

Legal Risk Management Tip March 2015

FORM U5: REPORTING AND BEYOND

Introduction

When an individual leaves a broker-dealer or an investment advisory firm, the former company has an obligation to notify regulatory authorities of the departure and for reasons other than a voluntary or partial termination, is required to provide an explanation of the reasons that the employee-employer relationship ended.

This month's Legal Tip focuses on Form U5 and how the termination of an associated person's registration with a Member Firm might be reported, certain types of issues that may arise and possible steps associated persons can take to change language reported on their Form U5.

To facilitate this discussion, we have created a hypothetical scenario to highlight some of the relevant considerations that relate to Form U5 reporting.

Hypothetical Case Study

A successful broker decides to transition to a new firm and provides notice to his broker-dealer employer. For two weeks the broker enjoys what seems to be a smooth transition. Three weeks later, the broker receives notice that his former employer has filed Form U5 relating to termination of his employment, which includes an explanation of the broker's departure that is inaccurate and potentially defamatory. It turns out that the broker, while highly productive, had an outside business activity that his former company did not ever formally approve in writing, but knew about. Although the broker resigned voluntarily, the former company reported the broker's reason for separating as "Permitted to Resign" on Form U5, accompanied by an explanation that stated, "Broker resigned after unapproved outside business activity identified." This information is now available for the new broker-dealer to view and is publicly displayed via BrokerCheck.¹ Of course, the broker did not think there were any issues to disclose when interviewing with his new shop, and now is being asked a number of hard questions about this recent Form U5 filing.

In this scenario, the broker is in a tough spot. He worked hard to get a new job and does not want to lose it. He calls his old employer to discuss, and the employer takes the position that the information on the U5 is accurate and is unwilling to voluntarily modify it. What options does the broker have?

In order to explore the broker's available options, we need to understand important details about Form U5 and the related reporting processes.

¹ BrokerCheck is available at <http://www.finra.org/>.

What is Form U5?

Form U5 is the Uniform Termination Notice for Securities Industry Registration used by broker-dealers and investment advisers to report information about a variety of matters regarding a registered representative (an “associated person”) of that firm.² The information on Form U5 is stored in the Central Registration Depository (“CRD”)³ system, where securities firms and regulatory authorities may report a variety of disclosure events, including civil judicial actions, criminal matters, customer disputes (customer complaints, arbitrations, and civil litigations), employment terminations, internal reviews (*i.e.*, a review of a broker’s conduct by his or her former firm), investigations, financial matters and regulatory actions.

Why is Form U5 Important?

Form U5 is a regulatory disclosure document that contains important information used by a number of parties for a variety of reasons:

1. FINRA, the SEC and the states use the information to help identify and sanction individuals who violate industry rules and applicable state statutes and federal regulations;
2. Regulatory and licensing authorities use the information to make informed registration and licensing decisions;
3. Member Firms use the information to help them make informed employment decisions; and
4. Investors use the information when considering whether to do business with a registered (or formerly registered) person.⁴

When is a Form U5 Filing Required?

Firms must file Form U5 within 30 days after the termination of an associated person’s registration with the employer.⁵ In addition, firms are required to update or amend information on Form U5 whenever the firm becomes aware that the previous filing contains inaccurate or incomplete information.⁶

What Information is Reported When an Associated Person Leaves a Member Firm?

Section 3 of Form U5 requires that the firm provide a reason for the termination of the associated person’s registration with that company. The available choices on Form U5 are: “Discharged,” “Other,” “Permitted to Resign,” “Deceased,” or “Voluntary.”⁷

If the reason for Termination is “Permitted to Resign,” “Discharged,” or “Other,” a Member Firm must provide an explanation of the relevant facts and circumstances in a manner that provides sufficient detail such that a reasonable person may understand the facts and circumstances that triggered the

² FINRA Form U5 Instructions.

³ CRD is an online registration and licensing system that contains administrative and disclosure information about brokerage firms and associated persons. See Jisook Lee, *A Closer Look at Expungement: Asking the Right Questions*, 4 The Neutral Corner (2013).

⁴ FINRA Regulatory Notice 10-39.

⁵ FINRA By-Laws, Article V, Section 3; FINRA Regulatory Notice 10-39.

⁶ FINRA Regulatory Notice 10-39.

⁷ For more information related to the Form U5 instructions, see

<http://www.finra.org/sites/default/files/AppSupportDoc/p015113.pdf>.

response.⁸ It is in this explanation section that many issues manifest themselves, and the language is often prepared solely by a Member Firm with no input from an associated person.

Can the Form U5 Be Amended or Changed?

A common question often posed by brokers is can the Form U5 be amended or changed once it has been filed by the former employer. The answer is – it depends.

Perhaps the best way to address this is for the broker to specifically inquire before he departs his employer what the intended Form U5 disclosures will be. That will provide an opportunity to discuss the termination reason and explanation prior to such disclosures being filed.

If the broker is unable to have this discussion prior to leaving the firm's employ, consider the following:

Engage Counsel Before the Form U5 is Filed

If the reason for termination is Permitted to Resign, Discharged or Other, the broker is aware that an explanation will be included on the Form U5. For this reason, the broker may wish to engage counsel to have discussions with the former employer prior to the Form U5 submission (which must occur within the first 30 days of the broker's termination from the company). Taking this initiative to discuss particulars could help to better ensure that the stated reasons provided by the former employer accurately reflect the circumstances surrounding the termination, and avoids future associated costs with amending or changing the Form U5 language down the line. Importantly, in accordance with FINRA Notice to Members 10-39, the Form U5 language must contain sufficient detail, "that a reasonable person may understand the circumstances that triggered an affirmative response."⁹

As discussed below, once Form U5 is submitted, it becomes more difficult¹⁰ for an associated person to modify or change.

Expungement

In the absence of any other formal method to modify Form U5 language, associated persons have little choice but to seek change to U5 language through the expungement process.¹¹ Expungement is considered an extraordinary remedy that should be recommended only under appropriate circumstances. Once information is expunged from the CRD system, it is permanently deleted and thus no longer available to the investing public, regulators or prospective broker-dealer employers.

⁸ FINRA Regulatory Notice 10-39.

⁹ Found at <https://www.finra.org/sites/default/files/NoticeDocument/p122040.pdf>.

¹⁰ Although technically, a firm has the ability to amend Form U5 voluntarily, this is unlikely to occur. Many firms are reluctant to modify the Form U5 language once reported as doing so may be perceived as a reporting error. Any modification, voluntary or otherwise, is expected to be scrutinized by the regulators, and the reasons for such modification will need to be explained by the broker-dealer or investment advisory firm. To further decrease the likelihood of a voluntary amendment, if a firm does not follow the Form U5 reporting guidelines, FINRA has the ability to impose civil and administrative penalties. See FINRA Regulatory Notice 10-39.

¹¹ This Legal Tip focuses on Intra-industry expungement. The rules and requirements of expungement when a customer dispute is involved are different. For rules applicable to customer dispute issues, see, e.g., FINRA Rules 2080, 2081, 12805, 13805.

Expungement is obtained through a process where an associated person seeks a formal order from an arbitration panel requiring a firm to modify the reported language on Form U5. In order for FINRA to grant expungement in an intra-industry dispute, it must do so pursuant to an arbitration award. To initiate the expungement process, an associated person must file for arbitration against her former employer specifying the reason expungement is proper and setting forth the basis for expungement relief. A FINRA arbitration panel can order expungement if information on Form U5 is found to be defamatory, misleading, inaccurate or erroneous. An associated person seeking arbitration will typically need to provide substitute language to replace the text subject to expungement.¹²

Once a panel awards expungement, depending on the particulars,¹³ a separate court order typically is required to compel FINRA to implement the relief granted by the arbitration panel.

Application to Hypothetical Case Study

Considering the above hypothetical, it appears that the broker-dealer reported that the broker was permitted to resign, when in actuality, the broker voluntarily resigned, which is not accurately reflected on the current filing. It also is unclear whether the Form U5 termination explanation is incorrect or defamatory, but, based on what is known so far, it seems to be causing the broker problems.

The broker has some options. First, he should consider engaging counsel to explore whether the broker-dealer disclosure is indeed inaccurate. If it is, the broker appears to have a viable basis to seek expungement. While there is no guarantee that the expungement process will result in amended or changed language on the broker's Form U5, it will initiate a FINRA arbitration proceeding that could do just that. If the arbitration panel finds for the broker in the proceeding, then the panel can direct expungement of defamatory information.

Conclusion

Should expungement be sought, the broker and his counsel will need to devote time, energy and expenses to work through the FINRA arbitration process. Being proactive, having open communications with the former employer upon termination and engaging counsel as needed may help the departing broker to avoid expungement later. However, ultimately the employing firm is responsible for filing the termination reason and explanations in Form U5 and there is no assurance that the broker will be given an opportunity to discuss these disclosures prior to the Form U5 filing. But it does not hurt to try.

For more information on these and other considerations, please contact us at (619) 298-2880 or at info@jackolg.com.

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¹² See John Nachmann, *Expungement of Information from the Central Registration Depository in Intra Industry Disputes*, 2 The Neutral Corner (2010).

¹³ If arbitrators award expungement relief and also determine that the information filed on Form U5 is defamatory in nature, FINRA will expunge the information without a court order. See 4 The Neutral Corner (2013).