CARLTON FIELDS

Avoiding a Messy Break-Up: How a Firm's Investigation Can Deflect a Financial Advisor's Form U-5 Defamation Claim

FINRA LITIGATION, ENFORCEMENT AND INVESTIGATIONS | SECURITIES AND DERIVATIVE LITIGATION |
MAY 3, 2016

John E. Clabby

Erin J. Hoyle

Breaking up is hard to do. In the investment industry, it can be even harder because one half of the couple needs to publish the reasons for the break-up.

When a registered representative separates from a broker-dealer or an investment advisory firm (collectively, "firm"), the firm must notify the appropriate state securities regulators and self-regulatory organizations (SROs), such as the Financial Industry Regulatory Authority (FINRA). If the terminating event is involuntary, the firm must provide a brief explanation. This mandatory reporting exposes the firm to a risk of a defamation claim by the registered representative who may be angry at how his or her former firm described any failings. But with a thorough investigation and careful drafting, a firm can both fulfill its Form U-5 obligations and avoid hundreds of thousands — and even millions — in a later arbitration award.

A firm's duty to notify requires a "Uniform Termination Notice for Securities Industry Registration," or Form U-5, filed with FINRA's Central Registration Depository (CRD) within 30 days of the registered representative's departure. The firm must indicate whether the registered representative left voluntarily, was permitted to resign, or was discharged. Further, the firm must state whether the registered representative was involved in any disciplinary action, consumer-initiated complaints, felony or misdemeanor crimes, governmental or regulatory investigations, or was under review by the firm for misconduct. For this task, the devil is in the details.

Typically, the firm submits the completed U-5 to FINRA and sends a copy to the departing employee. The U-5 serves a number of constituencies: (i) governmental and regulatory agencies identifying individuals who violate applicable industry rules, state statutes, and federal regulations; (ii) regulatory and licensing authorities making registration and licensing decisions; (iii) potential employers; and (iv) investors considering whether to do business with a registered representative. Because U-5 filings remain filed in the CRD, a negative U-5 may shadow a registered representative for the remainder of his or her career. Any negative commentary, even if truthful, damages a registered representative's reemployment, client base, and career trajectory. It is not surprising that, in the past decade, damages awards from successful U-5 defamation claims have reached hundreds of thousands of dollars, and, in a few high-profile cases, millions.

State law governs U-5 defamation claims. In most states, a brokerage firm holds a qualified privilege to defame and will only be liable for false and defamatory statements if it knew the statements were false or if it recklessly failed to determine whether the statements were false. To prevail, a registered representative must show that: (i) the employer's investigation was inadequate; (ii) it carelessly said more than needed; or (ii) it was motivated by ill will or spite.

Additionally, most U-5 defamation claims are subject to FINRA arbitration and its Code of Arbitration Procedure for *Industry* Disputes, in which the arbitrators are not strictly bound to the law and need not apply a qualified privilege defense. As a result, a firm considering a termination needs to be aware that while these proceedings have something of a "Wild West" quality, they still reward thorough, pre-termination investigation — the sort that asks questions first, and shoots later.

To reduce liability, firms should deploy proactive measures for accurate, circumspect filings that satisfy the regulatory requirements and minimize the likelihood of a defamation suit.

FINRA requires employers to confirm that factual support for the statements and representations in the filing exists at the time the U-5 is filed. Finding support after a lawsuit or demand has been served comes too late. The best investigations start when the potential wrongful conduct is first identified. Here are a few tips:

1) Conduct a thorough investigation.

When termination is a possibility for a U-5-eligible employee, a firm should deploy its internal investigation team. The team should preserve and review relevant documents, including customer complaints, and interview knowledgeable employees. If at all possible, investigators should obtain a statement from the subject employees or from other employees that may have knowledge of the misconduct.

The drafting process for the U-5 then can hew closely to the investigation's written findings, so that any later defamation claim has a built-in set of supporting documents, with relevant witness statements and other proofs at the ready. Diligent confirmation of the U-5 disclosures, and separate documentation of the proof behind those disclosures, demonstrates that a potentially defamatory statement was not knowingly or recklessly false.

Demonstrating a good faith investigation can go far in an arbitration setting, where standards are often less rigorous, and the panel is focused instead on who is in the wrong, comparatively. Outside counsel is essential for decisions affecting management, supervisors, or a significant employee, both for the protection of the privilege and for proper documentation of the investigation.

2) Watch your language.

The explanatory sections of a U-5 should be as concise as possible and convey only the information required. Discussing only those facts that are relevant to the termination limits the likelihood the U-5 will contain false or inaccurate statements that could form the basis for a defamation claim. Avoid any language that could be misconstrued as inflammatory.

The U-5 requires truthful reporting, but firms can still strive for diplomacy. To this end, a fact that might otherwise appear extraneous can be crucial. For example, rather than stating that a registered representative "falsified the client's signature," a firm could deploy less inflammatory language with exculpatory details where applicable, such as "signed client's name on form, with client's permission, but in violation of company policy."

3) No "whitewashing."

The line that a firm walks in drafting a Form U-5 disclosure is a fine one, with potential defamation liability on the one side and regulatory liability on the other for inaccurate or incomplete disclosures. If an investigation turns up wrongdoing, then the firm should disclose it. Failing to accurately disclose the grounds for a registered representative's departure can also lead to liability from the registered representative's subsequent employers and the firm's clients. A strong internal investigation can give a firm the needed confidence for those cases in which it must speak bluntly about any misconduct.

4) Implement a Form U-5 review team.

A firm should have procedures, preferably written, for how to draft and approve U-5 filings, and this process should be implemented as early as possible in the decision to terminate a U-5-eligible employee. This can be part of or separate from the firm's policy on pre-termination investigations. The team should include both a legal representative and a compliance representative to review the U-5 before filing to ensure the proper protective measures are in place to reduce exposure to defamation claims and any other liability stemming from U-5 disclosures. Outside counsel should be made part of these decisions for employees involving certain misconduct or those with high future earning potential, and the standard for retaining outside counsel should be included in the written procedures.

By understanding this landscape and implementing certain pre-termination measures, a broker-dealer or investment advisory

firm can reduce its exposure to costly defamation claims arising from Form U-5 filings, while complying with its regulatory duty to disclose wrongdoing to warn the investing public.