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FINRA's New 'Restricted Firm' Plan Is on Its Way

Broker-dealers with a history of misconduct who have also hired a high percentage of brokers with a similar track record need to brush up on a new Financial Industry Regulatory Authority rule that seeks to expose potential risks to investors by labeling these broker-dealers as "restricted firms."

FINRA's plan, **approved by the Securities and Exchange Commission** in late July, adopts Rule 4111, which uses criteria to decide whether to designate BDs as "restricted firms."

The rule becomes effective within 180 days of when FINRA issues a regulatory notice, which FINRA plans to do by the end of September.

As part of the SEC approval, FINRA will propose amendments to Rule 8312 (FINRA BrokerCheck Disclosure), to provide information as to whether a particular member firm or former member firm is designated a "restricted firm" pursuant to Rules 4111 and 9561.

The SEC also approved FINRA Rule 9561 (Procedures for Regulating Activities) and amended FINRA Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series), to create a new expedited proceeding to implement Rule 4111.

The rule change sets up a process to give a restricted firm an opportunity to challenge the dºesignation and the resulting obligations of that designation, as well as give the firm a one-time opportunity to avoid the imposition of obligations by voluntarily reducing its workforce, according to FINRA.

Rule 4111, according to **an AdvisorLaw blog**, "began as a way to impose additional capital requirements on firms with a significant history of misconduct. The Rule's maximum 'Restricted Deposit Requirement' (RDR) acts as an additional insurance policy, or a sort of regulatory hammer, to use against small firms, where problematic advisors tend to congregate and hang their licenses."

These firms, AdvisorLaw explains, "identified as 'restricted firms,' will have to maintain a financial deposit (in the form of cash or securities) in a segregated account, at a bank or clearing firm. The amount of the deposit is to be determined at the sole discretion of FINRA, and the firm's ability to withdraw will be restricted, subject only to FINRA approval."

FINRA, according to AdvisorLaw, "seems to indicate that all firms will be subject to this new rule, but that is nothing more than a smokescreen of fairness."

Based upon hypothetical test runs by FINRA itself, AdvisorLaw states, it was found that:

- FINRA will investigate up to 80 firms, or about 2% of the industry, per year.
- Of those, small firms (<150 reps) make up about 91%.
- Mid-sized firms (151 to 500 reps) account for about 8%.

"This is not a large firm problem—it is squarely aimed at the small firm that has less than 150 reps," AdvisorLaw maintains.

I checked with Jon Henschen, president of Henschen & Associates, a firm that helps advisors find broker-dealer relationships, to get more details on how onerous compliance with the new rule will be.

Do you see this rule as positive or negative, and why?

We see this move by FINRA as a positive for the public and a negative for the broker-dealers that are categorized as a "restricted firm." Since 2010, compliance standards and requirements have ramped up dramatically. To give you perspective, in the mid–'90s when I brokered at the wirehouse, Prudential Securities, our branch manager said in passing, "If a broker doesn't have a couple of dings on his compliance record, he's probably not aggressive enough."

That mindset was quite common in the '90s, but today the tolerance for bad broker behavior is much less.

Since 2010, we've seen a sharp decline in the number of advisors that were active stock and bond traders, and with that decline, we've seen a drop in the number of broker-dealers that catered to that market, many of whom had poor compliance histories on a BD and rep level. For the consumer, this was overwhelmingly a positive change.

Today, we still have active stock and bond traders and the firms that cater to this market, but they are in far lower numbers and are more concentrated in New York City, Long Island and Southern Florida.

This rule is intended to have money set aside to pay for litigation the firm may owe to clients in the event the firm is closed. There are many situations where a client has been wronged by an unethical advisor, the case goes to arbitration and the client is awarded a large sum for restitution, but the firm ends up closing their doors and the client never gets a dime.

These high-risk broker-dealers needing to have this reserve fund controlled by FINRA will be a layer of protection for the public.

What will BDs have to do to come into compliance?

Firms will have six months to make changes to not be under the category of "restricted firm."

Firms that will be categorized as "restricted firms" or rogue brokerages will be similar to the firms that fall under the FINRA Taping Rule (FINRA Rule 3170).

The taping rule requires certain firms to install taping systems to record all telephone conversations between their registered persons and existing and potential customers, review those recordings and file reports with FINRA. The taping rule was designed to prevent fraudulent and improper practices in the sale or marketing of financial products and behavior that may otherwise cause customer harm.

These firms had a significant number of registered persons who previously worked for firms that have been expelled from the industry or have had their registrations revoked for inappropriate sales practices.

Firms that are told they will be categorized as a "restricted firm" will have a six-month window to shed enough advisors with poor compliance records to not be included in these additional requirements.

Will firms have to advertise this restricted firm status, or would that just be an internal FINRA label?

Like with taping firms, the public will be able to view what firms are restricted firms on the FINRA website. Currently, FINRA shows disciplined firms (taping firms), including:

- Delaney Equity Group LLC.
- Portfolio Advisors Alliance LLC.
- Sandlapper Securities LLC.
- Windsor Street Capital LP.
- World-Xecution Strategies

Is coming into compliance a heavy lift for these firms, or it doesn't matter how heavy because the change is warranted?

The compliance mandate is either get rid of a certain number of your poor compliance reps or you will need to set aside cash or qualified securities into an account controlled by FINRA to pay for arbitration awards. For the broker-dealer, this is money that could have been used for technology improvements, more compliance people, recruiting, additional services, etc.

How do you view these requirements?

We view these requirements as a black eye and potentially drive out of business most firms that fall into this category. Not only will working capital have to go in a non-productive direction, but their reputation will be harmed and their ability to recruit will be much more difficult.

For advisors with clean compliance that are with such broker-dealers, they end up guilty by association and will have fewer resources at their disposal due to financial resources needing to go to the FINRA separate account.

This could very well be another bottleneck event that puts broker-dealers with high concentrations of problematic advisors out of business as well as flushing more representatives out of the industry.

Another conundrum for these broker-dealers is advisors with numerous compliance disclosures that oftentimes are large producers because a broker-dealer would not have brought them on unless the risk/reward [ratio] made sense (they won't bring on a rep with five disclosures with $100K of GDC, but they'll bring on a $1M GDC producer with five disclosures). Having to let go of advisors with numerous disclosures on their record can result in losing their primary revenue generators.

Another concern is that over time, will FINRA tighten the thumb screws by making more inclusive what is categorized as problematic? Today an advisor from an expelled firm and dismissed for cause is problematic, but a year from now, any advisor with three or more disclosures over the last 10 years will be added as problematic. Eventually, the only advisors in good standing will be those that can walk on water.

In spite of the downside for broker-dealers that get the label of rogue brokerage/restricted firm, the benefit will be fewer unethical representatives and the broker-dealers that harbor large concentrations of such reps, which will be good for the public.

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