



The Commonwealth of Massachusetts
Secretary of the Commonwealth
State House, Boston, Massachusetts 02133

William Francis Galvin
Secretary of the Commonwealth

June 28, 2019

Via email to pubcom@finra.org.

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

Re: Comments on Proposed Rule 4111. Restricted Firm Obligations

Dear Ms. Piorko Mitchell:

I am writing in my capacity as the chief securities regulator for Massachusetts regarding proposed Rule 4111 (the "Proposed Rule"), as explained in Regulatory Notice 19-17 (the "Notice"). The Proposed Rule is a good first step toward addressing the risk posed to Main Street investors by member firms and brokers with histories of serious misconduct. However, I believe that the Proposed Rule should be improved in order to truly protect investors from that risk and ensure that they will have meaningful recourse when they are harmed.

The Proposed Rule rightly places the burden of investor protection with the riskiest firms. The Proposed Rule will be stronger if it gives prevention of harm the highest priority, expands the substantive criteria used to identify risky member firms, and provides greater flexibility in when and how Restricted Firms are identified. Also, regardless whether FINRA makes information about Restricted Firms available to the public, FINRA should notify state regulators of Restricted Firms registered in their states.

I. The Proposed Rule rightly places the burden of investor protection at the feet of firms that hire bad brokers.

Main Street investors should be able to trust and rely on financial service providers to help safeguard and grow their hard-earned savings. Securities regulators across the country too often have seen the most vulnerable investors suffer grievous financial harm because of fraud, abuse, and troublesome incentives in the brokerage industry. In some instances, those investors are further victimized when their recourse via arbitration proves to be illusory because firms and brokers fail to pay arbitration awards.

Member firms who continue to hire brokers with histories of serious misconduct add to the risk of investor harm. It has been the experience of my office that many of these firms view investor protection measures as a punishment and a cost to be minimized. As a result, many firms that hire bad brokers fail to proactively subject these brokers to heightened supervision, and often fail to discharge their supervisory obligations at all.

We acknowledge that the Restricted Deposit Requirement will be a burden on member firms that want to hire bad brokers, but investors must come first. If a firm poses a risk to investors, that firm should bear the cost of appropriate measures to protect them. A preference for spending money elsewhere cannot be an excuse to leave investors holding the bag.

Again, the Proposed Rule rightly places the burden with these member firms to protect investors and ensure that they have meaningful recourse when harmed.

II. The Proposed Rule should give preventive measures the highest priority.

The Notice recognizes that the remedial tools available to regulators are sometimes limited and may allow unscrupulous member firms and brokers to stall efforts to make investors whole. The Proposed Rule should explicitly prioritize imposing conditions on Restricted Firms' continued membership that will prevent investors from being harmed in the first place.

In 2016, my office completed a sweep of select firms that hire brokers with past disciplinary histories.¹ My office found that the firms hiring these brokers were not taking steps to subject these brokers to heightened supervision. We urge that the regulators must be the ones to look out for investors and impose these conditions because the industry cannot be relied upon to do it themselves.

In the years since issuing the report, my office has continued to see member firms and brokers with histories of serious misconduct seeking to do business in Massachusetts. My office has worked hard to proactively impose heightened supervision and other conditions on the registrations of such firms and brokers in order to protect Massachusetts investors.

Implementation of the Proposed Rule should prioritize conditions and restrictions designed to prevent harm. This should include requiring heightened supervision of brokers with histories of misconduct, restricting the member firm's ability to sell risky and illiquid products, and restricting the member firm's ability to sell risky and costly products to retail investors.

III. The Proposed Rule should include additional criteria for identifying Restricted Firms.

The identification criteria in the Proposed Rule are missing key indicators of risk to investors. The Proposed Rule excludes financial issues,² "non-investment-related" civil matters,³

¹ Massachusetts Securities Division's Sweep of Select Broker-Dealers that Hire Bad Agents (December 1, 2016) (available at <https://www.sec.state.ma.us/sct/sctpdf/HS-White-Paper-12-08-16.pdf>)

² Notice at 32.

³ Proposed Rule 4111(i)(4)(A)(i), (ii); 4111(i)(4)(D)(i), (ii).

and internal reviews of a broker by other member firms⁴ from the criteria used to identify Restricted Firms. Neglecting these criteria prevents a complete assessment of the risk posed by a member firm and its brokers, and sends the message that member firms can ignore the risk that these events pose to investors.

Financial issues, such as judgments, liens, bankruptcies, and compromises resulting in outstanding debt should be included in the Proposed Rule. These matters are currently disclosed in Form BD and Form U4 for good reason. Financial distress is a powerful incentive for firms and brokers to behave recklessly with investor funds to increase commissions, or engage in outright theft.⁵ In February, my office filed an enforcement action charging a former broker with fraudulently misappropriating funds from at least one longtime brokerage customer, and engaging in a nearly twelve-year scheme to cover up the theft. During this time, the broker was the subject of two IRS tax liens totaling more than \$280,000 and foreclosure on his home when he failed to pay his mortgage. Until approximately five months before my office filed the enforcement action this year, this broker had only financial disclosures and the Proposed Rule would have been blind to the risk this broker posed to investors.

Even when ostensibly “non-investment-related,” civil suits, judgments, arbitrations, and settlements that involve dishonesty, deceit, or reckless or intentional wrongdoing should be included in the Proposed Rule. These matters may indicate a lack of care in financial matters or a willingness to deceive or to bend the rules. By excluding these civil matters, the Proposed Rule will miss problematic conduct involving digital currencies, viaticals, reverse mortgages, structured finance, as well as payday lending. Misconduct in these supposedly “non-investment-related” businesses has caused serious economic harm to many vulnerable investors and must be considered as a sign of potential investor risk.

Although the Proposed Rule includes internal reviews of a member firm’s brokers in the identification criteria, the Proposed Rule limits consideration of internal reviews to those done “by the member.”⁶ This is too narrow. The Proposed Rule should include internal reviews of a broker by a previous employer, regardless of whether they resulted in a termination disclosure on Form U5. On many occasions, my office has discovered that a purportedly voluntary termination was related to the results of, or broker’s unwillingness to cooperate with, an internal review of questionable conduct. In April, FINRA fined and suspended a broker for removing nonpublic customer information from his previous member firm when he left for his current firm in January 2018. This broker resigned from the previous member firm instead of complying with

⁴ Proposed Rule 4111(i)(4)(C)(ii).

⁵ In January 2016, a broker was convicted of stealing more than \$100,000 from one investor, after being permanently barred by FINRA. A subsequent arbitration revealed that the broker had sold two other investors unsuitable annuities and impersonated them on the phone in an effort to increase his commissions to pay back taxes to the IRS. The broker’s record includes seven separate financial disclosures prior to his conviction, termination, and permanent bar. See *‘That’s not me!’ What happened when AXA played a recording in an arbitration*, Financial Planning (Jun. 13, 2019), available at <https://www.financial-planning.com/news/finra-fines-axa-over-financial-advisor-arbitration-recording-on-annuities>.

⁶ Proposed Rule 4111(i)(4)(C)(ii).

the firm's internal review, yet this internal review would not have been considered under the Proposed Rule as currently drafted.

These issues need to be considered as criteria for identifying Restricted Firms under the Proposed Rule.

IV. The Proposed Rule should include flexibility to designate Restricted Firms outside of annual calculations.

Under the Proposed Rule, FINRA would identify Restricted Firms based on numerical thresholds calculated annually. While the numerical calculations in the Proposed Rule may be helpful to narrow the field, such a rigid approach risks failing to identify some member firms that pose serious risk to investors.

For example, a member firm may have compliance issues that are not disclosed, but are nonetheless brought to light in examination findings, regulatory enforcement actions, and the large-scale migration of brokers from expelled or troubled firms. Such serious issues demand immediate action, and investors should not be required to remain in harm's way until the next calendar year. Additionally, the predictable annual calculation based on rigidly defined metrics may provide an incentive for member firms to comply only enough to remain just below the triggering thresholds. Minimal compliance suggests a weak compliance culture, and these firms should be included within the scope of the Proposed Rule.

FINRA should supplement its calculations with a more flexible approach, similar to IIROC's "terms and conditions" rule. A more flexible approach would allow FINRA to impose obligations other than annually when new information comes to light that demands immediate action, instead of a wait-and-see approach. It would also allow FINRA to consider member firms within a certain range below the thresholds, thereby mitigating the problem of minimal compliance. Finally, a more flexible approach would allow FINRA to consider member firms with historical misconduct that is concentrated in certain branches or offices of supervisory jurisdiction. Concentrated or localized misconduct will be diluted in the context of a large firm, but may nonetheless be indicative of localized problems that demand additional attention.

V. FINRA should notify state regulators of Restricted Firms registered in their states.

My office and other state securities regulators have long been on the front lines in the fight to protect investors from fraud, abuse, and conflicted financial advice. While self-regulators play an important role in regulating the industry, the states have a strong and focused interest in being informed about the member firms that pose the most risk to our investors. State regulators can use that information to set examination priorities, and may pay extra attention to investor complaints regarding those firms. When a broker with a history of misconduct seeks state registration with a Restricted Firm, the state can consider whether investors in that state will

be adequately protected under the Proposed Rule or whether the state will need to impose its own conditions and restrictions.

Both FINRA and the states owe it to investors to ensure that the Proposed Rule is as effective as possible. Notifying state regulators of Restricted Firms in their states will result in a stronger rule, better allocation of resources, and more eyes on the riskiest member firms. In the end, investors will benefit.

The Proposed Rule is a positive first step toward protecting investors from the riskiest corners of the brokerage industry. I strongly urge FINRA to consider these changes to the Proposed Rule in order to make it more effective for investors everywhere. Please contact me or Diane Young-Spitzer, Acting Director of the Massachusetts Securities Division, at (617) 727-3548, if you have questions or we can assist in any way.

Sincerely,



William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts