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A legal update from Dechert's Financial Services and Securities Litigation and Financial Services Groups

NY Court: Broker-Dealers Immune from Defamation Suits Based on Statements in Employment Termination Notices

Introduction

On December 22, 2005, a divided court of the Appellate Division, First Department of the New York Supreme Court (the "Cicconi Court"), held that a brokerage firm has absolute immunity for any defamatory statement made on the broker's Uniform Termination Notice for Securities Industry Registration ("Form U5") filed with securities regulators.[1]

The Appellate Division is New York's intermediate level appellate court. It is divided into four departments, each of which exercises appellate jurisdiction over a separate geographic region.[2] The Cicconi Court declined to follow other states that allow terminated registered representatives to sue their former employers for defamation when they can prove that the employer made a statement on the form with actual malice.

New York courts previously have held, at least once judicial or quasi-judicial proceedings have commenced, that statements made on a Form U5 are absolutely privileged because statements made in the course of judicial or quasi-judicial proceedings are absolutely privileged if material. The Cicconi Court went a step further by declaring that the privilege accorded a statement in a Form U5 cannot depend upon whether a securities regulator or a self-regulatory organization ("SRO") actually proceeded with an investigation or a quasi-judicial process as a result of receiving a Form U5.

Summary of *Cicconi v. McGinn, Smith & Co.*

In July 2001, McGinn, Smith & Co., Inc. ("McGinn") bought all of the assets of Mercer Partners, a broker-dealer, as well as a 50% interest in its affiliate, IPOSyndicate.com. Kethe Cicconi ("Cicconi") was a founder of the acquired companies and McGinn retained Cicconi as part of the deal. Cicconi's employment contract with McGinn specified that he could be terminated only for cause, which was narrowly defined as material breach of contract, gross misconduct, a felony conviction, or disregard of McGinn's directions.

In December 2002, McGinn terminated Cicconi's employment, stating on its Form U5, filed with the National Association of Securities Dealers, Inc. ("NASD"), that the "reason for termination" was "performance based." Cicconi sued McGinn for defamation, contending that McGinn filed an intentionally false Form U5 to harm him. On McGinn's motion, the court dismissed the claim on the grounds that the statement on the Form U5 was absolutely privileged. On Cicconi's appeal, the appellate division affirmed.

Cicconi argued that the absolute immunity standard was overbroad, since not every Form U5 is investigated or results in a quasi-judicial proceeding. The Cicconi Court rejected this argument, reasoning that Form U5 is part of a broad and complex regulatory scheme.

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1 *Cicconi v. McGinn, Smith & Co.*, 2005 Slip Op. 10050 (N.Y. App. Div. Dec. 22, 2005).

2 The Supreme Court, of which the Appellate Division is a part, is the state's trial court. The First Department covers Manhattan and the Bronx. Therefore, the *Cicconi* decision is not a ruling from New York's highest court and is (a) subject to reversal and (b) not binding statewide.

Therefore, it concluded that the nature of the privilege given to any particular Form U5 statement cannot depend upon whether or not the agency proceeds with an investigation or a quasi-judicial process.

Further, the Cicconi Court said that the most important protection provided by absolute privilege is not that of the brokerage firms, but that of investors. The Cicconi Court said that by assuring brokerage firms that they will not be liable in lawsuits for statements on their Form U5 filings, "we avoid the possibility that they will hesitate to clearly state the exact grounds for an employee's termination."[3]

Form U5 Disclosure Requirements

Form U5 is the standard form that SROs and states have adopted to report the termination of a person's association with a broker-dealer. NASD rules generally require that member firms file the form within 30 days of an individual's termination and update the form within 30 days of learning any information that renders the original filing inaccurate.[4]

The portion of the form raising defamation concerns generally relates to the reasons for an individual's termination and to indications of possible misconduct by the individual:[5]

- In the case of a full termination of employment, Question 3 asks the broker-dealer to select a reason for the termination from one of five choices[6] and to provide an explanation
- Question 7A asks if a registered representative was or is under investigation by a government agency or self-regulatory organization
- Question 7B requires the disclosure of information about any internal reviews conducted by the broker-dealer
- Question 7C asks for detailed information about criminal proceedings brought against the registered representative
- Question 7D asks for detailed information about regulatory proceedings brought against the registered representative
- Question 7E asks for information on customer-initiated complaints, arbitration and civil litigation that may have named the registered representative as a respondent/defendant
- Question 7F asks for detailed information about the termination of the registered representative

Broker-dealers file Form U5 with the NASD,[7] which often initiates an investigation whenever the Form reports that an individual was terminated for cause or contains an affirmative answer to any of questions 7A through 7F.[8] Form U5 is often the first indication that securities regulators receive regarding possible misconduct by registered representatives of a broker-dealer.

The Broker-Dealers' Dilemma: Absolute Immunity Standard v. Qualified Immunity Standard

Whether broker-dealers should be granted an absolute or a qualified privilege for potentially defamatory U5 statements is a complex public policy issue.

When a broker-dealer terminates a registered representative, the brokerage firm has an obligation to file a complete and accurate Form U5. Failure to complete the Form U5 with adequate details can lead regulators

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3 The facts before the Ciconni Court involved only a former employee. A broker-dealer's supervisory responsibility extents to registered representatives who may or may not be employees. *See, e.g.*, NASD Notice to Members 99-45 (Providing guidance on broker-dealer's supervisory responsibilities).

4 *See* NASD By-Laws, art. V, §3, NASD Manual (CCH), at 1311 (1998).

5 Form U5, current as of October 2005.

6 The five choices are: "Discharged," "Other," "Permitted to Resign," "Deceased," and "Voluntary."

7 The information reported on a Form U5 is entered onto the "Central Registration Depository" ("CRD"), which is a computer database developed by the NASD and the securities commissions of the 50 states. In general, the data entered onto CRD is accessible by federal and state regulatory authorities, SROs, potential employers, and the general public.

8 Broker-dealers also file the form with any other relevant SROs or state securities administrators.

to impose sanctions on the broker-dealer.[9] In this case, the broker-dealer included negative comments on a Form U5, and the terminated person filed a defamation claim against the brokerage firm.

An absolute privilege rule encourages broker-dealers to disclose all information to regulators about a registered representative, without fear of retribution, and supporters argue that this is in the interest of investor protection. But critics charge that broker-dealers can use that privilege improperly; for example, if there is a dispute between the firm and a registered representative who is leaving to work at a competitor or for reasons of personal animus.[10] When a broker-dealer files an erroneous or maliciously false Form U5 in a jurisdiction with absolute privilege, the registered representative is left without a private remedy.[11]

If the filing is made in a jurisdiction with qualified immunity, the broker-dealer may have to defend itself in a court or arbitration. Courts that have adopted qualified privilege have sought to balance the need for broker-dealers to provide frank information to regulators, with the opportunity of the registered representative to seek redress for malicious statements.

But critics charge that qualified immunity allows the registered representative to force the broker-dealer to defend its Form U5 statements in an expensive proceeding. As a consequence, broker-dealers maintain that they must choose between omitting disclosure of wrongful behavior and potentially violating SRO rules (and more importantly, undermining investor protection), and facing a long and expensive court or arbitration fight. Even if the court or arbitration tribunal ultimately vindicates the broker-dealer, the victory may be Pyrrhic.

Not surprisingly, the courts are divided on the issue. Although all states recognize some form of immunity for potentially defamatory statements on a Form U5, New York's absolute immunity standard is currently a minority position. The New York absolute privilege rule was first decided in *Herzfeld & Stern v. Beck*[12] by the Appellate Division 14 years ago (the "Herzfeld Court"). The Herzfeld Court focused on the role that Form U5 played in causing the securities regulator to initiate an investigation. The Herzfeld Court reasoned that once an investigation had been launched, the absolute privilege that attached to quasi-judicial proceedings applied to the Form U5 that prompted the investigation.

The issue of an allegedly defamatory Form U5 that does not lead to an investigation was not addressed, however, until the current case. As mentioned above, in reaching its decision, the Cicconi Court focused on the role that Form U5 played within a larger regulatory framework and reasoned that the nature of the privilege accorded a particular U5 statement cannot depend upon whether a regulator or a SRO actually proceeded with an investigation or a quasi-judicial process.

The *Cicconi* case is an important decision in an important jurisdiction. The New York intermediate-level appellate court has broadened the scope of the absolute immunity standard to encourage the free flow of information when brokerage firms report terminations of registered representatives. It is unclear, however, how other state courts, including New York Supreme Courts outside Manhattan and the Bronx, federal courts, arbitration panels, and regulatory authorities, are going to react to the *Cicconi* decision.[13]

Moreover, even in cases where New York law would normally apply, defamation claims are often heard by arbitrators who may choose not to apply the relevant state substantive law[14] or by federal courts reviewing

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9 *See, e.g.*, NASD Notice to Members 88-67.

10 The dissent in the current case asserted that the cloak of absolute privilege has generated substantial abuses by way of distorted and false filings for tactical, competitive business reasons, without any realistic recourse available to those injured. The majority in the current case agreed that in certain instances this possibility might exist, but stated that "there are significant remedies available to our employee who disputes the employer's statement." *Cicconi Opinion* at 5. The majority did not specify what those remedies are.

11 Of course, the broker-dealer would have filed a false Form U5 with regulators, which is itself a violation. *See, e.g.*, NASD Hearing Panel Decision, OHO Redacted Decision 03-02 (September 8, 2003) (explaining that as a general matter, providing false information to the NASD on a Form U5 is a violation of NASD rules because IM-1001-1 provides that the filing with the [NASD] of information with respect to membership or registration as a [r]egistered [r]epresentative which is incomplete or inaccurate so as to be misleading, or which could in any way tend to mislead, or the failure to correct such filing after notice thereof, may be deemed to be conduct inconsistent with just and equitable principles of trade and when discovered may be sufficient cause for appropriate disciplinary action).

12 *Herzfeld & Stern v. Beck*, 572 N.Y.S.2d 683 (1991).

13 *See supra*, note 2.

14 *See Savino v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 2003-014887 (N.Y.S.E. Dec. 19, 2005). In *Savino*, a New York Stock Exchange arbitration panel awarded more than $14 million to three former Merrill Lynch stockbrokers fired in connection with a mutual fund trad-

arbitration awards, which narrowly focus on whether the arbitrators manifestly disregarded the law.[15] Adding to these uncertainties are the possible regulatory responses to the issue of immunity extended to Form U5 statements. Several years ago, the NASD considered adopting a rule that would have imposed a uniform standard of qualified immunity for Form U5. But the NASD withdrew the proposal in response to concerns that the NASD and the Securities and Exchange Commission ("SEC") lacked jurisdiction to impose a defamation standard that differed from local law.[16]

Although no regulatory agencies have yet formally proposed any immunity standard guidelines, it is conceivable that Congress, the SEC, or the SROs may revisit the issue in response to the New York *Herzfeld* and *Cicconi* line of decisions in the hope of creating unity in addressing Form U5 immunity issues across state lines.

Conclusion

The *Cicconi* decision is favorable to broker-dealers in New York, especially where New York law applies because of the location of the broker-dealer, or because of language in the standard arbitration agreement. In any event, regardless of the location of the broker-dealer, broker-dealers should consider taking steps to ensure that contracts with their registered representatives mandate the application of New York law in any case or controversy concerning the contract.

Prudent broker-dealers should still approach the Form U5 process with extreme caution. Broker-dealers should have a process in place to ensure that statements on a Form U5 satisfy regulatory guidelines and omit any unwarranted or inaccurate statements. In some cases, it may be difficult for the broker-dealer and the registered representative to agree on the disclosure.

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ing scandal on claims that included defamation and breach of contract.

15 The dissent cited a Michigan federal district court case in which the court declined to apply New York law, *Andrews v. Prudential Sec.* 1997 U.S. Dist. LEXIS 23694. Cf., *Fahnestock & Co. v. Waltman*, 935 F.2d 512 (2d Cir. 1991) (affirming award of compensatory damages for defamation). On the issue of immunity for statements made in Forms U5, the court stressed that its standard of review was whether the arbitrators had manifestly disregarded the law in awarding the employee compensatory damages for defamation.

16 *See, e.g.*, Rel. No. 34-39892 (April 21, 1998) (giving notice that the NASD had filed with the SEC a proposed rule providing NASD members with qualified immunity in arbitration proceedings for statements made on Forms U5).

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