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Insights

SEPTEMBER 1ST IMPLEMENTATION OF FINRA RULE 1017(A)(7) - "FINAL CRIMINAL MATTERS" AND "SPECIFIED RISK EVENTS" DEFINED

Aug 30, 2021

SUMMARY

Key Takeaways:

- This alert is intended to supplement our prior May 11th alert titled "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?"
- As set forth in FINRA Regulatory Notice 21-09, member firms will be required after September 1, 2021, to file a Continuing Membership Application ("CMA") or, alternatively, seek a Materiality Consultation ("MC"), 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**."
- At the time we released our May 11th alert, FINRA had yet to define "final criminal matters" and "specified risk events"; rather, its Regulatory Notice 21-09 stated that FINRA would post such definitions on its website "soon" and make changes going forward to the terms as deemed necessary and appropriate.
- Since the posting of our prior alert, we spoke with FINRA and were directed to definitions on FINRA's website for these key terms and will provide explanations below. A link to the page on FINRA's website can be found **here**.

Recap of FINRA Rule 1017(a)(7)

If you recall from our May 11th alert, effective September 1, 2021, FINRA Rule 1017(a)(7) will require a member firm to file a 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 CMA by alternatively seeking a MC 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 CMA.

Financial Criminal Matters and Specified Risk Events Defined

What is a “final criminal matter” and a “specified risk event?” According to FINRA’s website (effective as the date of this alert and subject to change in the future as FINRA deems necessary and appropriate):

- A “Final Criminal Matter” means a criminal matter that resulted in a conviction of, or plea of guilty or nolo contendere (“no contest”) by, a person that is disclosed, or is or was required to be disclosed, on the applicable Uniform Registration Forms, including:
  - U-4 questions - 14A(1)(a), 14A(2)(a), 14B(1)(a), 14B(2)(a);
  - U-5 Questions - 7C(1), 7C(3);
  - U-6 Questions – DRP 4B (where the disposition of the charge was convicted or pled guilty); or
  - FORM BD Questions – 11A(1) or 11B(1).

- A “Specified Risk Event” is intended to include:
  - Customer Awards - A final investment-related, consumer initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party;
  - Customer Settlements – A final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party;
  - Final Civil Judicial Actions – A final investment related, civil action where: (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanctions against the person was a bar, expulsion, revocation or suspension; and
  - Final Regulatory Action – A final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other

than fines, or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation, or suspension from associating with a member.

Practical Application

While this new rule upon first glance may seem novel, it is not when you get down to it. Indeed, FINRA's new rule is not the only instance in which a financial services regulator has prohibited, weighed into or caused significant impact in the employment decisions of a regulated entity. For example, all of the following bodies of law prohibit broker/dealers from employing certain individuals with past criminal backgrounds: (1) Article III, Section 4 of FINRA's By Laws which define "disqualification events" for associated persons; (2) Rule 506 of Regulation D under the Securities Act of 1933 adopted by the SEC which operates as the "Bad Actor Disqualification Rule;" and (3) 15 U.S. Code § 80a–9 – Ineligibility of certain affiliated persons and underwriters. Section 19 of the Federal Deposit Act (12 U.S.C. 1829) acts as the equivalent in regard to banks and Federal saving associations.

Moreover, pursuant to 12 CFR § 5.51, in certain instances in which a national bank or a Federal savings association is not in compliance with minimum capital requirements, or otherwise is in a "troubled condition[1]," or the OCC determines in writing that such a review is necessary, that institution must provide the OCC with notice at least 90 days prior to adding or replacing any member of its board of directors, employing any individual as a senior executive officer, or changing the responsibilities of any senior executive officer so that the individual would assume a different senior executive officer position. The OCC may disapprove of the proposed individual if the OCC determines on the basis of the individual's competence, experience, character, or integrity that it would not be in the best interests of the depositors of the national bank or Federal savings association or the public to permit the individual to be employed by, or associated with, the national bank or Federal savings association.

As another example, bank prudential regulators can also often be critical as to the competency, fitness and effectiveness of certain high ranking bank officers and board members while conducting safety and soundness reviews. Such criticisms undoubtedly lead to negative employment outcomes such as the financial institutions relieving those individuals from their respective positions. Needless to say that while the bank regulators in this scenario do not use an approval mechanism, their expressed opinions almost always lead to the desired result – the regulators effectively blackball an individual in which they don't have trust and/or confidence.

The UK goes even further by requiring regulatory permission before the hire of certain senior position in financial services firms. Indeed, for many years there has been a requirement that almost all senior-level hires in financial services firms must be pre-approved by the Financial Conduct Authority ("FCA") and, in some cases, also the Prudential Regulatory Authority ("PRA"). Based on a

comparison to these rules, the apparent novelty created by implementation of FINRA Rule 1017(a)(7) quickly vanishes.

Moreover, while the new FINRA rule 1017(a)(7) seems onerous and will undoubtedly slow down the hiring and on-boarding of financial advisors in certain scenarios, it could arguably be far worse! FINRA attempted to narrow the scope of the rule by limiting the specified risk events definition to include only ***substantiated*** matters as opposed to any complaints, arbitrations or court matters reported on the CRD. Indeed, the definitions apply to settlements, arbitrations awards or court judgments for $15,000 or more. While one could argue that the threshold amounts are too low, and should be adjusted upwards given the average cost-of-defense settlement in this day and age, at least FINRA attempted to limit application of the rule to situations where the claims were somewhat substantiated. Had FINRA not done so, any complaint or arbitration matter reportable on the CRD could have been called into application, regardless of its merits. The same can be said of regulatory matters or judicial civil actions. Both require a fine, penalty, restitution or disgorgement in excess of $15,000, or an order which requires a bar, expulsion, rescission, revocation or suspension. Therefore, FINRA's attempt to limit the scope of this rule is one positive the industry can rejoice about!

Based on these considerations, FINRA's rule does not seem so novel or onerous to member firms. It is also possible that U.S. financial services regulators continue tweaking their rules so that they become more intertwined in key employment decisions consistent with their UK counter-parts. Only time will tell how this topic continues to evolve. As for now, it is clear that FINRA continues to be concerned about financial advisors who have multiple negative disclosures on their records. As such, member firms must react accordingly.

Conclusion

With FINRA Rule 1017(a)(7) going live on September 1, 2021, firms will have to either file a CMA or, alternatively, seek a MC for anyone that a broker/dealer intends to hire with a background meeting the criteria listed above. Giving the immediacy of the implementation of this rule, now is the time for member firms to focus on future compliance! As always, if you have questions on this topic or need assistance with matters in the United States, or UK, involving broker/dealer and/or banking regulatory, compliance or litigation matters, please reach out to us as we would be delighted to help with your needs.

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1. ***Troubled condition*** according to 12 CFR § 5.51 means a national bank or Federal savings association that

> (i) Has a composite rating of 4 or 5 under the Uniform Financial Institutions Rating System (CAMELS);
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> (ii) Is subject to a cease and desist order, a consent order, or a formal written agreement, that requires action to improve the financial condition of the national bank or Federal savings

association unless otherwise informed in writing by the OCC; or

(iii) Is informed in writing by the OCC that, based on information pertaining to such national bank or Federal savings association, it has been designated in “troubled condition” for purposes of this section.

RELATED PRACTICE AREAS

- Financial Regulation Compliance & Investigations
- Regulation, Compliance & Advisory
- Broker-Dealer and Investment Advisor Regulatory Enforcement, Disputes and Investigations

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