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March 24, 2015



The New FINRA Broker Background Check Rule

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On December 30, 2014, the SEC approved FINRA Rule 3110(e), which requires FINRA member firms to verify the information provided by or contained in a broker's Form U-4 within 30 days of filing the form with FINRA. The Rule becomes effective on July 31, 2015. The Rule is intended to help verify background information on a broker, including publicly available information through the FINRA Broker-Check system and to prevent high-risk, recidivist brokers from moving from firm to firm and continuing questionable or outright improper conduct.

Background

One of FINRA's 2015 Regulatory and Examination Priorities is addressing concerns about high-risk brokers and improving background checks and due diligence by member firms on prospective hires. The new Rule is part of FINRA's initiative in this regard. FINRA is taking additional steps in this area as well, including a one-time background and financial check of all registered representatives, which checks will be completed by August 2015.

The SEC release discussing and approving the rule sets out the overall direction and policy of FINRA and the SEC in their review of proposed FINRA rules. An understanding of the underlying policies that guide FINRA and the SEC is often helpful to practitioners and the clients they advise, including brokerage firms and issuers. In reviewing and approving the rule, the SEC made a determination that the rule is consistent with Section 15A(b)(6) of the Exchange Act, which requires that FINRA rules "be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest."

A broker's Form U4 is accessible by regulators and member firms through the CRD system and by investors and the general public through FINRA's BrokerCheck system.

The SEC notes in its release that by streamlining and clarifying the FINRA member firms' obligations related to background investigations and public records searches, and by adding a requirement to adopt written procedures to verify the accuracy and completeness of submitted information, Form U4's filed in the CRD system will be complete and accurate. Clearly, true and correct information related to licensed brokers and representatives working in the financial industry is critically important for both regulators and investors. As with any system, the new rule will still undoubtedly result in a margin of error but will nonetheless be a significant improvement over the current rule, which is broad and lacks a basis for consistency and precision.

New FINRA Rule 3110(e)

When a broker joins a brokerage firm, a Form U-4 is completed and signed by the broker and countersigned by the member firm and then submitted to FINRA. Currently, the member firm must attest that it has taken reasonable steps to verify the accuracy and completeness of the information in the Form U-4. The new rule adds to the brokerage firm's requirements and obligates the firm to institute written procedures that are reasonably designed to verify the information in the applicant's Form U4 and to complete such review and verification within 30 days of submitting the Form to FINRA.

Member firms already had some obligations in this respect. Current rules require a firm to "ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to" submitting the certification to FINRA to hire such person. The new rule adds specifics to the existing requirement and adds the 30-day obligation and time limit. Investigations that are fully completed prior to submitting the Form U-4 will not require additional updates to satisfy the new rule and 30-day timing requirement. Rather, the 30-day window is to allow extra time for firms to complete their review when needed.

In particular, the new rule requires a defined investigation followed by a certification and verification submittal confirming the background check and verification process. The member firm must establish and implement written procedures directing the course of that investigation to ensure the verification of the information in the applicant's Form U4.

As explained by FINRA, the member firm has a specific requirement to ascertain the “good character, business reputation, qualifications and experience of an applicant before the member applies to register that application with FINRA and before making a representation to that effect on the application for registration.”

In addition, under the new rule the member firm must complete a specific background check and investigation, including a search of public records, and file a certification and verification confirming the investigation and information in the filed Form U4, no later than 30 calendar days after an initial or transfer form U4 is filed with FINRA and preferably prior to the time of filing the form U4. In some cases an extension may be granted—for example, where a firm has submitted fingerprints to the FBI to verify criminal background information, and such prints are returned as illegible and require a resubmittal, or similar such circumstances that are beyond the control of the member firm despite reasonable diligence. The member firm must complete a written report detailing the steps it has taken to verify information and which information they were not able to verify and the reason for same.

In some cases, the FINRA member must also review other forms within 60 days of filing the Form U4 such as 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 commodities firm or an introducing broker that is notice-registered with the SEC pursuant to Section 15(b)(11) of the Exchange Act.

The firm’s written procedures must specify the process for verifying information and completing due diligence. The new rule sets forth minimum due diligence and examples of a reasonable inquiry. The Rule requires the firm to conduct a national search of reasonably available public records, including but not limited to criminal and bankruptcy records, civil litigations and judgments, liens, and business records. Again, the public records search must be completed no later than 30 calendar days after the initial or transfer Form U4 is filed with FINRA.

The new rule does not amend or change the existing rules which require a member firm to amend a Form U4 within 30 calendar days of learning of facts or circumstances that require the filing of an amended Form U4.

Background and Financial Information Review of all Registered Persons

FINRA is conducting a one-time search of specific financial public records on all registered persons, which is expected to be completed on or before August 2015. This search, which also includes certain criminal public records, 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. Concurrent with FINRA's one-time search, it is offering a refund on Late Disclosure Fees for firms that review and amend a Form U4 related to specified financial information and, in particular, Question 14M on the Form U4. The temporary refund program seeks to encourage firms to self-report unsatisfied judgments or liens 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.

Member firms will receive a refund of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M if the Form U4 amendment is filed between April 24, 2014 and July 31, 2015. Question 14M relates to the reporting of judgments or liens. The refund will be given if the amendment is filed within the specified dates and one of the following conditions is met: (i) the judgment or lien has been satisfied, and at the time it was unsatisfied it was under \$5,000 and was filed with a court on or before August 13, 2012; or (ii) the unsatisfied judgment or lien was satisfied within 30 days of the person learning of such judgment or lien.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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