Public Statement

Statement of Dissent from the Commission's Order Approving the Financial Industry Regulatory Authority's Proposed Rule Change, as Modified by Amendment No. 1, to Address Brokers with a Significant History of Misconduct

Commissioner Hester M. Peirce

Dec. 14, 2020

Last week, the Commission approved a Financial Industry Regulatory Authority (FINRA) rule filing that is designed to address risks to investors presented by member firms and brokers that have a history of misconduct. FINRA notes research suggesting that some firms have a practice of hiring brokers who have a history of misconduct and that these brokers show a tendency to engage in higher levels of misconduct.[1] FINRA also cites studies that suggest that a history of misconduct or other regulatory events may predict that a firm or broker is likely to engage in similar conduct in the future.[2] The rule filing that the Commission approved contains several provisions that will provide FINRA with additional tools to mitigate these risks.

FINRA's concerns are justified, and I support the goals that FINRA seeks to achieve with this rule filing. Protecting investors from bad actors is a key part of both the Commission's and FINRA's missions. Our enforcement programs should focus particular energy on ensuring that firms and brokers that repeatedly engage in activity that harms investors are not permitted to continue doing business in our markets. At the same time, we also need to ensure that we pursue these goals in a manner that is consistent with other key values such as due process and the right to earn a livelihood. Because I am not convinced that this rule filing gives appropriate weight to these values, I cannot support the Commission's decision to approve it.

Due Process and Investor Protection

In the context of administrative proceedings, due process is "equal, even-handed, impartial justice under law," administered by officials whose discretion is cabined by standards that protect the public from "unfairness, arbitrariness, favoritism, and discriminatory enforcement."[3] To be an effective financial market regulator, we need to develop the technical expertise to address the types of problems that can affect a system as complex as our financial markets. As I have noted elsewhere, we also have broader responsibilities that must inform our exercise

of our technical expertise.[4] We may be tempted to think that anything that gets in the way of achieving a laudable regulatory goal, including protecting investors, is a distraction from our real job, something best left to other institutions, such as the courts. We can too easily forget that our pursuit of bad actors can injure or destroy the livelihoods of those who have done no wrong (or whose wrongdoing does not warrant such punishment).

FINRA's rule filing, even with its focus on investor protection, demonstrates a laudable sensitivity to concerns about due process. One key component of the filing is a new rule that would permit a hearing officer, on motion from FINRA's Department of Enforcement, to impose restrictions or conditions on a member firm's business during the pendency of the firm's appeal of the initial decision by the hearing officer or the hearing panel.[5] The rule is designed in part to address the risk posed by possible ongoing misconduct by the firm pending resolution of any appeal of the initial finding of wrongdoing, as the appeals process can take many months. The rule permits the respondent firm to oppose the motion and to appeal any decision to impose such restriction or condition to the Review Subcommittee of the National Adjudicatory Council, and the restriction or condition would be stayed pending that appeal.[6] These are prudent safeguards that should help mitigate the risk of egregiously unfair treatment.

I am not convinced, however, that these protections are adequate given the potentially high stakes of any conditions or restrictions for the viability of a respondent firm and the livelihoods of individual brokers. The new rule allows a hearing officer "to impose any conditions or restrictions that the Hearing Officer considers *reasonably necessary for the purpose of preventing customer harm*."[7] FINRA explains that any such conditions or restrictions "should target the misconduct demonstrated in the disciplinary proceeding and be tailored to the specific risks posed by the member firm or broker"[8] and suggests that these should be less burdensome than the sanction issued by the hearing officer or hearing panel against the firm.[9]

Although FINRA views this standard as "a limiting principle,"[10] I am not convinced that it will do much to limit the hearing officer's exercise of discretion in practice. The phrase "reasonably necessary" suggests that the hearing officer should weigh the need for interim customer protection measures against some measure of reasonableness or proportionality, but it is unclear what this measure should be. One view might be that in this context a condition or restriction is "*reasonably* necessary" if it bears some relationship to the findings in the underlying proceeding. FINRA, however, expressly rejects one commenter's suggestion that the hearing officer's authority be limited to imposing conditions or restrictions that are designed to prevent violations of the rules that the respondent firm has been found to have violated.[11] Does this mean that FINRA's Department of Enforcement is free to assert—and the hearing officer is free to accept—claims of potential investor harm arising out of any area of a respondent firm's business, notwithstanding any absence of relevant findings in the underlying proceeding? As already noted, FINRA also states that the conditions or restrictions should "target the misconduct demonstrated in the disciplinary proceeding,"[12] but nothing in the rule requires that the hearing officer do so.

Another view might be that an interim condition or restriction is "*reasonably* necessary" to the extent that it does not impose disproportionate burdens on the member firm or its customers, does not effectively deprive a respondent of its right of appeal, and does not impose de facto consequences that exceed those imposed for the underlying violation. But again, FINRA expressly rejects these factors as irrelevant to the determination of whether a condition or restriction is "reasonably necessary"[13] and asserts that "for investor protection purposes, the primary driver of the conditions or restrictions should be what is reasonably necessary to prevent customer harm, not the size of the respondent's employing firm or its claims about its resources."[14]

Rather than functioning as a limiting principle, as intended, FINRA's "reasonably necessary" standard could maximize the discretion available to the hearing officer considering these interim measures. Given that the phrase does not imply an obligation to tailor the conditions and restrictions, it seems likely to be interpreted as lowering the bar for imposing these measures: The hearing officer need not establish that such measures are necessary; she need only show that one might *reasonably* conclude that they are necessary.

This standard is inappropriate when, as here, an individual's profession or livelihood—or a firm's viability—is at stake.[15] For example, FINRA's examples of the types of conditions or restrictions that could be imposed by a hearing office include prohibitions on an entire line of business.[16] Larger member firms may be able to continue

operating for the pendency of an appeal under such restrictions, but, for a smaller firm engaged in one or two lines of business, a prohibition lasting for eighteen months could very well be fatal. Conduct that does not warrant an expulsion or a bar from the industry could nevertheless give rise to interim measures that effectively deprive the firm of the opportunity to carry on its business, a fate very similar to an expulsion or bar. That result would not, in my view, be reasonable.

Moreover, over time, FINRA's Department of Enforcement might seek such interim measures as a matter of course. Under the generous standard established by the new rule, hearing officers might grant such requests routinely and, governed by the same generous standard, those grants might be upheld routinely on appeal.[17] Such a development would raise the costs—in many cases, significantly—of seeking a review of a hearing officer or hearing panel decision. Despite its investor protection benefits, the rule's due process cost is too high.

Criminal Convictions and the Right to Pursue One's Livelihood

Another provision in FINRA's rule filing will impose additional costs on a firm when a person who seeks to become an owner, control person, principal, or registered person of the firm has, among other things, been convicted of, or pled guilty or no contest to, any felony or certain misdemeanors in the previous five years.[18] Specifically, these firms would have to seek a materiality consultation with FINRA. FINRA's Department of Membership Regulation then would conduct a wide-ranging assessment of the nature of the underlying offense, the disciplinary and employment history of the person's proposed supervisor, the firm's disciplinary history, and whether the firm "employs or intends to employ in any capacity multiple persons with one or more 'final criminal matters' or two or more 'specified risk events' in the prior five years."[19] If the Department determines that firm's association with this person is a material change for the firm, the firm would then have to submit a continuing membership application. The continuing membership application process entails further review by FINRA followed by denial, approval, or application of restrictions to the firm.[20]

The Commission concludes that this new requirement would enhance investor protection because it would allow FINRA to determine whether the member firm could continue to satisfy FINRA's membership standards if it proceeds to associate with the individual triggering the requirement and, when it determines that the member firm could not do so, to prohibit the association.[21] In the Commission's view, the additional scrutiny of firms seeking to associate with such individuals should "disincentiviz[e] broker-dealers from engaging in higher-risk activity that could lead to additional regulatory restrictions" and "incentivize broker-dealers to reexamine their hiring practices."[22]

Again, I support the stated objectives of this rule change. Subjecting broker-dealers that associate with individuals who have a disciplinary or criminal history involving, for example, the misuse of customer funds to additional regulatory oversight makes sense. The covered misdemeanors are limited to ones that might give rise to concern in light of the nature of an associated person's work, but all felonies are covered.[23] I could support a well-tailored rule designed to identify for additional scrutiny firms associating with individuals whose backgrounds raised concerns relevant to customer protection and market integrity.

The rule that the Commission has approved, however, is overly broad. Rather than focusing on a firm's association with individuals who have a final criminal matter that is relevant to whether the firm or the individual is capable of observing high standards of commercial honor and just and equitable principles of trade, the new rule will trigger a burdensome, invasive consultation process (that may trigger yet additional procedural and regulatory requirements) for any firm seeking to associate even with a single individual who, in the past five years, has been convicted of, or pled guilty or no contest to, any felony.[24]

At first glance, requiring additional scrutiny of broker-dealers seeking to hire individuals with felony convictions may appear reasonable. After all, most of us associate the term "felony" with more serious crimes, often involving violence or fraud,[25] and one might think it reasonable to conclude that any recent felony conviction makes a person unfit for a position of trust. Under contemporary American jurisprudence, however, reaching this conclusion would be unreasonable.

Committing a felony in early 21st-century American is a remarkably easy thing. The growing population of adults with felony convictions has drawn widespread attention.[26] And perhaps most of us who have not been convicted of a felony could have been if a prosecutor had looked hard enough. As noted civil libertarian Harvey Silverglate has explained,

> it is only a slight exaggeration to say that the average busy professional in this country wakes up in the morning, goes to work, comes home, takes care of personal and family obligations, and then goes to sleep, unaware that he or she likely committed several federal crimes that day.[27]

Knowing someone is a felon tells us little about who she is as a person. In some cases, prosecutors need not establish that the defendant acted with *mens rea* as an element of the offense.[28] Many such offenses are regulatory or public welfare offenses that involve unknowing violations of extremely technical regulations. Many other offenses are not associated with harm to others. We are a long way from the world in which one could assume that a felony conviction alone tells us anything about a person's moral character.[29]

Yet the collateral consequences of a felony conviction can be devastating, even if the underlying offense involved no wrongful intent. Persons convicted of, or pleading guilty to, a felony offense, in addition to having their civil rights restricted, can lose their housing, their jobs, and even their right to practice their profession.[30] Among the most devastating of these consequences is the loss of one's livelihood. The proliferation of licensing requirements for many jobs only exacerbates these consequences, as these requirements—many of which include not having been criminally convicted—encompass an ever-increasing number of fields.[31]

In some cases, restrictions on licensing or employment are appropriate. For example, it is appropriate to bar a person convicted of misappropriating client assets from certain positions of trust. In too many cases, however, the collateral consequences bear no relationship to the underlying offense.[32] The loss of employment opportunities may be a harsher punishment than the criminal sanction. The burden of these collateral effects—whether imposed by the criminal law, by licensing requirements, or by individual employers—is not evenly dispersed across society.[33]

The Commission reassures the public that the new rule "would not prevent a firm from hiring an associated person with a history of 'final criminal matters,'" and it is important to underscore that FINRA has not in this rule imposed a blanket ban on employment of individuals with a felony conviction, unlike the licensing requirements for many professions in many states. In many cases, in fact, the statutory disqualification provisions, which are administered by the Commission, likely would be the primary reason a firm would not be able to hire an individual with a felony conviction.[34] FINRA acknowledges, however, that the "anticipated costs [of the rule] may deter some broker-dealers from hiring individuals meeting the proposed criteria, who as a result may find it difficult to remain in the industry."[35] Given the extra administrative hassle, cost, and scrutiny from FINRA that hiring an individual with a felony conviction will attract under this new rule, I suspect that many firms will take a hard pass on such candidates, even if their felony conviction bears no relationship to their integrity and abilities.

I recognize that, given the many thousands of restrictions on employment opportunities for those convicted of felonies and other offenses, this rule change is a rather small thing. Indeed, this issue is one that deserves more attention across all of the securities laws.[36] I also acknowledge that FINRA's intentions—to enhance investor protection—are worthy. Yet it is also likely true that nearly every one of the thousands of restrictions on the rights of Americans with criminal histories to earn a living has been implemented with similarly praiseworthy intentions. Regardless of the good intentions underlying them, the aggregate effect of these restrictions threatens to consign anybody with a felony record to the margins of society and thus to deprive both those individuals and society as a whole of the full value of their talents and their labor.

I could have supported a narrowly tailored rule that imposed heightened scrutiny only on firms hiring individuals with criminal histories that clearly cast doubt on the person's ability to protect investors and safeguard market integrity. I cannot, however, support a rule that will add, even incrementally, to the obstacles that face an individual with a felony record by discouraging firms from looking behind the felony conviction to determine whether it says anything about the individual's character.

[1] *See* Exchange Act Release No. 34-88600 (Apr. 8, 2020), available at https://www.sec.gov/rules/sro/finra/2020/34-90635.pdf ("Final Order"), 85 FR 20745, at 20745-6 (Apr. 14, 2020) (File No. SR-FINRA-2020-011) ("Notice").

[2] *Id*.

[3] O. John Rogge, "An Overview of Administrative Due Process," 19 Villanova L. Rev. 1, 2 (1973).

[4] *See* Commissioner Hester M. Peirce, "Statement of Hester M. Peirce in Response to Release No. 34-88890; File No. S7-13-19" (May 15, 2020) (noting that "it is tempting [as a regulator] to think that First Amendment and other concerns about individual liberty are outside our job description; however, our responsibilities include defending the Constitution, and our rules are part of the legal framework that determines how freely Americans can exercise their constitutional rights"), available at https://www.sec.gov/news/public-statement/peirce-statement-response-release-34-88890-051520.

[5] FINRA modified its proposed rule to enhance procedural protections in part in response to due process concerns raised by commenters. *See* Notice at 20747.

[6] *Id*.

[7] *Id.* (emphasis added).

[8] *Id*.

[9] Notice at 20756.

[10] Notice at 20747.

[11] Notice at 20763.

[12] *Id*.

[13] *Id*.

[14] *Id*.

[15] *See* Rogge, *supra* note 3 at 3 (noting that heightened due process protections are necessary when "an individual's profession, livelihood, or liberty is at stake").

[16] Notice at 20747-8 (providing as examples of conditions or restrictions prohibitions "from offering private placements in cases of misrepresentations and omissions made to customers, or [from] penny stock liquidations in cases involving violations of the penny stock rules").

[17] The standard of review by the NAC Review Subcommittee would be *de novo*, except as to "a Hearing Officer's credibility determinations, which are entitled to considerable weight and deference, and can be overturned only where the record contains substantial evidence for doing so." Notice at note 13.

[18] *Id.* at 20752-3.

[19] Notice at 20753.

[20] *See* Continuing Membership Application Resources, FINRA, available at https://www.finra.org/registration-exams-ce/broker-dealers/continuing-membership-application-resources.

[21] Final Order at 21.

[22] Final Order at 21-2.

[23] The rule's reference to "final criminal matters" is defined with reference to the Uniform Registration Form. Notice at 20753-5. On Forms U4, covered misdemeanors are misdemeanors "involving: investments or an

investment-related business or any fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses." Form U4, Item 14B(1)(A).

[24] Final Order at 9-10, note 33.

[25] The dictionary definition of "felony" reflects this common understanding. Oxford Languages, which provides definitions for Google's dictionary function, defines the term as meaning "a crime, typically one involving violence, regarded as more serious than a misdemeanor, and usually punishable by imprisonment for more than one year or by death." Google, Definition of Felony, available at https://www.google.com/search?q=define%20felony&cad=h.

[26] *See*, *e.g.*, Christopher Zoukis, "Percentage of Americans with Felony Convictions Increases, Especially for Blacks," Prison Legal News (Jun. 8, 2018) ("A January 2018 report from Pew Charitable Trusts indicated that the number of U.S. residents with a felony record rose sharply in every state between 1980 and 2010. The report analyzed data from a University of Georgia study published in September 2017, which showed that several states have seen a double-digit increase in the percentage of people with a felony record during that 30-year period. As of 2010, around 19 million Americans had been convicted of a felony."), available at https://www.prisonlegalnews.org/news/2018/jun/8/percentage-americans-felony-convictions-increases-especially-blacks/; Tim Henderson, "Felony conviction rates are up nationwide. These states are reconsidering how they classify crimes," PBS (Jan. 2, 2018) ("In recent decades, every state has seen a dramatic increase in the share of its population convicted of a felony, leaving more people facing hurdles in finding a job and a place to live and prompting some states to revisit how they classify crimes."), available at https://www.pbs.org/newshour/nation/felony-conviction-rates-are-up-nationwide-these-states-are-reconsidering-how-they-classify-crimes.

[27] Harvey Silverglate, "Three Felonies a Day: How the Feds Target the Innocent," 498 (Kindle ed. 2009); *see also* Gary Fields and John R. Emshwiller, "Many Failed Efforts to Count Nation's Federal Criminal Laws," Wall Street Journal (July 23, 2011), available at https://www.wsj.com/articles/SB10001424052702304319804576389601079728920 ("'There is no one in the United States over the age of 18 who cannot be indicted for some federal crime,' said John Baker, a retired Louisiana State University law professor who has also tried counting the number of new federal crimes created in recent years. 'That is not an exaggeration.'"). Notwithstanding efforts to catalogue the number of federal crimes since at least the early 1980s, no one has succeeded in doing so. *See* Fields and Emshwiller *supra* note 24 ("For decades, the task of counting the total number of federal criminal laws has bedeviled lawyers, academics and government officials."). An initial estimate by the Department of Justice put the number at 3,000, while an American Bar Association (ABA) project completed in 1998 "concluded the number of crimes was by then likely much higher than 3,000." *Id*. The ABA declined to give an estimate, concluding that the effort was "'likely to prove futile and inaccurate.'" *Id*.

Perusing the Twitter account "A Crime a Day" gives a sense of the scale of the task. See A Crime a Day (@CrimeADay), Twitter, https://twitter.com/CrimeADay, which has been posting federal statutory and regulatory crimes since July 2014. The account has catalogued such gems as the following:

> "21 USC §§331, 333, 348 & 21 CFR §184.1973(d) make it a federal crime to sell hard candy that's more than 0.04% beeswax." @CrimeADay, Twitter (Nov. 17, 2020, 7:33 PM), https://twitter.com/CrimeADay/status/1328858900154683392.
>
> "26 USC §5687 & 27 CFR §31.202(a) make it a federal crime to possess a liquor bottle that has been refilled with liquor since it was originally filled." @CrimeADay, Twitter (Oct. 23, 2020, 9:52 PM), https://twitter.com/CrimeADay/status/1319819138114768896.
>
> "40 USC §6307 & 36 CFR §520.4(i) make it a federal crime to smoke a cigar at the national zoo." @CrimeADay, Twitter (Sept. 19, 2020, 7:45 PM), https://twitter.com/CrimeADay/status/1307465816099749890?s=20.

"7 USC §§8303, 8313 & 9 CFR §93.101(b)(3) make it a federal crime to import a pen-raised ostrich unless it had a microchip implanted in its pipping muscle when it was 1-day old, but not if it's a zoo ostrich or a Canadian ostrich." @CrimeADay, Twitter (Aug. 2, 2020, 8:55 PM), https://twitter.com/CrimeADay/status/1025183433843253249?s=20.

[28] For two examples, see John G. Malcom, "Morally Innocent, Legally Guilty: The Case for Mens Rea Reform," 18 Fed. Soc. Rev. 40, 46 (2017) (describing a felony plea and a felony charge involving the Marine Mammal Protection Act and the Clean Water Act, respectively), available at https://fedsoc-cms-public.s3.amazonaws.com/update/pdf/W7uuzRNNUySO7NSzOM3e19fm1WlH8inQN1KQoB6D.pdf.

[29] *See* Paul Larkin, Jr., Report: "The Mistaken Belief that All Strict Liability Crimes are Morally Objectionable," The Heritage Foundation (Aug. 4, 2016), available at https://www.heritage.org/report/the-mistaken-belief-all-strict-liability-crimes-are-morally-objectionable.

[30] *See* "What are Collateral Consequences of Conviction," National Inventory of Collateral Consequences of Conviction, available at https://niccc.nationalreentryresourcecenter.org/ ("Collateral consequences are legal and regulatory restrictions that limit or prohibit people convicted of crimes from accessing employment, business and occupational licensing, housing, voting, education, and other rights, benefits, and opportunities.").

[31] The National Inventory of Collateral Consequences of Conviction "catalogs over 6,000 mandatory occupational licensing consequences for people with criminal records." Chidi Umez and Rebecca Pirius, Barriers to Work: People with Criminal Records, National Conference of State Legislatures (Jul. 17, 2018). A significant portion of the American population have criminal records and thus may face limitations in their employment opportunities. Deborah L. Rhode, "Virtue and the Law: The Good Moral Character Requirement in Occupational Licensing, Bar Regulation, and Immigration Proceedings," 43 Law & Social Inquiry 1027 (2018) (noting that "[s]eventy million Americans have criminal records, and character-based licensing requirements are a substantial barrier to their economic livelihood and rehabilitation"), available at https://www.cambridge.org/core/journals/law-and-social-inquiry/article/virtue-and-the-law-the-good-moral-character-requirement-in-occupational-licensing-bar-regulation-and-immigration-proceedings/446215F7E021DBD079F4A24BE80F0B2D.

[32] *See* National Inventory of Collateral Consequences of Conviction, *supra* note 30 (noting that "some collateral consequences apply without regard to the relationship between the crime and opportunity being restricted, such as the revocation of a business license after conviction of any felony").

[33] *See* Amanda Agan and Sonja B. Starr, "The Effect of Criminal Records on Access to Employment," 107 Am. Econ. Rev.: Papers & Proc. 560 (2017) ("Because the poor and minorities disproportionately have criminal records, these employment challenges [for individuals with criminal convictions] may exacerbate existing socioeconomic and racial inequalities."), available at https://repository.law.umich.edu/cgi/viewcontent.cgi?article=2892&context=articles; Rhode, *supra* note 31 at 1027 ("Because racial and ethnic minorities are disproportionately likely to have run-ins with the criminal law, they pay a special price for these requirements.").

[34] The Exchange Act subjects individuals to a statutory disqualification from associating with a member of a self-regulatory organization for a variety of reasons, including that the person has been convicted of any felony within the past ten years. *See* Exchange Act Section 3(a)(39)(F), 15 U.S.C. § 78c(a)(39)(F) (defining statutory disqualification); Exchange Act Section 15A(g)(2), 15 U.S.C. § 78o-3(g)(2) (providing that a registered securities association may bar a member firm from associating with any person "who is subject to a statutory disqualification"). The Investment Advisers Act contains a similar provision. *See* Investment Advisers Act Section 203(e)(3), 15 U.S.C. § 80b-3(e)(3).

[35] Final Order at note 65 (citing Notice at 20758).

[36] *See*, *supra* note 25 (noting statutory disqualification provisions in the Exchange Act and the Investment Advisers Act).