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December 21, 2020

Via email

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: **SR-FINRA-2020-041**

Ladies and Gentlemen,

The following comments are provided in response to Securities and Exchange Commission's request for comments on proposed Rule 4111 (Restricted Firm Obligations), which imposes additional obligations on FINRA member firms with a significant history of misconduct.

Preliminary Identification Metrics

The initial premise of the proposed rule is that the Department of Member Supervision (the "Department") would calculate annually a member firm's "Preliminary Identification Metrics" to determine if it meets the "Preliminary Criteria for Identification" based on the "Preliminary Identifications Metrics Thresholds" set forth in proposed Rule 4111(i)(11).

As the criteria and thresholds are intended to be replicable and transparent to FINRA and affected member firms, I suggest that the rule include a requirement that the Department advise each member firm in writing annually what its six Preliminary Identifications Metrics are. I would also suggest that Rule 4111(b) include a date certain (e.g., by February 1) each year when the annual calculation will be made, and Rule 9559(a) include a requirement that each member firm be given notice of the Preliminary Identification Metrics.

While the proposal rule provides that the Preliminary Identification Metric will be computed annually, the rule does not set the date and FINRA states that it would announce the first Evaluation Date no less than 120 calendar days before the first Evaluation Date and subsequent Evaluation Dates would be on the same month and day each year, except when that date falls on a Saturday, Sunday or federal holiday, in which case the Evaluation Date would be

on the next business day. It is unclear why it would make any difference if the Evaluation Date is on a weekend or holiday. In addition, it is unclear why the Evaluation Date is not set at January 1, as annual membership fees are based on a calendar year. There not does not appear to be any logical reason why the first Evaluation Date cannot be fixed as a specific logical date and that FINRA cannot notify firms of their metrics.

While the proposal states that the criteria and thresholds are "intended to be replicable and transparent to FINRA and affected member firms" and the definitions of "Registered Person Adjudicated Events," "Registered Persons Pending Events," Member Firm Adjudicated Events," and "Member Firm Pending Events" in 4111(i)(4)A), (B), (D), and (E) refer to the "following events" that are reportable on the registered person's or member's Uniform Registration Forms, the events described do not tie to the Disclosure Questions in Form U4, U5, or U6 or the Regulatory Action Disclosures or Civil Judicial Disclosures in Form BD and in fact use wording different than that contained in Forms U4, U5, U6, and BD. As such, any ability to "replicate" the criteria and thresholds is at best problematic and impossible for member firms in at least one case.

Since data is taken in most instances from the Uniform Registration Forms, it would seem reasonable to reference the specific disclosure questions or items in the forms rather than rewriting the form language in a summary manner. Attached to this letter is a tabular representation of the proposed definitions with cross references to the assumed Disclosure Question in Form U4, U5, and U6 or item numbers in Form BD. I suggest that the definitions either incorporate the specific Disclosure Question or item references or track the specific wording of the applicable Uniform Registration Forms. Otherwise there is no assurance that anyone can "replicate" the criteria and thresholds.

In both the original proposal and current release FINRA agrees that additional guidance and resources could facilitate member firms' independent calculations and FINRA "will" explore ways to provide helpful resources; such as, "mapping the Disclosure Event and Expelled Firm Association Categories to the relevant disclosure questions on the Uniform Registration Forms." However, FINRA has yet to provide any such map.

It is unclear to the undersigned what the difference is between the events identified in 4111(i)(E)(ii) and (iii). A pending investigation by a regulatory authority involving a member firm, if reportable, would be reported as a Regulatory Action DRP on Form U6. Similarly, a pending regulatory action by the SEC (or other regulatory authority) would also be reported as a Regulatory Action DRP on Form U6. Form U6 refers to a matter as an "action" and as far as the undersigned can determine, does not mention the investigation.

In addition, while summary information about certain arbitration awards against a firm involving a securities or commodities dispute with a public customer are published by FINRA pursuant to Rule 8312 on BrokerCheck in Arbitration Awards Online and arbitration awards are reported by FINRA on Form U6, they are not identified using the terms "investment-related" or "consumer-initiated." I assume that arbitrations within this adjudicated event are the Arbitration Awards reported by FINRA on BrokerCheck. FINRA should confirm that this is the case and make

appropriate reference in the proposed Rule. And, while FINRA Dispute Resolution reports arbitration awards on Form U6, as far as the undersigned can determine, those U6s are not available to member firms on their CRD file.

The term "Registered Persons Associated with Previously Expelled Firms" (proposed Rule 4111(i)(4)(f)) is defined as any registered person who was associated with one or more previously expelled firms. As this is not a metric that is reportable or reported on a Uniform Registration Form and a firm may have been expelled long after a registered person left a previously expelled firm, I believe the only way that a member firm has to gather this information would be to do a BrokerCheck report on every registered person associated with the firm, as BrokerCheck indicates if a firm that a registered person was previously with has been expelled. If FINRA wants to use this metric, it should provide a list to every member firm of all associated registered persons who were associated with one or more previously expelled firms within the metric.

FINRA notes in the proposal that it would consider making available to member firms a list of expelled firms if that information is burdensome for member firms to obtain on their own. I have no idea how a member firm would obtain such information on its own except to pull a BrokerCheck report for every registered person.

In addition, the Previously Expelled Firm metric would require a firm to monitor every previously employed new hire's prior firm's status for five years to determine if the registered person fell within the metric.

Covered Pending Arbitration Claim

While the definition of Covered Pending Arbitration Claim, which is to be taken into consideration by the Department in setting the Restricted Deposit Requirement, was original proposed in Regulatory Notice 18-01 in connection with proposed IM-1011-2 and Rule 1013(c), the effect of application of the term through proposed Rule 4111(e) is materially different than IM-1011-2 and proposed Rule 1013(c). The proposition that the claim amount stated in an arbitration claim, whether alleged to be compensatory or not, has any basis in realty is unsupported by any empirical evidence. Moreover, there is no requirement that an arbitration claim state the amount of damages, which makes the concept more problematic.

An arbitration claim is a loss contingency that, for accounting and financial reporting purposes, is recognized or disclosed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 450-20. Recognition of loss contingencies is addressed in ASC 450-20-25. Under ASC 450-20-25-2 a loss contingency must be accrued if it is probable that a loss has been incurred and the amount of loss can be reasonably estimated. The ASC states that even losses that are reasonably estimable shall not be accrued if it is not probable that a liability has been incurred.

ASC 450-20-55-13 provides as follows:

> **450-20-55-13** The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition in paragraph 450-20-25-2(a) would be met if an unfavorable outcome is determined to be probable. Accrual would be inappropriate, but disclosure would be required, if an unfavorable outcome is determined to be reasonably possible, or if the amount of loss cannot be reasonably estimated.

The ASC 450-20 Glossary defines (a) probable as "the future event or events are likely to occur," (b) remote as "the chance of the future event or events occurring is slight," and (c) reasonably possible as "the chance of the future event or events occurring is more than remote but less than likely." In practice "probable" is interpreted as meaning "highly likely." As a general rule of thumb, remote is typically 10% or less, probable is 70 to 80%, and reasonably possible is somewhere in between.

If a member firm has determined that an adverse result on an arbitration claim is probable and the amount of loss is reasonably estimable, it is required to accrue for the loss on its financial statements. Requiring a member firm to set this accrual aside in a separate deposit account would not appear to entail any hardship. However, requiring that a member firm set aside funds to cover a remote loss or a probable loss that is not reasonably estimable based on the amount claimed in a statement of claim is contrary to applicable accounting standards and could impose a severe hardship on a firm.

According to the statistics published by FINRA Dispute Resolution, the percentage of cases where customers have been awarded damages in cases that go to hearing has ranged between 40% and 45% over the past six years. Under FASB 450-20 a 45% recovery rate would not be considered probable and might not be viewed as reasonably possible.

While it is unfortunate that in a small percentage of arbitration cases where losses are not considered to be probable or reasonably possible, an adverse arbitration award can render a firm insolvent and be uncollectable, that should not result in ignoring financial reporting standards applicable to reserving for loss contingencies.

While the Supplementary Material to proposed Rule 1014 provides that a firm may provide a written opinion of an independent reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claims, reasonably estimating the value of an arbitration claim is not possible in many cases.

Each year attorneys handling cases for member firms are requested to provide an audit response to the member firm's auditor that includes for any pending or threatened litigation a description of the litigation, including an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss. Attorney responses

are governed by the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1979). While it is possible for attorneys to evaluate the likelihood of an unfavorable outcome as probable and to provide a reasonable estimation of the amount or range of potential loss, in many cases neither is possible.

I would suggest that rather than referencing the "claim amount," the definition of Covered Pending Arbitration Claim be revised to refer to the applicable accounting standards codified in ASC 450-20.

It is unclear what FINRA intends by the descriptive term of "reputable" in reference to counsel as attorneys are licensed by individual states and not the United States. It may be that the reference to U.S. is meant to infer that an attorney is resident in the United States.

A Rule Proposal Looking for a Problem

In February 2018, FINRA published a Discussion Paper-FINRA Perspectives on Customer Recovery on the issue of the inability of customers to recover on their arbitration awards in FINRA arbitration proceedings. In 2017 the latest year of available data there were 51 unpaid arbitration awards totaling $21 million. However, more than 50% of the awards, 25 awards totally $12 million, were issued in uncontested cases. The percentage of uncontested cases resulting in unpaid awards has been at or above 50% since 2012, the earliest date covered. The data on uncontested cases while not an exact match mirrors data on inactive respondents. That is, an inactive respondent is logically not going to contest an arbitration case.

In addition, in 2016 and 2017 recipients of unpaid awards in fact received settlements representing 43% and 66% of their awards. The actual amount unpaid in 2016 and 2017 may have been only $8 million and $7 million.

The statistics published by FINRA downplay the fact that the number of unpaid awards represent less than 2% of cases closed in 2016 and 2017.

While it is unfortunate that an arbitration award is not paid when granted, the FINRA statistics do not support the creation of an elaborate system of additional regulation to address the issue.

FINRA itself states that 45 firms would have met the Preliminary Criteria for Identification. At December 31, 2019, there were 3,517 member firms. Consequently, proposed rule 4111 and its elaborate process is being proposed to address 1.2% of the member firms.

FINRA's Determination of a Maximum Restricted Deposit Requirement

It is an interesting concept that while proposed Rule 4111(i)(15) states that in setting a Maximum Restricted Deposit Requirement, the Department would consider the amount of any "covered pending arbitration claims" or unpaid claims, as one of the stated purposes of the

proposed rule is to "give FINRA another tool to incentive member firms to … pay arbitration awards," not one of three examples included in Attachment C includes the amount of any pending arbitration claims and each specifically states that there are no unpaid customer awards or settlements.

Consequently, it appears that the amounts derived by the Department were determined based either (a) on the average amount of arbitration and customer settlements paid over the previous five years, (b) an unidentified metric, or (c) arbitrarily.

As the average amount of arbitration and customer settlements paid would appear to indicate a firm is not having any difficulty paying arbitration awards, developing the amount of the Maximum Restricted Deposit Requirement in Examples A and B based on that metric would appear to be contrary to the identified purpose of the proposed rule and not supported by the factors identified in Rule 4111(i)(15).

A reasonable conclusion considering the factors identified in Examples A, B, and C is that there is no need for any Restricted Deposit Requirement.

It is also interesting to note that the Department has chosen to adopt the language of "aggravating" circumstances and "mitigating" factors in the examples where the proposed rule uses no such terminology. The aggravating circumstances identified are that each firm meets Preliminary Identification Metric Thresholds, which are the whole premise of the proposed rule.

The proposed rule states that the Department is to take into consideration twelve enumerated factors:

(1) the nature of the firm' operations and activities,
(2) the firm's revenues,
(3) the firm's commissions,
(4) the firm's assets,
(5) the firm liabilities,
(6) the firm's expenses,
(7) the firm net capital,
(8) the number of offices and registered persons,
(9) the nature of the disclosure events counted in the numeric thresholds,
(10) insurance coverage for customer arbitration awards or settlements,
(11) concerns raised during FINRA exams, and
(12) the amount of any of the firm's or its associated persons "covered pending arbitrations claims," unpaid arbitration awards, or unpaid settlements related to arbitrations.

The average of total revenue paid out in the past five years in arbitration and customer settlements and litigation is not an identified factor to be considered.

The Minimum Restricted Deposit Requirement Represents An Increased Net Capital Requirement

While the net capital treatment of the deposits in the Restricted Deposit Account provides that it is to be deducted in determining a member's net capital under SEA Rule 15c3-1 and Rule 4110, the effect of the rule is that it requires additional net capital. By removing the amount of the Restricted Deposit Account from a firm's net capital calculation, the impact of the rule is to require additional net capital.

Pursuant to Rule 4110(a) FINRA is granted authority, to be exercised by the Executive Vice President charged with oversight for financial responsibility, when necessary for the protection of investors or the public interest, at any time or from time to time with respect to a particular carrying or clearing member to prescribe greater net capital or net worth requirements than those otherwise applicable, including more stringent treatment of items in computing net capital or net worth, or require a member to restrict or increase net capital or net worth.

To the extent the issue of a firm not paying customer arbitration awards pertains to carrying or clearing member firms, Rule 4110(a) would appear to provide ample authority for FINRA to impose greater net capital or net worth requirements on such a firm.

If you have any questions, please call or email me.

Very truly yours,

Andrew R. Harvin

Enclosures

Proposed Rule 4111(i) Definitions and Form U4, U5, U6, and BD Cross Reference.

Proposed Rule 4111(i)(4)	Reference to Form U4, U5, U6, or BD
(A) Registered Person Adjudicated Events	
(i) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party or was a "subject of" the customer arbitration award or civil judgment;	U4 - Questions 14.I(1)(b) and (4)(b)[not limited to award against registered person] U5 – Question 7E(1)(b) and 4(b)
(ii) a final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil judgment settlement or a settlement prior to a customer arbitration or civil litigation;	U4 - Questions 14.I(1)(d), (2)(b), and (4)(a) U5 – Question 7E(1)(d), 2(b), and (4)(a)
(iii) a final investment-related civil judicial matter that resulted in a finding, sanction, or order	U4 - Question 14.H(1)(a) and (b) [and (c)?] U4 – Question 14I(1)(b) and (4)(b) U5 - Question 7E(1)(b) and (4)(b) U6 - Civil Judicial DRP
(iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization;	U4 - Questions 14.C, D, and E U5 – Question 7D (?) U6 – Regulatory Action DRP
(v) a criminal matter in which the registered person was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.	U4 - Questions 14.A(1)(a) and B(1)(a) U5 – Question 7C(1) and (3) U6 – Criminal DRP

(B) Registered Person Pending Events	
(i) a pending investment-related civil judicial matter	U4 - Question 14.H(2) U5 – Question 7E(1)(a) U6 – Civil Judicial DRP
(ii) a pending investigation by a regulatory authority	U4 - Question 14.G(2) U5 - Question 7A U6 – Regulatory Action DRP
(iii) a pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization;	U4 - Question 14.G(1) U5 - Question 7A U6 – Regulatory Action DRP
(iv) a pending criminal charge associated with any felony or any reportable misdemeanor.	U4 - Questions 14.A(1)(b) and B(2)(b) U5 – Question 7C(2) and (4) U6 – Criminal DRP

(D) Member Firm Adjudicated Events	
(i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party;	Reported on U6 – Civil Judicial DRP, but is not available to member firms
(ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order;	BD - Item 11.H(a) and (b) U6 - Civil Judicial DRP (?)
(iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or	BD - Item 11.C(1), (2), (3), (4), and (5) BD - Item 11.D(1), (2), (3), (4), and (5) BD - Item 11.E(1), (2), (3), and (4) U6 - Regulatory Action DRP
(iv) a criminal matter in which the member was convicted of or pled guilty or nolo contendere (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.	BD - Item 11.A(1) and B(1) U6 - Criminal DRP
(e) Member Firm Pending Event	
(i) a pending investment-related civil judicial matter;	BD - Item 11.H(2) U6 – Civil Judicial DRP
(ii) a pending investigation by a regulatory authority;	Not reportable on Form BD U6 – Regulatory Action DRP (Pending)(?)
(iii) a pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or	BD - Item 11.G U6 – Regulatory Action DRP
(iv) a pending criminal charge associated with any felony or any reportable misdemeanor.	BD - Item 11.A(2) and B(2) U6 – Criminal DRP

Registered Person Termination and Internal Review Events	
(i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations	U5 - Question 7.F(1), (2), and (3)
(ii) a pending or closed internal review by the member	U5 - Question 7.B