

KD Alert: SEC Approves Revamped FINRA Background Checks Rule; Broker Recruitment Compensation Rule Expected

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On May 1, 2014, Kaufman Dolowich & Voluck, LLP issued an alert advising that the Financial Industry Regulatory Authority's ("FINRA") Board of Governors had approved amendments to FINRA's supervision rule that would require brokerage firms to conduct background checks on newly licensed registered representatives and on registered representatives who were seeking to transfer their license from another firm (collectively, "registration applicants") in order to verify the accuracy and completeness of the information contained in the applicants' Form U4s. Form U4 is the Uniform Application for Securities Industry Registration or Transfer that is used by FINRA and other regulators to obtain information regarding an applicant, including his or her employment or disciplinary history.

On March 6, 2015, FINRA issued a Regulatory Notice in which it announced the approval of FINRA Rule 3110(e): Responsibility of Member to Investigate Applicants for Registration. FINRA Rule 3110(e) goes into effect on July 1, 2015 and is based on similar provisions in NASD Rule 3010(e) and Incorporated NYSE Rule 345.11; however, it departs from those rules in several respects. First, Rule 3110(e) clarifies that a brokerage firm must review a copy of an applicant's most recent Form U5, which is the Uniform Termination Notice for Securities Industry Registration, within sixty days of the filing date of the applicant's Form U4 if the applicant was previously registered with FINRA or another self-regulatory organization. Second, Rule 3110(e) contains a new requirement that firms adopt written procedures that are reasonably designed to verify the accuracy and completeness of the information contained in an applicant's Form U4. Such verification must take place no later than thirty days after an initial or transfer Form U4 is filed with FINRA. The written procedures must delineate the firm's process for verifying the information contained in an applicant's Form U4. FINRA expects that most firms will verify the information prior to the filing of a Form U4.

A firm's verification process must include a national search, conducted by the brokerage firm or a third party provider, of reasonably available public records in order to confirm the accuracy and completeness of the information contained in an applicant's Form U4. FINRA considers "reasonably available public records" to include criminal records, bankruptcy records, judgments, and liens, at a minimum. FINRA noted that a firm may find it necessary to conduct a more thorough search of public records depending on the applicant's job functions, responsibilities, or position at the firm. In general, the public records search must be conducted no later than thirty days after the initial or transfer Form U4 is filed with FINRA. Where this is not possible, then a firm's procedures must provide that verification is to be completed as soon as is practicable, and the firm must document the reason for the delay.

Firms may comply with the public record search requirement in a number of different ways. A firm could utilize a credit report from a major national credit reporting agency that contains public record information, along with a review of the applicant's fingerprint results. Alternatively, a firm could utilize a national public records database, such as LexisNexis, in conjunction with a review of the applicant's fingerprint results. Finally, a firm could review a consolidated report from a provider such as Business Information Group ("BIG") that includes criminal and financial public records. If an applicant is registered with several affiliated firms, then the firms are permitted to rely on one verification that is conducted by one of the affiliates.

As FINRA announced on April 24, 2014, it is conducting a one-time search of public financial records, which include bankruptcies, judgments, and liens, regarding all registered persons in order to confirm that all material financial information is accurately reported on the CRD system via Form U4 filings. FINRA expects to complete its review on or before August 2015.

On March 17, 2015, at the Securities Industry and Financial Markets Association's ("SIFMA") Compliance & Legal Seminar in Phoenix, AZ, Rick Ketchum, the chairman and CEO of FINRA, advised that FINRA's proposed new rule regarding disclosure of broker recruitment compensation should be issued shortly. On September 19, 2014, FINRA's Board of Governors had authorized FINRA to publish a Regulatory Notice requesting comments on a revised proposal that would require a recruiting brokerage firm to provide a FINRA-created document to retail customers of a transferring registered representative who are considering transferring their assets to the recruiting firm. The communication from FINRA would identify some of the consequences that could result from transferring assets to the new firm and suggest questions that customers may wish to ask in order to make an informed decision regarding whether or not to do so. The

questions relate to the costs that may be incurred as a result of a transfer of assets, whether or not all of the customers' investments are transferable, and the financial incentives that the broker may receive from the new firm that could influence his recommendation to transfer assets to the new firm and to recommend the purchase of new products or services at the new firm. In other words, FINRA appears to be moving away from requiring registered representatives to disclose specific incentives that may have been offered to them to transfer firms and will instead be providing customers with areas of inquiry that they may consider relevant in deciding whether or not to transfer their assets to another firm.

Both FINRA's new background check rule and its anticipated new rule regarding disclosure of broker recruitment compensation evidence FINRA's increasing emphasis on the importance of disclosure of brokers' employment and financial histories, including their compensation arrangements made in connection with the transfer to a new firm.