

# NASD NOTICE TO MEMBERS 97-77

NASD Regulation Requests Comment On Proposed Rule Regarding Forms U-4 and U-5, Qualified Immunity, And Advance Employee Notice; **Comment Period Expires December 31, 1997**

## Suggested Routing

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## Executive Summary

NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) requests comment on a proposed new rule, National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 1150 (Rule), which would provide NASD members with a qualified immunity in arbitration proceedings for statements made in good faith in certain disclosures filed with the NASD on Forms U-4 and U-5. The Rule would also require that member firms give notice of the contents of a Form U-5 (and amendments) to the subject of the form at least 10 days prior to filing the form with the NASD. Members would also be required to provide immediate notification to employees of material revisions to be filed on Form U-5.

Questions concerning this *Request For Comment* should be directed to Jean Feeney, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-6959, or Laura Gansler, Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8275.

## Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, N.W.  
Washington, D.C. 20006-1500;

or e-mailed to:  
[pubcom@nasd.com](mailto:pubcom@nasd.com)

Comments must be received by **December 31, 1997**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of

Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

# NASD REGULATION REQUEST FOR COMMENT 97-77

## Executive Summary

NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) requests comment on a proposed new rule, National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 1150 (Rule), which would provide NASD members with a qualified immunity in arbitration proceedings for statements made in good faith in certain disclosures filed with the NASD on Forms U-4 and U-5. The Rule would also require that member firms give notice of the contents of a Form U-5 (and amendments) to the subject of the form at least 10 days prior to filing the form with the NASD. Members would also be required to provide immediate notification to employees of material revisions to be filed on Form U-5.<sup>1</sup>

The purpose of the Rule is to encourage more candid and accurate disclosure by member firms on Forms U-4 and U-5 concerning the reasons for terminating employees, while affording employees an opportunity to review the Form U-5 prior to filing with the NASD. The Rule would be implemented on a four-year pilot basis, during which time NASD Regulation would assess the impact of the Rule on the nature and quality of disclosure by member firms.

Questions concerning this *Request For Comment* should be directed to Jean Feeney, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-6959, or Laura Gansler, Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8275.

## Background

The NASD By-Laws (Article IV, Sections 2 and 3) require that members make certain disclosures concerning registered persons, and certain other employees associated with them, in order to help the NASD and its members fulfill their

statutory mandate to register, qualify and oversee securities industry personnel. In particular, the Form U-5 provides information about disciplinary or regulatory problems in an employee's work history. Candid and accurate disclosure of a regulatory or disciplinary problem that contributed to an employee's termination is critical to ensuring that prospective broker/dealer employers make informed hiring decisions and establish appropriate supervisory systems.

For purposes of the proposed Rule, the most important of these disclosures are those required by Form U-5, the "Uniform Termination Notice for Securities Industry Registration." Members are required to file a Form U-5 with the NASD within 30 days of the termination of certain employees, and simultaneously to provide a copy of the filed form to the employee. The By-Laws also require that the member notify the NASD in writing, and send a copy to the registered person, within 30 days if the member learns of facts or circumstances causing any information in the prior notice to become inaccurate or incomplete. Members are also required to disclose certain information about employees on Form U-4, the "Uniform Application for Securities Industry Registration or Transfer."

In recent years, registered persons have brought a number of defamation<sup>2</sup> claims for allegedly untrue or misleading statements made on Form U-5. The claims are primarily brought in arbitration; at present, the number of defamation cases relative to the NASD's overall arbitration caseload is small.<sup>3</sup> However, because of the personal and financial interests at issue, the members' potential exposure to liability as a result of such claims may be substantial.

At common law, courts have generally found that employers are entitled to a qualified privilege for statements

made about former employees to prospective employers.<sup>4</sup> This qualified privilege has been codified in many state statutes. However, the privilege is not absolute, and may be overcome by proof that the employer knew or was reckless in not knowing that the statement was false. State law varies with respect to the standard of proof required to overcome a qualified privilege: some states require clear and convincing evidence, while others apply a preponderance of the evidence standard.

The potential liability for statements made on Forms U-5 has created a disincentive for member firms to provide full disclosure. Members have also questioned the fairness of exposure to potentially significant liability for disclosures they are required by the NASD to make.

At the same time, registered representatives are concerned that unless they are able to pursue an action against an employer in a particular case, member firms will be free to unfairly penalize them for their decisions to seek employment at another firm, or otherwise unfairly injure or tarnish their reputation.

As noted above, full disclosure of disciplinary problems on Forms U-4 and U-5 is in the public interest. Accordingly, NASD Regulation believes it is appropriate to provide some degree of protection for members for statements made on required forms in order to encourage full disclosure. Inadequate disclosure has the potential to compromise the integrity of the Central Registration Depository, and hinders regulatory enforcement action by the NASD and other regulators. At the same time, NASD Regulation recognizes that employees must have recourse for untruthful statements designed, for example, to penalize a departing employee, or to prevent him or her from obtaining new employment or

attracting existing customers to another member firm. NASD Regulation and other regulators have worked with representatives of NASD member firms and employees in an effort to formulate a fair and workable solution to this problem.

The proposed Rule is designed to strike a balance between the interests of the member firms, the employees, and the public by providing qualified immunity for statements made in good faith by member firms on certain required forms, and by providing employees with an opportunity to seek changes to disclosures contained in Forms U-5 prior to their filing. NASD Regulation seeks comment on all aspects of the proposed Rule from all interested persons and their representatives, including members, registered persons, other employees and employee groups, industry groups, and customers. In particular, NASD seeks comment on the specific issues raised below.

### **Description Disclosure Obligations**

NASD members are currently required to make truthful and accurate disclosures to the NASD regarding securities industry personnel, and are currently subject to disciplinary proceedings for failure to do so. Paragraph (a)(1) of the proposed Rule would reaffirm the current disclosure obligations of NASD members. It is not intended to impose any additional or higher disclosure obligations on NASD members than that which currently exists under NASD rules. NASD Regulation seeks comment regarding whether the reiteration of NASD members' current disclosure obligations in paragraph (a)(1) should be included in the proposed Rule.

### **Qualified Immunity**

The proposed rule would create a uniform qualified immunity standard for statements made in good faith by members in "covered forms." The qualified immunity would apply in all arbitrations between employees and members arising out of disclosures contained in "covered forms" instead of the various immunity standards that currently apply under state law.

Under the qualified immunity, a defending party would not be liable to a "covered person" for any defamation claim related to an alleged untrue statement contained in a "covered form" unless the covered person showed by clear and convincing evidence that the defending party either knew or was reckless in not knowing that the statement was materially false at the time it was made.

#### *Definitions And Scope Of Qualified Immunity*

The qualified immunity would apply to statements contained in a covered form that is filed with a regulatory agency or self-regulatory organization, or that is disseminated by reason of such filing, or otherwise disseminated orally, in writing, or through any electronic medium to an "appropriate person."

The Rule defines "covered forms" as those forms required to be filed pursuant to Article IV, Sections 2 and 3, of the NASD By-Laws, which include both Forms U-4 and U-5. Although defamation claims against members for statements contained in required filings generally have involved disclosures made on Form U-5 in connection with employee terminations, members of the industry have indicated that required disclosures pertaining to employees on Form U-4 provide the same potential

for defamation liability, and NASD Regulation believes that the same regulatory interests in complete disclosure apply to statements on that form.

The Rule defines “appropriate person” as “any federal or state government or regulatory authority, any self-regulatory organization, any employer or prospective employer of a covered person, any person who requests information concerning the covered person from the defending party and as to whom the defending party has a legal obligation to provide such information, or any person who has a legal obligation to obtain such information.” Accordingly, the Rule would apply to a request made, for example, by a pension fund if legal requirements imposed an obligation to obtain information concerning persons investing on behalf of the fund.

The Rule would apply to statements made by a member on a covered form with respect to a “covered person,” defined as any present or former registered person or employee of the member who is party to a proceeding relating to a dispute within the scope of the Rule. The Rule would also apply to the liability of both member firms and associated persons, and accordingly would protect the signatory of the form or other persons involved in the preparation of the form as well as the member itself.

NASD Regulation seeks comment regarding the scope of the qualified immunity. In particular, is the definition of “appropriate persons” too broad? Too narrow? Should disclosures to customers be explicitly included? Should disclosures to the media be included?

### *Standard Of Proof*

Most states recognize a qualified immunity for required disclosures, although at least one New York court has applied absolute immunity with respect to statements contained in Form U-5. In most states, the qualified immunity can be overcome by evidence that the member knew, or was reckless in not knowing, that the information in the required disclosure was false. However, state law varies with respect to the standard of proof required to demonstrate knowledge of, or recklessness with respect to, a statement’s falsity. Some states require clear and convincing evidence, while others apply a preponderance of the evidence standard. In still other states, there are conflicting decisions regarding the appropriate standard of proof.

In light of the variation among state laws regarding the standard of proof required to overcome a qualified immunity for required disclosures, NASD Regulation has considered the regulatory and public policy interests underlying the proposed Rule in determining the appropriate standard of proof. As discussed above, the purpose of the proposed Rule is to enhance disclosure of information concerning matters of public interest. A preponderance of the evidence standard might not provide sufficient protection to members to ensure full disclosure. On the other hand, absolute immunity might not enhance the quality of disclosure because of its potential to immunize defamatory statements. Because the clear and convincing standard provides significant protection to member firms for required disclosures without depriving employees of recourse for false statements made knowingly or recklessly, NASD Regulation preliminarily believes that a qualified immunity that may be overcome by clear and convincing standard may be more consistent with the purpose of the

Rule, and represent a reasonable balance between the competing interests involved.<sup>5</sup>

NASD Regulation seeks comment as to whether a uniform qualified privilege should be applied in arbitration proceedings, and whether the clear and convincing evidence standard is an appropriate standard of proof.

### *Signatory Requirement*

The proposed Rule does not require that the person signing the covered form on behalf of a member firm be a registered person, a compliance officer, or an attorney in order for the qualified immunity to apply. Nonetheless, such a requirement could enhance the quality of disclosure on the covered form by raising the level of accountability within the member firm. Those opposed to such a requirement argue that it would unduly interfere with current industry practice without enhancing the quality of disclosure.

NASD Regulation specifically requests comment regarding whether the Rule should include a provision requiring that the person signing a covered form be either a registered person or lawyer in order for the qualified immunity to apply to statements contained in the form. In particular, commenters are asked to consider the effect of such a requirement on current industry practice, the additional burdens, if any, such a requirement would place on member firms, and the benefits of such a requirement.

### *Applicability Of Qualified Immunity To Statements Made Prior To Filing Of Covered Forms*

Another issue involves whether immunity would attach to statements made prior to filing of covered forms. In some cases, members may be asked by prospective employers to

verify the reasons for a registered person's termination prior to the time the Form U-5 is submitted to the NASD. The Rule provides that the qualified immunity would attach to statements made prior to the filing of a Form U-4 or U-5 that are subsequently included in a filed form in the same language that is provided to an appropriate person.

NASD Regulation requests comment regarding whether the qualified immunity should attach to statements that are subsequently filed in a covered form in the same language.

### **Ten-Day Advance Review Period**

In addition to the qualified immunity provisions, the proposed Rule would require members to provide employees with copies of Forms U-5 or amendments to Forms U-5 at least 10 days before the form or amendment is filed with the NASD. Further, members would be required to provide material revisions to the employee immediately. The purpose of these provisions is to provide an employee with an opportunity to seek amended disclosure language prior to filing where he or she can demonstrate that the proposed language is inaccurate. The Rule explicitly states, however, that failure by an employee to respond during the 10-day period would not constitute a waiver of any rights of the employee.

NASD Regulation seeks comment concerning the appropriateness of the 10-day advance review period. In particular, commenters are asked to consider the impact of this provision on the nature of the disclosure contained in the filing. Would this provision encourage "negotiated disclosure" prior to filing that would lead to less complete and accurate information or limit its usefulness for regulatory purposes? Would it be likely to lead to delays in filing? Is

the requirement that firms notify employees immediately of material revisions to Forms U-5 practicable?

Where commenters believe that the requirement is appropriate, they are asked to consider whether it provides adequate opportunity for employees to make additional disclosure or to propose changes. Does it provide a member firm sufficient time to prepare the filing? Should the time period be shorter? Longer? How should notice be delivered, and should the method be specified in the Rule? Should there be a provision for extending the 30-day period in some cases? If so, what form should it take, and under what circumstances would extension be appropriate?

### **Expedited Mediation Or Arbitration**

Another issue is whether the proposed Rule should provide an expedited arbitration or mediation procedure for resolving disputes concerning disclosures contained in Forms U-5 before the forms are filed with the NASD. It is arguable that such a procedure could help to avoid or minimize post-filing disputes. While one difficulty of such a procedure is that the NASD's By-Laws currently require that Forms U-5 be filed within 30 days of termination, NASD Regulation would be able to provide qualified mediators on an expedited basis. Because timely reporting of the information required by Form U-5 is important for regulatory purposes, extension of the 30-day filing period could arguably undermine the goal of enhanced disclosure underlying the proposed Rule. Moreover, pre-filing mediation or arbitration could ultimately produce less, rather than more, candid disclosure than is currently the case.

NASD Regulation solicits comments regarding whether the proposed rule should include a procedure for expe-

ditied pre-filing mediation or arbitration. Commenters are asked to consider how such a procedure would work, whether it would be effective, and how it would be funded. Should there be an option to obtain pre-filing mediation or arbitration, or should it be mandatory on the demand of either party? Is mediation appropriate in the instance where the question is a member firm's response to a regulatory requirement? Would there be enough time to complete mediation before the 30-day filing period expired? Who would pay for the procedure?

### **Pilot Program**

The Rule would be implemented on a four-year pilot basis, during which time NASD Regulation would assess the impact of the Rule on the nature and quality of disclosure by member firms. If NASD Regulation determines at the end of the pilot period that the Rule has had little or no positive impact on the nature and quality of the disclosures made on Forms U-4 and U-5, it will not seek to renew the Rule.

NASD Regulation seeks comment regarding the pilot program. Should the Rule be implemented on a pilot basis? Is four years a sufficient amount of time to assess the impact of the Rule on the nature and quality of the disclosure by members? Should it be shorter, or longer? Are there particular measures NASD Regulation should use in determining whether the Rule has had a positive impact on the nature and quality of disclosures?

### **Request For Comment**

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, N.W.  
Washington, D.C. 20006-1500;

or e-mailed to:  
*pubcom@nasd.com*

Comments must be received by **December 31, 1997**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

### **Text Of Proposed Rule 1150**

*(Note: All language is new.)*

#### **Rule 1150. Regulatory Form Disclosures**

##### **(a) Mandatory Disclosures**

(1) A member must make truthful, accurate, and complete statements on the covered forms required under Article IV, Sections 2 and 3 of the By-Laws ("mandatory disclosures").

(2) A notice of termination (Form U-5) and any amendment to the notice required to be provided to an associated person pursuant to Article IV, Section 3 of the By-Laws shall be delivered to such associated person at least 10 days before the notice or amendment is filed with the Association.

(3) If a member makes a material revision to a notice of termination or amendment delivered to an associated person pursuant to subparagraph (2), the member must deliver the revision to the associated person immediately.

(4) An associated person's failure to respond to a notice delivered pur-

suant to subparagraph (2) or (3) shall not constitute a waiver of any rights of the associated person.

##### **(b) Qualified Immunity**

(1) This paragraph shall apply to any arbitration proceeding between a member or other party and a covered person relating to statements made in response to an information requirement of a covered form with respect to such covered person, to the extent that such statements are contained in a covered form that has been or, at a subsequent point in time, is (A) filed with a regulatory authority or self-regulatory organization, and (B) disseminated by reason of such filing, or otherwise disseminated orally, in writing, or through any electronic medium to an appropriate person.

(2) A defending party shall not be liable in a proceeding to a covered person for any defamation claim related to an alleged untrue statement that is contained in a covered form if the statement was true at the time that the statement was made.

(3) A defending party shall not be liable in a proceeding to a covered person for any defamation claim related to an alleged untrue statement that is contained in a covered form unless the covered person shows by clear and convincing evidence that:

(A) the defending party knew at the time that the statement was made that it was false in any material respect; or

(B) the defending party acted in reckless disregard as to the statement's truth or falsity.

##### **(c) Definitions**

For purposes of this Rule:

(1) The term "appropriate person" means any federal or state govern-

mental or regulatory authority, any self-regulatory organization, any employer or prospective employer of a covered person, any person who requests information concerning the covered person from the defending party and as to whom the defending party has a legal obligation to provide such information, or any person who has a legal obligation to obtain such information.

(2) The term "claim" means any claim, counterclaim, third-party claim, or cross-claim.

(3) The term "covered form" means any form or notice required under Article IV, Sections 2 and 3 of the By-Laws, including Forms U-4 and U-5, Disclosure Reporting Pages, and related explanatory materials.

(4) The term "covered person" means any present or former registered person or other employee of a member who is a party to a proceeding relating to a dispute within the scope of this Rule.

(5) The term "defending party" means any member who is a party to a proceeding and who is adverse to a covered person who is a party, and any associated person of such member.

(Rule 1150 is effective beginning on [Date] 1998 and ending on [Date] 2002, and applies to claims relating to any covered forms, as defined in Rule 1150, that are filed during that period.)

#### **Endnotes**

<sup>1</sup> The proposed Rule would require related changes to Article IV, Sections 3(a) and 3(b), of the NASD's By-Laws.

<sup>2</sup> "Defamation" has been defined as an "intentional false communication, either published or publicly spoken, that injures another's reputation or good name." *Black's Law Dictio-*

nary 417 (6th ed. 1990). “Libel” (written defamation) and “slander” (spoken defamation) are both forms of defamation. *Id.* at 1388.

<sup>3</sup> In 1996, approximately 3 percent of the arbitrations filed with NASD Regulation involved defamation claims.

<sup>4</sup> For example, states with large numbers of registered representatives which recognize

some degree of immunity for statements contained in required disclosures include New York, New Jersey, Florida, California, Illinois, Texas and Pennsylvania.

<sup>5</sup> The standard of proof has no bearing on what evidence is admissible under the Code of Arbitration Procedure. NASD Rule 10323 provides that admissibility of evidence shall be determined by arbitrators based on materiality and relevance. Arbitrators are instructed

that, although the Federal Rules of Evidence do not strictly govern the admissibility of evidence in arbitration proceedings, they may provide guidance on what evidence is probative.

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