SECURITIES LAW SERIES

What FAs Need to Know About Form U4 and Form U5 Expungement

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Introduction

The Financial Industry Regulatory Authority (FINRA) requires broker-dealers and financial advisors to file and update two important forms known as Form U4 and Form U5. While these forms are seemingly innocuous, the information they contain or any failure to timely update them can derail a financial advisor's career. The forms contain basic information about the registration status of a particular financial advisor but, more importantly, they contain significant details regarding the financial advisor's employment history, criminal history, litigation history, personal finances, and history of regulatory matters involving the financial advisor. Perhaps most surprising for people not familiar with the industry is that much of the very personal information in these forms is maintained by the Central Registration Depository (CRD) and publicly available through FINRA's website [www.brokercheck.finra.org]

What Is a Form U4?

Form U4 is the *Uniform Application for Securities Industry Registration or Transfer*. Investment advisers and broker-dealer representatives must use this form to become registered in the appropriate jurisdictions or with the relevant self-regulatory organization (SRO), such as FINRA. Form U4 is filed by a broker-dealer for every registered person that it employs. Both the firm and the financial advisor can update Form U4 when necessary but it is ultimately the financial advisor's responsibility to make sure Form U4 is accurate and up-to-date.

It is best to think of Form U4 as a "living" document rather than a form that gets filed and forgotten about. This is because Form U4 needs to be updated within 30 days of the event giving rise to the disclosure. Some of these events are of obvious public importance (criminal history, bankruptcy history, and adverse litigation history) but some of the required disclosures are less obvious.

What Must Be Disclosed on a Form U4?

On the more obvious end of the spectrum, financial advisors must disclose certain investment-related customer complaints, arbitrations, and civil litigations. "Investment-related" is a defined term which includes "securities, commodities, banking, insurance, or real estate." In general, financial advisors must disclose (a) being named in a litigation or arbitration, (b) any adverse arbitration award against them, (c) complaints that allege more than $5,000 in damages, and (d) complaints that are settled for more than $15,000. Interestingly, and contrary to the plain language of Form U4, if a financial advisor is named in an arbitration but then dismissed prior to a settlement of that action, the settlement does not need to be disclosed on that financial advisor's Form U4. It is an unfortunate fact that even the most specious customer complaints must be reported if they meet the required dollar threshold. The financial advisor's only recourse is to seek to have such frivolous complaints expunged, a process that we will discuss in more detail below.

Financial advisors must also disclose adverse criminal and regulatory actions. With regard to criminal matters, all felony convictions, guilty pleas, or charges must be reported, while only certain classes of misdemeanors, such those involving fraud or forgery, must be disclosed. The distinction between felonies and misdemeanors is clear in most states, but some states, such as New Jersey, do not have misdemeanors and felonies in its penal code. For such states, FINRA provides a definition of "felony" as any offense punishable by a year or more of imprisonment and/or a fine of at least $1,000. Being "charged" with a crime is also a defined term under Form U4 and it requires that a formal complaint, information, or indictment be filed against the accused person. By contrast, something like a police report that describes an incident and perhaps even specifies what crime the officer believes was committed is not a "charge" as defined by FINRA.

Some of the less obvious items that a financial advisor is required to disclose involve personal finances. A registered representative is

required to disclose any bankruptcy filing, which is a clear and obvious event. However, financial advisors are also required to disclose any "compromise with creditors" which can be less obvious. For example, if a person comes to an agreement with their credit card company to pay less than the full amount owed on their card, this is a disclosable event that many financial advisors would not think they needed to report on their Form U4. Form U4 also requires financial advisors to disclose any "unsatisfied judgments or liens." Unfortunately, every lien or judgment is "unsatisfied" for some short period of time before payment is made. As such, financial advisors must disclose every lien no matter how quickly they might make payment upon being notified of its existence.

The Consequences for Failing to Disclose Can be Career-Ending: Statutory Disqualification

A financial advisor must update Form U4 within 30 days of any triggering event. A failure to update the form will expose the financial advisor to a possible fine and suspension from FINRA. And the consequences can be catastrophic if FINRA finds that the adviser's failure to update Form U4 was "willful" (meaning that the financial advisor of his own volition provided false answers on his Form U4). Under Section 3(a)(39)(F) of the Securities Exchange Act of 1934, a person is subject to statutory disqualification if he or she "willfully" made any "false or misleading" statement in any application to become associated with a member of a self-regulatory organization (such as FINRA). FINRA's bylaws provide that a person who is subject to statutory disqualification cannot become or remain associated with a FINRA-member firm. A member firm can apply for relief from this rule but very few firms are willing to do so on behalf of an employee or prospective employee. Thus, the willful failure to disclose something like a child-support lien, bankruptcy, or tax lien, perhaps out of mere embarrassment, can have the effect of permanently ending a financial advisor's career.

What Is a Form U5?

Form U5 is the *Uniform Termination Notice for Securities Industry Registration*. Broker-dealers and investment advisers must use this form to terminate the registration of an individual in the appropriate jurisdictions or SRO. Form U5 must be filed within 30 days of the financial advisor's departure from a firm, and it terminates that employee's registration with the firm.

What Must be Disclosed on a Form U5?

Form U5 refers to every departure as a "termination" even when the employment ends voluntarily. (That is because the financial advisor's registration "terminates" upon departure). Firms must provide a reason for termination and check one of five boxes: "Voluntary," "Deceased," "Permitted to Resign," "Discharged," or "Other." If "Permitted to Resign," "Discharged," or "Other" is selected the firm must also provide an explanation that is sufficiently detailed to make the circumstances surrounding the departure clear to FINRA staff. For example, FINRA deems it unacceptable to state that an employee was discharged for violating firm policy without detailing what specific policy provision was violated.

The language used to describe the termination is critical for two reasons. First, future employers will have access to that language and adverse language may harm a financial advisor's future employability. Unfortunately, it is not unheard of for a firm to abuse Form U5 by using the "reason for termination" language as a means to defame the financial advisor and try and retain a financial advisor's clients. Second, FINRA reviews all Form U5s that are marked with either "Discharged," "Permitted to Resign, or "Other," and the language chosen by the firm to describe the reason for termination is the staff's first impression of the conduct in question. Typically, FINRA will send both the firm and the former employee requests for information pursuant to FINRA Rule 8210. Depending on the conduct in question, these inquiries can then lead to enforcement actions.

Form U5 also has disclosure questions that are similar to Form U4 and need not be answered if all the relevant disclosures are already reported in the individuals Form U4. However, if a disclosable event, such a customer complaint, happens after the financial advisor is gone, the firm is responsible for filing an amended Form U5 to disclose that new complaint. Question 7(B) on Form U5 is not included on Form U4. It asks the following:

> Currently is, or at termination was, the individual under internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct?

The presence of this "internal review" question is clearly designed to prevent financial advisors from avoiding disclosure of some potential wrongdoing by leaving a firm while in the middle of a compliance review. However, question 7(F)(1) on Form U5 (like question 14(J)(1) on Form U4) also asks if the financial advisor was discharged, resigned, or was permitted to resign after allegations were made that accused the individual "violating investment-related statutes, regulations, rules or industry standards of conduct." This is called the "termination disclosure." The presence of both of these questions can be confusing since they might appear to cover the same ground. Many firms instinctively answer "Yes" to both under any circumstance where a financial advisor leaves while under a compliance-related cloud. FINRA has provided no guidance, but in our view the best interpretation is that the "internal review" question should be answered "Yes" if an individual leaves before the conclusion of the review. If the review is completed and there is a finding that makes it appropriate to answer "Yes" to 7(F)(1) then a firm should answer "No" to 7(B).

The "internal review" and "termination disclosure" can also be confusing for financial advisors who focus on the language "investment-related statutes, regulations, rules" and ignore or fail to appreciate how broadly "industry standards of conduct" can be interpreted. Form U5 instructions

specifically state that the "internal review" disclosure should be only about compliance matters and should "not include situations involving employment related disputes." It is fair to say that FINRA is being naïve about how readily a firm can turn an employment dispute into a compliance matter involving the nebulous phrase, "industry standards of conduct." For example, firms have interpreted "industry standards of conduct" to include matters involving sexual harassment or substance abuse.

What Are Your Options if You Disagree with Form U5 Language?

The law in many states provides that the language in Form U5 is protected by either qualified or, in the case of New York, complete immunity from defamation claims. FINRA has a process under FINRA Rule 8312 by which a financial advisor can dispute the accuracy of both Form U4 and Form U5. Under Rule 8312, FINRA independently reviews the contested disclosure, but in our experience the process rarely results in any meaningful changes to the financial advisor's Form U4 or Form U5. As such, sometimes the financial advisor's only means of changing unfair or inaccurate information on Form U5 or Form U4 is to bring an expungement arbitration.

Expungement Arbitration for Customer Disclosures

The rules for expungement of customer-dispute information are more stringent than expungements for disputes involving only a financial advisor and FINRA-member firm. FINRA Rule 2080 governs the expungement of customer-dispute information and provides that any expungement must be based on the following grounds:

A. the claim, allegation, or information is factually impossible or clearly erroneous;

B. the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or

C. the claim, allegation, or information is false.

FINRA Rules 12805 and 13805 set forth the procedure that an arbitrator must follow to grant expungement of customer-dispute information. The panel or arbitrator must hold a hearing, which can be in person or by telephone. Even if the customer in question is not named in the arbitration, he or she or their counsel must be informed of the hearing and given an opportunity to testify before the panel. Importantly, FINRA Rule 2081 forbids a member or associated person from requiring a customer to consent to, or not to oppose, expungement as a condition of settlement. Such clauses were routinely included in settlement agreements before FINRA adopted this rule in 2014. Finally, the panel must specify and explain in its order which of the FINRA Rule 2080 grounds for expungement serve as the basis for any expungement order.

Once a financial advisor has received a favorable expungement award, FINRA Rule 2080 requires that the award be confirmed by a court of competent jurisdiction. Rule 2080 also requires that FINRA be named as an additional party to such confirmation proceedings. Alternatively, FINRA can be asked to waive this requirement. Such waiver requests are routinely granted.

Expungement Arbitration for Termination Disclosures

Employment-related or "intra-industry" disputes are not subject to the provisions of FINRA Rules 2080, 2081, 12805, and 13805 as long as the expungement requested does not involve customer-dispute information. These cases almost universally involve termination-related disclosures on Form U5. A hearing is not required, although a panel may insist on one, and there need be no specific grounds cited for why the expungement

is being ordered. In practice, however, it is a good strategy to place evidence before the panel that meet the grounds set forth in FINRA Rule 2080 since arbitrators are familiar with those grounds and will have been trained to follow those guidelines in other expungement cases. Oddly, despite clear guidance that 2080 does not apply to these disputes, FINRA still requires a court order to expunge the information unless the arbitrators make a determination that the U5 is defamatory. This position by FINRA seems to come from Notice to Members (NTM) 99-09, which first announced the requirement for court confirmation in customer-dispute expungements. NTM 99-09 stated as follows:

> [FINRA] will continue to expunge information from the CRD system based on expungement directives in arbitration awards rendered in disputes between firms and current or former associated persons, where arbitrators have awarded such relief based on the defamatory nature of the information.

This requirement regarding a finding of defamation is not in FINRA rules and seems contrary to the guidance that FINRA Rule 2080 does not apply to intra-industry expungements. Nevertheless, court confirmation of an award can add thousands of dollars in legal fees to the expungement process so, whenever possible, financial advisors should seek a finding that the language in their Form U5 is defamatory.

Maintaining accurate and timely information in a financial advisor's Form U4 and U5 is critical and can have career-ending consequences. Any time a registered person even suspects that a disclosable event may have occurred they should speak to their compliance officer responsible for updating Form U4. It is also wise to seek outside counsel to ensure that the compliance officer's advice is well-grounded. There are numerous instances where financial advisors have been told by their firms to report items that did not need to be reported and vice-versa. With regard to Form U5, any financial advisor who is leaving their firm, whether voluntarily or otherwise, would be well advised to seek counsel.

Voluntary departures may still involve complex employment-related disputes or "internal review" disclosures. Terminations that require "reason for termination" language will trigger a FINRA inquiry that no one should answer without counsel. In addition, many firms will discuss the proposed reason for termination in a Form U5 and will even consider proposed changes to the language as long as it remains complete and accurate.

Contact Herskovits PLLC

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