

Regulatory Notice

08-20

Proposed Changes to Forms U4 and U5

FINRA Requests Comments on Proposed Changes to Forms U4 and U5

Comment Period Expires: May 27, 2008

Executive Summary

FINRA requests comment on proposed changes to Forms U4 and U5. The proposed changes, which were developed by a working group composed of regulators and industry participants (the Working Group), are intended to benefit regulators, investors and the industry. Proposed revisions, among other things, would require firms to report, as customer complaints, allegations of sales practice violations made in arbitration claims and civil lawsuits against registered persons who are not named as parties in those proceedings. The proposals also include revisions to Forms U4 and U5 designed to ease, clarify or facilitate reporting requirements and other technical and/or conforming changes.

Questions concerning this *Notice* should be directed to Richard E. Pullano, Associate Vice President and Chief Counsel, Registration and Disclosure, at (240) 386-4821; or Stefanie M. Watkins, Senior Counsel, Registration and Disclosure, at (240) 386-4824.

Action Requested

FINRA encourages all interested parties to comment on to the proposed changes to Forms U4 and Form U5. Comments must be received by May 27, 2008. Member firms and other interested parties can submit their comments using the following methods:

- Mail comments in hard copy to the address below; or
- Email written comments to pubcom@finra.org.

April 2008

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topic(s)

- BrokerCheck
- Central Registration Depository (CRD® or CRD system)
- Form U4
- Form U5
- Uniform Registration Forms

Referenced Rules & Notices

- NASD IM 8310-2

To help FINRA process and review comments more efficiently, persons commenting on these proposed changes should use only one method. Comments sent by hard copy should be mailed to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1500

Important Notes:

The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, comments will be posted on the FINRA Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Proposed Revisions**Proposed Revisions to Question 14I on Form U4 and Question 7E on Form U5 to Require the Reporting of Allegations of Sales Practice Violations Made Against Registered Persons in a Civil Lawsuit or Arbitration in Which the Registered Person Is Not a Named Party**

The proposed changes to the Uniform Forms revise the customer complaint questions to elicit reporting of arbitrations and litigations that do not name a registered person as a party, but nonetheless allege sales practice violations against such person(s) in the text of the arbitration claim or civil complaint. The proposed revisions would have firms treat these matters as customer complaints.

Under the current reporting structure, a firm is not required to report on a registered person's Form U4 (Uniform Application for Securities Industry Registration or Transfer) that a customer has alleged a sales practice violation against such person in the body of a lawsuit or arbitration claim, unless the registered person also has been named as a defendant/respondent. Likewise, a firm is not required to report on Form BD that it has been named as a respondent in a consumer-initiated arbitration or to report that a sales practice violation was alleged against one of its registered persons under these circumstances. As a result, this form of "customer complaint" against a registered person or firm is currently unreported via the Uniform Registration Forms and, therefore, unavailable to regulators or prospective broker-dealer employers of the registered person via the Central Registration Depository (CRD®) or to the public through BrokerCheck.

Specifically, Question 14I(1) on the Form U4 requires a “yes” answer only if the registered person has ever been named as a respondent or defendant in an investment-related, consumer-initiated arbitration or civil litigation that alleged that he or she was involved in one or more sales practice violations³ and which:

- (1) is still pending;
- (2) resulted in an arbitration award or civil judgment against the person, regardless of amount; or
- (3) was settled for an amount of \$10,000 or more.

Question 7E(1) on Form U5 (Uniform Termination Notice for Securities Industry Registration) is worded similarly.

Question 14I(2) requires a “yes” answer if the registered person has ever been the subject of an investment-related, consumer-initiated complaint not otherwise reported under Question 14I(1) that alleged that he or she was involved in one or more sales practice violations and which was settled for \$10,000 or more.

Regulators have interpreted Question 14I(1) on Form U4 and Question 7E(1) on Form U5 to mean that even if a registered person is identified in the body of an arbitration claim or lawsuit as the person responsible for the alleged sales practice violation(s), the event is not required to be reported on the person’s Form U4 or U5 because he or she was not specifically named as a respondent/defendant in the arbitration or civil litigation.⁴ In other words, a “yes” answer to Question 14I(1) on Form U4 and Question 7E(1) on Form U5 is currently required only when the customer has sued a registered person or filed an arbitration claim naming the registered person as a respondent.

If the customer has sued or filed an arbitration claim against the firm only and not the registered person, a “yes” answer currently is not required on these questions, even if the customer has identified the registered person in the body of the lawsuit or arbitration as the person responsible for the alleged sales practice violation(s).⁵ If, however, a customer files a written complaint with a firm alleging that a registered person is responsible for the same sales practice violation(s), the firm and the registered person are responsible for reporting that customer complaint on the person’s Form U4 (Question 14I(3)) or Form U5 (Question 7E(3)), provided the complaint meets the threshold reporting requirements.

The same holds true for settlements. If a customer complaint against a registered person is settled (either by the person or the person's firm) for \$10,000 or more, the event is reported on the registered person's Form U4 or U5 under Questions 14I(2) or 7E(2), respectively. If the firm settles an arbitration or civil lawsuit for \$10,000 or more, and the person described in the complaint or claim as the person responsible for the alleged sales practice violation(s) is not a named respondent/defendant, the matter is not reported on any Uniform Registration Form and is thus unavailable to the public through BrokerCheck, and is also unavailable to regulators or prospective broker-dealer employers of the person through the CRD system. The inconsistent treatment regarding the reporting of alleged sales practice violations is difficult to reconcile on principle: in both instances a sales practice violation has been alleged. Moreover, this reporting inconsistency raises practical concerns because the practice of making a firm the sole respondent in an arbitration claim is becoming more prevalent in circumstances where the allegations involve sales practice violation(s) against a registered person.

After considerable discussion, the Working Group developed proposed revisions to Questions 14I(2) and (3) on Form U4 and Questions 7E(2) and (3) on Form U5 that are intended to address this issue. FINRA is seeking comment on the Working Group's proposal to require firms to report allegations of sales practice violations against a registered person in an arbitration or litigation, notwithstanding the fact that the customer or the customer's counsel has not named the registered person as a party in the action. More specifically, the proposed questions address this reporting inconsistency by adding "arbitration claim or civil litigation" to "customer complaint" in Questions 14I(2) and (3) on Form U4 and Questions 7E(2) and (3) on Form U5. The proposed change would require the reporting of alleged sales practice violations made by a customer against persons identified in the body of a complaint or arbitration claim, even when those persons are not named as parties.

As proposed by the Working Group, Questions 14I(2) and (3) on Form U4 would read as follows (the italicized terms would have the same meaning as they do on the current Forms U4 and U5):⁶

- 14I(2)** Have you ever been the subject of an *investment-related*, consumer-initiated complaint, arbitration claim or civil litigation, not otherwise reported under question 14I(1) above, which alleged that you were *involved* in one or more *sales practice violations*, and that was settled for an amount of \$10,000 or more, or resulted in an arbitration award or civil judgment against the named respondent(s), regardless of amount?

14I(3) Within the past twenty-four (24) months, have you been the subject of an *investment-related*, consumer-initiated, written complaint, arbitration claim or civil litigation, not otherwise reported under question 14I(1) or (2) above, which:

(a) alleged that you were *involved* in one or more *sales practice violations* and contained a claim for compensatory damages of \$5,000 or more (if no damage amount is alleged, the complaint, arbitration claim or civil litigation must be reported unless the *firm* has made a good faith determination that the damages from the alleged conduct would be less than \$5,000), or;

(b) alleged that you were *involved* in forgery, theft, misappropriation or conversion of funds or securities?

As proposed by the Working Group, Questions 7E(2) and (3) on Form U5 would read as follows (the italicized terms would have the same meaning as they do on the current Forms U4 and U5):⁷

7E(2) In connection with events that occurred while the individual was employed by or associated with your *firm*, was the individual the subject of an *investment-related*, consumer-initiated complaint, arbitration claim or civil litigation, not otherwise reported under question 7(E)(1) above, which alleged that the individual was *involved* in one or more *sales practice violations*, and that was settled for an amount of \$10,000 or more, or resulted in an arbitration award or civil judgment against the named respondent(s), regardless of amount?

7E(3) In connection with events that occurred while the individual was employed by or associated with your *firm*, was the individual the subject of an *investment-related*, consumer-initiated, written complaint, arbitration claim or civil litigation, not otherwise reported under questions 7(E)(1) or 7(E)(2) above, which:

(a) would be reportable under question 14I(3)(a) on Form U4, if the individual were still employed by your *firm*, but which has not previously been reported on the individual's Form U4 by your *firm*; or

(b) would be reportable under question 14I(3)(b) on Form U4, if the individual were still employed by your *firm*, but which has not previously been reported on the individual's Form U4 by your *firm*.

“Yes” answers to revised Questions 14I(2) or 14I(3) on Form U4 and Questions 7E(2) and 7E(3) on Form U5 would indicate that the registered person, though not named as a respondent/defendant in a customer-initiated arbitration or civil lawsuit, was either named in or could be reasonably identified from the body of the “arbitration claim or civil litigation” as a registered person who was involved in one or more of the alleged sales practice violations. A firm would be required to report a “yes” answer only after it has made a good faith determination after a reasonable investigation that the alleged sales practice violation(s) involved the registered person.⁸

FINRA proposes that reports of alleged sales practice violations made by a customer against persons identified in the body of a complaint or arbitration claim (as described above) would be treated the same way that customer complaints are currently treated. For example, such matters would be required to be reported no later than 30 days after receipt by the firm. In addition, as is currently the practice with respect to customer complaints reported to CRD, registered persons would have an opportunity to provide context on the reported matter on Form U4; persons not currently registered with a FINRA member firm, but who were registered within the previous two years, would be afforded an opportunity to provide context on the reported matter through a Broker Comment.⁹ Such matters would be disclosed through BrokerCheck consistent with NASD Interpretive Material 8310-2. To the extent such a matter becomes non-reportable (if, for example, the arbitration or litigation is dismissed and the dismissal is not part of a settlement, or it is settled for less than the dollar amount designated on Form U4), it would, like other customer complaints that become non-reportable, be eligible for disclosure through BrokerCheck as an Historic Complaint, provided certain criteria are met.¹⁰ FINRA proposes that firms would be required to respond to these proposed questions on a prospective basis only. FINRA would draft new interpretive guidance or modify existing interpretive guidance as appropriate to address filing or interpretive issues.

Proposed Revisions to Question 14I on Form U4 and Question 7E on Form U5 to Raise the Dollar Threshold from \$10,000 to \$15,000

Currently, Questions 14I(1)(c) and 14I(2) on Form U4 and Questions 7E(1)(c) and 7E(2) on Form U5 require customer complaints to be reported only when they have been settled for \$10,000 or more. Recognizing that the monetary threshold for settlements of customer complaints was set some time ago and has never been adjusted for inflation, members of the Working Group are considering raising the existing settlement amount to \$15,000 to more accurately reflect the business criteria (including the cost of litigation) firms consider when deciding to settle claims.

Proposed Revisions to the Initial Form U5 to Allow Firms to Amend the “Reason for Termination” and the “Date of Termination”

Currently, firms are explicitly precluded from changing the Reason for Termination and Date of Termination sections of Form U5 absent a court order or an arbitration award that meets certain criteria. Since 2000, firms have had the ability to add a Registration Comment (essentially, a note on the person’s CRD record) to report an error in connection with the filing of either the reason for, or date of, termination. The Registration Comment explains the reason for the change, but does not amend the original reason for/date of termination.

After reviewing the Registration Comments reported by firms since 2000, the Working Group concluded that it would be beneficial for firms and regulators to permit firms to amend the reason for, or date of, termination because:

- (1) the majority of requests to change a reason for, or date of, termination are a result of clerical errors made by a firm; and
- (2) the inaccurate information originally reported currently remains on a person’s CRD record unless the person is able to obtain an arbitration award or a court order directing that the original entry be expunged or changed.

The proposed change would require firms to provide a reason for the amendment. To monitor such amendments, including those reporting terminations for cause, FINRA staff is proposing to notify other regulators and the broker-dealer currently employing the person (if the person is with another firm) when a reason for termination or date of termination has been amended.

Technical, Conforming and Other Changes to Forms U4 and U5

FINRA is proposing various technical, conforming and other changes to Forms U4 and U5. These changes are generally intended to clarify the information elicited by regulators and to facilitate reporting by firms and regulators.

FINRA proposes changing “free text” fields to discrete fields on the Disclosure Reporting Pages (DRPs) of Forms U4 and U5. The proposed changes to the DRPs will not change the information currently elicited; however, the presentation of the DRPs will change. For example, a completeness check will prevent a filing from being submitted without a firm having provided information in response to the allegations and disposition detail questions. FINRA anticipates that this will reduce the need for additional communications between FINRA staff and firms that occur when DRP filings are incomplete, and generally will make the filing process more efficient.

FINRA also proposes adding to Section 7 (Disclosure Questions) of Form U5 an optional Certification Checkbox that would enable firms to affirmatively represent that all required disclosure has been reported on a person and the record is current at the time of termination. The checkbox would allow the firm to bypass the process of re-reviewing a person’s entire disclosure history for purposes of filing Form U5 if there is no new or updated disclosure to report at the time of the person’s termination.

Endnotes

- 1 See *Notice to Members 03-73* (November 2003) (NASD announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Submit only information that you wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and the rules thereunder.
- 3 See “Explanation of Terms,” which, in part, defines “sales practice violation” as “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...”
- 4 See Question 4 under the 14I(1) set of questions on Forms U4/U5 Interpretive Guidance on FINRA’s Web site at www.finra.org.
- 5 Moreover, in addition to not being reportable on Forms U4 or U5, such a matter is not reportable on Form BD because Form BD does not require the reporting of any customer-initiated complaints, arbitrations or civil litigations. FINRA notes, however, that certain summary information about arbitration awards rendered in claims brought by customers against firms may be obtained through BrokerCheck.
- 6 The italicized “explained terms” have the following meanings:

Firm: a broker-dealer, investment adviser, or issuer, as appropriate.

Investment-related: securities, commodities, banking, insurance or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank or savings association).

Involved: an act or aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act.

Sales Practice Violations: any conduct directed at or involving a customer that 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.
- 7 See *supra* note 3.

Endnotes (cont'd)

- 8 In this regard, the Working Group discussed adding instructions to the Forms that would provide guidance to firms on when an affirmative answer to the proposed questions was appropriate. The instruction would indicate that a “yes” answer would be required where (1) the Statement of Claim or Complaint specifically mentions a registered representative by name and alleges the registered representative was *involved* in one or more *sales practice violations*; or (2) the Statement of Claim or Complaint does not mention a registered representative by name, but the firm has made a good faith determination after a reasonable investigation that the *sales practice violations* alleged *involve* one or more particular registered representatives.
- 9 Individuals who currently are not registered with FINRA, but who have been FINRA-registered within the last two years and who are, therefore, available on BrokerCheck, may submit a Broker Comment to provide an update or context to information that is disclosed through BrokerCheck. Individuals who currently are registered with FINRA, are associated with a member firm, and who wish to provide an update or context to information that is disclosed through BrokerCheck are required to file an amended Form U4.
- 10 See NASD IM-8310-2(b)(7).