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July 1, 2019

By email 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:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in response to the request for comment by the Financial Industry Regulatory Authority ("FINRA") on *Regulatory Notice 19-17: Protecting Investors from Misconduct* (the "Proposal").[2] NASAA commends FINRA's attempt to strategically identify, and more strongly regulate, the limited number of FINRA member firms with histories of regulatory noncompliance. The Proposal represents another step in FINRA's recent multi-pronged effort to protect investors from the bad behavior of certain high-risk firms – an effort NASAA supports.

The Proposal is designed to proactively deter misconduct by the highest risk FINRA member firms and to mitigate the issue of nonpayment of arbitration awards. The Proposal would create a new category of "Restricted Firms," which are those firms that present high risks to investors because of demonstrated patterns of prior misconduct by the firms and their associated persons, and empower FINRA to require these firms to set aside additional monies for the protection of investors beyond the firms' existing minimum net capital requirements. The Proposal contains a robust process for evaluating these issues and, as demonstrated by FINRA data, should affect only a small number of broker-dealers. The Proposal thus should increase investor protection while imposing minimal burdens on the brokerage industry. NASAA supports the Proposal and encourages its adoption with changes as set out below to better align the Proposal with its investor protection goals.

[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] *See* Regulatory Notice 19-17: Protecting Investors from Misconduct, FINRA (May 2, 2019), *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-17.pdf.

1. **Designation as a "Restricted Firm" Under New Rule 4111 Should be Public Information**

FINRA does not propose to publicly disclose those firms receiving a Restricted Firm designation, however, publishing this information would strengthen both investor protection and transparency. Identification of Restricted Firms would be a valuable public service entirely consistent with FINRA's general standards for public disclosure of disciplinary information under FINRA Rule 8313. An appropriate analogy is to FINRA's treatment of so-called "Taping Firms." At a minimum, though, the names of Restricted Firms should be provided to state securities regulators so it can be included in NASAA members' regulatory oversight and risk analyses.

Designation as a Restricted Firm is closely analogous to being designated a Taping Firm under FINRA Rule 3170. FINRA allows for public disclosure to investors of a firm's Taping Rule status if requested via the BrokerCheck toll-free telephone listing.[3] This provides investors – and other regulators such as NASAA members – with access to this information. The underlying purposes of the Taping Rule are the same as those behind the Proposal: both rules seek to identify high risk FINRA member firms and to impose additional regulatory and compliance obligations on them.[4] For the same reasons that FINRA makes the identity of Taping Firms and those disciplined under the Taping Rule known to the public, it should make the identities of Restricted Firms under new Rule 4111 known as well.

Publicizing which firms have been designated as Restricted Firms would strengthen the Proposal immeasurably. Being designated under new Rule 4111 will have regulatory consequences for Restricted Firms (including the requirement to set aside additional money in Restricted Deposit Accounts), but these obligations only go so far. If investors do not have access to this information they will not be able to know they are doing business with a high risk firm. Investors cannot obtain the same level of information through BrokerCheck that FINRA will use in designating members as Restricted Firms. Making the identities of Restricted Firms public would serve as a clear, simple – and entirely warranted – notice to investors to tread carefully when doing business with these firms and their associated persons. At a minimum, the names of Restricted Firms should be provided to state securities regulators so NASAA members can include this information in their own regulatory oversight and risk analyses. Regulatory coordination and collaboration is an important mainstay of deterrence and oversight, and will be particularly relevant with respect to Restricted Firms.

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[3] *See* FINRA Rule 3812(b)(2)(F). A recent FINRA proposal would also require this information be provided proactively on BrokerCheck, and NASAA supported this proposal. *See* Letter from Joseph Borg, NASAA President, to Jennifer Piorko Mitchell, Re: FINRA Regulatory Notice 18-16: High Risk Brokers (Aug. 1, 2018), *available at* https://www.finra.org/sites/default/files/18-16_NASAA_Comment.pdf.

[4] *See, e.g.*, Notice to Members 05-46: Taping Rule, NASD (July 2005) (describing the purpose of the Taping Rule), *available at* http://www.finra.org/sites/default/files/NoticeDocument/p014653.pdf.

2. Account for any Registered Person Adjudicated Events that have been Expunged Pursuant to FINRA Rule 2080 when Calculating and Evaluating the Preliminary Criteria for Identification

The Proposal would create an entirely new regulatory process for identifying and assigning Restricted Firm status.[5] A key step in this process will be FINRA's analysis of member firms according to certain "Preliminary Criteria for Identification."[6] These criteria, defined in great detail in proposed FINRA Rule 4111, correspond to many of the mandatory disclosures on Form BD and Form U4, including the disclosures required by Item 14I of Form U4. Item 14I requires registered individuals to disclose information regarding customer complaints and customer-initiated arbitration and civil litigation.[7] The information captured in Item 14I is particularly relevant in identifying patterns of misconduct at a firm that could present high risks to investors – *e.g.*, numerous customer complaints about a single representative or about multiple representatives related to the same issues could be indicative of a pattern of misconduct. But FINRA Rule 2080 allows associated persons to have Item 14I information expunged from CRD. Once such a disclosure has been expunged, it is no longer reported under Item 14I on the individual's subsequent Form U4 filings.[8] The Proposal does not address how or if expunged customer complaint information will be considered when determining and assessing the Preliminary Criteria for Identification.

How expunged customer complaints, arbitrations, and civil litigations are treated when determining whether a firm meets the Preliminary Criteria for Identification is an important question that must be addressed before the Proposal can be implemented. In NASAA's view, this is a critical issue. NASAA has consistently advocated for significant reform to the rules and processes related to expungement.[9] NASAA must again note that expungement was intended as

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[5] This process can be visualized through a flowchart included as Attachment B to the Proposal.

[6] *See* Proposed Rule 4111(i)(9).

[7] Form U4 Item 14I(1)-(5).

[8] NASAA is unaware of any law, rule, regulation, or guidance dictating this result. However, the general understanding of what it means for something to "*be expunged*" could be the reason events that would otherwise be reportable pursuant to Item 14I but that have been expunged under Rule 2080 are not reported on subsequent Form U4 filings. Further, arbitration awards recommending expungement pursuant to Rule 2080 contain the following (or similar) language: "The Arbitrator recommends the expungement of all references to this matter from registration records maintained by the CRD." The use of "*all references"* and reference to *"registration records"* in such awards has resulted not only the removal from CRD of *existing* references to an expunged matter but in practice has also relieved individuals from disclosing the expunged matter in their future Form U4 filings, because these future filings are *registration records maintained by the CRD*.

[9] *See* Letter from Joseph Borg, NASAA President and Alabama Securities Director, to Marcia Asquith, FINRA Office of the Corporate Secretary, Re: FINRA Regulatory Notice 17-42, Proposed Amendments to the Codes of Arbitration Procedure Relating to Requests to Expunge Customer Dispute Information (Feb. 5, 2018) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comments-to-FINRA-Regarding-Reg-Notice-17-42-Expungement.pdf; *see also* Letter from William Beatty, NASAA President and Washington Director of Securities, to Barbara Black, FINRA Dispute Resolution Taskforce, Re: NASAA Comments on Expungement of Matters from the Central Registration Depository (Aug. 31, 2015), *available at* http://nasaa.cdn.s3.amazonaws.com/wpcontent/uploads/2011/07/NASAA-Expungement-Letter-enclosure.pdf.;

an extraordinary remedy to be granted in only limited circumstances. Today, however, expungement is anything but an extraordinary remedy.[10]

Because expungements are routinely granted and represent potentially valuable regulatory data in assessing patterns of misconduct, FINRA must account for expunged Registered Person Adjudicated Events when determining whether a firm should be designated a Restricted Firm. FINRA should revise the Proposal to add the number of expunged Registered Person Adjudicated Events to the Preliminary Criteria for Identification. The number of expunged Registered Person Adjudicated Events should be counted and assessed in the same manner as the other metrics in the Proposal when determining whether a firm satisfies the Preliminary Criteria for Identification. If FINRA fails to account for expunged Registered Person Adjudicated Events in its Restricted Firm analysis, it will be creating a powerful incentive for registered persons to seek even more expungements. More importantly, not counting the number of expungements in the Preliminary Identification Criteria could also lead to firms encouraging – or even facilitating – expungements for their associated persons in the hopes of avoiding designation as a Restricted Firm. These incentives would only make expungement more common and less extraordinary, moving it even further from its intended purpose.[11]

Letter from Joseph Borg, NASAA President, to Barbara Sweeney, Secretary NASD Regulation, Inc., Re: Request for Comments – 01-65 Proposed Rules and Policies Relating to the Expungement of Information from the Central Registration Depository (Dec. 31, 2001), *available at* http://www.nasaa.org/wp-content/uploads/2011/07/95-Letter.37262-47637.pdf; Letter from Deborah Bortner, NASAA CRD Steering Committee Co-Chair, to Margaret H. McFarland, Deputy Secretary, U.S. Securities and Exchange Commission, Re: File No. SR-NASD-2002-168; Proposed Rule 2130 Concerning the Expungement of Customer Dispute Information from CRD (Jun. 4, 2003) *available at* http://www.nasaa.org/wpcontent/uploads/2011/07/82-ProposedNASDRule-202130.37775-72237.pdf; Letter from Karen Tyler, NASAA President, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, Re: Release No. 34-57572; File No. SR-FINRA-2008-010, Notice of Filing of Proposed Rule Change Relating to Amendments to the Codes of Arbitration Procedure To Establish New Procedures for Arbitrators To Follow When Considering Requests for Expungement Relief (Apr. 24, 2008) *available at* http://www.nasaa.org/wpcontent/uploads/2011/07/31-Release-No34-57572SR-FINRA-2008-010NASAA.pdf; Letter from Andrea Seidt, NASAA President, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, Re: Release No. 34-71959, File No. SR-FINRA-2014-020 Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2081 Prohibited Conditions Relating to Expungement of Customer Dispute Information (May 14, 2014) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-ReleaseNo-34-71959-File-No-SR-FINRA-2014-020.pdf.

[10] In 2018, 684 expungements were granted – more than twice the number granted in 2016. In the current year-to-date, more than 350 expungements have been granted, indicating that 2019 is likely to see another record number of customer complaints being removed from CRD. It is important to note that these figures do not count individual customer complaints or arbitrations but instead only count the individual representatives that have been granted an expungement, many of whom are granted expungement for multiple customer complaints or arbitrations.

[11] NASAA's position on expungement is that it is an extraordinary remedy to be granted only in limited circumstances and the current process has failed to maintain the narrow scope of this remedy. If at such future time that expungement relief is awarded in the truly exceptional instances for which it was established, NASAA would be supportive of FINRA revisiting how it evaluates expunged information for purposes of proposed Rule 4111.

3. Include Additional Financial Disclosure Information from Form BD and Form U4 in the Preliminary Criteria for Identification

NASAA encourages FINRA to expand the Preliminary Criteria for Identification to include financial disclosure requirements from Form BD and Form U4. Specifically, Form BD questions 11I through 11K and Form U4 questions 14K through 14M require disclosure of information about bankruptcies, unsatisfied liens and judgments, and security bonds. The information contained in these disclosures is essential to the investor protection concerns underlying the Proposal as these questions demonstrate potential inability (or unwillingness) to satisfy one's financial obligations. FINRA has crafted the Preliminary Criteria for Identification to capture those firms most likely to pose harm to investors. Adding these additional financial disclosure questions to the Restricted Firm criteria would be consistent with this objective.

4. Include Examples of Potential Conditions or Restrictions that Reasonably May be Imposed on Restricted Firms

Proposed Rule 4111 would provide FINRA with authority to require Restricted Firms to maintain a Restricted Deposit Account and "be subject to such conditions or restrictions on the member's operations" as FINRA determines.[12] This broad authority would, in keeping with FINRA Rule 8310(a)(7), include the ability to "impose any other fitting sanction" as FINRA deems appropriate.[13] The Proposal is silent, though, on what such conditions or restrictions might entail. We encourage FINRA to provide greater guidance on this point and, in particular, to identify conditions or restrictions that generally may be appropriate, such as:

- Mandatory heightened supervision plans for every associated person of the Restricted Firm with a disciplinary disclosure on the person's Form U4;[14]
- Disclosure by the firm of its status as a Restricted Firm to the firm's existing customers in a format acceptable to FINRA;
- Requirement that the Restricted Firm obtain approval from FINRA before hiring any employee (or retaining any person on an independent contractor basis) who has any disciplinary disclosures on the person's Form U4 or unpaid arbitration awards;
- Requirement that the Restricted Firm retain an independent compliance consultant at its own expense to monitor its regulatory compliance and

[12] *See* Proposed Rule 4111(a).

[13] *See Sanctions for Violation of the Rules*, FINRA Rule 8310 (eff. Dec. 15, 2008).

[14] In this regard, heightened supervision plans should conform with the standards set forth in FINRA Regulatory Notice 18-15: Heightened Supervision (*available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-15_1.pdf).

report any material breaches of applicable securities laws and regulations to FINRA;

- Limitations on the menu of products maintained by the Restricted Firm, particularly with regard to products with known sales practice issues (or, in the alternative, limitations on the firm's ability to solicit certain products);
- Requirement that the Restricted Firm perform more frequent reviews of customer transactions as well as sales practice assessments of transaction volumes and products sold;
- Requirement for the Restricted Firm to obtain errors and omissions insurance coverage pursuant to terms acceptable to FINRA (if the firm does not already maintain such coverage); and
- Limitations on the Restricted Firm's solicitation of new clients.

In sum, we applaud the FINRA staff's work preparing the Proposal. Rule 4111 would, if adopted, serve as a bulwark against FINRA member firms that maintain cultures of regulatory noncompliance.

If you have any questions about these comments, please contact NASAA's General Counsel, A. Valerie Mirko (vm@nasaa.org or 202-737-0900), or NASAA's Broker-Dealer Section Chair, Leslie Van Buskirk (Leslie.VanBuskirk@dfi.wisconsin.gov or 608-266-3432).

Sincerely,

Michael Pieciak
NASAA President
Commissioner, Vermont Department of Financial Regulation