

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-89305; File No. SR-FINRA-2020-011)

July 13, 2020

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1, to Address Broker-Dealers with a Significant History of Misconduct

I. Introduction

On April 3, 2020, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend FINRA’s rules to help further address the issue of broker-dealers with a significant history of misconduct and the firms that employ them. The proposed rule change was published for comment in the Federal Register on April 14, 2020.³ On May 27, 2020, FINRA consented to an extension of the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to July 13, 2020.⁴ On July 2, 2020, FINRA responded to the comment letters received in response to the Notice and filed an amendment to the proposed rule change (“Amendment No. 1”).⁵

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Exchange Act Release No. 88600 (Apr. 8, 2020), 85 FR 20745 (Apr. 14, 2020) (File No. SR-FINRA-2020-011) (“Notice”).

⁴ See letter from Michael Garawski, Associate General Counsel, Office of General Counsel, FINRA, to Daniel Fisher, Branch Chief, Division of Trading and Markets, U.S. Securities and Exchange Commission, dated May 27, 2020.

⁵ See letter from Michael Garawski, Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Secretary, U.S. Securities and Exchange Commission, dated July 2, 2020 (“FINRA Letter”). The FINRA Letter is available at the

The Commission is publishing this order pursuant to Section 19(b)(2)(B) of the Exchange Act⁶ to solicit comments on Amendment No. 1 from interested persons and to institute proceedings to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.

Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to the proposed rule change, nor does it mean that the Commission will ultimately disapprove the proposed rule change. Rather, as discussed below, the Commission seeks additional input from interested parties on the changes to the proposed rule change, as set forth in Amendment No. 1.

II. Description of the Proposed Rule Change

Background

FINRA's proposed rule change would: (1) amend the FINRA Rule 9200 Series (Disciplinary Proceedings) and the 9300 Series (Review of Disciplinary Proceedings by National Adjudicatory Council and FINRA Board; Application for SEC Review) to allow a hearing officer to impose conditions or restrictions on the activities of a respondent member broker-dealer or respondent associated person, and require the member broker-dealer employing a respondent associated person to adopt heightened supervisory procedures for such associated person, when a disciplinary matter is appealed to the National Adjudicatory Council ("NAC") or called for NAC review; (2) amend the FINRA Rule 9520 Series (Eligibility Proceedings) to require member broker-dealers to adopt heightened supervisory procedures for statutorily disqualified associated persons during the period a statutory disqualification eligibility request is

Commission's website at <https://www.sec.gov/comments/sr-finra-2020-011/srfinra2020011-7399761-219028.pdf>.

⁶ 15 U.S.C. 78s(b)(2)(B).

under review by FINRA; (3) amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure) to require the disclosure through FINRA BrokerCheck of the status of a member broker-dealer as a “taping firm” under FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms); and (4) amend the FINRA Rule 1000 Series (Member Application and Associated Person Registration) to require a member broker-dealer to submit a written request to FINRA’s Department of Member Regulation, through the Membership Application Group (“MAP Group”), seeking a materiality consultation and approval of a continuing membership application, if required, when a natural person that has, in the prior five years, one or more “final criminal matters” or two or more “specified risk events” seeks to become an owner, control person, principal or registered person of the member broker-dealer.⁷

Proposed Rule Change to the FINRA Rule 9200 Series (Disciplinary Proceedings) and the 9300 Series (Review of Disciplinary Proceeding by National Adjudicatory Council and FINRA Board; Application for SEC Review)

Currently, FINRA rules require that when a hearing panel or hearing officer decision is on appeal or review before the NAC, any sanctions imposed by the hearing panel or hearing officer decision, including bars and expulsions, are automatically stayed and not enforced against

⁷ See Notice at 20745.

The proposed rule change would impact all members, including members that are funding portals or have elected to be treated as capital acquisition brokers (“CABs”), given that the funding portal rule set incorporates the Rule 9200 Series and Rule 9300 Series and Rule 9556 by reference, and the CAB rule set incorporates Rules 1011, 1017 and 8312 and the Rule 9200 Series, Rule 9300 Series and Rule 9500 Series by reference. In addition, FINRA is proposing corresponding amendments to CAB Rule 111, to reflect that a CAB would be subject to IM-1011-3, and amendments to Funding Portal Rule 900(b) to require heightened supervision during the time an eligibility request is pending. See Notice at note 61.

the respondent during the pendency of the appeal or review proceeding.⁸ In turn, the filing of an application for Commission review stays the effectiveness of any sanction, other than a bar or an expulsion, imposed in a decision constituting a final FINRA disciplinary action.⁹

In the Notice, FINRA expressed concern about customers who could engage in securities transactions with disciplined respondents during the pendency of an appeal from, or a NAC review of, a hearing panel or hearing officer disciplinary decision.¹⁰ According to FINRA, “authorizing Hearing Officers to impose conditions or restrictions during the period an appeal or review proceeding is pending would allow FINRA to target the demonstrated bad conduct of a respondent during the pendency of an appeal or review and add an interim layer of investor protection while the appellate review of the disciplinary proceeding remains pending.”¹¹

Accordingly, FINRA proposed amendments to its Rule 9200 Series and Rule 9300 Series that would authorize hearing officers to impose conditions or restrictions on disciplined respondents and require broker-dealers to adopt heightened supervision plans concerning their associated persons who are the disciplined respondents.¹² The proposed rule change would require a heightened supervision plan to be reasonably designed and tailored to include specific supervisory policies and procedures that address the violations found and be reasonably designed to prevent or detect a reoccurrence of the violations.¹³ The proposed rule change would also

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

⁹ See FINRA Rule 9370(a).

¹⁰ See Notice at 20746.

¹¹ See Notice at 20748.

¹² See Notice at 20746.

¹³ See Notice at 20748.

establish a process for an expedited review by the Review Subcommittee of the NAC of any such conditions or restrictions imposed.¹⁴ Specifically, proposed Rule 9285(a) would provide that the hearing officer who participated in an underlying disciplinary proceeding and found that a respondent violated a statute or rule provision which is subsequently appealed to the NAC or called for NAC review, may impose conditions or restrictions on the activities of the respondent during the appeal as the hearing officer considers reasonably necessary for the purpose of preventing customer harm.¹⁵ Under the proposed rule change, the conditions or restrictions imposed by a hearing officer would remain in place until FINRA's final decision takes effect and all appeals are exhausted.¹⁶

Proposed Rule Change to the FINRA Rule 9520 Series (Eligibility Proceedings)

The FINRA Rule 9520 Series sets forth rules governing eligibility proceedings, in which FINRA evaluates whether to allow a member, person associated with a member, potential member or potential associated person subject to a statutory disqualification to enter or remain in the securities industry.¹⁷ These eligibility proceedings require a broker-dealer to propose a written plan of heightened supervision of the statutorily disqualified associated person that would

¹⁴ See Notice at 20746.

¹⁵ See Notice at 20747. Additionally, the Notice sets forth in greater detail how this process would operate.

¹⁶ See Notice at 20748. The proposed rule change would also amend Rule 9556 to grant FINRA the authority to bring an expedited proceeding against a respondent that fails to comply with conditions and restrictions imposed pursuant to proposed Rule 9285 that could result in a suspension or cancellation of membership or suspension or bar from associating with any FINRA member. See Notice at 20749.

¹⁷ See Notice at 20750.

become effective upon FINRA’s approval of the broker-dealer’s application to associate with the statutorily disqualified person.¹⁸

The proposed rule change would amend FINRA Rule 9522 to require a member broker-dealer that files an application to continue associating with a disqualified person under FINRA Rule 9522(a)(3) or Rule 9522(b)(1)(B) to include an interim plan of heightened supervision that would be in effect throughout the entirety of the application review process.¹⁹ The proposed rule change would delineate the circumstances under which a statutorily disqualified person may remain associated with a member broker-dealer while FINRA is reviewing the application.²⁰

Proposed Rule Change to FINRA Rule 8312 (FINRA BrokerCheck Disclosure)

FINRA Rule 8312 governs the information FINRA releases to the public through its BrokerCheck system. Currently, FINRA Rule 8312(b) requires that FINRA release information about, among other things, whether a particular member broker-dealer is subject to the provisions of FINRA Rule 3170 (the “Taping Rule”), but only in response to telephonic inquiries via the BrokerCheck toll-free telephone listing.²¹ The proposed rule change would remove the requirement that FINRA inform the public that a broker-dealer is subject to the Taping Rule only in response to telephonic inquiry via the BrokerCheck toll-free telephone listing.²² Specifically,

¹⁸ See Notice at 20750.

¹⁹ See Notice at 20749.

²⁰ See id.

²¹ See FINRA Rule 8312(b). The Taping Rule is designed to help ensure that a broker-dealer with a significant number of registered persons that previously were employed by “disciplined firms” has specified supervisory procedures in place to prevent fraudulent and improper sales practices or customer harm. See Notice at 20751. Under the Taping Rule, a broker-dealer with a specified percentage of registered persons who have been associated with disciplined firms in a registered capacity in the last three years is designated as a “taping firm.” See FINRA Rule 3170.

²² See Notice at 20751.

proposed FINRA Rule 8312(b) would require FINRA to release through BrokerCheck information as to whether a particular broker-dealer is subject to the Taping Rule (a “taping firm”).²³ FINRA believes that broadening the disclosure through BrokerCheck of the status of a broker-dealer as a taping firm would help inform more investors of the heightened procedures required of the broker-dealer, which may incentivize investors to research more carefully the background of an associated person associated with the taping firm.²⁴

Proposed Rule Change to FINRA Rule 1000 Series (Member Application and Associated Person Registration)

The FINRA Rule 1000 Series govern, among other things, FINRA’s membership proceedings. Currently, a member broker-dealer is permitted (subject to exceptions) to expand its business under the safe-harbor set forth in IM-1011-1 without the filing and prior approval of a continuing membership application.²⁵ For example, under the existing parameters of this safe harbor, a broker-dealer could hire an associated person even if he or she has a significant history of misconduct.²⁶ The proposed rule change would limit the application of the safe harbor by imposing additional obligations on a member broker-dealer when a natural person who has, in

²³ See id.

²⁴ See id.

²⁵ See Notice at 20752.

²⁶ See id.

Currently, none of the safe harbor’s parameters relates to the history of a broker-dealer’s associated persons. However, based on its review of studies indicating the predictability of future regulatory-related events for associated persons with a history of past regulatory-related events, FINRA is concerned about instances where a broker-dealer hires associated persons with a significant history of misconduct within the safe-harbor parameters, thus avoiding prior consultation or review by FINRA. FINRA believes there are instances in which hiring of an associated person with a significant history of misconduct should be considered a material change in business operations. See Notice at 20752.

the prior five years, either one or more “final criminal matters” or two or more “specified risk events” seeks to become an owner, control person, principal or registered person of the broker-dealer.²⁷

Specifically, when a natural person seeking to become an owner, control person, principal or registered person of a member broker-dealer has, in the prior five years, one or more “final criminal matters” or two or more “specified risk events,” proposed Rule 1017(a)(7) would require a member broker-dealer to either: (1) file a continuing membership application or (2) submit a written request seeking a materiality consultation for the contemplated activity with the MAP Group.²⁸ If the broker-dealer seeks a materiality consultation, the MAP Group would consider, among other things, whether the “final criminal matters” or “specified risk events” are customer-related; whether they represent discrete actions or are based on the same underlying conduct; the anticipated activities of the person; the disciplinary history, experience and background of the proposed supervisor, if applicable; the disciplinary history, supervisory practices, standards, systems and internal controls of the member firm and whether they are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules.²⁹ Where FINRA determines that a contemplated change is material, FINRA would instruct the broker-dealer to file a continuing membership application if it intends to proceed with such change. Proposed Rule 1017(a)(7) would establish that the safe-harbor for

²⁷ See Notice at 20752. The proposed rule change would also adopt definitions of “final criminal matter” and “specified risk event.”

²⁸ See Notice at 20752 and 20753.

²⁹ See Notice at 20753.

business expansions in IM-1011-1 would not be available to a member broker-dealer when a materiality consultation is required.³⁰

Additionally, the proposed rule change would adopt a corresponding change to IM-1011-3 (Business Expansions and Persons with Specified Risk Events) to specify that the safe-harbor for business expansions in IM-1011-1 would not be available to any broker-dealer seeking to add a natural person who: (i) has, in the prior five years, one or more “final criminal matters” or two or more “specified risk events” and (ii) seeks to become an owner, control person, principal or registered person of the member.³¹ In those circumstances, proposed IM-1011-3 would provide that if the broker-dealer is not otherwise required to file a continuing membership application, it must comply with the requirements of proposed FINRA Rule 1017(a)(7).³²

The Commission has received five comment letters on the proposed rule change. In response to comments, FINRA submitted the FINRA Letter and Amendment No. 1, amending the proposed rule change as described below.

III. Description of Amendment No. 1

In the initial filing of the proposed rule change, proposed FINRA Rule 1011(h) defined the term “final criminal matter” to mean “a final criminal matter that resulted in a conviction of, or guilty plea or nolo contendere (no contest) by, a person that is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms.” Proposed FINRA Rule 1011(p) defined the term “specified risk event” to mean any one of several specified events “that are disclosed, or are or were required to be disclosed, on an applicable Uniform Registration Form.”

³⁰ See id.

³¹ See id.

³² See id.

The “was required to be disclosed” language in the proposed “final criminal matter” definition differs in substance from the “are or were required to be disclosed” language in the proposed “specified risk event” definition.³³ In response to comments, FINRA agreed with some commenters that “this difference should be eliminated, and that both definitions should include disclosures that are required if the member firm and person proceed with the contemplated change, including disclosures that are required on Uniform Registration Forms that have not yet been executed.” Thus, FINRA amended proposed FINRA Rule 1011(h) to include in the definition of “final criminal matter” a relevant criminal event that “is or was” required to be disclosed on a Uniform Registration Form, and to make some grammar- and syntax-related modifications.³⁴

Also in response to comments, FINRA amended proposed FINRA Rule 1017(a)(7) to define “owner” and “control person” for purposes of that proposed rule (and, by extension, IM-1011-3).³⁵ Specifically, Amendment No. 1 would modify proposed FINRA Rule 1017(a)(7) to provide that, “for purposes of FINRA Rule 1017(a)(7): (i) the term ‘owner’ has the same meaning as ‘direct owner’ on Form BD Schedule A and ‘indirect owner’ on Form BD Schedule B; and (ii) that ‘control person’ means a person who would have ‘control’ as defined on Form BD.”³⁶

³³ See id.

³⁴ See id.

³⁵ See id.

³⁶ See id. (stating that “[d]efining ‘control person’ by reference to the Form BD definition of ‘control’ means that the term would not be defined with reference to the term ‘controlling’ as defined in the FINRA By-Laws, Art. I(h).”)

IV. Proceedings to Determine Whether to Approve or Disapprove File No. SR-FINRA-2020-011 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act to determine whether the proposed rule change should be approved or disapproved.³⁷ Institution of proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. As noted above, institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved.

Pursuant to Section 19(b)(2)(B) of the Exchange Act,³⁸ the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis and input concerning whether the proposed rule change, as modified by Amendment No. 1, is consistent with the Exchange Act and the rules thereunder, in particular Section 15A(b)(6) of the Exchange Act, which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.³⁹

Under the Commission's Rules of Practice, the "burden to demonstrate that a proposed rule change is consistent with the [Exchange Act] and the rules and regulations issued thereunder . . . is on the [SRO] that proposed the rule change."⁴⁰ The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable

³⁷ 15 U.S.C. 78s(b)(2)(B).

³⁸ See id.

³⁹ 15 U.S.C. 78o-3(b)(6).

⁴⁰ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

requirements must all be sufficiently detailed and specific to support an affirmative Commission finding,⁴¹ and any failure of an SRO to provide this information may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the applicable rules and regulations.⁴² For the reasons discussed above, the Commission believes it is appropriate to institute proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act to allow for additional consideration of the issues raised by the proposed rule change, as modified by Amendment No. 1, as it determines whether the proposed rule change should be approved or disapproved.⁴³

V. Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposed rule change, as modified by Amendment No. 1. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change, as modified by Amendment No. 1, is consistent with Section 15A(b)(6) of the Exchange Act, or any other provision of the Exchange Act, rules, and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.⁴⁴

⁴¹ See id.

⁴² See id.

⁴³ 15 U.S.C. 78s(b)(2)(B).

⁴⁴ Section 19(b)(2) of the Exchange Act, as amended by the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is

Interested persons are invited to submit written data, views, and arguments regarding whether the proposed rule change, as modified by Amendment No. 1, should be approved or disapproved by [insert date 15 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert 21 days from publication in the Federal Register].

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-FINRA-2020-011 on the subject line.

Paper Comments:

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

All submissions should refer to File No. SR-FINRA-2020-011. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change, as modified by Amendment No. 1, that are filed with the Commission, and all written communications relating to the proposed rule change, as modified by Amendment No.

appropriate for consideration of a particular proposed rule change by a self-regulatory organization. See Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

1, between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-FINRA-2020-011 and should be submitted on or before [insert date 15 days from publication in the Federal Register]. Rebuttal comments should be submitted by [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴⁵

J. Matthew DeLesDernier
Assistant Secretary

⁴⁵ 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(57).