



July 1, 2019

Jennifer Piorko Mitchell  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

Re: Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct, Regulatory Notice 19-17

Dear Mrs. Mitchell:

Better Markets<sup>1</sup> appreciates the opportunity to comment on the above-captioned Regulatory Notice (“Notice” or “Rule”) released for comment by the Financial Industry Regulatory Authority (“FINRA”). The Notice proposes a convoluted, Rube Goldberg-type process<sup>2</sup> to identify and place new obligations on “predator wolf-pack” firms populated with recidivist brokers whose business model appears to be maximizing profits by targeting and ripping off unsuspecting and vulnerable investors in violation of FINRA and other rules.

While it is arguably better than nothing, trying to minimally regulate firms that specialize in recidivist brokers—by making it a little costlier for them to operate—is grossly insufficient and doomed to fail to achieve the purported objectives of the Notice. FINRA has the indispensable mission to protect investors and promote market integrity; it must do more to stop firms that specialize in recidivist brokers. Rather than, at best, half measures, FINRA must revoke the licenses and expel these firms that are based on a predator wolf-pack business model that specialize in harming investors.

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<sup>1</sup> Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

<sup>2</sup> See *infra*, “Description of the Proposal.” According to his entry in Wikipedia, Rube Goldberg “is best known for his popular cartoons depicting complicated gadgets performing simple tasks in indirect, convoluted ways.” [https://en.wikipedia.org/wiki/Rube\\_Goldberg](https://en.wikipedia.org/wiki/Rube_Goldberg).

Making matters worse, these predator firms are not just going after any investors; they are specifically targeting and harming the most vulnerable kinds of investors, including seniors, those with language barriers, and those who lack of basic financial literacy.<sup>3</sup> What possible service or good do predator firms provide to investors that cannot be offered by thousands of other FINRA members that actually follow FINRA's and Securities and Exchange Commission's (SEC) rules? What is the public interest, market integrity, and pro-investor rationale for permitting these predatory firms to use FINRA's seal-of-approval to continue to harm investors? This Notice fails to answer these threshold questions, which, in our view, is a disservice to millions of American investors who have to rely upon FINRA as the cop on the beat and the front-line regulator of the broker-dealer profession.

While it is tempting to say that the policies proposed in this Notice are steps in the right direction, we cannot say that in this comment letter. Investors, and particularly those harmed by such unscrupulous brokers and firms who retain them, deserve concrete, effective, swift and far-reaching consequences from FINRA for brokers that repeatedly violate FINRA's rules, and the firms that employ them, not convoluted and weak attempts at regulation. We do not believe FINRA is lacking authority under its current rules to more forcefully and effectively punish and expel predators, and to bar predator wolf-packs from ever forming. However, if FINRA feels it lacks such authority to properly reduce investor harm by effectively punishing and deterring high-risk firms, then it should have proposed a rule that would have authorized FINRA to become a more effective regulator.

Instead, FINRA chooses to do the bare minimum by proposing to make it marginally more expensive for the worst-of-the-worst broker-dealer firms, that have already proven that they will brazenly disregard FINRA rules, to continue hiring and rewarding brokers that give self-serving advice and sell unsuitable products that are harmful for investors' and their families' financial health. These are not close calls; these are not brokers with a blemish or violation here or there; these are not firms hiring a broker or two with isolated violations. These are predator wolf-pack firms whose business model is to maximize profits by breaking rules and ripping off unsuspecting and vulnerable investors. They need to be put out of business and barred from forming new ones. Investors need to be protected from the harmful practices of the wolf-packs and be better served by other, law-abiding FINRA members.

Investors need and deserve honest, qualified, and competent brokers and firms who respect and follow the rules when offering their services and financial products. Americans need these good broker firms and their brokers to help them meet their life goals, including saving for their children's college education, preparing for retirement, and enjoying a decent standard of living. As the front-line regulator of brokers and brokerage firms, FINRA has a paramount responsibility to ensure that all investors—especially the unsophisticated, elderly, and less educated—are

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<sup>3</sup> Broker misconduct, particularly among the recidivists, is more prevalent in counties and cities with a large proportion of retirees and a lower educated population. Said differently, bad brokers and the firms that employ and reward them specifically target and flourish in areas where there are unsophisticated investors and vulnerable adults who can more easily be preyed upon. See Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct* at 27, J. OF POL. ECON. (forthcoming) (Sept. 1, 2017), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2739170](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170).

protected from predatory and unscrupulous broker firms who employ brokers who repeatedly break the law with impunity with little or nothing to fear from FINRA.

FINRA can and must do more to address and extinguish the predatory wolf-pack business model, and our comment letter will focus on ways FINRA must significantly improve this Notice and its oversight of the broker-dealer firms.

## **SUMMARY OF COMMENTS**

- FINRA is falling far short of its regulatory duties by seemingly caring more about the economic viability of recidivist broker firms that are FINRA's members than about the investor clients they harm.
- The Proposal risks perpetuating the recidivist mills' business model and increasing moral hazard when permitting firms with a long history of investor harm to remain operational by depositing some funds into a segregated account.
- The Proposal should not be approved unless significantly improved by applying more stringent criteria in identifying high-risk firms, including at a minimum:
  - look-back or review period of 10 years, and not just 5.
  - The disclosure events should include all settlements, penalties, arbitration claims, etc., that are at or above \$5,000, and not \$15,000 as proposed.
  - The disclosure events should include all events that are harmful to investors, not just those that are discovered through consumer complaints (so called, "consumer-initiated events,"). FINRA should count with equal weights events that are discovered through, for example, whistleblower tips or regulatory examinations. The Proposal seems to be limited to only events that are consumer-initiated events.
- FINRA must not permit those who have been laid-off or terminated as part of the consultation process to be hired by other firms for at least one year, and never by another high-risk firm. The Proposal only inadequately prohibits the firm who has laid off the broker from rehiring the same person within a year. Additionally, during the consultation period, FINRA must require the termination or lay-off of brokers, starting with those with the most disclosure events regardless of their role within the organization or the revenue they generate.
- FINRA must prominently publicize the names of high-risk firms. At a minimum, FINRA must prominently publicize the names of the firms that have been designated high-risk **twice**. FINRA must also publicize the names of newly formed firms that are made-up of 20% or more brokers who were affiliated with previously twice-designated high-risk firm.
- FINRA must require brokers who are affiliated with twice-designated high-risk firms to disclose to their former, current and prospective clients the fact that they are employed by such a firm.

- At the end of the second year, if the firm is still a high-risk firm, FINRA must expel the firm, and de-license all current brokers who were employed by the firm at the time of initial designation.
- We support FINRA obtaining authority to impose specific “terms and conditions” on certain firms who either circumvent the obligations and restrictions placed upon them by the Proposed Rule 4111 (as amended by our comments herein) or otherwise refuse to significantly improve their compliance culture.

## **DESCRIPTION OF THE PROPOSAL**

FINRA’s proposed Rule 4111<sup>4</sup> creates an extraordinarily lengthy and complex process that would, eventually, impose financial obligations and other requirements on certain high-risk member firms that are identified through a complicated process and application of various criteria and metrics. The proposed Rule 4111 would annually evaluate FINRA’s entire 3,580-plus broker-dealer membership through the following six different metrics (using information obtained from Uniform Registration Forms):

1. Registered Person Adjudicated Events;<sup>5</sup>
2. Registered Person Pending Events;<sup>6</sup>
3. Registered Person Termination and Internal Review Events;<sup>7</sup>
4. Member Firm Adjudicated Events;<sup>8</sup>
5. Member Firm Pending Events;<sup>9</sup> and
6. Registered Persons Associated with Previously Expelled Firms (also Referred to as the Expelled Firm Association category).<sup>10</sup>

For each of these “Preliminary Identification Metrics” categories, FINRA proposes to apply different thresholds, depending on the firm’s size (as measured by number of registered persons in the firm); only once above these thresholds would a firm be designated as having met the “Preliminary Criteria for Identification.”<sup>11</sup> The table below shows the different Preliminary Identification Metrics Thresholds that FINRA would apply as part of its annual computation and evaluation of disclosure events:

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<sup>4</sup> Proposed Rule text is available at [http://www.finra.org/sites/default/files/notice\\_other\\_file\\_ref/Regulatory\\_Note\\_19-17\\_Attachment\\_A.pdf](http://www.finra.org/sites/default/files/notice_other_file_ref/Regulatory_Note_19-17_Attachment_A.pdf).

<sup>5</sup> “Registered Person Adjudicated Events,” defined in proposed Rule 4111(i)(4)(A).

<sup>6</sup> “Registered Person Pending Events,” defined in proposed Rule 4111(i)(4)(B).

<sup>7</sup> “Registered Person Termination and Internal Review Events,” defined in proposed Rule 4111(i)(4)(C).

<sup>8</sup> “Member Firm Adjudicated Events,” defined in proposed Rule 4111(i)(4)(D).

<sup>9</sup> “Member Firm Pending Events,” defined in proposed Rule 4111(i)(4)(E).

<sup>10</sup> “Registered Persons Associated with Previously Expelled Firms,” defined in proposed Rule 4111(i)(4)(F).

<sup>11</sup> See Proposed Rule 4111(i)(11).

| Firm Size Category | Number of Registered Persons In-Scope in Firm Size Category | Preliminary Identification Metrics Thresholds   |  |  |   |                                  |   |
|--------------------|---|---|--|--|---|----------------------------------|---|
|                    |   | Thresholds for Registered Person Event Metrics: |  |  | Thresholds for Member Firm Event Metrics: |                                  | Threshold for Expelled Firm Association Metric: |
|                    |   | Registered Person Adjudicated Event Metric      | Registered Person Pending Event Metric | Registered Person Termination and Internal Review Event Metric | Member Firm Adjudicated Event Metric      | Member Firm Pending Event Metric | Expelled Firm Association Metric                |
|                    |   | (1)   | (2)                                    | (3)  | (4)                                       | (5)                              | (6)   |
| 1                  | 1-4   | 0.50  | 0.20                                   | 0.10   | 0.75                                      | 0.25                             | 0.75  |
| 2                  | 5-9   | 0.30  | 0.20                                   | 0.10   | 0.30                                      | 0.10                             | 0.50  |
| 3                  | 10-19   | 0.20  | 0.10                                   | 0.10   | 0.30                                      | 0.05                             | 0.50  |
| 4                  | 20-50   | 0.20  | 0.10                                   | 0.10   | 0.20                                      | 0.02                             | 0.50  |
| 5                  | 51-150  | 0.20  | 0.05                                   | 0.10   | 0.15                                      | 0.01                             | 0.25  |
| 6                  | 151-499   | 0.15  | 0.05                                   | 0.10   | 0.10                                      | 0.01                             | 0.10  |
| 7                  | 500+  | 0.10  | 0.05                                   | 0.10   | 0.05                                      | 0.01                             | 0.05  |

Source: FINRA Proposed Rule 4111(i)(11).

For example, a firm with 10 registered persons would need to have more than two “Adjudicated Events” and more than one “Pending Event” to pass the thresholds of these categories. Additionally, a smaller firm would need to have, on average, more “Adjudicated Events” per capita compared to its peers than larger firms (again, compared to its peers). Or, smaller firms need to have a higher concentration of “Persons Associated with Previously Expelled Firms” among its brokers’ ranks than larger firms to qualify.<sup>12</sup> Finally, a firm needs to pass the thresholds of at least two categories to be designated as having met the Preliminary Criteria for Identification.<sup>13</sup>

To assess the impact of the proposed Rule, FINRA evaluated its entire membership between the 2013-2018 period to analyze categories of events that would have caused firms to meet the Preliminary Criteria for Identification. According to this analysis, “there were 60-98 such firms at the end of each year during the review period” or 1.6-2.4% of all firms registered with FINRA in any year during the review period.<sup>14</sup> Furthermore, “approximately 90-94% percent of these firms were small, 4-10% percent were mid-sized and 0-2% percent were large at the end of each year during the review period.”<sup>15</sup> The below table shows this analysis, separated by firm size (according to number of registered representatives).

<sup>12</sup> Within categories one-five, FINRA would calculate using simple averages: dividing the number of events over number of registered representatives. For the sixth category, the metric would show the percentage concentration of the firm with employees who were associated with previously expelled firms at any point in their career.

<sup>13</sup> A firm can be flagged Preliminarily for meeting just two or more of the set forth thresholds as compared to other firms their size. If a firm were to meet the threshold for two metrics (metrics one-five), one would have to be for adjudicated events, and the firm must have at least two events.

<sup>14</sup> See Notice at 25.

<sup>15</sup> See Notice at 25-26.

**Attachment D-2: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size\***

| Identification Year | Number of FINRA Registered Member Firms | Firms Meeting the Preliminary Criteria for Identification |          |       |       |                  |          |       |
|---------------------|---|---|----------|-------|-------|------------------|----------|-------|
|                     |   | Small   | Mid-Size | Large | Total | Small            | Mid-Size | Large |
|                     |   | Number of Firms   |          |       |       | Percent of Total |          |       |
| 2013                | 4,140                                   | 84  | 4        | 1     | 89    | 94%              | 4%       | 1%    |
| 2014                | 4,068                                   | 92  | 4        | 2     | 98    | 94%              | 4%       | 2%    |
| 2015                | 3,941                                   | 79  | 5        | 2     | 86    | 92%              | 6%       | 2%    |
| 2016                | 3,835                                   | 61  | 5        | 1     | 67    | 91%              | 7%       | 1%    |
| 2017                | 3,721                                   | 54  | 6        | 0     | 60    | 90%              | 10%      | 0%    |
| 2018                | 3,582                                   | 55  | 6        | 0     | 61    | 90%              | 10%      | 0%    |

\* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st. FINRA defines a small firm as a member with at least one and no more than 150 registered persons, a mid-size firm as a member with at least 151 and no more than 499 registered persons, and a large firm as a member with 500 or more registered persons. See FINRA By-Laws, Article I.

Source: Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct, Regulatory Notice 19-17, Attachment D-2. Available at [http://www.finra.org/sites/default/files/notice\\_other\\_file\\_ref/Regulatory\\_Note\\_19-17\\_Attachment\\_D.pdf](http://www.finra.org/sites/default/files/notice_other_file_ref/Regulatory_Note_19-17_Attachment_D.pdf).

Once a firm meets the Preliminary Criteria for Identification, there are several more steps before it is designated as a “Restricted Firm” and thus become subject to the new financial and other obligations. After the Criteria is met, FINRA will conduct a focused analysis of the firm’s disclosure events to reduce the likelihood of misidentification. Once this analysis is complete, FINRA will preliminarily designate the firm as “Restricted Firm” and propose a “Restricted Fund” amount. After these preliminary decisions, FINRA will invite the firm to engage in consultations. During this consultation process, the firm will have the opportunity to rebut two presumptions: the presumption that it must be designated as a “Restricted Firm” and the presumption that the firm must maintain a “Restricted Fund” in the amount proposed by FINRA.<sup>16</sup>

If a firm successfully rebuts both presumptions, no further obligations are imposed. However, if FINRA decides that the firm has not rebutted the presumption that the firm should be a Restricted Firm but has rebutted the presumption of maintaining the maximum amount in the Restricted Fund, it will be designated as Restricted Firm, but will have either no Restricted Fund or will have appropriately reduced Restricted Fund. However, the firm would have to implement and maintain specific conditions or restrictions on operations at FINRA’s discretion with the aim of addressing the Preliminary Criteria for Identification metrics.<sup>17</sup> Finally, if the firm has not rebutted either presumption, then the firm will be designated as a Restricted Firm for that year, be required to establish a Restricted Deposit Account, deposit and maintain in that account the maximum Restricted Deposit Requirement, and implement specific conditions identified by

<sup>16</sup> See Proposed Rule 4111(e)(1).

<sup>17</sup> *Ibid.*

FINRA to address the metrics indicating the firm meeting the Preliminary Criteria for Identification.<sup>18</sup>

Once a firm is designated as a “Restricted Firm,” and after it fails to rebut the presumptions, the firm would be permitted to reduce its staffing levels so as to fall below the thresholds that had triggered the firm’s identification.<sup>19</sup> If a firm satisfactorily reduces staffing, then the firm is no longer designated as a Restricted Firm for that year.

If a firm fails to adequately reduce staff, FINRA will finalize its designation the firm as a Restricted Firm, and require the firm to establish a bankruptcy-remote, segregated account Restricted Fund, and FINRA will determine a Maximum Restricted Deposit Requirement to be deposited into this fund.<sup>20</sup> This account “must be subject to an agreement in which the bank or the clearing firm agrees: not to permit withdrawals from the account absent FINRA’s prior written consent; to keep the account separate from any other accounts maintained by the member with the bank or clearing firm; that the cash or qualified securities on deposit will not be used directly or indirectly as security for a loan to the member by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm; that if the member becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and withdrawals will not be permitted without FINRA’s prior written consent; that FINRA is a third-party beneficiary to the agreement; and that the agreement may not be amended without FINRA’s prior written consent. In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member.”<sup>21</sup>

In setting the Restricted Deposit Requirement, FINRA will “tailor the member’s maximum ... amount to its size, operations and financial conditions” and consider the nature of “member’s operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any “covered pending arbitration claims” or unpaid arbitration awards, and concerns raised during FINRA exams.”<sup>22</sup> The Notice explains that this Maximum Restricted Deposit is intended to be high enough to change the firm’s behavior **but “not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement.”**<sup>23</sup>

After FINRA designates the firm as Restricted Firm and requires the establishment of a “Restricted Fund,” the firm can request a hearing with the Office of Hearing Officers in an expedited proceeding.<sup>24</sup> The proposed Rule would not permit any stay during the hearing

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<sup>18</sup> *Ibid.*

<sup>19</sup> *See* in Proposed Rule 4111(d).

<sup>20</sup> *See* Proposed Rule 4111(i)(15).

<sup>21</sup> *See* Notice at 17.

<sup>22</sup> *See* Notice at 12.

<sup>23</sup> *See* Notice at 12 and 28, emphasis added.

<sup>24</sup> *See* Notice at 15.

proceedings. Additionally, if a firm is found to not have complied with the obligations of Rule 4111, FINRA **could** suspend or cancel the firm’s membership, with FINRA’s CEO’s **consent**.

Finally, FINRA discusses but **does not** propose in the Notice a general authority to impose specific “terms and conditions” upon firms that either game the proposed Rule 4111 by staying just below the thresholds that would trigger their identification or otherwise do not change their behavior and fail to “demonstrate commitment to the development of strong compliance culture.”<sup>25</sup> Unfortunately, other than a brief reference and discussion of a similar “terms and conditions” authority that a Canadian SRO has implemented, there is no further discussion regarding the contours and possible uses of such authority. In our comments below, we will support in concept granting such authority to FINRA to empower it with appropriate regulatory tools to stop and deter firms that have substantial and unaddressed compliance failures and seem impervious to obligations and restrictions envisioned by Rule 4111 (as amended by our comments herein).

## **COMMENTS**

### **FINRA’s Primary Mission Is to Protect Investors and the Integrity of the Securities Markets, Not Serve the Interests of Its Worst Members Who Repeatedly Violate the Law. The Proposal Risks Perpetuating the Recidivist Wolf-Packs Business Model.**

As the front-line regulator of broker-dealers, FINRA has a paramount responsibility to ensure that investors—particularly the vulnerable population of retail and unsophisticated investors—are protected and not preyed upon by unscrupulous brokers and firms that hire and reward these brokers. As briefly described in the Notice, FINRA currently has several regulatory tools that aim to deter or punish misconduct by firms and brokers. These include the ability to not renew or deny membership applications, conduct firm-focused examinations and other monitoring for risks, and bring enforcement cases. But, as the Notice itself admits, “persistent compliance issues continue to arise in some FINRA member firms.”<sup>26</sup>

There are multiple, peer-reviewed studies showing the disproportionate harm that firms that specialize in bad brokers inflict on investors.<sup>27</sup> As released, the Proposal fails to even remotely solve this fundamental challenge.

Instead of appropriately working to rid its membership ranks of firms that attract and pay brokers who have indisputable records of repeat misconduct and investor abuses, this Notice tinkers on the margins by essentially making it slightly costlier for firms to hire or retain brokers with checkered pasts by slightly raising the firm’s regulatory costs. While some firms may indeed

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<sup>25</sup> See Notice at 21-23.

<sup>26</sup> See Notice at 3.

<sup>27</sup> See, e.g., Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct*, J. OF POL. ECON. (forthcoming) (Sept. 1, 2017), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2739170](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739170). See also Benjamin Lesser & Elizaeth Dilts, *Wall Street’s Self-Regulator Blocks Public Scrutiny of Firms with Tainted Brokers*, REUTERS INVESTIGATES (June 12, 2017), available at <https://www.reuters.com/investigates/specialreport/usa-finra-brokers/>.



decide to fire or not hire a broker with a long rap-sheet in order not to tie funds into the Restricted Fund and assume costs associated with heightened supervision (as proposed in the Notice) and potential liability, it would still permit firms that repeatedly choose to hire recidivist brokers to operate.

The Notice fails to make any persuasive public policy rationale for keeping these recidivist wolf-packs in business. Indeed, every FINRA member shares the reputational stain caused by such recidivist wolf-packs and should, in their own self-interest if not in the public interest, demand that such firms be shut down.

As FINRA detailed in the Notice, there is no dispute about these firms and brokers and the business practices:

“Such firms expose investors to real risk. For example, FINRA has identified certain firms that have a concentration of individuals with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. These firms generally have a retail business with vulnerable customers and engage in cold calling to make recommendations of securities. FINRA has also identified groups of individual brokers who move from one firm of concern to another firm of concern. In addition, certain firms, along with their representatives, have substantial numbers of disclosures on their records.”<sup>28</sup>

Others have exposed the prevalence of these recidivist wolf-pack firms more starkly. A recent Wall Street Journal investigation exposed a deeply troubling fact: There are **over 100 FINRA regulated firms**—

“where 10% to 60% of the in-house brokers had three or more investor complaints, regulatory actions, criminal charges or other red flags on their records... These brokerages helped sell to investors more than \$60 billion of stakes in private companies.”<sup>29</sup>

The Journal gave an example of one still operating and seemingly flourishing broker-dealer, Newbridge Securities Corp., in Boca Raton, FL, employing over 100 brokers, showing that—

“Investors have a one in four chance of getting a broker there with at least three red flags. Regulators sanctioned the firm 20 times—an average of twice a year—over the past decade, with fines of \$1.75 million.”

These are the firms that FINRA licenses and is legally mandated to regulate. And yet, the Notice fails to show what, if anything, do these firms do to deserve the privilege of carrying a FINRA license and engaging investors? What services or products do they provide to investors and the public that cannot be provided by other law-abiding firms and brokers? The Notice offers no description or explanation.

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<sup>28</sup> See Notice at 3.

<sup>29</sup> See Jean Eaglesham & Coulter Jones, *Firms with Troubled Brokers Are Often Behind Sales of Private Stakes*, WALL ST. J. (June 24, 2018), available at <https://www.wsj.com/articles/firms-with-troubled-brokers-are-often-behindsales-of-private-stakes-1529838000>.

The pernicious practices described above cry out for a fundamental re-thinking of how brokerage firms that are designed for and specialize in investor harm are regulated by FINRA—a rethinking that should include expelling these firms so they cannot continue to cause investor harm. But, inexcusably, FINRA seems to be more concerned about the economic viability of these firms. In fact, several times in the Notice, FINRA argues that it does **not** want to drive-out these firms that seek and embrace recidivist brokers and engage in profitable yet harmful investor conduct. Because the Restricted Fund will be set at levels to ensure that the firm will continue to be economically viable and make profits despite the obligation to segregate some funds into the Restricted Fund, the proposal will perpetuate the recidivist mill business models. Whatever profits will need to be frozen in the segregated Restricted Fund, the firm would likely offset these by doubling-down on its predatory practices, all the while using FINRA’s membership as an imprimatur to attract and mislead investors.

This Restricted Fund will increase moral hazard by allowing firms with a lax culture of compliance to essentially insure their business practices through the Restricted Fund. Instead of discouraging and reducing the number of recidivist wolf-pack firms that profit through investor harm and violation of FINRA rules, the Proposal runs the risk of actually increasing their numbers. If the Rule is adopted as proposed, FINRA would signal to firms that have a culture of non-compliance but are below the thresholds that would trigger their designation, that they can in fact become much more profitable, even if they go beyond the thresholds, so long as they are willing to set aside some funds and slightly increase the cost of doing business. This Rule, if approved as proposed, could serve as an acceptable on-ramp for firms that have a culture of non-compliance and are seeking to maximize profits to join the ranks of wolf-pack firms.

Allowing high-risk firms to remain operational is also unfair to the vast majority of FINRA’s members who want to serve their clients honestly and well. High-risk firms sully the reputation of the entire industry and erode the confidence of the entire investing public and the public at large, who also lose faith in the regulators who are supposed to be vigilant against fraudsters. Investors who have been hurt by a recidivist wolf-pack are further demoralized and victimized when they see that the same fraudsters are still holding a license— a public privilege—and continue to work in the industry. Investors are the constituency FINRA must serve, and all its regulatory actions and proposals should be designed for the maximal benefit of investors—and, by extension, the brokers who serve those investors honestly—and not the recidivist wolf-pack firms that have decided to cheat time and time again.

The Notice also fails to quantify the harm to investors caused by brokers who peddle unsuitable investments that generate high commissions for themselves and profits for their brokerage firms. The Notice further fails to analyze the additional harm to investors that will be realized when firms with a long history of misconduct are permitted to continue engaging investors. These costs are real, and FINRA must take them account as it debates the merits of this Proposal and its regulatory approach to high-risk broker firms.

FINRA has not been charged by Congress to ensure that recidivist brokers have gainful employment in the financial industry or that firms that specialize in hiring and unleashing them on unsuspecting and vulnerable investors maximize their profits. FINRA exists to protect investors and promote market integrity.<sup>30</sup> If FINRA indeed has investors' best interest in mind, it should not compromise that interest for the benefit of broker-dealer firms who are either unable or unwilling to comply with the letter and spirit of the law. Neither the employment prospects of recidivist brokers nor FINRA's concern for decreasing the number of small broker-dealers among its membership should outweigh what is best for the investing public.

### **The Measures in the Proposal Are Inexcusably Weak and Should Not be Approved Without Complete Overhaul.**

#### **FINRA Should Identify Firms Using More Stringent Criteria and Capture More High-Risk Firms. FINRA's Proposed Criteria and Metrics Risk Under-Identifying Many High-Risk Firms.**

First, the Notice proposes to count towards the "disclosure event" any "final investment-related, consumer-initiated customer arbitration award or civil judgement against the person for a dollar amount at or above \$15,000 in which the person [e.g., broker] was a named party."<sup>31</sup> FINRA must lower this monetary threshold to \$5,000. With the median brokerage account balance of U.S. investors at only \$6,200, setting the "disclosure event" threshold at \$5,000 would better serve the investing public.<sup>32</sup> Moreover, lowering the threshold from the proposed \$15,000 threshold to \$5,000 would enable FINRA to capture more misconduct, and this lowered threshold could serve as a more sensitive gauge for FINRA to assess the quality of the service and the level of integrity among brokers and the firms that employ them.

Second, FINRA should not exclude "disclosure events" that are harmful to investors but are not "consumer-initiated." There is no public interest, market integrity, or investor protection rationale for FINRA to overlook or discount harmful conduct simply based on who initiated the complaint. FINRA should include events that it has discovered through its regulatory activities (examinations and inspections, whistleblower tips, enforcement, sweeps, etc.). There is no reason why FINRA should exclude a "disclosure event" discovered at a broker-dealer firm that is training its recidivist brokers ways to churn, peddle unsuitable products, or engage in any other predatory conduct upon especially vulnerable investors who are either too intimidated or unsophisticated to lodge a complaint. These discovered, non-consumer-initiated events should count with equal weight as those that are consumer-initiated.

Third, FINRA should expand the review period to include the previous 10 years, instead of 5 as proposed in the Notice, but credit firms that have demonstrated record of improved compliance during the previous 5 years. A look-back period of 5 years risks under-identifying medium and large firms whose disclosure events (even if they are many) would still need to be

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<sup>30</sup> See About FINRA (last visited on June 21, 2019), available at <http://www.finra.org/about>.

<sup>31</sup> See Proposed Rule 4111(i)(A)(i-ii).

<sup>32</sup> See Brokerage Accounts in the United States, Advanced Analytical Consulting Group and Deloitte, (November 30, 2015), available at <https://www.dol.gov/sites/default/files/ebsa/researchers/analysis/retirement/brokerage-accounts-in-the-us.pdf>.

divided by the large number of affiliated registered representatives for them to breach the proposed Preliminary Identification Metrics Thresholds. Expanding the look-back period to 10 years would mitigate the risk of under-identification. To alleviate concerns that a 10 year lookback period is unduly harsh, and to incentivize firms to actually reform, FINRA could consider crediting firms that have demonstrated improved compliance in the most recent 5-year period.

Fourth, FINRA must not permit those who have been laid-off or terminated as part of the consultation process to be hired by other firms for at least one year, and never by another high-risk firm. The Proposal only prohibits the firm who has laid off the broker from rehiring the same person within a year. But this leaves open the scenario where a recidivist broker who has been laid-off simply joins another recidivist wolf-pack that is either more brazen and unwilling to comply with FINRA rules or is just below the threshold to be identified as a high-risk firm. FINRA should not permit this unhealthy turnover.

Finally, as firms engage in consultations with FINRA to take advantage of the one-time opportunity to reduce the number of brokers to fall below the designation thresholds, FINRA must require that the firms begin their termination or laying-off process with those brokers who have the highest number of disclosure events. Alternatively, FINRA could require that the firm terminate or lay-off those brokers who would have had a harmful combination of frequent and severe violations of FINRA and SEC rules that have direct impact on investors. In all circumstances, FINRA should **prohibit** firms from retaining recidivist brokers due to their position within the firm or the amount of revenue they produce.

#### FINRA Should Prominently Publicize the Names of the High-Risk Firms So Investors Are Maximally Empowered to Make More Informed Broker-Dealer Choice.

First, FINRA must prominently publicize the names of the high-risk firms. If FINRA refuses to do what is right and necessary and expel firms who specialize in harming investors, then it must at least provide bold and unmistakable warnings that would empower investors to make more informed broker-dealer choices. FINRA's use of robust disclosures would help investors to better protect themselves. Blunt and prominent warnings have long been an effective technique for informing consumers of dangerous products, such as cigarettes.

At a minimum, FINRA must prominently publicize the names of the firms that have been **twice-designated** as high-risk. Similarly, FINRA must also publicize the names of newly formed firms that are made-up of 20% or more of brokers who were affiliated with of previously twice-designated high-risk firm.

Second, FINRA must require brokers who are affiliated with twice-designated high-risk firms to disclose to their former, current and prospective clients the fact that they are employed by such a firm. These registered representatives either clearly know or are willfully ignorant of the fact that they are affiliated with and paid by a broker-dealer that essentially has been running a multi-year boiler room. All investors who have been or are about to be solicited by these brokers deserve to know the fact that whichever firm is employing the broker has been twice-designated as a high-risk firm by the front-line SRO.

Finally, FINRA should engage in more investor education on the topic, clearly explaining the methods these recidivist wolf-packs employ and why they pose a threat to investors. FINRA should also design and implement a disclosure system, either on BrokerCheck or through a separate user-friendly database, that clearly identifies those brokers with a demonstrable pattern of violating the law. Such an enhanced education and disclosure regime will prove more effective at warning investors that the use of these brokers and brokerage firms will be harmful to the investor's financial health.

#### FINRA Must Expel Firms at The End of the Second Year of Designation.

The Notice must be amended to authorize FINRA to expel firms that have not significantly changed their behavior at the end of the second year of designation, and de-license and bar all current brokers of the firm who were affiliated with the firm at the time of the initial designation. This expulsion order should not be appealable and should take immediate effect. The rationale for this swift and effective remedy is elegantly simple: firms that have been twice-designated and have not significantly improved their compliance culture prove that they are irredeemable, and they do not deserve to be permitted to serve, or more likely, harm **any** additional investors. It would be a disgrace for FINRA to continue to lend its imprimatur and the privilege of being a firm regulated by FINRA to twice-designated firms that specialize in fraud and misconduct. At the end of the second year of designation, FINRA should have the authority, and the will to exercise that authority, to solve this issue and send a strong signal to the brokerage industry that it will no longer tolerate boiler-rooms, predator wolf-packs, and fraud-houses.

#### FINRA Must Obtain Authority to Impose Specific and Effective Terms and Conditions on Firms That Game FINRA's Rules.

As noted above, the Notice briefly discusses but **does not** propose a general authority to impose specific "terms and conditions" upon firms that either game the proposed Rule 4111 by staying just below the thresholds that would trigger their identification or otherwise do not change their behavior and fail to "demonstrate commitment to the development of strong compliance culture."<sup>33</sup> While it is unclear to us why FINRA declined to actually propose such "terms and conditions" authority, we nonetheless support in concept granting such authority to FINRA to empower it with appropriate regulatory tools to stop and deter firms that have substantial and unaddressed compliance failures and that seem impervious to the obligations and restrictions envisioned by Rule 4111 (as amended according to comments in this letter). Given the extensive due process available to FINRA members, and their strong influence over FINRA's board and the advisory committees that guide FINRA's policymaking and examination priorities, it is extraordinarily unlikely that FINRA would abuse this "terms and conditions" authority. We therefore support FINRA obtaining authority to impose specific "terms and conditions" on certain firms who either circumvent the obligations and restrictions placed upon them by the Proposed Rule 4111 (as amended by our comments herein) or otherwise refuse to significantly improve their compliance culture.

## CONCLUSION

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<sup>33</sup> See Notice at 21-23.

We hope these comments are helpful. We support fair and appropriate measures designed to ensure that all brokers receive all the process to which they are due. But none of the procedural or fairness arguments advanced to date can justify the excessive leniency that FINRA has displayed toward bad brokers and brokerage firms. The priority must be to protect investors and to eject recidivist brokers and brokerage firms from the industry.

FINRA has the authority, duty, and competency to do what is in the best interest of investors: reduce the prevalence of recidivism and expel firms specializing in investor harm. Now FINRA must apply its resolve to achieve this goal. FINRA must go beyond the specifics of this Notice and fundamentally change its treatment of and tolerance for firms that specialize in harming investors.

Sincerely,



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