

Client Alert

January 9, 2015

Heightened Scrutiny of Brokers – SEC Approves FINRA’s Proposed Background Check Rule

By Daniel Nathan and Thomas Grothe

In recent years, questions have been raised in many quarters about how brokers with questionable backgrounds have been able to move among firms and remain in the industry. FINRA has responded by enhancing a broker-dealer’s obligations for reviewing the backgrounds of its newly hired brokers.

The SEC recently approved proposed FINRA Rule 3110(e), which requires FINRA member firms to verify the information in Form U4 within 30 calendar days of filing. The proposed rule, which will take effect on July 31, 2015, is intended to improve the information that winds up in FINRA’s Central Registration Depository (CRD) and BrokerCheck. FINRA’s 2015 Regulatory and Examinations Priorities Letter (January 6, 2015) discusses its concern with “high-risk and recidivist brokers,” including firms’ due diligence on prospective hires, and highlights the proposed rule with respect to investor protection.

A Form U4, signed by the applicant and her firm, must be filed when an individual registers with a FINRA member, and the person signing on behalf of the firm must certify that she has taken appropriate steps to verify the accuracy and completeness of the information contained in the form. The new proposed rule takes this concept further, requiring firms to institute written procedures that are reasonably designed to verify the information in an applicant’s Form U4 no later than 30 calendar days after its filing with FINRA. FINRA expects firms to verify all information in an initial or transfer (when a previously registered applicant moves between FINRA members) Form U4 (but not an amendment), and to document any items that are not feasible or practical to verify and the reason for such lack of confirmation. At a minimum, firms would be required to conduct a national search of “reasonably available public records.” FINRA indicated that the obligation to search public records will be limited to national records, as the comparability of the laws, rules, and regulations of foreign jurisdictions are often difficult to assess. FINRA also indicated that it will not specifically define the term “reasonably available public records” because the scope thereof may change over time, although FINRA did offer examples of such records, including criminal and bankruptcy records, civil litigations and judgments, liens, and business records (if reasonably available).

FINRA members are already expected to “ascertain by investigation the good character, business repute, qualifications, and experience” of an applicant before certifying such in the individual’s application for registration. The proposed rule refines this pre-filing responsibility and further adds the 30-day obligation. In response to comment letters, FINRA clarified that these obligations are complementary and that it expects that firms will conduct the investigation and verification processes concurrently. The same information about an applicant may inform both obligations. FINRA encourages firms to complete the verification process even before filing the Form U4, but the 30-day window is designed to ease the process and allow firms to hire personnel quickly when needed. In some cases, the FINRA member must also review other forms within 60 days of filing the Form U4

Client Alert

(the most recent Form U5, including any amendments, for applicants that have previously registered with FINRA or another self-regulatory organization and CFTC Form 8-T for applicants who have been recently employed by a Futures Commission Merchant or an Introducing Broker that is notice-registered with the SEC pursuant to Section 15(b)(11) of the Securities Exchange Act of 1934).

The proposed rule also establishes a temporary program to refund Late Disclosure Fees (Supplementary Material .15 to FINRA Rule 3110), intended to encourage firms to voluntarily report certain underreported information. This program is of limited duration, running concurrently with FINRA's one-time search of specific financial public records on all registered persons and set to end on July 31, 2015. This search, which also includes certain criminal public records and will be completed by August of 2015, is intended to identify instances when required information was not reported to the CRD via Form U4. FINRA will contact firms for which it detects missing information and request an explanation and/or an amendment to report the events, which could result in a Disclosure Processing Fee and potentially a Late Disclosure Fee. The temporary refund program seeks to encourage firms to self-report unsatisfied judgments or liens (Form U4 Question 14M) of below \$5,000 and older than five years in certain cases, which is intended to reduce the strain on FINRA's time and resources.

OUR TAKE:

- Broker-dealer firms drafting compliance procedures should emphasize documentation. If information cannot be verified or the verification is delayed outside of the firm's control, plan to record the issue and the reason for it; the rule allows for that possibility. The firm should also complete such verification as soon as practical.
- A firm that already conducts some search of public records for new hires or transfers will want to ensure that its scope satisfies the newly delineated requirements of this proposed rule and that the process is in writing.
- Firms that outsource a function such as searching public records should perform due diligence and risk assessment on the third-party provider; outsourcing operations is another focus in FINRA's 2015 priorities letter.
- An applicant's consent on Form U4 does not necessarily provide consent for the firm to obtain an investigative consumer report (not a necessary part of the public records search, but one way to obtain information). Consent to acquiring such a report depends on the laws, rules, and regulations of the jurisdiction in which the firm and the applicant are operating.
- The 30-day verification window does not provide a safe harbor from Late Disclosure Fees for amending filings with disclosure events that should have been reported on the initial or transfer Form U4; such events should still be detected during the pre-filing investigation phase.

Client Alert

Contact:

Daniel A. Nathan
(202) 887-1687
dnathan@mofo.com

Thomas M. Grothe
(212) 336-4299
tgrothe@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for 11 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.