CAMBRIDGE

VIA ELECTRONIC MAIL: pubcom@finra.org

July 01, 2019

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

Re: Regulatory Notice 19-17: Request for Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct

Dear Ms. Mitchell,

Cambridge Investment Research, Inc. ("Cambridge") appreciates the opportunity to comment on Regulatory Notice 19-17: Request for Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct. FINRA is seeking a broad range of commentary regarding all aspects of this proposal and hopes to obtain input regarding whether this proposed new rule will be effective and efficient in addressing the history of misconduct FINRA has observed among a small number of member firms. FINRA has proposed a rule which would impose tailored obligations, including possible financial requirements, upon a designated member firm when that firm's calculation results under this proposed new rule cross specified numeric thresholds. FINRA states that this proposed rule is prompted by the activities of a small number of member firms that continue to create a disproportionate number of compliance issues relative to their peers. FINRA believes these firms pose greater risk to the investing public due to the nature and number of regulatory-related events these firms have disclosed. FINRA holds that the remedies it has created under this proposal are intended to apply to that small number of member firms only.

Cambridge supports FINRA's goal of protecting the investing public and agrees that member firms which pose a heightened risk of harm to the investing public, and whose conduct undermines investor confidence, should be subject to additional scrutiny. As always, Cambridge supports the

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implementation of sensible, well-crafted, and clearly understandable rules and commends FINRA for its efforts to protect investors from misconduct.

Cambridge agrees that an objective data assessment coupled with a comprehensive and transparent review of that data will aid FINRA in identifying those high risk member firms and registered persons contemplated by this proposal. However, given the prospective impacts upon member firms, registered persons and their clients, Cambridge believes FINRA should revise certain aspects of the rule to accomplish its underlying goals.

Cambridge requests FINRA consider amending the prospective rule per the analysis below and hopes FINRA will consider the following comments as it further develops this proposed rule.

Calculation Metrics, Criteria, and Methodology

Considering FINRA's intent to identify those comparatively few firms that, in FINRA's view, present a heightened risk to the investing public, Cambridge believes the Calculation Metrics, Criteria, and Methodology described in Proposed Rule 4111 should be modified to focus on those investor-related events creating the high level of risk FINRA seeks to address.

As FINRA has noted, the vast majority of member firms do not pose the high degree of risk prompting this proposal. Thus, certain changes to these Calculation Metrics, Criteria, and Methodology would better align the application of Proposed Rule 4111 with the spirit behind it, that is, to identify those high risk member firms only and to impose measures to protect the investing public from the high risk activities of those member firms.

Preliminary Identification Metric Thresholds

Overall, Cambridge agrees that the employment of an iterative process, that includes phases of data assessment followed by a comprehensive and transparent review, makes the most sense and supports the structured process as portrayed in Attachment B of the proposal. Cambridge believes, given the novelty, breadth and depth of this proposed rule, coupled with the prospective impact of the attendant effects of its implementation upon member firms, that FINRA should implement various checks and balances throughout the process. These checks and balances should be measured and reasoned so as to lessen the number and impact of potential false positive results.

The proposed rule gives FINRA broad discretion to determine whether a firm is a Restricted Firm and should be subject to heightened financial requirements. Considering the significant impact this will have on certain member firms and the burden and harm placed on misidentified firms, Cambridge believes such firms should be notified if the threshold calculations causes them to be identified as high risk during the preliminary identification process and allow the firms to review and address any data points and calculations the firms do not believe are accurate prior to the Evaluation stage. In addition, Cambridge believes the initial review during the Evaluation stage should require FINRA to consult with the member firm and demonstrate its reasons for a continued review. Cambridge further believes FINRA should establish a fact-based, demonstrable and transparent process to conclude a firm is a Restricted Firm.

Arbitration and Civil Judgments

Proposed rule 4111(i)(4)(A)(i) includes disclosure of arbitration awards and civil judgments in which the registered person was a named party. This metric takes into account all customer arbitration awards and civil judgments regardless of the size of the award or judgment and without recognition of the registered person's specific involvement in the matter. As a result, this proposed metric could capture individuals who are in an ownership or leadership position or the chain of supervision and are simply a named party as a result of a zealous litigation strategy or tactic even though they are not involved in the conduct ultimately at issue in the award or judgment. Because these individuals may have no direct history of misconduct, but are otherwise caught up in an action that causes them to be included in the Preliminary Identification Metrics, Cambridge believes this does not further FINRA's purpose underlying the rule. Therefore, Cambridge suggests FINRA modify its definition to include named parties only to the extent the award or judgment concludes they were involved with the underlying conduct giving rise to the event.

Additionally, Cambridge believes FINRA should establish a minimum award threshold in an amount of no less than $50,000 for 4111(i)(4)(A)(i) to apply. This amount reflects an average minimum cost to defend investment-related, consumer-initiated actions that are otherwise not settled for legitimate business reasons and are not necessarily reflective of high risk behavior. For example, a small award or judgement for a loss in account value due to a market correction that the registered person or member firm refused to settle does not seem like the type of high risk behavior FINRA is seeking to eliminate. A more narrowly tailored rule with a minimum threshold dollar amount to account for such real-world examples would still accomplish FINRA's goals while not inhibiting sound businesses decisions to challenge zealous claims that may have little merit but result in some type of award or judgment.

Settlements

Proposed Rule 4111(i)(4)(A)(ii) contemplates capturing settlements as low as $15,000. Cambridge believes such a low threshold renders the proposed rule overly inclusive. Often matters are resolved merely to avoid the cost of litigation, without regard to the merit (or lack of merit) in the underlying claim. The cost associated with the defense of such matters could easily exceed $50,000 and thus a settlement at or below that figure does not necessarily reflect enhanced risk. Instead, settlement of a matter at or below $50,000 may simply reflect a sound business decision. Cambridge proposes the settlement threshold contemplated in this particular subparagraph be increased to at least $50,000. Failing to increase this minimum could result in an increased number of matters taken to a final award or judgment, thus increasing the burden on investors seeking relief as well as registered persons and member firms who desire to avoid the negative impacts of Proposed Rule 4111.

Criminal Felonies

Proposed Rule 4111(i)(4)(A)(v) includes any criminal felony for which the registered person was convicted, pled guilty or no contest. While criminal findings are relevant to a member firm's determination of whether to associate with a particular registered person, they do not necessarily reflect conduct indicating present-day high risk behavior concerning the investing public.

Cambridge recommends that this provision, along with Proposed Rule 4111(i)(4)(B)(iv), be limited in time to those events occurring within the 10 years prior to the calculation in order to align with the approach used for statutory disqualification.

Registered Person Pending Events

Proposed Rule 4111(i)(4)(B), Registered Person Pending Events, includes certain events associated with a registered person that are reportable on a Uniform Registration Form. Cambridge believes this provision should be amended with regard to time and scope. As FINRA is likely aware, member firms typically err on the side of reporting potential disclosure events, including those matters which are stale or moot given the age of the event. This conservative approach to the firm's reporting obligation, which arguably benefits the investing public in the form of additional information, also potentially harms well-intended firms by potentially erroneously increasing the pending events metric calculation in a manner not consistent with the specific focus of identifying member firms or registered persons who may pose a high risk of misconduct to the investing public.

Further, a matter may remain pending for an extended period of time through no fault of the firm or an individual. The mere pendency of a matter, without any adjudication of wrongdoing, adversely impacts both the firm and the registered person in the context of the calculation contemplated by this proposed rule. At the same time, the pending event in no way informs the question of the nature and extent of any particular risk presented by that firm or the registered person – presumably the question to which the proposed rules seeks information. It is not uncommon for certain pending matters to remain for years with no actions taken. Including these types of matters will likely inflate calculations, possibly pushing a member firm into the realm of Evaluation or even a Restricted Firm, when that member is not necessarily engaging in high risk behavior.

Thus, Cambridge believes this provision should be limited to those events occuring within the 10 year period prior to the calculation so as to eliminate old matters which will likely never come to fruition, but rather were reported as a matter of practice versus on a substantive basis. Additionally, this provision should include additional language to further define those specific matters, investigations, actions, or charges that FINRA is attempting to mitigate, which are more specifically relevant to this review.

Member Firm Internal Reviews

Proposed Rule 4111(i)(4)(C)(ii) includes pending or closed internal reviews by the member firm. Cambridge believes this provision should be amended to differentiate among the types of internal reviews conducted by member firms and should limit the reviews included in this calculation metric to those relating to the violations FINRA believes to be indicia of high risk behavior. Cambridge also believes this provision should be limited to reviews pending or closed within the 10 years prior to the calculation.

Additionally, Cambridge requests FINRA provide clarification and guidance regarding the scope and application of this provision. FINRA should include additional language to note the specific sales practice or investor-related disclosure events FINRA believes identify the improper behavior this metric is intended to capture. This clarification could include references to specific questions on forms U-4 and U-5; citations to certain rules, notices, or interpretive guidance; or newly created FAQs discussing how FINRA intends to identify and capture the type of information and data it considers relevant for evaluation under this provision.

Civil Judicial Matters

Proposed Rule 4111(i)(4)(E)(i) deals with member firm pending civil judicial matters. Often these matters involve conduct unrelated to the heightened risk posed to investors by member firms and registered persons with histories of misconduct. Cambridge suggests FINRA amend this provision to distinguish those investment-related matters from those that are administrative in nature, and exclude all matters that are not sales practice or investment-related from the calculation.

Pending Investigations

As currently drafted, Proposed Rule 4111(i)(4)(E)(ii) captures any pending investigation by a regulatory authority. Again, this provision potentially casts too broad a net and should provide a mechanism for distinguishing among various types of matters. Given the regularity with which FINRA, the SEC, and the various state securities agencies oversee and investigate the dealings of member firms, application of this metric as written will likely produce an inflated result and thus be less relevant to FINRA's inquiry. A more defined provision that distinguishes between the various types of matters subject to investigation by these agencies concerning to FINRA would more closely align with the objectives of this proposed rule.

Registered Persons Formerly Associated with Expelled Firms

Proposed Rule 4111(i)(4)(F), regarding Registered Persons Associated with Previously Expelled Firms, includes any registered person who (1) was registered with the member firm for one or more days during the prior year and (2) had been associated with a previously expelled firm at any time. Cambridge believes this metric is well intended but may create adverse results for both registered persons and member firms that pose little to no risk to the investing public. As a preliminary matter, there is no direct causal connection between a registered person's association with an expelled firm and the high risk behavior this proposal seeks to address. There are numerous examples where a registered person without disclosure history indicative of high risk behavior may have at one time associated with a member firm now expelled. In these instances, the registered person likely had nothing to do with the matter justifying the expulsion. In the event the registered person participated in high risk behavior or improper conduct at the expelled firm, this should evidence itself as a disclosure on that individual's form U-4 or U-5, which would be included in the metrics in Propose Rule 4111. It seems counter to FINRA's stated objective in the proposed rule to potentially penalize a member firm, now employing a registered person who has no sales practice violations or investor-related disclosure events but who was formerly registered with an expelled member for a brief time, because of the past affiliation of one of its registered persons with an expelled firm. The impending result is likely that member firms will refuse to register any registered persons leaving expelled firms, thereby driving such persons from the industry and creating investor harm by mass abandonment of client relationships. Including anyone associated with a previously expelled member in the metrics does not produce the focused risk based result FINRA seeks with this proposed rule.

If FINRA retains this provision, Cambridge believes FINRA should only include this metric for expelled firms that truly created investor harm. Cambridge recommends FINRA consider the facts underlying the events causing the member firm's expulsion. For instance, did the member firm violate net capital requirements or was the expulsion a result of investor harms? Application of this provision as defined will likely result in a chilling effect among member firms when considering registering a person with a history of affiliation with an expelled member firm. This could drive otherwise compliant registered persons out of the business, and could harm that person's clients as a result.

These proposed changes would allow for those registered persons who may have been associated with an unscrupulous former member, but did not engage in high risk behavior, to move on from an undesirable past association; however, it would allow FINRA to focus on trending high risk behaviors of those registered persons who seek to avoid scrutiny by changing firms.

Preliminary Criteria for Identification

Cambridge recommends FINRA modify the Preliminary Criteria for Identification defined in 4111(i)(9)(B). The criteria should be amended consistent with the comments and concerns noted above. For example, included in this calculation is whether a "member has two or more Registered Person and Member Firm Events during the Evaluation Period." Cambridge believes applying this criteria in such broad form likely will generate false positive results because it creates the potential that one event may be reflected in multiple disclosures and counted several times in the various criteria.

Discussing proposed rule 4111(c)(1), FINRA contemplates that a false positive result could be produced by duplicative events, non-sales related events, and events warranting a different regulatory response. FINRA recognizes that these events potentially giving rise to a false positive could all be removed in advance from the calculation criteria. A process to screen out erroneously included disclosure events that are "duplicative (involving the same customer and the same matter)"[1] or not indicative of any relevant pattern "reflective of a firm posing a high degree of risk"[2] would further FINRA's goal of identifying those events that "are associated with an emerging pattern of customer harm"[3] only; "and would capture timely information of potential ongoing or recent misconduct."[4]

Maximum Restricted Deposit Requirement

Cambridge believes the Maximum Restricted Deposit Requirement may trigger unintended consequences which result in harm to the investing public. If for example, the requirement of a deposit cannot be implemented because of minimum net capital requirements, will FINRA have

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[1] *Regulatory Notice 19-17* at 11.
[2] *Id.*
[3] *Id.* at 32.
[4] *Id.*

additional impactful recourse? Member firms without significant retained earnings, subject to the Deposit Requirement, may receive an exception due to the lack of stability of the firm whereas a member firm with greater working capital subject to the requirement would not be granted an exception, and thus potentially placed at a competitive disadvantage.

In the Examples of Maximum Restricted Deposit Requirements provided on Attachment C of the Notice, FINRA, by way of example, shows that the Restricted Deposit Requirement will likely be greater than a member firm's excess net capital. This example of how this requirement will be calculated is problematic because a calculation based on gross revenues does not contemplate contractual obligations the member firm may have to vendors, service providers, staff and registered persons for which those revenues have already been allocated. Further, as it is likely these obligations do not rise to the level of a significant undue financial hardship under Proposed Rule 4111(d)(1)(B), it is possible that members who should be subject to this provision will act in advance to extract any excess net capital that could be exposed to this restriction. Thus, the only member firms likely to have dollars which could be subjected to this requirement are those who do not anticipate being subjected to this rule because they are not intentionally creating high risk to the investing public and are seeking to comply with FINRA rules and requirements.

Department Evaluation Process

The Initial Department Evaluation Process under Proposed Rule 4111(c)(1) outlines the steps FINRA staff would take "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."[5] As noted above, FINRA staff would engage in review of multiple factors to, on its own, determine whether a false positive identification occurred as a result of the Preliminary Criteria for Identification Calculation.

Within the Notice, FINRA lists the type of information a member firm could provide to redefine or challenge a result. Nothing contained in this section, however, compels or obligates FINRA staff to consider this information in connection with its review during this evaluation process. Rather, the rule simply requires FINRA staff to conduct an evaluation to determine whether further review is warranted. As a result, FINRA's determination could be based on information not specifically contemplated for consideration by the proposed rule.

The potential lack of transparency is made more troublesome by the fact that FINRA's finding in this regard is subject to a rebuttable presumption adverse to the member firm. It would be more equitable for FINRA to give the member firm notice of the result of the calculation identifying the member firm as a potential Restricted Firm, provide the firm with a preliminary computation identifying which criteria produced the result, give an explanation of the components of the computation, and give the member firm a meaningful opportunity to challenge FINRA's preliminary computation.

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[5] *Id.*

Proposed Additional and Alternative Measures and Means

In addition to giving those member firms who fall subject to the Evaluation process an opportunity to present evidence during the Evaluation stage in order address a potential false positive outcome as a result of the calculation, Cambridge suggest FINRA consider additional and alternative measures and means.

Additional Factors

The proposed rule contemplates a determination of risk based solely on a strict numerical basis derived from the number of disclosures and the number of registered persons. Though this consideration is bound to a five-year period, this means of measuring risk does not account for the fact that older and/or larger member firms may have more disclosure events because they serve more investors. To address this issue, Cambridge suggests FINRA consider weighting the Preliminary Identification Metric Thresholds to account for the length of time a member firm has existed along with the number of registered persons and customers served by that member firm.

To illustrate this point, consider which of the following scenarios presents the greater risk: (1) a member firm with 100 registered persons, serving 10,000 investors, with 21 Registered Person Adjudicated Events, or (2) a member firm with 100 registered persons, serving 100 investors, with 21 Registered Person Adjudicated Events. In both situations, the member firm's metrics place that member firm above the threshold of 0.20, however, on a per investor basis, the ratios change to 0.0021 and 0.21 respectively. As such, including a weighted metric based on the size of the member firm's investor base would provide a more accurate reflection of the risk that member firm may pose to the investors it serves and could assist in further identifying those member firms that pose a higher degree of risk to the investing public generally.

Additional Rule Amendment Proposal

In conjunction with the proposed rule, Cambridge urges FINRA to consider amending Rule 2080(a) to exclude from the requirement to obtain a court order those instances where a dispute with a customer was disclosed on a registered person's Uniform Disclosure Forms, but that registered person was not involved in the subject matter of the dispute, was not subject to any consequences as a result of the determination or settlement of the matter, or was removed or dismissed from the matter as a party after a review of the facts. As mentioned earlier, registered persons have often incurred disclosure events as a result of being named in a matter due to their position within a chain of supervision, their presence in an office, their role as a senior manager, officer or director of the member firm, or because the person bringing the matter named them in error. As these disclosures could potentially carry much greater weight, FINRA should allow for these types of events to be more readily removed from these registered person's Uniform Disclosure Forms.

Terms and Conditions

As stated above, Cambridge believes FINRA should give member firms additional opportunities to engage and cooperate with FINRA staff throughout this new process. While FINRA contemplates a one-time reduction of staff to remedy the result placing that member firm in a restricted firm status, FINRA could provide additional remedial options. FINRA contemplates a "terms and conditions" rule[6], but chose not to propose this approach at this time. Cambridge does not believe this should be an all or none proposition. Contemplation of new rule provisions is not a Sophie's choice. FINRA could incorporate "terms and conditions" measures during the Initial Evaluation and Consultation phases to deal with those member firms whose calculation results place them at or above the thresholds. These measures could include opportunities to appeal any findings or cooperatively remedy those pertinent issues. Cambridge urges FINRA to reconsider its approach in order to handle a potential dramatic increase in volumes of Preliminary Identification Metric Thresholds under the proposed new rule. For example, what will happen in instances of a widespread product collapse or market collapse resulting in a high number of new events occurring within both the Registered Person and Member Firm categories? Will FINRA adjust the thresholds or will many firms be swept up into the status of a Restricted Firm? Without factoring in such broad sweeping events, member firms on the cusp in a particular category may find themselves subject to this proposed new rule by no fault of their own, even though they are not participating in high risk activities detrimental to clients.

List of Firms and Registered Persons

To further assist firms with this new process, FINRA could compile and publish a comprehensive list of expelled member firms and provide member firms information as to whether prospective new registered persons desiring to associate with the member would trigger identification under this rule and subject the member firm to further scrutiny under the rule.

Additional Incentive for Compliance

As an additional incentive for greater compliance, FINRA could implement measures to protect member firms, not subject to a restriction under Proposed Rule 4111, who seek to assist those registered persons whose business practices did not contribute to another restricted member firm's negative disclosure history but who may become caught up in the potentially negative impacts of such restriction, and their clients in relocating their business to a member firm not subject to the punitive provisions of this proposed rule.

Under this additional measure, which could further incentivize member firms who may fall into a Restricted Firm status to greater compliance, FINRA could include language specifically limiting that Restricted Firm from bringing certain legal actions against other member firms. For example, registered persons departing Restricted Firms may subject their new member firm to certain legal actions if it were to accept registrations of a large number of registered persons from the Restricted Firm. Adding language to the proposed rule that would protect member firms from such legal actions could provide another powerful incentive for firms to avoid being identified as a Restricted Firm.

[6] *Id.* at 21-23.

Conclusion

In conclusion, Cambridge respectfully suggests that to achieve the intent articulated by FINRA in this proposed rule, FINRA should modify the rule as noted above. Cambridge believes the novelty and breadth of the proposed rule compels an extremely measured approach to its implementation. The potential for unintended consequences to firms and registered persons must be balanced against the need for such a strict, data-driven analysis. Cambridge strongly supports FINRA's efforts to protect investors, but also asks FINRA to balance the prospective harm to the reputations of honest member firms, registered persons and their clients.

Cambridge would be happy to further discuss any of the comments or recommendations in this letter with FINRA.

Respectfully submitted,

// Seth A. Miller

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