

## Background Checks

### SEC Approves Consolidated FINRA Rule Regarding Background Checks on Registration Applicants

Effective Date of FINRA Rule 3110(e): July 1, 2015

Effective Date of FINRA Rule 3110.15: April 24, 2014, to December 1, 2015

#### Executive Summary

The SEC approved FINRA's proposed rule change to adopt NASD Rule 3010(e) (Qualifications Investigated) relating to background checks on registration applicants as FINRA Rule 3110(e) (Responsibility of Member to Investigate Applicants for Registration)<sup>1</sup> in the consolidated FINRA rulebook.<sup>2</sup> FINRA Rule 3110(e) is based in part on substantially similar provisions in NASD Rule 3010(e) and Incorporated NYSE Rule 345.11 (Investigation and Records),<sup>3</sup> and includes new provisions relating to the verification of information in the Form U4 (Uniform Application for Securities Industry Registration or Transfer). The SEC also approved FINRA Rule 3110.15 (Temporary Program to Address Underreported Form U4 Information), which establishes a temporary program that will issue a refund to members of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M, subject to specified conditions.<sup>4</sup> FINRA Rule 3110(e) becomes effective on July 1, 2015. FINRA Rule 3110.15 became retroactively effective on April 24, 2014, and it will automatically sunset on December 1, 2015.<sup>5</sup>

The amended rule text is attached as Appendix A.

Questions regarding this *Notice* should be directed to Afshin Atabaki, Associate General Counsel, Office of General Counsel, at (202) 728-8071 or [afshin.atabaki@finra.org](mailto:afshin.atabaki@finra.org).

Technical questions regarding the temporary refund program under FINRA Rule 3110.15 should be directed to Mario DiTrapani, Vice President, CRD/Public Disclosure, at (240) 386-4796 or [mario.ditrapani@finra.org](mailto:mario.ditrapani@finra.org).

#### March 2015

##### Notice Type

- ▶ Consolidated Rulebook
- ▶ New Rule

##### Suggested Routing

- ▶ Compliance
- ▶ Human Resources
- ▶ Legal
- ▶ Operations
- ▶ Registration
- ▶ Risk
- ▶ Senior Management
- ▶ Training

##### Key Topics

- ▶ Background Checks
- ▶ Bankruptcies
- ▶ BrokerCheck®
- ▶ Central Registration Depository
- ▶ Criminal Records
- ▶ Forms U4 and U5
- ▶ Judgments
- ▶ Liens
- ▶ Public Records

##### Referenced Rules & Notices

- ▶ FINRA Rules 3110(e) and 3110.15
- ▶ Information Notices 3/12/08 and 8/17/12
- ▶ MSRB Rule G-7
- ▶ NASD Rules 3010(e) and 3010(f)
- ▶ Notice to Members 05-39
- ▶ NYSE Rule 345.11
- ▶ NYSE Rule Interpretations 345.11/01 and /02
- ▶ Regulatory Notice 07-55
- ▶ SEA Rule 17f-2
- ▶ SEA Sections 3(a)(39), 15(b)(4) and 15(b)(11)



## Background & Discussion

### Background Checks

A critical part of the registration process in the securities industry is the background investigation of applicants for registration and the timely and accurate reporting of information to the Central Registration Depository (CRD<sup>®</sup>) system via the Form U4. For instance, FINRA reviews the information disclosed on the Form U4 to determine whether an applicant is subject to a statutory disqualification<sup>6</sup> or whether the applicant may present a regulatory risk for the firm and customers. Further, firms use the information reported to the CRD system to determine whether an applicant is subject to a statutory disqualification or a candidate for special supervision. Firms also use the information reported to the CRD system to check the backgrounds of applicants they are considering sponsoring for registration. In addition, the information that FINRA releases to the public through BrokerCheck, which helps investors make informed choices about the individuals and firms with which they conduct business, is derived from the CRD system.

FINRA Rule 3110(e), which is based on NASD Rule 3010(e) and NYSE Rule 345.11, sets forth a member's obligation to conduct a background check on applicants it intends to sponsor for registration.<sup>7</sup>

### Investigation Process

FINRA Rule 3110(e) requires that each member firm ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the firm applies to register that applicant with FINRA and before making a representation to that effect on the application for registration. This is a principle-based requirement, and it is substantially similar to the requirement under NASD Rule 3010(e). Firms are required to complete the investigation process prior to filing the Form U4. Further, FINRA does not place any limits on the scope of such a background investigation—a firm must obtain all the necessary information to make an evaluation.<sup>8</sup> Firms should consider all available information gathered in the pre-registration process for this purpose, including, but not limited to, Form U4 and Form U5 (Uniform Termination Notice for Securities Industry Registration) responses, authorized searches of the CRD system, fingerprint results obtained under SEA Rule 17f-2 and communications with previous employers. Firms also may wish to consider private background checks, credit reports and reference letters for this purpose. However, firms must 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.

Consistent with the requirement under NASD Rule 3010(e), if an applicant previously has been registered, FINRA Rule 3110(e) requires that a firm review a copy of the applicant's most recent Form U5,<sup>9</sup> including any amendments, within 60 days of the filing date of the applicant's Form U4.<sup>10</sup> If the firm is unable to review the Form U5, it has to demonstrate that it has made reasonable efforts to do so.<sup>11</sup> FINRA Rule 3110(e) clarifies that a firm is required to review a copy of an applicant's most recent Form U5 if the applicant previously has been registered with FINRA or another self-regulatory organization.

### Verification Process

FINRA Rule 3110(e) requires that a firm adopt written procedures reasonably designed to verify the accuracy and completeness of the information contained in an applicant's Form U4 by no later than 30 calendar days after an initial or a transfer Form U4 is filed with FINRA. While this is a new requirement, it is based on an underlying requirement in the Form U4 that the person signing the form on behalf of the firm certify that he or she has taken appropriate steps to verify the accuracy and completeness of the information contained in and with that form.<sup>12</sup> FINRA Rule 3110(e) expressly requires that a firm's written procedures specify the firm's process for verifying the information in the Form U4 and that the firm complete that verification process by no later than 30 calendar days after the Form U4 is filed.

FINRA understands that the verification process could vary firm by firm. For instance, one firm may verify an applicant's identity and name by checking a valid state-issued driver's license, whereas another firm may do so by reviewing a valid government-issued passport. Further, the verification process for some of the information in the Form U4 is embedded in the form itself. For instance, the Form U4 provides that the person signing the form on behalf of the firm certify that the firm has communicated with the applicant's previous employers for the past three years and has documentation on file with the names of the persons contacted and the date of contact. Moreover, FINRA does not expect firms to verify all of the information in the Form U4 where such verification is not feasible or practical. However, in such cases, a firm should document that the information could not be verified and the reasons (including the steps taken to verify the information).

Firms must complete the verification process by no later than 30 calendar days after filing the Form U4 with 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. FINRA Rule 3110(e) does not require firms to conduct the verification process only during the 30-day window after the Form U4 has been filed or base the verification on information that is obtained only during the 30-day window after the form has been filed. Rather, 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. For most applicants, FINRA expects that firms will conduct the

investigation and verification process concurrently using some of the same information and prior to filing the Form U4. Moreover, FINRA encourages firms to complete the verification process prior to filing the Form U4. In this regard, as is the case today with respect to amended Form U4 filings, a firm will be subject to a Late Disclosure Fee if the disclosure event should have been reported on the initial or transfer Form U4, regardless of whether the firm completes the verification process within the 30-day window pursuant to FINRA Rule 3110(e).

Under FINRA By-Laws, a firm is obligated to file an amended Form U4 no later than 30 calendar days after learning of the facts or circumstances giving rise to the amendment.<sup>13</sup> Therefore, if a firm completes its verification process during the 30-day window pursuant to FINRA Rule 3110(e) and learns of facts or circumstances that require the filing of an amended Form U4, the firm will continue to have 30 calendar days from the date it learns of such facts or circumstances to file an amended Form U4, provided that the firm will be subject to any applicable Late Disclosure Fees.

FINRA also recognizes that there will on occasion be circumstances beyond a firm's control that prevent completion of the verification process within the 30-day window after the Form U4 is filed with FINRA. For example, a firm may not be able to comply with the 30-day window where the firm is relying on fingerprint results for verifying criminal information, and the FBI determines the fingerprints to be "illegible" and requires resubmission of the fingerprints. In such circumstances, the firm's procedures should provide that the verification must be completed as soon as practical, and the firm should document the basis for the delay.

In addition, FINRA Rule 3110(e) requires that a firm's verification process must, at a minimum, provide for a national search<sup>14</sup> of reasonably available public records conducted by the firm or a third-party service provider to verify the accuracy and completeness of the information contained in an applicant's Form U4. Similar to the overall verification process, the requirement to conduct a public records search must be satisfied by no later than 30 calendar days after an initial or a transfer Form U4 is filed with FINRA. The public records search is a new requirement, and it is a mandatory component of the overall verification process described above. Public records include, but are not limited to general information, such as name and address of individuals, criminal records, bankruptcy records, civil litigations and judgments, liens, and business records. However, FINRA Rule 3110(e) requires a national search only of reasonably available public records. The scope of what is considered reasonably available public records may change over time, but FINRA understands that currently such records include criminal records, bankruptcy records, judgments and liens. This is a minimum or base requirement. A firm may find it necessary to conduct a more in-depth search of public records depending on the applicant's job function, responsibilities or position at the firm.

A firm could comply with the requirement to conduct a national search of reasonably available public records in several ways. For example, a firm may satisfy the requirement by: (1) reviewing a credit report from a major national credit reporting agency that contains public record information (such as bankruptcies, judgments and liens) and the applicant's fingerprint results;<sup>15</sup> (2) searching a reputable national public records database, such as LexisNexis, a division of Reed Elsevier, Inc., and reviewing the applicant's fingerprint results; or (3) reviewing a consolidated report from a specialized provider, such as Business Information Group, Inc. (BIG),<sup>16</sup> that includes criminal and financial public records. Moreover, as explained above, the scope of the requirement is limited to reasonably available public records, which currently include criminal records, bankruptcies, judgments and liens. FINRA notes that the public records search requirement does not require firms to obtain a credit report, which contains both public and non-public records. FINRA included a credit report in the list above as an example of a type of document that includes reasonably available public records. FINRA further reiterates that, as is the case with the investigative process, firms must ensure that such public records searches 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.

The verification requirement, including the public records search, applies to an initial Form U4 or a transfer Form U4. The term "initial Form U4" refers to the Form U4 filing required when an individual is registering with a FINRA member for the first time, including in the context of concurrent or subsequent dual registration, or is registering with a FINRA member after more than two years have passed since the individual was last registered with a FINRA member. The term "transfer Form U4" refers to a Form U4 filing required when a registered person terminates his or her registration with one FINRA member and registers with another FINRA member without having to requalify by examination (*i.e.*, within two years of having been registered with another FINRA member). This would include a Form U4 filed for an individual who terminates his or her registration with a FINRA member and registers with another member within 30 calendar days.<sup>17</sup> The verification requirement applies to an applicant that is concurrently registering with multiple firms, including affiliated firms. However, where an applicant is concurrently registering with multiple affiliated firms, the affiliated firms may rely on a single verification conducted by any one of the affiliates. In addition, where an applicant who is registered with a firm subsequently registers with an affiliate of that firm, the affiliated firm will be required to verify any new information disclosed on the Form U4 and conduct the minimum public records search for criminal records, bankruptcy records, judgments and liens. However, the affiliated firm will not be required to verify any historical Form U4 information, such as residential and employment history, that was verified by the original firm during the initial registration.

The verification requirement does not apply to the mass transfer process because that process does not involve the filing of a Form U4, which is the basis for the verification requirement under FINRA Rule 3110(e).

## Temporary Refund Program

As announced on April 24, 2014, to verify against public records whether material financial information has been timely and accurately reported to the CRD system via the Form U4, FINRA is performing a one-time search of specific financial public records, including bankruptcies, judgments and liens, on all registered persons.<sup>18</sup> FINRA expects to complete this process on or before August 2015.

FINRA has established a temporary refund program to address concerns regarding the assessment of the Late Disclosure Fee in circumstances where an unsatisfied judgment or lien has been satisfied, and at the time it was unsatisfied was of a relatively low amount (under \$5,000) and was reportable prior to the August 13, 2012, introduction of the procedures regarding the application of the Late Disclosure Fee to the reporting of judgments and liens on the Form U4.<sup>19</sup> The refund program also addresses circumstances where the failure to report related to a mistaken belief that satisfying a judgment or lien shortly after learning it was unsatisfied (within 30 calendar days of when it became unsatisfied) obviated the need to report the matter.<sup>20</sup>

Specifically, as stated in FINRA Rule 3110.15, FINRA will issue a refund to firms of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M (unsatisfied judgments or liens) if the Form U4 amendment is filed between April 24, 2014, and December 1, 2015, and one of the following conditions is met:

1. the judgment or lien has been satisfied, and at the time it was unsatisfied, it was under \$5,000, and the date the judgment or lien was filed with a court (as reported on Form U4 Judgment/Lien DRP, Question 4A) was on or before August 13, 2012; or
2. the unsatisfied judgment or lien was satisfied within 30 days after the individual learned of the judgment or lien (as reported on Form U4 Judgment/Lien DRP, Question 4.B.).

The refund program has a retroactive effective date of April 24, 2014, and it will automatically sunset on December 1, 2015. Thus, firms will not be able to obtain a refund pursuant to the parameters established under the program after December 1, 2015. While the program is in effect, FINRA will initially assess firms a Late Disclosure Fee and subsequently refund the fee in the firm's FINRA Flex-Funding Account if the firm can establish, or if FINRA otherwise determines, that the conditions of the program have been satisfied.

## Endnotes

1. See Securities Exchange Act Release No. 73966 (December 30, 2014), 80 FR 546 (January 6, 2015) (Order Approving File No. SR-FINRA-2014-038).
2. The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see [Information Notice 3/12/08](#) (Rulebook Consolidation Process).
3. See also Incorporated NYSE Rule Interpretations 345.11/01 and /02. For convenience, this *Notice* refers to Incorporated NYSE Rules as NYSE Rules.
4. See *supra* note 1.
5. The refund program under FINRA Rule 3110.15 originally was scheduled to expire on July 31, 2015. However, based on FINRA's experience with the program, FINRA extended the expiration date of the program until December 1, 2015 to give firms adequate time to conduct their reviews and identify and report information to FINRA. See File No. SR-FINRA-2015-005, which was filed with the SEC for immediate effectiveness on March 3, 2015.
6. See Sections 3(a)(39) and 15(b)(4) of the Securities Exchange Act of 1934 (SEA).
7. Firms must comply with MSRB Rule G-7 (Information Concerning Associated Persons) regarding those applicants engaged solely in municipal securities activities.
8. See [Regulatory Notice 07-55](#) (FINRA Reminds Member Firms of Their Obligations Regarding Background Investigations of Prospective Personnel) (November 2007).
9. FINRA is eliminating NASD Rule 3010(f) (Applicant's Responsibility), which requires an applicant to provide a copy of his or her Form U5 upon a firm's request, because firms have electronic access to an applicant's Form U5 through the CRD system.
10. If the applicant has been recently employed by a Futures Commission Merchant or an Introducing Broker that is notice-registered with the SEC pursuant to SEA Section 15(b)(11), the registering firm also is required to review a copy of the individual's most recent CFTC Form 8-T.
11. FINRA expects firms to use this provision in very limited circumstances, such as where the previous firm fails to file a Form U5 or goes out of business before filing a Form U5.
12. The Form U4 also provides that the person signing the form on behalf of the firm certify that the firm has communicated with the applicant's previous employers for the past three years and has documentation on file with the names of the persons contacted and the date of contact. In addition, firms have an obligation to comply with SEA Rule 17f-2. Pursuant to SEA Rule 17f-2, specific persons employed in the securities industry are required to be fingerprinted for purposes of a criminal background check. Firms are responsible for obtaining those fingerprints and required identifying information. Firms then submit the fingerprints together with the required identifying information to FINRA. FINRA, in turn, submits these fingerprints to the FBI. FINRA also makes the fingerprint results available to the employing member and regulators, consistent with applicable federal laws and FBI and FINRA requirements. See [Notice to Members 05-39](#) (May 2005).

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13. See FINRA By-Laws, Article V, Section 2(c).
14. The requirement is limited to a national search. However, firms may find it necessary to conduct a search of public records in a foreign jurisdiction as part of their verification process and, where appropriate, should consider such a search consistent with applicable foreign laws, rules and regulations.
15. Firms may rely on the SEA Rule 17f-2 fingerprint results to comply with the requirement to conduct a public records search of criminal records.
16. For example, FINRA has contracted with BIG to provide competitive pricing to member firms that are conducting background investigations of applicants, currently at a cost of \$10 to \$13 per applicant (depending on volume). In general, FINRA does not endorse any particular third-party service, and a firm's use of BIG's services or the services of any other specific provider would not be deemed to be a safe harbor by FINRA. BIG is a provider in the Compliance Resource Provider Program. Additional information regarding that program is available at: <http://www.finra.org/industry/p118766>.
17. If an individual has been registered with another FINRA member firm within 30 calendar days prior to filing a Form U4, the individual is required to complete the Form U4 with the exception of Section 9 (Identifying Information/Name Change), Section 10 (Other Names), Section 11 (Residential History), Section 12 (Employment History) and Section 13 (Other Business).
18. See [FINRA Board Approves Amendment to Supervision Rule Requiring Firms to Conduct Background Checks on Registration Applicants](#), FINRA News Release, April 24, 2014.
19. See [Information Notice 8/17/12](#) (Late Disclosure Fee Related to Reporting of Judgment/Lien Events).
20. FINRA believes that there may be a misconception regarding the obligation to report unsatisfied judgments and liens under Question 14M on the Form U4. The obligation to amend a Form U4 arises on the date a registered person receives notice or learns that he or she is subject to an unsatisfied judgment or lien, and an amended Form U4 should be filed no later than 30 calendar days from that date, regardless of whether the registered person satisfies the judgment or lien in the interim period prior to the 30-day deadline for filing a Form U4 amendment.  
  
Additional guidance regarding the reporting of judgments and liens is available on the [Form U4 and U5 Interpretive Questions and Answers](#) page under Question 14M.

## Appendix A

### Amended Rule Text

New language is underlined; deletions are in brackets.

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### 3000. SUPERVISION AND RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS

#### 3100. SUPERVISORY RESPONSIBILITIES

##### 3110. Supervision

###### (a) Supervisory System

Each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) through (2) No Change.

(3) The registration and designation as a branch office or an office of supervisory jurisdiction (OSJ) of each location, including the main office, that meets the definitions contained in paragraph [(e)](f) of this Rule.

(4) through (7) No Change.

(b) through (d) No Change.

###### **(e) Responsibility of Member to Investigate Applicants for Registration**

Each member shall ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the member applies to register that applicant with FINRA and before making a representation to that effect on the application for registration.

If the applicant previously has been registered with FINRA or another self-regulatory organization, the member shall review a copy of the applicant's most recent Form U5, including any amendments thereto, within 60 days of the filing date of an application for registration, or demonstrate to FINRA that it has made reasonable efforts to do so. In conducting its review of the Form U5, the member shall take such action as may be deemed appropriate.

The member shall also review an applicant's employment experience to determine if the applicant has 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 Exchange Act. In such a case, the member shall also review a copy of the applicant's most recent CFTC Form 8-T, including any amendments thereto, within 60 days of the filing date of an application for registration, or demonstrate to FINRA that it has made reasonable efforts to do so. In conducting its review of a Form 8-T, the member shall take such action as may be deemed appropriate.

In addition, each member shall establish and implement written procedures reasonably designed to verify the accuracy and completeness of the information contained in an applicant's initial or transfer Form U4 no later than 30 calendar days after the form is filed with FINRA. Such procedures 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, to verify the accuracy and completeness of the information contained in the applicant's initial or transfer Form U4.

**[(e)](f) Definitions**

(1) No Change.

(2) (A) through (B) No Change.

(C) The term "business day" as used in paragraph [(e)](f)(2)(A) of this Rule shall not include any partial business day provided that the associated person spends at least four hours on such business day at his or her designated branch office during the hours that such office is normally open for business.

**• • • Supplementary Material: -----**

**.01 Registration of Main Office.** A member's main office location is required to be registered and designated as a branch office or OSJ if it meets the definitions of a "branch office" or "office of supervisory jurisdiction" as set forth in Rule 3110[(e)](f). In general, the nature of activities conducted at a main office will satisfy the requirements of such terms.

**.02 Designation of Additional OSJs.** In addition to the locations that meet the definition of OSJ in Rule 3110[(e)](f), each member shall also register and designate other offices as OSJs as is necessary to supervise its associated persons in accordance with the standards set forth in Rule 3110. In making a determination as to whether to designate a location as an OSJ, the member should consider the following factors:

(a) through (e) No Change.

**.03 through .14** No Change.

**.15 Temporary Program to Address Underreported Form U4 Information.** FINRA is establishing a temporary program that will issue a refund to members of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M (unsatisfied judgments or liens) if the Form U4 amendment is filed between April 24, 2014 and December 1, 2015 and one of the following conditions is met: (1) the judgment or lien has been satisfied, and at the time it was unsatisfied, it was under \$5,000 and the date the judgment or lien was filed with a court (as reported on Form U4 Judgment/Lien DRP, Question 4.A.) was on or before August 13, 2012; or (2) the unsatisfied judgment or lien was satisfied within 30 days after the individual learned of the judgment or lien (as reported on Form U4 Judgment/Lien DRP, Question 4.B.). This program has a retroactive effective date of April 24, 2014, and it will automatically sunset on December 1, 2015. Members will not be able to use the program after December 1, 2015.

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\* No Change.

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