 78554-55. Better Markets states that FINRA declined to propose a general terms and conditions authority on the grounds that it would provide a less effective deterrent than the proposed numerical thresholds approach, but that is an inaccurate description of what FINRA stated in the Filing. In the Filing, FINRA described the advantages and disadvantages of a terms and conditions approach, and stated that FINRA was not proposing a terms and conditions approach at this time but will continue to explore the approach. See Filing, 85 FR 78554-55.

prevent a firm from delaying Uniform Registration Form submissions to manipulate their annual metrics.

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FINRA believes that the foregoing responds to the material issues raised by the commenters to the rule filing. If you have any questions, please contact me at [redacted], email: [redacted].

Best regards,

/s/ Michael Garawski

Michael Garawski
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FINRA Office of General Counsel