FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

April 9, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-06 | FINRA Requests Comment on Proposed Amendments to its Membership Application Program to Incentivize Payment of Arbitration Awards (Notice)

Dear Ms. Mitchell:

On February 8, 2018, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on its proposed amendments (Proposed Amendments) to FINRA's membership application program (MAP) rules.[1] The Proposed Amendments seek to incentivize FINRA members to pay arbitration awards, and settlements related to arbitrations by, among other things, requiring firms to file materiality consultations (MatCons) prior to adding associated persons with "covered pending arbitration claims" (as defined in the Proposed Amendments). The Proposed Amendments also require firms that are transferring their assets, to file a MatCon if: i) the firm, or its associated persons, is the subject of a covered pending arbitration claim; and ii) a continued membership application would not, otherwise, be required. Further, in certain enumerated circumstances, the Proposed Amendments, if adopted, would require firms to evidence an ability to pay pending arbitration claims prior to consummating specified transactions and allowing firms to demonstrate the value of pending claims *vis a vis* an opinion of outside counsel.[2]

The Financial Services Institute[3] (FSI) appreciates the opportunity to comment on the Proposed Amendments. FSI applauds FINRA for dedicating organizational resources, and devoting rulemaking efforts, to finding a solution to unpaid investor arbitration awards. FINRA's February 8, 2018, discussion paper – FINRA Perspectives on Customer Recovery (Paper) – provided the industry with important contextual data and transparency into FINRA's efforts in this space.[4] The Paper was a promising first-step in starting a productive discussion among industry stakeholders.

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[1] *See, generally*, FINRA Regulatory Notice 18-06 (Feb.8, 2018) (Notice).
[2] *Id.*
[3] The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.
[4] *See* Discussion Paper – FINRA Perspectives on Customer Recovery, (Feb. 8, 2018), available at http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

Moreover, FSI supports the intent of the Proposed Amendments. FSI also supports certain aspects of the current proposal, such as requiring firms filing new member applications to report any arbitration claims that are filed, awarded or that become unpaid while the application is pending. Nonetheless, FSI is concerned that, other aspects of the Proposed Amendments, may have the unintended consequences of giving undue consideration to pending, but not yet substantiated, arbitration claims. Since these are merely claims, it is important to keep in mind that the underlying allegations have not been proven and, thus, are not an indication of any wrongdoing on the part of a firm or an advisor.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.[5] These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).[6]

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate $48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly $6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.[7]

Discussion

FSI appreciates the opportunity to comment on the Proposed Amendments to FINRA's membership rules. Again, while FSI commends FINRA's efforts in addressing unpaid investor arbitration awards, FSI is concerned that certain aspects of the Proposed Amendments have the unintended consequences of giving undue consideration to pending, yet unsubstantiated, arbitration claims.

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[5] Cerulli Associates, Advisor Headcount 2016, on file with author.

[6] The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

[7] Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

In particular, the Proposed Amendments appear to require firms to file a MatCon seeking permission to hire a single advisor who has a pending investor arbitration claim. Thus, FSI is concerned about this MatCon requirement, and the additional weight the Proposed Amendments, in general, give to unsubstantiated claims. These concerns are discussed in greater detail below.

Background

FINRA's MAP group assesses both new member applications (NMAs) and continuing member applications (CMA) to ensure that applicants meet FINRA's admission standards.[8] As part of this process, MAP evaluates applicants' financial vitality, as well as their operational and supervisory structures.[9] Currently, the NMA and CMA processes can be long and, at times, arduous for applicants. Thus, FSI members are pleased that FINRA's Board of Governors has approved further proposed amendments to the membership application rules that would, reportedly, "restructure and streamline the rules, strengthen investor protections with respect to changes of control, and codify current practices to reduce the application review period, among other changes."[10] FSI is concerned, however, that the Proposed Amendments promulgated in this Notice would not streamline the membership application process but, instead, in certain respects, would add complexities to the process. Moreover, these complexities appear to do little to facilitate the investor protection interests they are designed to assist, e.g., diminishing the number of unpaid investor arbitration awards.

a. Existing Rule

NASD Rule 1013 sets forth the membership application requirements to become a new FINRA member firm. NASD Rule1017 sets forth certain events that would require existing FINRA members to file membership applications, including certain ownership changes, changes in control or in the firm's business operations. In particular, NASD Rule 1017 requires existing FINRA member firms to file membership applications for certain mergers, acquisitions, asset transfers, changes in their equity ownership and control, and other material changes to the member's business.[11]

NASD Rule 1014 sets forth the standards for denying or approving CMAs and NMAs. Pursuant to NASD Rule 1014 (b)(1), a firm's failure to meet certain standards creates a presumption that a membership application should be denied. For instance, the presumption of denial exists if the firm, its control persons, principals, registered representatives or associated persons are the subject of unpaid arbitration awards, other adjudicated customer awards, or unpaid, settled arbitration awards.[12] That presumption is, however, rebuttable. Meaning, firms may offer evidence that, despite the existence of one or more of these events, the firm is still able to meet FINRA's admission standards.[13]

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[8] See Notice at p. 2.
[9] *Id.*
[10] See FINRA News Release, Report from FINRA Bord of Governors Meeting – March 2018 (March 14, 2018), available at http://www.finra.org/newsroom/2018/report-finra-board-governors-meeting-march-2018.
[11] See NASD Rule 1017 (a)(1) – (5); *see also*, NASD Rule 1011 (k) defining "material change in business operations".
[12] See NASD Rule 1014(b)(1); *see also* NASD Rule 1014 (a)(3)(C); *see also*, Notice at p. 4.
[13] See NASD 1014(b)(1).

b. Summary of the Proposed Changes of Concern to FSI Members

i Proposed Requirement to File Materiality Consultations

As an initial matter, the Proposed Amendments would convert the MatCon process from a voluntary process, to one that, under certain circumstances, would be mandatory. Currently, the MatCon process is voluntary and is designed to assist firms in determining whether a contemplated change is material, such that a CMA should be required.[14] The submission requirements for MatCons are largely embodied in FINRA guidance and allow FINRA to request additional documentation as it deems necessary to render a materiality decision. [15]

The Proposed Amendments, if adopted, would make MatCons mandatory in two circumstances. First, unless a CMA is independently required, members would have to file a MatCon prior to adding any associated persons, involved in sales, who are the subject of any of the following:

- "covered pending arbitration claims,"
- unpaid investor related arbitration awards, or
- unpaid, settled investor related arbitration claims.[16]

For the above purposes, the phrase "covered pending arbitration claim" (CPAC) would refer to an investor claim against the associated person that is unresolved and exceeds the member's excess net capital.[17] Upon filing the MatCon, FINRA would determine whether it is in the public's interest that the firm file a CMA.[18]

Moreover, unless a CMA is required, firms transferring their assets, business or a line of operation, would also be required to file a MatCon, where the transferring member, or any of that member's associated persons, have a CPAC, unpaid arbitration award, or unpaid settled arbitration claim.[19] FINRA would, then, assess the MatCon and determine whether the firm is required to file a CMA.[20] For these purposes, CPAC would refer to an investor claim against either the firm, or its associated persons, that is unresolved and exceeds the member's excess net capital.

Critically, absent from the proposal are clear and concise rule-based parameters around the MatCon process. In particular, the Proposed Amendments do not place limitations on FINRA's time to issue a decision regarding a firm's MatCon. They also do not place limitations on FINRA's time to respond to firms' communications during the MatCon process and do not state whether, now that MatCon's would be mandatory, firms would be able to appeal MatCon decisions and, if so, the process for commencing that appeal.

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[14] See Overview of Materiality Consultation Process, available at http://www.finra.org/industry/overview-materiality-consultation-process.
[15] *Id.*; *see, also* FINRA Notice to Members 00-73 (Oct. 2000).
[16] See Proposed FINRA Rule IM-1011-2.
[17] See Proposed FINRA Rule 1011(c)(1)(2).
[18] *Id.* If the business expansion already independently requires an application, then a MatCon would not be required.
[19] See Proposed FINRA Rule 1017 (a)(4).
[20] *Id.*

ii. Allowing Firms to Overcome Rebuttable Presumption By Evidencing Their Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements or, for New Member Applications, Pending Arbitration Claims

As discussed above, the current iteration of FINRA's membership rules set forth the circumstances that would create a rebuttable presumption that a membership application should be denied. NMAs will, for the first time, be subject to a rebuttable presumption of denial if the applicant, or any of its associated persons, are subject to a pending arbitration claim.[21] Additionally, where the rebuttable presumption is triggered on the basis of a firm's or an associated person's "unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements or, for new member applications, pending arbitration claims," applicants may overcome the presumption by demonstrating their ability to satisfy the award or claim.[22] Sufficient evidence of the firm's ability to pay would include escrow, insurance, or a guarantee.[23] Firms would be able to demonstrate the value of the claim by submitting an opinion of outside counsel.[24]

FSI's Suggested Modifications to the Proposed Amendments

a. IM-1011-2 Should Be Clarified to Exclude Firms' Routine Hiring Decisions

IM-1011-2 should be clarified to indicate that, for this rule to apply, the addition of an associated person must, specifically, be in connection with a merger, acquisition, asset transfer or some other business expansion. Absent that clarification, the proposal may be interpreted to require a MatCon for the simple hiring of a single advisor. In particular, proposed rule IM-1011-2 states, in pertinent part, that:

> "If a member is seeking to add one or more Associated Persons involved in sales and one or more of those Associated Persons has a Covered Pending Arbitration Claim…, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, the member may not effect the contemplated business expansion unless the member has first submitted a written letter to [FINRA] …seeking a materiality consultation for the contemplated business expansion.

While IM-1011-2 references business expansions, without the requested clarification, IM-1011-2 would appear to equate the act of "adding one of more associated persons involved in sales" and a business expansion. This would, seemingly, require a member to file a MatCon anytime it hires an advisor who has a CPAC.

b. IM-1011-2 and Proposed Rule 1017 (a)(4) Should Exclude Pending Arbitration Claims as a Basis For Requiring Firms to File a MatCon

To the extent that it is FINRA's intent that IM-1011-2 refer to the hiring of any advisor with a CPAC, regardless of the existence of a business expansion, firms should not be forced into participating in membership proceedings so that FINRA can review the firm's decision to hire a single advisor; particularly when this filing requirement is based on an unsubstantiated claim. In

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[21] See Proposed FINRA Rule 1014 (b)(1).
[22] See Proposed FINRA Rule 1014 Supp. Mat. .01.
[23] *Id.*
[24] *Id.*

addition to this provision potentially causing FINRA to overreach into firms' routine hiring decisions, it may also have a negative impact on firms' recruiting efforts in a time where there is already a shortage of advisors.[25]

Along these same lines, firms engaging in asset transfers that would not trigger a CMA under the current iteration of the MAP rules, should not be required to file a MatCon, solely because they, or their associated persons, have a CPAC. If adopted, proposed rule 1017(a)(4) may be interpreted to require firms transferring *any* asset, no matter how immaterial, to file a MatCon where the firm, or any of the firm's, potentially hundreds of associated persons, are the subject of unsubstantiated, pending, investor arbitration claims. This would, consequently, be unduly burdensome, particularly since, in most cases, these claims are subject to other FINRA rules that require disclosure.[26]

Further exacerbating FSI's concerns, is the fact that filing the MatCon may, ultimately, result in the firm having to file a CMA. The CMA may, in turn, result in the firm being prohibited from consummating a minor asset transfer, because one of its associated persons has a pending, and unsubstantiated customer claim. This may have the unintended consequences of forcing firms to terminate associated persons so that the firm can consummate a non-material asset transfer; even though there is no demonstrable evidence that the associated person engaged in any actual wrongdoing.

c. <u>The Proposed Amendments Should Provide Clarity Into the MatCon Process</u>

As stated above, if the Proposed Amendments are adopted, they would convert MatCons from a voluntary process, to a mandatory one. Thus, notwithstanding the concerns set forth above, like the requirements attributable to CMAs and NMAs, the Proposed Amendments should impose clarity regarding, and parameters around, the MatCon process. These parameters may include remedies for firms should they not agree with the MatCon decision, timeframes around FINRA issuing a MatCon decision, limitations on FINRA's time to either issue a decision or ask additional questions, etc..[27] Absent these parameters, firm's may end up in the MatCon process, for indefinite periods of time, for changes that are, arguably, not material to their businesses.

d. <u>The Nexus Between an Associated Person's Pending Claim and the Firm's Net Capital Is Unclear</u>

For the purposes of IM-1011-2, CPAC is defined as follows:

> "An investment-related, consumer initiated claim filed *against the Associated Person* 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*."

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[25] *See* Investment News, *Shrinking talent pool puts strain on advisory firms*, (March 20, 2017), explaining that "[b]y 2022, the industry is expected to face a shortfall of at least 200,000 advisers", available at http://www.investmentnews.com/article/20170520/FREE/170529995/shrinking-talent-pool-puts-strain-on-advisory-firms.

[26] See e.g., FINRA Rule 4530; see also, Uniform Application for Securities Industry Registration or Transfer, question 14.

[27] FSI understands that FINRA has published guidance on the MatCon process. *See, e.g.*, Overview of Materiality Consultation Process, available at http://www.finra.org/industry/overview-materiality-consultation-process. However, guidance and rules are different and if the MatCon process becomes a rule-based requirement; rather than a voluntary process, rules regarding the process are seemingly also appropriate.

(*emphasis added*).[28]

This definition appears to interpose a nexus between the associated person's CPAC and the firm's net capital. While firm's may cover arbitration awards against their associated persons, they may elect not to. In that case, the associated person would be responsible for satisfying any award stemming from the claim.

Further, it also interposes a nexus between the individual and the firm hiring the individual. IM 1011-2 speaks to members "seeking to add one or more [a]ssociated [p]ersons". Meaning, these individuals were not formerly associated with the firm that is filing the CMA. Also, presumably meaning, that the acts or omissions giving rise to the customer claim mostly likely occurred while the individual was associated with another firm. Thus, it is likely that if any firm would cover the individual's claim, it would be the firm the individual was associated with at the time the misconduct occurred and not the firm that is obligated to file the MatCon. Consequently, the nexus between the individual's claim and the filing firm's excess net capital is unclear.

e. <u>An Opinion of In-House Counsel Should Be Adequate Under the Supplemental Material to Rule 1014</u>

Obtaining an opinion from external legal counsel can be costly and does not increase the regulatory value of the opinion offered. Firms should, therefore, be allowed to rely on opinions of in-house legal counsel. Regardless of whether the opinion is prepared by internal or external counsel, in both cases, the firm is the attorney's client and the attorney is being paid by the client for his or her services. In the case of external counsel, the fee is larger and is tendered for the specific purposes of drafting an opinion acceptable to the client. Arguably, external counsel has a greater impetus to not act independently. Additionally, in-house counsel is more familiar with the firm and its risk profile. Thus, in-house counsel may be able to provide an opinion that is more informed than an opinion provided by external counsel. This would provide FINRA staff with better intelligence for assessing the membership application and the investor protection issue stemming from the claim. Further, any concerns FINRA would have regarding the attorney's partiality should be satiated by the fact that, both internal and external counsel are bound by rules of professional ethics requiring them to issue an opinion that is truthful and based on the law.

<u>Conclusion</u>

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with the Department on this and other important regulatory efforts.

[28] See Proposed Rule 1011 (c)(1)(A).

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

Respectfully submitted,

Robin M. Traxler
Vice President, Regulatory Affairs & Associate General Counsel