

# Special NASD Notice to Members 98-27

## Interim Forms U-4 And U-5 Go Into Effect; Interim Form BD Also Approved

### Suggested Routing

- Senior Management
- Advertising
- Continuing Education
- Corporate Finance
- Executive Representatives
- Government Securities
- Institutional
- Insurance
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
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- Registered Representatives
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- Research
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- Variable Contracts

This *Special Notice to Members* provides guidance to members in filling out the Interim Forms U-4 and U-5, which become effective on March 16, 1998, and in understanding what information NASD Regulation, Inc., will release as part of its Public Disclosure Program. This guidance will be updated and supplemented as necessary and can be found at the NASD Regulation<sup>SM</sup> Web Site at [www.nasdr.com](http://www.nasdr.com).

The recently approved Uniform Application for Broker-Dealer Registration (Form BD) will also become effective March 16, 1998. Copies of the three forms are included with this *Notice*.

Questions concerning this *Notice* may be addressed to any of the following individuals in NASD Regulation's CRD/Public Disclosure Department: Ann Bushey, at (301) 590-6389; John Vaughn, at (301) 590-6865; or Janis Paulikas, at (301) 590-6184.

### Background

On January 20, 1998, the Securities and Exchange Commission (SEC) approved the rule changes filed on October 17, 1997, by the National Association of Securities Dealers, Inc. (NASD<sup>®</sup> or Association) which would amend the Interpretation on the Release of Disciplinary Information, IM-8310-2 of Rule 8310 of the Procedural Rules of the NASD, to modify the disclosure information currently released through the Program; and implement revisions to the disclosure questions on the Uniform Application for Securities Industry Registration or Transfer (Form U-4) and the Uniform Termination Notice for Securities Industry Registration (Form U-5) to facilitate the immediate release of the additional information through the PDP.<sup>1</sup> The SEC further approved an amendment to the proposed rule change, filed on November 12, 1997, in which the NASD

further proposed that the disclosure of the additional information and use of the Interim Forms would become effective on February 17, 1998. These Interim Forms had been distributed to members for use beginning on February 17, 1998. However, in response to a request from the Securities Industry Association, we are delaying implementation of the Interim Forms U-4 and U-5 until March 16, 1998, in order to allow firms to make necessary operational changes.

To accomplish the release of the modified information, the disclosure questions set forth on the Interim Forms U-4 and U-5 and the relevant Disclosure Reporting Pages (DRPs) have been reformatted in a manner that is compatible with the current Central Registration Depository (CRD<sup>SM</sup>)<sup>2</sup> system architecture. There are, however, several areas that the member must keep in mind on the Interim Forms. These are detailed below.

### Changes To The Customer Complaint Questions

Significant changes have been made to the customer complaint questions. These questions have been revised so as to require disclosure of all pending arbitrations and civil proceedings that relate to securities or commodities transactions; pending written customer complaints alleging sales practice violations and compensatory damages of \$5,000 or more for 24 months from original posting if closed without a settlement by the firm; and settlements of \$10,000 or more of arbitrations, civil suits, and customer complaints involving securities or commodities transactions.

### Changes To Other Questions

- Items 22A and 22B: Criminal charges and convictions under

Items 22A and 22B now include matters regarding criminal charges and convictions handled through military courts. For jurisdictions that do not differentiate between a felony and misdemeanor, the Explanation of Terms now defines equivalent offenses and includes courts martial.

- Item 22C: Civil/judicial matters under Item 22C now include a sub-question requiring disclosure of investment-related civil actions brought by a state or foreign financial regulatory authorities that are dismissed pursuant to a settlement agreement.
- Item 22E now clarifies that orders that deny, suspend, or revoke an individual's registration or license, or otherwise prevent the individual from associating with an investment-related business or restricts the individual's activities, must be reported. Stipulations and agreements not contained in an order are not reportable under this item.
- Pending matters under Item 22I must be the result of written notification. In addition, the Explanation of Terms defines investigations for the SEC and NASD Regulation as including the matters after the "Wells" notice has been given.
- Financial matters over 10 years old, including bankruptcies, compromises with creditors, or actions taken under the Securities Investor Protection Act are no longer reportable.
- Item 22N, which deals with terminations, has been clarified to include situations in which the individual voluntarily resigned after allegations were made against the individual.

### Expanded Explanation Of Terms

The Interim Forms contain an expanded Explanation of Terms to define or clarify terms used throughout the Forms. The Explanation of Terms has been moved to the instruction pages of the Forms and has been made consistent across all Form types, to the extent possible.

### Formatting Of Disclosure Questions On The Interim Forms

As stated above, the questions have been reformatted on the Interim Forms to accommodate current CRD system architecture. In order to avoid system reprogramming, additional questions had to be fitted within the existing numbering system. Any questions that now contain more than one part (subitem) are delineated on the Forms with the word "-OR-" separating the subitems. To further aid the member and individual in providing all pertinent data, the corresponding subitem numbers have been added to the boxes in Item 1 of the DRPs which require the member or individual to indicate the specific subitem to which the details relate. Members and individuals are cautioned to read the entire question and provide an affirmative response and corresponding details if any part of the question results in reportable information.

The expansion of the Public Disclosure Program and the implementation of the Interim Forms may result in the need to amend a previous form filing. It is possible that a firm or individual who supplied a "yes" answer in a previous filing will now be able to amend that answer to a "no" response. Conversely, a firm or individual who supplied a "no" answer in a previous filing may now be required to amend that answer to a "yes" response.

**The Interim Forms are being implemented on a prospective basis. Therefore, an individual is not required to file an amendment to page 3 of the Interim Form U-4 by any particular date if an answer to a question changes from "No" to "Yes" solely because the scope of the question on the Interim Form has been revised. Rather, page 3 should be completely updated the next time any amendment to the Interim Form (*i.e.*, any page of the Form or the DRP) is filed or when an Interim Form is filed to effect a transfer, whichever is earlier. As a result of changes to the scope of the questions, an individual also may be able to change a "Yes" answer to a "No" answer on page 3. CRD will accept such amendments at any time on or after March 16, 1998. Filing such an amendment, of course, triggers the obligation to completely update the Interim Form, *i.e.*, to change a "No" to a "Yes" if required due to changes in the questions.**

### Questions Regarding The Interim Forms

Outlined below is a list of Frequently Asked Questions regarding a registered person's obligation to file a Form U-4.

#### Form U-4

#### Questions 22A and 22B

**Question 1:** Is a registered person required to report military charges?

**Answer:** Yes. If a registered person is charged with, pleads guilty or no contest to, or is convicted of a felony or certain enumerated misdemeanors in a military court, such event must be reported.

**Question 2:** If a registered person is convicted of a crime and later par-

done, must the conviction continue to be reported?

**Answer:** Yes. A pardon does not automatically result in an expungement of the criminal record.

**Question 3:** If a registered person is arrested but not charged with a crime, is the arrest required to be reported?

**Answer:** No. An arrest without a charge is not required to be reported.

**Question 4:** Is a misdemeanor charge of failure to file income tax required to be reported?

**Answer:** No.

**Question 5:** Is an offense that results in an individual being placed in a pre-trial diversion or intervention program required to be reported?

**Answer:** Each case must be reviewed individually to determine if formal charges were filed. If so, the matter must be reported. The registered person should attach the official court documents and a copy of the relevant statute to the Form to demonstrate that no formal charges were filed or charges otherwise are not required to be reported.

**Question 6:** Are misdemeanor gambling charges or convictions required to be reported?

**Answer:** No.

## Question 22E

**Question 1:** If a regulatory agency enters an order against a registered person in connection with an investment-related activity, and later vacates the order, may the registered person answer "No" to Question 22E(4)?

**Answer:** No. The question asks whether a regulatory agency has ever entered an order. The vacated order represents the final disposition of the action; it does not alleviate the registered person from disclosing the original findings.

## Question 22G

**Question 1:** Is a registered person required to report an oral complaint? What if it is subsequently settled for more than \$10,000?

**Answer:** Oral complaints are not required to be reported, even if they result in a settlement. However, if a customer lodges an oral complaint with a member, and the customer later submits the complaint in writing in the course of settlement negotiations, the oral complaint has become a written complaint, which must be reported.

**Question 2:** What constitutes a sales practice violation?

**Answer:** Sales practice violation is defined in the instructions to include any conduct directed at or involving a customer which would constitute a violation of any rules for which a person could be disciplined by any self-regulatory organization; any provision of the Securities Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale, or purchase of a security or in connection with the rendering of investment advice.

**Question 3:** If a registered person settles a written customer complaint that was reported under Question 22G, and the settlement is less than \$10,000, must he report the settlement under Question 22H(2)?

**Answer:** No. The registered person can answer "No" to Question 22H(2). However, the "Yes" response to Question 22G will remain on CRD for

two years after the "Yes" answer is entered on CRD.

**Question 4:** If a registered person reports a customer complaint under Question 22G, but after 24 months the complaint has neither been settled for \$10,000 or more, nor evolved into arbitration or civil litigation, should the registered person file an amended Interim Form U-4 changing the answer to Question 22G to "No"?

**Answer:** Yes, the registered person should do so.

**Question 5:** If a customer files a written complaint with a broker/dealer that must be reported under Question 22G and later files an arbitration regarding the same allegations, does the registered person have to answer "Yes" to both Questions 22G and 22H? What if a customer files a written complaint with the member and then subsequently files an arbitration claim that raises completely separate allegations, e.g., the written complaint alleges a sales practice violation with respect to a mutual fund transaction, while the subsequent arbitration alleges a different sales practice violation with respect to a bond transaction?

**Answer:** When the written customer complaint is filed with the broker/dealer, the registered person must answer "Yes" to Question 22G. When the arbitration is filed over the same allegations, the registered person should amend his U-4 by changing the answer to Question 22G to "No" and answering Question 22H(1) "Yes". When a written customer complaint evolves into an arbitration, the answer to Question 22G is "No" because the event "has otherwise been reported" under Question 22H(1).

If the subsequent claim raises different allegations, then the registered person must answer "Yes" to both

Questions 22G and 22H(1) because the complaint and the arbitration concern different allegations and transactions, and therefore should be treated as separate events.

**Question 6:** How is the 24-month period calculated for purposes of reporting a complaint on the Interim Form U-4 and disclosing information through the Public Disclosure Program?

**Answer:** For purposes of a registered person's obligation to report a customer complaint, the 24 months is calculated from the date the complaint is filed with the firm. However, the complaint will be disclosed through the Public Disclosure Program for 24 months, beginning on the date that the U-4 filing on the complaint is entered on CRD.

For example, if a firm receives a reportable customer complaint about a broker on September 1, 1998, and the Interim Form U-4 reporting the complaint is entered on the CRD on September 15, 1998, then the broker is obligated to answer "Yes" to Question 22G until September 1, 2000. CRD will disclose the "Yes" answer until September 15, 2000. Thus, there may be a brief period during which the complaint is no longer reportable by the broker but is still subject to disclosure under the Public Disclosure Program. This policy, which was developed in consultation with NASAA, is designed to encourage prompt reporting of customer complaints.

The NASD considered, but rejected, a policy that would use the firm filing date both for determining the registered person's reporting obligation and the public disclosure period. That policy was rejected because it could encourage registered persons or firms to withhold reports of customer complaints and thereby shorten the disclosure period. For

example, if in the previous example the complaint was filed with the firm on September 1, 1998, but the U-4 was not filed until October 30, 1998, and the September 1 date was used for both reporting and disclosure, then the effective disclosure period would be only 22 months, *i.e.*, October 30, 1998 to September 1, 2000.

### Question 22H

**Question 1:** What if a customer files an arbitration claim alleging sales practice violations against several respondents and then withdraws the claim as to a particular respondent prior to any settlement or award? Is the registered person obligated to report any subsequent settlement or award by the remaining respondents?

**Answer:** When the arbitration claim is filed, the registered person should answer "Yes" to Question 22H(1). When the claim is withdrawn, the registered person may file an amendment changing his answer to 22H(1) from "Yes" to "No".

If the arbitration was preceded by a written customer complaint regarding the same allegations, then the registered person should have: (1) answered "Yes" to Question 22G at the time the written customer complaint was filed with the broker/dealer; (2) filed an amendment answering "No" to Questions 22G and "Yes" to Question 22H(1) when the arbitration was filed; and, (3) filed a further amendment when the arbitration is withdrawn changing the answer to Question 22H(1) to "No". Question 22G remains "No" at the time the arbitration is withdrawn because the arbitration has been reported on a previous Form U-4, even though it is not currently required to be reported. See Q5 under Question 22G. If the arbitration was not preceded by a written customer complaint regarding the same

allegations, then the registered person continues to answer "No" to Question 22G. Essentially, the Form requires the registered person to report the most serious outcome related to a particular set of allegations.

A registered person against whom an arbitration is withdrawn is not required to report the subsequent settlement; as a practical matter, a person who no longer is a respondent may not have ready access to information about the subsequent disposition of the matter. The final disposition of the arbitration as to that registered person is the withdrawal, and he has no obligation to report any subsequent disposition.

**Question 2:** What if a customer withdraws an arbitration claim against a particular respondent as part of a settlement of \$10,000 or more?

**Answer:** The registered person should answer "Yes" to Question 22H(1). For item 8a on the DRP, the registered person can report that the matter was settled, and in item 8c can report that the claim was withdrawn as part of the settlement and that no contribution was made to the settlement.

**Question 3:** If a registered person has reported an arbitration under Question 22H(1)(a), and the arbitration is settled by other respondents for \$10,000 or more, but the registered person is not a party to the settlement and does not pay any part of it, should the registered person answer "Yes" to Question 22H(1)? What if the registered person is a party to the settlement, but still does not pay any part of the settlement?

**Answer:** In either case, the answer to Question 22H(1) is "Yes". If an arbitration is settled as to some respondents but not others, then the respondents who do not settle must

continue to report that the arbitration is pending under Question 22H(1)(a) until there is some other disposition, e.g., withdrawal or dismissal of the claim or a separate settlement. If the registered person is a party to the settlement under Question 22H(1)(c), he must report the settlement, even if he contributed nothing to the settlement. The registered person can state on the DRP that he contributed nothing to the settlement.

**Question 4:** If a registered person is not named as respondent in an arbitration, but the statement of claim alleges that such person engaged in a sales practice violation, must the matter be reported?

**Answer:** No. Only persons who are named as respondents are required to report.

**Question 5:** If an arbitration claim names several registered persons as respondents, and the statement of claim contains allegations of sales practice violations, but does not specifically allege that each respondent was involved in a violation, which respondents should answer "Yes" to Question 22H(1)? For example, if the statement of claim alleges that a broker engaged in churning and that his office manager should have been overseeing the broker's activities, and the persons named as respondents are the broker and his branch manager, as well as the compliance director and the president of the broker/dealer, who should report?

**Answer:** The broker and his branch manager should answer "Yes" to Question 22H(1), but the compliance director and the president may answer "No."

Under the NASD's interpretation of this question on the previous Form U-4, any person who was named in an arbitration that alleged compen-

satory damages of \$10,000 or more, fraud, or the wrongful taking of property was required to report the arbitration. The rewording of Question 22H(1) on the Interim U-4 requires that a registered person must report an arbitration if he is named as a respondent and the statement of claim alleges that he was involved in one or more sales practice violations. Because the statement of claim alleges no sales practice violation by the compliance director or the president, they are not required to report the arbitration, even though they are named as respondents.

The term "involved" continues to be defined on the Forms, and the term "sales practice violations" is defined for the first time to clarify reporting obligations. The term "involved" includes both doing an act and failing reasonably to supervise another in doing an act. The term "sales practice violations" includes any conduct directed at or involving a customer that would constitute a violation of an SRO rule for which a person could be disciplined; any provision of the Securities and Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale, or purchase of a security or in connection with the rendering of investment advice, and thus includes churning. Thus, the broker and the branch manager must report the arbitration.

It is not necessary that a statement of claim use precise legal terminology. The fact that the claim does not use the legal term "failing reasonably to supervise" does not alleviate the branch manager's obligation to report. The allegation that the manager should have been overseeing a broker's activities is sufficient to trigger reporting. Firms and registered persons should review each claim on a case-by-case basis and make a good faith determination as to whether reporting is required.

**Question 6:** If a customer complaint is settled for a total of \$10,000 or more, but the registered person's contribution is less than \$10,000, should the registered person answer "Yes" to Question 22H(1)?

**Answer:** Yes. The question refers to the total amount of the settlement. The fact that the registered person contributes less than the threshold amount does not change his obligation to report.

**Question 7:** What if an arbitration is dismissed by an arbitration panel or the panel decides in favor of the respondent?

**Answer:** The registered person can file an amended Interim Form U-4 changing the answer to Question 22H(1) from "Yes" to "No".

## Question 22I

**Question 1:** When does a registered person have to report that he is the subject of an NASD investigation?

**Answer:** The Forms define the term "investigation". An investigation is defined to include an NASD Regulation investigation after the Wells notice has been given or after an associated person has been advised by the staff that it intends to recommend formal disciplinary action. An investigation does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, "blue sheet" requests or other trading questionnaires, or examinations.

**Question 2:** If the NASD files a complaint against a registered person, but the complaint is dismissed and not appealed, what should the registered person report?

**Answer:** When the registered person receives written notice that he is the subject of an NASD investigation,

the registered person should answer "Yes" to Question 22I. When the complaint is dismissed, the answer can be amended to "No".

A set of the Interim Forms is included with this *Notice*. Additional copies of the forms may be obtained by contacting NASD MediaSource<sup>SM</sup> at (301) 590-6142. There is no charge for ordering additional Forms. When placing your order, please allow two to three weeks for delivery. You may also photocopy the Interim Forms U-4 and U-5. The Interim Forms may also be obtained from the Internet at [www.nasdr.com](http://www.nasdr.com).

Members are required to use the Interim Forms as of March 16, 1998, and all other versions of the forms will then be considered obsolete. All forms received through March 13, 1998, will be processed. Subsequent to that date, the obsolete forms will be returned to the member.

In light of this delay in implementing the Interim Forms, we are implementing the following procedures to handle your form filings within the next 30 days:

- Between February 13 and March 13, 1998, we will accept for processing pages 1, 2, and 4 from both the Current and Interim Form U-4. (Note: Both the Interim Forms and the Current Forms U-4 and U-5 can be found on the NASD Regulation Web Site at [www.nasdr.com](http://www.nasdr.com).) This will permit firms which have completed the transition to the Interim Form to submit it and also permit firms which are still in transition to submit the current version of the Form.
- Since the disclosure questions have changed between the Current and Interim Forms, only page 3 and the Disclosure Reporting Page (DRP) of the Current Form U-4 can be accepted for processing during

the February 13 through March 13 period. Form filings containing a page 3 or a DRP from the Interim Form U-4, if required, will be returned to your firm.

- If an Interim page 3 or a DRP is returned to your firm, please mail or Federal Express the page 3 and related DRP from the Current Form U-4 to the following: CRD, P.O. Box 9401, Gaithersburg, MD 20898-9401, Attn: C. Horton. To further ensure quick processing, please indicate on your envelope or shipping label "Interim Replacement Form."
- **Between February 13th and March 13th, 1998, we will accept for processing the Current Form U-5 only. All Interim Forms U-5 received during this period will be returned, unprocessed to your firm. If a U-5 form filing is returned to your firm, please follow the procedures outlined above.**

### Modification Of The Public Disclosure Program

In approving the rule changes filed by NASD on October 17, 1997, the SEC approved the modification of the disclosure information currently released through the Public Disclosure Program. The modified information now includes the following:

- All pending consumer-initiated arbitrations and civil proceedings that relate to securities or commodities transactions;
- Pending written customer complaints alleging sales practice violations and compensatory damages of \$5,000 or more for 24 months from original posting if closed without a settlement by the firm;
- Settlements of \$10,000 or more of arbitrations, civil suits, and cus-

tomers complaints involving securities or commodities transactions;

- Current investigations involving criminal or regulatory actions;
- Terminations of employment after allegations involving violations of investment-related statutes or rules, fraud, theft, or failure to supervise investment-related activities;
- Bankruptcies less than 10 years old and outstanding liens or judgments;
- Bonding company denials, payouts or revocations; and
- Any suspension or revocation to act as an attorney, accountant or federal contractor.

Please note, however, that the following types of events will be archived (*i.e.*, classified as non-reportable and maintained in a Z record<sup>3</sup>) because they are not reportable on the Interim Forms. Examples of these events include:

- misdemeanor gambling charges/convictions;
- bankruptcies and compromises with creditors that are more than 10 years old (*i.e.*, 10 years from the date filed);
- arbitration proceedings that were dismissed or were decided in favor of the respondent;
- arbitration proceedings that were settled for less than \$10,000; and
- written customer complaints that do not meet the 22G/22H2 reporting thresholds/criteria.

In cases where a previously reported event is no longer reportable under the Interim Form U-4, a page 3 amendment should be filed changing

the previous “yes” answer to “no.” A DRP should be included with the amendment providing details to support the change in answer. Upon receipt and review of the amendment filing, the event will be archived in CRD.

## Endnotes

<sup>1</sup> Securities Act Rel. No. 39322 (November 13, 1997), 62 F.R. 62391; Securities Act Rel. No. 39562 (January 20, 1998), 63 F.R. 3942).

<sup>2</sup> The CRD is operated by NASD Regulation pursuant to an agreement between the

NASD and the North American Securities Administrators Association.

<sup>3</sup> A Z record is a filing “tag” added to each event that has been deemed no longer reportable on the current Interim Forms.

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