

Insights

THROUGH THE ISSUANCE OF NEW RULES AIMED AT RECIDIVIST BROKERS AND THE FIRMS THAT HIRE THEM, FINRA LOUDLY EXCLAIMS TO ITS MEMBERSHIP “CAN YOU HEAR ME NOW???”

May 11, 2021

SUMMARY

Key Takeaways:

- After years of warning firms of the need for enhanced diligence in retaining or hiring brokers with a significant history of misconduct, FINRA has adopted new rules to address such brokers.
- As set forth in FINRA Regulatory Notice 21-09, member firms will be required to file a Continuing Membership Application (or alternatively seek a Materiality Consultation) when a natural person seeks to become an owner, control person, principal, or even a registered person with a member firm if that individual has, in the past five years, one or more “final criminal matters” or two or more “specified risk events.”
- Additional rule changes address (i) enhancement of the “Taping Rule” by requiring firms to disclose such status on BrokerCheck, (ii) requirement of heightened supervisory procedures during an appeal of a disciplinary matter, and (iii) a mandate to place a disqualified broker under heightened supervision during the application process.

“Recidivist?”

FINRA leadership’s first use of the word “recidivist” raised many sharp eyebrows across the securities industry. Remember Judge Haller’s familiar reaction in *My Cousin Vinny* to Vinny Gambini’s use of the phrase “two yutes?” Haller replied in bewilderment, completely open-mouthed and wide-eyed stating, “Ah, the two what? Uh ... Uh, what was that word???” Well, the industry’s reaction upon hearing the word recidivist was very similar. All mouths dropped signaling a state of confusion, you could hear a pin drop, and everyone was quietly thinking to themselves, “Say what?”

So in response, the defense bar did what all prudent lawyers do when they find themselves at a complete loss for thoughts - we immediately ran for our dictionaries in search of an answer. Yet, careful to do so in stealth so as to avoid any sense of immediate embarrassment from our colleagues!

The word “recidivist” returns two very similar definitions: (1) a convicted criminal who reoffends, and (2) one who relapses – a habitual criminal. It may be unfair and overly pejorative to refer to a broker who has several complaints on their record as a habitual criminal, especially considering member firms are required to report certain complaints regardless of merit or disposition. Nonetheless, FINRA does make a fair point that brokers who have a demonstrated history of sales practice violations pose a certain amount of risk to investors and the industry as a whole. While we can argue the relevancy and severity of each individual’s disclosure history, the general concept is undeniably a topic of concern.

FINRA's Early Concerns

FINRA first began discouraging member firms from hiring “high risk” or “recidivist” brokers by launching its “High Risk Broker Initiative” in 2013. The purpose of that program was to identify individuals that FINRA viewed as posing a heightened risk of harm to customers and the reputation of the securities industry, based on an accumulation of multiple negative disclosure events, and to expedite regulatory exams and investigations into those individuals.

The following year, FINRA upped the ante on its efforts by designating an enforcement team to prosecute claims against recidivist brokers. It also warned firms in its 2014 Regulatory and Examination Priorities Letter that it would increase the rigor around examining recidivist brokers, and their respective firms, during annual branch exams. As part of its exam process, FINRA signaled that it would: (1) focus on the broker’s client accounts in conducting sales practice reviews; (2) examine the firm’s due diligence process in connection with hiring the brokers; and (3) examine the member firm’s supervision of the broker, including whether it placed the brokers on a heightened supervision plan specifically tailored to guard against future sales practice violations. Similarly, FINRA indicated that in addition to keeping tabs on brokers it deemed recidivist, it would also track and focus additional regulatory attention on the member firms that hired such brokers.

FINRA made similar pronouncements in its Regulatory and Examination Priorities Letters in 2015, 2017, and 2018. Within all of its pronouncements, FINRA reiterated its themes around member firms’ hiring practices and heightened supervision programs. Behind the message, FINRA’s intention should have been clear to member firms. Its first object was to discourage firms from hiring recidivists. In the event that firm’s did not heed to that warning, FIRNA then expected firms to take responsibility for the hire by supervising the broker’s actions in a manner designed to guard against future infractions.

FINRA apparently has grown tired of asking firms to take risk mitigation actions around recidivist brokers seriously! As of late, FINRA has taken a more aggressive approach, summarized below, sending what should be an unequivocal message to the industry that FINRA intends to continue enforcement of consumer protection around recidivist brokers and their firms.

FINRA's 2021 Rule Changes

In 2021, FINRA adopted new rules, and amended some older ones, to create an array of new disincentives towards member firms hiring or continuing to employ brokers with (what should be substantiated) negative disclosure events. A complete discussion of the newly adopted rules and related rule changes can be found at FINRA Regulatory Notice 21-09.

A. Continuous Membership Application Requirement

Arguably, Rule 1017(a)(7) is the most onerous rule to member firms. Effective September 1, 2021, this rule will require a member firm to file a Continuing Membership Application ("CMA") when a natural person seeks to become an owner, control person, principal, or even a registered person with a member firm if that individual has, in the past five years, one or more "final criminal matters" or two or more "specified risk events." Rule 1017(a)(7) also indicates that a member firm can avoid the filing of a full-blown CMA by alternatively seeking a "Materiality Consultation" with FINRA's Member Regulation division, at no cost, before making the hire. Through that process, FINRA will provide an indication as to whether the firm can proceed with the hire with no further action or, alternatively, whether the hire would result in a "material change in business operations," therefore requiring the filing of a full-blown CMA. Either way, FINRA is asserting itself into the hiring decisions of its members and indirectly requiring its permission to proceed with the hire. Interestingly, FINRA has yet to define the parameters of "final criminal matters" or "specified risk events." Rather, FINRA indicated in its recent Regulatory Alert 21-09 that it would post such definitions on its website soon and make changes going forward to the terms as deemed necessary and appropriate.

B. Disclosure of Status as a Taping Firm

FINRA's increased scrutiny regarding brokers with a negative disclosure history did not stop with hiring requirements. In 2014, FINRA adopted Rule 3170, otherwise known as the "Taping Rule," which requires heightened supervisory procedures for the telemarketing activities of brokers and establishes related record retention requirements. Member firms who have hired over a threshold amount of registered representatives previously associated with disciplined firms in the past three years are required to enhance supervision around the telemarketing activities of ALL of its registered representatives. These heightened procedures include the tape recording of all telephone conversations between the brokers and their clients and the retention of those records for no less than three years. Let there be no mistake. The cost alone in carrying out these requirements is prohibitive for most member firms, and even the largest

firms would find this to be an extreme hurdle. Effective May 1, 2021, FINRA amended Rule 8312 (FINRA BrokerCheck Disclosures) to require FINRA to release through BrokerCheck the identity of all member firms subject to the Taping Rule. Prior to this amendment, FINRA was only required to identify such firms in response to telephone inquiries made to its hotline.

C. Heightened Supervision Procedures Required During Appeal of Disciplinary Matter

Additionally, effective April 15, 2021, FINRA is removing some of the discretion member firms once had in placing certain individuals on heightened supervision. FINRA amended Rule 9200 Series (Disciplinary Proceedings) and Rule 9300 Series (Review of Disciplinary Proceeding by National Adjudicatory Counsel and FINRA Board) to address the pendency of an appeal, or the National Adjudicatory Counsel's (NAC) review of a Hearing Panel or Hearing Officer disciplinary decision. Now, Hearing Officers may impose "conditions and restrictions" on a disciplined Respondent during the pendency of an appeal, and member firms are required to adopt a heightened supervision program concerning the Respondents until FINRA's final decision takes effect.

D. Mandatory Requirement to Place a Disqualified Broker Under Heightened Supervision During Application Review Process

Finally, effective June 1, 2021, FINRA amended and renamed Rule 9522 (now - Initiation of Eligibility Proceeding; Member Regulation Consideration; and Requirements for an Interim Plan of Heightened Supervision) to require a member firm that files an application to continue associating an otherwise disqualified individual to include an interim plan of heightened supervision that would remain in effect during the pendency of the application review process.

Conclusion

FINRA is obviously getting more aggressive in policing the actions of recidivist brokers and the firms that hire them. What started as mere suggestions and related warnings to the industry, has grown into a loud roar as if FINRA is shouting out to its membership – Can you hear me now? Smart firms should listen intently as this topic is not subsiding anytime soon! If you have questions on this topic or need assistance with securities regulatory or litigation matters, please reach out to us as we would be delighted to help with your needs.

RELATED PRACTICE AREAS

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MEET THE TEAM



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