



## PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION

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

December 28, 2020

Ms. Vanessa Countryman, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090  
rule-comments@sec.gov

**Re: SR-FINRA-2020-041 - Proposed Rule Change To Adopt FINRA Rule 4111  
(Restricted Firm Obligations) and FINRA Rule 9561 (Procedures for  
Regulating Activities Under Rule 4111**

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate 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 both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews in order to protect the rights and fair treatment of the investing public.

In general, PIABA supports SR-FINRA-2020-041, which proposes to adopt FINRA Rules 4111, 9561 and Capital Acquisition Broker Rule 412 and amend FINRA Rule 9559 and Funding Portal Rule 900(a) regarding the treatment and obligations of “Restricted Firms” (“Rule Proposal”). In particular, Rule 4111 would categorize member firms that have significantly higher levels of risk-related disclosures than similarly sized peers as “Restricted Firms” and impose certain obligations on those firms. Such obligations may include requiring a member firm to maintain a specific deposit amount, with cash or qualified securities in a segregated account at a bank or clearing firm, from which the member firm could make withdrawals only with FINRA's approval (“Restricted Deposit Account”). The obligations also may include conditions or restrictions on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the preliminary identification criteria used by FINRA to determine if a member firm qualifies as a Restricted Firm.

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PIABA is a firm supporter of FINRA's efforts to enhance its programs to address the risks posed to investors by individual brokers and member firms that have a history of misconduct. The proposed changes in SR-FINRA-2020-041 are a step toward that end, however, the proposed measures do not do nearly enough to discourage bad actors from engaging in misconduct nor purge the securities industry of member firms and brokers with a history of misconduct that, by FINRA's own admission,<sup>1</sup> may be predictive of future misconduct. Further, while the proposed Rule allows FINRA to consider outstanding unpaid arbitration awards and settlements as criteria when designating a firm as a Restricted Firm, the Rule fails to establish a remedy, such as, by way of example, requiring these outstanding debts to be paid by the firm prior to depositing funds into a Restricted Deposit Account to cover future obligations, which could preclude the need to consider such criteria in the first place. Finally, PIABA also must reiterate its grave concerns that expungement of customer disputes from firms' and brokers' industry records – which remains rampant and predominantly unchecked – will adversely affect FINRA's ability to determine whether a firm should be deemed Restricted, yet the Rule Proposal offers no remedy for the skewed data that FINRA will rely upon in its deliberations.

### **The Rule Proposal Seeks to “Incentivize” Compliant Behavior Rather than Enforce Compliance**

As FINRA noted, the member firms affected by the Rule Proposal often fail to meet their supervisory obligations and persistently employ brokers who engage in misconduct. FINRA asserted that the Rule Proposal was intended to “incentivize” these firms to engage in more rigorous supervision of their problematic brokers:

The proposed rule is intended to place additional restrictions on identified firms and increase scrutiny by these firms on their brokers. As a result, FINRA anticipates that the proposed rule will reduce the risk and associated costs of possible future customer harm and lead to improvements in the compliance culture, relative to the economic baseline of the current regulatory framework. The proposed rule is intended to create incentives for firms and brokers **to limit or end practices** that result in customer harm and provide increasing restrictions on those that choose not to alter their activities. (Emphasis added.)<sup>2</sup>

It is laudable, and indeed imperative, to encourage firms and brokers with a history of misconduct to improve their compliance culture and supervisory efforts, and PIABA supports the additional conditions and restrictions that FINRA may impose on Restricted Firms. PIABA is supportive of FINRA including a non-exhaustive list of examples of such conditions and restrictions within the Supplementary Material to the proposed Rule. However, investors are still left vulnerable to such firms and brokers. FINRA has determined that these firms represent a heightened risk to the investing public, yet by keeping this information private, FINRA is preventing investors from making informed decisions about those with

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<sup>1</sup> FINRA's 2015 study published by the Office of the Chief Economist found that past disclosure events, including regulatory actions, customer arbitrations and litigations of brokers, have significant power to predict future investor harm.

<sup>2</sup> Proposed Rule Change To Adopt FINRA Rule 4111 (Restricted Firm Obligations) and FINRA Rule 9561 (Procedures for Regulating Activities Under Rule 4111), 85 Fed. Reg. 78540, 78563 (Dec. 4, 2020) (“Rule Proposal”).

whom they are investing. FINRA should reconsider its decision to keep a firm's designation as a Restricted Firm private, especially if a firm is so designated for a period of time exceeding one year.

### **The Rule Should Clarify How Awards and Settlements May Be Paid From the Restricted Deposit Account**

As FINRA is aware, the problem of uncollectable arbitration awards from member firms and registered representatives is a significant one and an issue that PIABA has worked diligently 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 are forced through the process and receive an award must be able to collect that award. In the same vein, there must be a mechanism that ensures firms will abide by the settlement agreements they enter into in resolution of customer disputes.<sup>3</sup>

It appears that, in direct response to PIABA's comments on Regulatory Notice 19-17, FINRA has taken the position that the Rule Proposal is not intended to remedy investors' inability to collect on awards or settlements. FINRA repeated throughout the Rule Proposal:

FINRA believes that a financial requirement is the measure most likely to motivate Restricted Firms to change behavior. As such, the Restricted Deposit Requirement is an essential feature of the proposal to protect investors, *with the possible secondary benefit* of helping to address the issue of unpaid arbitration awards.<sup>4</sup>

As noted in PIABA's comment to Regulatory Notice 19-17, 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"<sup>5</sup> means that the more thinly capitalized firms may not be required to deposit funds sufficient to cover outstanding awards and settlements, let alone "Covered Pending Arbitration Claims." Since unpaid and anticipated awards are used as criteria to determine Restricted status and the maximum deposit required by a Restricted Firm, it is axiomatic that the maximum deposit should at the very least cover those criteria.

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.<sup>6</sup> 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

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<sup>3</sup> We note that FINRA has included unpaid settlements related to arbitrations within the definition of "unpaid arbitration awards." See Rule Proposal, p. 78542, fn. 11.

<sup>4</sup> Rule Proposal, p. 78540 (emphasis added).

<sup>5</sup> Regulatory Notice 19-17, p. 12; Rule Proposal, p. 78545.

<sup>6</sup> PIABA assumed any awards issued following a firm's termination of membership or within a year prior to the firm's termination were unpaid.

small sums in a Restricted Deposit Account will simply not have a material impact on the issue of unpaid awards or settlements.

Additionally, we see nothing in the rule proposal that explains why, exactly, the rule would incentivize member firms to pay awards. The Rule Proposal does not mandate that outstanding awards or settlements be paid at all, merely considered as factors when (1) determining the maximum amount to be deposited by a Restricted firm, and (2) determining whether to allow a firm to withdraw funds for another purpose.<sup>7</sup> In fact, it seems that, even if a current member firm<sup>8</sup> funds a Restricted Deposit Account, there is no assurance that FINRA would approve such funds to be used to satisfy unpaid awards or settlements and instead demand that the firm find the money elsewhere. *See, e.g.*, Rule Proposal, p. 78565 (“The presumptions of denial that would apply when a Restricted Firm ... applies for a withdrawal from a Restricted Deposit would still apply when the firm seeks to use the funds to satisfy unpaid arbitration awards; unless the presumption of denial can be overcome, those firms would generally need to satisfy unpaid arbitration awards using funds other than those in a Restricted Deposit Account.”) Thus, even after a firm has funded its Restricted Deposit Account, there is no guarantee that the funds will be used to pay outstanding arbitration awards or settlements.

The proposed rule should address how aggrieved investors can access those restricted deposits to satisfy the arbitration awards that the Restricted Firms refuse to pay themselves. While the Rule Proposal addresses the rebuttable presumption that a former member firm may withdraw funds to pay an outstanding award or settlement, the proposed Rule should address how an investor may access these funds if the former firm refuses to apply for a withdrawal, or if no one from the former firm is available to make such a request on behalf of the investor.

Further, the fact that FINRA will not make public that a firm is Restricted may mean that an investor with an unpaid award or settlement is not aware that the Restricted Deposit Account even exists. To the extent the funds in the account are available to satisfy unpaid arbitration awards and settlements, that can only be accomplished if investors are aware that there are funds available from which such awards and settlements may be satisfied. For this reason, as well as those stated above, FINRA should make investors aware when a firm is designated as a Restricted Firm.

### **Expungement of Customer Dispute Disclosures Will Skew the Data FINRA Relies Upon to Determine Whether a Firm Should be Restricted**

Proposed FINRA Rule 4111 also calls into question the ongoing problem related to the pervasive nature of expungement of customer disputes. First and foremost, to the extent the threshold analysis to determine “restricted” status reviews a member firm’s disclosure history, FINRA can only review the disclosures that exist in the record; if customer complaints are expunged, FINRA will be unable to consider the full breadth of relevant disclosures and likely overlook certain firms and brokers who are recidivists and should be designated “Restricted,” yet have expunged their records. According to a report devoted to

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<sup>7</sup> *See* Rule Proposal, p. 78542.

<sup>8</sup> It is only if the firm is no longer a member that there is a rebuttable presumption that the withdrawal will be used to pay outstanding awards or settlements.

the issue of expungement in the securities industry, “successful and, to a greater extent, unsuccessful expungement attempts, are a significant predictor of future misconduct.”<sup>9</sup> “Roughly one-third of advisers with misconduct are repeat offenders. Prior offenders are five times as likely to engage in new misconduct as the average financial adviser.”<sup>10</sup> Despite this predictive quality, customer dispute disclosures are expunged regularly. As PIABA has pointed out, expungements of customer disputes 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’s 2013 report entitled “Expungement Study of the Public Investors Arbitration Bar Association,”<sup>11</sup> 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.”<sup>12</sup> 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 2019, PIABA published a study that noted, “From 2015-2018, there has been an explosive increase in the filing of what are known as “Expungement-Only” cases, which rose 924% from 2015 to 2018.... ¶ The 2,194 customer complaints contained in 1,078 arbitration proceedings that brokers requested be expunged increased by 1016% from 2015 to 2018. One individual broker successfully requested that twenty-four (24) complaints be expunged in a single proceeding.”<sup>13</sup> 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.

This creates serious concerns regarding the efficacy of FINRA’s ability to discern whether a firm should be Restricted, because member firms and its brokers can sanitize their records.

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<sup>9</sup> Honigsberg, C. and Jacob, M., “Deleting Misconduct: The Expungement of BrokerCheck Records” (Nov. 14, 2018), p. 2 (“Honigsberg Report”), p. 1.

<sup>10</sup> Egan, M., Matvos, G. and Seru, A., “The Market for Financial Adviser Misconduct” (Sept. 1, 2017), *Journal of Political Economy*, Forthcoming, p. 1 (“Egan Report”); <https://ssrn.com/abstract=2739170> or <http://dx.doi.org/10.2139/ssrn.2739170>. *See also* Honigsberg Report, p. 15 (“just over 16% of brokers with an unsuccessful expungement received another allegation of misconduct after the expungement – for comparison, only 4% of non-expungement brokers receive an allegation of misconduct”).

<sup>11</sup> Available at <https://piaba.org/system/files/2018-01/REPORT%20-%20Expungement%20Study%20of%20the%20Public%20Investors%20Arbitration%20Bar%20Association.pdf>

<sup>12</sup> 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>.

<sup>13</sup> Doss, J., Braganca, L. “2019 Study on FINRA Expungements: A Seriously Flawed Process that Should be Stopped Immediately to Protect the Integrity of the Public Record.”

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. Although FINRA acknowledged PIABA's concerns regarding expungements, it asserted that "FINRA believes, however, that the data reported on the Uniform Registration Forms is reliable enough on which to base proposed Rule 4111."<sup>14</sup> FINRA further asserted:

FINRA recognizes that the number of expungement requests may increase as a result of this proposal. However, the existing regulatory framework and FINRA rules are designed to ensure that expungements are granted only after a neutral adjudicator (arbitrator or judge) concludes that expungement is appropriate.

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Accordingly, FINRA does not believe that the proposal would directly result in inappropriate expungements being granted or appropriate expungements being not granted, or that it would undermine the quality of the underlying CRD information used for the proposed metrics.<sup>15</sup>

Although PIABA disagrees with FINRA's conclusions, PIABA recognizes that FINRA has made strides to reform the expungement process and supports FINRA's continuing efforts to address this serious issue.<sup>16</sup>

### **Other Considerations**

1. PIABA reiterates its concerns that the Rule does not account for an analysis related to failed products. Limiting the analysis as the proposed rule does 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.<sup>17</sup> 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.

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<sup>14</sup> Rule Proposal, p. 78561.

<sup>15</sup> Rule Proposal, p. 78561.

<sup>16</sup> See, e.g., Rule Proposal, p. 78561, fn. 130 re: proposed amendments to the FINRA *Code of Arbitration Procedure*.

<sup>17</sup> 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/>

2. The Rule Proposal is intended to address “certain firms that have a concentration of associated persons with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities.”<sup>18</sup> However, the Rule Proposal allows firms a one-time staff reduction option to stave off Restricted status. It is unclear how this is designed to “deter and remedy misconduct by member firms and the individuals they hire.” Rather than incentivize member firms to diligently monitor and supervise its brokers, it incentivizes them to discharge the “low hanging fruit” and continue business as usual. It is unclear how this services FINRA’s mission to protect investors or market integrity.

3. The term "Covered Pending Arbitration Claim" is defined in proposed Rule 4111(i)(2) as:

[A]n investment-related, consumer-initiated claim filed against the member or its associated persons in any arbitration forum that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. The claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees, and shall be the maximum amount for which the member or associated person, as applicable, is potentially liable regardless of whether the claim was brought against additional persons or the associated person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for all or part of such maximum amount. This term conforms, in relevant part, to the definition of Covered Pending Arbitration Claim in Rule 1011(c). *See* Securities Exchange Act Release No. 88482 (March 26, 2020), 85 FR 18299 (April 1, 2020) (Order Approving File No. SR—FINRA-2019-030).<sup>19</sup>

The fact that a claim is only covered if it exceeds a firm’s excess net capital improperly excludes claims that are less than a firm’s excess net capital yet may still remain unpaid by the firm. Further, because the designation as Restricted occurs based on a snapshot of the firm as of a particular date, and the restricted deposit requirement is likewise determined based on fixed point in time, a firm may be able to manipulate whether an arbitration claim is covered simply by adjusting its excess net capital while FINRA is determining the restricted deposit requirement. Allowing the firm such control would undermine the purpose of the rule proposal.

4. The Rule Proposal fails to address the issue of fluctuating valuation of “qualified securities” deposited into the Restricted Deposit Account in lieu of cash. Asserting that the “qualified securities” have an aggregate value that is not less than the member’s Restricted Deposit Requirement (“except in certain identified situations”) presupposes the value of the securities at the time they are deposited; there is no guarantee that the securities will retain that value up to the time they are redeemed to pay an outstanding debt by the firm, and there is no mechanism in the Rule Proposal to ensure the Restricted Deposit Account maintains its valuation between FINRA reviews. Therefore, the Rule Proposal should address the frequency of the Restricted Deposit Account valuation and establish rules requiring account replenishment as necessary.

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<sup>18</sup> Rule Proposal, p. 78541.

<sup>19</sup> Rule Proposal, pp. 78541-2, fn. 10.

### **Conclusion**

Once again, PIABA acknowledges and appreciates the considerable time and effort FINRA put into the Rule Proposal and in addressing the questions and comments made to its precursor, Regulatory Notice 19-17. While PIABA supports FINRA's continuing efforts to build and strengthen the tools available to protect investors against unscrupulous member firms and securities professionals, much more must be done to ensure high-risk bad actors are held accountable for prior misconduct, such as ensuring the payment of outstanding arbitration awards and settlements, taking account of product failures, and successfully culling bad actors from the securities industry before they can take advantage of unsuspecting investors. There remains a concern that the Proposed Rule could 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 consider the additional changes set forth herein.

We thank you for the opportunity to comment on the Rule Proposal and urge FINRA to consider the issues set forth above before any final version is adopted.

Sincerely,

A handwritten signature in blue ink, appearing to read "David P. Meyer", with a stylized flourish at the end.

David P. Meyer,  
PIABA President