

KD Alert: FINRA Targets Brokerage Firms that Hire Recidivist Brokers in New Examination and Enforcement Initiatives

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Broker-dealers often are confronted with the decision whether or not to hire registered representatives who have been the subject of customer complaints or arbitrations, disciplinary proceedings, or terminations “for cause” from prior firms. Indeed, many of these registered representatives with disciplinary “histories” leave their current firms to go to new brokerage firms when new complaints or issues arise, in a process that securities regulators sometimes refer to as “cockroaching.” Broker-dealers should be careful with regard to hiring high-risk brokers in light of new developments at the Financial Industry Regulatory Authority (“FINRA”).

On January 2, 2014, FINRA, which regulates the conduct of broker-dealers and their associated persons, published its regulatory and examination priorities for 2014. FINRA noted that among its priorities this year is an increased focus on what it terms “recidivist brokers,” or stockbrokers who have had a significant number of customer complaints filed against them, as well as the firms that have hired them. In particular, when FINRA conducts an examination of a broker-dealer that has hired such brokers, it will review the due diligence that was undertaken by the firms in connection with the hiring of each such broker and the supervision of these brokers at the firm (including the placing of these brokers under heightened supervision, if appropriate). Examiners will also closely review these brokers’ clients’ accounts for sales practice violations. This creates a strong incentive for brokerage firms to take a fresh look at their hiring practices and procedures, as employing high producing, high risk brokers will result in higher levels of scrutiny of the firms themselves.

This new examination priority follows up on FINRA’s implementation, in February 2013, of a High Risk Broker program to identify such brokers and investigate their conduct on an expedited basis. During 2013, the program identified forty two “rogue” brokers, who were categorized as such due to customer complaints, terminations, arbitrations, and field reports that discussed their conduct. Of these forty two brokers, sixteen were ultimately barred from the industry as a result of enforcement actions that were brought against them. In 2014, FINRA plans to expand this program by creating an enforcement team that is dedicated specifically to prosecuting cases involving such brokers.

In addition, FINRA is concerned about the harm that could be inflicted by brokers who move from one firm that has been the subject of serious discipline by FINRA to another broker-dealer. FINRA has described this process as “cockroaching,” an obviously unflattering term that reflects FINRA’s concern that such brokers may bring unethical or illegal practices with them to their new firm. As a result, FINRA now uses an analytical tool known as the Broker Migration Model, which is a computerized system that helps FINRA track the movement of such registered representatives from one firm to another to identify these individuals as well as the firms that hire them. FINRA uses the model’s risk scoring to prioritize its investigations and to expedite its examinations and enforcement efforts regarding the brokers and the firms that hire them.

Broker-dealers should be aware that if they hire high-risk “recidivist brokers,” both they and the broker will be subject to increased scrutiny by FINRA. Brokerage firms that do hire brokers with multiple disclosure events on their Form U-4’s (such as customer complaints, enforcement proceedings and terminations for cause) should be prepared to document their thorough pre-hire review and the bases for the hiring decision.

The attorneys at Kaufman Dolowich & Voluck, LLP have substantial experience advising broker-dealers regarding compliance with FINRA rules and regulations as well as representing broker-dealers and their associated persons in connection with enforcement proceedings, employment issues (including pre-hire reviews), and customer arbitrations. If we can be of any assistance to you in these matters please contact the attorneys in KD’s Financial Services practice.