The Song Remains the Same – FINRA's Riff on High-Risk Brokers and Firms

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Summary

Key Takeaways:

- On September 28, 2021, FINRA released Regulatory Notice 21-34 which introduces additional new rules aimed at addressing high risk or "recidivist" brokers and the member firms that hire them.
- Under Rule 4111, which becomes effective on January 1, 2022, FINRA is empowered to impose new obligations on broker-dealers who employ higher numbers of brokers who have risk-related disclosures than other similarly sized peers. The obligations that can be imposed include a requirement to deposit cash or qualified securities in a segregated, restricted account, and other conditions and restrictions that FINRA deems necessary or appropriate for the protection of investors and in the public interest.
- While arguably setting the equivalent of a financial penalty for firms hiring brokers with negative disclosure histories, FINRA is also seeking to address continuing concerns raised by Claimants' attorneys over unpaid arbitration awards by high risk, undercapitalized or defunct member firms.

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FINRA's History or Expressed Concerns Regarding High Risk Brokers

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As noted in one of our prior Alerts, FINRA first began discouraging member firms from hiring "high risk" brokers by launching its "High Risk Broker Initiative" in 2013. The purpose of that program was to identify individuals that FINRA viewed as posing a heightened risk of harm to customers and to the reputation of the securities industry, based on an accumulation of multiple negative disclosure events, and to expedite regulatory exams and investigations into those individuals.

The following year, FINRA upped the ante on its efforts by designating an enforcement team to prosecute claims against recidivist brokers. It also warned firms in its 2014 Regulatory and Examination Priorities Letter that it would increase the rigor around examining recidivist brokers, and their respective firms, during annual branch exams. As part of its exam process, FINRA signaled that it would: (1) focus on the broker's client accounts in conducting sales practice reviews; (2) examine the firm's due diligence process in connection with hiring the brokers; and (3) examine the member firm's supervision of the broker, including whether it placed the brokers on a heightened supervision plan specifically tailored to guard against future sales practice violations. Similarly, FINRA indicated that in addition to keeping tabs on recidivist brokers, it would also track and focus additional regulatory attention on the member firms that hired such brokers.

In 2014, FINRA also adopted Rule 3170, otherwise known as the "Taping Rule," which requires heightened supervisory procedures for the telemarketing activities of brokers and establishes related record retention requirements. Member firms who hire over a threshold amount of registered representatives previously associated in the past three years with disciplined firms are required to enhance supervision around the telemarketing activities of all of its registered representatives. These heightened procedures include the recording of all telephone conversations between the brokers and their clients and the retention of those records for no less than three years.

FINRA continued expressing concern about high risk brokers and firms in its Regulatory and Examination Priorities Letters in 2015, 2017, and 2018. Within all of its pronouncements,

FINRA reiterated its themes around member firms' hiring practices and heightened supervision programs. Its first objective was to discourage firms from hiring recidivists. In the event that firm's did not heed that warning, FINRA expected firms to take responsibility for the hire by supervising the broker's actions in a manner designed to guard against future infractions.

In March 2021, FINRA released FINRA Regulatory Notice 21-09, which introduced Rule 1017(a)(7). That Rule requires member firms to file a Continuing Membership Application ("CMA") when a natural person seeks to become an owner, control person, principal, or even a registered person with a member firm if that individual has, in the past five years, one or more "final criminal matters" or two or more "specified risk events." Alternatively, the member firm can seek a "Materiality Consultation" with FINRA to determine whether the firm can proceed with the hire with no further action or, alternatively, whether the hire would result in a "material change in business operations," therefore requiring the filing of a CMA. Additional rule changes addressed in the prior 2021 Regulatory Notice included: (i) enhancement of the "Taping Rule" by requiring firms to disclose such status on BrokerCheck, (ii) requirement of heightened supervisory procedures during an appeal of a disciplinary matter, and (iii) a mandate to place a disqualified broker under heightened supervision during the application process.

In September 2021, FINRA is singing the same tune, this time with release of FINRA Regulatory Notice 21-34 which introduces new Rule 4111.

Rule 4111 Summarized

Rule 4111(a) requires any member firm that FINRA designates as a "Restricted Firm" to establish a "Restricted Deposit Account" and deposit in that account cash or qualified securities with an aggregate value that is not less than the member firm's Restricted Deposit Requirement as set by FINRA.[1] Restricted Firms may also be subjected to other conditions or restrictions on the member firm's operations as determined by FINRA to be necessary or appropriate for the protection of investors and in the public interest. Said conditions and restrictions may be in the alternative or additional to a Restricted Deposit Requirement.

Rule 4111 Process

Rule 4111 follows a multi-step process that is best illustrated in a Flow Chart released by FINRA.

1. Annual Calculation of Preliminary Criteria for Identification.

FINRA will run a calculation annually for each member firm to determine whether it will be designated as a "Restricted Firm" and subject to Rule 4111 application. While FINRA states that the calculation is intended to be replicable and transparent to member firms, a cursory review reveals that the description of the intended calculation is cumbersome and hard to follow. Only time will tell if the calculation is easily understood and sustainable. In theory, the determination will take into account certain metrics around the following six categories:

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

The calculation will also take into account the size of the firm by dividing the metrics calculated above by the overall population of the firm's brokers.

2. Discretionary Considerations.

Upon completion of the initial calculation, FINRA will also apply a certain degree of subjective discretion to determine whether the firm presents insufficient risk or, alternatively, whether further review is necessary under Rule 4111. Such considerations would include whether the preliminary identification metrics included:

- Disclosure events or other conditions that are inconsistent with the rule's goals and purposes;
- Disclosures that are not sale-practice related;

- Duplicative disclosures;
- Compliance concerns that are better addressed by a different regulatory tool (such as enforcement actions, cease and desist orders, or more frequent examinations); or
- Instances in which the member firm has addressed the concerns illuminated by the disclosure events or conditions.

3. One-Time Opportunity to Reduce Staffing Levels.

Any member firm identified by FINRA as a "Restricted Firm" for the first time will have a one-time opportunity to reduce its staffing levels so that it falls below the preliminary identification metrics threshold. This option must be elected within 30 business days after being informed by FINRA that it met the preliminary criteria for identification, and the firm will have to demonstrate the staff reduction by identifying to FINRA all terminated individuals. Rule 4111(c)(2) will prohibit the member firm from rehiring any persons terminated pursuant to this option, in any capacity, for one year.

4. Restricted Deposit Requirement Under Rule 4111(i)(15).

FINRA exercises complete discretion in determining a member firm's Restricted Deposit Requirement and whether to require a maximum amount. The stated goal of the Restricted Deposit Requirement is to alter the firm's behavior without forcing the firm out of business solely by virtue of the deposit. Factors for FINRA's consideration in setting the amount include:

- the nature of the member firm's operations and activities;
- revenues;
- commissions;
- assets;
- liabilities;
- expenses;
- net capital;
- the number of offices and registered persons;

- the nature of the disclosure events counted in the numeric thresholds;
- insurance coverage for customer arbitration awards or settlements;
- concerns raised during FINRA exams; and
- the amount of any of the firm's or its associated persons' pending arbitration claims or unpaid arbitration awards.

5. Consultation Process.

After FINRA has determined that a member firm has met the preliminary criteria for identification, and no mitigating circumstances or firm actions are exercised to relieve the firm from Rule 4111 application, FINRA will hold a consultation with the member firm. During the consultation process, the member firm will have 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 Restricted Deposit Requirement. There will be two rebuttable presumptions in a consultation: (a) that the member firm should be designated as a Restricted Firm; and (2) that it should be subject to the Restricted Deposit Requirement. The member firm will bear the burden of overcoming those presumptions and can do so by showing that:

- the preliminary criteria for identification is inaccurate;
- the member firm would face significant undue financial hardship if it were subject to the Restricted Deposit Requirement;
- a lesser deposit requirement would satisfy the objectives of Rule 4111 and be consistent with the protection of investors and the public interest; or
- other conditions and restrictions on the operations and activities of the member firm and its associated persons would address the concerns and protect investors and the public interest.

6. Department of Member Regulation's Decision.

Following the consultation, FINRA will render an overall decision as to whether the firm is a Restricted Firm, whether it is subject to a Restricted Deposit Requirement, and at what amount. FINRA will also indicate whether the member firm will be subject to other specified

conditions or restrictions, as necessary or appropriate, on the operations and activities of the member firm and its associated persons that relate to, and are designed to address the concerns indicated by, the preliminary criteria for identification and to protect investors and the public interest.

7. Other Material Guidance and Considerations.

Once FINRA renders a decision, the member firm can elect to either accept the designation or challenge all or part of FINRA's decision through an appeal process established by new Rule 9561 and amendments to the prior Rule 9559.

If required to establish a Restricted Deposit Account, the member firm must:

- Establish and account in the name of the member firm, at a bank or the member firm'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 firm 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 firm 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 firm becomes a former member, the assets deposited in the Restricted Deposit Account to satisfy the Restricted Deposit Requirement shall be kept in the Restricted Deposit Account, 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.

Conclusion

FINRA continues to focus its attention on concerns regarding high risk or recidivist brokers and the firms that hire them. While we advised earlier in the year that this topic will be a continuing focus, we have been surprised at the frequency with which FINRA is releasing new rules to address its concerns over high risk brokers and firms. We will continue to alert you as to material developments on this topic. If you have questions on this topic or need assistance with securities regulatory or litigation matters, please reach out to us as we would be delighted to help with your needs.

1. A firm that is able to demonstrate financial hardship may qualify for no or a lesser deposit requirement.

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