

# The National Association of Investment Professionals

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## Comment re Notice to Members 97-77

Proposed Rule 1150 regarding Forms U-4 and U-5, qualified immunity

Dear Ms. Conley:

Thank you for receiving comments regarding the qualified immunity proposal, Rule 1150. Please consider the following in further consideration of the proposed rule.

### **Executive Summary**

\* Under existing state laws, employers already enjoy a qualified privilege for statements made about former employees. Truth-telling is never actionable, making this rule unnecessary.

\* There is no evidence that member firms face a problem with U-5 defamation claims, which is the justification given for this proposed rule.

\* Neither SROs nor the SEC have authority to ignore existing state law, as this proposal would do with its uniform "clear and convincing" evidence standard, as well as other proposed legal standards for defamation.

\* The discussions between regulators and the industry regarding this proposal failed to include industry employees--the people who would be most affected by the rule. This exclusion appears to be a violation of NASD policy.

\* The record is clear that disclosure rules have been neither consistently followed by firms nor enforced by regulators. Whether or not U-5 defamation claims pose a problem for the industry can only be ascertained after existing disclosure rules are fully enforced.

For the above reasons, the proposal should be withdrawn at this time.

### **Employers already enjoy a qualified privilege**

The Notice to Members 97-77 notes that "At common law, courts have generally found that employers are entitled to a qualified privilege for statements made about former

employees to prospective employers.” The privilege “may be overcome by proof that the employer knew or was reckless in not knowing that the statement was false.”<sup>1</sup>

Clearly, under existing state tort law, telling the truth--or even making honest mistakes--is not actionable. Therefore, no further rule is needed to promote candid and accurate disclosure.

### **No evidence that U-5 defamation claims are a problem**

The proposed rule seeks to lessen the alleged risk broker/dealers face from defamation suits, and thereby improve disclosure. But in drafting this proposal, the NASDR and other regulators have done nothing to quantify whether U-5 defamation claims are indeed a problem.<sup>2</sup> In fact, NASDR executive vice president Linda Fienberg, in a September 1997 letter, expressly noted that the NASDR’s U-5 immunity committee has “not reviewed defamation cases during our discussions and drafting process. ... We have not analyzed specific defamation cases ... in working on a proposal with respect to Form U-5 disclosure.”<sup>3</sup>

Nevertheless, several studies on U-5 defamation claims do exist. None found that firms face a problem from U-5 defamation exposure.

A 1995 study by NASD assistant general counsel Anne H. Wright found only seven “pure” U-5 defamation claims over about five years, and concluded that “available statistics do not suggest that [U-5 defamation] claims are routinely raised or that large damage awards are the norm. ...”<sup>4</sup> Another 1995 report on defamation cases prepared by the *Securities Arbitration Commentator* newsletter concluded that the “statistics are not persuasive” that firms are getting hit with many defamation claims arising from U-5 filings.<sup>5</sup> Most recently, *Registered Representative* magazine reviewed NASDR arbitration cases decided between September 1996 and July 1997.<sup>6</sup> The magazine found four “pure”

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<sup>1</sup> For a discussion of state tort law as it may apply to U-5 filings, see the May 31, 1996 remarks of SEC Commissioner Isaac C. Hunt Jr. before the NYSE Legal Advisory Committee, entitled: “What Level of Protection is Appropriate for Brokerage Firms in Preparing Form U-5s--Qualified or Absolute Immunity?”

<sup>2</sup> Notice to Members 97-77 says only that: “... members’ *potential* exposure ... *may* be substantial”; “The *potential* liability” is a disincentive for disclosure; and that “Members have also questioned the fairness of exposure to *potentially* significant liability. ...” (Emphasis added.)

<sup>3</sup> Sept. 17, 1997 letter to Thomas O’Keefe, president, National Association of Investment Professionals (NAIP).

<sup>4</sup> “Form U-5 Defamation,” published at 52 Washington & Lee Law Review, 1299 (1995). Wright’s study found 55 defamation-related cases since 1989, an amount that represented a “small fraction” of intraindustry disputes, which themselves are a “tiny percentage” of all arbitrations.

<sup>5</sup> *Securities Arbitration Commentator*, 10/95, Vol. VII, No. 8, Page 5. The study found 57 cases heard between May ‘89 and early 1995 that had “definite U-5 allegations,” along with other claims. The newsletter added that the number of these awards since 1989 “remains relatively steady.”

<sup>6</sup> *Registered Representative*, October 1997, with the corrected figure of \$616,000 printed in November 1997. The magazine found 11 “pure” U-5 defamation cases (no other claims made) out of a total of 41

U-5 defamation cases where registered employees won monetary damages--a total of \$616,000--an amount that would not appear to be a problem for the industry.<sup>7</sup>

No doubt the NASDR felt compelled to act on the immunity issue, regardless of whether any problem exists, due to pressure from the SEC. A bit of history on SEC involvement: In May 1994, the SEC's Division of Market Regulation issued its Large Firm Project report--the findings from its sweep of "rogue" brokers at major firms.<sup>8</sup> Among several recommendations, the Division called for "uniform policies" regarding the "liability and immunity of broker-dealers and their associated persons with respect to state law defamation actions" arising from required regulatory filings. Shortly thereafter, the SEC Chairman endorsed the idea of qualified immunity for members. However, the SEC's support for qualified immunity was premature and unwarranted.<sup>9</sup>

With considerable (albeit misguided) pressure from the SEC, it is understandable that the NASDR has submitted this proposal. But facts and data should never be ignored in rulemaking.<sup>10</sup> That critical data was ignored in drafting proposed Rule 1150 is sufficient reason to withdraw it.

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cases where brokers filed various claims that also included a U-5 problem, and/or where the U-5 was ordered amended by the arbitration panel. (This commentator was involved in the magazine's study.)

<sup>7</sup> The securities industry booked \$11.27 billion in pre-tax net profits in 1996, according to the SIA.

<sup>8</sup> "The Large Firm Project: A Review of Hiring, Retention and Supervisory Practices," Division of Market Regulation, Division of Enforcement, May 1994.

<sup>9</sup> Division staff failed to cite any evidence in the Large Firm report of a U-5 defamation claim problem, saying only that: "Regulators have raised *concerns* that the *fear* of litigation has led firms to be less candid in their filings. ... Staff believes that *concerns* of firms and supervisory personnel regarding civil liability for statements made in regulatory filings ... warrant further examination." (Emphasis added.)

Nevertheless, SEC Chairman Arthur Levitt then proceeded to publicly and enthusiastically support the idea of qualified immunity. On Sept. 14, 1994, Chairman Levitt endorsed qualified immunity for U-5 statements during a hearing on rogue brokers before the House Subcommittee on Telecommunications and Finance (Committee on Energy and Commerce). In a Feb. 9, 1995 address at a New York Stock Exchange ethics conference, Chairman Levitt said:

"There's one key issue on which we haven't yet made significant headway -- that of offering qualified immunity to firms on form U-5. Hardly a day goes by without a reminder of the importance of this issue --like the article in the Wall Street Journal last week which observed that 'Brokers can move from firm to firm with impunity.' The president of a firm went on to say, 'The problem is, on Wall Street, the brokerage firm that has an employee terminated [is] scared to death to give the real reason.'

"It's a complex issue. But I assure you today that we intend to address it -- whether it requires an SRO or SEC rule, or an act of Congress, we will continue to seek an environment in which firms are not penalized for honesty on Form U-5."

However, in a May 9, 1997 letter to Rep. Edward J. Markey (D-Mass.), the SEC Chairman noted that "Under state law, truth is an absolute defense to a defamation action." The Chairman's letter was in response to a previous letter from Rep. Markey. Rep. Markey's letter had asked if the SEC was aware of cases within the last five years where a broker/dealer was successfully sued by a former employee "for disclosing truthful information regarding the reasons for an employee's departure or dismissal" (emphasis in original). The SEC Chairman replied that, "the staff is not aware of any such cases."

<sup>10</sup> Completely absent from the debate on U-5 immunity is any attempt to find the true reason for lax disclosure by members. It is well understood in the industry that a clean termination is the easiest and safest way to rid oneself of a problem representative. With a clean U-5, the rep can obtain employment

### **Neither SROs nor the SEC have authority to write law**

The proposal says that, “In most states, the [existing] 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. ...”

Proposed Rule 1150 would protect member firms “if the [U-4 or U-5] statement was true at the time that the statement was made.” Plaintiffs would have to show, “by clear and convincing evidence,” that respondents “knew at the time that the statement was made that it was false in any material respect” or “acted in reckless disregard as to the statement’s truth or falsity.”

While the securities acts give the SEC broad authority in making rules governing the securities industry, as well as delegating rulemaking responsibility to SROs, the securities acts do not give regulators authority to supersede specific state laws that would otherwise apply to a particular claim. Any lawmaking by an association of member firms, or by the SEC, that supersedes specific state law is bound to be successfully challenged in a court of law, especially given the NASD’s policy of mandatory industry arbitration of employment claims. This proposal, if implemented, will provide further ammunition to those who would challenge the legitimacy of the arbitration system.

### **Industry employees had no input in the rule-drafting process**

Under the NASD’s August 1996 settlement with the SEC (the Remedial Sanctions Order), the NASD was directed to make rules “with any consultations with interested NASD constituencies made in a fair and evenhanded manner.”<sup>11</sup> The NASD later made representations to the SEC that all constituencies would have input at the early stages of any rulemaking process.<sup>12</sup>

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elsewhere. And while it is true that a clean, but false, U-5 termination form would minimize a firm’s defamation exposure, the far larger benefit of such non-disclosure by a firm is reduced exposure from customer suits and regulatory inquiries. After all, the danger of an occasional suit by a rogue broker is minimal, presuming the broker has a history of documentable problems. Far greater are the risks from suits by multiple customers who could discover a problem via the public reporting of U-5 information and/or use the information as an admission by the firm of a failure to supervise. Also, in the case of terminations for cause and the subsequent filing of a U-5 that indicates a problem, regulatory inquiries of the broker by SROs are automatic. A clean U-5 allows firms to avoid such inquiries from the NASDR or NYSE, and thereby eliminate the risk of failure-to-supervise charges.

<sup>11</sup> SEC Release No. 37538, August 8, 1996.

<sup>12</sup> On July 18, 1997, Richard Ketchum, NASD COO and executive vice president, sent to the SEC a draft memo to “memorialize a policy for ensuring that NASD rulemaking is fair and balanced and that interested constituencies have the proper access to staff and committees during the important formative stages of the rulemaking process.” (Cited from the report of the NASD’s independent auditor, Frederick Werblow, July 25, 1997, Page 15.)

Unfortunately, registered representatives, the people who would be most affected by this proposal, have not had input in the U-5 immunity debate.<sup>13</sup> The ad hoc U-5 immunity task force, which drafted this proposed rule, included representatives from the NASDR, other SROs, NASAA, the SEC and the SIA. The industry representative, the SIA, represents brokerage firms, not registered employees.

Nevertheless, the NASDR cites employee “representatives” in its Notice to Members 97-77, claiming these representatives spoke for employees during the U-5 immunity discussions.<sup>14</sup> In fact, these employee “representatives” were three plaintiffs’ attorneys, who, with all due respect, represent their own interests, which are not necessarily the interests of those who work within the industry.<sup>15</sup> Industry employees, after all, generally want to avoid litigation; plaintiffs’ attorneys may have incentives to support policies that increase the scope and expense of litigation.

This exclusion of industry employees is a clear violation of the Remedial Sanctions Order. For this reason alone, the proposal should be withdrawn.

If such a rule is later determined to be both legal and necessary, a new round of U-5 immunity discussions should be sure to include true employee representatives in the immunity-debate process. New discussions, if any, should also be done in open, public forums appropriate to such law-writing activity, not the secret, closed-door sessions used thus far. The members of any qualified-immunity committee should also be disclosed so that interested constituencies could determine for themselves whether their interests were represented by these members.<sup>16</sup>

### **Existing disclosure rules should be enforced first**

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<sup>13</sup> In a May 1997 letter to the NASDR, the NAIP, the one known association for registered persons, offered to play a part in the U-5 immunity discussions. The NASDR did not respond to this offer. (See the NAIP’s comment letter, dated Dec. 30, 1997, for a full discussion of NASDR/NAIP contacts. This commentator sits on the NAIP board.)

This commentator would also note that the timing of the proposal’s release (Nov. 3, 1997) and deadline for comment (Dec. 31, 1997)--smack dab in the middle of the holiday season after several years of discussion on this issue--seems designed to minimize input by relatively non-organized constituencies such as brokers. Therefore, the NASDR’s comment period should be extended by at least three months, assuming the proposed rule is not withdrawn first.

<sup>14</sup> Notice to Members 97-77 reads: “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.” (Emphasis added.)

<sup>15</sup> One of the plaintiffs’ attorneys, Jeffrey Liddle of Liddle & Robinson in New York City, now rejects the entire proposal and the legal research on which it is supposedly based (see Mr. Liddle’s comment letter dated Dec. 17, 1997). Another, Leslie Corwin of Morrison, Cohen, Singer & Weinstein in New York City, does not support the clear-and-convincing evidentiary standard (see Mr. Corwin’s comment letter dated Oct. 9, 1997). The third plaintiffs’ attorney and member of the U-5 ad hoc panel has not spoken publicly about the proposal.

<sup>16</sup> This commentator, as editor of a trade journal read by 90,000 stockbrokers, has on several occasions asked the NASDR for the names of the members on the NASDR’s ad hoc U-5 immunity task force, and was rebuffed each time.

The genesis of the U-5 immunity process was the recognition in the Large Firm report that full disclosure on form U-5s has not always been forthcoming. While the NASDR has existing rules that, if enforced, would ensure full and accurate disclosure, only relatively recently have major firms, such as those included in the Large Firm Project, received any kind of significant fines from regulators for lax and late disclosure, the largest and latest one being a \$125,000 NYSE fine against Smith Barney in June 1997.<sup>17</sup>

Meanwhile, despite several well-known cases of outright malicious fabrications by firms on brokers' U-5s,<sup>18</sup> this commentator can find no mention in the CRD (the public reporting database) of regulatory action against any of the abusing firms.

Since regulators appear unwilling or unable to get involved in individual employee-firm disputes, no additional impediments should be put before employees who wish to assert a private action.

Once the rules relating to full and accurate disclosure are enforced (including for lax and late filings, as well as for malicious fabrications), the NASDR could then quantify any subsequent increase in the incidence and expense of arbitration claims, and use that data to consider new rules, if indeed such rules were appropriate.

## Conclusion

This proposed rule is unnecessary since under existing state laws, employers already enjoy a qualified privilege for statements made about former employees. Truth telling is never actionable.

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<sup>17</sup> Smith Barney was already on NYSE "probation" for the same problem. There are only a handful of such enforcement actions industrywide, and the Smith Barney fine is clearly the largest ever. In fact, the Large Firm Project report noted that, prior to formal enforcement action for violations of reporting rules, fines against Big Board members are handled pursuant to "NYSE Rule 476A, entitled 'Imposition of Fines for Minor Violation(s) of Rules,' [also] known as the 'traffic ticket' rule," the report said, because of its maximum \$5,000 fine.

<sup>18</sup> A few U-5 defamation-related cases are worth a brief mention:

\* *Ulrich v. Whitaker*, (1995) NASD arbitration No. 93-281. Panel says firm (Eaton Vance Distributors) used the U-5 as leverage in negotiating a severance agreement.

\* *Benzer v. Shearson Lehman Bros.*, (1994) NYSE arbitration No. 1992-2500. Panel says firm was "grossly negligent in its failure to verify the accuracy" of the U-5.

\* *Baravati v. Rosenkrantz Lyon & Ross*, (1993), NASD arbitration No. 91-419. Panel says firm used "unconscionable language" on the U-5. Award confirmed by a federal court and the court of appeals for the Seventh Circuit.

\* *Glennon v. Dean Witter Reynolds*, (1993) NASD arbitration No. 91-2594. Panel gives \$1.5 million plus attorney's fees to former BOM, refers case to NASD enforcement. Award upheld by the U.S. District Court, middle district of Tennessee (1994), which said the firm "deliberately and intentionally" maligned the BOM on his U-5.

\* *Glasser v. Prudential Securities*, (1996) NYSE arbitration No. 94-003795. Panel orders 15 limited partnership-related complaints removed from the rep's CRD record, calls firm's reporting inadequate. Refers case to NYSE enforcement.

Despite the regulatory referrals in the latter two cases, neither regulator has taken any action, and none appears to be forthcoming.

The NASDR provides no evidence that firms face an undue amount of risk from U-5 defamation claims; in fact, the NASDR has expressly stated that it has not analyzed any data regarding the issue. This blatant ignoring of key data raises a question as to whether the U-5 immunity discussions were truly a fact-finding process, or simply the result of effective lobbying by the industry.<sup>19</sup>

Furthermore, the NASD has no authority to force arbitrators to ignore applicable state law. In fact, such legal standard-setting by an SRO will likely help undermine the legitimacy of industry arbitration by provoking further challenges to the system.

Stockbrokers, the industry employees who would be most affected by the proposed rule, were never, at any time, involved in discussions leading to the draft rule. This is apparently a violation of NASD policy.

Finally, the NASDR already has authority to ensure that full and accurate disclosures are made. Yet, the record indicates an inability or unwillingness to take serious enforcement action in response to an acknowledged industrywide disclosure problem. The entire regulatory community is to blame here, including the SEC. It is, frankly, frightening that regulators not only dropped the ball in enforcing disclosure rules, but then readily accepted the industry's argument that the "fear" of defamation claims prevented full disclosure. Surely, regulators everywhere are aware that the "fear" of litigation is, and never has been, a valid reason for either a member firm or associated person to avoid making required disclosures. Despite any such "fears," the rules must be fully enforced, and only then would the NASDR be in a position to analyze whether or not the rules of disclosure are an undue burden on firms.

For these reasons, proposed Rule 1150 should be withdrawn from consideration at this time.

Sincerely,

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The commentator works as the Editor in Chief of a trade journal for stockbrokers, and serves on the board of the National Association of Investment Professionals (NAIP), a professional association for registered representatives. Views are his own.

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<sup>19</sup>The lobbying effort was quite effective in not only deflecting attention away from lax disclosure, but also in opening a Pandora's Box of possible increased legal protections from a variety of employment claims. For example, after failing to achieve absolute immunity, the SIA is now asking that the proposal be expanded to include *all* claims arising from forms U-4 and U-5, not just defamation claims. (See SIA comment letter dated Dec. 19, 1997).

Note, too, that malicious U-5s serve as an effective tool dealers can use against whistleblowers, as well as against any departing broker in an attempt to keep that broker's accounts, negotiate severance agreements, etc. More protection for U-5 statements will increase the effectiveness of using the U-5 in such a fashion.