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Invested in America

July 1, 2019

Via E-Mail to pubcom@finra.org

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

Re: Regulatory Notice 19-17 (Protecting Investors from Misconduct)

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on Notice 19-17 (the "Notice" or the "Proposal").[2] The Proposal would impose tailored obligations, including financial set-asides, on designated member firms that cross specified, numeric disclosure-event thresholds. The stated purpose of the Proposal is to give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards. We respectfully submit the following comments and recommendations for your consideration.

SIFMA supports targeted efforts to ensure firms pay their arbitration awards in full.

We applaud FINRA's continuing efforts to help ensure that arbitration claims, awards, and settlements are paid in full. At the same time, we have been careful to explain that the issue of unpaid awards is not an indictment of the current securities arbitration system, or of the various processes currently available to help collect an arbitration award. Nor does it justify calls to create some form of post-award collection pool, insurance, or guaranty. Such a pool would be unfair and inappropriate because, among

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] FINRA Regulatory Notice 19-17, available at https://www.finra.org/industry/notices/19-17.

other things, it would essentially require the many good actors (firms who pay their awards) to pay for the few bad actors (firms who do not).[3]

The issue of unpaid awards cannot be solved on the "back-end" as a matter of post-award collection because at that point the money is already gone. Rather, the issue needs to be addressed on the "front-end" – before an arbitration arises by ensuring that the firm maintains adequate resources to satisfy it. The Proposal appropriately embraces the "front-end" approach by seeking to identify those small number of firms with an extensive history of misconduct and/or relevant disclosure events, and as appropriate, requiring those firms to set aside cash deposits or qualified securities that could be applied to pay the firm's or its representatives' unpaid awards. SIFMA supports this approach.

FINRA should ensure that firms can independently self-evaluate and continuously monitor their status as a prospective Restricted Firm.

The Proposal would create a multi-step process for FINRA to identify whether a firm should be subject to additional obligations (e.g., a cash deposit set-aside, etc.). The first step is an annual calculation by the Department of Member Supervision (the "Department") of a firm's "Preliminary Identification Metrics",[4] which is the calculated metric for each of the following six categories of events or conditions:

1. "Registered Person Adjudicated Events"[5]
2. "Registered Person Pending Events"[6]
3. "Registered Person Termination and Internal Review Events"[7]
4. "Member Firm Adjudicated Events"[8]
5. "Member Firm Pending Events"[9]
6. "Expelled Firm Association"[10]

Next, the Department would compare the firm's six metrics numbers to the chart of "Preliminary Identification Metrics Thresholds"[11] and determine if the firm meets the "Preliminary Criteria for Identification."[12] If the firm meets that criteria, then the Department would continue its process,

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[3] *See, e.g.*, SIFMA testimony before U.S. Senate Committee on Banking, Housing and Urban Affairs (June 28, 2018) (objecting to a bill that would have required FINRA to establish an industry-financed recovery pool to pay the full value of unpaid arbitration awards), available at https://www.sifma.org/resources/news/sifma-submits-testimony-raising-concerns-with-unpaid-arbitration-legislation-s-2499/.

[4] Proposed Rule 4111(i)(10) (Definitions).

[5] *Id.* at (i)(4)(A).

[6] *Id.* at (i)(4)(B).

[7] *Id.* at (i)(4)(C).

[8] *Id.* at (i)(4)(D).

[9] *Id.* at (i)(4)(E).

[10] *Id.* at (i)(4)(F).

[11] *Id.* at (i)(11).

[12] *Id.* at (i)(9).

ultimately determining whether the firm should be designated as a "Restricted Firm" required to establish a "Restricted Deposit Account."

The process proposed by FINRA is essentially FINRA-controlled, with the Department making the calculations and then informing the firm. Firms cannot readily duplicate the Department's calculations with precision because they don't know all of the required variables, including, for example: (i) the "Evaluation Date"[13] (the date on which the Department calculates the firm's Preliminary Identification Metrics); (ii) the "Evaluation Period"[14] (the five years prior from the Evaluation Date); and (iii) the "Registered Persons In-Scope"[15] (all persons registered with the firm for one or more days within the one year prior to the Evaluation Date). More importantly, firms cannot identify with certainty or precision what disclosures/reportable events the Department is counting as part of its calculation.

The better approach would be to allow firms to be more directly involved in the process. Firms should have the in-house ability to make the same exact calculation as FINRA to determine if the firm meets the Preliminary Criteria for Identification. This would allow a firm to monitor itself on a continuous basis, self-police, and address any issues before FINRA comes knocking on its door. It would encourage firms to focus greater attention on the Proposal's metrics and take proactive corrective measures and would thereby probably reduce the Proposal's regulatory burden on the Department.

Accordingly, we recommend that FINRA provide member firms with an electronic template or worksheet that firms could use to make the identical calculation as the Department. We further recommend that such template/worksheet be available on a year-round basis so that firms can periodically, or even continuously, monitor their metrics and take corrective action to avoid triggering the relevant thresholds.

FINRA should not designate clearing firms as potential custodians of the Restricted Deposit Account.

The Proposal states that the Restricted Deposit Account must be established at a bank or the member's clearing firm, and must be subject to an agreement in which the bank or clearing firm agrees to a number of requirements. A number of clearing firms expressed concern with serving the role of custodian of the Restricted Deposit Account.

These clearing firms believe it would be problematic to custody a Restricted Deposit Account given the clearing firm's unique role in the relationship between an introducing broker and its clients. Fulfilling this role would impose additional duties and responsibilities on clearing firms that are not part of their systems and procedures today, and that would require significant time and resources to develop. Moreover, custody by a clearing firm likely would not provide FINRA with the level of transparency that it would want regarding these funds. For these reasons, we recommend that the Proposal be revised to state that a Restricted Deposit Account must be established at a third-party bank or trust company.

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[13] *Id.* at (i)(5).

[14] *Id.* at (i)(6).

[15] *Id.* at (i)(13).

FINRA should facilitate clearing firms' compliance with their due diligence obligation by sharing the identify of an introducing firm client designated as a Restricted Firm.

The Proposal states that firms designated as Restricted Firms: "present heightened risk of harm to investors and their activities may undermine confidence in the securities market as a whole"; "often act in ways that harm their customers and erode trust in the brokerage industry"; and "expose investors to real risk."

Pursuant to FINRA Rule 4311(b)(4), a clearing firm is required to conduct appropriate due diligence with respect to its introducing firm relationships to assess, among other things, the reputational risk that the relationship will have on the clearing firm. Pursuant to the Supplementary Material to Rule 4311, the clearing firm's due diligence may include, without limitation, "inquiring by the [clearing] firm into the introducing firm's … complaint and disciplinary history."

The Proposal is specifically targeted towards individuals and firms with a history of misconduct and FINRA's related view that such history "can be predictive of similar future events." As a result, FINRA's designation of a firm as a Restricted Firm is directly relevant to, and interrelated with, clearing firms' due diligence obligation. Accordingly, in the interest of investor protection and regulatory transparency, and in order to facilitate clearing firms' compliance with their due diligence obligation, we recommend that FINRA share with clearing firms the identify of their introducing firm clients, if any, that FINRA has designated as a Restricted Firm.

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If you have any questions or would like to further discuss these issues, please contact the undersigned.

Sincerely,

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: ***via e-mail to:***
Robert L.D. Colby, Chief Legal Officer, FINRA
Richard W. Berry, Executive Vice President and Director, FINRA-DR