Cetera FINANCIAL GROUP

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VIA Email to:PUBCOM@FINRA.ORG

July 1, 2019

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

Re: Regulatory Notice 19-17 – Proposed Rules 4111 and 9559

Dear Ms. Mitchell:

Please allow this to serve as comments of Cetera Financial Group, Inc. ("CFG") with regard to Regulatory Notice 19-17 (the "Notice") and proposed FINRA Rules 4111 and 9559. CFG is the corporate parent of six FINRA member firms: Cetera Advisor Networks, LLC, Cetera Advisors, LLC, Cetera Investment Services, LLC, Cetera Financial Specialists, LLC, First Allied Securities, Inc., and Summit Brokerage Services, Inc. We submit these comments on behalf of all six firms.

Proposed Rule 4111 would create a framework under which FINRA could require certain member firms to make deposits of cash or marketable securities that could not be withdrawn or otherwise utilized by the member firm without consent from FINRA. The intent of the proposal is to enhance investor protection by establishing additional authority to enforce compliance with FINRA's rules and to ensure that the member firms are able to meet their financial obligations to both customers and FINRA.

We will offer comments with respect to specific provisions of the proposed rules below, but in general, we support both the concept and the manner in which FINRA has approached this effort. A small number of FINRA member firms have consistently demonstrated a lack of willingness or ability to comply with FINRA and other industry rules. This has resulted in a disproportionate expenditure of examination and enforcement resources by FINRA on these firms, often without achieving compliance. In some circumstances, it has allowed member firms to continue operating in ways that are detrimental to their customers and the industry as a whole. We support any initiative that promotes compliance with FINRA rules enhances investor protection and public confidence in the securities industry and public capital markets.

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We note that FINRA has also considered the possibility of a ruled modeled on Investment Industry Regulatory Organization of Canada ("IIROC") Consolidated Rule 9208 ("Rule 9208"). Rule 9208 gives IIROC more latitude than Rule 4111 would afford FINRA in identifying firms that may be engaged in problematic behavior and in tailoring conditions or limitations on their activities in order to promote compliance with applicable rules. FINRA has elected not to pursue the approach in Rule 9208. We believe that this is an appropriate choice, but we also believe that a process such as that set forth in Rule 9208 is worth further study by FINRA. As discussed in more detail below, the formulaic/quantitative approach set forth in Rule 4111 has limitations and may result in a significant number of "false positives", especially if it utilizes all of the identification criteria that are currently proposed. The framework for Rules 4111 and 9559 has built-in procedural safeguards that should address most of these issues, but may in some cases result in presumptions regarding certain firms that are not warranted and which are not soon forgotten. Especially with regard to smaller FINRA members, identification as a potential "Restricted Firm" and the need to respond may also strain scarce resources and divert time and attention from running their businesses. Subject to design and implementation of procedural safeguards, we believe that a system similar to that established in Rule 9208 could yield better outcomes for both investors and member firms.

Our comments below focus primarily on four issues: The manner in which potential Restricted Firms are identified, procedural safeguards that will make the system established by Rules 4111 and 9559 function more efficiently, public identification of Restricted Firms, and other methods that may accomplish the desired results in a more efficient way. In that order, we offer the following:

1. Criteria for Identification of Restricted Firms

a. Adjudicated vs. Pending Events. Proposed Rule 4111(b) lists six categories of information ("Preliminary Identification Metrics") that would be used to perform the initial screening and determine which firms would be subject to further review. They can be separated into three general categories: "Adjudicated" and "Pending" events (for both firms and representatives), and employment-related events for representatives. We believe that Adjudicated events are appropriate criteria for inclusion, but that Pending events generally are not, and that employment-related events for representatives should be considered with great caution, if at all.

In determining whether to use any element of data in the evaluation process, two criteria should be applied: The degree to which the data is reliable and the degree to which it is predictive of future conduct. Determining whether or not past actions are reliable indicators of future conduct is an inherently difficult concept. A discussion of that is beyond the scope of this letter, but we believe that there are significant flaws in the methodology and conclusions reached by one of the academic studies that are cited in the Notice in support of the proposed criteria.

The merits of all adjudicated events have been determined by an independent body. The respondent (firm or representative) has had an opportunity to rebut the allegations and establish that no violations have occurred or whether mitigating circumstances exist. While there can never be certainty that a hearing panel or other adjudicative body has reached the correct conclusion, each side has had an opportunity to present evidence and their interpretation of the facts and law. The decision of a neutral fact-finder is inherently more reliable than any mere allegation, which is essentially all that any pending event can be. This raises questions of both accuracy and fairness.

With respect to all Pending events, no such process has occurred. Proposed Rule 4111(i)(4)(B) includes pending investment-related civil judicial matters, pending regulatory matters, and certain types of pending criminal charges. It is an unfortunate fact, but a significant percentage of civil judicial matters are frivolous and ultimately determined to be without merit, and are often filed for purely economic reasons. The motives of the individuals filing such claims must be taken into account in including information about them in the screening process contemplated by Rule 4111. Regulatory actions do not present the same set of economic incentives to pursue unsubstantiated claims, but a significant percentage of both regulatory investigations and criminal proceedings are ultimately either discontinued without action by the regulatory agency, dismissed by prosecutors prior to trial, or dismissed by a court or other fact-finding body. Allegations are fundamentally different from decisions of courts or hearing panels. Including unadjudicated events in the formula used to determine whether a firm may become subject to restrictions on its activities raises substantial questions about both reliability of the information and the fairness of the process. We would also note that regulatory and criminal proceedings often take long periods of time (multiple years in many cases) to resolve. Firms may become stuck in a "time warp" waiting for pending matters to be concluded. We suggest that the balance in this instance militates in favor of excluding all categories of pending or unadjudicated events from the screening criteria.

There is also a practical reason why unadjudicated events are best excluded from consideration. Rules 4111 and 9559 provide for an expedited hearing process of which Restricted Firms may avail themselves if they disagree with a FINRA determination about a requirement to post deposits of cash or securities. Even if FINRA does not rely on unadjudicated events in presenting its case at such hearings, the respondent/Restricted Firm may seek to introduce evidence regarding the criteria on which the firm ended up being designated a Restricted Firm in the first place, suggesting either bias in the process or that FINRA has not applied its own rules correctly. This will result in large amounts of time being devoted to introduction of evidence regarding facts that are not relevant to the proceeding and delay it's resolution. In situations such as those envisioned by Rule 4111, the appearance of fairness is as important as the substance of the procedural protections. The balance weighs in favor of excluding all unadjudicated events from the review process.

b. Termination and Internal Review Events

Section (i)(4)(C) of Proposed Rule 4111 provides that events relating to terminations of registered persons go into the initial determination of which firms meet the threshold for Restricted Firms. This raises two separate issues:

i. Situations in which individuals are terminated, resigned after allegations, or where there are pending or closed internal reviews by the member firm. Reporting of these events by member firms is mandated by FINRA rules, but member firms must balance their reporting obligations with concerns regarding claims for defamation or wrongful termination by representatives who may allege that their terminations were either unjust or motivated by improper motives on the part of the firm. The representative may have an opportunity to discuss the circumstances leading to their termination, but the firm often submits the information without the individual having an opportunity to change or contest it until after the fact. As discussed above, the most important criteria for including any category of events in determining which firms may be subject to restrictions is it's reliability. The process and considerations that go into termination of representatives and initiation and conclusion of internal reviews create issues in that regard.

ii. If member firms believe that they may be nearing the numerical threshold for events that could subject them to Restricted Firm status, they may not report adverse employee actions such as terminations for cause or internal reviews. These determinations are inherently based on the judgment of the individuals making them, and a justification for any action can generally be made after the fact. It is not in the interest of any of the constituents in this exercise to create incentives for member firms not to report employment-related actions accurately. We believe that this would create such an incentive.

c. Persons Associated with Previously Expelled Firms

Proposed Rule 4111 (i)(4)(f) includes as one of the criteria for determining Restricted Firm status the number of registered individuals who have been associated with firms that have previously been expelled from FINRA membership. We recognize that there have been instances in which FINRA members firms were run inappropriately and utilized sales practices or other practices that created risk for investors. Many of these firms have been expelled from FINRA membership with good reason, and many of their affiliated representatives deserved the same fate. However, many such firms have made a practice of recruiting representatives who had little or no prior background in the securities industry and were taught bad habits before they had enough experience to know better. If the firm with which a representative was formerly associated is expelled from FINRA membership, other FINRA members may be unwilling to hire them for fear that it will cause them to meet one or more of the criteria for becoming a Restricted Firm. This may create an unfair "guilt by association" for individuals who have been employed by bad firms in the past but have not engaged in wrongdoing themselves. This raises issues of both procedural fairness and restriction on the ability of individuals to make a living. Both should be considered carefully.

2. Procedural Safeguards and Protections

Rule 4111 would give FINRA a new and powerful ability to impose potentially far-reaching restrictions on the conduct of member firms. We support both the spirit and letter of this initiative.

That being said, in order for it to accomplish the desired results, the entire process must be viewed as striking the appropriate balance between investor protection and procedural fairness for member firms who meet the initial screening criteria. For these reasons, we suggest that Rule 9559 include the following provisions:

a. **Decision Makers** - All contested hearings should be conducted by a hearing panel consisting of both industry members and a Hearing Officer. Fairly or not, Hearing Officers are often viewed as extensions of FINRA Enforcement, and therefore not as objective as hearing panels. Requiring that all cases be decided by a panel including two industry members will mitigate this perception. It would also bolster confidence in the level of expertise available with respect to matters that are technical in nature. Three heads are better than one in this instance.

b. **Hearing Process** - Rule 9559 provides for expedited hearings in instances where the Restricted Firm disagrees with the initial determination of FINRA staff. This is a necessary provision because firms need certainty in order to operate their businesses and extended delays create uncertainty. However, Rule 9559 provides that hearings must be conducted in as little as five days after the firm receives a notice regarding having become subject to Restricted Firm status. This strikes us an unreasonably short period of time. Many firms that become subject to these proceedings are likely to be small and lacking the resources necessary to prepare for a hearing on such short notice. In many cases, they will require the assistance of legal counsel or other experts, all of whom require time to familiarize themselves with the factual and other background of the case. In order to promote the perception of fairness and give firms an opportunity to prepare, we suggest that Rule 9559 establish a presumption that a hearing would be conducted within a specified period of time after notice of the determination, but that it could be extended for a reasonable period of time (perhaps 30 days) upon a request from the firm and showing of reasonable cause.

3. Public Notice of Restricted Firm Status

There will certainly be instances in which member firms go through the process set forth in Rules 4111 and are required to post deposits or submit to other restrictions on their conduct. This is an appropriate result in most cases, but public disclosure of such status will have undesirable collateral consequences. Any determination of Restricted Firm status should not be publicly announced by FINRA or become subject to discovery by third parties in other proceedings. This is true for several reasons:

a. Rule 4111 is intended to create a mechanism to vindicate the rights of FINRA to impose appropriate restrictions on the conduct of members and enhance investor protection. These are both important and laudable goals. However, if decisions regarding restrictions on member firms' activities become known to the public, they may create a perception of financial weakness or a propensity for the firm to commit bad acts, and lead to a "run on the bank" scenario in which many customers of the firm decide to close their accounts. This will have the perverse effect of making the firm less financially viable and more likely to fail.

Many FINRA members operate with minimal excess net capital, especially if they do not hold customer funds or securities. The provisions of Rule 4111 establish limits on the amount of the deposit that FINRA may require after a finding that a firm become a Restricted Firm, but they may still be in excess of the practical ability of the firm to supply them. The ability of a firm to meet its obligations often depends on its ability to survive as a going concern. In some cases, the amount of the deposit will be insufficient to meet all prospective claims of customers or other creditors, and the only means by which to ultimately satisfy such claims is for the firm to remain in business. Anything that adversely impacts that ability should be considered carefully.

b. Many FINRA member firms have been subject to public campaigns from claimants representatives seeking to induce firm clients to bring claims for damages. These representatives, including attorneys, often post advertisements seeking individuals who have done business with

firms and encourage them to contact the attorney and institute a claim against the firm.

If a Claimant's representative becomes aware that a firm has become a Restricted Firm, they may be more inclined to increase their advertising or other promotion in order to generate revenue for themselves or to make it more likely that the claims of their clients are satisfied before the assets of the firm are dissipated. This may lead to the "run on the bank" scenario mentioned above. In addition, claimants' representatives may use the fact that a firm has been designated a Restricted Firm to suggest that the firm has engaged in wrongful conduct for which the customer may be entitled to compensation. This raises questions of both fairness and the effectiveness of Rule 4111. If it promotes more claims, it may well diminish the pool of assets available to satisfy customer claims rather than increasing it and undermine its own aims.

It can be argued that the determination that a FINRA member become a Restricted Firm would be material to a current or prospective customer. However, if disclosure of that fact makes it more likely that a firm will fail or otherwise be less likely to meet its obligations to customers, it fails to strike the correct balance between investor protection and the right of the public to know.

4. Other methods to accomplish the goals of Rule 4111

We agree with the intent and the general methodology of Rules 4111 and 9559. We believe that they represent a reasonable approach to a persistent problem that has negative effects on both investors and the securities industry in general. However, we believe that FINRA should also consider other means by which to accomplish these objectives. They include:

a. **IIROC Consolidated Rule 9208**. Subject to our comments about the need for procedural fairness, we believe that FINRA should consider the approach taken by IIROC Consolidated Rule 9208 as an alternative to that of Rule 4111. The circumstances that Rule 4111 is intended to address are sufficiently severe and arise infrequently enough that they may justify the use of such authority by FINRA. Substituting the expertise and discretion of FINRA staff for the more quantitative approach set forth in Rule 4111 strikes us as reasonable in these limited circumstances, and perhaps ultimately more

fair and efficient for the process as a whole. We suggest that additional study of the merits and burdens of such an approach be undertaken.

b. **Financial responsibility.** Rule 4111 gives FINRA authority to require firms to post cash or other assets, with the goal of modifying their behavior and demonstrating their ability to meet their obligations to customers and others. This has benefits, but some firms may not have immediate access to cash or other acceptable assets and may need an interim or other method to satisfy these requirements. We therefore suggest that FINRA consider additional means by which Restricted Firms can satisfy these obligations through third-party guarantees such as performance bonds or insurance. These would have to be subject to appropriate terms and conditions, but may offer flexibility that is lacking in the current version of Rule 4111.

c. **Ongoing review.** The terms of Rule 4111 create extraordinary and unprecedented authority for FINRA. While we believe that this is necessary and justified, FINRA is embarking on an uncharted journey that may have unanticipated effects. We therefore suggest that Rules 4111 and 9559 include requirements that they be at reviewed at specified intervals (every three or five years, for example) to determine whether or not they are meeting their objectives in the most efficient way. While we are not aware of similar provisions in any current FINRA rule, we submit that such a requirement is justified in this instance.

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Thank you for providing us the opportunity to submit these comments. If you have questions or I may offer any further information, I can be reached at 619/702-9735 or mark.quinn@cetera.com.

Sincerely,

Mark Quinn