

# Regulatory Notice

07-55

## Personnel Background Investigations

### FINRA Reminds Member Firms of Their Obligations Regarding Background Investigations of Prospective Personnel

#### Executive Summary

A critical part of the hiring process in the securities industry is the background investigation of prospective personnel. For instance, background investigations can help member firms determine whether a prospective employee is subject to a statutory disqualification or whether he or she may present a regulatory risk for the firm and customers. It is essential for firms to understand their obligations with respect to background investigations. As such, this *Notice* reminds member firms of their obligations under FINRA rules.

Questions concerning this *Notice* may be directed to the Office of General Counsel at (202) 728-8071.

#### Background and Discussion

Separate, mutually exclusive provisions of the FINRA rules govern member firms' obligations regarding background investigations of prospective personnel, as described below.

#### NASD Rule 3010(e)

NASD Rule 3010(e) provides that a member firm must ascertain by investigation the good character, business reputation, qualifications and experience of a job applicant before the firm applies to register that applicant with FINRA. NASD Rule 3010(e) requires an extensive, thorough and diligent investigation of a potential applicant's background.

November 2007

#### Notice Type

- Guidance

#### Suggested Routing

- Compliance
- Executive Representatives
- Human Resources
- Legal
- Operations
- Principals
- Registered Representatives
- Registration
- Senior Management
- Training

#### Key Topic(s)

- Background Investigations
- Central Registration Depository (CRD®)
- Fingerprints
- Forms U4 and U5
- Hiring Process
- Statutory Disqualification

#### Referenced Rules & Notices

- Article III, Sections 3 and 4 of the FINRA By-Laws
- NASD Rule 3010(e)
- NTM 97-19
- NTM 05-39
- NYSE Interpretation Handbook Rule 345.11/01
- NYSE Rule 345.11
- NYSE Rule 346



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Undertaking such a background investigation can help the firm detect potential issues when considering persons for employment. NASD Rule 3010(e) does not place any limits on the scope of such a background investigation. The firm must obtain all of the information necessary to determine the applicant's character, business reputation, qualifications and experience.<sup>1</sup>

In addition, if the job applicant previously has been registered with FINRA, NASD Rule 3010(e) requires that the firm review a copy of the applicant's most recent Form U5 (Uniform Termination Notice for Securities Industry Registration) within 60 days of the filing date of an application for registration, or demonstrate that it has made reasonable efforts to do so.<sup>2</sup>

Dual member firms of FINRA and the NYSE also are subject to NYSE Rule 345.11, which is incorporated into the FINRA rules.<sup>3</sup>

### Statutory Disqualification Provisions

Article III, Section 3 of the FINRA By-Laws provides, among other things, that no person may become associated with a member firm, continue to be associated with a member firm or transfer association to another member firm if such person is or becomes subject to a disqualification under Article III, Section 4 of the FINRA By-Laws.<sup>4</sup> Among other events, certain criminal convictions cause an individual to be subject to a disqualification.<sup>5</sup> Firms have an obligation to determine whether prospective personnel, including persons who are not required to be registered, are subject to a disqualification under Article III, Section 4.

### Form U4 Requirements

As set forth in the Form U4, the person signing the Form U4 on behalf of the member firm must certify that he or she has taken appropriate steps to verify the accuracy and completeness of the information contained in and with the Form U4. This requires thorough review of the Form U4 and appropriate steps to verify all of the information contained in and with the Form U4, such as the applicant's 10-year employment history.

In addition, the Form U4 provides that the person signing the Form U4 on behalf of the firm must certify that the firm has communicated with all of 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. Firms should be aware that complying with this Form U4 requirement does not, in and of itself, satisfy any of the other obligations regarding background investigations of prospective personnel discussed in this *Notice*.

## Resources

To satisfy the obligations discussed in this *Notice*, firms should consider all available information gathered in the hiring process, including, but not limited to Forms U4 and U5 responses, authorized searches of the CRD, fingerprint results<sup>6</sup> and communications with previous employers. Firms must ensure that they obtain and retain the required written consent of the applicant in connection with CRD pre-registration searches. Firms also may wish to consider private background checks, credit reports and reference letters.<sup>7</sup>

Firms must ensure that personnel 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.

## Endnotes

- 1 Member firms must comply with Municipal Securities Rulemaking Board (MSRB) Rule G-7 regarding those applicants engaged solely in municipal securities activities.
- 2 Firms also must review a job 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 Securities Exchange Act of 1934 (Exchange Act). In such a case, the hiring member also is required to review a copy of the applicant's most recent Commodity Futures Trading Commission Form 8-T.
- 3 NYSE Rule 345.11 requires member organizations to investigate thoroughly the previous record of: (1) persons required to be registered with the NYSE; (2) persons who regularly handle or process securities or monies or maintain the books and records relating to securities or monies who are not otherwise required to be registered; and (3) persons having direct supervisory responsibility over persons engaged in the above activities who are not otherwise required to be registered.

For persons required to be registered with the NYSE, member organizations fulfill their investigative obligation by verifying the information contained in the Form U4 (Uniform Application for Securities Industry Registration or Transfer) and by reviewing the applicant's most recent Form U5, if the applicant previously has been registered. For persons subject to NYSE Rule 345.11 who are not required to be registered, member organizations fulfill their investigative obligation by verifying the information contained in the employment questionnaire or application required under SEC Rule 17a-3(a)(12). NYSE Rule 345.11 also requires member organizations to make further inquiry, where appropriate, in light of the background information developed, the position for which the person is being considered or other circumstances. *See also* NYSE Interpretation Handbook Rule 345.11/01.

## Endnotes (cont'd)

- 4 Dual member firms of FINRA and the NYSE also are subject to the disqualification provisions of NYSE Rule 346.
- 5 See Sections 3(a)(39) and 15(b)(4) of the Exchange Act.
- 6 Pursuant to Section 17(f)(2) of the Exchange Act and SEC Rule 17f-2, certain persons employed in the securities industry are required to be fingerprinted for purposes of a criminal background check. Firms are responsible for obtaining a prospective employee's fingerprints and certain required identifying information. Firms then submit the prospective employee's 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 firm and regulators, consistent with applicable federal laws and FBI and FINRA requirements. See *NASD Notice to Members 05-39* (NASD Suggests Best Practices for Fingerprinting Procedures) (May 2005).
- 7 To identify registered persons with a history of customer complaints, disciplinary actions or arbitrations, firms also should consider the following "best hiring practices" set forth in *NASD Notice to Members 97-19* (April 1997): (1) discuss with the applicant the nature of the applicant's prior customers and the types of securities sold while associated with prior employers; (2) obtain from the applicant explanations regarding any customer complaints and regulatory actions to determine the merit, to the extent practicable, of each before hiring; (3) ask applicants about the existence of and nature of any pending proceedings, customer complaints, regulatory investigations or arbitrations not listed in CRD; and (4) involve compliance and legal staff, as appropriate, in the hiring process, and designate an individual (above the branch manager level) or a committee to review the customer complaints, disciplinary actions or arbitrations before hiring a registered person with such a history.