Agenda

CEFLI Compliance & Ethics Committee Meeting
Wednesday, May 15, 2019
2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
Dial In: (800) 239-9838
Passcode: 3646069

I. Welcome and Introduction. — Donald J. Walters

A. Antitrust Statement.

II. Approval of Minutes – April 17, 2019 Meeting. — The Committee

III. Issues for Review. — The Committee

A. Fraudulent Policy/Contract Withdrawals.

The life insurance industry continues to encounter instances of fraudulent activity whereby fraudsters attempt to gain access to account values to perpetrate fraudulent withdrawals of monies from life insurance policies or annuity contracts. When these circumstances arise, companies must determine whether they will "make the customer whole" as a means to compensate the customer for their fraudulent loss.

In the event a company becomes aware of the fraudulent withdrawal from a life insurance policy or annuity contract, questions have been presented concerning the timing of any decision to reimburse the customer for instances of fraudulent withdrawals.

For example:

- *Does your company "make the customer whole" as soon as they become aware of the fraudulent withdrawal?*
- *Does your company "make the customer whole" after completing an investigation and determining the customer was not involved in the fraud?*
- *Does your company "make the customer whole" only if the company was "at fault" in the situation (i.e., procedures were not followed appropriately, agent involvement, etc.)?*

The Committee will be asked to discuss their practices associated with reimbursing customers for instances of fraudulent withdrawals from life insurance policies or annuity contracts.

B. Anti-Money-Laundering (AML) Training Programs.

The life insurance industry continues to be subject to attempts to conduct money-laundering activities. As a result, life insurance company anti-money-laundering personnel have instituted a variety of programs, policies and procedures designed to detect and deter money laundering activities.

It is recognized that anti-money-laundering practices may differ from company to company. Therefore, a series of questions concerning anti-money-laundering practices has been presented for discussion including:

- *How often does your company require producers to complete an AML training course?*
- *Are producers free to select any AML training course to complete or does your company provide a list of "approved" vendors for this purpose?*
- *Does your company offer its own AML training course (i.e., that was developed on an "in-house" basis)?*
- *Upon completing an AML training course, what proof of completion (i.e., a certificate of completion) is required?*
- *Does your company allow producers to undergo an AML training course that does not generate a completion certificate?*

The Committee will be asked to discuss their company's practices with respect to anti-money-laundering training policies and procedures for producers.

C. SIU and Antifraud Examination Activities.

It is recognized that some states insurance departments conduct examinations of life insurers to determine the adequacy and scope of their antifraud policies and procedures and antifraud activities. In some instances, these examination activities will encompass the work of a company's special investigations unit (SIU).

Given that not all state insurance departments conduct SIU and antifraud examinations, a question has been presented to promote discussion of the extent to which life insurance companies may be subject to SIU and antifraud examinations by various state insurance departments.

The Committee will be asked to discuss the extent to which their companies may have been subject to SIU and antifraud examinations by various state insurance departments.

D. Oversight of Third-Party Vendors.

In order to conduct business operations, life insurers engage in agreements with a wide range of third-party vendors to provide products and services to a life insurance company.

As the volume and type of third-party vendor agreements continue to grow, life insurance companies have employed a variety of techniques to monitor the expiration and possible renewal of these agreements. Moreover, life insurance companies have developed a variety of strategies to conduct appropriate oversight of the performance of these contractual agreements with third-party vendors.

The Committee will be asked to discuss their practices with respect to conducting appropriate oversight of the performance of contractual agreements with third-party vendors.

E. Reporting of Late Filing Penalty.

Life insurance companies file a wide range of regulatory reports to various regulatory agencies. In some instances, these reports are required to be submitted online.

In an instance in which a company may encounter a technological deficiency thereby delaying their capacity to be able to submit reports online, state insurance departments may impose a penalty for a late filing.

A question has been presented concerning whether incurring a penalty for a late filing of a required report by one state insurance department may also require reporting of that late filing penalty to all other state insurance departments.

The Committee will be asked to discuss whether they may be aware of any requirements to report a penalty for late filing of a required report in one jurisdiction to all other jurisdictions.

IV. Reporting Items. CEFLI Staff.

A. SEC Chairman Clayton Suggests Regulation Best Interest May Be Released Sooner Than Expected.

SEC Chairman Clayton recently indicated that revisions to the SEC's Regulation Best Interest may be released "sooner than expected."

The SEC had previously projected that Regulation Best Interest would be released in September.

Media reports indicate that the SEC staff is circulating draft versions of Regulation Best Interest for review and possible approval by the SEC Commissioners. These reports indicate that the final version of the rule may be issued within the next several weeks.

B. DOL Plans to Issue New Fiduciary Rules.

In a recent hearing before the House Education and Labor Committee, Labor Secretary Alexander Acosta indicated that the DOL plans to issue new fiduciary rules following the issuance of the SEC's Regulation Best Interest.

Secretary Acosta indicated that the DOL is working with the SEC as it completes work on Regulation Best Interest which is expected to come out soon. (See above.) Secretary Acosta indicated that the new DOL Fiduciary Rules would be issued thereafter and would be designed to work in conjunction with the SEC's Regulation Best Interest.

C. FINRA Announces New Office of Innovation.

FINRA recently announced the establishment of a new Office of Innovation to assist FINRA staff in identifying, understanding and fostering various innovations in the securities markets. The new Office is an outgrowth of the Innovation Outreach Initiative under FINRA360.

Haimera Workie, a senior director at FINRA, will lead the new Office of Innovation. Mr. Workie served previously as the Deputy Associate Director of the Division of Trading and Markets at the US Securities and Exchange Commission.

D. House Passes Senior Security Act of 2019.

The US House of Representatives recently passed HR 1876 the Senior Security Act of 2019 which calls for the SEC Chairman to establish an interdivisional task force to:

- Identify the challenges senior investors encounter, such as cognitive decline and financial exploitation.
- Identify areas in which senior investors would benefit from changes in SEC or FINRA regulations.
- Coordinate with other areas of the SEC and self-regulatory agencies.
- Coordinate with entities outside of the SEC.

While this legislation is significant in terms of its focus on senior financial exploitation, it is also significant to note that the list of entities the SEC could consult with on these matters include *state insurance regulators* and state securities regulators.

E. FINRA Regulatory Notice 19-13 - Electronic Signatures for Discretionary Accounts.

The SEC recently approved a proposed rule to amend FINRA Rule 4512 (Customer Account Information) to permit the use of electronic signatures for discretionary accounts. (See copy attached.)

Currently, FINRA requires a manual (or "wet") signature for each person authorized to exercise discretion in a discretionary account.

Due to technological advances in electronic signatures, including authentication and security, FINRA has amended Rule 4512 to permit the use of electronic signatures under the circumstances.

The amendments to FINRA Rule 4512 became effective on May 6.

F. FINRA Regulatory Notice 19-17 - Restricted Firm Obligations.

FINRA is requesting comment on proposed rule that would impose specific obligations on firms that would be designated with a significant history of misconduct. (See copy attached.) These obligations could include requiring such firms to make deposits of cash or qualified securities that could not be withdrawn without FINRA's prior written consent.

Comments on the proposed rule are due by July 1, 2019.

G. FINRA Regulatory Notice 19-18 - Anti-Money Laundering (AML) Programs.

FINRA recently issued guidance concerning suspicious activity monitoring and reporting obligations to comply with FINRA Rule 3310 (Anti-Money-Laundering Compliance Program). (See copy attached.)

The Regulatory Notice provides examples of money-laundering red flags and indicated that anti-money-laundering practices such as customer due diligence and the submission of suspicious activity reports would be reviewed as part of FINRA's 2019 Exam Priorities.

(Though it is recognized that not all CEFLI member companies are regulated by FINRA, the red flags identified within the Regulatory Notice also include Potential Red Flags in Insurance Products (see, P. 10). Also, other red flags contained within the guidance may be helpful to life insurance company compliance and ethics professionals as well.)

H. SEC Issues Risk Alert - Regulation S-P Compliance Issues.

The SEC's Office of Compliance Inspections and Examinations ("OCIE") recently issued a Risk Alert containing a list of compliance issues related to Regulation S-P to remind investment advisers and broker-dealers of their obligations regarding privacy and opt out notices as well as policies and procedures for safeguarding customer records and information. (See copy attached.)

I. SEC OCIE Director Questions Firms' Compliance Budgets.

In a recent speech, Pete Driscoll, Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE") recently indicated that the SEC is noticing that compliance budgets are being cut or are not commensurate with firms' risk profiles at selected firms.

He also noted that chief compliance officers are often not empowered to ensure a firm's compliance which indicates an insufficient "tone at the top" from senior management in terms of making compliance a priority.

J. Whistleblower Protection Reform Act (HR 2515) - Passed by House Financial Services Committee.

The House Financial Services Committee passed legislation to protect whistleblowers from employee retaliation.

The legislation would amend the definition of whistleblower under the Securities and Exchange Act of 1934 to clarify that whistleblowers who report alleged misconduct internally their employers (but not to the securities and exchange commission) are protected by Dodd Frank's anti-retaliation provisions.

V. CEFLI Activities.

A. CEFLI National Compliance & Ethics Forum - Des Moines, Iowa - June 12-13.

CEFLI is pleased to introduce a new 2019 CEFLI National Compliance & Ethics Forum. The 2019 National Compliance & Ethics Forum will take place at the Renaissance Savery Hotel in Des Moines, Iowa on June 12-13.

The new 2019 National Compliance & Ethics Forum will consolidate and supplant our previous Regional Compliance Forums.

Like our previous Regional Compliance Forums, the agenda for the National Compliance & Ethics Forum will be developed through the submission of issues for discussion by those who register to attend the Forum. Participation will be limited exclusively to member company representatives to establish an open environment for our discussions.

The 2019 CEFLI National Compliance & Ethics Forum is free of charge to all CEFLI member company representatives as a benefit of your company's CEFLI membership.

Registration to attend the Forum is now available via the CEFLI website.

You also may make hotel reservations at the Renaissance Savery Hotel through the following link:

https://www.marriott.com/event-reservations/reservation-link.mi?id=1555102840077&key=GRP&app=resvlink

CEFLI's room block closes on May 22. Please make your reservations ASAP.

We hope you will be able to join us in Des Moines on June 12-13 for this unique opportunity to "connect" with your fellow industry professionals from across the country!

B. Compliance Fundamentals Training Conference - May 8-10 - Austin, Texas.

On May 8-10, CEFLI conducted its Compliance Fundamentals Training Conference at The Driskell Hotel in Austin, Texas.

CEFLI staff will provide a brief report regarding the Compliance Fundamentals Training Conference.

VI. Next Meeting.

The next meeting of the Committee is scheduled to take place:

June 11, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT

The Committee will hold its remaining 2019 meetings as follows:

July 24, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
August 14, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
September 25, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
October 16, 2019 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT
November 13, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST
December 18, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

Please mark your calendar and plan to join us!

VII. Other Business.

The Committee will be asked to identify and discuss any other business to be brought before the Committee.

DRAFT

Minutes
Meeting of the
CEFLI Compliance & Ethics Committee
April 17, 2019
2 PM EDT/1 PM CDT/11 AM PDT

A meeting of the CEFLI Compliance & Ethics Committee (the "Committee") was held via conference call on Wednesday, April 17, 2019 at 2 PM EDT/1 PM CDT/11 AM PDT.

The following CEFLI member company representatives participated in the meeting:

Molly Akin, Ohio National Financial Services
Marcie Allen, Texas Life
Renee Ambrosy, CNO Financial
Lauren Barbaruolo, Oxford Life Insurance
Chad Batterson, Athene
Meagan Bellin, Securian Financial
Ann Biznzer, Cincinnati Life
Katelynn Blalock, Western & Southern Financial Group
Diane Boyette, Southern Farm Bureau Life
Vickie Bulger, Primerica Life Insurance
Laura Bullard, Forester Financial
Bryan Brewster, Wilton Re
Amanda Capps, Symetra Life
Andrea Christensen, Sagicor
Ryan Cloud, Guggenheim Life
Allison Corrado, Lombard International
Steve Corbly, Cincinnati Life
Jessica English, Thrivent
Rita Fenani, Pacific Life
Jill Fiddler, Assurity Life
Patrick Garcy, Sagicor
Paula Gentry, Cincinnati Life
Jim Golembiewski, Sagicor
Ken Gould, Protective Life
Dennis Herchel, SBLI
Nancy Hill, Pacific Life
Lisa Holland, State Farm Life

Nathan Huss, Sammons
Laurie Lewis, Amica
Martin Karp, Oxford Life Insurance
De Keimach, Delaware Life
Megan Knatt, American Enterprise
Michele Kulish Danielson, American Enterprise
Brian Leary, Fidelity Investments
Dan Leblanc, SBLI
Kathy Mangum, Southern Farm Bureau Life
Dave Milligan, American Equity
Matt Missik, Pacific Life
Deb Naegele, Cincinnati Life
Mark Neidinger, National Guardian Life
Jim Odland, Thrivent
Sabrina Olender, Foresters Financial
Monique Pascual, Pacific Guardian Life
Liza Perry, USAA
Kathy Pettit, John Hancock
Megan Phillips, Principal Life
Tony Poole, AAA Life
Christine Poppe, Cuna Mutual
Daniel Reinecke, Gerber Life Insurance
Michael Roberson, Pacific Guardian Life
Sally Roudebush, Lincoln Heritage Life
Cara St. Martin, Allianz
Scott Schabel, Jackson National Life
Angie Schneider, Cincinnati Life
Ryan Schwoebel, Protective Life
Lori Straight, Sammons
Carla Strauch, Thrivent
Angelea Taul, Western & Southern Financial Group
Jill Terry, Cincinnati Life
Louisa Treber, Securian Financial
Bill Turner, American Fidelity
Laura Van Laningham, Illinois Mutual
John Vitou, Jackson National Life
Rochelle Walk, Wilton Re
Michelle Ward, Erie Family Life
Larry Welch, Citizens Inc
Stacey White, American National
Emily Wilburn, Illinois Mutual
Pam Wilson, Cincinnati Life
Kim Yerigan, Cincinnati Life

Mallory Bennett, Kelly Ireland and Donald Walters of CEFLI also participated in the meeting.

I. Welcome and Introduction.

The meeting began with a recitation of CEFLI's anti-trust statement.

II. Approval of Minutes – March 28, 2019 Meeting.

On motion, duly made and seconded and unanimously carried, the Committee: RESOLVED, that, the Minutes of the March 28, 2019 meeting are hereby approved.

III. Issues for Review.

A. California Senate Bill 179 - The Gender Recognition Act.

California recently enacted Senate Bill 179 which became effective on January 1, 2019 and requires an applicant when applying for an original driver's license or a renewal driver's license to choose a gender category of female, male or nonbinary.

This California law raises an interesting question concerning how life insurance companies may be accommodating applicants who may select a non-binary gender choice in their applications for life insurance and annuity products. Other states are reportedly considering similar types of legislation.

The Committee was asked to discuss their company's practices with respect to accommodating applicants who may select a non-binary gender choice in their applications for life insurance and annuity products.

A Committee member indicated that they have not amended their application to deal with this issue and have not experienced any challenges form applicants on this basis.

A Committee member reported that their research shows non-binary designation requirements exist in some fashion in AR, CA, CO, DC, ME, MN, NJ, NYC, OR and WA.

Some Committee members have taken honorifics off communications with policyholders, addressing correspondence to individuals by name rather than using "Mr." or "Mrs."

A Committee member indicated that their filed applications only have two gender options, and their online applications require an answer to this question in order to proceed to the next questions, which is a challenge if someone wants to select something other than M/F.

The issue of gender on a driver's license might arise with respect Know Your Customer and using the driver's license as identification for medical records, which is a current practice for insurers.

B. Anti-Rebating Laws and Innovation Strategies.

During the recent NAIC Spring National Meeting, the Innovation and Technology (EX) Task Force examined the extent to which anti-rebating laws may serve as a possible impediment to pursuing various innovation strategies.

As an example, scenarios were identified in which insureds may be encouraged to accept certain items, such as a "wearable," that may provide the insurer with a broader range of information that may allow an applicant to qualify for more favorable rates or receive other benefits.

It was acknowledged that only a handful of states maintain anti-rebating laws and other states have recently repealed them. Therefore, the Task Force is examining the question of whether anti-rebating laws are necessary.

The Committee was asked to discuss the extent to which compliance may be involved in the development of innovation strategies and whether issues associated with anti-rebating laws may have impacted the implementation of a possible innovation strategy.

A Committee member reported having a recent experience regarding wanting to offer a cloud-based storage service as a benefit to policyholders. The company tried to put a provision in the contract to offer that type of service free as part of the chassis of the contract and found that they faced significant opposition from several states that wouldn't approve the contract filing because the benefit wasn't insurance and was considered an illegal inducement.

The company in question opted to offer the cloud-based storage benefit to in-force customers only to get around the rebating issue. They would prefer that regulators find a way to allow innovative benefits within the four corners of the contract rather than abandoning rebating laws, which would have implications for producers.

C. Role of Compliance in Development of Policies and Procedures Related to Social Media, Text Messaging and Other Electronic Communication Methods by Producers.

Over the past several years, life insurance companies have examined their policies and procedures to determine whether to permit producers to use social media, text messaging and other electronic communication methods in communications with customers.

The Committee was asked to discuss whether their company conducts a periodic review of their current policies and procedures with respect to the use of social media, text messaging and other electronic communication methods by producers with customers and, if so, to what extent compliance may be involved in decisions to modify and update existing policies and procedures.

A Committee member indicated that they have a regular 2-3-year review cycle for all policy and procedures. They will also review policies at the request of the producer to determine if new methods of communication may be permissible.

Another Committee member reported that this would fall under their regular ad review process and would also have implications from a records retention standpoint for these types of communications.

D. Staffing Trends within Compliance Departments – Data Scientists/Operations Staff.

Compliance departments continue to hire professionals who possess a range of skills that may not be considered traditional life insurance company compliance skills. For example, it has been reported that many life insurance company compliance departments are building their staffs to attract individuals who possess expertise in non-traditional compliance areas such as data analysis and other quantitative skill sets.

The Committee was asked to discuss their observations with respect to trends in hiring practices among compliance departments at life insurance companies and whether their companies have considered adding professionals with non-traditional compliance expertise such as data analytics to their existing staff.

Several Committee members reported an increase in the hiring of individuals with non-traditional compliance expertise, such as Underwriting, New Business, Marketing, Internal Audit, Client Services, IT and Producer Resources.

One Committee member indicated that their Compliance staff is comprised of approximately 50/50 of those with a compliance background and those form other business disciplines and another indicated being the only career compliance professional in a staff of five.

E. Identity Verification Practices.

In order to meet a variety of different compliance requirements, life insurance companies take steps to verify the identity of new customers as well as existing customers.

Recognizing that identity verification practices may differ from company to company, a question has been posed to determine what types of tools/software companies may be using to comply with identity verification laws and regulations as well as Know Your Customer rules for various types of transactions.

The Committee was asked to discuss their company's identity verification practices and whether these practices may differ according to the manner in which a product may be sold (i.e., direct-to-consumer sales) or whether these practices may differ for new customers versus existing customers.

A Committee member volunteered that they have starting using Pindrop for call center ID and verification. Accurint was used in the past, but Pindrop has been a slightly lower-cost solution with cleaner results.

Other ID and customer verification tools used by Committee members include ID Verify by LexisNexis and CLEAR from Thomson Reuters.

Most of the tools used focus on call center and online verification of customers though such things as voice-recognition and knowledge-based verification of customer information.

F. New York Circular Letter No. 1 - Accelerated Underwriting - Adverse Underwriting Decision Notifications.

The New York Department of Financial Services issued Circular Letter No. 1 earlier this year regarding the use of external consumer data and information sources in underwriting for life insurance.

Within the Circular Letter, the New York Department of Financial Services confirmed that:

> *"An adverse underwriting decision would include the inability of an applicant to utilize an expedited, accelerated or algorithmic underwriting process in lieu of a traditional medical underwriting."*

The Circular Letter also references New York Insurance Law §4224 (a)(2) which requires insurers to notify the insured or potential insured of the right to receive the specific reason or reasons for declination, limitation, rate differential or other adverse underwriting decision.

The Committee was asked to discuss whether their companies may have modified their existing notifications of an adverse underwriting decision to include circumstances where an insured or potential insured would not be eligible to undergo accelerated underwriting in lieu of a traditional medical underwriting.

A Committee member indicated that companies often have eligibility questions that must be answered to determine if a customer is eligible for accelerated underwriting. Ineligibility would not be considered an adverse decision.

G. South Carolina Bulletin No. 2019-02 - Rescission of a Life Insurance Policy.

South Carolina recently issued Bulletin No. 2019-02 "reminding" life insurers doing business in that state that, per SC Code §38-63-220(d), an insurer can only "vacate" or rescind coverage on an individual life policy by "instituting proceedings."

The Bulletin further states: (1) "A proceeding to vacate a policy is a judicial proceeding commenced to cancel the policy or have it declared null and void"; and (2) "Unilateral rescissions of life insurance policies violate South Carolina law."

The language of the Bulletin seems to suggest that all rescissions must be commenced by judicial action (e.g., DJA or other civil actions). However, the Bulletin also states:

> "Thus, the South Carolina General Assembly mandated that if an insurer wanted to challenge the truthfulness of the application, it must do so during the first two years of the policy. *After the policy has been in effect for two years, the application cannot be challenged on this basis*." (Emphasis added.)

The Bulletin further states: "A letter or other notice to the <u>insured</u> stating that the policy has been canceled or rescinded does not qualify as a proceeding to vacate a policy under South Carolina law." (Underline added.)

This language suggests that, per the Bulletin, the South Carolina Department of Insurance is focused on live rescissions within the first two years from "date of issue."

The Committee was asked to discuss their views on the "unilateral rescission" prohibition, two-year time limit on "challenges" to the truthfulness of the application, and the "judicial proceedings" mandate found within South Carolina Bulletin No. 2019-02; especially as to whether these requirements apply only to live rescissions or any rescission.

A Committee member indicated that their contracts do not allow for unilateral rescission and a legal action would have to be filed by the company for rescission.

Another Committee member reported that South Carolina was the last state to change their contestability law from “during the lifetime of the insured” to 2 years from the policy’s effective date.

Some Committee members are troubled by the Bulletin and the case (SC Supreme Ct. v Carroll) it is based on, and at least one Committee member has retained outside counsel to help them navigate the interpretation and requirements.

IV. Reporting Items.

A. UPDATE: New Illinois Law - Sexual Harassment Prevention Training.

During the Committee’s March 28 meeting, an issue was presented with respect to a new Illinois Law (20 ILCS 2105/2105/-15.5) that requires sexual harassment prevention training for any profession that has continuing education requirements.

CEFLI staff reported that, subsequent to the meeting, a member of the Committee provided guidance indicating that the Illinois Law requiring sexual harassment prevention training was deemed to be inapplicable to the insurance industry.

B. UPDATE: OR Senate Bill 769 - Redacting of Social Security Numbers in Consumer Correspondence and Document Destruction Policies.

Over the past several months, the Committee has discussed the potential compliance implications of a recently enacted Oregon law (ORS § 646A.620) that was read to prohibit the printing, displaying or posting of Social Security numbers on, for example, any mail that is “part of any documentation the consumer requested for a transaction or service, unless the Social Security number is redacted.”

CEFLI staff reported that with the assistance of John Mangan of the ACLI, we have been able to determine that the Oregon Division of Financial Regulation has confirmed that ORS § 646A.620 does not change the rules of delivery of policies and applications in the life insurance industry.

C. UPDATE: Maryland Fiduciary Standard Legislation Fails.

CEFLI staff reported that Maryland recently introduced legislation entitled the Financial Consumer Protection Act of 2019 (SB 786) that would require both registered representatives with broker-dealers and life insurance producers to act as fiduciaries with “a duty to act in the best interest of the customer without regard to the financial or other interest of the person or firm providing the advice.”

The Maryland Senate Finance Committee disapproved of the Financial Consumer Protection Act, which included a provision that would impose a fiduciary duty on financial professionals operating in Maryland. Therefore, the legislation failed to get enacted in the 2019 session of the Maryland Legislature.

D. New Jersey Introduces Fiduciary Rule.

CEFLI staff reported that the New Jersey State Securities Bureau recently released a rule that would impose a fiduciary duty on broker-dealer registered representatives.

The rule proposal would subject registered representatives of broker-dealers (a "broker") operating in New Jersey to a fiduciary standard rather than the current FINRA suitability standard.

A broker who fails to act as a fiduciary would be engaging in an "unethical or dishonest business practice."

Many commenters on a pre-proposal urged New Jersey to wait until the SEC issues its final version of Regulation Best Interest.

Comments on the New Jersey proposed rule are due by June 14.

E. FINRA Chief Legal Officer Sees Changes to Suitability Rule.

CEFLI staff reported that Robert Colby, FINRA's Chief Legal Officer, recently indicated that FINRA will either revise its current Suitability Rule once the SEC's Regulation Best Interest is final or will eliminate it entirely.

The goal will be to eliminate any overlap between the SEC's Regulation Best Interest and FINRA's Suitability Rule so Regulation Best Interest and FINRA's Suitability Rule are "completely aligned."

F. House Financial Services Committee Approves Cannabis Safe Harbor Bill for Insurers and Banks.

CEFLI staff reported that the House Financial Services Committee recently approved HR 1595, the Secure and Fair Enforcement Banking Act of 2019, which would provide access to financial services for cannabis-related businesses and service providers. An amendment to the legislation included a safe harbor for insurers that wish to provide financial services to cannabis -related businesses and service providers in states that have legalized marijuana.

G. Personnel Matters - Allison Lee Nominated for SEC Vacancy.

CEFLI staff reported that President Trump nominated Allison Lee, a former SEC enforcement attorney, for a vacancy on the Securities and Exchange Commission. Ms. Lee was reported to be a favored candidate among many Democrats.

If the Senate confirms Ms. Lee, she would replace Kara Stein, also a Democrat, on the Commission.

V. CEFLI Activities.

A. Next Meeting: Regulation 187 Issue Forum - Thursday, April 25 - 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT.

The next meeting of the CEFLI Regulation 187 Issue Forum is scheduled to take place on Thursday, April 25 at 2 PM EDT/1 PM CDT/12 Noon MDT/11 AM PDT.

A call for agenda items will be issued within the next several days.

Please mark your calendar and plan to join us.

B. Compliance Fundamentals Training Conference - May 8-10 - Austin, Texas.

On May 8-10, CEFLI will be conducting its Compliance Fundamentals Training Conference at The Driskell Hotel in Austin, Texas.

CEFLI's Compliance Fundamentals Training Conference is available free of charge as part of your company's membership benefits. The Conference is designed to provide education and training for those who may be new to the life insurance industry or those who may be new to the compliance function within a life insurance company.

Registration for the Conference is available online via CEFLI's website. A copy of the preliminary program for the Conference is attached.

We hope to see you in Austin on May 8-10!

C. *New Conference* - National Compliance & Ethics Forum - Des Moines, Iowa - June 12-13.

CEFLI is pleased to introduce a new 2019 CEFLI National Compliance & Ethics Forum. The 2019 National Compliance & Ethics Forum will take place at the Renaissance Savery Hotel in Des Moines, Iowa on June 12-13.

The new 2019 National Compliance & Ethics Forum will consolidate and supplant our previous Regional Compliance Forums.

Like our previous Regional Compliance Forums, the agenda for the National Compliance & Ethics Forum will be developed through the submission of issues for discussion by those who register to attend the Forum. Participation will be limited exclusively to member company representatives to establish an open environment for our discussions.

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Registration to attend the Forum is now available via the CEFLI website.
You also may make hotel reservations at the Renaissance Savery Hotel through the following link:

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We hope you will be able to join us in Des Moines on June 12-13 for this unique opportunity to "connect" with your fellow industry professionals from across the country!

D. Privacy Webinar - Tuesday, April 30.

CEFLI and Mayer Brown will conduct a webinar on the California Consumer Privacy Act on Tuesday, April 30 at 1 PM EDT/12 Noon CDT/11 AM MDT/10 AM PDT.

Please mark your calendars and plan to join us!

VI. Next Meeting.

The Committee will hold its next meeting on May 15, 2019 - 2 PM EDT/1 PM CDT/12 Noon MST/11 AM PDT.

The Committee will hold further 2019 meetings as follows:

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December 18, 2019 - 2 PM EST/1 PM CST/12 Noon MST/11 AM PST

Please mark your calendar and plan to join us!

VII. Other Business.

There being no further business to discuss, the meeting was adjourned.

Account Authorization Records

SEC Approves Amendments to FINRA Rule 4512 to Permit the Use of Electronic Signatures for Discretionary Accounts

Effective Date: May 6, 2019

Summary

The Securities and Exchange Commission (SEC) approved a proposed rule change to amend FINRA Rule 4512 (Customer Account Information) to permit the use of electronic signatures for discretionary accounts and to clarify the scope of the rule.[1] These changes become effective on May 6, 2019.

The text of the amended rule is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- Afshin Atabaki, Associate General Counsel, Office of General Counsel, at (202) 728-8902 or Afshin.Atabaki@finra.org.

Background and Discussion

For discretionary accounts, FINRA Rule 4512(a)(3) currently requires member firms to maintain a record of the dated, manual (or "wet") signature of each named, natural person authorized to exercise discretion in such accounts. To comply with the current requirement, most firms print a paper copy of the account record and require that the authorized individual physically sign it. They then convert the paper record to an electronic record for retention on electronic storage media consistent with Rule 17a-4(f) under the Securities Exchange Act of 1934 (SEA).

April 16, 2019

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

Key Topics

- Account Authorization
- Discretionary Authority
- Electronic Signatures
- Recordkeeping

Referenced Rules & Notices

- E-Sign Act
- FINRA Rule 4512
- SEA Rule 17a-3
- SEA Rule 17a-4

Financial Industry Regulatory Authority

Given technological advances relating to electronic signatures, including authentication and security, FINRA has amended Rule 4512(a)(3) to permit the use of electronic signatures. The rule change is consistent with the Electronic Signatures in Global and National Commerce Act (E-Sign Act), which facilitates the use of electronic signatures. The rule change is also consistent with the requirements of SEA Rule 17a-3(a)(17)(ii) relating to discretionary accounts,[2] which does not prescribe the type of signature that must be obtained from an authorized individual. While FINRA Rule 4512(a)(3) would continue to require member firms to obtain the signature of the authorized individual, it would provide firms the option of obtaining either a manual or an electronic signature.

For purposes of compliance with amended Rule 4512(a)(3), a valid electronic signature would be any electronic mark that clearly identifies the signatory and is otherwise in compliance with the E-Sign Act, the guidance issued by the SEC relating to the E-Sign Act,[3] and the guidance provided by FINRA staff through interpretive letters.[4]

FINRA has also amended Rule 4512(a)(3) to clarify that the rule is limited to discretionary accounts maintained by member firms for which associated persons of such firms are authorized to exercise discretion. Specifically, the amended rule provides that for a discretionary account maintained by a member firm, the firm must maintain a record of the dated signature of each named, associated person of the firm authorized to exercise discretion in the account. This change will eliminate any potential confusion regarding the scope of the rule and aid members' compliance efforts.

Endnotes

1. *See* Securities Exchange Act Release No. 85282 (March 11, 2019), 84 FR 9573 (March 15, 2019) (Order Approving File No. SR-FINRA-2018-040).
2. 17 CFR 240.17a-3(a)(17)(ii).
3. *See* Securities Exchange Act Release No. 44238 (May 1, 2001), 66 FR 22916 (May 7, 2001) (Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media Under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f)).
4. *See, e.g.*, Letter from Nancy Libin, NASD, to Jeffrey W. Kilduff, O'Melveny & Myers, LLP, dated July 5, 2001, www.finra.org/industry/interpretive-letters/july-5-2001-1200am.

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Attachment A

Below is the amended rule text. New language is underlined; deletions are in brackets.

* * * * *

4500. BOOKS, RECORDS AND REPORTS

* * * * *

4512. Customer Account Information

(a) Each member shall maintain the following information:

(1) through (2) No Change.

(3) for discretionary accounts <u>maintained by a member</u>, in addition to compliance with subparagraph (1) and, to the extent applicable, subparagraph (2) above, and NASD Rule 2510(b), the member shall maintain a record of the dated, [manual] signature of each named, [natural] <u>associated</u> person <u>of the member</u> authorized to exercise discretion in the account. This recordkeeping requirement shall not apply to investment discretion granted by a customer as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite dollar amount or quantity of a specified security. Nothing in this Rule shall be construed as allowing members to maintain discretionary accounts or exercise discretion in such accounts except to the extent permitted under the federal securities laws.

(b) through (c) No Change.

• • • Supplementary Material: --------------

.01 through **.06** No Change.

* * * * *

Regulatory Notice 19-17

May 2, 2019

Notice Type
- Request for Comment

Suggested Routing
- Compliance
- Legal
- Operations
- Registered Representatives
- Risk
- Senior Management

Key Topics
- Expedited Proceedings
- Restricted Deposit and other Obligations

Referenced Rules & Notices
- FINRA Rule 3110
- FINRA Rule 4110
- FINRA Rule 9559
- Regulatory Notice 18-06
- Regulatory Notice 18-15
- Regulatory Notice 18-16
- Regulatory Notice 18-17

Protecting Investors from Misconduct

FINRA Requests Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct

Comment Period Expires: July 1, 2019

Summary

As part of FINRA's ongoing initiatives to protect investors from misconduct, FINRA is requesting comment on proposed new Rule 4111 (Restricted Firm Obligations) that would impose tailored obligations, including possible financial requirements, on designated member firms that cross specified numeric disclosure-event thresholds. These thresholds were developed through a thorough analysis and are based on the number of events at similarly sized peers. The member firms that could be subject to these obligations, while small in number, present heightened risk of harm to investors and their activities may undermine confidence in the securities markets as a whole. The proposal would further promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards.

FINRA is requesting comment on:

1. proposed new Rule 4111 (Restricted Firm Obligations), which would authorize FINRA to require "Restricted Firms," identified by a multi-step process involving threshold calculations, to make deposits of cash or qualified securities that could not be withdrawn without FINRA's prior written consent, adhere to other conditions or restrictions on the member's operations that are necessary or appropriate for the protection of investors and in the public interest, or be subject to some combination of those obligations; and

Financial Industry Regulatory Authority

2. proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111) (new Rule 9559) and amendments to existing Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) to be renumbered as Rule 9560 (Rule 9560 or the Hearing Procedures Rule) to create an expedited proceeding that allows a prompt review of the determinations under the Restricted Firm Obligations Rule and grants a member a right to challenge any obligations imposed.[1]

The proposed rule text is available in Attachment A. A flow chart describing proposed Rule 4111 is available in Attachment B. A chart presenting examples of restricted deposit requirements is available as Attachment C. The attachments referenced in the Economic Impact Assessment are available in Attachment D (Attachments D-1, D-2 and D-3).

Questions concerning this *Notice* should be directed to:

- Kosha Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6903 or *Kosha.Dalal@finra.org*; or
- Michael Garawski, Associate General Counsel, OGC, at (202) 728-8835 or *Michael.Garawski@finra.org*.

Questions concerning the Economic Impact Assessment in this *Notice* should be directed to:

- Jonathan Sokobin, Senior Vice President and Chief Economist, Office of the Chief Economist (OCE), at (202) 728-8248 or *Jonathan.Sokobin@finra.org*; or
- Hammad Qureshi, Senior Economist, OCE, at (202) 728-8150 or *Hammad.Qureshi@finra.org*.

Action Requested

FINRA encourages all interested parties to comment. Comments must be received by July 1, 2019.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Jennifer Piorko Mitchell
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[2]

Before becoming effective, the proposed rule change must be filed with and approved by the Securities and Exchange Commission (SEC or Commission) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).[3]

Background & Discussion

FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and member firms that have a history of misconduct. FINRA has a number of tools to deter and remedy misconduct by member firms and the individuals they hire, including review of membership applications, focused examinations, risk monitoring and disciplinary actions. These tools have been effective in identifying and addressing a range of misconduct by individuals and firms, and FINRA has continued to strengthen them. In recent years, for example, we have enhanced our key investor protection rules and examination programs, expanded our risk-based monitoring of brokers and firms and deployed new technologies designed to make our regulatory efforts more effective and efficient.[4]

While these efforts have strengthened protections for investors and the markets, persistent compliance issues continue to arise in some FINRA member firms. While historically small in number and a top focus of FINRA regulatory programs, such firms generally do not carry out their supervisory obligations to ensure compliance with applicable securities laws and regulations and FINRA rules, and they often act in ways that harm their customers and erode trust in the brokerage industry. Recent academic studies, for example, find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence that the past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events.[5] While these firms may eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with a history of misconduct that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers.

Such firms expose investors to real risk. For example, FINRA has identified certain firms that have a concentration of individuals with a history of misconduct, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. These firms generally have a retail business with vulnerable customers and engage in cold calling to make recommendations of securities. FINRA has also identified groups of individual brokers who move from one firm of concern to another firm of concern. In addition, certain firms, along with their representatives, have substantial numbers of disclosures on their records. For example, as of year-end 2018, there were 20 small firms (*i.e.*, firms with no more than 150 registered persons) with 30 or more disclosure events over the prior five years, 10 mid-size firms (*i.e.*, firms with between 151 and 499 registered persons) with 45 or more disclosure events over the prior five years, and five large firms (*i.e.*, firms with 500 or more registered persons) with 750 or more disclosure events over the prior five years.[6] In such situations, FINRA closely examines the firms' and brokers' conduct, and where appropriate, FINRA will bring enforcement actions to bar or suspend the firms and individuals involved.

However, individuals and firms with a history of misconduct can pose a particular challenge for FINRA's existing examination and enforcement programs. In particular, examinations can identify compliance failures—or imminent failures—and prescribe remedies to be taken, but examiners are not empowered to require a firm to change or limit its business operations in a particular manner. While these constraints on the examination process protect firms from potentially arbitrary or overly onerous examination findings, an individual or firm with a history of misconduct can take advantage of these limits to simply continue ongoing activities that harm or pose risk of harm to investors until they result in an enforcement action.

Enforcement actions in turn can only be brought after a rule has been violated—and any resulting customer harm has already occurred. In addition, these proceedings can take significant time to develop, prosecute and conclude, during which time the individual or firm is able to continue misconduct, perpetuating significant risks of additional harm to customers and investors. Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council (NAC), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel imposes a significant sanction, the firm can forestall its effectiveness through the appeals process, because sanctions are stayed during appeals to the NAC and potentially the SEC. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership, limiting FINRA's jurisdiction and eliminating the leverage that FINRA has to incent the firm to comply with the sanction, including making restitution to customers.

Temporary cease and desist proceedings do not always provide an effective remedy for potential ongoing harm to investors during the enforcement process.[7] Temporary cease and desist proceedings are available only in narrowly defined circumstances. Moreover, initiation by FINRA of a temporary cease and desist action does not necessarily enable more rapid intervention, because FINRA must be prepared to file the underlying disciplinary complaint at the same time.

In addition, by the time intervention is practical, as noted above, the firm may have exited the industry, thereby limiting FINRA's jurisdiction over the misconduct. In such circumstance, the firm may also fail to pay arbitration awards in favor of harmed investors, preventing their recovery and potentially diminishing confidence in the arbitration process.

A typical example of these challenges would be a firm that hires representatives with numerous disclosure events, has a poor supervisory structure and compliance culture, consistently engages in aggressive sales practices to retail customers relating to unregistered penny stocks, private placements or illiquid securities, and affirmatively seeks to stall the imposition of disciplinary sanctions. In FINRA's experience, such a firm may attempt to prolong FINRA's examination and investigation efforts by failing to provide full and timely responses to FINRA's requests for information. This lack of cooperation requires FINRA to increase regulatory pressure to gain cooperation and seek other sources for information, delaying FINRA's investigative efforts.

When FINRA is ready to pursue enforcement action against such a firm, a temporary cease and desist order may not be available (since many circumstances are not within the scope of that authority) or may not enable more rapid intervention (since the disciplinary complaint must be ready to be filed at the same time). While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm can further prolong the disciplinary action by litigating through the stages described above.

In light of these considerations, FINRA has undertaken an initiative to better address the issues created by individuals and firms with a history of misconduct. The initial focus of this initiative has been to strengthen the controls by FINRA and firms over the risks posed by *individuals* with a history of misconduct, including:

- *Regulatory Notice 18-15* (Heightened Supervision), which reiterates the existing obligation of member firms to implement for such individuals tailored heightened supervisory procedures under Rule 3110;
- *Regulatory Notice 18-16* (FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them), which seeks comment on proposed rule amendments that, among other things, would impose additional restrictions on member firms that employ brokers with a history of specified misconduct events by requiring the filing with FINRA of a materiality consultation when such individuals seek to become owners, control persons, principals or registered persons of a firm; authorize Hearing Panels and Hearing Officers to impose conditions and restrictions on a respondent in a disciplinary proceeding that are reasonably necessary for the purpose of preventing customer harm during that respondent's appeal of a disciplinary decision; and require firms that apply to continue associating with a statutorily disqualified person to include in that application an interim plan of heightened supervision that would be effective throughout the application process; and
- *Regulatory Notice 18-17* (FINRA Revises the Sanction Guidelines), which announced revisions to the FINRA Sanction Guidelines.

In addition, FINRA raised fees for statutory disqualification applications,[8] and it revised the qualification examination waiver guidelines to more broadly consider past misconduct when considering examination waiver requests.[9]

While these efforts should help mitigate the risks posed by individual brokers with a history of misconduct, challenges remain where a member firm itself has a concentration of such brokers without adequate supervision—in some cases because the firm seeks out such brokers—or otherwise has a history of substantial compliance failures.

As a result, FINRA is proposing to adopt Rule 4111, which would impose obligations on members that have significantly higher levels of risk-related disclosures than similarly sized peers. FINRA would preliminarily identify these members by using numeric, threshold-based criteria and several additional steps that would guard against misidentification. The obligations could include requiring a member 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 could make withdrawals only with FINRA's approval. This proposal also aims to preserve firm funds for payment of arbitration awards against them. The proposal would achieve this both through how a member's "covered pending arbitration claims" and unpaid arbitration awards could impact the size of its restricted deposit requirement, and a presumption that a member would continue to maintain a restricted deposit if it has any "covered pending arbitration claims" or unpaid arbitration awards.[10]

FINRA also considered proposing a "terms and conditions" rule similar to Investment Industry Regulatory Organization of Canada (IIROC) Consolidated Rule 9208, which permits IIROC, in an effort to strategically target the most problematic firms, to exercise discretion to identify firms and develop appropriate terms and conditions on their operations.[11] Although FINRA is still considering such a rule, it is not proposing it at this time.

Proposed Amendments

1. Proposed Rule 4111 (Restricted Firm Obligations)

FINRA is proposing to adopt Rule 4111 (Restricted Firm Obligations), a new rule that would use numeric-based thresholds based on firm-level and individual-level disclosure events or conditions disclosed on the Uniform Registration Forms[12] and, subject to an internal Department of Member Supervision (Department) review and member firm consultation process, presumptively impose a "Restricted Deposit Requirement" on members that present a high degree of risk to the investing public. FINRA believes that a restricted deposit is most likely to change such members' behavior—and therefore protect investors—through its direct financial impact.

▶ General/Multi-Step Process for Identifying "Restricted Firms" (Proposed Rule 4111(a))

The proposed rule would create a multi-step process to guide FINRA's determination of whether a member raises investor-protection concerns substantial enough to require that it be subject to additional obligations. Those obligations could include a requirement to maintain a deposit of cash or qualified securities in an account from which withdrawals would be restricted, or conditions or restrictions on the member's operations that are necessary or appropriate for the protection of investors and in the public interest.[13] The proposed rule would give each affected member firm several ways to affect outcomes, including a one-time opportunity to reduce staffing so as to no longer trigger the preliminary identification criteria and numeric thresholds, a consultation with the Department at which the member could explain why it should not be subject to a Restricted Deposit Requirement or propose alternatives, and the right to challenge a Department determination by requesting a hearing before a Hearing Officer in an expedited proceeding.

The proposed multi-step process includes numerous features designed to focus the obligations on the small number of firms motivating this rule proposal. As the attached flow chart reflects (Attachment B), this process is akin to a "funnel." The top of the funnel applies to a limited set of firms with numerous disclosures, with a narrowing in the middle of the potential member firms that may be subject to additional obligations, and the bottom of the funnel reflecting the small number of member firms that present high risks to the investing public.

▶ Annual Calculation by FINRA of Preliminary Criteria for Identification (Proposed Rule 4111(b))

The multi-step process would begin with an annual calculation. As explained more below, the Department would calculate annually a member firm's "Preliminary Identification Metrics" to determine if it meets the "Preliminary Criteria for Identification." A key driver of that is whether a firm's "Preliminary Identification Metrics" meet quantitative, risk-based "Preliminary Identification Metrics Thresholds."[14]

Several principles guide the Preliminary Criteria for Identification and the Preliminary Identification Metrics Thresholds. The criteria and thresholds are intended to be replicable and transparent to FINRA and affected member firms; employ the most complete and accurate data available to FINRA; are objective; account for different firm sizes and business profiles; and target the sales-practice concerns that are motivating the proposal. FINRA also has sought to develop criteria and thresholds that identify members that present a high risk but limit improperly imposing obligations on firms whose risk profile and activities do not warrant such obligations.

Using these guiding principles, FINRA is proposing numeric thresholds based on six categories of events or conditions, nearly all of which are based on information disclosed through the Uniform Registration Forms.[15] The six categories are:

1. Registered Person Adjudicated Events;[16]
2. Registered Person Pending Events;[17]
3. Registered Person Termination and Internal Review Events;[18]
4. Member Firm Adjudicated Events;[19]
5. Member Firm Pending Events;[20] and
6. Registered Persons Associated with Previously Expelled Firms (also referred to as the Expelled Firm Association category).[21]

To calculate whether a member meets the Preliminary Criteria for Identification, which is defined in proposed Rule 4111(i)(9), the Department would first compute the Preliminary Identification Metrics for each category, which are set forth in proposed Rule 4111(i)(10). Each category's Preliminary Identification Metric computation would start with a calculation of the sum of the pertinent disclosure events or, for the Expelled Firm Association category, the sum of the Registered Persons Associated with Previously Expelled Firms. For the adjudicated disclosure-event based categories, the counts would include disclosure events that reached a resolution during the prior five years from the date of the calculation. For the pending-events categories and pending internal reviews, the counts would include disclosure events that are pending as of the date of the calculation. In addition, for the three Registered Person disclosure-event based categories, the counts would include disclosure events across all "Registered Persons In-Scope," defined in proposed Rule 4111(i)(13) as persons registered with the member firm for one or more days within the one year prior to the calculation date.

Each of those six sums would then be standardized to determine the member's six Preliminary Identification Metrics. For the five Registered Person and Member Firm event categories (Categories 1-5 above), the proposed Preliminary Identification Metrics are in the form of an average number of events per registered broker, calculated by taking each category's sum and dividing it by the number of Registered Persons In-Scope. For the Registered Persons Associated with Expelled Firms category (Category 6), the proposed Preliminary Identification Metric is in the form of a percentage concentration at the member of registered persons who, at any time in their career, were associated with previously expelled firms. This concentration is calculated by taking the number of Registered Persons Associated with Previously Expelled Firms and dividing it by the number of Registered Persons In-Scope.

A firm's six Preliminary Identification Metrics are used to determine if the member firm meets the Preliminary Criteria for Identification. To meet the Preliminary Criteria for Identification, a firm would need to meet the Preliminary Identification Metrics Thresholds, set forth in proposed Rule 4111(i)(11), for two or more of the appropriate categories listed above for its size and, if it does, one of these categories must be for adjudicated events and the firm must have two or more events (in categories besides the Expelled Firm Association category). This involves analyzing the extent to which the Preliminary Identification Metrics meet the specified numeric Preliminary Identification Metrics Thresholds and meet additional conditions intended to prevent a member from becoming potentially subject to additional obligations solely as a result of pending matters or a single event or condition. Specifically, the Department would:

- first, pursuant to proposed Rule 4111(b) and (i)(9)(A), evaluate whether two or more of the member firm's Preliminary Identification Metrics are equal to or more than the corresponding Preliminary Identification Metrics Thresholds for the member firm's size,[22] and whether at least one of those Preliminary Identification Metrics is the Registered Person Adjudicated Event Metric, the Member Firm Adjudicated Event Metric, or the Expelled Firm Association Metric; and

- second, pursuant to proposed Rule 4111(b) and (i)(9)(B), evaluate whether the member firm has two or more Registered Person or Member Firm Events (*i.e.*, two or more events from Categories 1-5 above).[23]

If all these conditions are met, the member would meet the Preliminary Criteria for Identification.

Each specific numeric threshold in the Preliminary Identification Metrics Thresholds grid in proposed Rule 4111(i)(11) is a number which represents outliers with respect to peers for the type of events in the category (*i.e.*, the firm is at the far tail of the respective category's distribution), which is intended to preliminarily identify member firms that present significantly higher risk than a large percentage of the membership. In addition, there are numeric thresholds for seven different firm sizes, to ensure that each member firm is compared only to its similarly sized peers. As explained more below in the Economic Impact Assessment, based on recent history FINRA expects that its annual calculations will identify between 60-98 member firms that meet the Preliminary Criteria for Identification.

The following three examples demonstrate—in practical terms—the point at which a member firm's Preliminary Identification Metrics would meet the Preliminary Identification Metrics Thresholds in proposed Rule 4111(i)(11):

	Preliminary Identification Metrics Thresholds	Practical Equivalent
Example 1 (member firm size between 1-4 registered persons)	The Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric, for a member that has between one and four Registered Persons In-Scope as of the Evaluation Date,[24] is 0.50 (or 0.50 events per Registered Broker In-Scope).	For a member with four Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric if the sum of its four Registered Persons In-Scope's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was *two or more*. (4 Registered Persons In-Scope) * (0.50 Preliminary Identification Metrics Threshold for the Registered Person Adjudicated Event Metric) = (2 Adjudicated Events)
Example 2 (member firm size between 20-50 registered persons)	The Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric, for a member that has between 20-50 Registered Persons In-Scope as of the Evaluation Date, is 0.20 (or 0.20 events per Registered Broker In-Scope).	For a member with 50 Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric if the sum of the member's Adjudicated Events, which reached a resolution over the five years before the Evaluation Date, was *ten or more*. (50 Registered Persons In-Scope) * (0.20 Preliminary Identification Metrics Threshold for the Member Firm Adjudicated Event Metric) = (10 Adjudicated Events)
Example 3 (member firm size between 51-150 registered persons)	The Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric, for a member that has between 51-150 Registered Persons In-Scope as of the Evaluation Date, is 0.25 (or a 25% concentration level).	For a member with 100 Registered Persons In-Scope as of the Evaluation Date, the member would meet the Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric if the sum of its Registered Persons Associated with Previously Expelled Firms was *25 or more*. (100 Registered Persons In-Scope) * (0.25 Preliminary Identification Metrics Threshold for the Expelled Firm Association Metric) = (25 Registered Persons Associated with Previously Expelled Firms)

FINRA has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily identify the member firms that are motivating this rule proposal.[25] As explained below, however, the proposed rule involves several additional steps to guard against the risk of misidentification.

- Initial Department Evaluation (Proposed Rule 4111(c)(1))

For each member firm that meets the Preliminary Criteria for Identification, the Department would conduct, pursuant to proposed Rule 4111(c)(1), an initial internal evaluation to determine whether the member does not warrant further review under Rule 4111. In doing so, the Department would review whether it has information to conclude that the computation of the member's Preliminary Identification Metrics included disclosure events or other conditions that should not have been included because they are not consistent with the purpose of the Preliminary Criteria for Identification and are not reflective of a firm posing a high degree of risk. For example, the Department may have information that the computation included disclosure events that were not sales-practice related, were duplicative (involving the same customer and the same matter), or mostly involved compliance concerns best addressed by a different regulatory response by FINRA. As another example, the Department may have information that the Expelled Firm Association Metric calculation included registered persons who had associated with previously expelled firms only for a brief amount of time. The Department would also consider whether the member has addressed the concerns signaled by the disclosure events or conditions or altered its business operations, including staffing reductions, such that the threshold calculation no longer reflects the member's current risk profile. Essentially, the purpose of the Department's initial evaluation is to determine whether it is aware of information that would show that the member—despite having met the Preliminary Criteria for Identification—does not pose a high degree of risk.

If the Department determines, after this initial evaluation, that the member does not warrant further review, the Department would conclude that year's Rule 4111 process for the member and would not seek that year to impose any obligations on the member. If, however, the Department determines that the member does warrant further review, the Rule 4111 process would continue.

- One-Time Opportunity to Reduce Staffing Levels (Proposed Rule 4111(c)(2))

If the Department determines, after its initial evaluation, that a member that meets the Preliminary Criteria for Identification warrants further review under Rule 4111, such member—if it would be meeting the Preliminary Criteria for Identification for the first time—would have a one-time opportunity to reduce its staffing levels to no longer meet these criteria, within 30 business days after being informed by the Department. The member would be required to demonstrate the staff reduction to the Department by identifying the terminated individuals. The proposed rule would prohibit the member from rehiring any persons terminated pursuant to this option, in any capacity, for one year. A member that has reduced staffing levels at this stage may not use that staff-reduction opportunity again.

If the Department determines that the member firm's reduction of staffing levels results in its no longer meeting the Preliminary Criteria for Identification, the Department would close out that year's Rule 4111 process for the member and would not seek that year to impose any obligations on that member. If, on the other hand, the Department determines that the member still meets the Preliminary Criteria for Identification even after its staff reductions, or if the member elects not to use its one-time opportunity to reduce staffing levels, the Department would proceed to determine the member's maximum Restricted Deposit Requirement, and the member would proceed to a Consultation with the Department.

- FINRA's Determination of a Maximum Restricted Deposit Requirement (Proposed Rule 4111(i)(15))

For members that warrant further review after being deemed to meet the Preliminary Criteria for Identification and after the initial Department evaluation, the Department would then determine the member's maximum "Restricted Deposit Requirement."

The Department would tailor the member's maximum Restricted Deposit Requirement amount to its size, operations and financial conditions. As provided in proposed Rule 4111(i)(15), the Department would consider the nature of the member's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of any "covered pending arbitration claims" or unpaid arbitration awards, and concerns raised during FINRA exams.[26] Based on a consideration of these factors, the Department would determine a maximum Restricted Deposit Requirement for the member that would be consistent with the objectives of the rule, but not significantly undermine the continued financial stability and operational capability of the member as an ongoing enterprise over the next 12 months. FINRA's intent is that the maximum Restricted Deposit Requirement should be significant enough to change the member's behavior but not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement.

To provide increased transparency, Attachment C contains several examples that are intended to demonstrate how, in different scenarios, the Department might exercise its discretion in determining a maximum Restricted Deposit Requirement. Nothing in the examples is intended to suggest that the Department will follow specific formulas in determining a maximum Restricted Deposit Requirement or the weight that any specific circumstances carry. FINRA welcomes comments on alternative ways of calculating the Restricted Deposit Requirement that would be more predictable while remaining impactful but avoiding disproportionate effects on different types of firms.

- Consultation (Proposed Rule 4111(d))

As explained above, if the Department determines, after initially calculating that a member firm meets the Preliminary Criteria for Identification, conducting its internal evaluation, and affording the one-time opportunity to reduce staffing levels (if available), that a member warrants further Rule 4111 review, the Department would consult with the member, pursuant to proposed Rule 4111(d). This Consultation will give the member an opportunity to demonstrate why it does not meet the Preliminary Criteria for Identification, why it should not be designated as a Restricted Firm, and why it should not be subject to the maximum Restricted Deposit Requirement.

In the Consultation, there would be two rebuttable presumptions: that the member should be designated as a Restricted Firm; and that it should be subject to the maximum Restricted Deposit Requirement. The member would bear the burden of overcoming those presumptions.

Proposed Rule 4111(d)(1) governs how a member may overcome these two presumptions. Proposed Rule 4111(d)(1)(A) provides that a member may overcome the presumption that it should be designated as a Restricted Firm by clearly demonstrating that the Department's calculation that the member meets the Preliminary Criteria for Identification is inaccurate because, among other things, it included events, in the six categories described above, that should not have been included because, for example, they are duplicative, involving the same customer and the same matter, or are not sales-practice related. Proposed Rule 4111(d)(1)(B) provides that a member may overcome the presumption that it should be subject to the maximum Restricted Deposit Requirement by clearly demonstrating to the Department that the member would face significant undue financial hardship if it were required to maintain the maximum Restricted Deposit Requirement and that a lesser deposit requirement would satisfy the objectives of Rule 4111 and be consistent with the protection of investors and the public interest; or that other conditions and restrictions on the operations and activities of the member and its associated persons would address the concerns indicated by the thresholds and protect investors and the public interest.

Proposed Rule 4111(d)(2) governs how the Department would schedule and provide notice of the Consultation.

Proposed Rule 4111(d)(3) provides guidance on what the Department would consider during the Consultation, when evaluating whether a member should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement. This provision also provides members with guidance on how to attempt to overcome the two rebuttable presumptions. For example, proposed Rule 4111(d)(3) requires that the Department consider information provided by the member during any meetings as part of the Consultation; relevant information or documents, if any, submitted by the member, in the manner and form prescribed by the Department, as would be necessary or appropriate for the Department to review the computation of the Preliminary Criteria for

Identification; a plan, if any, submitted by the member, in the manner and form prescribed by the Department, proposing in detail the specific conditions or restrictions that the member seeks to have the Department consider; such other information or documents as the Department may reasonably request from the member related to the evaluation; and information provided by the member during any meetings as part of the Consultation. To the extent a member seeks to claim undue financial hardship, it would be the member's burden to support that with documents and information.

- Department Decision (Proposed Rule 4111(e)); No Stays

After the Consultation, proposed Rule 4111(e) would require that the Department render a Department decision. Under proposed Rule 4111(e)(1), there are three paths that decision might take:

- If the Department determines that the member has rebutted the presumption that it should be designated as a Restricted Firm, the Department's decision would be required to state that the member will not be designated that year as a Restricted Firm.

- If the Department determines that the member has not rebutted the presumption that it should be designated as a Restricted Firm or the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member as a Restricted Firm and require the member to promptly establish a Restricted Deposit Account, deposit and maintain in that account the maximum Restricted Deposit Requirement, and implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

- If the Department determines that the member has not rebutted the presumption that it should be designated as a Restricted Firm but has rebutted the presumption that it must maintain the maximum Restricted Deposit Requirement, the Department's decision would designate the member as a Restricted Firm; would impose no Restricted Deposit Requirement on the member or require the member to promptly establish a Restricted Deposit Account, deposit and maintain in that account a Restricted Deposit Requirement in such dollar amount less than the maximum Restricted Deposit Requirement as the Department deems necessary or appropriate; and would require the member to implement and maintain specified conditions or restrictions, as necessary or appropriate, on the operations and activities of the member and its associated persons that relate to, and are designed to address the concerns indicated by, the Preliminary Criteria for Identification and protect investors and the public interest.

Pursuant to proposed Rule 4111(e)(2), the Department would be required to provide a written notice of its determination to the member, pursuant to proposed new Rule 9559,[27] no later than 30 days from the date of the letter that scheduled the Consultation. Where the Department decision imposes a Restricted Deposit Requirement or other conditions or restrictions, it also would inform the member of its ability to request a hearing with the Office of Hearing Officers in an expedited proceeding, as further described below.

Proposed Rule 4111(e)(2) would provide that a request for a hearing would not stay the effectiveness of the Department's determination. However, upon requesting a hearing of a Department determination that imposes a Restricted Deposit Requirement, the member would only be required to maintain in a Restricted Deposit Account the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year, until the Office of Hearing Officers or the National Adjudicatory Council (NAC) issues its final written order in the expedited proceeding. This has one exception: a member that is re-designated as a Restricted Firm and is already subject to a previously imposed Restricted Deposit Requirement would be required to maintain the full amount of its Restricted Deposit Requirement until the Office of Hearing Officers or the NAC issues its final written order in the expedited proceeding.

- Continuation or Termination of Restricted Firm Obligations (Proposed Rule 4111(f))

The proposed Restricted Firm Obligations Rule would require FINRA to evaluate annually whether each member is, or continues to be, a Restricted Firm and whether the member should be subject to any obligations. For this reason, proposed Rule 4111(f) contains provisions that set forth how any obligations that were imposed during the Rule 4111 process in one year are continued or terminated in that same year and in subsequent years.

Proposed Rule 4111(f)(1), titled "Currently Designated Restricted Firms," establishes constraints on a member's ability to seek to modify or terminate, directly or indirectly, any obligations imposed pursuant to Rule 4111. Because the Restricted Firm Obligations Rule would entail annual reviews by the Department to determine whether a member is a Restricted Firm that should be subject to obligations, a Restricted Firm would have an annual opportunity to seek the termination or modification of any obligations that continue to be imposed. For this reason, proposed Rule 4111 does not authorize a Restricted Firm to seek, outside of the Consultation process and any ensuing expedited proceedings after a Department decision, an interim termination or modification of any obligations imposed. Rather, proposed Rule 4111(f)(1) provides that a member that has been designated as a Restricted Firm will not be permitted to withdraw all or any portion of its Restricted Deposit Requirement, or seek to terminate or modify any deposit requirement, conditions, or restrictions that have been imposed on it, without the prior written consent of the Department.

Proposed Rule 4111(f)(2), titled "Re-Designation as a Restricted Firm," addresses the scenario when the Department determines in one year that a member is a Restricted Firm, and in the following year determines that the member still meets the Preliminary Criteria for Identification. In that instance, the Department would re-designate the member as a Restricted Firm, and the obligations previously imposed on the member would remain effective and unchanged, unless either the member or the Department requests, within 30 days of the Department's decision to re-designate the member as a Restricted Firm, a Consultation. If a Consultation is requested, the obligations previously imposed would remain effective and unchanged unless and until the Department modifies or terminates them after the Consultation. In addition, in the Consultation process, a presumption would apply that any previously imposed Restricted Deposit Requirement, conditions or restrictions would remain effective and unchanged, absent a showing by the party seeking changes that they are no longer necessary or appropriate for the protection of investors or in the public interest. At the end of the Consultation, the Department would be required to provide written notice of its determination to the member, no later than 30 days from the date of the letter provided to the member under Rule 4111(d)(2) that schedules the Consultation.

Proposed Rule 4111(f)(3), titled "Previously Designated Restricted Firms," addresses the scenario where the Department determines in one year that a member is a Restricted Firm, but in the following years determines that the member either does not meet the Preliminary Criteria for Identification or should not be designated as a Restricted Firm. In that case, the member would no longer be subject to any obligations previously imposed under proposed Rule 4111. There would be one exception: a former Restricted Firm would not be permitted to withdraw any portion of its Restricted Deposit Requirement without submitting an application and obtaining the Department's prior written consent for the withdrawal. Such an application would be required to include, among other things set forth in proposed Rule 4111(f)(3), evidence as to whether the member has "covered pending arbitration claims" or any unpaid arbitration awards outstanding against the member. The Department would determine whether to authorize a withdrawal, in part or in whole, but there would be a presumption that the member would be required to continue to maintain its Restricted Deposit Requirement if it has any "covered pending arbitration claims" or any unpaid arbitration awards. The Department would be required to issue a notice of its decision on an application to withdraw from the Restricted Deposit Account, pursuant to proposed new Rule 9559, within 30 days from the date the application is received.

- Restricted Deposit Account (Proposed Rule 4111(i)(14))

If a Department decision requires a member to establish a Restricted Deposit Account, proposed Rule 4111(i)(14) would govern this account. The underlying policy for the proposed account requirements is that, to make a deposit requirement effective in creating appropriate incentives to members that pose higher risks to change their behavior, the member must be restricted from withdrawing any of the required deposit amount, even if it terminates its FINRA membership.

The proposed rule would require that the Restricted Deposit Account be established, in the name of the member, at a bank or the member's clearing firm. The account must be subject to an agreement in which the bank or the clearing firm agrees: not to permit withdrawals from the account absent FINRA's prior written consent; to keep the account separate from any other accounts maintained by the member with the bank or clearing firm; that the cash or qualified securities on deposit will not be used directly or indirectly as security for a loan to the member by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien, or claim of any kind in favor of the bank, clearing firm or any person claiming through the bank or clearing firm; that if the member becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and withdrawals will not be permitted without FINRA's prior written consent; that FINRA is a third-party beneficiary to the agreement; and that the agreement may not be amended without FINRA's prior written consent. In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member.

These account restrictions would impact how a Restricted Firm calculates its net capital levels. As explained in proposed Rule 4111.01, a deposit in the Restricted Deposit Account would be an asset of the member firm that could not readily be converted into cash, due to the restrictions on accessing it. Accordingly, the member would be required to deduct deposits in the Restricted Deposit Account when determining its net capital under Exchange Act Rule 15c3-1 and FINRA Rule 4110.

- Books and Records (Proposed Rule 4111(g))

Proposed Rule 4111(g) would establish new requirements to maintain books and records that evidence the member's compliance with the Restricted Firm Obligations Rule and any Restricted Deposit Requirement or other conditions or restrictions imposed under that rule. In addition, the proposed books and records provision would specifically require a member subject to a Restricted Deposit Requirement to provide to the Department, upon its request, records that demonstrate the member's compliance with that requirement.

- Notice of Failure to Comply (Proposed Rule 4111(h))

FINRA also is proposing a requirement to address the situation when a member fails to comply with the obligations imposed. Under proposed Rule 4111(h), FINRA would be authorized to issue a notice pursuant to proposed new Rule 9559 directing a member that is not in compliance with its Restricted Deposit Requirement, or with any conditions or restrictions imposed under Rule 4111, to suspend all or a portion of its business.

- Definitions (Proposed Rule 4111(i))

The above description of proposed Rule 4111 introduces many of the terms that would be defined by Rule 4111. A complete list of defined terms used in the proposed rule appears in proposed Rule 4111(i).

- Compliance with Continuing Membership Application Rule (Proposed Rule 4111.02 - Compliance with Rule 1017)

Proposed Supplementary Material .02 would clarify that nothing in the proposed rule would alter a member's obligations under Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations). A member firm subject to proposed Rule 4111 would need to continue complying with the requirements of Rule 1017 and submit continuing membership applications as necessary.

- Periodic Review of Preliminary Identification Metrics Thresholds

FINRA would review the Preliminary Identification Metrics Thresholds on a periodic basis, to consider whether the thresholds remain targeted and effective at identifying firms that pose higher risks.

2. Proposed Amendments to the Rule 9550 Series to Establish a New Expedited Proceeding to Implement the Requirements of Proposed Rule 4111

FINRA is proposing to establish a new expedited proceeding in the Rule 9550 Series (Expedited Proceedings), specifically proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111), that would allow member firms to request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and grant a right to challenge any of the "Rule 4111 Requirements," including any Restricted Deposit Requirements, imposed.[28] The new expedited proceeding would govern how the Department provides notice of its determinations and afford affected member firms the right to seek a Hearing Officer's review of those determinations.

- Notices Under Proposed Rule 4111 (Proposed New Rule 9559(a))

Proposed new Rule 9559(a) would establish an expedited proceeding for the Department's determinations under proposed Rule 4111 to designate a member as a Restricted Firm and impose obligations on the member; and to deny a member's request to access all or part of its Restricted Deposit Requirement.

Proposed new Rule 9559(a) would require the Department to serve a notice that provides its determination and the specific grounds and factual basis for the Department's action; states when the action will take effect; informs the member that it may file, pursuant to Rule 9560, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explains the Hearing Officer's authority. The proposed rule also would provide that, if a member does not request a hearing, the notice of the Department's determination will constitute final FINRA action.

Proposed new Rule 9559(a) also would provide that any of the Rule 4111 Requirements imposed in a notice issued under proposed new Rule 9559(a) are immediately effective. In general, a request for a hearing would not stay those requirements. There would be one partial exception: when a member requests review of a Department determination under proposed Rule 4111 that imposes a Restricted Deposit Requirement on the member for the first time, the member would be required to deposit, while the expedited proceeding was pending, the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year.

- Notice for Failure to Comply with the Proposed Rule 4111 Requirements (Proposed New Rule 9559(b))

Proposed new Rule 9559(b) would establish an expedited proceeding to address a member's failure to comply with any requirements imposed pursuant to proposed Rule 4111.

Proposed new Rule 9559(b) would authorize the Department, after receiving authorization from FINRA's CEO, or such other executive officer as the CEO may designate, to serve a notice stating that the member's failure to comply with the Rule 4111 Requirements, within seven days of service of the notice, will result in a suspension or cancellation of membership. The proposed rule would require that the notice identify the requirements with which the member is alleged to have not complied; include a statement of facts specifying the alleged failure; state when the action will take effect; explain what the member must do to avoid the suspension or cancellation; inform the member that it may file, pursuant to Rule 9560, a request for a hearing in an expedited proceeding within seven days after service of the notice; and explain the Hearing Officer's authority. The proposed rule also would provide that, if a member does not request a hearing, the suspension or cancellation will become effective seven days after service of the notice.

Proposed new Rule 9559(b) also would provide that a member could file a request seeking termination of a suspension imposed pursuant to the rule, on the ground of full compliance with the notice or decision. The proposed rule would authorize the head of the Department to grant relief for good cause shown.

- Hearings (Proposed Amendments to the Hearing Procedures Rule)[29]

If a member requests a hearing under proposed new Rule 9559, the hearing would be subject to Rule 9560 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series). FINRA is proposing several amendments to Rule 9560 that would be specific to hearings requested pursuant to proposed new Rule 9559.

Hearings in expedited proceedings under proposed new Rule 9559 would have processes that are similar to the hearings in most of FINRA's other expedited proceedings—including requirements for the parties' exchange of documents and exhibits, the time for conducting the hearing, evidence, the record of the hearing, the record of the proceeding, failures to appear, the timing and contents of the Hearing Officer's decision, the Hearing Officer's authority, and the authority of the NAC to call an expedited proceeding for review—and FINRA is proposing amendments to the Rule 9560 provisions that govern these processes to adapt them for expedited proceedings under proposed new Rule 9559. A few features of the proposed amendments to Rule 9560 warrant emphasis or guidance:

- Hearing Officer's Authority (Proposed Amended Rule 9560(d) and (n))

Hearings in expedited proceedings under proposed new Rule 9559 would be presided over by a Hearing Officer. The Hearing Officer's authority would differ depending on whether the hearing is in an action brought under proposed new Rule 9559(a) (Notices Under Rule 4111) or 9559(b) (Notice for Failure to Comply with the Rule 4111 Requirements):

  - Proposed amended Rule 9560(n)(6) would provide that the Hearing Officer, in actions brought under proposed new Rule 9559(a), may approve or withdraw any and all of the Rule 4111 Requirements, or remand the matter to the Department, but may not modify any of the Rule 4111 Requirements, or impose any other requirements or obligations available under proposed Rule 4111.

  - Proposed amended Rule 9560(n)(6) would authorize the Hearing Officer, in failure-to-comply actions under proposed new Rule 9559(b), to approve or withdraw the suspension or cancellation of membership, and impose any other fitting sanction. Authorizing a Hearing Officer to impose any other fitting sanction is intended to provide a Hearing Officer with authority that is appropriate for responding to situations involving firms that repeatedly fail to comply with an effective FINRA action under proposed Rule 4111.

- Timing Requirements

The proposed amendments to the Hearing Procedures Rule are intended to give members a prompt process for challenging a Department decision under proposed Rule 4111. Proposed amended Rule 9560(f) would require that a hearing in actions under proposed new Rule 9559(a) be held within 30 days, and that a hearing in failure-to-comply actions under proposed new Rule 9559(b) be held within 14 days, after the member requests a hearing.[30]

Proposed amended Rule 9560(o) would require the Hearing Officer, in all actions pursuant to proposed new Rule 9559, to prepare a proposed written decision, and provide it to the NAC's Review Subcommittee, within 60 days of the date of the close of the hearing. Pursuant to Rule 9560(q), the Review Subcommittee could call the proceeding for review within 21 days after receipt of the proposed decision. As in most expedited proceedings, the timing of FINRA's final decision would then depend on whether or not the Review Subcommittee calls the matter for review.[31]

- Contents of the Decision

Proposed amended Rule 9560(p) governs the contents of the Hearing Officer's decision. The proposed amendments would broaden Rule 9560(p)(6) to account for the kinds of obligations that could be imposed under proposed Rule 4111. Rule 9560(p) would otherwise remain the same. For example, Rule 9560(p) would continue to require that the Hearing Officer's decision include a statement setting forth the findings of fact with respect to any act or practice the respondent was alleged to have committed or omitted or any condition specified in the notice, the Hearing Officer's conclusions regarding the condition specified in the notice, and a statement in support of the disposition of the principal issues raised in the proceeding.

Additional guidance may be helpful, considering the different kinds of issues that may arise in an expedited proceeding pursuant to proposed new Rule 9559. For example, in a request for a hearing of a Department determination that imposes a Restricted Deposit Requirement or other obligations under Rule 4111, the principal issues raised may include whether: (1) the member firm should not be designated a Restricted Firm; (2) the Department incorrectly included disclosure events when calculating whether the member meets the Preliminary Criteria for Identification; (3) a Restricted Deposit Requirement would impose an undue financial burden on the member; or (4) the obligations imposed are inconsistent with the standards set forth in proposed Rule 4111(e). In a request for a hearing of a Department determination that denies a request to withdraw amounts from a Restricted Deposit Account, the principal issues raised may include whether the member firm has covered pending arbitration claims or unpaid arbitration awards.

- No Collateral Attacks on Underlying Disclosure Events

In expedited proceedings pursuant to proposed new Rule 9559(a) to review a Department determination under the Restricted Firm Obligations Rule, a member firm may sometimes seek to demonstrate that the Department included incorrectly disclosure events when calculating whether the member meets the Preliminary Criteria for Identification. When the member does so, however, it would not be permitted to collaterally attack the underlying merits of those final actions. An expedited proceeding under proposed new Rule 9559 would not be the forum for attempting to re-litigate past final actions.[32]

Additional Approach Considered

FINRA also has considered a "terms and conditions" rule, but is not proposing such a rule at this time. As further discussed below in the Economic Impact Assessment, the numeric threshold-based approach in Rule 4111 has benefits and limitations. Because the rule would provide transparent, objective criteria based on public disclosure events, it would allow firms to understand clearly how they could become subject to the rule. On the other hand, the numeric-based criteria and thresholds may not identify all firms that raise the concerns motivating this proposal; firms may minimally change behavior simply to stay below established criteria and thresholds; firms may attempt to underreport required disclosures on Uniform Registration Forms; and the numerous steps that guard against misidentifications will affect how quickly FINRA can intervene.

Because of these limitations, FINRA also has considered an additional option for addressing firms with a history of misconduct that may pose a risk to investors. A key objective in developing possible approaches was to strengthen FINRA's ability to take earlier, effective intervention. The firms motivating FINRA action in this area typically have substantial and unaddressed compliance failures over multiple examination cycles that put investors or market integrity at risk. These serious compliance failures may be prolonged by firms while FINRA works to build a case of violations of specific securities requirements, which often requires obtaining the willing cooperation of customers. To meet this challenge, FINRA has considered another option that would permit FINRA to address prolonged noncompliance by the small number of firms whose activities present heightened risk of harm to investors and that may undermine confidence in the securities markets as a whole.

Specifically, FINRA has considered a proposal that would be similar to the IIROC's "terms and conditions" rule. Under this rule, IIROC may impose terms and conditions on an IIROC Dealer Member's membership when IIROC considers these terms and conditions appropriate to ensure the member's continuing compliance with IIROC requirements. IIROC has indicated that it will use this authority against its dealers that fail to address significant compliance findings or that fail to demonstrate a commitment to the development of a strong compliance culture, and primarily to address situations in which there are outstanding compliance issues that clearly require regulatory action, but that may not be best addressed through an enforcement proceeding.[33] IIROC's imposition of terms and conditions may be challenged by requesting a hearing panel review and a further appeal to provincial authorities, but the terms and conditions do not appear to be stayed during an appeal.

Compared to proposed Rule 4111, the regulatory benefits of a "terms and conditions" rule approach could arise from greater flexibility in identifying firms of concern, which may not trigger Rule 4111's thresholds, and quicker intervention to ensure compliance. Such an approach could also help mitigate the under- and over-inclusive concerns of the threshold-based criteria approach, and it could help fill the gap where a firm might not otherwise meet the numeric thresholds of proposed Rule 4111 but still has a history of serious noncompliance that poses a high degree of risk to investors or the markets. It also could allow for the imposition of tailored limitations and controls on firms and their brokers who might otherwise endanger customers, while motivating changes in the practices, activities and culture of firms seeking to terminate any terms and conditions imposed.

This approach could empower FINRA—outside of the continuing membership application process, the enforcement process and the proposed new Restricted Firm Obligations Rule—to require that a member abide by identified terms and conditions to incent its compliance with the federal securities laws and FINRA rules. Possible terms and conditions could include operational, conduct, financial, or sales practice obligations; limitations on business expansions; or other obligations on the business of the member or its associated persons.

Under this "terms and conditions" approach, the circumstances in which FINRA could intervene would be limited to when a member has repeatedly and significantly demonstrated a lack of compliance with the securities laws, the rules thereunder, or FINRA rules in specific ways that threaten investors or market integrity, and has not acted promptly to resolve the noncompliant condition. To ensure that the authority could be used in only the most serious circumstances, the imposition of terms and conditions would require the prior approval of FINRA's Chief Executive Officer or other executive officer not in FINRA's Departments of Member Supervision or Enforcement. In addition, a firm could be given an opportunity to request a prompt review of any terms and conditions imposed through an expedited proceeding process.

Although FINRA has closely considered, and will continue to further explore, this option, it is not proposing a terms and conditions approach at this time pending consideration of proposed Rule 4111.

Economic Impact Assessment

1. Regulatory Need

FINRA uses a number of measures to deter and discipline misconduct by firms and brokers, and continually strives to strengthen its oversight of the brokers and firms it regulates. These measures span across several FINRA programs, including review of new and continuing membership applications, risk monitoring of broker and firm activity, cycle and cause examinations, and enforcement and disciplinary actions.

As part of its efforts to monitor and deter misconduct, FINRA has adopted rules that impose supervisory obligations on firms to ensure they are appropriately supervising their brokers' activities. These rules require each firm to establish, maintain and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and FINRA rules. Under this regulatory framework, FINRA also provides guidance to ensure consistency in interpretation of the rules and to further strengthen compliance across firms. As such, all firms play an important role in ensuring effective compliance with applicable securities laws and FINRA rules to prevent misconduct. This is consistent with the incentives of economic agents.[34]

Nonetheless, some firms do not effectively carry out these supervisory obligations to ensure compliance and they act in ways that could harm their customers—sometimes substantially. For example, recent academic studies find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms. These studies also provide evidence of predictability of future disciplinary and other regulatory-related events for brokers and firms with a history of past similar events.[35] These patterns suggest that some firms may not be acting appropriately as a first line of defense to prevent customer harm. Further, some firms may take advantage of the fair-process protections afforded to them under the federal securities laws and FINRA rules to forestall timely and appropriate regulatory actions, thereby limiting FINRA's ability to curb misconduct promptly. Without additional protections, the risk of potential customer harm may continue to exist at firms that fail to effectively carry out their supervisory obligations or are associated with a significant number of regulatory-related events. Further, even where harmed investors obtain arbitration awards, brokers and firms may still fail to pay those awards. Unpaid arbitration awards harm successful customer claimants and may diminish investors' confidence in the arbitration process.[36]

To mitigate these risks, FINRA seeks additional authority to impose obligations on firms that pose these types of greater risk to their customers. The proposed Restricted Firm Obligations Rule would identify firms based upon a concentration of significant firm and broker events on their disclosure records that meet the proposed criteria and specified thresholds. Under the proposal, FINRA seeks the authority to impose obligations on firms that are necessary or appropriate.

2. Economic Baseline

The economic baseline used to evaluate the economic impacts of the proposed rules is the current regulatory framework, including FINRA rules relating to supervision, the membership application process, statutory disqualification proceedings and disciplinary proceedings that provide rules to deter and discipline misconduct by firms and brokers. This baseline serves as the primary point of comparison for assessing economic impacts of the proposed rules, including incremental benefits and costs.

The proposals are intended to apply to firms that pose greater risks to their customers than other firms. One identifier of these types of firms is that they and their brokers generally have substantially more regulatory-related events on their records than do their peers.[37] Consistent with this, the proposed Restricted Firm Obligations Rule would specifically apply to firms that have far more Registered Person and Member Firm Events, or far higher concentrations of Registered Persons Associated with Previously Expelled Firms, compared to their peers.[38] Based on staff analysis of all firms registered with FINRA between 2013 and 2018, firms that would have met the Preliminary Criteria for Identification had on average 4-8 times more Registered Person and Member Firm Events than peer firms at the time of identification. Specifically, the number of events per firm, for firms that would have met the Preliminary Criteria for Identification, ranged, on average, from 26-42 events during the Evaluation Period, compared to 5-7 events per firm for other firms. The median number of events per firm, for the firms that would have met the Preliminary Criteria for Identification, ranged from approximately 10-17 events, compared to 0 events amongst other firms.

Although disciplinary and regulatory-related events are one of the identifiers for firms posing higher risk, FINRA recognizes that firms posing higher risks do not always manifest themselves with greater disclosures on their records. These firms may be newer, have recently made changes in management, staff or approach, or simply may be more effective in avoiding regulatory marks.

3. Economic Impacts

A. Proposed Restricted Firm Obligations Rule

To estimate the number and types of firms that would meet the Preliminary Criteria for Identification, FINRA analyzed the categories of events and conditions associated with the proposed criteria for all firms during the 2013-2018 review period. For each year, FINRA determined the approximate number of firms that would have met the proposed criteria. The number of firms that would have met the proposed criteria during the review period serves as a reasonable estimate for the number of firms that would have been directly impacted by this proposal had it been in place at the time. This analysis indicates that there were 60-98 such firms at the end of each year during the review period, as shown in Attachment D-1. These firms represent 1.6-2.4% of all firms registered with FINRA in any year during the review period. The population of firms identified by the proposed criteria reflects the distribution of firm size in the full population of registered firms. Approximately 90-94% percent of these firms were small, 4-10% percent were mid-sized and 0-2% percent were large at the end of each year during the review period, as shown in Attachment D-2.[39]

In developing the proposed Preliminary Criteria for Identification, FINRA paid significant attention to the impact of possible misidentification of firms; specifically, the economic trade-off between including firms that are less likely to subsequently pose risk of harm to customers, and not including firms that are more likely to subsequently pose risk of harm to customers. There are costs associated with both types of misidentifications.[40] The proposed criteria, including the proposed numerical thresholds, aim to balance these economic trade-offs associated with over- and under-identification.[41] Further protection to misidentification would be provided by the proposed initial Department evaluation and the Consultation process.

- Anticipated Benefits

The proposal's primary benefit would be to reduce the risk and associated costs of possible future customer harm. This benefit would arise directly from additional restrictions placed on firms identified as Restricted Firms and increased scrutiny by these firms on their brokers. Further, this benefit would also accrue indirectly from improvements in the compliance culture, both by firms that meet the proposed criteria and by firms that do not. For example, the proposal may create incentives for firms that meet the Preliminary Criteria for Identification to change activities and behaviors, to mitigate the Department's concerns. Similarly, the proposal may have a deterrent effect on firms that do not meet the

Preliminary Criteria for Identification, particularly firms that may be close to meeting the proposed criteria. These firms may change behavior and enhance their compliance culture in ways that better protect their customers.

The proposal also may help address unpaid arbitration awards associated with firms identified as Restricted Firms under the proposal. Under the proposed rule, the Department may require a Restricted Firm to maintain a restricted deposit at a bank or a clearing firm that agrees not to permit withdrawals absent FINRA's approval. Moreover, the proposed rule would have a presumption that the Restricted Firm maintain the deposit if it has any covered pending arbitration claims or unpaid arbitration awards. Accordingly, the proposed rule could potentially create incentives for firms to pay unpaid arbitration awards, thereby alleviating, to some extent, harm to successful claimants and enhancing investor confidence in the arbitration process.[42]

To scope these potential benefits and assess the potential risk posed by firms that would meet the proposed Preliminary Criteria for Identification, FINRA evaluated the extent to which firms that would have met the criteria during 2013-2016[43] (had the criteria existed) and their brokers were associated with "new" Registered Person and Member Firm Events after having met the proposed criteria. These "new" events correspond to events that were identified or occurred after the firm's identification, and do not include events that were pending at the time of identification and subsequently resolved in the years after identification. As shown in Attachment D-3, FINRA estimates that there were 89 firms that would have met the Preliminary Criteria for Identification in 2013. These firms were associated with 1,859 "new" Registered Person and Member Firm Events that occurred after their identification, between 2014 and 2018. Attachment D-3 similarly shows the number of events associated with firms that would have met the Preliminary Criteria for Identification in 2014, 2015 and 2016. Across 2013-2016, there were 183 unique firms[44] that would have met the proposed Preliminary Criteria for Identification, and these firms were associated with a total of 2,793 Registered Person and Member Firm Events that occurred in the years after they met the proposed criteria.[45]

Attachment D-3 also shows the number of Registered Person and Member Firm Events for these firms compared to other firms. Specifically, FINRA calculated a factor which represents a multiple for the average number of events (on a per registered person basis) for firms that would have met the Preliminary Criteria for Identification relative to other firms of the same size. For example, as shown in Attachment D-3, the factor of 6.3x for 2013 indicates that firms meeting the Preliminary Criteria for Identification in 2013 had 6.3 times more new disclosure events (per registered person) in the years after identification (2014-2018) than other firms of the same size registered in 2013. Overall, this analysis demonstrates that firms that would have met the Preliminary Criteria for Identification during the review period had on average approximately 6-9 times more new disclosure events after their identification than other firms in the industry during the same period.

- Anticipated Costs

The anticipated costs of this proposal would fall primarily upon firms that meet the Preliminary Criteria for Identification and that the Department deems to warrant further review after its initial evaluation. Although FINRA would perform the annual calculation and conduct an internal evaluation, firms may choose to expend effort to determine if they would meet the Preliminary Criteria for Identification, and incur associated costs, at their own discretion. To the extent that a firm deemed to warrant further review under proposed Rule 4111 chooses to rebut the presumption that it is a Restricted Firm subject to the maximum Restricted Deposit Requirement, it would incur costs associated with collecting and providing information to FINRA. For example, these firms may provide information on any disclosure events that may be duplicative or not sales-practice related. These firms may also provide information on any undue financial hardship that would result from a Restricted Deposit Requirement. Likewise, a firm availing itself of the one-time staffing reduction opportunity incurs the separation costs, along with the potential for lost future revenues.

In addition, firms subject to a Restricted Deposit Requirement or other obligations would incur costs associated with these additional obligations. These would include, for example, costs associated with setting up the Restricted Deposit Account and ongoing compliance costs associated with maintaining the account. Further, as a result of restrictions on the use of cash or qualified securities in the deposit account or other restrictions on the firm's activities, the firm may lose economic opportunities, and its customers may lose the benefits associated with the provision of these services.

Similarly, a firm required to apply heightened supervision to its brokers would incur implementation and ongoing costs associated with its heightened supervision plan.[46] Firms that meet the Preliminary Criteria for Identification also may incur costs associated with enhancing their compliance culture, including possibly terminating registered persons with significant number of disclosure events—through exercising the one-time staffing reduction option under proposed Rule 4111 or otherwise—and reassigning the responsibilities of these individuals to other registered persons. Finally, there may be indirect costs, including greater difficulty or increased cost associated with maintaining a clearing arrangement, loss of trading partners, or similar impairments where third parties can determine that a firm meets the proposed Preliminary Criteria for Identification or has been deemed to be a Restricted Firm.

Firms that do not meet the proposed Preliminary Criteria for Identification, particularly ones that understand they are close to meeting the proposed criteria, also may incur costs associated with enhancing their compliance culture to avoid meeting the proposed criteria. These costs may include terminating registered persons with disciplinary records, replacing them with existing or new hires, enhancing compliance policies and procedures, and improving supervision of registered persons. Finally, registered persons with significant number of disciplinary or other disclosure events on their records may find it difficult to retain employment, or get employed by new firms.

- Other Economic Impacts

FINRA also has considered the possibility that, in some cases, this proposal may impose restrictions on brokers' and firms' activities that are less likely to subsequently harm their customers. In such cases, these brokers and firms may lose economic opportunities or find it difficult to retain brokers or customers. FINRA believes that the proposal mitigates such risks by requiring an initial layer of Departmental review, and providing affected firms an opportunity to engage in a Consultation with the Department and request a review of FINRA's determination in an expedited proceeding. FINRA recognizes that some firms may elect to terminate the registrations of certain brokers with disclosure events, and these brokers may find it difficult to get employed by other firms.

FINRA also considered that some firms may consider not reporting, underreporting, or failing to file timely, required disclosures on Uniform Registration Forms in an effort to avoid costs associated with the proposals. However, this potential impact is mitigated because many events are reported by regulators or in separate public notices by third parties and, as a result, FINRA can monitor for these unreported events. Further, failing to update timely Uniform Registration Forms is a violation of FINRA rules and can result in fines and penalties, thereby serving as a deterrent for underreporting or misreporting.

Considering that the proposed criteria are based on a firm's experience relative to its similarly sized peers, FINRA does not believe that the proposed criteria impose costs on competition between firms of different sizes. Further, because FINRA would perform the annual calculation to determine the firms that meet the Preliminary Criteria for Identification, the costs a firm incurs to monitor its status in relation to the proposed criteria would be discretionary and not likely create any competitive disadvantage based on firm size. Although the proposed rule would not impose these monitoring costs, FINRA would provide transparency around how the Preliminary Identification Metrics are calculated and appropriate guidance to assist firms seeking to determine their status. Similarly, FINRA does not anticipate that the proposed Restricted Firm Obligations Rule, including the Restricted Deposit Requirement or any required conditions and restrictions, would create competitive disadvantages across firms of different sizes. This is, in part, because FINRA would consider firm size, among other factors, when determining the appropriate maximum Restricted Deposit Requirement or any conditions and restrictions, to ensure that the obligations are appropriately tailored to the firms' business models but do not significantly undermine the continued financial stability and operational capability of the firm as an ongoing enterprise over the ensuing 12 months.

As discussed above, FINRA would exercise some discretion in determining the maximum Restricted Deposit Requirement and tailor it to the size, operations and financial conditions of the firm. This approach is intended to align with FINRA's objective to have the specific financial obligation be significant enough to change a Restricted Firm's behavior but not so burdensome that it would indirectly force it out of business. In determining the specific maximum Restricted Deposit Requirement, FINRA would consider a range of factors, including the nature of the firm's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric threshold, the amount of any "covered pending arbitration claims" or unpaid arbitration awards, and concerns raised during FINRA exams. In developing the proposal, FINRA considered the possibility of having a transparent formula, based on some of these factors, to determine a maximum Restricted Deposit Requirement. However, given the range of relevant factors and differences in firms' business models, operations, and financial conditions, FINRA decided not to propose a uniform, formulaic approach across all firms. Nonetheless, FINRA recognizes that in the absence of a transparent formulaic approach, firms that meet the Preliminary Criteria for Identification may overestimate or underestimate the maximum Required Deposit Requirement and incur associated costs.[47] Accordingly, FINRA seeks comment on alternative approaches that could be used to determine the maximum Restricted Deposit Requirement, and why these alternatives may be more efficient and effective than the proposed rule.

In developing the proposal, FINRA also considered the possibility that the size of the maximum Restricted Deposit Requirement may be too burdensome for the firms, and could undermine their financial stability and operational capability. FINRA believes that these risks are mitigated by providing affected firms an opportunity to engage in a Consultation process with FINRA and propose a lesser Restricted Deposit Requirement or restrictions or conditions on their operations. Further, as discussed above, Restricted Firms would have the opportunity to request a review of FINRA's determination in an expedited proceeding.

B. Proposed Expedited Proceeding Rule

When FINRA imposes obligations on a firm pursuant to the proposed Restricted Firm Obligations Rule, the firm may experience significant limitations to its business activities and incur direct and indirect costs associated with the obligations imposed. The proposed Expedited Proceeding Rule would, in general, require that these obligations apply immediately, even during the pendency of any appeal.

The proposed rule would be associated with investor protection benefits through the impact of the no-stay provision (proposed new Rule 9559(a)(4)). Under the proposal, obligations imposed by FINRA would be effective immediately, except that a firm subject to a Restricted Deposit Requirement under proposed Rule 4111 would be required to make a partial deposit while the matter is pending review. This would reduce the risk of investor harm during the pendency of a hearing requested by the firm. Similarly, the no-stay provision may limit hearing requests by firms that seek to use them only as a way to forestall FINRA obligations.

The benefit of the proposed rule accruing to firms would be to permit firms to appeal FINRA's determinations (both to request prompt review of obligations imposed or of determinations for failure to comply) in an expedited proceeding, thereby reducing undue costs where firms may have been misidentified. For example, the proposed rule is anticipated to reduce the costs associated with obligations imposed on misidentified firms by the proceeding's expedited nature. Similarly, the proposed rule's time deadlines may also reduce the costs of the proceedings, in certain cases.

The costs would be borne by firms that choose to seek review via the proposed expedited proceeding, and these costs can be measured relative to a standard proceeding. These firms would incur costs associated with provisions and procedures specific to this proposed rule, including the provision that the obligations imposed would not be stayed.[48] This would include the obligations imposed under the proposed rule, including the Restricted Deposit Requirement, and the requirement that the firm, upon the Department's request, provide evidence of its compliance with these obligations. However, the extent of the costs associated with the Restricted Deposit are mitigated by the expedited nature of the proceeding and by the provision that would require a firm, during an expedited hearing process, to maintain only a partial deposit requirement.

As with the other proposals, FINRA does not anticipate that the proposed rule would have differential competitive effects based on firm size or other criteria. The costs and benefits are anticipated to apply to all firms that request an expedited hearing.

4. Alternatives Considered

FINRA recognizes that the design and implementation of the rule proposals may impose direct and indirect costs on a variety of stakeholders, including firms, brokers, regulators, investors and the public. Accordingly, in developing its rule proposals, FINRA seeks to identify ways to enhance the efficiency and effectiveness of the proposals while maintaining their regulatory objectives. FINRA seeks comment on potential alternatives to the proposed amendments in this *Notice* and why these alternatives may be more efficient or effective at addressing broker and firm misconduct than the proposed amendments.

In developing this proposal, FINRA considered several alternatives to addressing the risks posed by firms and their brokers that have a history of misconduct, including an alternative to the proposed numeric threshold-based approach and alternative specifications to the proposed numeric threshold based-approach.

A. Alternative to the Proposed Numeric Threshold-Based Approach

In addition to the proposed approach based on numeric thresholds, FINRA considered an approach similar to IIROC's "terms and conditions" rule that would allow FINRA to identify a limited number of firms with significant compliance failures and impose on them appropriate terms and conditions to ensure their continuing compliance with the securities laws, the rules thereunder, and FINRA rules. FINRA considered and evaluated the economic impacts of such a Terms and Conditions rule relative to proposed Rule 4111.

Compared to proposed Rule 4111, a Terms and Conditions rule would provide FINRA with greater flexibility in identifying firms that should be subject to additional obligations. This greater flexibility could help better target its application and reduce misidentification by allowing FINRA to leverage non-public information, including regulatory insights collected as part of its monitoring and examination programs, in identifying firms that pose the greatest risk. Further, under a Terms and Conditions rule, FINRA could quickly update its identification of firms based on emerging risk patterns, to ensure that the rule continues to be effective at addressing firms that presently pose the greatest risk. This flexibility could mitigate the risk that the criteria and thresholds in proposed Rule 4111 no longer identify the appropriate firms.

Further, as discussed above, the identification criteria in proposed Rule 4111 may not identify all the firms that pose material risk to their customers, such as firms that may act to stay just below the proposed criteria and thresholds by any means, including misreporting or underreporting disclosure events. The absence of a set identification criteria in a Terms and Conditions rule would make it more difficult for firms to evade the identification criteria and thus could provide greater investor protections.

A Terms and Conditions rule also may have certain disadvantages relative to proposed Rule 4111. For example, a benefit of proposed Rule 4111 is the deterrent effect it may have on firms that do not meet the proposed Preliminary Criteria for Identification, particularly firms that may be close to meeting the criteria. These firms may change behavior and enhance their compliance culture in ways that could better protect their customers. By comparison, under a Terms and Conditions rule, in the absence of transparent criteria, firms must assess FINRA's view of the significance of repeated exam findings to determine whether to change their conduct to avoid potential terms and conditions.

Although FINRA has considered, and will continue to explore this alternative, it is not proposing a terms and conditions approach at this time.

B. Alternative Specifications for the Proposed Numeric Threshold-Based Approach

FINRA also considered several alternatives to the numerical thresholds and conditions for the Preliminary Criteria for Identification. In determining the proposed criteria, FINRA focused significant attention on the economic trade-off between incorrect identification of firms that may not subsequently pose risk of harm to their customers, and not including firms that may subsequently pose risk of harm to customers but do not meet the proposed thresholds. FINRA also considered three key factors: (1) the different categories of reported disclosure events and metrics; (2) the counting criteria for the number of reported events or conditions; and (3) the time period over which the events or conditions are counted. FINRA considered several alternatives for each of these three factors.

- Alternatives Associated with the Categories of Disclosure Events and Metrics

In determining the different types of disclosure events, FINRA considered all categories of disclosure events reported on the Uniform Registration Forms, including the financial disclosures. FINRA decided to exclude financial disclosures because while financial events, such as bankruptcies, civil bonds, or judgments and liens, may be of interest to investors in evaluating whether or not to engage a broker or a firm, these types of events by themselves are not evidence of customer harm.

In developing the Preliminary Criteria for Identification, FINRA also considered whether pending criminal, internal review, judicial and regulatory events should be excluded from the threshold test. FINRA decided to include these pending events because they often are associated with an emerging pattern of customer harm and capture timely information of potential ongoing or recent misconduct. Further, as with other categories, the proposed Preliminary Identification Metrics Thresholds for the relevant Preliminary Identification Metrics, including the Registered Person Pending Event Metric and the Member Firm Pending Event Metric, are intended to capture firms that are on the far tail of the distributions. Thus, firms meeting these thresholds have far more pending matters on their records than other firms in the industry. Nonetheless, FINRA recognizes that pending matters include disclosure events that may remain unresolved or that may subsequently be dismissed or concluded with no adverse action because they lack merit or suitable evidence.[49] In order to ensure that a firm does not meet the Preliminary Criteria for Identification solely because of pending matters, FINRA has proposed the conditions that, to meet the criteria, the firm must meet or exceed at least two of the six Preliminary Identification Metrics Thresholds, and at least one of the thresholds for the Registered Person Adjudicated Event Metric, Member Firm Adjudicated Event Metric, or Expelled Firm Association Metric.[50]

- Alternatives Associated with the Counting Criteria for the Proposed Criteria and Metrics

FINRA considered a range of alternative counting criteria for the Preliminary Criteria for Identification. For example, FINRA considered whether the Preliminary Criteria for Identification should be based on firms meeting two or more Preliminary Identification Metrics Thresholds, or whether the number of required thresholds should be decreased or increased. Decreasing the number of required thresholds from two to one would increase the number of firms that would have met the Preliminary Criteria for Identification during the review period from 60-98 firms to 150-220 firms, each year. Alternatively, increasing the number of required thresholds from two to three decreases the number of firms that would have met the Preliminary Criteria for Identification from 60-98 to 15-35, each year. FINRA reviewed the list of firms identified under these alternative counting criteria and examined the extent to which they included firms that were subsequently expelled, associated with unpaid awards, or identified as suitable candidates for additional obligations by the Department. FINRA also paid particular attention to firms that would have been identified by these alternative criteria but subsequently were not associated with high-risk activity, as well as firms that would not have been identified by these alternatives that were associated with high-risk events. Based on this review, FINRA believes that the proposed approach—meeting two or more of the Preliminary Identification Metrics Thresholds—more appropriately balances these trade-offs between misidentifications than the alternative criteria.

- Alternatives Associated with the Time Period over which the Metrics Are Calculated

The proposed Preliminary Identification Metrics are based on three different time periods over which different categories of events and conditions are counted (look-back periods). Pending events, including the Registered Person Pending Events and the Member Firm Pending Events categories, are counted in the Preliminary Identification Metrics only if they are pending as of the Evaluation Date. Adjudicated events, including the Registered Person Adjudicated Events and the Member Firm Adjudicated Events categories, are counted in the Preliminary Identification Metrics over a five-year look-back period. The Expelled Firm Association Metric does not have a limit on the look-back period, and is based on the association of Registered Persons In-Scope with a previously expelled firm at any time in their career.[51]

In developing the proposal, FINRA considered alternative criteria for the time period over which the disclosure events or conditions are counted. For example, FINRA considered whether adjudicated events should be counted over the individual's or firm's entire reporting period or counted over a more recent period. Based on its experience, FINRA believes that events that are more recent (*e.g.*, events occurring in the last five years) generally pose a higher level of possible future risk to customers than other events. Further, counting events over an individual's or firm's entire reporting period would imply that brokers and firms would always be included in the Preliminary Identification Metrics for adjudicated events, even if they subsequently worked without being associated with any future adjudicated events. Accordingly, FINRA decided to include adjudicated events only in the more recent period (*i.e.*, a five-year period).[52]

Similarly, FINRA also considered whether there should be limits on the time period over which the Expelled Firm Association Metric is calculated. For example, FINRA considered alternative metrics that would only be based on firm expulsions over the last three to five years. Further, FINRA considered alternatives where the individual broker's association with the previously expelled firm was within a five-year window around the firm's expulsion. In evaluating these alternatives, FINRA recalculated the underlying thresholds to capture firms that are on the far tail of the distribution for these alternative metrics.[53] As with other alternatives, FINRA evaluated these alternatives by paying particular attention to the economic trade-offs of misidentifications, including over- and under-identification of firms. Based on this evaluation, FINRA determined that the Expelled Firm Association Metric proposed in this *Notice* better accounts for these economic trade-offs. Nonetheless, FINRA specifically seeks comments on alternatives FINRA should consider for the Expelled Firm Association Metric and why these alternatives may be more effective and efficient for identifying the firms that this proposal seeks to address.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues.

General

1. Are there alternative ways to address members that pose a high degree of risk that should be considered? What are the alternative approaches that FINRA should consider?
2. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:
    c. What are these economic impacts and what are their primary sources?
    d. To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models?
    e. What would be the magnitude of these impacts, including costs and benefits?
3. Are there any expected economic impacts associated with the proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Proposed Rule 4111

4. As discussed above, the framework in proposed Rule 4111 for identifying members that pose a high degree of risk is based on identifying members with significantly more reportable events than their peers, based upon six proposed categories of events and conditions.
    a. Does this appear to be a reasonable approach for identifying members that could be subject to additional obligations? Are there other approaches FINRA should consider?
    b. Do the seven firm-size categories in proposed Rule 4111(i)(11) appropriately group firms of similar sizes? Should FINRA consider additional size categories or consider combining certain size categories?
    c. The framework is based on six different categories of events and conditions. Each of these categories is based on a combination of disclosure events. Do these categories appropriately combine similar types of disclosure events? Should FINRA consider additional disclosure categories or consider aggregating or disaggregating certain categories?
    d. FINRA anticipates that the distributions of the six categories of events and conditions would change over time. Should FINRA consider updating the Preliminary Identification Metrics Thresholds periodically, to ensure that they continue to identify members that are significantly different than their peers? If so, how frequently should FINRA consider updating the thresholds?

5. As discussed above, when developing proposed Rule 4111, FINRA considered several numerical and categorical thresholds for identifying member firms that could potentially be subject to a Restricted Deposit Requirement and other obligations. In determining the proposed metrics and thresholds, FINRA paid significant attention to the economic trade-offs associated with misidentifications, including both over- and under-identification of member firms. FINRA seeks comments on the proposed numerical thresholds and metrics, including the following key factors associated with developing the metrics: (a) the different categories of reported disclosure events and conditions; (b) the counting criteria for the metrics; and (c) the time period over which the metrics are calculated. Specifically, FINRA seeks comment on whether alternative inputs for any of these factors should be considered, and why these alternatives may better identify firms that pose greater risks to their investors.
6. Should FINRA consider alternative thresholds or look-back periods for the Expelled Firm Association Metric? What factors or conditions should FINRA consider when developing a metric with respect to expelled firm association?
7. Proposed Rule 4111 includes several processes, including qualitative reviews and consultations, to minimize potential sources of misidentifications. These processes may aid in the identification of the members motivating this proposal, but may also delay the imposition of obligations on them. Are there alternative processes that should be considered?
8. Proposed Rule 4111 is premised on a notion that the most effective tool to change the behavior of a member firm that presents a high degree of risk is a financial restriction. The proposal, however, affords members that meet the Preliminary Criteria for Identification the opportunity to advocate for a lower Restricted Deposit Requirement or for conditions and restrictions as alternatives to a Restricted Deposit Requirement. Are there better ways to create a potential financial restriction that serves as an effective incentive to change firm behavior?
9. Proposed Rule 4111 would restrict a member firm from withdrawing any amount from the Restricted Deposit Account, even if it terminates its FINRA membership. However, the proposed Restricted Deposit Account would not be bankruptcy remote and could be used to satisfy claims in a bankruptcy proceeding. Should FINRA consider ways to structure the Restricted Deposit Account so that it is bankruptcy remote or preferentially available to customer claims in the event of a bankruptcy? If so, how should FINRA structure the Restricted Deposit Account, and what conditions and priorities should FINRA consider placing on claims in the event of a bankruptcy?
10. Proposed Rule 4111 would allow a member firm that meets the Preliminary Criteria for Identification, and that the Department determines warrants further review under Rule 4111, to present why certain disclosure events should not be counted.

For example, a member could maintain that disclosure events should not be included in the annual calculation because they involved the same person and the same event or were non-sales-practice related. Are there other characteristics of disclosure events that should lead to not including those events in the calculation of whether the member firm meets the Preliminary Criteria for Identification?

11. Proposed Rule 4111 uses a principles-based approach for determining a maximum Restricted Deposit Requirement.
    a. FINRA intends to take several factors into account in determining the maximum Restricted Deposit Requirement, including the nature of the member's operations and activities, annual revenues, commissions, net capital requirements, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, the amount of covered pending arbitration claims or unpaid arbitration awards, and concerns raised during FINRA examinations. Are there other factors FINRA should consider in making this determination? What are those factors, and how should FINRA account for them?
    b. Should FINRA instead consider a formula-based approach(es)? If so, what would be an appropriate formula-based approach that results in a meaningful Restricted Deposit Requirement? How would the formula-based approach account for differences in firms' business models, financial conditions, or other factors discussed above?
12. Should there be a cap on the maximum Restricted Deposit Requirement? If so, what should the cap be? Should it be expressed as a specific dollar amount? As a number derived from a firm-specific figure, such as a percentage of the member's gross revenues? Or something else?
13. Apart from having to comply with a Restricted Deposit Requirement or other obligations, are there collateral consequences that could result from being designated as a Restricted Firm, even if FINRA does not publicly disclose that designation? If so, what are those collateral consequences?
14. This *Notice* explains that FINRA would review the Preliminary Identification Metrics Thresholds in proposed Rule 4111 on a periodic basis, to consider whether the thresholds remain targeted and effective at identifying member firms that pose higher risks. How frequently should FINRA conduct those periodic reviews?

Proposed New Rule 9559 and Proposed Amended Rule 9560

15. Hearings in expedited proceedings under proposed new Rule 9559 would be presided over by a Hearing Officer. By requiring the appointment of a Hearing Officer instead of a Hearing Panel, FINRA intends to create efficiencies, considering the number of potential expedited proceedings that could result from the proposed rule and the substantial amount of time and resources that the Office of Hearing Officers could expend in identifying Hearing Panelists. However, there would be potential benefits to having a Hearing Panel preside over the proceedings, especially due to the industry experience that Hearing Panelists may have. Should FINRA consider requiring that a Hearing Panel be appointed in proceedings under proposed new Rule 9559? Would the benefits of appointing Hearing Panelists outweigh the costs?

Additional Approaches Considered

16. Should FINRA consider a rule proposal that would provide it discretion to identify firms that pose significant concerns and impose tailored terms and conditions on a firm, similar to the IIROC's "terms and conditions" rule? If so, should FINRA consider adopting both proposed Rule 4111 and a "terms and conditions" rule, or just one of these kinds of rules? What would be the costs and consequences to member firms of a "terms and conditions" rule, and what kinds of limitations should be placed on such a rule?
17. FINRA's authority to seek temporary cease and desist orders is limited to alleged violations of specific Exchange Act provisions, specific Exchange Act rules, and specific FINRA rules. It is also limited to circumstances in which the alleged violative conduct is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding.[54] Should FINRA consider expanding its authority to seek temporary cease and desist orders?

In addition to comments responsive to these questions, FINRA invites comment on any other aspects of the rules that commenters wish to address. FINRA further requests any data or evidence in support of comments. While the purpose of this *Notice* is to obtain input as to whether or not the current rules are effective and efficient, FINRA also welcomes specific suggestions as to how the rules should be changed.

Endnotes

1. The proposed new rule establishing expedited proceeding procedures for regulating activities under proposed Rule 4111 would be new Rule 9559 (Procedures for Regulating Activities Under Rule 4111); current Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) would be renumbered as Rule 9560. References in this Notice to "new Rule 9559" are to the proposed new rule; references to "Rule 9560" or "the Hearing Procedures Rule" are to current Rule 9559.

2. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.

3. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

4. For example, in October 2018, FINRA announced plans to consolidate its Examination and Risk Monitoring Programs, integrating three separate programs into a single, unified program to drive more effective oversight and greater consistency, eliminate duplication and create a single point of accountability for the examination of firms. That effort is well underway, and FINRA expects the consolidation will bring those programs under a single framework designed to better direct and align examination resources to the risk profile and complexity of member firms.

5. For example, in 2015 FINRA's Office of the Chief Economist (OCE) published a study that examined the predictability of disciplinary and other disclosure events associated with investor harm based on past similar events. The OCE study showed that past disclosure events, including regulatory actions, customer arbitrations and litigations of brokers, have significant power to predict future investor harm. *See* Hammad Qureshi & Jonathan Sokobin, *Do Investors Have Valuable Information About Brokers?* (FINRA Office of the Chief Economist Working Paper, Aug. 2015). A subsequent academic research paper presented evidence that suggests a higher rate of new disciplinary and other disclosure events is highly correlated with past disciplinary and other disclosure events, as far back as nine years prior. *See* Mark Egan, Gregor Matvos, & Amit Seru, *The Market for Financial Adviser Misconduct*, J. Pol. Econ. 127, no. 1 (Feb. 2019): 233-295.

6. The number of disclosure events correspond to the number of Registered Person and Member Firm Events (defined in proposed Rule 4111(i)(12)) during the Evaluation Period (defined in proposed Rule 4111(i)(6)), as of December 31, 2018. As per the Evaluation Period definition, all final events are counted over the prior five years, and all pending events are counted if they were pending as of December 31, 2018.

7. *See* FINRA Rule 9800 Series (Temporary and Permanent Cease and Desist Orders).

8. *See* Securities Exchange Act Release No. 83181 (May 7, 2018), 83 FR 22107 (May 11, 2018) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2018-018).

9. *See Regulatory Notice 18-16*.

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10. The term "covered pending arbitration claim" is defined in proposed Rule 4111(i)(2) to mean an investment-related, consumer initiated claim filed against the member or its associated persons 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. This term also is proposed in *Regulatory Notice 18-06* (February 2018). FINRA anticipates that the term would be amended in proposed Rule 4111(i)(2) to conform to any final definition adopted under the proposal in *Regulatory Notice 18-06*. For purposes of this *Notice*, the term "unpaid arbitration awards" also includes unpaid settlements related to arbitrations.
11. *See* IIROC Consolidated Rule 9208.
12. "Uniform Registration Forms" mean Forms BD, U4, U5 and U6.
13. *See* proposed Rule 4111(a) and (d).
14. This part of the *Notice* uses many terms that are defined in proposed Rule 4111(i). The terms used have the meanings as defined in proposed Rule 4111(i).
15. *See supra* note 12. One of the event categories, Member Firm Adjudicated Events, includes events that are derived from customer arbitrations filed with FINRA's dispute resolution forum.
16. "Registered Person Adjudicated Events," defined in proposed Rule 4111(i)(4)(A), means any one of the following events that are reportable on the registered person's Uniform Registration Forms: (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; (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; (iii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iv) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (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.
17. "Registered Person Pending Events," defined in proposed Rule 4111(i)(4)(B), means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms: (i) a pending investment-related civil judicial matter; (ii) a pending investigation by a regulatory authority; (iii) a pending regulatory action that was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (iv) a pending criminal charge associated with any felony or any reportable misdemeanor. Registered Person Pending Events does not include pending arbitrations, pending civil litigations, or consumer-initiated complaints that are reportable on the registered person's Uniform Registration Forms.

18. "Registered Person Termination and Internal Review Events," defined in proposed Rule 4111(i)(4)(C), means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms: (i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations; or (ii) a pending or closed internal review by the member.

19. "Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D), means any of the following events that are reportable on the member firm's Uniform Registration Forms, or are based on customer arbitrations filed with FINRA's dispute resolution forum: (i) a final investment-related, consumer-initiated customer arbitration award in which the member was a named party; (ii) a final investment-related civil judicial matter that resulted in a finding, sanction or order; (iii) a final regulatory action that resulted in a finding, sanction or order, and was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (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.

20. "Member Firm Pending Events," defined in proposed Rule 4111(i)(4)(E), means any one of the same kinds of events as the "Registered Person Pending Events," but that are reportable on the member firm's Uniform Registration Forms.

21. "Registered Persons Associated with Previously Expelled Firms," defined in proposed Rule 4111(i)(4)(F), means any registered person registered for one or more days within the year prior to the "Evaluation Date" (*i.e.*, the annual date as of which the Department calculates the Preliminary Identification Metrics) with the member, and who was associated with one or more previously expelled firms (at any time in his/her career).

22. For each of the six Preliminary Identification Metrics, proposed Rule 4111(i)(11) establishes numeric thresholds for seven different firm sizes. Firm sizes are based on the number of registered persons, and range from members that have 1-4 registered persons to members that have 500 or more registered persons. Thus, the proposal establishes 42 different numeric thresholds.

23. "Registered Person and Member Firm Events," a term defined in proposed Rule 4111(i)(12), means the sum of events in the following five categories: (i) Registered Person Adjudicated Events; (ii) Registered Person Pending Events; (iii) Registered Person Termination and Internal Review Events; (iv) Member Firm Adjudicated Events; and (v) Member Firm Pending Events.

24. The "Evaluation Date" is defined in proposed Rule 4111(i)(5) to mean the date, each calendar year, as of which the Department calculates the Preliminary Identification Metrics to determine if the member firm meets the Preliminary Criteria for Identification.

25. OCE has tested the Preliminary Criteria for Identification, including the Preliminary Identification Metrics Thresholds, in several ways. For example, OCE has compared the firms captured by the proposed criteria to the firms that have recently been expelled or that have unpaid arbitration awards. OCE also has consulted with Member Supervision staff and examiners about whether, based on their experience, the criteria identifies firms that appear to present high risks to investors.

26. *See supra* note 10, for an explanation of references in this *Notice* to the term "unpaid arbitration awards."

27. *See supra* note 1, for explanations of references in this *Notice* to "new Rule 9559" and references to "Rule 9560" or the "Hearing Procedures Rule."

28. Proposed new Rule 9559(a)(1) would define the "Rule 4111 Requirements" to mean the requirements, conditions, or restrictions imposed by a Department determination under proposed Rule 4111.

29. *See supra* note 1, for explanations of references in this *Notice* to "new Rule 9559" and references to "Rule 9560" or the "Hearing Procedures Rule."

30. Proposed amended Rule 9560 contains other related timing requirements for proceedings pursuant to proposed new Rule 9559.

31. *See* FINRA Rule 9560(q).

32. Attempts to collaterally attack final matters are also precluded in other FINRA proceedings. *Cf. Dep't of Enforcement v. Amundsen*, Complaint No. 2010021916601, 2012 FINRA Discip. LEXIS 54, at *21-24 (FINRA NAC Sept. 20, 2012) (rejecting respondent's attempt to collaterally attack a judgment that was required to be disclosed on Form U4), *aff'd*, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148 (Apr. 18, 2013), *aff'd*, 575 F. App'x 1 (D.C. Cir. 2014); *Membership Continuance Application of Member Firm*, Application No. 20060058633, 2007 FINRA Discip. LEXIS 31, at *51 (July 2007) (holding, in a membership proceeding, that a firm may not address its and its FINOP's past disciplinary history by collaterally attacking those past violations) (citing *BFG Sec., Inc.*, 55 S.E.C. 276, 279 n.5 (2001)); *Jan Biesiadecki*, 53 S.E.C. 182, 185 (1997) (describing, in eligibility proceedings, FINRA's long-standing policy of prohibiting collateral attacks on underlying disqualifying events).

33. *See* IIROC Consolidated Rule 9208; *see also* IIROC Notice 17-0010, at pp. 2, 14 (Jan. 12, 2017) (IIROC Compliance Priorities), available at *www.iiroc.ca/Documents/2017/2461049c-03b1-4bfa-ba16-2ac05bd59ab4_en.pdf*.

34. *See, e.g.*, Roland Strausz, *Delegation of Monitoring in a Principal-Agent Relationship*, Rev. Econ. Stud. 64(3):337-57 (July 1997). The paper shows that in a standard principal-agent framework, the delegation of monitoring by the principal (*e.g.*, a regulator) to the agent (*e.g.*, a firm) can be economically efficient for both parties.

35. *See supra* note 5.

36. Investors may also file claims in courts or other dispute resolution forums. Successful claimants in these forums may face similar challenges associated with collecting awards or judgments.

37. As discussed above, recent studies provide evidence of predictability of future regulatory-related events for brokers and firms with a history of past regulatory-related events. As a result, brokers and firms with a history of past regulatory-related events pose greater risk of future harm to their customers than other brokers and firms.

38. For example, for each of the six Preliminary Identification Metrics, the Preliminary Identification Metrics Threshold was chosen to capture 1% - 5% of the firms with the highest number of events per registered broker or the highest concentrations of Registered Persons Associated with Previously Expelled Firms, in respective firm-size categories.

39. FINRA defines a small firm as a member with at least one and no more than 150 registered persons, a mid-size firm as a member with at least 151 and no more than 499 registered persons, and a large firm as a member with 500 or more registered persons. *See* FINRA By-Laws, Article I.

40. For example, subjecting firms that are less likely to pose a risk to customers to the proposed Restricted Deposit Requirement or other obligations would impose additional and unwarranted costs on these firms, their brokers and their customers.

41. In order to evaluate the effectiveness of the proposed criteria at identifying firms that pose greater risks, FINRA examined the overlap between the firms that would have met the Preliminary Criteria for Identification each year during the review period and the firms that were subsequently expelled, associated with unpaid awards, or identified by Department staff as suitable candidates for additional obligations. Finally, as discussed below, FINRA also examined disclosure events associated with firms that would have met the Preliminary Criteria for Identification each year during the review period, subsequent to meeting the criteria, to assess the extent of risk posed by these firms.

42. Further, as discussed above, the Department would consider unpaid awards as one of the factors in determining the amount of the Restricted Deposit Requirement. As a result, Restricted Firms would have additional incentives to pay unpaid arbitration awards.

43. This analysis examines firms that would have met the Preliminary Criteria for Identification from 2013 until 2016, to allow sufficient time for the "new" events to resolve in the post-identification period.

44. Certain firms would have met the criteria in multiple years during the review period. The 183 firms discussed in the text correspond to the unique number of firms that would have met the criteria in one or more years during the review period.

45. Specifically, FINRA examined and counted all Registered Person and Member Firm Events that occurred any time after the firms were identified until March 15, 2019.

46. These costs would likely vary significantly across firms. Costs would depend on the specific obligations imposed specific to the firm and its business model. In addition, costs could escalate if a heightened supervision plan applied to brokers that serve as principals, executive managers, owners or in other senior capacities. Such plans may entail re-assignments of responsibilities, restructuring within senior management and leadership, and more complex oversight and governance approaches.

47. For example, firms may, conservatively, overestimate the amount of the required deposit, and withhold the use of additional funds, thereby losing out on economic opportunities associated with these excess funds, until FINRA informs these firms of their actual maximum Restricted Deposit Requirement.

48. The effect of the no-stay provision is that imposed obligations would apply immediately, even during the pendency of any hearing request. As a result, the no-stay provision would impose direct costs on misidentified firms.

49. For example, customers may file complaints that are false or erroneous and such complaints may subsequently be withdrawn by the customers or get dismissed by arbitrators or judges.

50. In order to assess the impact of removing pending events from the Preliminary Criteria for Identification and restricting the criteria solely to final events, FINRA examined the number of firms that would have met or exceeded at least one Preliminary Identification Metrics Threshold in the Registered Person Adjudicated Events, Member

Firm Adjudicated Events, or Registered Persons Associated with Expelled Firms categories, during the relevant period. This analysis showed that the number of firms identified by this alternative criteria would increase from 60-98 firms to 150-220 firms, each year, during the review period. Similarly, FINRA estimates the number of firms that would have met or exceeded at least two thresholds within these categories to be 50-75 firms, each year, during the review period.

51. Registered Persons In-Scope include all persons registered with the firm for one or more days within the one year prior to the Evaluation Date.

52. This is consistent with the time period used for counting "specified risk events" in *Regulatory Notice 18-16*.

53. These alternatives would have identified approximately the same number of firms as meeting the Preliminary Criteria for Identification, during the review period.

54. *See* FINRA Rules 9810(a), 9840(a).

Regulatory Notice 19-18

May 6, 2019

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topics
- Anti-Money Laundering
- Compliance Programs

Referenced Rules & Notices
- Bank Secrecy Act
- FINRA Rule 3310
- Notice to Members 02-21

Anti-Money Laundering (AML) Program

FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations

Summary

FINRA is issuing this *Notice* to provide guidance to member firms regarding suspicious activity monitoring and reporting obligations under FINRA Rule 3310 (Anti-Money Laundering Compliance Program).

Questions concerning this *Notice* should be directed to:

- Victoria Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104 or *victoria.crane@finra.org*; or
- Blake Snyder, Senior Director, Member Regulation, at (561) 443-8051 or *blake.snyder@finra.org*.

Background and Discussion

FINRA Rule 3310 (Anti-Money Laundering Compliance Program) requires each member firm to develop and implement a written anti-money laundering (AML) program reasonably designed to achieve and monitor the firm's compliance with the requirements of the Bank Secrecy Act (BSA),[1] and the implementing regulations promulgated thereunder by the Department of the Treasury (Treasury).

FINRA Rule 3310(a) requires firms to "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under [the BSA] and the implementing regulation thereunder." The BSA authorizes Treasury to require that financial institutions file suspicious activity reports (SARs).[2]

Financial Industry Regulatory Authority

Under Treasury's SAR rule,[3] a broker-dealer must report a transaction to the Financial Crimes Enforcement Network (FinCEN) if it is conducted or attempted by, at or through a broker-dealer, it involves or aggregates funds or other assets of at least $5,000, and the broker-dealer knows, suspects or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part):

- involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity (including, without limitation, the ownership, nature, source, location or control of such funds or assets) as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law or regulation;
- is designed, whether through structuring or other means, to evade any regulations promulgated under the BSA;
- has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or
- involves use of the broker-dealer to facilitate criminal activity.[4]

Broker-dealers must report the suspicious activity by completing a SAR and filing it in accordance with the requirements of Treasury's SAR rule.[5] Broker-dealers must maintain a copy of any SAR filed and supporting documentation for a period of five years from the date of filing the SAR.[6] FinCEN has provided guidance[7] to the industry advising that if the activity that was the subject of a SAR filing continues, firms should review any continuing activity at least every 90 days to consider whether a continuing activity SAR filing is warranted, with the filing deadline being 120 days after the date of the previously related SAR filing.

In situations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, broker-dealers must immediately notify by telephone an appropriate law enforcement authority in addition to filing timely a SAR. The firm may call FinCEN's Hotline at (866) 556-3974.

Money Laundering Red Flags

FINRA published a list of "money laundering red flags" in *Notice to Members 02-21* (NTM 02-21). Since NTM 02-21 was published, guidance detailing additional red flags that may be applicable to the securities industry have been published by a number of U.S. government agencies and international organizations.[8] FINRA is issuing this *Notice* to provide examples of these additional money laundering red flags for firms to consider incorporating into their AML programs, as may be appropriate in implementing a risk-based approach to BSA/AML compliance. This could include, as applicable, incorporation into policies and procedures relating to suspicious activity monitoring or suspicious activity investigation and SAR reporting. Upon detection of red flags through monitoring, firms should consider whether additional investigation, customer due diligence measures or a SAR filing may be warranted.

The following is not an exhaustive list and does not guarantee compliance with AML program requirements or provide a safe harbor from regulatory responsibility. Further, it is important to note that a red flag is not necessarily indicative of suspicious activity, and that not every item identified in this *Notice* will be relevant for every broker-dealer, every customer relationship or every business activity.

Firms should also be aware of emerging areas of risk, such as risks associated with activity in digital assets. Regardless of whether such assets are securities, BSA/AML requirements, including SAR filing requirements apply, and firms should thus consider the relevant risks, monitor for suspicious activity and, as applicable, report any such activity.

This *Notice* is intended to assist broker-dealers in complying with their existing obligations under BSA/AML requirements and does not create any new requirements or expectations. In addition, this *Notice* incorporates the red flags listed in NTM 02-21 so that firms can refer to this *Notice* only for examples of potential red flags.

I. Potential Red Flags in Customer Due Diligence and Interactions With Customers

1. The customer provides the firm with unusual or suspicious identification documents that cannot be readily verified or are inconsistent with other statements or documents that the customer has provided. Or, the customer provides information that is inconsistent with other available information about the customer. This indicator may apply to account openings and to interaction subsequent to account opening.
2. The customer is reluctant or refuses to provide the firm with complete customer due diligence information as required by the firm's procedures, which may include information regarding the nature and purpose of the customer's business, prior financial relationships, anticipated account activity, business location and, if applicable, the entity's officers and directors.
3. The customer refuses to identify a legitimate source of funds or information is false, misleading or substantially incorrect.
4. The customer is domiciled in, doing business in or regularly transacting with counterparties in a jurisdiction that is known as a bank secrecy haven, tax shelter, high-risk geographic location (*e.g.*, known as a narcotics producing jurisdiction, known to have ineffective AML/Combating the Financing of Terrorism systems) or conflict zone, including those with an established threat of terrorism.
5. The customer has difficulty describing the nature of his or her business or lacks general knowledge of his or her industry.
6. The customer has no discernable reason for using the firm's service or the firm's location (*e.g.*, the customer lacks roots to the local community or has gone out of his or her way to use the firm).

7. The customer has been rejected or has had its relationship terminated as a customer by other financial services firms.
8. The customer's legal or mailing address is associated with multiple other accounts or businesses that do not appear related.
9. The customer appears to be acting as an agent for an undisclosed principal, but is reluctant to provide information.
10. The customer is a trust, shell company or private investment company that is reluctant to provide information on controlling parties and underlying beneficiaries.
11. The customer is publicly known or known to the firm to have criminal, civil or regulatory proceedings against him or her for crime, corruption or misuse of public funds, or is known to associate with such persons. Sources for this information could include news items, the Internet or commercial database searches.
12. The customer's background is questionable or differs from expectations based on business activities.
13. The customer maintains multiple accounts, or maintains accounts in the names of family members or corporate entities, with no apparent business or other purpose.
14. An account is opened by a politically exposed person (PEP),[9] particularly in conjunction with one or more additional risk factors, such as the account being opened by a shell company[10] beneficially owned or controlled by the PEP, the PEP is from a country which has been identified by FATF as having strategic AML regime deficiencies, or the PEP is from a country known to have a high level of corruption.
15. An account is opened by a non-profit organization that provides services in geographic locations known to be at higher risk for being an active terrorist threat.[11]
16. An account is opened in the name of a legal entity that is involved in the activities of an association, organization or foundation whose aims are related to the claims or demands of a known terrorist entity.[12]
17. An account is opened for a purported stock loan company, which may hold the restricted securities of corporate insiders who have pledged the securities as collateral for, and then defaulted on, purported loans, after which the securities are sold on an unregistered basis.
18. An account is opened in the name of a foreign financial institution, such as an offshore bank or broker-dealer, that sells shares of stock on an unregistered basis on behalf of customers.
19. An account is opened for a foreign financial institution that is affiliated with a U.S. broker-dealer, bypassing its U.S. affiliate, for no apparent business purpose. An apparent business purpose could include access to products or services the U.S. affiliate does not provide.

II. Potential Red Flags in Deposits of Securities

1. A customer opens a new account and deposits physical certificates, or delivers in shares electronically, representing a large block of thinly traded or low-priced securities.
2. A customer has a pattern of depositing physical share certificates, or a pattern of delivering in shares electronically, immediately selling the shares and then wiring, or otherwise transferring out the proceeds of the sale(s).
3. A customer deposits into an account physical share certificates or electronically deposits or transfers shares that:
   - were recently issued or represent a large percentage of the float for the security;
   - reference a company or customer name that has been changed or that does not match the name on the account;
   - were issued by a shell company;
   - were issued by a company that has no apparent business, revenues or products;
   - were issued by a company whose SEC filings are not current, are incomplete, or nonexistent;
   - were issued by a company that has been through several recent name changes or business combinations or recapitalizations;
   - were issued by a company that has been the subject of a prior trading suspension; or
   - were issued by a company whose officers or insiders have a history of regulatory or criminal violations, or are associated with multiple low-priced stock issuers.
4. The lack of a restrictive legend on deposited shares seems inconsistent with the date the customer acquired the securities, the nature of the transaction in which the securities were acquired, the history of the stock or the volume of shares trading.
5. A customer with limited or no other assets at the firm receives an electronic transfer or journal transfer of large amounts of low-priced, non-exchange-listed securities.
6. The customer's explanation or documents purporting to evidence how the customer acquired the shares does not make sense or changes upon questioning by the firm or other parties. Such documents could include questionable legal opinions or securities purchase agreements.
7. The customer deposits physical securities or delivers in shares electronically, and within a short time-frame, requests to journal the shares into multiple accounts that do not appear to be related, or to sell or otherwise transfer ownership of the shares.
8. Seemingly unrelated clients open accounts on or at about the same time, deposit the same low-priced security and subsequently liquidate the security in a manner that suggests coordination.

III. Potential Red Flags in Securities Trading[13]

1. The customer, for no apparent reason or in conjunction with other "red flags," engages in transactions involving certain types of securities, such as penny stocks, Regulation "S" stocks and bearer bonds, which although legitimate, have been used in connection with fraudulent schemes and money laundering activity. (Such transactions may warrant further due diligence to ensure the legitimacy of the customer's activity.)
2. There is a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security.
3. The customer's activity represents a significant proportion of the daily trading volume in a thinly traded or low-priced security.
4. A customer buys and sells securities with no discernable purpose or circumstances that appear unusual.
5. Individuals known throughout the industry to be stock promoters sell securities through the broker-dealer.
6. A customer accumulates stock in small increments throughout the trading day to increase price.
7. A customer engages in pre-arranged or other non-competitive securities trading, including wash or cross trades, with no apparent business purpose.
8. A customer attempts to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market.
9. A customer engages in transactions suspected to be associated with cyber breaches of customer accounts, including potentially unauthorized disbursements of funds or trades.
10. A customer engages in a frequent pattern of placing orders on one side of the market, usually inside the existing National Best Bid or Offer (NBBO), followed by the customer entering orders on the other side of the market that execute against other market participants that joined the market at the improved NBBO (activity indicative of "spoofing").
11. A customer engages in a frequent pattern of placing multiple limit orders on one side of the market at various price levels, followed by the customer entering orders on the opposite side of the market that are executed and the customer cancelling the original limit orders (activity indicative of "layering").
12. Two or more unrelated customer accounts at the firm trade an illiquid or low-priced security suddenly and simultaneously.
13. The customer makes a large purchase or sale of a security, or option on a security, shortly before news or a significant announcement is issued that affects the price of the security.

14. The customer is known to have friends or family who work at or for the securities issuer, which may be a red flag for potential insider trading or unlawful sales of unregistered securities.
15. The customer's purchase of a security does not correspond to the customer's investment profile or history of transactions (*e.g.*, the customer may never have invested in equity securities or may have never invested in a given industry, but does so at an opportune time) and there is no reasonable explanation for the change.
16. The account is using a master/sub structure, which enables trading anonymity with respect to the sub-accounts' activity, and engages in trading activity that raises red flags, such as the liquidation of microcap issuers or potentially manipulative trading activity.
17. The firm receives regulatory inquiries or grand jury or other subpoenas concerning the firm's customers' trading.
18. The customer engages in a pattern of transactions in securities indicating the customer is using securities to engage in currency conversion. For example, the customer delivers in and subsequently liquidates American Depository Receipts (ADRs) or dual currency bonds for U.S. dollar proceeds, where the securities were originally purchased in a different currency.
19. The customer engages in mirror trades or transactions involving securities used for currency conversions, potentially through the use of offsetting trades.
20. The customer appears to buy or sell securities based on advanced knowledge of pending customer orders.

IV. Potential Red Flags in Money Movements

1. The customer attempts or makes frequent or large deposits of currency, insists on dealing only in cash equivalents, or asks for exemptions from the firm's policies and procedures relating to the deposit of cash and cash equivalents.
2. The customer "structures" deposits, withdrawals or purchases of monetary instruments below a certain amount to avoid reporting or recordkeeping requirements, and may state directly that they are trying to avoid triggering a reporting obligation or to evade taxing authorities.
3. The customer seemingly breaks funds transfers into smaller transfers to avoid raising attention to a larger funds transfer. The smaller funds transfers do not appear to be based on payroll cycles, retirement needs, or other legitimate regular deposit and withdrawal strategies.
4. The customer's account shows numerous currency, money order (particularly sequentially numbered money orders) or cashier's check transactions aggregating to significant sums without any apparent business or lawful purpose.

5. The customer frequently changes bank account details or information for redemption proceeds, in particular when followed by redemption requests.
6. The customer makes a funds deposit followed by an immediate request that the money be wired out or transferred to a third party, or to another firm, without any apparent business purpose.
7. Wire transfers are made in small amounts in an apparent effort to avoid triggering identification or reporting requirements.
8. Incoming payments are made by third-party checks or checks with multiple endorsements.
9. Outgoing checks to third parties coincide with, or are close in time to, incoming checks from other third parties.
10. Payments are made by third party check or money transfer from a source that has no apparent connection to the customer.
11. Wire transfers are made to or from financial secrecy havens, tax havens, high-risk geographic locations or conflict zones, including those with an established presence of terrorism.
12. Wire transfers originate from jurisdictions that have been highlighted in relation to black market peso exchange activities.
13. The customer engages in transactions involving foreign currency exchanges that are followed within a short time by wire transfers to locations of specific concern (*e.g.*, countries designated by national authorities, such as FATF, as non-cooperative countries and territories).
14. The parties to the transaction (*e.g.*, originator or beneficiary) are from countries that are known to support terrorist activities and organizations.
15. Wire transfers or payments are made to or from unrelated third parties (foreign or domestic), or where the name or account number of the beneficiary or remitter has not been supplied.
16. There is wire transfer activity that is unexplained, repetitive, unusually large, shows unusual patterns or has no apparent business purpose.
17. The securities account is used for payments or outgoing wire transfers with little or no securities activities (*i.e.*, account appears to be used as a depository account or a conduit for transfers, which may be purported to be for business operating needs).
18. Funds are transferred to financial or depository institutions other than those from which the funds were initially received, specifically when different countries are involved.

19. The customer engages in excessive journal entries of funds between related or unrelated accounts without any apparent business purpose.
20. The customer uses a personal/individual account for business purposes or vice versa.
21. A foreign import business with U.S. accounts receives payments from outside the area of its customer base.
22. There are frequent transactions involving round or whole dollar amounts purported to involve payments for goods or services.
23. Upon request, a customer is unable or unwilling to produce appropriate documentation (*e.g.*, invoices) to support a transaction, or documentation appears doctored or fake (*e.g.*, documents contain significant discrepancies between the descriptions on the transport document or bill of lading, the invoice, or other documents such as the certificate of origin or packing list).
24. The customer requests that certain payments be routed through nostro[14] or correspondent accounts held by the financial intermediary instead of its own accounts, for no apparent business purpose.
25. Funds are transferred into an account and are subsequently transferred out of the account in the same or nearly the same amounts, especially when the origin and destination locations are high-risk jurisdictions.
26. A dormant account suddenly becomes active without a plausible explanation (*e.g.*, large deposits that are suddenly wired out).
27. Nonprofit or charitable organizations engage in financial transactions for which there appears to be no logical economic purpose or in which there appears to be no link between the stated activity of the organization and the other parties in the transaction.
28. There is unusually frequent domestic and international automated teller machine (ATM) activity.
29. A person customarily uses the ATM to make several deposits into a brokerage account below a specified BSA/AML reporting threshold.
30. Many small, incoming wire transfers or deposits are made using checks and money orders that are almost immediately withdrawn or wired out in a manner inconsistent with the customer's business or history; the checks or money orders may reference in a memo section "investment" or "for purchase of stock." This may be an indicator of a Ponzi scheme or potential funneling activity.
31. Wire transfer activity, when viewed over a period of time, reveals suspicious or unusual patterns, which could include round dollar, repetitive transactions or circuitous money movements.

V. **Potential Red Flags in Insurance Products**

1. The customer cancels an insurance contract and directs that the funds be sent to a third party.
2. The customer deposits an insurance annuity check from a cancelled policy and immediately requests a withdrawal or transfer of funds.
3. The customer cancels an annuity product within the free-look period. This could be a red flag if accompanied with suspicious indicators, such as purchasing the annuity with several sequentially numbered money orders or having a history of cancelling annuity products during the free-look period.
4. The customer opens and closes accounts with one insurance company, then reopens a new account shortly thereafter with the same insurance company, each time with new ownership information.
5. The customer purchases an insurance product with no concern for the investment objective or performance.

VI. **Other Potential Red Flags**

1. The customer is reluctant to provide information needed to file reports to proceed with the transaction.
2. The customer exhibits unusual concern with the firm's compliance with government reporting requirements and the firm's AML policies.
3. The customer tries to persuade an employee not to file required reports or not to maintain the required records.
4. Notifications received from the broker-dealer's clearing firm that the clearing firm had identified potentially suspicious activity in customer accounts. Such notifications can take the form of alerts or other concern regarding negative news, money movements or activity involving certain securities.
5. Law enforcement has issued subpoenas or freeze letters regarding a customer or account at the securities firm.
6. The customer makes high-value transactions not commensurate with the customer's known income or financial resources.
7. The customer wishes to engage in transactions that lack business sense or an apparent investment strategy, or are inconsistent with the customer's stated business strategy.
8. The stated business, occupation or financial resources of the customer are not commensurate with the type or level of activity of the customer.
9. The customer engages in transactions that show the customer is acting on behalf of third parties with no apparent business or lawful purpose.

10. The customer engages in transactions that show a sudden change inconsistent with normal activities of the customer.
11. Securities transactions are unwound before maturity, absent volatile market conditions or other logical or apparent reason.
12. The customer does not exhibit a concern with the cost of the transaction or fees (*e.g.*, surrender fees, or higher than necessary commissions).
13. A borrower defaults on a cash-secured loan or any loan that is secured by assets that are readily convertible into currency.
14. There is an unusual use of trust funds in business transactions or other financial activity.

Endnotes

1. 31 U.S.C. 5311, *et seq*.
2. *See* 31 U.S.C. 5318(g).
3. *See* 31 CFR 1023.320.
4. *See* 31 CFR 1023.320(a)(2).
5. *See* 31 CFR 1023.320.
6. *See* 31 CFR 1023.320(d).
7. *See* FinCEN SAR Activity Review Issue 21 (May 2012).
8. *See, e.g*, Financial Action Task Force (FATF), Guidance for a Risk-Based Approach for the Securities Sector, October 2018; FATF, Money Laundering and Terrorist Financing in the Securities Sector, October 2009; FATF, Guidance for Financial Institutions in Detecting Terrorist Financing, April 2002; FATF Report, Laundering the Proceeds of Corruption, July 2011; FATF Report, Risk of Terrorist Abuse in Non-Profit Organisations, June 2014; FinCEN Advisory FIN-2010-A001: Advisory to Financial Institutions on Filing Suspicious Activity Reports regarding Trade Based Money Laundering, February 2010; U.S. Department of State, Money Laundering Methods, Trends and Typologies, March 2004; Securities and Exchange Commission (SEC) National Exam Risk Alert on Master/Sub-accounts, September 2011; SEC National Exam Risk Alert on Broker-Dealer Controls Regarding Customer Sales of Microcap Securities, October 2014; and SEC Responses to Frequently Asked Questions about a Broker-Dealer's Duties When Relying on the Securities Act Section 4(a)(4) Exemption to Execute Customer Orders, October 2014. *See also Regulatory Notices 09-05* (January 2009) and *10-18* (April 2010); and Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering, Money Laundering and Terrorist Financing "Red Flags."
9. A "Politically Exposed Person" is defined by FATF as an individual who is or has been entrusted with a prominent public function, for example, Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations, or important political party officials. *See* FATF Guidance, Politically Exposed Persons, June 2013.
10. A "shell company" is an issuer of securities for which a registration statement has been filed with the SEC that has: (1) no or nominal operations; and (2) either: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash or cash equivalents and nominal other assets. *See* 17 CFR 230.504.
11. The FATF Report on Risk of Terrorist Abuse in Non-Profit Organisations (FATF Report), June 2014, defines "terrorist threat" as: A person or group of people, object or activity, with the potential to cause harm. Threat is contingent on actors that possess both the capability and intent to do harm.
12. The FATF Report defines "terrorist entity" as a terrorist and/or terrorist organization identified as a supporter of terrorism by national or international sanctions lists, or assessed by a jurisdiction as active in terrorist activity. *See id*.
13. These red flags could also be indicative of securities law violations.
14. Nostro accounts are accounts that a financial institution holds in a foreign currency in another bank, typically in order to facilitate foreign exchange transactions.

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RISK ALERT
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

April 16, 2019

Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies

Key Takeaway: Through sharing some of the Regulation S-P compliance issues it observed, OCIE encourages registrants to review their written policies and procedures, including implementation of those policies and procedures, to ensure compliance with the relevant regulatory requirements.

I. Introduction

The Office of Compliance Inspections and Examinations ("OCIE")[*] is providing a list of compliance issues related to Regulation S-P, the primary SEC rule regarding privacy notices and safeguard policies of investment advisers and broker-dealers.[1] These issues were identified in recent examinations of SEC-registered investment advisers ("advisers") and brokers and dealers ("broker-dealers," and together with advisers, "registrants" or "firms").[2] The information in this Risk Alert is intended to assist advisers and broker-dealers in providing compliant privacy and opt-out notices, and in adopting and implementing effective policies and procedures for safeguarding customer records and information, under Regulation S-P.[3]

Privacy and Opt-Out Notices

Regulation S-P, among other things, requires a registrant to: (1) provide a clear and conspicuous notice to its customers that accurately reflects its privacy policies and practices generally no later than when it establishes a customer relationship ("Initial

[*] The views expressed herein are those of the staff of OCIE. The Securities and Exchange Commission ("SEC") has expressed no view on the contents of this Risk Alert. This document was prepared by OCIE staff and is not legal advice.

[1] *See* 17 CFR Part 248, Subpart A, and Appendix A to Subpart A. *See also* Privacy of Consumer Financial Information (Regulation S-P), Release Nos. 34-42974, IC-24543, IA-1883 (June 22, 2000) (adopting rules implementing the privacy provisions of Subtitle A of Title V of the Gramm- Leach-Bliley Act ("GLBA") with respect to financial institutions regulated by the SEC); Disposal of Consumer Report Information, Release Nos. 34-50781, IA-2332, IC-26685 (December 2, 2004) (adding rule requiring proper disposal of consumer report information (17 CFR 248.30(b), "Disposal Rule") and amending rule requiring policies and procedures reasonably designed to safeguard customer records and information (17 CFR 248.30(a), "Safeguards Rule") to require written policies and procedures); Final Model Privacy Form under the Gramm-Leach-Bliley Act, Release Nos. 34-61003, IA-2950, IC-28997 (November 16, 2009) (adding model privacy form and instructions in appendix).

[2] This Risk Alert reflects issues identified in deficiency letters from broker-dealer and adviser exams completed during the past two years. This Risk Alert does not discuss all types of deficiencies or weaknesses related to Regulation S-P that have been identified by staff.

[3] This Risk Alert does not discuss all requirements of Regulation S-P.

Privacy Notice"),[4] (2) provide a clear and conspicuous notice to its customers that accurately reflects its privacy policies and practices not less than annually during the continuation of the customer relationship ("Annual Privacy Notice,"[5] and together with the Initial Privacy Notice, "Privacy Notices"),[6] and (3) deliver a clear and conspicuous notice to its customers that accurately explains the right to opt out of some disclosures of non-public personal information about the customer to nonaffiliated third parties ("Opt-Out Notice").[7] Regulation S-P describes the information that must be included in Privacy Notices, including the categories of nonpublic personal information that the registrant collects and discloses, and in Opt-Out Notices.[8]

Written Safeguarding Policies and Procedures to Safeguard Customer Information

The Safeguards Rule of Regulation S-P requires registrants to adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.[9] These written policies and procedures must be reasonably designed to ensure the security and confidentiality of customer records and information, protect against any anticipated threats or hazards to the security or integrity of customer records and information, and protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

II. Most Frequent Regulation S-P Compliance Issues

Below are examples of the most common deficiencies or weaknesses identified by OCIE staff in connection with the Safeguards Rule.

A. *Privacy and Opt-Out Notices.* OCIE staff observed registrants that did not provide Initial Privacy Notices, Annual Privacy Notices and Opt-Out Notices to their customers. When such notices were provided to customers, the notices did not accurately reflect firms' policies and procedures. The staff also noted Privacy Notices that did not provide notice

4 17 CFR 248.4. Regulation S-P defines "customer" to mean a consumer that has a customer relationship with a financial institution, and a "customer relationship" as a continuing relationship between a consumer and a financial institution and includes an individual who has a brokerage account with a broker-dealer or an advisory contract with an investment adviser (whether written or oral). 17 CFR 248.3(j)-(k). As used in this Risk Alert, "customer" refers to brokerage customers and advisory clients as applicable.

5 17 CFR 248.5. Section 75001 of the Fixing America's Surface Transportation Act, Pub. L. No. 114-94, 129 Stat. 1312 (2016), ("FAST Act") amended the GLBA by adding subsection 503(f) to provide an exception to the Annual Privacy Notice requirement. Under this exception, a financial institution is not required to provide an Annual Privacy Notice if the financial institution (1) does not share nonpublic personal information about the customer except for certain purposes that do not trigger the customer's statutory right to opt out and (2) has not changed its policies and practices with regard to disclosing nonpublic personal information from the policies and practices that were disclosed in the most recent Privacy Notice.

6 The SEC has adopted a model form to satisfy Privacy Notice disclosure requirements. Use of the form provides a "safe harbor" for the required disclosures under Regulation S-P. 17 CFR 248.2. *See also* Final Model Privacy Form under the Gramm-Leach-Bliley Act, *supra* note 1.

7 17 CFR 248.7. Under the exceptions in 17 CFR 248.13, 248.14 and 248.15, however, an Opt-Out Notice is not required if the registrant shares nonpublic personal information with a non-affiliated third party for certain purposes.

8 17 CFR 248.6, 248.7.

9 17 CFR 248.30(a).

to customers of their right to opt out of the registrant sharing their nonpublic personal information with nonaffiliated third parties.

B. *Lack of policies and procedures.* OCIE staff observed registrants that did not have written policies and procedures as required under the Safeguards Rule. For example, firms had documents that restated the Safeguards Rule but did not include policies and procedures related to administrative, technical, and physical safeguards. The staff observed written policies and procedures that contained numerous blank spaces designed to be filled in by registrants. There were also firms with policies that addressed the delivery and content of a Privacy Notice, but did not contain any written policies and procedures required by the Safeguards Rule.

C. *Policies not implemented or not reasonably designed to safeguard customer records and information.* OCIE staff observed registrants with written policies and procedures that did not appear implemented or reasonably designed to (1) ensure the security and confidentiality of customer records and information, (2) protect against anticipated threats or hazards to the security or integrity of customer records and information, and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to customers. For example, staff observed:

- <u>Personal devices</u>. Policies and procedures that did not appear reasonably designed to safeguard customer information on personal devices. For example, staff observed registrants' employees who regularly stored and maintained customer information on their personal laptops, but the registrants' policies and procedures did not address how these devices were to be properly configured to safeguard the customer information.

- <u>Electronic communications</u>. Policies and procedures that did not address the inclusion of customer personally identifiable information ("PII") in electronic communications. For example, staff observed registrants that did not appear to have policies and procedures reasonably designed to prevent employees from regularly sending unencrypted emails to customers containing PII.

- <u>Training and monitoring</u>. Policies and procedures that required customer information to be encrypted, password-protected, and transmitted using only registrant-approved methods were not reasonably designed because employees were not provided adequate training on these methods and the firm failed to monitor if the policies were being followed by employees.

- <u>Unsecure networks</u>. Policies and procedures that did not prohibit employees from sending customer PII to unsecure locations outside of the registrants' networks.

- <u>Outside vendors</u>. Registrants failed to follow their own policies and procedures regarding outside vendors. For example, staff observed registrants that failed to require outside vendors to contractually agree to keep customers' PII confidential, even though such agreements were mandated by the registrant's policies and procedures.

- PII inventory. Policies and procedures that did not identify all systems on which the registrant maintained customer PII. Without an inventory of all such systems, registrants may be unaware of the categories of customer PII that they maintain, which could limit their ability to adopt reasonably designed policies and procedures and adequately safeguard customer information.

- Incident response plans. Written incident response plans that did not address important areas, such as role assignments for implementing the plan, actions required to address a cybersecurity incident, and assessments of system vulnerabilities.[10]

- Unsecure physical locations. Customer PII that was stored in unsecure physical locations, such as in unlocked file cabinets in open offices.

- Login credentials. Customer login credentials that had been disseminated to more employees than permitted under firms' policies and procedures.

- Departed employees. Instances where former employees of firms retained access rights after their departure and therefore could access restricted customer information.

III. Conclusion

In response to these observations, many of the registrants modified their written policies and procedures to mitigate the issues identified by OCIE staff. OCIE encourages registrants to review their written policies and procedures, including implementation of those policies and procedures, to ensure that they are compliant with Regulation S-P.

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

[10] For a discussion of related cybersecurity compliance issues, please see the OCIE Risk Alert Observations from Cybersecurity Examinations, August 7, 2017.