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Self-reporting is getting complicated: Balancing FINRA's rule 4530 and the SEC's whistleblowing requirements

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FINRA rule 4530 will take effect on July 1, 2011. The new rule, part of FINRA's consolidated rulebook process, adds to the reporting requirements currently found in NASD rule 3070 and New York Stock Exchange rule 351. Specifically, broker-dealers will soon be required to: (1) notify FINRA of certain regulatory, litigation, and related events; (2) make quarterly reports of customer complaints and (3) file copies of certain criminal actions, civil complaints, and arbitration claims with FINRA. Even if rule 4530 does not mandate the reporting of a particular event, there may be occasions when a broker-dealer will still want to notify the SEC of the information in order to foreclose a characterization of "original information" under the whistleblower provisions of section 21F of the Securities Exchange Act of 1934.

Reporting requirements

Written customer complaints

Broker-dealers are required to report to FINRA any written customer complaint against the firm or any of its associated persons if the complaint alleges theft, forgery, or the misappropriation of funds or securities. "Customer" is defined as any person, other than a broker or dealer, with whom the firm engages in, has engaged in, or sought to engage in securities activities.

Even if reported to FINRA pursuant to new rule 4530 (a)(1)(B), these complaints must also be included in the firm's quarterly reports of statistical and summary information regarding written customer complaints. Further, the quarterly reports must include any written grievance by a customer with whom the firm engaged in securities activities, and any securities-related written grievance by a customer with whom the firm sought to engage in securities activities.

Criminal and civil actions and arbitration claims

A broker-dealer must report to FINRA any indictment, conviction, or guilty or no contest plea of the firm, or an associated person of the firm, that involves: (a) any felony; (b) a misdemeanor involving the purchase or sale of a security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, robbery, larceny, theft, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion or misappropriation of funds or securities; (c) activity that is substantially equivalent to any of the above; or (d) a conspiracy to commit any of those offenses or substantially equivalent activity. These actions apply to actions brought in a US court, non-US court, or military court.

FINRA must also be notified if the broker-dealer or any of its associated persons is a defendant or respondent in civil litigation or arbitration that is related to securities or commodities, or is subject to a claim for damages by a customer or broker-dealer that is disposed of for an amount exceeding $15,000 for associated persons, or $25,000 for firms. In calculating these thresholds, firms must include aggregate amounts resulting from joint and several liability as well as attorney's fees and interest.

This reporting requirement includes insurance-related civil litigation and arbitration that involves securities-insurance products or non-securities insurance products that are related to the provision of financial services. Further, claims for damages must be reported if they relate to the provision of financial services or relate to a financial transaction, such as a loan by a customer to an associated person.

Regulatory actions

A broker-dealer must report to FINRA if the firm or any of its associated persons is named as a defendant or respondent in a regulatory proceeding by a governmental regulatory authority or self-regulatory organization (SRO) alleging a violation of any securities or commodities law, rule, or regulation. Firms must also report if a securities, commodities, or insurance regulator or SRO denies membership to, or disciplines, them or any of their associated persons. Regulators and SROs include US and non-US authorities.

Reporting related to third parties

Reporting may also be required as a result of a control or other relationship of the firm or any of its associated persons. For example, if a broker-dealer is the controlling stockholder of a broker, dealer, investment company, investment adviser, underwriter, or insurance company that was suspended, expelled, or had its registration denied, or revoked by any domestic or foreign regulatory body, jurisdiction, or organization, the broker-dealer must notify FINRA. Similarly, reporting is required in the case of a financial institution, including a bank or trust company, that was convicted of or pleaded no contest to, any felony or misdemeanor in a domestic or foreign court. A report must also be filed with FINRA for an associated person who is associated in any capacity with an entity listed above, including by virtue of being a controlling stockholder, director, partner, officer, or sole proprietor of such an entity.

Statutory disqualifications

A report to FINRA is also required if a broker-dealer or any of its associated persons are subject to a statutory disqualification. A broker-dealer must also report if it or any of its associated persons is involved with any person who is subject to a statutory disqualification in selling any financial instrument, providing investment advice, or financing any such activities.

Findings

External findings

Member firms are required to report if they or any of their associated persons are found by an external body to have violated any law, rule, regulation, or standard of conduct that is related to securities, commodities, insurance, finance, or investments of any US or non-US regulatory body, SRO, or business or professional organization (collectively, "Regulatory Requirement"). An "external body" includes, among others, a court, domestic, or foreign regulatory body, SRO or business or professional organization.

Internal reviews and findings

If, on its own, a broker-dealer concludes, or reasonably should have concluded, that the firm or any of its associated persons has violated any Regulatory Requirement, the firm must make a report to FINRA. The standard for whether the firm "reasonably should have concluded" is whether a reasonable person would have concluded that a violation occurred. FINRA stated in regulatory notice 11-06 that it will rely on a firm's good faith reasonable determination.

With respect to broker-dealers, FINRA requires only that the firm report conduct that has a widespread or potentially widespread impact to the firm, its customers, or the markets, and conduct that arises from a material failure of the firm's systems, policies, or practices involving numerous customers, multiple errors, or significant dollar amounts. In the case of associated persons, firms need only to report: (i) conduct that has widespread or potentially widespread impact on the firm, its customers, or the markets; (ii) conduct that has a significant monetary result on a member firm, customer, or market; or (iii) multiple instances of any violative conduct.

Disciplinary action against associated persons

A broker-dealer must report any action that it takes against an associated person that involves a suspension, termination, or other disciplinary action that would significantly limit an associated person's activities. The firm must also report if it imposes a fine of $2,500 or more, or withholds commissions or any other remuneration above $2,500.

Former associated persons

Broker-dealers must report to FINRA any matter involving a former associated person that occurred while the person was associated with the firm, unless the firm cannot determine that the person was an associated person of the firm based on the information in Web CRD or otherwise reflected in the firm's books and records maintained pursuant to rule 17a-4(e)(1) under the Exchange Act. If information is reported on an individual's Form U5, no separate notice to FINRA is required, although relevant information must be included in the firm's reporting of quarterly statistical and summary complaint information.

Who decides whether to report

Broker-dealers have leeway to determine who within the firm is responsible for concluding whether there was a violation, but the issue must be brought to such person(s) attention. FINRA has stated that it is not a defense to assert that an issue did not merit elevating to the attention of the person(s) responsible for determining whether a violation occurred.

In addition, FINRA stated in regulatory notice 11-06 that it is possible that senior management may conclude that no violation of a Regulatory Requirement occurred, even if a department within the firm concluded otherwise.

When reports must be made

Member firms are required to report to FINRA promptly, but within no more than 30 calendar days, after the firm knows or should have known of one of the events enumerated above relating to the firm or one of its associated persons.

Exchange Act section 21F and the rules thereunder

Overview

Pursuant to section 21F of the Exchange Act, the SEC is required, under certain conditions, to pay awards to whistleblowers who voluntarily provide the SEC with "original information" about violations of the federal securities laws. The information must lead to the SEC's successful enforcement of a federal court or administrative action in which the SEC obtains monetary sanctions exceeding $1m. The information may also lead to a successful related action brought by the US Attorney General, a state attorney general in a criminal case, an SRO, or other regulatory authority.

Original information and exclusions from such designation

"Original information" is defined in rule 21F-4 under the Exchange Act as information derived from an individual's "independent knowledge" or independent analysis. Independent knowledge is based on factual information in the individual's possession and not derived from publicly available sources. Independent knowledge may be obtained through an individual's business experiences, communications, and observations. To be considered original, the information may not already be known to the SEC from another source, and not stem from an allegation made by a third party, such as the press, or through a governmental, administrative, or judicial hearing, or a governmental audit, investigation, or report.

Under certain circumstances, information that otherwise would be considered "original" will not be viewed as such. Examples that might be relevant for broker-dealers is information that was obtained: (a) through a communication that was subject to attorney-client privilege, (b) by an individual because she was an officer, director, or partner of a broker-dealer and another person informed her of the alleged misconduct, (c) in connection with the firm's processes for identifying, reporting, and remediating possible violations, or (d) by an employee whose principal duties involve compliance or internal audit responsibilities.

Notwithstanding the above, information can still be deemed original if it is not subject to the attorney-client privilege, and the relevant individual has a reasonable basis for believing that the broker-dealer is engaging in conduct that will impede an investigation of the misconduct, or that disclosure to the SEC is necessary to prevent the firm from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the broker-dealer or investors. (Information that is subject to the attorney-client privilege may qualify as eligible information if an exception from the privilege applies; *e.g.*, a crime-fraud exception under a state's conduct or bar rules. Moreover, if at least 120 days have elapsed from the time that

the individual reported the information to the broker-dealer's audit committee, chief legal officer, chief compliance officer, or his or her supervisor, or if the individual received the information under circumstances indicating that such person was already aware of the information, the information would no longer be subject to the exclusions described above.

The interplay with rule 4530

Information obtained by a broker-dealer in order to comply with rule 4530, should be reviewed and handled with a view that such information might be deemed "original information" for purposes of section 21F and the SEC's whistleblower rules. For example, even if senior management concludes that no violation of a Regulatory Requirement occurred and that a report need not be made to FINRA, an employee, even one in the internal audit or compliance department, could claim that senior management's decision not to report will result in conduct continuing that could result in injury to the firm or investors and submit the information under rule 21F-9, in hopes of receiving a whistleblower award. Another issue is that the types of events that are reportable under rule 4530 are narrower than the types of violations included under section 21F.

Compliance considerations

In preparing for new rule 4530, broker-dealers may wish to consider:

- Updating their processes for reporting quarterly statistical and summary written customer complaint information. Under the new rule, firms will need to report (1) any written grievance involving the firm or any of its associated persons by a customer with whom the firm has engaged in securities activities, (2) any securities-related written grievance involving the firm or any of its associated persons by a prospective customer, or (3) any written complaint alleging forgery or theft or misappropriation of funds or securities;

- Determining a process for documenting the nature and scope of information received regarding violations, potential violations, and customer complaints;

- Designating appropriate personnel with responsibility for receiving information about violations, possible violations, and customer complaints, and for limiting such information to persons with a "need to know";

- Developing a process for deciding whether a violation occurred and for documenting such determination;

- Designating appropriate personnel who are responsible for determining if a violation occurred and reporting any violations;

- Implementing a process for tracking customer complaints and other information that potentially could be reportable pursuant to section 21F to make sure that the matter is resolved in a timely matter;

- Developing appropriate documentation procedures with a mindful eye that the information might be obtained by FINRA, the SEC, or another party in the future;

- Reviewing multiple reports for consistency in reporting and characterization;

- Providing training to associated persons to remind them of their obligation to report to legal or compliance any reportable event under rule 4530; and

- Reviewing processes for designating communications as privileged.

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