

February 23, 2021

The Honorable Elizabeth Warren
United States Senate
309 Hart Senate Office Building
Washington, DC 20510

Dear Senator Warren:

The Financial Industry Regulatory Authority (FINRA) appreciates the opportunity to respond to your letter of February 16, 2021, regarding the recent market events related to trading in GameStop and similarly volatile stocks, particularly with respect to the activities of online trading platforms and their dealings with retail customers.

FINRA's mission is to protect investors and promote market integrity, and we agree that these events require thorough investigation and careful study – not only to ensure enforcement of existing rules, but also to assess whether current standards applicable to broker-dealers should be enhanced to better protect investors in light of changes in technology, investor behavior and the broader evolution of the markets. Your letter raises important issues in that regard. Below, we have set out responses to your specific question topics.

Background

As you know, FINRA is a not-for-profit, self-regulatory organization responsible for regulating its member broker-dealers and their associated persons pursuant to the Securities Exchange Act of 1934 (Exchange Act). Operating under the oversight of the Securities and Exchange Commission (SEC or Commission), FINRA fulfills its mission by, among other things, adopting rules that supplement those of the SEC (and that are subject to approval by the SEC), examining its member firms for compliance with FINRA rules and SEC rules applicable to broker-dealers, surveilling trading in the securities markets and enforcing member firm compliance where necessary.

The SEC has stated that it will be conducting a review of recent market events¹ and publishing a report of its findings.² FINRA has offered to support that effort however the SEC deems appropriate. We believe that a comprehensive review of these events by the SEC is both a necessary and important step to help inform potential regulatory responses by the SEC, FINRA or other regulators.

In considering such responses, we note that the SEC has primary regulatory authority with respect to several of the topics raised in your letter. These include: the development

¹ See Statement of Acting Chair Lee and Commissioners Peirce, Roisman, and Crenshaw Regarding Recent Market Volatility, dated January 29, 2021.

² See Statement from Treasury Regarding the Meeting Between the Treasury Department, Securities and Exchange Commission, Federal Reserve Board, Federal Reserve Bank of New York, and Commodity Futures Trading Commission, dated February 4, 2021.

by the SEC of a national market system defining the overall structure of the securities markets, which has included decades of analysis and regulation by the SEC of the practice of payment for order flow on the exchanges and over-the-counter markets; the SEC's financial responsibility requirements for broker-dealers, whether or not FINRA member firms, which govern their capital, liquidity and protection of customer funds and securities; determining the scope and application of Regulation Best Interest (Reg BI) (which imposes a "best interest" standard of conduct for recommendations of securities and strategies to retail customers) with respect to online trading platforms; and the authority to prohibit mandatory predispute arbitration agreements between broker-dealers or investment advisers and their customers. As discussed below, certain of FINRA's own rules, as approved by the SEC, help supplement or support the SEC's approach to these areas under federal law.

In further support of the SEC, FINRA has responsibility to help enforce the SEC's requirements with respect to FINRA member broker-dealers – in addition to enforcing FINRA's own rules. Even as the SEC conducts its broader review of the recent market events, FINRA is actively considering a range of matters related to those events, closely coordinating with the SEC and other regulatory authorities. Those efforts involve extensive collaboration across multiple FINRA departments, including those that supervise member firm activities involving customers and the markets and those that investigate potential regulatory violations and bring enforcement actions for those violations. While we are not in a position to address any specific investigative or supervisory matter, FINRA will thoroughly investigate the conduct of those over whom it has jurisdiction – its member firms and their registered personnel – and take appropriate regulatory or disciplinary action to remediate violations of applicable legal requirements where warranted.

FINRA is committed to dedicating the resources and expertise needed to supervise broker-dealers' compliance with applicable requirements. To support this objective, FINRA deploys a risk assessment program to monitor member broker-dealers for potential risks to investors and markets. Informed by these risk assessments, FINRA examines member firms regularly to assess and test their policies, procedures and supervision for compliance with applicable rules.³ FINRA also conducts automated surveillance of market activities. Based on these risk monitoring, examination and surveillance activities, FINRA investigates and takes disciplinary actions against firms and individuals as necessary. When it encounters potential violations that involve persons beyond FINRA's jurisdiction or that are linked to an existing SEC matter, FINRA refers the matter to the SEC (or other relevant authority) for its action.

In addition, the FINRA Investor Education Foundation (Foundation) provides free, unbiased information and tools to help investors protect themselves and better understand the markets and basic principles of investing through multiple channels.⁴ The

³ In addition to routine firm examinations, FINRA also conducts many investigations and reviews "for cause," meaning these investigations and reviews are triggered by specific allegations or events, such as customer complaints, whistleblower tips or arbitrations.

⁴ More information about the Foundation is available at: <https://www.finrafoundation.org/>. See also, *Following the Crowd: Investing and Social Media* (January 29, 2021), available at <https://www.finra.org/investors/alerts/following-crowd-investing-and-social-media>.

Foundation also engages in research to better understand the financial capability of American households and to explore trends and circumstances affecting the way Americans manage and invest their money. For example, to assist us in understanding new investors and their educational needs in light of the changing nature of technology and investor demographics, the Foundation conducted a review in the past year of investors who opened new, taxable investment accounts during 2020, including first-time investors.⁵

Responses to Question Topics

Question 1: Best Execution

A firm's duty of best execution is one component of the overarching national market system regulatory structure implemented and overseen by the SEC. As discussed more fully in response to Question 4 below, this regulatory structure also addresses, among many other related matters, the payment for order flow in exchange and over-the-counter markets.⁶

FINRA oversees member firms' compliance with their duty of best execution through an array of approaches, including automated surveillance of trading, routine examinations, targeted "sweep" examinations, rulemaking and detailed interpretive guidance and economic analysis. For example, in *Regulatory Notice* 15-46, FINRA comprehensively rearticulated broker-dealers' best execution requirements. FINRA also has identified best execution in its annual regulatory priorities since 2013 and has provided firms additional guidance on common best execution examination findings each year since 2017, when FINRA began publishing its annual examination findings report.⁷

⁵ FINRA Investor Education Foundation & NORC, *Investing 2020: New Accounts and the People Who Opened Them* (February 2, 2021), available at <https://www.finrafoundation.org/insights-new-accounts>.

⁶ As discussed below, the SEC has reviewed the practice of payment for order flow a number of times since the practice emerged in the 1980s and has pursued an approach based primarily on disclosure to address concerns about the potential conflicts of interest caused by payment for order flow arrangements. See, e.g., Memorandum to the Equity Market Structure Advisory Committee (EMSAC) from the SEC Division of Trading and Markets, *Certain Issues Affecting Customers in the Current Equity Market Structure* (January 26, 2016), at pg. 7-8, available at <https://www.sec.gov/spotlight/equity-market-structure/issues-affecting-customers-emsac-012616.pdf> (describing the SEC's prior reviews of the practice and discussing relevant payment for order flow disclosure requirements in Exchange Act Rule 10b-10 and Rules 606 and 607 of Regulation NMS).

⁷ All of these annual reports are available publicly on FINRA's website at <https://www.finra.org/media-center/reports-studies>. Beginning this year, FINRA replaced the separate annual priorities letters and reports on exam and risk monitoring findings with the 2021 Report on FINRA's Examination and Risk Monitoring Program (Examination and Risk Monitoring Report, or Report). For selected regulatory obligations, the Report: (1) identifies the applicable rules and key related considerations for member firm compliance programs; (2) summarizes noteworthy findings from recent examinations and

Where member firms fall short of their best execution obligations, enforcement is an important tool, as was the case in the proceeding you note against Robinhood. In that particular matter, Robinhood was censured and fined,⁸ and FINRA further required Robinhood to comply with specific undertakings that included retaining an independent consultant to review the adequacy of the firm's policies, systems, procedures and training related to achieving compliance with FINRA's best execution rule. Consistent with this required undertaking, Robinhood engaged an independent consultant to review its best execution program and received the independent consultant's report in April 2020. In June 2020, Robinhood certified to FINRA that it adopted and implemented all recommendations as set forth in the independent consultant's report. Further in response to the report, Robinhood revised its Written Supervisory Procedures and Execution Quality Procedures Manual.⁹

These steps were noted recently in the separate SEC action against Robinhood that you cite, which concluded after the FINRA action but concerned distinct best execution violations under federal antifraud provisions that preceded FINRA's action and the undertakings that FINRA imposed. FINRA notes that the SEC action also imposed new undertakings that require a similar independent consultant report. While we are not able to address ongoing supervisory, investigative or enforcement matters involving Robinhood or any other particular firm, we do review firms for compliance with undertakings in the course of FINRA's continued focus on an area of conduct that has required them.

Question 2: "Game-Like" Features and Emerging Communication Risks

FINRA's 2021 Examination and Risk Monitoring Report noted member firms' use of emerging digital communication channels, including app-based platforms with interactive or "game-like" features that may be intended to influence customers, and related forms of marketing.¹⁰ The game-like features we have seen across multiple firms include, among others, items such as badges that serve as visual markers of achievement,

outlines effective practices that FINRA observed during its oversight; and (3) provides additional resources that may be helpful to member firms in achieving compliance.

⁸ See Robinhood Financial, LLC, Letter of Acceptance, Waiver and Consent (AWC) (FINRA Case No. 2017056224001).

⁹ See In the Matter of Robinhood Financial, LLC, Securities Exchange Act Release No. 90694 (December 17, 2020) (discussing, in the context of the SEC's action against Robinhood, the remedial steps the firm took in response to FINRA's action). This letter refers to Robinhood generally for discussion purposes. FINRA notes that while its proceeding specifically involved Robinhood Financial, LLC, the remediation steps described in the SEC action in response to FINRA's action discuss improvements made both by Robinhood Financial, LLC, as well as its affiliated firm, Robinhood Securities, LLC, to which Robinhood Financial, LLC began sending all customer orders for trade execution beginning in November 2019.

¹⁰ See 2021 Report on FINRA's Examination and Risk Monitoring Program at p.22. <https://www.finra.org/sites/default/files/2021-02/2021-report-finras-examination-risk-monitoring-program.pdf>

leaderboards that rank participants, social networking features (including in-app messaging) and prizes for games (such as free stock) to encourage account sign-ups. These developments in product offerings are not confined to broker-dealers and appear in many financial services and other consumer-oriented businesses.

These features can appear in many aspects of how broker-dealers interact with customers, from initial advertisements through the opening of accounts and the presentation of different investment choices to communications following a trade. While some of these offerings may be designed to better enable the delivery of information to investors or to improve investor access to firm systems and investment products and services, they may also result in increased risks to customers if not designed with appropriate compliance considerations in mind, raising important regulatory questions, such as:

- *Advertising and marketing.* Are a member broker-dealer's communications to investors – regardless of format and technology – in compliance with FINRA's rules regarding communications with the public?¹¹
- *Recommendations to customers.* Depending on the facts and circumstances, do some of these interactions constitute "recommendations" that would be covered by the SEC's Reg BI, which requires a broker-dealer making recommendations of securities to act in a retail customer's "best interest"? If not, should they?¹²
- *Other influences on customers.* Are there other game-like aspects of platform design that are intended to influence customers where the potential risks to investors and markets warrant attention beyond the application of existing rules?

FINRA agrees with the SEC that "this is a dynamic, expanding, and ever-changing marketplace, and that it is our responsibility to consider whether existing protections can be improved."¹³ Accordingly, we are committed to supporting the SEC staff's review (announced in October 2020)¹⁴ of the increase in self-directed trading by retail investors that is not covered by Reg BI, and the effectiveness of existing regulatory requirements in protecting investors in those circumstances. FINRA is also committed to supporting the SEC as it continues to oversee the implementation of Reg BI and considers further

¹¹ See FINRA Rule 2210(d)(1).

¹² Reg BI applies if there is a "recommendation," and the determination of whether there is a "recommendation" depends on the facts and circumstances of a firm's interaction with its customer. Differences in platform design and the nature of communications may affect whether or not a firm provides a "recommendation" for purposes of Reg BI.

¹³ See Joint Statement Regarding Complex Financial Products and Retail Investors, dated October 28, 2020.

¹⁴ See *id.*

refinements in Reg BI's application. At the same time, FINRA is also considering the effectiveness of its own rules in addressing these developments.

Although Robinhood is in the best position to describe its services in detail, the firm's platform incorporates digital interactions that could be viewed as having game-like features, as has been widely reported. At this point we cannot discuss the status or conclusions of any FINRA supervisory, investigative or enforcement matters involving Robinhood or any other particular firm. However, as noted above we are generally assessing the use of these types of digital interactions within the securities industry, how they may impact investors' decision-making, both positively and negatively, and risks they may create for investors.

Question 3: Registration and Licensing

FINRA rules require generally that individuals associated with a FINRA member and engaged in the investment banking or securities business of the member be appropriately registered with FINRA as a "principal" or "representative."¹⁵

- The term "principal" is defined under FINRA rules as any person associated with a member,¹⁶ including, but not limited to, sole proprietor, officer, partner, manager of office of supervisory jurisdiction, director or other person occupying a similar status or performing similar functions, who is actively engaged in the management of the member's investment banking or securities business, such as supervision, solicitation, conduct of business in securities or the training of persons associated with a member for any of these functions.¹⁷

¹⁵ See FINRA Rule 1210 (Registration Requirements); see also Exchange Act Rule 15b7-1 (Compliance with Qualification Requirements of Self-Regulatory Organizations). Exemptions from registration are set forth in Rule 1230.

¹⁶ For purposes of the FINRA registration rules, the term "person associated with a member" includes: (1) a natural person who is registered or has applied for registration with FINRA; (2) sole proprietor, partner, officer, director, or branch manager of a member or other natural person occupying a similar status or performing similar functions; or (3) a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member. See Article I, Section (rr) of the FINRA By-laws. The term "investment banking or securities business" generally means the business of underwriting or distributing shares of securities, purchasing securities and offering the same for sale as a dealer or purchasing and selling securities upon the order and for the account of others. See Article I, Section (u) of the FINRA By-laws.

¹⁷ See FINRA Rule 1220(a)(1) (Definition of Principal). The term "actively engaged in the management of the member's investment banking or securities business" includes: (1) the management of, and the implementation of corporate policies related to, the member's investment banking or securities business; (2) the exercise of managerial decision-making authority with respect to the member's investment banking or securities business; or (3) the exercise of management-level responsibilities for supervising any aspect of the member's investment banking or securities business, such as serving as a

- A “representative” is defined under FINRA rules as any person associated with a member, including assistant officers other than principals, who is engaged in the member’s investment banking or securities business, such as supervision, solicitation, conduct of business in securities or the training of persons associated with a member for any of these functions.¹⁸

A FINRA member firm’s chief executive officer (CEO) and chief financial officer (CFO), or individuals who are the functional equivalent of a member firm’s CEO or CFO, are considered principals under FINRA rules.¹⁹ Other senior or executive management of a member firm, such as officers, may be considered principals either because they are persons associated with the member who are actively engaged in the management of the member’s investment banking or securities business or because they are performing a function, such as the head of a business unit, that is required to be performed by a principal of the member. The determination of whether an individual is functioning as a principal or representative and of the appropriate registration category for such individual can be fact-specific and requires careful assessment of the individual’s activities.

The FINRA registration requirements are not limited in scope to executives of FINRA member firms. Many member firms are subsidiaries of one or more holding companies. Senior individuals employed at a holding company for a member firm may be subject to registration as principals depending on their functions with respect to the member firm. For instance, the requirement to be appropriately registered with FINRA as a principal would apply to an individual who is directly or indirectly controlling a FINRA member firm, such as the CEO of the parent or holding company of a FINRA member firm, if under the relevant facts and circumstances that person is “actively engaged in the management of the member’s investment banking or securities business.” On the other hand, depending on the nature of the person’s responsibilities, and other facts and circumstances, the CEO or other senior person of the parent or holding company of a FINRA member may not be required to register with FINRA.

Question 4: Payment for Order Flow

As noted above, FINRA’s approach to best execution operates in the context of the broader set of interrelated market structure rules established by the SEC, and FINRA continues to coordinate closely with the SEC in this area.

The SEC has periodically reviewed the practice of payment for order flow since it emerged in the 1980s, including most recently with its Equity Market Structure Advisory Committee (EMSAC). In a 2016 SEC staff memorandum addressed to the EMSAC, the SEC Division of Trading and Markets described components of a broker-dealer’s duty of best execution as articulated under SEC guidance and FINRA rules, and noted the Commission’s longstanding view that “a broker-dealer does not necessarily violate its

voting member of the member’s executive, management or operations committees. See *id.*

¹⁸ See FINRA Rule 1220(b)(1) (Definition of Representative).

¹⁹ See FINRA Rule 1220(a)(1). A FINRA member’s CEO and CFO (or equivalent officers) are considered principals based solely on their status.

best-execution obligation merely because it receives payment for order flow,” but that “the existence of payment for order flow raises the potential for conflicts of interest for broker-dealers handling customer orders.”²⁰ The memorandum explained further that “[t]o date, the Commission has pursued an approach based primarily on disclosure to address concerns about the potential conflicts of interest caused by payment-for-order-flow arrangements.”²¹

Following the EMSAC’s debate of several regulatory alternatives to address payment for order flow, which considered, among other things, the potential unintended consequences of banning the practice altogether, the EMSAC recommended certain enhanced disclosures,²² and the Commission subsequently took steps that advanced its disclosure-based approach. Specifically, in 2018, the Commission adopted amendments to Rule 606 of Regulation NMS that require, among other things, new aggregate payment for order flow disclosures in broker-dealer’s public quarterly reports.²³ These new disclosures have increased the public transparency of payment for order flow arrangements and have served to inform much of the current debate around the practice.

Operating in the context of this overall approach to best execution and payment for order flow, FINRA reviews whether member firms – including wholesale retail market makers and introducing firms – are meeting their regulatory obligations. FINRA recently highlighted these efforts in the Examination and Risk Monitoring Report.²⁴ The Report

²⁰ See Division of Trading and Markets Memorandum to the EMSAC, *supra* note 6, at pg. 7-8. Specifically, as noted in the memorandum, Exchange Act Rule 10b-10 requires that a broker-dealer indicate on customer confirmation statements when payment for order flow – which is defined broadly under the rule – has been received on a transaction, and also indicate that the source and nature of the compensation received in connection with the particular transaction will be furnished upon the customer’s written request. The memorandum also cites relevant disclosure requirements in Rule 606 of Regulation NMS, which generally requires broker-dealers to publish quarterly public reports that identify the top ten venues to which they route orders for execution and discuss material aspects of payment for order flow arrangements, and Rule 607 of Regulation NMS, which requires broker-dealers to disclose upon opening a new customer account and on an annual basis thereafter policies relating to payment for order flow and order routing. See *id.* (discussing these requirements in more specific detail).

²¹ See *id.* at p. 8.

²² See EMSAC Recommendations Regarding Modifying Rule 605 and Rule 606 (November 29, 2016), available at <https://www.sec.gov/spotlight/emsac/emsac-recommendations-rules-605-606.pdf>.

²³ See Securities Exchange Act Release No. 84528 (November 2, 2018), 83 FR 58338 (November 19, 2018) (Disclosure of Order Handling Information Adopting Release). In addition to the enhanced Rule 606 disclosures the Commission adopted following EMSAC discussion, the Commission also adopted a rule to require a pilot program designed to study the impacts of exchange access fees and rebates on order routing, although that rule was recently vacated in federal court. See *N.Y. Stock Exch. LLC v. SEC*, 962 F.3d 541 (D.C. Cir. 2020).

²⁴ See 2021 Report on FINRA’s Examination and Risk Monitoring Program at pg. 31-33. <https://www.finra.org/sites/default/files/2021-02/2021-report-finras-examination-risk-monitoring-program.pdf>.

identified a number of considerations a member firm should take into account in achieving best execution compliance, including how the firm ensures that it is not unduly influenced by economic incentives, such as payment for order flow or other routing inducements. The Report further discussed examination findings indicating areas in which some firms needed to improve their procedures for assessing execution quality and mitigating routing conflicts. In addition, FINRA noted its ongoing targeted examination efforts to evaluate, among other things, whether “zero-commission” trading adversely affected firms’ compliance with their best execution obligations.²⁵

As FINRA reviews member firms’ order handling and routing activity, FINRA applies SEC guidance as well as the requirements set out in FINRA Rule 5310 and published guidance thereunder. In particular, FINRA guidance – consistent with controlling SEC guidance referred to above – makes clear that member firms cannot allow routing inducements (including payment for order flow) to interfere with their duty of best execution. FINRA guidance also stresses the need for member firms to consider price improvement opportunities, including those that may be available outside existing internalization or payment for order flow arrangements, when conducting customer order execution quality reviews.²⁶ Simply put, FINRA Rule 5310 requires member firms to assure that they direct customer orders to markets that provide the most beneficial terms for such orders.²⁷ To support this overarching objective, the Rule requires member firms to compare any material differences in execution quality their customers will receive at competing markets – including markets they may have existing routing arrangements with, as well as those they do not.²⁸ And the Rule states that firms should consider how existing routing arrangements that involve internalization or payment for order flow factor into their routing decisions.²⁹ Where firms have not sufficiently considered whether their customers may receive better execution quality at competing markets that the firms do

²⁵ FINRA’s targeted examination letters on zero commissions are posted publicly on FINRA’s website and available at <https://www.finra.org/rules-guidance/guidance/targeted-examination-letters>. In addition to the targeted review currently underway on the impact of zero commissions, FINRA previously conducted targeted examinations of order routing and execution quality, beginning in 2014, and order routing conflicts, beginning in 2017. These best execution examinations of numerous firms focused on equities and, in some cases, options. They included a review of the impact of the receipt of order routing inducements, such as payment for order flow and liquidity rebates, on a firm’s order routing practices and decisions. These examinations also included a review of the firms’ procedures related to the requirement that they regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security.

²⁶ See, e.g., *Regulatory Notice* 15-46 (November 2015) (discussing payment for order flow and the execution quality review requirements in FINRA Rule 5310.09).

²⁷ See FINRA Rule 5310.09(b).

²⁸ See *id.*

²⁹ See FINRA Rule 5310.09(b)(8).

not have relationships with, FINRA has charged them with violations of the best execution rule.³⁰

In addition to reviewing firms' best execution practices, FINRA also examines firms for compliance with the SEC's new Rule 606 disclosure requirements referred to above. FINRA is also considering whether it can take further steps – including focused economic analysis, investor education, and tools to facilitate investor access to Rule 606 disclosures – to support the effectiveness of the new requirements and thereby complement the Commission's efforts. FINRA stands ready to engage with the SEC and Congress on any other steps that may be appropriate to address routing conflicts and reinforce the duty of best execution.

Question 5: Dispute Resolution and Arbitration

As you note, broker-dealers and investment advisers often require customers to enter into agreements to arbitrate disputes arising from the services provided to such customers. With respect to FINRA's member firms, FINRA rules do not require such agreements, nor do they preclude customers from pursuing relief in state or federal courts.³¹

It is important to note that the Supreme Court has held that predispute arbitration agreements are enforceable as to claims brought under the Exchange Act.³² Subsequently, in Dodd-Frank, Congress provided the SEC (not FINRA) with explicit

³⁰ See, e.g., Robinhood Financial, LLC, Letter of Acceptance, Waiver and Consent (FINRA Case No. 2017056224001), *supra* note 8 (describing violations of FINRA's best execution rule because the firm routed its customers' order to four broker-dealers that all paid for the order flow, and "did not exercise reasonable diligence to ascertain whether these four broker-dealers provided the best market for the subject securities to ensure its customers received the best execution quality from these as compared to other execution venues"); E*Trade Securities LLC, Letter of Acceptance, Waiver and Consent (FINRA Case No. 20130368815-01) (describing violations of FINRA's best execution rule because the firm lacked sufficient information to reasonably assess the execution quality it provided to its customers because, among other things, the firm "did not take into account the internalization model employed by the firm" and "was overly reliant on comparisons of the firm's overall execution quality with industry and custom averages, rather than focusing on comparisons to the actual execution quality provided by the market centers to which the firm routed orders").

³¹ See FINRA Rule 12200.

³² Until the Supreme Court's decision in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), the courts would not enforce predispute arbitration agreements relating to federal securities law claims. In addition, until its rescission in 1987, SEC Rule 15c2-2(a) provided that: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer." As a result of *McMahon* and the rescission of Exchange Act Rule 15c2-2(a), firms can compel arbitration of customer claims through inclusion of predispute arbitration provisions in their customer agreements.

authority to prohibit or place limitations on the use of such agreements.³³ The SEC has not exercised that authority.

Where member firms do use mandatory arbitration clauses, FINRA rules establish minimum disclosure requirements regarding the use of such agreements, and impose certain other conditions and limitations.³⁴ For example, FINRA rules protect a customer's right to pursue class actions in court notwithstanding any predispute arbitration agreement.³⁵ Member firms with provisions in predispute arbitration agreements or any other customer agreements that do not comply with FINRA rules may be subject to disciplinary action.³⁶

FINRA's primary role in the arbitration process is to administer cases brought to the forum in a neutral, efficient and fair manner. In its capacity as a neutral administrator of the forum, FINRA does not have any input into the outcome of arbitrations.³⁷ Investors have the option to have their case decided exclusively by public arbitrators, who have no ties to the securities industry. To provide transparency about awards rendered in the forum, FINRA makes all awards publicly available and publishes detailed arbitration statistics on its website, including the number of cases filed and their respective outcomes.³⁸

FINRA recognizes the importance of providing a diverse pool of arbitrators from which parties can choose. FINRA has embarked on an aggressive campaign to recruit new arbitrators with a particular focus on adding arbitrators from diverse backgrounds,

³³ Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), authorizes the SEC to limit or prohibit the use of customer agreements to arbitrate future disputes if it finds that such limitation or prohibition is in the public interest and for the protection of investors.

³⁴ See FINRA Rule 2268.

³⁵ See FINRA Rules 2268 and 12204.

³⁶ For example, in 2014, FINRA's Board of Governors issued a decision finding that a firm violated FINRA rules when it inserted provisions in predispute arbitration agreements that prevented customers from bringing or participating in judicial class actions and prevented FINRA arbitrators from consolidating more than one party's claims. See *Dep't of Enforcement v. Charles Schwab & Co.*, No. 2011029760201, 2014 FINRA Discip. LEXIS 5 (FINRA Bd. of Governors Apr. 24, 2014).

³⁷ The arbitration forum administered by FINRA is intended to provide impartial dispute resolution that is less costly and faster than traditional litigation. The forum charges low arbitration fees, uses a customer friendly discovery guide, strictly limits dispositive motions made prior to the party resting its case, and provides sanctions for frivolous motions and abusive motion practices. See, e.g., FINRA Rules 12212, 12504, 12506 and 12511. In addition, member firms pay for most costs, and FINRA waives fees for customers experiencing financial hardship. Information regarding FINRA's arbitration program is available at <http://www.finra.org/arbitration-and-mediation>.

³⁸ See <http://www.finra.org/arbitration-and-mediation/arbitration-awards> and <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>.

professions and geographical locations, and we publish on our website information regarding the results of an anonymous and voluntary demographic survey sent to FINRA arbitrators.³⁹

Your letter also asks about FINRA's requirements for payment of arbitration awards. FINRA rules require prompt payment of such awards.⁴⁰ FINRA suspends from membership (or association with a member) any member firm or associated person who fails to pay an arbitration award.⁴¹ FINRA also publishes a list of firms and associated persons responsible for unpaid awards,⁴² and makes this information available to investors through the firm's or individual's BrokerCheck® record. However, FINRA's suspension for nonpayment of awards applies only to the activities under FINRA's jurisdiction and cannot prevent the person from continuing to work with retail investors in *other* parts of the financial services industry, such as by acting as an investment adviser.⁴³

³⁹ As of February 17, 2021, FINRA's arbitrator roster is composed of 4,327 non-public arbitrators and 3,873 public arbitrators, totaling 8,200 arbitrators. Based on the above-referenced survey, of the arbitrators who joined the roster in 2020, 40 percent were female, 14 percent were African American or Black, 3 percent were Hispanic or Latino, and 4 percent were Asian. In 2019, 39 percent were female, 19 percent were African American or Black, 6 percent were Hispanic or Latino, and 3 percent were Asian. In addition to greater diversity among newer arbitrators, the demographics of the established roster are beginning to shift. Notably, the percentage of women on the established roster has increased from 24 percent in 2016 to 30 percent in 2020 and the percentage of African American or Black arbitrators has increased from 5 percent in 2016 to 9 percent in 2020. See <https://www.finra.org/arbitration-mediation/our-commitment-achieving-arbitrator-and-mediator-diversity-finra>.

⁴⁰ See FINRA Rule 12904(j). Customers who obtain a monetary award in arbitration can have the award confirmed in court, putting them in the same position – in terms of their ability to collect on that award – as if they had initially obtained the award through court proceedings. Thus, a customer's recovery depends on factors such as the ability of the respondent to pay, not on whether the customer obtained the award in arbitration or in court.

⁴¹ See FINRA Rule 9554(a). An associated person or firm has four available defenses to FINRA disciplinary measures for nonpayment in customer cases. See *Notice to Members 00-55* (August 2000).

⁴² See <https://www.finra.org/arbitration-mediation/member-firms-and-associated-persons-unpaid-customer-arbitration-awards>. The list also includes those firms and individuals with unpaid customer arbitration awards, but where bankruptcy is a defense to the non-payment. These firms or individuals may be active in the brokerage industry notwithstanding any unpaid award due to the bankruptcy defense to non-payment.

⁴³ See FINRA Rule 9554(a). In addition, firms with unpaid awards cannot re-register with FINRA, and individuals cannot register as representatives of any member firm, without paying or discharging the outstanding award. With respect to new member firms, in accordance with the standards for admission under the rules governing FINRA's Membership Application Program, FINRA can presumptively deny a new membership

FINRA has been focused on other ways to strengthen its rules to reinforce payment of awards.⁴⁴ For example, FINRA recently amended its Membership Application Program rules to create further incentives for the timely payment of awards.⁴⁵ In addition, FINRA continues to focus on addressing member firms and brokers with a significant history of misconduct, and has recently taken significant steps in this area, which may have important ancillary benefits for the payment of awards.⁴⁶ As our new rule changes go into effect, we will continue to review our practices in this area.

Regarding reporting of settlements of arbitration claims, while we are not in a position to address any specific investigative or supervisory matter, member firms are required to report to FINRA if the member firm or an associated person is a defendant or respondent in a securities- or commodities-related civil litigation or arbitration, or is the subject of any

application if the applicant or its associated persons have a pending arbitration claim or are subject to an unpaid arbitration award. See FINRA Rule 1014(a).

⁴⁴ FINRA issued a Discussion Paper – entitled [FINRA Perspectives on Customer Recovery](#) – to encourage a continued dialogue about addressing the challenges of customer recovery across the financial services industry, including recovery in FINRA's forum. In addition, to better inform discussions regarding customer recovery, FINRA also makes available on its website data on unpaid arbitration awards arising in the FINRA forum for the past five years. See <https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration>.

⁴⁵ The amendments prevent a member firm with substantial arbitration claims from avoiding payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers or owners, to another firm and closing down. The amendments also address situations in which member firms are considering hiring individuals with pending arbitration claims. See Securities Exchange Act Release No. 88482 (March 26, 2020), 85 FR 18299 (April 1, 2020) (Order Approving File No. SR-FINRA-2019-030).

In addition, FINRA has amended its rules to expand a customer's options to withdraw an arbitration claim (or take certain other steps) if a member firm or associated person becomes inactive before a claim is filed or during a pending arbitration. See Securities Exchange Act Release No. 88254 (February 20, 2020), 85 FR 11157 (February 26, 2020) (Order Approving File No. SR-FINRA-2019-027).

⁴⁶ For example, FINRA recently filed with the SEC a proposed rule change to adopt Rule 4111 (Restricted Firm Obligations) to allow FINRA to impose obligations on FINRA member firms that have significantly higher levels of risk-related disclosures than similarly sized peers. The proposal is designed to address a broad range of investor protection concerns and may deter behavior that could otherwise result in unpaid arbitration awards, incentivize firms to obtain insurance coverage for potential awards, and incentivize the payment of unpaid awards through presumptions that would apply to requests for withdrawals from restricted deposits. See Securities Exchange Act Release No. 90527 (November 27, 2020), 85 FR 78540 (December 4, 2020) (Notice of Filing of No. SR-FINRA-2020-041).

In addition, FINRA recently amended its rules to address brokers with a significant history of misconduct. See Securities Exchange Act Release No. 90635 (December 10, 2020), 85 FR 81540 (December 16, 2020) (Order Approving File No. SR-FINRA-2020-011).

claim for damages by a customer that relates to the provision of financial services or relates to a financial transaction, and such civil litigation, arbitration or claim for damages has been disposed of by judgment, award or settlement exceeding certain dollar thresholds.⁴⁷ FINRA staff review arbitration claims and disclosures reporting arbitration awards or settlements to determine whether the issues raised in the arbitration or settlement require a further regulatory review or response.

Question 6: Financial Responsibility and Market Volatility

We are not in a position to discuss any FINRA investigative or supervisory matter involving a particular firm. Generally, however, a broker-dealer's financial responsibility is subject to extensive regulation by the SEC, primarily through the SEC's Net Capital Rule⁴⁸ and Customer Protection Rule.⁴⁹

The SEC's Net Capital Rule is designed to assure that a broker-dealer always has sufficient liquid assets to promptly satisfy the claims of customers and creditors if the broker-dealer goes out of business.⁵⁰ In addition to the maintenance of liquid assets sufficient to satisfy customer and creditor claims required by the Net Capital Rule, the SEC and FINRA have emphasized the importance of broker-dealers developing and maintaining funding and liquidity risk management practices to prepare for adverse circumstances.⁵¹ Moreover, the SEC's Customer Protection Rule protects customer

⁴⁷ See FINRA Rule 4530(a)(1)(G). In addition, member firms are generally required to file with FINRA copies of any customer-initiated securities- or commodities-related civil litigation or arbitration in which the member or an associated person is named as a defendant or respondent as well as to report to FINRA summary information regarding any written customer complaints, which may include a customer claim for damages. See FINRA Rules 4530(d) and (f). Member firms must comply with these initial filing and reporting obligations irrespective of the eventual disposition of the matter.

⁴⁸ See Exchange Act Rule 15c3-1.

⁴⁹ See Exchange Act Rule 15c3-3.

⁵⁰ More specifically, the SEC's Net Capital Rule requires a broker to compute its "net capital" by beginning with its GAAP equity (*i.e.*, the amount by which the value of its assets exceeds the amount of its liabilities under Generally Accepted Accounting Principles) and qualifying subordinated debt, and then subtracting the value of any illiquid assets (*e.g.*, non-marketable securities, fixed assets and any other assets that cannot be readily converted to cash) and also subtracting specified percentages of the values of its securities positions ("haircuts") that are intended to provide a cushion for market fluctuations and to allow for the costs of their liquidation. A broker that carries customer accounts must maintain minimum net capital that is generally equal to two percent of its aggregate reserve formula debits. See Exchange Act Rule 15c3-1(a)(1)(ii). Subject to a number of procedural and other requirements, FINRA Rule 4110 provides a special process for FINRA to supplement the SEC's Net Capital Rule by prescribing greater net capital requirements for its carrying or clearing member firms when necessary for the protection of investors or in the public interest.

⁵¹ See, *e.g.*, Exchange Act Rule 17a-3(a)(23) (requiring larger broker-dealers to "document the credit, market, and liquidity risk management controls established and maintained by the broker or dealer to assist it in analyzing and managing the risks associated with its business activities"); SEC Office of Compliance Inspections and Examinations (OCIE)

funds and securities held by a broker-dealer by generally prohibiting the broker-dealer from using those funds and securities to support its proprietary trading activities.⁵²

The Federal Reserve sets initial margin requirements for broker-dealers,⁵³ and FINRA sets maintenance margin requirements.⁵⁴ In addition, a member firm is expected to have procedures to evaluate and if necessary adjust its own higher “house margin” requirements in response to volatile trading conditions.⁵⁵ Margin helps protect the member firm from credit risk from the customer and is a key part of the financial responsibility requirements for broker-dealers. In particular, FINRA’s maintenance margin requirements are designed to require member firms to protect themselves by obtaining margin that is generally sufficient to satisfy their customers’ obligations to them in the event a liquidation is necessary.

Increases in a broker-dealer’s deposit requirements at clearing organizations (resulting, for example, from an increased level of customer or proprietary trading activity or increased volatility)⁵⁶ may have a significant impact on a broker-dealer’s cash flow needs

Examination Priorities 2016 (including evaluation of broker-dealers’ liquidity risk management practices as an examination focus); FINRA *Regulatory Notice* 15-33, Liquidity Risk (providing additional guidance on effective liquidity risk management practices that firms should consider and implement, including descriptions of specific stress criteria that FINRA has used in reviews of liquidity risk at its member firms and descriptions of effective and ineffective practices observed in the course of those reviews); FINRA *Regulatory Notice* 10-57, Funding and Liquidity Risk Management Practices (announcing FINRA’s expectation that broker-dealers regularly assess their funding and liquidity risk management practices to maximize the likelihood that they can continue to operate under adverse circumstances and describing elements of sound practices for funding and liquidity risk management); Joint Statement: Broker-Dealer Risk Management Practices, OCIE, NYSE & NASD (July 29, 1999), available at <https://www.sec.gov/news/studies/bdriskp.htm>.

⁵² More specifically, the SEC’s Customer Protection Rule requires broker-dealers to have possession or control of all fully paid and excess margin securities held for the account of customers. It also requires brokers to make periodic computations using a specified “reserve formula” to determine the amount (if any) by which the aggregate amount of money it has received from customers or obtained from the use of customer securities (“credits” in the reserve formula) exceeds the amount owed to it by customers or in respect of customer transactions (“debits” in the reserve formula), and to deposit such excess in a special reserve bank account for the exclusive benefit of customers.

⁵³ Regulation T, 12 C.F.R. part 220.

⁵⁴ FINRA Rule 4210(c)-(g).

⁵⁵ FINRA Rule 4210(d), (f)(1) and Interpretation /01 to Rule 4210(f)(1). FINRA also periodically reminds member firms of these obligations. See, e.g., FINRA *Regulatory Notices* 11-15 and 09-53, and NASD *Notice to Members* 99-33.

⁵⁶ Clearing organization deposit requirements do not impact a broker-dealer’s net capital for purposes of the SEC’s Net Capital Rule, because that rule specifically provides that such clearing deposits do not need to be deducted in the computation of a broker-dealer’s net capital. See Exchange Act Rule 15c3-3(c)(2)(iv)(E)(3).

and operating liquidity, depending on the relative size of the increase and the broker-dealer's liquidity. Increased clearing deposit requirements generally must be satisfied by depositing proprietary liquid assets (cash or liquid securities) in accordance with the rules of the relevant clearing organization.

FINRA's risk monitoring program includes the regular review and assessment of a member firm's financial filings (in addition to a wide range of other information, such as arbitration filings, customer complaints, tips, actions by other regulators and externally sourced information). FINRA staff involved in this risk monitoring program communicate with member firm staff concerning activities that may create financial pressures on the firm's capital and liquidity, including deposits required by clearing organizations. The frequency and nature of those communications, which can be initiated by a firm or FINRA staff, depend on our assessment of a firm's risks and its systemic impact. In times of significant market volatility, communications between impacted firms and their assigned risk monitoring staff typically increase and focus closely on operational issues (e.g., system outages), net capital status, liquidity pressures, credit and market risk concerns and sales practice issues. In connection with these communications, we may request additional reporting by the firm to facilitate enhanced monitoring. In addition, FINRA staff actively coordinate and share this type of information with the SEC in times of market volatility or other market- or firm-specific stress events. During the market volatility events of late January, FINRA maintained communications with a number of firms and with the SEC consistent with this approach.

Question 7: Existing Regulations and Resources

As noted above, we are reviewing recent market events to determine whether any existing rules or regulations were violated. In addition, we look forward to supporting the SEC, as appropriate, in conducting its review of these events. We expect to align our regulatory responses with the findings and recommendations resulting from that review and to coordinate those responses with the SEC, particularly since as discussed above many of the relevant issues being considered are primarily governed by SEC rules and policy. As always, we will share insights from our regulatory operations with the SEC to help inform its response to recent events.

In the interim, we are also considering whether additional guidance or rulemaking by FINRA would be appropriate in a variety of areas highlighted by recent market events. This evaluation will consider, for example, FINRA rules and guidance concerning firms' operations and engagement with customers during volatile market conditions. We are also considering whether there are ways to apply current SEC rules and policies more effectively.

FINRA draws on personnel from various departments across the organization, including its Enforcement, Member Supervision and Market Regulation functions, among others, to respond to major market events such as this. We will continue to assess the adequacy of our personnel and other resources to support our extensive efforts to protect investors and preserve market integrity and will add resources if needed.

Conclusion

FINRA is committed to its mission of protecting investors and promoting market integrity, and to adapting its regulatory programs to new broker-dealer business models and technologies, as well as the evolving ways in which investors access the capital markets. The recent market events involving trading in GameStop and similarly volatile stocks have raised important questions regarding the rules governing broker-dealer activity, many of which involve areas of market oversight and policymaking traditionally conducted primarily by the SEC. Accordingly, FINRA supports the SEC's announced review of these matters and will coordinate its potential regulatory responses with the SEC and other regulatory authorities based on the results of that review. FINRA also will continue to investigate specific matters involving its broker-dealer members related to these market events and take appropriate action, including potential disciplinary action, if the facts warrant. In addition, FINRA will consider whether additional rulemaking or guidance may be appropriate.

We share your interest in protecting investors and look forward to working with the SEC and Congress on these issues. If you have any questions, please do not hesitate to contact me at (202) 728-8425, or your staff may contact Greg Dean, Senior Vice President, Office of Government Affairs at (202) 728-8217. In addition, we would be happy to meet with you or your staff to discuss this matter further.

Sincerely,

A handwritten signature in black ink that reads "Robert W. Cook". The signature is written in a cursive style with a large, stylized initial 'R'.

Robert W. Cook
President and Chief Executive Officer