PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION
1225 West Main Street, Suite 126 | Norman, OK 73069
Toll Free (888) 621-7484 | Fax (405) 360-2063
www.piaba.org

July 1, 2019

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506
pubcom@finra.org

RE: 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

Dear Ms. Piorko Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to investor protection.

PIABA generally supports the adoption of FINRA Rule 4111 (Restricted Firm Obligations) as well as the accompanying new Rule 9559 (Procedures for Regulating Activities Under Rule 4111). As FINRA noted in Regulatory Notice 19-17: "The proposal would further promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards." This is consistent with PIABA's goals of promoting the interests of investors and investor protection. We applaud all steps that regulators take in furtherance of those goals, but the problem that high-risk firms and high-risk brokers create is enormous. While we generally support the rules for what they will do to strengthen the regulation and compliance of high-risk firms and brokers, with the noted exceptions below, Rules 4111 and 9559 will not cure the long-standing unpaid arbitration award issue and we are concerned it is misleading to those interested in the unpaid arbitration award issue to suggest otherwise.

The proposed rules would create a multi-step process to strengthen regulation of high-risk firms. First, the process identifies "Restricted Firms" that meet quantifiable Preliminary Identification Metrics. FINRA's threshold is based on firm size and number of disclosure events. After opportunity for further Department evaluation and consultation with the firm, the rule authorizes FINRA to require identified Restricted Firms to deposit cash or qualified securities that may not be withdrawn without FINRA's prior written consent ("Restricted Deposit Account"). FINRA may also require adherence to other conditions or restrictions on the member's operations deemed necessary to protect investors and in the public interest.

Proposed FINRA Rule 4111 begins to address a number of issues affecting public investors unfairly harmed by bad actors in the industry, in particular recidivist individuals and firms. But it has significant shortfalls that should be corrected before adoption. We address the following, and additional comments, in further detail:

(1) The proposed rule does not come close to resolving the epidemic of unpaid FINRA arbitration awards;
(2) The threshold calculations used to designate "Restricted Firms" highlight the problems with expungement of customer dispute information – FINRA cannot deem a firm "High Risk" if the settled customer complaints are routinely erased from the CRD system;
(3) There are meaningful questions regarding the nature and extent of FINRA's discretion in applying and enforcing the proposed rules; and
(4) The predictive model used to identify "Restricted Firms" is unduly narrow insofar as it focuses exclusively on firm size and reporting history, and does not address the nature of the products being sold by the member. Accordingly, the proposed rule does not address the common problem of a single product (or product type) raising a host of arbitration claims, and awards, which serve to bankrupt the member.

Unpaid Arbitration Awards

As FINRA is aware, the problem of uncollectable firms and registered representatives is a significant one and something that PIABA has worked hard to address. As we have stated repeatedly, if FINRA arbitration is to promote confidence in the markets and be perceived as a fair alternative to jury trials, investors who go through the process and receive an award must be able to collect that award.

We therefore noted with interest the last sentence of Regulatory Notice 19-17, which reads:

The proposal would further promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and ***to pay arbitration awards.*** (Emphasis added).

Recent press surrounding the proposed rule goes even further. According to an Investment News editorial dated May 11, 2019, FINRA "finally may have come up with a fair way to ensure that investors who win arbitration awards actually receive them."[1] The editorial piece highlights the misleading nature of suggesting the rule is a mechanism to resolve the unpaid arbitration award issue.

While it is true that a small number of firms[2] would be required to set aside some sum of funds (so long as it would not cause an undue burden on the firms' operations), we do not see anything in the rule

[1] "*FINRA plan to address unpaid arbitration award problem deserves fair hearing*" InvestmentNews, (May 11, 2019), available at: https://www.investmentnews.com/article/20190511/FREE/190519995/finra-plan-to-address-unpaid-arbitration-award-problem-deserves-fair
[2] In the Regulatory Notice, FINRA noted that "1.6-2.4% of all firms registered with FINRA in any year during the review period," or 60 – 98 firms, would have met the criteria subjecting the firms to the rule's coverage. Regulatory Notice 19-17, p. 25.

proposal that attempts to square the sums to be set aside with the unpaid arbitration award experience. Stated differently, we have seen no data that shows the sums set aside will be sufficient to cover anticipated arbitration awards. To the contrary, the language in the proposed rule limiting the amount FINRA can require a high-risk firm to set aside to a sum that will "not significantly undermine the continued financial stability and operational capability of the member as an ongoing enterprise over the next 12 months"[3] means that the more thinly capitalized a firm, the smaller amount FINRA would require the firm to put in the Restricted Deposit Account. Such a limiting feature would necessarily result in it having a very minimal impact on unpaid awards.

In further support of this conclusion, PIABA has reviewed the list of firms with unpaid awards between 2013 and 2017, available on FINRA's website, and calculated the unpaid award amount for each firm.[4] Half of the firms listed appear to have 2 or more unpaid awards. More than 85% of the firms have unpaid awards of $100,000 or more. Forty percent of the firms have unpaid awards in excess of $1 million. Requiring those firms to deposit small sums in a Restricted Deposit Account will simply not have a material impact on the issue of unpaid awards. Additionally, we see nothing in the rule proposal that explains why, exactly, the rule would incentivize member firms to pay awards.

While PIABA appreciates any effort to make sure wronged investors are appropriately compensated, to be more effective in combating the unpaid award problem, analysis must be completed to assess the nature and extent of harm that Restricted Firms have done in the past, and more quantifiably use that data in determining the amount of deposits to be required. It may be that the data shows that a restricted deposit size would need to be so significantly large that enhanced additional measures must also be taken for a particular individual or firm for there to be any meaningful impact on unpaid awards.

The proposed rule should also address how aggrieved investors could access those restricted deposits to satisfy the arbitration awards that the Restricted Firms refuse to pay themselves. The proposed rule must also clarify what will happen to a Restricted Deposit Account if a firm goes out of business, in particular if there are outstanding unpaid awards, but also considering that valid customer claims may not be identified until years afterwards. Finally, the proposed rule should clarify that Restricted Deposit Accounts can be used to pay not only unpaid arbitration awards, but unpaid arbitration *settlements* as well.[5]

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[3] Regulatory Notice 19-17, p. 12.
[4] PIABA assumed any awards issued following a firm's termination of membership or within a year prior to the firm's termination were unpaid.
[5] FINRA should be able to track data regarding breach of contract/breach of settlement agreement claims and/or customer communications that a member firm or associated person has failed to pay a settlement agreement in further violation of FINRA rules.

Expungement of Customer Dispute Information under FINRA Rules 2080 and 12805

Proposed FINRA Rule 4111 also calls into question the ongoing problem related to the pervasive nature of expungements. First and foremost, to the extent the threshold analysis to determine "restricted" status reviews a member firm's disclosure history, it is axiomatic that FINRA can only review the disclosures that exist in the record. If customer complaints are expunged, FINRA will be unable to consider those disclosures and potentially miss appropriately designating a recidivist firm as being "Restricted." As PIABA has pointed out a number of times, expungements are granted all too frequently, and in violation of FINRA's attempts to ensure expungement is an extraordinary remedy, rather than the norm as it exists today.

PIABA first reported on the issue on September 24, 2007, and found that expungement was granted in 98.4% of the cases. PIABA next reported on the issue in 2013 in a report titled "Expungement Study of the Public Investors Arbitration Bar Association."[6] The 2013 study found that, for awards issued from May 18, 2009, through December 31, 2011, expungement was granted 96.9% of the time it was requested in cases resolved by settlement or stipulated awards. PIABA then updated its analysis in 2015 in a report titled simply "Update to the 2013 Expungement Study of the Public Investors Arbitration Bar Association."[7] The update found that, for cases filed from January 1, 2012, through December 31, 2014, expungement was granted in 87.8% of the cases.

In short, despite FINRA's attempts to curb the problem of rampant expungements, the problem remains unabated with only very small progress having been made on this issue over the last decade. Which leads us to the second problem related to expungements: FINRA member firms can avoid being labeled "Restricted Firms" if they sanitize their records. The proposed rule therefore will have the likely and unintended consequence of further incentivizing member firms and registered representatives to pursue expungement of customer complaints. Accordingly, to the extent FINRA contemplates the proposed rule, PIABA urges FINRA to simultaneously pursue meaningful expungement reform.

FINRA Discretion

While PIABA understands the need for a certain amount of flexibility in the application of the proposed rule, we question the extent it should be allowed. For example, proposed FINRA Rule 4111(h) states that (emphasis added): "FINRA *may* issue a notice pursuant to Rule 9559(b) directing a member that is not in compliance with the Restricted Deposit Requirement or the conditions or restrictions imposed by this Rule to suspend all or a portion of its business." We question why the discretion is permitted in the event a member has failed to abide by the rules' strictures. The non-compliant member is, by definition, a high-risk one. Accordingly, we cannot conceive of a good reason a high-risk firm would be allowed to continue its business unabated despite its violation of the rule. Instead, a non-compliant firm should be subject to immediate suspension. Accordingly, this section of the rule should state that "FINRA shall … suspend all of its business."

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[6] Available at https://piaba.org/system/files/2018-01/REPORT%20-%20Expungement%20Study%20of%20the%20Public%20Investors%20Arbitration%20Bar%20Association.pdf

[7] Available at: https://piaba.org/sites/default/files/newsroom/2015-10/Update%20on%20the%202013%20Expungement%20Study%20of%20PIABA%20%28October%2020%2C%202015%29.pdf .

The Predictive Model Is Too Narrow

FINRA's proposed rule uses history as a guide to future performance by focusing the threshold analysis on member firm reported events as a trigger for application of Restricted Firm status. Despite the admonishment that past performance is not a guarantee of future performance, the data identified by FINRA *does* support the concept that the more bad actors employed by a member firm, the more likely sales abuses will take place in the future.[8] But limiting the analysis as the proposed rules would require ignores the all-too-common problem presented by product failures. High-risk firms will often focus a large percentage of their business on selling particular products, commonly non-publicly traded investments. A failure of such a product will bring a rash of claims. And, in the event the member firm bears culpability for the sale of the products (such as UBS with Puerto Rico municipal bonds or Securities America with Medical Capital), the resulting liabilities can destroy the firm and leave investors without recourse. Securities America threatened to do exactly that when it testified, in court, that the failure to approve a minimal class action settlement would result in its bankruptcy over the following weekend.[9] Any threshold analysis must therefore consider the nature of the products sold by the member firms, and the extent to which it sells said products. If FINRA is truly trying to protect against risky behavior, the member firms' actual ongoing sales behavior must be factored into the analysis.

Additional Comments

The proposed rule would allow a restricted firm to deposit cash or "qualified securities" to meet the firm's obligation. However, the proposed rule lacks a mechanism to address the changing value of those securities. If the securities drop in value, will the firm be required to supplement the value? If the securities increase in value, will the firm be allowed to withdraw the excess value? FINRA should address the frequency of the Restricted Deposit Account valuation and establish rules requiring the account replenishment.

It is clear that FINRA put considerable time, effort, and thought into proposed Rule 4111, and the particular metrics to determine "Restricted Firm" status. We question, however, what happens when the product of a particular metric applied to a particular firm size results in a fraction. For example, the "Registered Person Adjudicated Event Metric" is .3 for firms of between 5 and 9 people. Accordingly, if the firm was comprised of 6 registered representatives, the trigger would seem to be 1.8 (the product of .3 and 6). Would it take 1 event to satisfy that trigger, or will FINRA round up and require 2 events? Clarification is needed regarding how such rounding issues will be addressed.

Conclusion

Once again, PIABA acknowledges and appreciates the considerable time and effort FINRA put into RN 19-17 and its proposed rule changes. We urge FINRA to put the rule into context and acknowledge that it is

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[8] *See* McCann, Qin, and Yan *"How Widespread and Predictable is Stock Broker Misconduct?"* Journal of Index Investing, Summer 2017, Vol. 26, Issue 2, Pp. 6-25, available at: https://www.slcg.com/pdf/workingpapers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck%20Final.pdf;

[9] *See* Susanne Craig, "*Judge Backs Arbitration in Case Against Securities America*," Dealbook, March 18, 2011, available at: https://dealbook.nytimes.com/2011/03/18/judge-backs-arbitration-in-securities-america-case/

an incremental step toward protecting public investors from high-risk firms. However, despite its good intentions and FINRA's commendable efforts, absent meaningful changes, the proposed rule could well have the unintended consequence of making the expungement problem worse. Moreover, while the clear purpose of the proposed rule is to better regulate high-risk firms and brokers, we strongly urge FINRA to acknowledge that it is not likely to have a meaningful impact on resolving the unpaid arbitration award issue or, in the alternative, provide sufficient data to support the impact of the new rule on unpaid arbitration awards. PIABA simply does not want to see a well-intended rule be tainted or misused by those seeking to give it attributes it will not have. We thank you for the opportunity to comment on the proposed rule, and urge FINRA to consider the issues set forth above before any final version is adopted.

Sincerely,

Christine Lazaro
President

Samuel B. Edwards
Executive Vice-President