United States Senate
WASHINGTON, DC 20510

November 22, 2019

Mr. Robert W. Cook
President and Chief Executive Officer
FINRA
1735 K St NW
Washington, D.C. 20006

Dear Mr. Cook:

We write to urge that FINRA amend proposed Rule 4111 to provide more concrete protections for investors from firms and broker-dealers with a history of misconduct. Proposed Rule 4111 requires firms and brokers with a history of misconduct to set aside funds that can be used, among other things, to reimburse investors that secure an arbitration award against the firm or broker. As an oversight authority, FINRA has the responsibility to police unethical behavior by brokers and their firms, but as proposed, we have serious concerns that the structure of Rule 4111 permits member firms and brokers to continue to target and mislead investors. These concerns include:

- Lack of public identification of high risk firms in order to better protect investors;
- Significant under-counting of the number of high-risk firms;
- The creation of a moral hazard by permitting high-risk firms to remain in business after they set aside funds;
- A failure to ensure settlements are paid; and
- Insufficient deterrence of future misconduct through record expungement and insubstantial financial penalties.

Proposed Rule 4111 does not publicize the names of high-risk firms that hire recidivist rule-breaking brokers. However, firms with a high number of recidivist brokers are selling tens of billions of dollars a year in both private placements and unsuitable registered securities. A June 2018 *Wall Street Journal* report found that the total market for private placements includes, "1,200 firms that sold around $710 billion of private placements," in 2017. Of these 1,200 firms, the *Wall Street Journal* found "over a hundred firms where 10% to 60% of the in-house brokers had three or more investor complaints, regulatory actions, criminal charges or other red flags" who facilitated the sale of more than $60 billion of private placements in 2017.[i] Another investigation by Reuters identified dozens of high-risk firms with hundreds of recidivist brokers.[ii] Often, these brokers target vulnerable investors, who may be exposed to losses or fraud and are less likely to be able to sustain such losses. FINRA's failure to publicize the names of

high-risk brokers and firms that have repeatedly broken the rules needlessly leaves investors vulnerable to potential future harm.

The proposed Rule also seems to under-count the number of these high-risk firms by setting the threshold for "disclosure events" at $15,000 and limiting it to events that are "consumer-initiated."[iii] With the average broker account in the U.S. totaling $6,200,[iv] we have concerns that the proposed Rule will leave behind many investors who have lost the entirety of their account due to the predatory actions of a broker but will not have these pernicious acts count towards the "disclosure event" count since they do not meet the monetary threshold of $15,000. Additionally, we have concerns that counting only "consumer-initiated" events will unduly let recidivist high-risk brokers off the hook since harmful practices that are discovered through FINRA's own examinations and inspections, or through whistleblower tips, would not count towards the threshold number.

A significant concern we have is that proposed Rule 4111 seems to permit high-risk broker firms to operate perpetually so long as they maintain funds in the Restricted Fund.[v] The proposal discusses a yearly designation process but does not seem to contemplate expelling firms and de-licensing brokers even after they demonstrate their unwillingness to change their behavior or lay-off especially dangerous brokers. As a result, the proposed Rule risks creating and perpetuating a moral hazard.

In addition, as proposed, Rule 4111 does not resolve the issue that too many arbitration awards remain unpaid. FINRA's arbitration process should promote confidence among investors, and investors who go through the process and receive an award should be able to collect it. However, research by the Public Investors Advocate Bar Association (PIABA) found that half of the firms listed as having unpaid awards had two or more unpaid awards. More than 85% of those firms had unpaid awards of $100,000 or more, while 40% of firms had unpaid awards in excess of $1 million.[vi] PIABA research further found that the amount of funds that Restricted Firms under the proposed rule would be required to set aside for unpaid arbitration awards would not be sufficient to cover anticipated arbitration awards.[vii] The proposed Rule also fails to address where these set-aside funds go if a firm goes out of business and whether these funds can be used for both the unpaid arbitration awards and the unpaid arbitration settlements. FINRA should ensure firms have enough funds on hand to pay back unpaid awards and settlements and specify what mechanism should be used to protect these funds before and after a firm goes out of business.

We are also concerned by the failure to address expungements of customer dispute information within a broker's disclosure history. These expungements are granted all too frequently and fail to protect investors from unscrupulous brokers and firms. Analysis conducted by PIABA found that expungement was granted when requested in 98% of cases in 2007; in nearly 97% of cases between 2009 and 2013; and in nearly 88% of cases between 2012 and 2014. We urge FINRA to reconsider its policy on disclosure history and the use of expungement,[viii] especially if FINRA believes, as published on its website, that "expungement is an extraordinary remedy that should be recommended only under appropriate circumstances."[ix]

We appreciate that FINRA put in a considerable amount of effort in proposing Rule 4111 to address the nature of Restricted Firms and their brokers. However, we have several questions about whether the protections proposed in this Rule would meaningfully protect investors from predatory firms and brokers with a history of treating investors poorly. FINRA should strengthen the proposed Rule and fill the obvious gaps.

To respond to our concerns, please answer the following questions:

1. Does FINRA currently lack regulatory authority to expel high-risk firms from its membership or ban recidivist brokers from the industry?

2. What are the public interest, market integrity, and pro-investor reasons, if any, for permitting these high-risk firms to use FINRA's seal-of-approval to continue operating and potentially harming investors? What unique service or public good do high-risk firms provide to investors that cannot be offered by other FINRA members who have not repeatedly violated FINRA's rules or harmed investors?

3. Please provide a detailed description of the quantitative analysis used to set the threshold for "disclosure events" at $15,000? As part of this detailed description, please also include the assumptions used to conduct the analysis and other information that had an impact in the outcome of the analysis. How was this analysis incorporated into the decision to essentially permit a multi-year designation process?

4. Please describe why FINRA proposes to not publicize to potential investors the names of the high-risk (designated) firms and brokers. What are the public interest, market integrity, and pro-investor reasons, if any, for keeping the names of demonstrably high-risk brokers and firms secret from the public? What else should investors consider when researching their brokers if complaints from other investors are hidden from them?

5. Why did FINRA not propose to include the briefly described "terms and conditions" provision into the proposed Rule? How has the Canadian SRO, cited in the Proposal, used similar authorities in regulating their broker-dealer members?

6. Would FINRA consider heightened supervision or limits on types of recommendations, products they could sell or other restrictions for designated Restricted Firms?

7. Will FINRA take any additional steps if a firm is designated as a Restricted Firm for more than 1 year? If there is no change in the behavior of a Restricted Firm, will FINRA outline additional steps such as summary suspension after receiving the Restricted Firm designation two years in a row?

8. In its analysis, FINRA determined between 60 and 98 firms may have been designated as Restricted Firms during the period 2013 – 2018 if the proposed rule had been in effect during that time. Of the firms that may have been designated Restricted Firms during that

time period, how many have had unpaid arbitration awards? What is the number and dollar amounts of the unpaid awards?

9. Expungement is granted far too often to be deemed "extraordinary relief." Since the "restricted" designation is premised on disclosures, expungement will prevent FINRA from being able to ensure that it has captured all of the firms that should be Restricted. More must be done to curb inappropriate expungements. What additional steps is FINRA considering to address concerns with inappropriate expungements in light of the fact that customer complaint disclosures are one metric upon which the Restricted Firm determination depends?

10. Would FINRA devote more resources to member supervision and enforcement if it had financial responsibility for unpaid awards?

We would like FINRA to address our concerns with proposed Rule 4111 and work to strengthen the rule to better hold unscrupulous brokers accountable and keep investors safe. We look forward to hearing back from you by December 13, 2019. For more information, please contact Carol Wayman at 202.224.3150 or at Carol_Wayman@cortezmasto.senate.gov.

Sincerely,

Catherine Cortez Masto
United States Senator

Elizabeth Warren
United States Senator

Sherrod Brown
United States Senator

Jack Reed
United States Senator

Tina Smith
United States Senator

Tammy Baldwin
United States Senator

[i] Eaglesham, Jean and Jones, Coulter. "Firms with Troubled Brokers are Often Behind Sales of Private Stakes." *The Wall Street Journal*. June 2018. Available at: https://www.wsj.com/articles/firms-with-troubled-brokers-are-often-behind-sales-of-private-stakes-1529838000

[ii] 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

[iii] Kelleher, Dennis and Bagramian, Lev. "Comment Letter: Regulatory Notice 19-17: Request for Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct." *Better Markets, Inc.* Available at: https://www.finra.org/sites/default/files/2019-07/19-17_Better-Markets_comment.pdf ("Kelleher and Bagramian Comment Letter"), p.11.

[iv] 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-accountsinthe-us.pdf

[v] Kelleher and Bagramian Comment Letter, p.10.

[vi] Edwards, Samuel and Lazaro, Christine. "Comment Letter: Regulatory Notice 19-17: Request for Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct." *PIABA Newsroom*. Available at: https://piaba.org/piaba-newsroom/comment-letter-regulatory-notice-19-17-request-comment-proposed-new-rule-4111

[vii] Edwards and Lazaro. "Comment Letter: Regulatory Notice 19-17."

[viii] Edwards and Lazaro. "Comment Letter: Regulatory Notice 19-17."

[ix] https://www.finra.org/arbitration-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance