Insight

IN-DEPTH DISCUSSION

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FINRA Members Subject to New Background Screening Rules

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Last year, the Financial Industry Regulatory Authority (FINRA), a non-governmental organization that regulates member brokerage firms and exchange markets, approved proposed Rule 3110(e), which enhances the background screening requirements already in place for FINRA-member institutions and registered individuals. That new rule became effective on July 1, 2015. The primary change expands a member firm's obligation to investigate the background of applicants for registration by actually requiring the member firm to verify the completeness and accuracy of information that an applicant for registration provides on his or her Form U4.[1] According to Richard Ketchum, FINRA Chairman and Chief Executive Officer, the new background check rules reflect "important initiatives to improve the accuracy and totality of details reported on a registered individual's Form U4" and now impose a requirement that firms "use publicly available records to verify that information."

FINRA member institutions should become familiar with the new background screening rules and should also consider a privileged audit of their background screening procedures to ensure compliance with federal and state fair credit reporting and employment laws, including the federal Fair Credit Reporting Act (FCRA) and state and local ban-the-box laws and ordinances.

Existing FINRA Requirements

FINRA's Form U4 is used to register individuals with FINRA member firms. Form U4 requires applicants to make specific disclosures about their criminal history, regulatory action history, civil judicial and litigation history, and personal financial history (including bankruptcies). The Form U4 is filed with the Central Registration Depository (CRD). FINRA reviews the information disclosed on the Form U4 to determine whether an applicant is subject to a "statutory disqualification" or whether the applicant otherwise presents a regulatory risk for the member firm and its

1 The U4 is the "Uniform Application for Securities Industry Registration or Transfer" and is available at https://www.finra.org/file/form-u4.

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customers.[2] Firms also use that same information to determine whether an applicant is a candidate for special supervision and to check the backgrounds of individuals they are considering sponsoring for registration. Some of the information maintained on the CRD is available to investors through BrokerCheck.

When terminating the employment and/or registration of a registered individual, FINRA member firms must complete FINRA Form U5, which provides information regarding the reason for an applicant's termination of registration with a firm, potential claims regarding investment misconduct or other negative activities.[3]

What the Amendment to Rule 3110(e) Now Requires

Under the old rule, FINRA-regulated firms were required to investigate the good character, business reputation, qualifications and experience of applicants. However, the amendment to Rule 3110(e), which applies to new or transfer registration applicants, contains two separate components: an obligation to *investigate* the good character, business reputation, qualifications and experience of applicants and to *verify* information contained on the applicant's U4.

The Duty to Investigate

Member firms have always been subject to a duty to investigate an applicant's good character, business reputation, qualifications and experience of applicants, but now must do so before applying to register the applicant with FINRA and filing the U4 with the CRD and before the firm represents on the Form U4 that it has conducted this investigation and verified the accuracy and completeness of the information contained in the Form U4. Neither the amendment nor FINRA place any limits on the scope of such an investigation. Instead, the Regulatory Notice announcing the amended rule advises firms to "obtain all the necessary information to make an evaluation."[4] To that end, FINRA recommends that firms "consider all available information gathered in the pre-registration process for this purpose, including, but not limited to, Form U4 and Form U5 … responses, authorized searches of the CRD system, fingerprint results … and communications with previous employers." The Regulatory Notice also advises firms to consider private background checks, credit reports and reference letters, but reminds firms to "ensure that such background investigations are conducted in accordance with all applicable laws, rules and regulations, including federal and state requirements, and that all necessary approvals, consents and authorizations have been obtained."

In furtherance of the firm's investigation, the amendment also now requires the firm to make a reasonable effort to review an applicant's most recent Form U5 if the applicant previously has been registered with FINRA or another self-regulatory organization.

The Duty to Verify

In terms of the requirement that firms verify information contained on the applicant's Form U4, firms now must adopt and implement written procedures for verifying the accuracy and completeness of the information contained on an applicant's Form U4 "no later than 30 calendar days after the form is filed with

2 Section 3(a)(39) of the Securities Exchange Act sets out the reasons for which an applicant may be subject to a "statutory disqualification."

3 The Form U5 is available at: https://www.finra.org/file/form-u5.

4 The Regulatory Notice can be found at https://www.finra.org/industry/notices/15-05.

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FINRA, with the understanding that if they become aware of any discrepancies as a result of the verification process conducted after the filing of the Form U4, they will be required to file an amended Form U4. The amendment states that the "procedure shall, at a minimum, provide for a search of reasonably available public records to be conducted by the member, or a third-party service provider." FINRA recommends that these procedures set out the process the member firm will follow for completing the necessary public record search and also state that those checks will include, at a minimum, a national search of available filings.

The amendment's requirement that firms conduct a "national search" is a minimum requirement, and the need for a public records search is "mandatory." According to FINRA, the latter may include, but is not limited to "general information, such as name and address of individuals, criminal records, bankruptcy records, civil litigations and judgments, liens, and business records." The national search is limited to "reasonably available public records." Although the scope of this may change over time, FINRA reminded members that at a minimum, such a search would include criminal records, bankruptcy records, judgments and liens. Of course, firms may find it necessary to conduct a more in-depth search on a particular applicant depending on the applicant's job function, responsibilities, or position at the firm.

Although the verification process must be completed no later than 30 calendar days after the Form U4 is filed, FINRA has emphasized that the verification process is not limited to only the 30 days following the filing of a Form U4 and can be done prior to this period: "The 30-day window is intended to accommodate firms that may find it difficult to conduct the verification process before filing an applicant's Form U4, such as where an applicant is hired immediately to fill a needed role at the firm." FINRA also notes that the investigation and verification requirements are complimentary but not identical. While the two requirements are separate, some of the information obtained while satisfying these two requirements may overlap. For most applicants, FINRA expects firms will conduct the investigation and verification process concurrently using some of the same information and prior to filing the Form U4.

On a separate note, in April 2014, FINRA announced that it will now also conduct public financial records searches for all registered representatives and, for those members who have not been fingerprinted in the last five years, will also search publicly available criminal records. According to FINRA, these searches will "better position FINRA to assess firm and registered individual compliance with reporting requirements."

Recommendations for FINRA-Regulated Employers

FINRA's new background screening requirements are a major change to what it previously expected of member firms. As a result, FINRA-regulated employers should consider doing a number of things. Specifically:

- Review policies and procedures regarding hiring and disclosures to ensure compliance with FINRA rules.
- Ensure that personnel records pertaining to applicants and employees comply with FINRA's record retention requirements.
- Initiate investigations of registered individuals promptly. Some jurisdictions do not offer court and other public records online and, thus, it could take extra time to receive and review the requested information. Any delay in initiating the investigation could result in the member firm failing to meet the new deadlines for completion of the investigation and verification of information on a registered individual's Form U4.

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- If using a third-party consumer reporting agency (e.g., a background check company) to perform any part of the investigation, member firms should evaluate the sufficiency of the paperwork they use with their screening procedures (e.g., consent forms and adverse action notices), and otherwise ensure they are following the requirements of the FCRA and its state and local counterparts.[5] This includes obtaining advance, written consent for background checks and providing specific notices before and when an adverse employment decision is based, in whole or in part, on information concerning an individual's background report, including criminal records or credit history. Notably, the consent and disclosures set forth in Section 15A of the Form U4 (entitled "Individual/Applicant's Acknowledgement And Consent") are not compliant with the FCRA and its state and local counterparts and cannot be relied upon to lawfully perform an investigation using a third-party consumer reporting agency.

In addition, other regulated employers in the financial industry (e.g., banks, credit unions, investment advisers, investment companies, swap dealers, and insurers) should consider whether they are subject to any similar investigation and screening requirements and, if so, assess whether their practices currently comply with the applicable regulatory scheme. For example, the SAFE Act and Regulation Z of the Truth in Lending Act broadly regulate loan originators and others involved in consumer credit transactions secured by a dwelling, such as mortgage loans; Section 19 of the Federal Deposit Insurance Act regulates banks; and Section 205(d) of the Federal Credit Union Act regulates credit unions. Each of these statutes specifically exclude individuals with certain types of criminal records from working in certain types of positions and impose steep penalties for non-compliance with the statutory exclusions. That said, these statutes may not necessarily apply to the entire workforce and, thus, financial services employers must ensure that their screening policies are narrowly tailored and not so overbroad that they risk violating state and local ban-the-box laws.[6]

5 See Jennifer Mora, *Federal Courts Increase Scrutiny of Employer Compliance with the FCRA's Adverse Action Requirements*, Littler Insight (Jan. 4, 2016); Rod Fliegel, Jennifer Mora, and William Simmons, *The Swelling Tide of Fair Credit Reporting Act (FCRA) Class Actions: Practical Risk-Mitigating Measures for Employers*, Littler ASAP (Aug. 1, 2014).

6 See Jennifer Mora, David Warner, and Rod Fliegel, *New York City Commission on Human Rights Issues Guidance on Citywide "Ban-the-Box" Law*, Littler Insight (Nov. 9, 2015); Jennifer Mora, Jennifer Warberg and Philip Gordon, *Oregon to Become the Latest State to Ban the Box*, Littler ASAP (June 22, 2015).

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