

July 1, 2019

Via E-Mail

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

**Re: FINRA Regulatory Notice 19-17
Protecting Investors from Misconduct: FINRA Requests Comment on Proposed
New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations
on Firms with a Significant History of Misconduct**

Dear Ms. Mitchell:

We are submitting this letter on behalf of our client, the Committee of Annuity Insurers (the "Committee"),¹ in response to Regulatory Notice 19-17, *Protecting Investors from Misconduct* (the "Notice"), issued by the Financial Industry Regulatory Authority, Inc. ("FINRA") on May 2, 2019.² The Notice solicits comment on proposed new Rule 4111 (the "Proposed Rule"), as well as an additional proposed new rule to outline procedures for regulating activities and proposed amendments to existing rules to outline procedures for hearings.

Background

The Notice summarizes FINRA's review of its programs to address the heightened risks that can be posed to investors and the broader market by some FINRA member firms and individuals with histories of misconduct. Despite examination and enforcement efforts, FINRA notes that persistent compliance issues continue to arise in a small number of FINRA member firms. To remedy these issues, FINRA launched an initiative to enhance its controls over the risks posed by individuals, including clarifying heightened supervision requirements, revising the FINRA Sanction Guidelines, raising fees for statutory disqualification applications, and revising examination waiver guidelines to consider an individual's past misconduct. FINRA has also proposed rules to: (i) require materiality consultations for FINRA member firms that employ brokers with a history of misconduct; (ii) authorize Hearing Panels and Hearing Officers to impose conditions and restrictions on individuals during an appeal of a disciplinary decision; and (iii) require an interim plan of heightened supervision with any firm's application to continue associating with a statutorily disqualified person.

¹The Committee was formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of securities, banking, and tax policies regarding annuities. For three decades, the Committee has played a prominent role in shaping government and regulatory policies with respect to annuities, working with and advocating before the SEC, CFTC, FINRA, IRS, Treasury, Department of Labor, as well as the NAIC and relevant Congressional committees. Today the Committee is a coalition of many of the largest and most prominent issuers of annuity contracts. The Committee's member companies represent more than 80% of the annuity business in the United States. A list of the Committee's member companies is attached as Appendix A.

² The Notice is posted at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-17.pdf.

Overview of the Proposed Rule

FINRA notes, however, that challenges remain at the member firm level, particularly where a member firm has a concentration of brokers with past misconduct issues and without adequate supervision. To remedy these issues, the Proposed Rule seeks to impose tailored obligations on firms that have significantly higher levels of risk-related disclosures than their similarly sized peers ("Restricted Firms"). Under the Proposed Rule, any Restricted Firm would be subject to a requirement to hold a Restricted Deposit Requirement (described in more detail below), and may also be subject to additional obligations, including other conditions or restrictions on the Restricted Firm's business and operations.

The Proposed Rule would create a multi-step process to guide FINRA's determination of whether to impose additional obligations on a member firm. The first step in this process is to calculate the sum of disclosure events and persons for six categories for the firm, which include: (i) registered person adjudicated events; (ii) registered person pending events; (iii) registered person termination and internal review events; (iv) firm adjudicated events; (v) firm pending events; and (vi) registered persons associated with previously expelled firms. Next, FINRA would compute the firm's Preliminary Identification Metrics by standardizing each of the sums. The final step is to determine if the firm meets the Preliminary Criteria for Identification by evaluating whether: (i) two or more of the firm's Preliminary Identification Metrics are equal to or more than the corresponding Preliminary Identification Metrics Thresholds for the firm's size; (ii) at least one of those Preliminary Identification Metrics is the Registered Person Adjudicated Event Metric, the Member Firm Adjudicated Event Metric, or the Expelled Firm Association Metric; and (iii) the member firm has two or more Registered Person or Member Firm Events.

FINRA also identifies additional steps intended to guard against the risk of misidentification of firms that could result from using the process identified under the Proposed Rule. For example, once a firm is deemed to meet the "Preliminary Criteria for Identification," the Proposed Rule would require FINRA to conduct an initial evaluation to "determine whether it is aware of information that would show that the member—despite having met the Preliminary Criteria for Identification—does not pose a high degree of risk."³

FINRA would also permit firms who meet the Preliminary Criteria for Identification to reduce staffing levels in a manner such that the firm would no longer meet the criteria. However, this option is only available if it is the firm's first time meeting the criteria. The Proposed Rule permits FINRA to continue the review if FINRA determines that a firm still meets the Preliminary Criteria for Identification following any reduction in staffing levels, or if a firm is not eligible for or opts out of reducing staffing levels. The next step in the review process grants FINRA the discretion to determine the maximum amount of any deposit that a member could be required to maintain, in cash or qualified securities, in a segregated account at a bank or clearing firm, the so-called "Restricted Deposit Requirement." In addition to discouraging misconduct, FINRA notes that this additional financial requirement imposed on Restricted Firms aims to preserve firm funds for payment of arbitration awards.

As another line of defense intended to guard against the risk of misidentification, the Proposed Rule requires a member firm consultation with FINRA during which the firm could explain why it should not be designated as a Restricted Firm and why it should not be subject to a Restricted Deposit Requirement. While the Proposed Rule outlines how a firm may overcome the presumption that it should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement, it grants FINRA discretion to make the final determination as to whether a firm has overcome the presumption. Upon finding that a firm should be designated as a Restricted Firm, the Proposed Rule would grant FINRA discretion to impose any additional obligations, including financial requirements or other conditions or restrictions.

³ The Notice, at p. 11.

General Comments

The Committee appreciates the opportunity to submit comments in response to the Notice. The Committee is generally supportive of FINRA's efforts and its attempts to enhance customer protection by imposing additional obligations on a targeted group of firms. Particularly, the Committee supports FINRA's transparency around how the Preliminary Identification Metrics are calculated. The Committee has several comments regarding the financial requirements and other specified conditions or restrictions that a Restricted Firm may be subject to under the Proposed Rule. The Committee also requests clarification on several aspects of the Proposed Rule. Set forth below are the Committee's specific comments.

Specific Comments

FINRA's Exercise of Discretion. The Committee has several comments regarding the Proposed Rule's broad grant of discretion to FINRA's Department of Member Supervision in determining who is a Restricted Firm and the financial requirements and other specified conditions or restrictions that a Restricted Firm may be subject to under the Proposed Rule. The Committee believes that the amount of discretion that would be permitted under the Proposed Rules may not be set up in a manner that promotes consistency and fairness in how the Proposed Rule is applied. While the Committee appreciates the need for discretion in some instances, we urge FINRA to consider striking an appropriate balance between discretion and consistency and fairness within the Proposed Rule.

Initial Evaluation by FINRA. As noted above, FINRA points to several steps that it states are intended to guard against the risk of misidentification, including an initial evaluation by FINRA. During the initial evaluation, the Proposed Rule would grant FINRA broad discretion to determine whether the firm was misidentified and therefore should not be subject to further review. The Proposed Rule prescribes that FINRA would base its decision on whether FINRA has information to conclude that the computation of the member's Preliminary Identification Metrics included disclosure events (and other conditions) that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. Additionally, FINRA would be required to consider whether the member already addressed the concerns that the Proposed Rule is intended to address, or whether the Preliminary Criteria for Identification no longer reflect the member's current risk profile.

The Committee understands the need to mitigate concerns of including firms who are not the target of the Proposed Rule. However, the Committee believes that this initial evaluation provides FINRA with broad discretion to decide whether a firm has been misidentified and therefore whether the firm should be subject to continued review under the Proposed Rule.

Member Consultation. As noted above, the Proposed Rule also provides that a member firm consultation with FINRA is intended to guide against misidentification. While the Proposed Rule outlines how a firm may overcome the presumption that it is a Restricted Firm and should not be subject to financial requirements and specified conditions or restrictions, it grants FINRA the discretion to make the final determination as to whether a firm has overcome the presumption. The Proposed Rule also grants FINRA the authority to request relevant information or documents that are "necessary or appropriate . . . to review the computation of the Preliminary Criteria for Identification."⁴ Furthermore, the Proposed Rule grants FINRA the authority to request "other information or documents" that FINRA may "reasonably request in its discretion from the member related to the evaluation," as well as "any other information . . . deems necessary or appropriate to evaluate the matter."⁵

⁴ Proposed FINRA Rule 4111(d)(3)(B).

⁵ Proposed FINRA Rule 4111(d)(3)(D)-(E).

The Committee believes that the Proposed Rule's consultation provides FINRA with broad discretion to decide whether a firm should be designated as a Restricted Firm and whether it should be subject to financial requirements and specified conditions or restrictions. The Committee believes that a carefully tailored and objective structure in determining whether mis-identification has occurred would be preferred.

Maximum Restricted Deposit Requirement. The Notice requests comment on whether there should be a cap on the maximum Restricted Deposit Requirement. As noted above, the Proposed Rule grants FINRA the discretion to determine a Restricted Firm's maximum Restricted Deposit Requirement amount. FINRA notes that the maximum Restricted Deposit Requirement amount would be tailored to the firm's size, operations and financial conditions. FINRA further notes that it would consider a number of factors when determining the maximum Restricted Deposit Requirement, including "the nature of the firm'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 or unpaid settlements related to arbitrations, and concerns raised during FINRA exams."⁶ Attachment C to the Notice contains several examples that are intended to demonstrate how FINRA might exercise its discretion in determining a maximum Restricted Deposit Requirement. However, the Notice states that "nothing in the examples is intended to suggest that the Department will follow specific formulas in determining a maximum Restricted Deposit Requirement or the weight that any specific circumstances carry."⁷

The Committee agrees that any obligations on a Restricted Firm should not significantly undermine the continued financial stability and operational capability of the firm.⁸ The Committee also agrees that FINRA should consider a firm's size and other important factors when determining any conditions or restrictions that will be imposed.⁹ However, the Proposed Rule merely provides guidance, and falls short of placing limitations on FINRA's ability to determine the maximum Restricted Deposit Requirement. Without a formula or limitations, this provision does not prevent FINRA from making an arbitrary determination of a firm's maximum Restricted Deposit Requirement, or the weight of any mitigating factors. We believe it should be possible to develop a formula for calculating the maximum Restricted Deposit Requirement, by, e.g., focusing on the correlation between revenues derived from penny stock sales and unpaid arbitration amounts. A formula of this type would seem to make more sense because, unlike excess net capital, there is a direct correlation between revenue and sales that give rise or may give rise to, unpaid arbitration awards. Similar to the transparency provided around how the Preliminary Identification Metrics are calculated, the Committee requests that FINRA also provide transparency around the calculation of and caps on the maximum Restricted Deposit Requirements.

Department Decisions. The Proposed Rule provides that FINRA may make one of three determinations:

- If FINRA determines that the firm has rebutted the presumption that it should be designated as a Restricted Firm, then the firm will not be subject to any additional obligations.
- Alternatively, FINRA may determine that the firm has failed to rebut both the presumption that the firm should be designated as a Restricted Firm and the presumption that it should be subject to the maximum Restricted Deposit Requirement, in which case the firm would be required to comply with the maximum Restricted Deposit Requirement and "specified conditions or restrictions, as necessary or

⁶ Proposed FINRA Rule 4111(i)(15)(A).

⁷ The Notice, at p. 12.

⁸ The Notice, at p. 12.

⁹ The Notice, at p. 12.

appropriate, on the operations and activities of the firm and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.”¹⁰

- Lastly, FINRA may determine that the firm failed to rebut the presumption that the firm should be designated as a Restricted Firm but that it has rebutted the presumption that it should be subject to the maximum Restricted Deposit Requirement. As a result, FINRA could choose to (1) impose no Restricted Deposit Requirement; or (2) require the member to maintain a Restricted Deposit Account with an amount less than the maximum Restricted Deposit Requirement and impose “specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the firm and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.”¹¹

The Committee believes that this provision would grant FINRA broad discretion to determine any additional obligations, including the amount of a financial requirement and conditions or restrictions that may be imposed on a Restricted Firm. Furthermore, this provision does not provide examples of the types of conditions or restrictions that may be imposed. For example, FINRA could impose conditions or restrictions that have the same effect as sanctions. The Committee believes that granting FINRA too much discretion to impose conditions or restrictions on a firm circumvents the enforcement process and any level of due process afforded by formal proceedings. For these reasons, the Committee requests that FINRA limit the additional obligations to conditions or restrictions that are directly targeted to remedy the events of the Firm that constitute Preliminary Criteria for Identification, and will not have a materially adverse business impact on other aspects of the firm’s operations.

Termination of Restricted Firm Obligations. The Proposed Rule anticipates that a firm may be designated as a Restricted Firm in one year, but not meet the Preliminary Criteria for Identification or otherwise is not designated as a Restricted Firm the following year. However, the Proposed Rule would restrict a previously designated Restricted Firm from withdrawing any amount from the Restricted Deposit Account, unless FINRA decides to authorize a withdrawal.

This provision appears to suggest that a previously designated Restricted Firm could always, at FINRA’s discretion, be subject to additional obligations in the form of Restricted Deposit Requirements. This seems to be a possibility regardless of any changes in a previously designated Restricted Firm’s staffing or behavior, or the passage of time. FINRA states that the Proposed Rule is “premised on a notion that the most effective tool to change the behavior of a member firm that presents a high degree of risk is a financial restriction.”¹² However, the Committee has doubts that a member who may be subject to a financial restriction regardless of changed behavior will be motivated to change its behavior. The Committee urges FINRA to reconsider its position on maintaining Restricted Deposit Requirements for previously designated Restricted Firms. As you know, the maintenance of a Restricted Deposit Account imposes at least three direct costs on member firms: the charge for maintaining the account; the cost to maintain excess capital; and the cost imposed through the annual independent audit. A firm that is no longer designated a Restricted Firm should not be subject to these on-going costs.

Clarifying Questions. The Committee is seeking clarification on many aspects of the Proposed Rule that could have implications on other aspects of a firm’s business.

“Good Standing.” The Notice requests comment on whether “there are collateral consequences that could result from being designated as a Restricted Firm, even if FINRA does not publicly disclose the firm’s designation.”¹³ The Committee believes that being designated as a Restricted

¹⁰ Proposed FINRA Rule 4111(e)(1)(B).

¹¹ Proposed FINRA Rule 4111(e)(1)(C).

¹² The Notice, at p. 35.

¹³ The Notice, at p. 36.

Firm could have other collateral consequences. In particular, many selling agreements to which a firm may be a party typically include a covenant that a firm maintain its status as a FINRA member firm in "good standing." The Committee is requesting clarification on whether a firm's status as a Restricted Firm would impact whether the firm is viewed as being in good standing with FINRA.

Public Availability of Restricted Firm Status. As noted above, FINRA requests information on whether "there are collateral consequences that could result from being designated as a Restricted Firm, *even if* FINRA does not publicly disclose the firm's designation."¹⁴ Given FINRA's choice of words, the Committee asks that FINRA clarify whether a firm's status as a Restricted Firm could be made publicly available by FINRA.

Calculation of Preliminary Criteria for Identification. The Proposed Rule anticipates that the Department would calculate, on an annual basis, a member firm's Preliminary Identification Metrics to determine if it meets the Preliminary Criteria for Identification. The Proposed Rule appears to require Restricted Firms to keep records relating to, among other things, the calculation of the Preliminary Criteria for Identification. The Committee is requesting clarification on whether a firm would be provided the necessary information to be able to calculate its Preliminary Criteria for Identification. In addition to a firm's calculation, the Committee requests clarification on whether FINRA will provide advance notice to firms that meet or come close to meeting the Preliminary Criteria for Identification.

CONCLUSION

The Committee appreciates the opportunity to provide these comments on the Proposed Rule. Please do not hesitate to contact Clifford Kirsch (212.389.5052 or CliffordKirsch@eversheds-sutherland.com) or Eric Arnold (202.383.0741 or EricArnold@eversheds-sutherland.com), if you have any questions regarding these comments.

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Respectfully submitted,

EVERSHEDS SUTHERLAND (US) LLP

BY: Clifford Kirsch EA
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Eric Arnold

FOR THE COMMITTEE OF ANNUITY INSURERS

¹⁴ The Notice, at p. 36 (emphasis added).

Appendix A

COMMITTEE OF ANNUITY INSURERS

AIG
Allianz Life
Allstate Financial
Ameriprise Financial
Athene USA
AXA Equitable Life Insurance Company
Brighthouse Financial, Inc.
Fidelity Investments Life Insurance Company
Genworth Financial
Global Atlantic Financial Group
Great American Life Insurance Co.
Guardian Insurance & Annuity Co., Inc.
Jackson National Life Insurance Company
John Hancock Life Insurance Company
Lincoln Financial Group
Massachusetts Mutual Life Insurance Company
Metropolitan Life Insurance Company
National Life Group
Nationwide Life Insurance Companies
New York Life Insurance Company
Northwestern Mutual Life Insurance Company
Ohio National Financial Services
Pacific Life Insurance Company
Protective Life Insurance Company
Prudential Insurance Company of America
Sammons Financial Group
Symetra Financial Corporation
Talcott Resolution
The Transamerica companies
TIAA
USAA Life Insurance Company