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KD Alert: FINRA Proposes Rule Amendments to Require Greater Transparency Regarding Registered Representatives' Background and Compensation

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On April 24, 2014, the Financial Industry Regulatory Authority ("FINRA") announced that its Board of Governors had approved amendments to FINRA's supervision rule that would require brokerage firms to conduct background checks on both newly licensed registered representatives and registered representatives seeking to transfer their registrations from another firm (collectively, "registration applicants") in order to verify the accuracy and completeness of the information contained in the applicants' Form U4's. Form U4 is the Uniform Application for Securities Industry Registration or Transfer that is used by FINRA and other regulators to acquire information about an applicant, including his or her employment and disciplinary history. In particular, FINRA has advised that it plans to require firms to review public records to ensure that criminal and bankruptcy records, civil litigations, judgments, and liens are reported on an applicant's U4. Firms would also be required to adopt written procedures regarding background checks, which would include a requirement that a public records search be conducted regarding each registration applicant.

In addition to requiring background checks by firms prior to associating representatives, FINRA also advised that it plans to conduct its own search of public financial records for all registered representatives and a search of all public criminal records for all registered representatives who have not been fingerprinted within the past five years. Once these initial reviews are completed, FINRA will conduct periodic reviews of public records to ensure that firms and registered representatives are complying with their reporting requirements.

Finally, FINRA advised that it is considering whether to include additional data from the Central Registration Depository ("CRD") system in its online BrokerCheck tool. It is evaluating whether or not there is a meaningful correlation between some of the data on the CRD system – including failing registration examinations – and broker misconduct.

FINRA's proposals for increased scrutiny of applicants for registration follow on the heels of its March 10, 2014 rule filing with the Securities & Exchange Commission ("SEC") in which it proposed the adoption of FINRA Rule 2243, which would establish disclosure and reporting obligations relating to firms' recruitment practices. In particular, the proposed new rule would require that member firms that provide enhanced compensation to recruit a registered representative from another firm must disclose the details of such enhanced compensation to any former customer of the registered representative at the prior firm who (a) is contacted by the registered representative or the new firm regarding the registered representative's move to the new firm or (b) wishes to transfer an account that he held at the prior firm to an account with the registered representative at the new firm. The disclosures must be made if a registered representative has received (or will receive) $100,000.00 or more of either "aggregate upfront payments" or "aggregate potential future payments" in connection with his or her transfer to a new firm. Such compensation may include signing bonuses, up-front or back-end bonuses, loans, accelerated payouts, transition assistance, and an ownership interest in the new firm.

These disclosures would be required for one year following the transfer of the registered representative's association from his prior firm to a new firm. Where a registered representative or the new firm initiates contact with a former customer, the initial disclosure may be made orally or in writing. If the disclosure is made orally, then the disclosure must also be provided in writing by the new firm at the time that the account is transferred from the prior firm to the new firm (or within 10 days of the oral disclosure, whichever time period is shorter). Where a former customer seeks to transfer his account from a prior firm to an account with his registered representative at the new firm, and there has been no personal contact with the customer, then the disclosure must be provided in writing at the time that the account is transferred from the prior firm to the new firm. No such disclosures are required in connection with the transfer of institutional accounts, provided that such account is not held by a natural person.

The SEC comment period regarding this rule closed in April, and the SEC has received numerous comments, including criticism from sectors of the industry who contend that this rule would have a chilling effect on the ability or willingness of registered representatives to change firms. The SEC has until mid-May to act on FINRA's proposal, though it can choose to extend this period to the end of June or later. The SEC must approve Rule 2243, reject it or hold proceedings regarding the rule's potential rejection.

It is clear from this rule filing, and from FINRA's recent approval of amendments to its supervision rule that would require member firms to conduct background checks on registration applicants, that FINRA continues to move in the direction of requiring greater disclosure of registered representatives' employment and financial histories as well as their compensation.