Don’t Get Egg On Your Face!
Ensure That Your Settlement With A State Regulator Does Not Result In Inadvertent Statutory Disqualification

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INTRODUCTION

My son, like most teenage boys, spends his fair share of time (read that “every waking minute”) devoting himself to achieving higher and higher skill levels in the video games he received for Christmas that make Pac-Man and Asteroids – the games into which I poured my share of quarters way back when – seem as quaint and unsophisticated as an 8-track tape player. For reasons that are unclear to me, perhaps, their own amusement, the people who program modern games often hide within the millions of lines of code “easter eggs,” clever little surprises, such as a new and better weapon, that are revealed, typically, by pressing some complex sequence or combination of buttons. Based on my limited research, it seems that the discovery of such easter eggs is a happy event; indeed, entire websites are devoted to sharing the well hidden locations of easter eggs.

FINRA, unfortunately, has a different view of easter eggs. Sadly, buried among the dozens and dozens of pages of the July 2007 amendments to NASD’s By-Laws that were necessitated by NASD’s consolidation with NYSE Regulation, is one easter egg that, when accidentally discovered, will not bring a smile to anyone’s face. The amendment in question served to change the definition of ‘Statutory Disqualification.’ As a result of this seemingly modest amendment, which, interestingly, had nothing whatsoever to do with the consolidation, it has become much more difficult for individuals and firms who have been charged with violations of state securities laws to resolve those charges without the need for an evidentiary hearing.

Why? Like most attorneys who defend broker-dealers and registered representatives who have been named as respondents by a state securities commissioner, up until July 2007 I often resolved the charges through the use of a Consent Agreement. The Agreement would include a recitation that some provision of the state law had been violated, and, sometimes, to avoid a large (or, sometimes, any) monetary sanction, an agreement by the respondent permanently to cease conducting business in that particular state. Prior to the amendment in question, such Consent Agreements did not prevent the respondent from remaining a member, or associating with a member, of NASD. All of that changed with FINRA’s easter egg. Now, as a result of the new definition of ‘Statutory Disqualification,’ such a Consent Agreement may result in the respondent’s inadvertent statutory disqualification. Therefore, any such Consent Agreement should be carefully considered in light of the amended definition.

STATUTORY DISQUALIFICATION UNDER THE OLD NASD RULE

Disqualification is pretty much what the common definition of the word implies: once you are disqualified, you are out of the game. Statutory Disqualification simply means that there are certain events, defined in the statute, that will render one disqualified. Article III, Section 3 of FINRA’s By-Laws provides that no member shall be continued in membership if it becomes subject to disqualification; and that no person shall be associated with a member, continue to be associated with a member, or transfer association to another member if such person is or becomes subject to disqualification. Generally, a person subject to disqualification may not associate with a FINRA member in any capacity unless and until approved in an Eligibility proceeding, which is a long, difficult and expensive proposition, and which comes with only a very small likelihood of success. *See* Article III, §§ 3(b) and 3(d). Accordingly, disqualification should, for the most part, be considered permanent and final.

Prior to July 30, 2007, Article III, Section 4 of NASD's By-Laws provided that a person was subject to disqualification with respect to membership, or association with a member if such person fell into any of a number of specifically enumerated categories listed in the rule. This rule, while very similar to the § 3(a)(39) of the Securities Exchange Act of 1934 (15 U.S.C. § 78a, et seq.) (the "Exchange Act"), had two significant differences: according to NASD a respondent was **not** statutorily disqualified as a result of being "subject to any final order of a State securities commission… that…(1) bars a person from association with an regulated by such commission…or…(2) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct." §§ 3(a)(39) and 15(b)(4)(H) of the Securities Exchange Act of 1934. Thus, a registered representative facing a state investigation into an alleged violation of state securities laws could safely resolve that investigation by entering into an agreement with the state consenting to findings of state law violations and significant sanctions without affecting his or her standing as an associated person of an NASD member.

STATUTORY DISQUALIFICATION UNDER THE NEW FINRA RULE

Under the new definition of 'Statutory Disqualification' in FINRA's By-Laws, the laundry list of events triggering statutory disqualification was replaced with a single sentence: "A person is subject to a 'disqualification' with respect to membership, or association with a member, if such person is subject to any 'statutory disqualification' as such term is defined in Section 3(a)(39) of the Act." The danger with this definition, as amended, is that the import of the change is not immediately apparent unless the By-Law is read in conjunction with two additional statutes.

The starting point is Section 3(a)(39)(F) of the Exchange Act, which provides, among other things, "[a] person is subject to a 'statutory disqualification' with respect to membership or participation in, or association with a member of, a self-regulatory organization if such person . . . has committed . . . any act, or is subject to an order or finding, enumerated in subparagraph (D), (E), (H) or (G) of paragraph (4) of section 15(b)."

The pertinent subparagraph of section 15(b) that a respondent who is considering a Consent Agreement to settle with a state needs to worry about is (H), which states as follows:

> is subject to ***any final order of a State securities commission*** (or any agency or officer performing like functions) . . . that --
>
> (i) bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities or credit union activities; or

(ii) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct." (emphasis added).

AVOIDING INADVERTENT STATUTORY DISQUALIFICATION

Under the new definition, therefore, to avoid being declared statutorily disqualified, a respondent cannot sign a Consent Agreement with a state that includes a bar or a finding of a violation of any state laws or regulations that "prohibit fraudulent, manipulative, or deceptive conduct." § 15(B)(4)(H). Unfortunately, as noted above, Consent Agreements respondents typically use to effect settlements with states include one, or both, such provisions. The result – a settlement with a single state that inadvertently renders the respondent disqualified from doing any business with anyone anywhere – can be devastating.

Therefore, before signing any agreement that includes a finding of any violation of any state securities law or regulation, or a sanction that includes a willingness to have one's state registration cancelled permanently, be sure to keep in mind FINRA's new definition of Statutory Disqualification. The amended definition also affects the obligations of member firms. Under FINRA Conduct Rule 3010(e), a member firm is obliged to 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. Thus, the member firm must pay careful attention to an applicant's answers to Question 14D(2) on Form U-4, which elicits information about state regulatory actions, to determine whether an applicant is subject to any final order of a State securities commission that would render him disqualified. Significantly, while orders barring an applicant from engaging in business are easy to identify, orders that constitute findings of "violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct" can be more complicated, and certainly less obvious. At a minimum, it is safe to say that member firms should carefully consider the impact of hiring someone who is subject to any final order from a state securities commission that arguably falls into that category.