

FORM U-5 DEFAMATION LIABILITY; A SLIPPERY SLOPE

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When a registered person leaves his or her employment with a broker-dealer, the departing firm has an obligation to file a standardized document, known as a Uniform Termination Notice for Securities Industry Registration, or Form U-5 (U-5), with the NASD's Central Registration Depository (CRD) notifying the NASD that the registered person no longer is employed by the firm.¹ The firm is required to file a U-5 within thirty days of the date the registered person's employment with the broker-dealer officially terminated.² Typically, the former employing firm completes the U-5, submits it to the NASD and sends a copy to the departing employee.²

The departing employee rarely, if ever, sees the actual, completed U-5 before it is filed with the NASD which creates risk for the broker-dealer. Once filed, a U-5 cannot be revoked, it can only be amended and usually only with great difficulty and resistance from the NASD. Once it is filed, it remains a matter of public record that the departing employee carries with him or her typically for the balance of their career in the securities industry. In very rare instances, if the terminating firm wishes to take the time and energy, it can assist a former registered person in revising the U-5.

Over the past decade or so, there have been a growing number of arbitrations and litigations arising out of filed U-5s in which former registered persons have alleged, many with great success, that their former employer defamed, libeled and damaged the departing employee by filing a less than accurate U-5. The potential liability, in fact, has been so great to broker-dealer firms that many of the damage awards to former employees for U-5 defamation claims have dwarfed the typical public customer award. Arbitration panels in particular have taken a very harsh view of employers who do not carefully and accurately reflect the circumstances and facts surrounding the reason the registered person left the broker-dealer. That potential liability, which can run into the millions of dollars, underscores the need to both accurately and carefully document and complete the U-5. While typically left to lower echelon HR or Compliance personnel to complete, due to the enormous potentially detrimental effect of a misleading, inaccurate or carelessly completed U-5 on a representative's employment and career opportunities, virtually all U-5's should be reviewed by counsel or senior Compliance personnel and particularly in the case of a difficult termination or negotiated severance.

The largest single area of dispute arising out of filed U-5s is the reason for termination. The actual form, now completed on line at the broker-dealer through a direct connection with the NASD's CRD, has five options under "Reason for Termination": "voluntary", "permitted to resign" "discharge" "other" and "deceased". In the industry, a "voluntary" termination rarely raises any questions and is considered to be a "clean" mark on a registered person's employment history. A voluntary termination simply does not raise any "red flags" and requires no explanation. On the other side of the spectrum, "discharge" connotes a firing for cause and is considered a black mark on a representative's employment record. In the context of "discharge" terminations, if, in fact, the representative was fired for

breach of a company or industry rule or for a serious, material infraction, it is important that the termination and the reason for firing be well documented and justifiable. So long as the termination was triggered by a violation of a serious, material nature, and the reasons can be documented, there typically are little or no problems. Be aware that the NASD will generally open an investigation and you will be required to show the investigator your documentation that led to the termination.

The overwhelming majority of disputes involving defamation claims and U-5 filings arise out of the more amorphous, "permitted to resign" designation. It is generally accepted throughout the securities industry that a "permitted to resign" designation on a U-5 is a "warning [device] to a prospective employer that there may be some questions to ask regarding customer complaints or administrative problems, possible regulatory problems". One NASD hearing officer called a "permitted to resign" designation "a red flag and a warning mechanism". Typically, a "permitted to resign" designation is considered by prospective employers to be the same as a "discharge" termination and many firms have policies of either not interviewing or not hiring prospective employees with either a "permitted to resign" or "discharge" termination on their record.

As the industry undergoes retrenchment, and employers can be more particular about whom they interview and hire, coupled with the increasing public disclosure requirements and availability of the employment histories of registered persons from the CRD, information contained in the Form U-5 can have a material effect on a broker's ability to survive and prosper in this industry. Conversely, terminating firms are exposed to greater levels of scrutiny and accountability for filing false, careless or inaccurate U-5s.

Our Recommendation

Most terminations are not potential problems. Voluntary terminations should be documented as such. If the firm mutually agrees that a broker should leave, carefully consider whether to treat such severance as voluntary or permitted to resign. Checking "permitted to resign" is tantamount to affixing a big, red "warning" sign to the departing employee for all future, potential employers. While a firm faces little risk of any liability to third parties for checking "voluntary" termination, there is great potential risk and exposure when checking "permitted to resign". Particularly in those instances where the broker's exit is the result of a mutual decision and negotiation, it is safer to err on the side of "voluntary" termination than place the departing firm and broker at risk with the negative connotation associated with "permitted to resign".

¹ NASD Rule 1021 (Registration Requirements All Principals); NASD Rule 1031 (Registration Requirements All Representatives)

² Bylaws of the National Association of Broker Dealers Article 5, Sec. 3(a) Following the Termination of the association with a member of a person who is registered with it, such member shall, not later than 30 days after such Termination, give notice of the Termination of such association to the NASD via electronic process or such other process as the NASD may prescribe on a form designated by the NASD, and concurrently shall provide to the person whose association has been terminated a copy of said notice as filed with the NASD. A member that does not submit such notification and provide a copy to the person whose association has been terminated, within the time period prescribed, shall be assessed a late filing fee as specified by the NASD. Termination of registration of such person associated with a member shall not take effect so long as any complaint or action under the Rules of the Association is pending against a

member and to which complaint or action such person associated with a member is also a respondent, or so long as any complaint or action is pending against such person individually under the Rules of the Association. The NASD, however, may in its discretion declare the Termination effective at any time.

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