

**THE USE OF THIRD PARTY SUBPOENAS TO DETERMINE A BROKERAGE FIRM'S
PRE-HIRING DUE DILIGENCE AND POST-HIRING SUPERVISION**

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I. INTRODUCTION

What did the brokerage firm know or should have known about an employee prior to hiring and during employment? This question is often answered by the issuance of third party subpoenas to an associated person's prior or post employer. A third party subpoena issued to a prior or post employer is a valuable tool in obtaining discovery in instances where a brokerage firm's pre-hiring due diligence or post-hire supervision are at issue.

The need for third party subpoenas can arise in certain case specific circumstances. When a potential hire has become the subject of disciplinary or regulatory actions, customer complaints, settlements, terminations, frequently moves between brokerage firms or has a less than desirable track record in managing their own finances it is important to obtain discovery from all prior and post employers relating to the specific circumstance. Seeking an associated person's personnel file and communications from prior and post employers can lead to discovery of admissible evidence during the arbitration hearing.

II. OBTAINING A PERSONNEL FILE THROUGH THE USE OF THIRD PARTY SUBPOENAS

FINRA Rules 12512 and 12513 set forth the process and procedures for issuing third party subpoenas.¹ FINRA Rule 12512 requires that the requesting party file a written motion

¹ See Code of Arbitration Procedure for Customer Disputes, FINRA Rule 12512 and 12513 available at http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4096&record_id=5174&filtered_tag= (last visited June 23, 2015).

with FINRA which includes a draft subpoena.² A typical subpoena seeking an associated person's personnel file may include, *inter alia*, the following language:

The associated person(s) personnel file including, but not limited to: Form U-4, Form U-5, employment application, employment agreement, promissory notes, letters of reprimand and commendation, and letter of resignation or any documents that mention, relate or pertain to any inquiry or investigation of the associated person(s).

To overcome any objections the respondent brokerage firm and or third party prior or post employment firm may assert it is important to cite language contained on the Form U4 (Uniform Application for Securities Industry Registration or Transfer). On the Form U4 a registered representative acknowledges and consents as follows:

I authorize all of my employers and any other person to furnish to any jurisdiction, SRO, designates entity, employer, prospective employer, or an agent acting on its behalf, any information they have, including without limitation my creditworthiness, character, ability, business activities, educational background, general reputation, history of my employment and, in the case of former employers, complete reasons for my termination. Moreover, I release each employer, former employer and each other person from any and all liability, of whatever nature, by reason of furnishing any of the above information, including that information reported on the Uniform Termination Notice for Securities Industry Registration (Form U5). I recognize that I may be the subject of an investigative consumer report and waive any requirement of notification with respect to any investigative consumer report ordered by any jurisdiction, SRO, designated entity, employer, or prospective employer, I understand that I have the right to request complete and accurate disclosure by the jurisdiction, SRO, designated entity, employer or prospective employer of the nature and scope of the requested investigative consumer report.³

FINRA Rules and guidance also set forth a brokerage firm's supervision and due diligence requirements. FINRA Rule 3010(e) governing Supervision states in pertinent part:

(e) Qualifications Investigated

Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making

² FINRA Rule 12512 available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4166&filtered_tag= (last visited June 23, 2015).

³ Form U4 (Uniform Application for Securities Industry Registration or Transfer) available at https://www.finra.org/sites/default/files/Form_U4_060115.pdf (last visited July 27, 2015).

such a certification in the application of such person for registration with this Association.⁴

In November 2007 FINRA issued Regulatory Notice 07-55 which states:

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 of a statutory disqualification or whether he or she may represent 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.

...

To satisfy the obligations discussed in this Notice, firms should consider all available information gather in the hiring process, including, but not limited to Forms U4 and U5 responses, authorized searches of the CRD, fingerprint results and communications with previous employers.

...

Firms also may wish to consider private background checks, credit reports and reference letters.⁵

In March 2015, the importance of background checks were reiterated by FINRA in Regulatory Notice 15-05 which states:

FINRA Rule 3110(e) requires that each member firm ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the firm applies to register that applicant with FINRA and before making a representation to that effect on the application for registration. This is a principle-based requirement, and it is substantially similar to the requirement under NASD Rule 3010(e). Firms are required to complete the investigation process prior to filing the Form U4. Further, FINRA does not place any limits on the scope of such a background investigation—a firm must obtain all the necessary information to make an evaluation. [footnote omitted] Firms should consider all available information gathered in the pre-registration process for this purpose, including, but not limited to, Form U4 and Form U5 (Uniform Termination Notice for Securities Industry Registration) responses, authorized searches of the CRD system, fingerprint results obtained under SEA Rule 17f-2 and communications with previous employers. Firms also may wish to consider private background checks, credit reports and reference letters for this purpose. However, firms must ensure that such background investigations are conducted in accordance with all applicable laws, rules and

⁴ FINRA Rule 3010 available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3717 (last visited June 23, 2015).

⁵ FINRA Regulatory Notice 07-55 available at <http://www.finra.org/sites/default/files/NoticeDocument/p037480.pdf> (last visited June 23, 2015).

regulations, including federal and state requirements, and that all necessary approvals, consents and authorizations have been obtained.⁶

The discovery of an associated person's employment file from a previous employer is reasonably calculated to discover what due diligence – if any – was conducted by the current and post employer prior to hiring the associated person and what the current and post employer actually knew or should have known about the associated person's employment at another brokerage firm. The associated person's employment file would provide relevant information including, *inter alia*, as follows:

- Customer complaints (written and verbal; reported and unreported);
- Litigation involving the associated person (civil, criminal, *etc.*);
- Documents relating to reprimand and/or wrongdoing while employed;
- Documents relating to financial duress (tax liens, unpaid promissory notes, *etc.*).

Since due diligence is required prior to the filing of an associated person's registration papers and is conducted at the time of hiring of all persons in the securities industry,⁷ information about past employment is critical in making the threshold determination whether to hire and what level of supervision is required of a new hire (*i.e.*, heightened or special supervision). If the associated person had a number of customer complaints, is involved in litigation and/or has engaged in a pattern of wrongdoing, the respondent firm should consider placing the associated person on heightened or special supervision. If the brokerage firm has failed to institute an appropriate level of added supervision this may help support and or give rise to a claim for failure to supervise.

⁶ FINRA Regulatory Notice 15-05 available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-05.pdf (last visited June 23, 2015).

⁷ See FINRA Rule 3010(e), FINRA issued Regulatory Notice 07-55 and FINRA in Regulatory Notice 15-05 discussed on pgs. 2-3, *supra*.

The use of information related to an employee's own finances is a critical part of the hiring process. If the associated person is under financial duress they may be more likely to engage in conduct that puts their own interests ahead of the interests of the customer. Financial duress caused by an employee's inability to properly manage their own affairs is also an indication that the associated person may not be able to properly manage the affairs of others. Examples of discoverable financial problems relating to a broker include unpaid promissory notes and tax liens. Such financial problems may ultimately lead to a broker soliciting clients to borrow money which the brokerage firm knew or should have known about.

III. OBTAINING COMMUNICATIONS THROUGH THE USE OF THIRD PARTY SUBPOENAS

As set forth in Section II, *supra*, FINRA Rule 12512 requires that the requesting party files a written motion with FINRA which includes a draft subpoena.⁸ A typical subpoena seeking an associated person's communications at prior or post employment firms may include, *inter alia*, the following language:

All documents including, but not limited to, correspondence, emails, text messages, instant messages, telecopies, memos, notes, phone records, telephone message pads, billing records or invoices, diaries, journal entries, inter-office memos and tape recordings that mention, relate or pertain to the associated person.

To overcome any objections the respondent brokerage firm and or third party prior or post employment firm may assert it is important to cite FINRA Rules and guidance. FINRA Rules and guidance set forth a brokerage firm's requirements. FINRA Document Production List 1, Request Nos. 2, 6 and 8 state:

2) All correspondence sent to the customer parties or received by the firm/associated persons relating to the claims, accounts, transactions, or products or types of products at issue including, but not limited to, documents relating to asset allocation, diversification, trading strategies, and market conditions; and all advertising materials sent to customers

⁸ FINRA Rule 12512 available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4166&filtered_tag= (last visited June 23, 2015).

of the firm that refer to the products and/or account types that are at issue or that were used by the firm/associated persons to solicit or provide services to the customer parties. (In addition, if requested, the firm/associated persons shall produce confirmation slips and monthly statements. Even if not requested, the firm/associated persons must produce confirmation slips and monthly statements that have handwritten notations or that are not identical to those the firm sent to the customer parties.);

6) All notes the firm/associated persons made relating to the customer parties and/or the customer parties' claims, accounts, transactions, or products or types of products at issue, including, but not limited to, entries in any diary or calendar, relating to the claims or products at issue; and

8) All recordings, telephone logs, and notes of telephone calls or conversations about the transactions at issue that occurred between the associated persons and the customer parties (and any person purporting to act on behalf of the customer parties), and/or between the firm and the associated persons.⁹

Further, in December 2007 FINRA issued Regulatory Notice 07-59 which states:

FINRA appreciates the supervisory challenges firms face given the ever-increasing pace of change in electronic communications technology. However, as FINRA noted in the context of addressing the supervision and recordkeeping requirements for text messaging, a member firm's obligations to supervise electronic communications are based on the content and audience of the message, rather than the electronic form of the communication. Consequently, as indicated in the proposed and final guidance, FINRA expects a firm to have supervisory policies and procedures to monitor *all* electronic communications technology used by the firm and its associated persons to conduct the firm's business. To that end, a firm should consider, prior to implementing new or different methods of communication, the impact on the firm's supervisory system, particularly any updates or changes to the firm's supervisory policies and procedures that might be necessary. In this way, firms can identify and timely address any issues that may accompany the adoption of new electronic communications technologies. Finally, firms are reminded that they have a separate, but equally important, obligation to ensure that their use of electronic communications media enables them to make and keep records, as required by SEC Rules 17a-3 and 17a-4, NASD Rule 3110 and NYSE Rule 440.¹⁰

It is prudent to use third party subpoenas to obtain emails, text messages and instant messages. These types of documents may evidence a personal relationship that the brokerage

⁹ FINRA Discovery Guide (2013) available at <http://www.finra.org/sites/default/files/ArbMed/p394527.pdf> (last visited July 1, 2015).

¹⁰ FINRA Regulatory Notice 07-59 available at <https://www.finra.org/sites/default/files/NoticeDocument/p037553.pdf> (last visited July 1, 2015).

firm should have been aware of and which may influence the management of a customer's account. In a case where the closeness or familiarity of the principal parties is at issue, such documents may prove to be critical. Text messages, emails and instant messages may also evidence the timing or existence of communication among key persons.

These types of documents may also support a claim for misrepresentations and failure to supervise if the brokerage firm failed to monitor the associated person's communications, including texts and instant messages relating to their accounts. For instance, a broker engages in gambling activity which is evidence by text messaging through a phone provided by the broker firm and ignored.

IV. CONCLUSION

With these rules and guidance in mind, it is evident that relevant due diligence documents may exist in a pre or post employment firm's personnel file. If the associated person(s) has a pattern of disciplinary or regulatory action that occurred prior to the complained of wrongful conduct, an unstable employment history or financial history the previous firm's personnel files may help support a claim that the respondent firm failed to conduct due diligence prior to their hiring. If the associated person has a pattern of disciplinary or regulatory action that occurred after the complained of wrongful conduct, an unstable employment history or unstable financial history the post firm's personnel file may help support a claim that the respondent firm failed to supervise an associated person during the course of their employment.