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Public Investors Arbitration Bar Association

July 29, 2013

Via Email Only

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: SR-FINRA-2013-025 – Proposed Rule Change To Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook

Dear Ms. Murphy,

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 securities and commodities arbitration forums, while also advocating for public education regarding investor rights. Our members and their clients have a profound interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") to govern the conduct of securities firms and their representatives. These rules are in place primarily to protect the nation's investors and savers, as well as to provide a minimum industry standard upon which the public and regulators can rely.

PIABA supports FINRA's efforts to consolidate existing National Association of Securities Dealers ("NASD") and New York Stock Exchange (NYSE) supervisory rules as its own rules. PIABA commends FINRA for clarifying and strengthening the express provisions of proposed Rule 3110 with respect to one-person OSJs and supervision of multiple OSJs by a single principal and supplementary material paragraphs .03 and .04. However, the proposed amended rules (the "Proposed Rules") do not do enough to ensure adequate supervision or record retention for the protection of investors. Portions of the Proposed Rules stray beyond mere consolidation and actually weaken protections for the investing public. Troublingly, we note that, in certain instances, the Proposed Rules enlarge existing grey areas and make securities firms' responsibilities for their personnel even more vague than under the current standards. By introducing greater uncertainty into the rules and removing clear bright line requirements, the Proposed Rules diminish the investing public's

ability to hold broker/dealers accountable for violations of rules, regulations and laws. Securities firms' near universal insistence on pre-dispute arbitration agreements specifying the FINRA arbitration forum further compounds the potential harm to investors by each additional degree of vagueness and uncertainty introduced. Because public investors do not generally have access to courts of law which may provide controlling guidance on the interpretation of rules and the scope of obligations, investors and industry members often face the Sisyphean task of proving the same obligations again and again.[1] We are concerned that a misplaced desire for flexibility may lead to reduced and diminished supervision and harm to the investing public. We strenuously oppose any changes that reduce the protection of the investing public or that make proof of misconduct more difficult.

To the extent that FINRA seeks to achieve its stated "core mission[s]" of "investor protection and market integrity" by "overseeing virtually every aspect of the brokerage industry", it must move to clarify and strengthen its supervisory rules and guidance and also improve its currently inadequate rules governing the creation, retention and destruction of records.[2] PIABA encourages the Securities and Exchange Commission ("SEC") to actively oversee these changes and to request additional rules and guidance providing bright line rules to protect investors. Our specific concerns with respect to these two areas are detailed below.

Comments Regarding the Supervisory Rules

PIABA strongly encourages the SEC to require FINRA to implement clearer standards governing securities firms' supervision of their associated persons. Public investors place their trust in industry personnel because of their affiliation with established securities firms. Cloaked in securities firms' apparent authority and prestige, associated persons all too often place their own financial interests ahead of the best interests of the investing public. Adequate investor protection cannot be achieved without requiring securities firms to supervise associated persons adequately.

In this vein, we request that the SEC exercise its supervisory authority to require FINRA to ensure adequate investor protection in at least the following additional ways: (i) clarifying amorphous "risk-based" standards; (ii) requiring

[1] *See* Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 992-93(2002) (finding that because of mandatory pre-dispute arbitration agreements, "courts have had few opportunities to generate relevant precedent" because courts have had substantially fewer opportunities to adjudicate disputes).

[2] FINRA, *About the Financial Industry Regulatory Authority* (visited July 18, 2013), available: http://www.finra.org/AboutFINRA/.

heightened supervision of any associated person who reaches a certain threshold of customer complaints; (iii) requiring securities firms to supervise withdrawals from investor accounts in certain circumstances, particularly where several clients of the same associated person withdraw large amounts of money at the same time; and (iv) requiring firms to supervise outside business activities of the representative.

"Risk-Based" Review and Examination

Proposed FINRA Rule 3110 employs the terms "risk-based review", "risk-based principles", and other "risk-based" qualifiers with respect to critical investor protection functions without providing any clear bright line criteria for assessing whether supervisory systems meet minimum standards. See Proposed FINRA Rule 3110(c)(2)(B) and Supplementary Material paragraphs .06 and .07. By way of explanation, the Proposed Rule Change vaguely states that "risk-based approach for specified aspects of a member's supervisory procedures is intended to allow firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concerns may be warranted." (Proposed Rule Change at 30.) We fear that flexible "risk-based" systems designed to accommodate different "business models" may be improperly accommodating "business models" which produce profits by cutting compliance and investor protection out of the business. In many instances, the "need" for "risk-based" systems may be illusory because the real need may be for member firms to invest in adequate compliance personnel and training.[3]

For example, Proposed FINRA Rule 3110(b)(2) and Supplementary Material .06 provide that a FINRA member may use "risk based" systems to review transactions related to a member's investment banking or securities business. The Proposed Rule Change claims that dues-paying FINRA "members may need to prioritize their review processes due to the volume of information" and use "reasonable sampling of information . . to discern the degree of overall compliance[.]" (Proposed Rule Change at 47.) We are concerned that FINRA members may use these provisions to justify sporadic checks or spotty "sampling" methods for ensuring compliance instead of devoting necessary personnel and resources to ensure compliance.

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[3] For a case where this may have been the case, *see* Nathaniel Popper, *Fast-Growing Brokerage Firm Often Tangles With Regulators,* N.Y. Times (March 21, 2013) at A1, available: http://www.nytimes.com/2013/03/22/business/as-lpl-financial-expands-scrutiny-of-its-practices-intensifies.html?pagewanted=all ("high commissions leave LPL less money for compliance and can attract brokers interested in skirting the rules.").

As we mentioned in our July 20, 2011, letter on this subject,[4] we are concerned that "risk-based" supervision will focus on risks to the broker/dealer and not on risks to investors. Moreover, securities firms may attempt to deny supervisory fault after this "risk-based" review system goes awry by contending that they fulfilled their obligations by creating a "risk-based" review system which, unfortunately, will not capture many manifested risks affecting consumers. In response to our concerns, FINRA contends that the "risk-based approach for specified aspects of a member's supervisory procedures is intended to increase, not diminish, investor protection by allowing firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concern may be warranted." (Proposed Rule Change at 35.)

To the extent that "risk-based" approaches provide an additional layer of supervision above present requirements, PIABA supports the move to increase investor protection. Nonetheless, we remain concerned that FINRA's proposed move toward "risk-based" standards may actually erode and displace existing investor protections by making it more difficult for investors and arbitrators to determine whether a supervisory system fulfilled the rules' requirements.

Increased Supervision after Repeated Customer Complaints

At present, FINRA's supervisory rules impose no additional obligation to more closely monitor likely bad actors. When multiple investors have complained about a particular associated person, securities firms have effective notice that serious problems may exist. Effective investor protection requires that securities firms ratchet up their supervision, training, and oversight to address likely problems.

The benefits to investors substantially outweigh the slight additional burden of requiring additional supervision and oversight for associated persons with a history of customer complaints. A decade ago, the NASD proposed this common sense reform to improve investor protection.[5] For reasons that remain unclear, neither the NASD nor FINRA ever acted on the proposal. At that time, the NASD released statistical information about the distribution of customer complaints among

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[4] Letter from Peter J. Mougey, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (July 20, 2011), http://www.sec.gov/comments/sr-finra-2011-028/finra2011028.shtml.

[5] See NASD, *Notice to Members*, 03-49, available: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003181.pdf

associated persons. The information shows that a very small percentage of associated persons generate multiple complaints:

> The preliminary data show that of the 29,500 persons subject to customer complaints within the last five years, 3.3 percent of all registered persons (22,003 persons) were subject to 1 complaint, .71 percent of all registered persons (4,726 persons) were subject to 2 complaints, .22 percent of all registered persons (1,487 persons) were subject to three complaints, .09 percent of all registered persons (568 persons) were subject to four complaints, and .04 percent of all registered persons (290 persons) were subject to 5 complaints.[6]

Because only approximately one percent of associated persons have two or more customer complaints filed against them within a five-year period, securities firms face a minimal burden to increase their supervision responsibilities for associated persons who generate abnormally high numbers of customer complaints. Accordingly, PIABA requests that the SEC require FINRA to impose heightened supervisory plans for associated persons with an anomalous number of complaints within a five-year period. This reform may appropriately incentivize associated persons to carefully consider whether their recommendations are suitable for a particular investor.

If supervisory responsibility does not increase after repeated customer complaints, securities firms may be able to ignore known problems without any cost. Instead, securities firms may rationally conclude that it makes prudent economic sense to employ associated persons who generate abnormal amounts of customer complaints if they also generate substantial revenues. Our experience shows that securities firms may be making this calculation and continuing to employ brokers who play fast and loose with the rules.

The decision to ignore the need for additional supervisory responsibility is not without cost. At present, the absence of heightened supervisory requirements forces public investors, who reasonably trust and rely on associated persons, to bear the losses created by these customer complaint-generating brokers. Even though securities firms know that particular associated persons generate statistically anomalous numbers of customer complaints, they seek to disclaim responsibility for

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[6] *Id.* at Endnote 4.

the financial wreckage they cause by contending that they complied with "customary" supervisory requirements.

Supervising Suspicious Withdrawals

The SEC should require FINRA to create and implement rules requiring securities firms to actively supervise suspiciously concentrated withdrawals. At present, the current supervision rules impose no explicit obligation on securities firms to supervise repeated suspicious withdrawals.[7] We remain particularly concerned that current supervisory standards fail to require enhanced supervision when several clients of the same broker withdraw large amounts of money at around the same time. It would be difficult to imagine a clearer red flag that a particular broker is selling away from the securities firm or running a Ponzi scheme.

This responsibility must be borne by securities firms, because they alone sit in a position to stop ongoing theft, conversion, and dissipation of investor assets. Securities firms have custody and control over customer accounts, and they alone possess the information needed to disrupt Ponzi schemes and other frauds before they metastasize and cause even greater losses.

Moreover, imposing supervisory responsibility to identify and closely supervise suspicious withdrawals is a nearly costless reform. If anything, enhanced supervision for suspicious withdrawals may help securities firms retain assets already under management and improve profitability. Securities firms already track their assets under management and maintain systems which associate brokers with individual accounts. We encourage FINRA to promptly develop appropriate supervisory rules which appropriately define criteria for identifying suspicious withdrawal patterns and remain committed to providing support and ongoing comments on this issue.

Supervising Outside Business Activities

The SEC should also require FINRA to implement rules regarding the supervision of outside business activities. Under FINRA Rule 3270, associated persons must disclose outside business activities to member firms, and the representative must do so before participating in such activities. It would make sense to require firms to monitor these outside business activities, especially because many incidents of selling away or theft stem from outside business

[7] The Proposed Rules aim to incorporate currently applicable NASD Rule 3012(a)(2)(B) into FINRA Rule 3110(c)(2). This rule contains generally applicable procedures and does not address the concern detailed here.

activities. Since the firm can already place specific conditions on the activities or prohibit the representative from engaging in the activity, pursuant to Rule 3270, Supplemental Material .01, firms should be mandated to supervise such activities.

While FINRA has stated that it would consider addressing NASD Rule 3040 in a separate proposal, Rule 3040 only addresses private securities transactions of representatives. In order to better protect the investing public from theft and selling away, FINRA must address outside business activities as part of its supervisory rules and regulations.

Record Retention and Document Preservation

Record creation, maintenance, and preservation are other components of adequate supervision. We also write to raise concerns about supervisory rule inadequacies in these areas. We initially wrote to FINRA to address these issues on June 13, 2008, and were disappointed that the Proposed Rule Change and the Proposed Rules failed to heed our concerns or provide any principled basis for rejecting our comments.[8] Today, we write to voice our concerns again and highlight the following issues: (i) the Proposed Rules remove responsibility for acknowledging and responding to oral complaints; (ii) the Proposed Rules condone inconsistent periods for customer arbitration claims and document retention; and (iii) the Proposed Rules do not require securities firms to refrain from destroying documents and records about a particular customer account after receiving a customer complaint.

Exclusion of Oral Complaints

As we explained in our July 20, 2011, letter, Proposed FINRA Rule 3110 substantially weakens investor protections by removing the explicit requirement that securities firms acknowledge and respond to oral customer complaints. (Proposed Rule Change at 16; Proposed FINRA Rule 3110(b)(5).) To justify removing this consumer protection, FINRA makes two assertions: (i) that "oral complaints are difficult to capture and assess;" and (ii) oral complaints "raise competing views as to the substance of the complaint being alleged." (Proposed Rule Change at 16.)

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[8] Letter from Lawrence S. Schultz, President, Public Investors Arbitration Bar Association to Marcia E. Asquith, Office of the Corporate Secretary, FINRA (June 13, 2008), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p038775.pdf.

These two asserted concerns do not justify removing the explicit requirement that member firms acknowledge and respond to oral customer complaints. As an initial matter, many FINRA member firms and members of the NYSE have been capturing oral complaints for years without any apparent difficulty. FINRA cannot credibly contend that oral complaints are too difficult to "capture" without explaining why capturing an oral complaint is somehow more difficult than taking a message and writing it down. Once a member firm has "captured" an oral complaint by writing it down, it may be processed in the same manner as any other written complaint. In addition, securities firms frequently record the telephone communications of their brokers. In many instances, a securities firm may simply consult its audiotape to determine whether the message was faithfully transcribed. To the extent that competing views may exist over the substance of the complaint, competing views may also arise with written complaints, yet FINRA has not removed the requirement that its member firms acknowledge and respond to written complaints.

FINRA's member firms may avoid many of these difficulties simply by providing a complaining customer with a complaint form. If the customer does not feel comfortable writing her complaint out, FINRA's member firms may solve the problem simply by writing the complaint down and then asking the customer to verify whether the complaint recorded accurately reflects her concerns.

Oral complaints cannot be excluded because the vast majority of communications between brokers and clients occur orally, typically over the telephone. Unsurprisingly, most complaints will also be voiced orally, as FINRA itself instructs customers to do.[9] In our experience, many unsophisticated customers are not comfortable reducing their thoughts to writing, may not type well, or are otherwise intimidated by the thought of formally writing a letter about a problem. As FINRA does not currently restrict its members to only conducting business with persons possessing a college education or otherwise possessing skill in writing, its members should be obligated to take oral complaints as seriously as written ones and respond to them.

If the SEC approves the current form of Proposed FINRA Rule 3110, FINRA will increase the amount of vagueness existing in its rules. By removing the explicit requirement that member firms acknowledge and respond to oral complaints, FINRA creates uncertainty about what obligations its member firms

[9] FINRA, Avoid Common Investor Problems, (visited July 20, 2013) ("If you believe you have been subjected to unfair or improper business conduct by a securities professional, FINRA encourages you *to voice* your concerns") (emphasis added).

have to address oral complaints. The Proposed Rule Change does not help clarify the extent of member firms' obligations. At the most, the Proposed Rule Change "remind[s] members that the failure to address any customer complaint, written or oral, *may be* a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade)." (Proposed Rule Change at 17 (emphasis added).) If the standards of commercial honor applicable to FINRA member firms require them to acknowledge and respond to oral complaints anyway, no good reason exists for removing the explicit requirement from the rules. Removing it will only serve to reduce investor protection.

Retention of Correspondence and Internal Communications

FINRA rules provide that customer disputes may be arbitrated unless "six years have elapsed from the occurrence or event giving rise to the claim," (Rule 12206(a), FINRA Code of Arbitration Procedure). The Proposed Rule Change introduces inconsistency by authorizing member firms to destroy internal communications and correspondence related to a customer's account after three years. (Proposed FINRA Rule 3110, Supplementary Material .10 (Retention of Correspondence and Internal Communications).)

To explain its decision to maintain a record retention period inconsistent with the time limits for arbitration, FINRA cites 17 C.F.R. § 240.17a-4(b) and claims that "the proposed rule purposefully aligns the record retention period for communications with the SEC's record retention period for the same types of communications *to achieve consistent regulation in this area*." (Proposed Rule Change at pg. 136 (emphasis added).) As an initial point, no inconsistency would arise if FINRA required member firms to keep records relating to a customer account for longer than the bare minimum required by SEC regulations. FINRA's response makes little sense, because it serves only to increase inconsistency, hinder investor protection, and bless the destruction of important documents after the minimum amount of time required under SEC Rules.

FINRA's stated objective of consistency would be better served by a uniform minimum six-year document retention requirement for all documents related to a customer account. Indeed, under the current regulatory structure, securities firms must already retain certain customer account records for at least six years. 17 C.F.R. § 240.17a-4(c) (regulated broker dealers "*shall preserve for a period of not less than six years after the closing of any customer's account . . .* records which relate to . . . the opening and maintenance of the account) (emphasis added). Instead, Proposed FINRA Rule 3110 would allow broker/dealers to destroy correspondence and internal communications after only three years. In fact,

FINRA's three-year retention period may confuse securities firms about which types of documents they may destroy and lead them to destroy documents after three years even though the SEC requires many documents to be kept for at least six years. *See* 17 C.F.R. § 240.17a-4(a), (c).

To be sure, a three-year period increases consistency only if FINRA defines "this area" narrowly as communications and correspondence about a customer account and not customer account documents, generally. Curiously, despite our prior comments on this issue, FINRA's Proposed Rule Change provides no principled explanation for allowing its member firms to destroy documents related to a customer's account before the six-year period for filing an arbitration expires. By blessing the destruction of customer account documents halfway through the arbitration-filing period, FINRA disregards its responsibility to protect investors and only requires its dues-paying member firms to retain records for the shortest possible period applicable under current SEC regulations.

Most troublingly, FINRA's Proposed Rule Change effectively seeks "consistent regulation" at the expense of public investors. (Proposed Rule Change at pg. 136.) When investors rely on FINRA's rule that they may bring an arbitration action within six years of the events giving rise to the claim, they are likely not aware that after three years, FINRA authorizes their securities firm to quietly destroy the evidence they may well need to establish their claim. This betrays investor interests and expectations and, as we pointed out in our July 20, 2011, letter, may significantly impede "the ability of consumers to pursue legitimate claims."[10] The events giving rise to many claims – such as claims for self-dealing, commission seeking, and unsuitable investment advice – may be viewed as taking place at the time the broker sold the unsuitable securities. The risks associated with recommended investments or strategies – risks the investor may never have been warned about – may not even materialize until after more than three years have passed. For example, the so-called dot-com bubble lasted from 1997 to 2000. Investors convinced to invest unsuitably risky securities in 1997 might not have even suffered damages from the unsuitable advice until after three years passed from the time they purchased the unsuitable securities.

As we pointed in our July 20, 2011, letter on this issue, we live in an age of electronic storage.[11] Securities firms incur nearly zero costs by retaining documents for six years instead of three years. To put this in perspective, today, any person

[10] Letter from Peter J. Mougey, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (July 20, 2011), http://www.sec.gov/comments/sr-finra-2011-028/finra2011028.shtml.

[11] Id.

can purchase an external hard drive which will store a terabyte of data for about seventy dollars or less.[12] According to electronic discovery expert Ralph Losey, just one gigabyte of electronic storage may contain about 75,000 pages worth of text, or enough paper to fill a pickup truck.[13] A terabyte contains 1,024 gigabytes, or enough storage for over a thousand pickup trucks worth of documents, each containing 75,000 pages of text. In our experience, even document intensive customer disputes are highly unlikely to approach 75,000 pages of text.

Because electronic storage costs have sunk to be incredibly low and will continue to grow even cheaper, FINRA's failure to require a consistent six-year document retention period reflects a failure to properly weigh the interests of investor protection against the minimal cost associated with a six-year retention period. We strongly urge the SEC to either change its own regulation to a six-year period or require FINRA to alter Proposed FINRA Rule 3110 to provide for a six-year document preservation period which matches the six year eligibility period.

A Need for More Tailored Preservation Obligations

Although a consistent six-year record retention requirement would be the most expeditious way to solve many record retention issues, at the least, FINRA should require securities firms to prevent the spoliation of evidence once it is reasonably foreseeable that an arbitration might be filed. Spoliation is "'the destruction or significant alteration of evidence, or the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation.'" Zubulake v. UBS Warburg LLC, 220 F.R.D. 212, 216 (S.D.N.Y. 2003) (quoting West v. Goodyear Tire & Rubber Co., 167 F.3d 776, 779 (2d Cir.1999)). In ordinary litigation, it is well established that the "scope of a party's preservation obligation can be described as follows: Once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents." Zubulake, 220 F.R.D. at 218.

At present, FINRA's rules do not adequately protect investors from the spoliation of evidence. Even though arbitration may be reasonably anticipated after a customer makes an oral or written complaint, the supervisory rules do not require securities firms to immediately preserve all documents related to an account after a customer files a complaint. When the Supreme Court upheld mandatory pre-

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[12] http://www.amazon.com/Passport-Portable-External-Drive-Storage/dp/B006Y5UV4A/ref=sr_1_1?ie=UTF8&qid=1374189715&sr=8-1&keywords=terabyte+external+hard+drive.

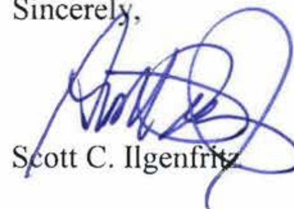
[13] See Ralph Losey, e-Discovery Team, http://e-discoveryteam.com/.

dispute arbitration agreements in Shearson/American Express, Inc. v. McMahon, it relied on the SEC's "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs." 482 U.S. 220, 233 (1987). Although arbitration provides a forum for resolving disputes, ensuring adequate arbitration procedures should include the enactment of rules to prevent the spoliation of evidence once arbitration is foreseeable. We respectfully request that the SEC require, at the very least, that FINRA issue a rule requiring "litigation holds" as soon as arbitration is reasonably foreseeable.

Conclusion

In summary, PIABA appreciates and supports FINRA's commitment to consolidating and streamlining its rules and its strengthening of certain aspects of Proposed FINRA Rule 3110. Although the Proposed Rules contain significant flaws addressed above, PIABA supports the ongoing consolidation of the FINRA rulebook. Nonetheless, PIABA hopes that FINRA will take the opportunity to use this process to not only streamline its rules, but to also ensure effective investor protection and supervisory procedures. PIABA thanks the Securities and Exchange Commission for the opportunity to comment on this proposal.

Sincerely,



Scott C. Ilgenfritz

SCI/dh