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December 24, 1997

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

Re: NASD Regulation Request for Comment 97-77

Dear Ms. Conley:

The Bond Market Association (the "Association")¹ submits this letter to provide NASD Regulation, Inc. ("NASD Regulation") with comments on proposed National Association of Securities Dealers, Inc. ("NASD") Rule 1150 (the "Rule"), which, among other things, would establish a uniform minimum standard of qualified immunity and associated standard of proof² for member firms (and their associated persons) in NASD arbitration proceedings for statements made concerning the termination of employees in NASD Form U-5, Uniform Termination Notice for Securities Industry Registration, and other mandatory disclosures.³ The Association commends NASD Regulation for addressing this issue of critical importance to the oversight of securities industry personnel and welcomes the opportunity to comment on the proposed Rule.

I. Introduction

The Association supports NASD Regulation's efforts to promote candid and accurate disclosure by member firms of material information regarding the termination of their former employees. The confidence of investors in the U.S. securities markets depends heavily on the integrity and trustworthiness of securities industry personnel; regulators and member firms must therefore have access to information regarding registered representatives to help ensure that the industry avoids entrusting individuals with a track record of misconduct or incompetence with responsibility for customer accounts. All of the Association's comments for the modifications to the Rule discussed below are driven by the experience of its members as to the steps that will foster this critical objective.

The duty of disclosure, however, routinely exposes member firms to the threat of arbitration claims or lawsuits, as former employees allege that disclosure documents such as Form U-5 contain untrue statements concerning their employment history. The significant cost of defending and litigating such claims in arbitration proceedings and subsequent litigation - whether or not claimants ultimately prevail in these suits⁴ - has had a chilling effect on the nature and extent of disclosure contained in Form U-5 and other documents required to be submitted to self-regulatory organizations ("SROs") and regulatory bodies. Furthermore, while the Association condemns those rare incidents where member firms have apparently abused the disclosure regime to retaliate against

former employees, such abuses are, in our experience, infrequent and are adequately deterred by existing disciplinary rules.⁵ As a result, the small likelihood of potential problems affecting employees should not be permitted to drive the level of protection afforded to the vast majority of member firms that discharge their obligations under Form U-5 in good faith but are nonetheless regularly called upon to incur the cost and burden of defending themselves against meritless claims of defamation.

The Association supports the approach taken in the Rule and endorses the proposed uniform minimum standard of qualified immunity and accompanying standard of proof. In the Association's view, however, the Rule can be improved in three key respects: first, the Rule should be broadened to cover all circumstances in which qualified immunity is appropriate for the protection of the investing public; second, the Rule should not allow a claimant to overcome a member firm's qualified immunity when the claimant cannot show that the firm knew an alleged untrue statement was materially false when made; and third, the Rule should preserve the higher degree of protection now afforded member firms for defamation claims to which they and all other similarly situated entities are now entitled in many contexts. Each of these suggestions would greatly improve the Rule and enhance disclosure to the marketplace by promoting a framework where frivolous claims are less likely to prevail without inhibiting the ability of truly aggrieved former employees to be compensated for abuses by member firms.

The Association, furthermore, is seriously concerned about some of the provisions proposed in the Rule that are not likely appreciably to improve the quality of information disclosed. For example, mandating that terminated employees be given the opportunity to review their Form U-5, or to seek pre-filing mediation or arbitration with respect to its contents, would be administratively burdensome and could unnecessarily delay dissemination of information regarding a terminated employee's employment history to prospective employers. Pre-filing arbitration and mediation procedures may also result in the disclosure of information that jeopardizes investigations into other employees, thus exposing the investing public to further misconduct at the hands of such individuals. Likewise, the proposal that a registered person, compliance officer or attorney sign the Form U-5 or any other covered form would impose unnecessary administrative burdens on member firms without any corresponding improvement in disclosure.

In this connection, the Association also suggests that NASD Regulation modify the Form U-5 itself to help reduce the occasions for disagreement over certain disclosure requirements that frequently generate disputes. Form U-5 should, in the Association's view, be revised to limit the circumstances in which narrative explanations are required and to offer member firms a greater choice of unambiguous prescribed categories pertaining to a terminated employee's conduct. The form should also minimize disclosures that are in the nature of allegations of possible misconduct and instead seek to elicit verifiable facts regarding the employee's termination. NASD Regulation should also facilitate an improvement in the quality of disclosure by issuing formal Questions and Answers, similar to those prepared by the Municipal Securities Rulemaking Board, that identify and provide suitable explanations for frequently occurring situations.

II. Discussion

A. The adoption of a uniform minimum standard of qualified immunity with respect to statements made in Form U-5 and other mandatory disclosures is necessary to further the interests of the investing public in disclosure of candid and accurate information regarding terminated employees.

The Association endorses the adoption of a uniform minimum standard of qualified immunity in NASD arbitration proceedings for member firms with respect to statements regarding terminated employees made in Form U-5 and other mandatory disclosures. There is little question that member firms, as with other employers, currently enjoy some degree of immunity with respect to statements regarding the circumstances under which former employees are terminated. Most states recognize a conditional or "qualified" privilege for statements made by an employer concerning a current or former employee's work record or qualifications because of the compelling social interest in making such information available to prospective employers.⁶ The case for establishing a uniform minimum standard of immunity - i.e., a floor, but not a ceiling, for example, where a higher level of immunity is available under state or other law applicable to all entities similarly situated to member firms - for statements made in Form U-5 and other mandatory disclosures is even stronger because member firms are required by the NASD (as well as other SROs and, in some cases, regulatory bodies) to disclose their reasons for terminating employees and are subject to disciplinary action and may face potentially significant liability for failure to provide sufficient disclosure.⁷ Member firms must therefore, in many cases, either expose themselves to the threat of arbitration or litigation or face sanctions for failure to honor such obligations. The Rule is constructive in assuring member firms that they may fulfill their regulatory duties without fear of having to litigate whether their disclosures enjoy the benefit of, at least, qualified immunity.

Establishing a uniform minimum standard of immunity applicable in all NASD arbitration proceedings would also help ensure that arbitrators take heed of the significant policy reasons underlying the Rule when adjudicating defamation and related claims. The threat that former employees may institute actions against their former employers for alleged defamatory statements made in Form U-5 and other mandatory disclosures is often compounded by the extremely limited judicial review of arbitration awards.⁸

As drafted, however, the Rule would not adequately cover all circumstances in which qualified immunity is appropriate for the protection of the investing public. Moreover, the Rule in its present form would allow claimants to overcome a member firm's qualified immunity even when the claimant cannot show that the firm knew an alleged untrue statement was materially false when made. As discussed more fully below,⁹ it is critical that NASD Regulation broaden the scope of claims to which qualified immunity applies and limit the circumstances in which it may be overcome to encourage members to provide candid and accurate disclosure of preliminary investigations and information regarding the circumstances of an employee's termination.

Furthermore, the Rule, as proposed, could have the unintended and perverse effect of reducing the level of protection from defamation claims that member firms and everyone else now enjoy under the law in those jurisdictions or in those contexts where members currently have the benefit of a higher standard of immunity. The Rule should, in our view, clarify that, in those circumstances in which the law confers a higher level of protection - such as the absolute immunity currently afforded to any person or entity, including a member firm, that responds to a subpoena for the production of information in connection with a judicial proceeding¹⁰ - the qualified immunity provided by the Rule will not supplant the greater protection to which the member firm, and anyone else acting in the same circumstances, would otherwise be entitled.

1. The scope of the qualified immunity afforded member firms under the proposed Rule should encompass all circumstances necessary to promote candid and accurate disclosure of required information.

The Association appreciates the care that NASD Regulation has taken to ensure that qualified immunity is available to member firms in circumstances where, by virtue of the identity of the person to whom the statement is communicated or the nature of the information to be disclosed, such immunity is necessary to advance the purposes of the NASD's disclosure regime. However, the Association believes that the scope of the qualified immunity afforded members under the Rule, as proposed, is too narrow to achieve that purpose.¹¹ The Association has identified a number of additional situations in which it is necessary to broaden the scope of the Rule if it is to meet its salutary goal of candid and accurate disclosure.

a. To enable the Rule to achieve its purpose, qualified immunity should apply to any claims that are substantially related to the defamation claims now addressed in the Rule.

A member firm should be entitled to qualified immunity with respect to any claim that alleges that the firm has made an untrue statement on Form U-5 or in other mandatory disclosures, regardless of whether claimant's counsel has chosen to label the underlying claim as one for defamation.¹² Defamation claims may often be recharacterized as a number of different claims - e.g., false light, interference with contractual relations or prospective business advantage, intentional infliction of emotional distress.¹³ If qualified immunity were limited to claims for defamation, claimants could easily circumvent the immunity provisions of the Rule by reframing their cause of action as a claim other than defamation and thereby exposing member firms to uncertainty with respect to the immunity and standard of proof provisions under state laws.

b. To ensure that member firms disclose appropriate information regarding terminated employees to other governmental and self-regulatory bodies, the Rule should provide qualified immunity with respect to any statements the publication of which is compelled by law or by the rules of an SRO.

Member firms should enjoy qualified immunity for statements made in forms, documents or other kinds of publication compelled by governmental and regulatory bodies and other

SROs, which advance the same goal of disseminating information regarding terminated and current employees to appropriate persons.¹⁴ Such disclosures (e.g., New York Stock Exchange, Inc. ("NYSE") Form RE-3)¹⁵ regarding the work record and conduct of former employees are intended to make the relevant information known to enforcement personnel, prospective employers and the investing public and should be supported and encouraged by NASD Regulation.

Because the statements made in such other publications may not be identical to statements made in NASD forms, the Rule, as proposed, would fail to confirm the availability to member firms of immunity from liability premised on those statements, if introduced as evidence in an NASD-sponsored arbitration proceeding. Confirming the availability of a uniform minimum standard of qualified immunity with respect to such statements is also consistent with the policy reasons for allowing member firms to disseminate NASD forms to governmental and regulatory bodies and SROs, as proposed in the Rule, without losing their qualified immunity.

c. Customers should qualify as "appropriate persons" to whom information may be disclosed upon request without jeopardizing a member firm's qualified immunity.

In addition to the "appropriate persons" listed in the Rule,¹⁶ member firms should have the right to provide a copy of a representative's Form U-5 or other relevant information concerning the representative's employment history to any customer that requests that information and has a reasonable interest in obtaining it. Customers may often have an interest in possible allegations of misconduct by a representative with whom they have established or are establishing a business relationship. Member firms should be able to respond to such customers' requests with information about representatives on the same basis as other "appropriate persons" without jeopardizing their qualified immunity when such disclosure would advance the purposes of the Rule.¹⁷

Furthermore, member firms may already have a common-law qualified privilege to disclose information regarding terminated employees to a customer in response to a reasonable request for such information.¹⁸ Extending the scope of the Rule to include statements made to customers would therefore clarify the appropriate standard of qualified immunity in NASD arbitration proceedings in all cases where qualified immunity would otherwise be applicable to the member firm under federal or state law.

While the Rule, as proposed, would allow a member firm to disseminate information to customers who have "a legal obligation to obtain such information" or, upon request, to whom it "has a legal obligation to respond to such information," there is no significant policy reason to require members to risk the loss of qualified immunity if they provide the same information to other customers with whom a representative has established a business relationship or has had other significant contacts. In this regard, the Association notes that it is unclear what types of persons would be deemed to have a legal right or legal duty to obtain information regarding a registered representative within the meaning of that provision of the Rule.¹⁹

2. To promote full and accurate disclosure, the Rule should ensure that member firms will not be held liable for an alleged untrue statement contained in a mandatory disclosure unless it is shown that the member knew the statement was false in some material respect at the time it was made.

The Association is concerned about any standard of intent, such as the proposed "reckless disregard" standard, that would expose member firms to significant liability for complying with their duty to make disclosure of preliminary or unverifiable information.²⁰ Terminations can occur under hotly disputed circumstances, where reasonable people may differ as to the proper characterization of the events giving rise to the firing or resignation of an employee; member firms must, consistent with their NASD obligations, nevertheless attempt to articulate, as clearly as possible, any allegations of misconduct by the terminated employee and other information on Form U-5 for the benefit of investing public. To avoid encouraging litigation over the "wordsmithing" of mandatory disclosures, a member firm's qualified immunity should, in the Association's view, only be overcome in circumstances where the claimant can, at a minimum, show that the member firm knew a statement was materially²¹ false at the time it was made.

An "actual knowledge" standard, as distinguished from the "reckless disregard" standard currently applicable in most states, would improve disclosure of relevant information regarding the termination of employees in furtherance of the purpose of the Rule. The "reckless disregard" standard has proven itself to be far too susceptible of varying interpretations on a given set of facts to deter the assertion of meritless claims. Such deterrence is, of course, a necessary prerequisite to achieving the Rule's purpose of promoting disclosures required under the NASD By-Laws.

Form U-5, for example, requires a member firm, within thirty days of an employee's termination, to make specific statements regarding such employee - e.g., allegations brought against an individual in connection with an internal review of his or her conduct at the time of termination - regardless of whether the firm has had an opportunity to verify or corroborate preliminary reports or whether the alleged misconduct warranted further investigation after the termination of the employee.²² A "reckless disregard" standard invites claimants to contend that the member firm should be held liable for information that may turn out to have been inaccurate in hindsight.

In recognition of the deficiencies of the "reckless disregard" standard and the salutary goal of promoting candid and accurate disclosure, some courts have endorsed a higher degree of protection for member firms with respect to statements made about terminated employees.²³ In the case of NASD arbitration proceedings, the Association believes that it would be appropriate to clarify that the proposed standard at least requires claimants to prove "actual knowledge" on the part of the member firm that a particular statement was materially false in order to overcome the firm's qualified immunity. Such a standard would adequately deter the particular abuses potentially associated with Form U-5 - such as deliberately false statements made in retaliation for otherwise proper employee conduct - without establishing an unnecessarily obscure standard of qualified immunity

for the vast majority of member firms who discharge their obligations to provide candid and accurate disclosure in good faith.

3. Clear and convincing evidence of a member firm's knowledge of a statement's falsity should, as proposed, be required to overcome the member firm's qualified immunity.

The Association strongly supports the proposed requirement that claimants present "clear and convincing evidence" that a member firm knew a statement was false to hold the member firm liable for an alleged defamatory statement made in mandatory disclosures. This standard, as some commentators have noted, is particularly well suited to circumstances in which a factfinder must make a determination as to the defendant's state of mind, and where reliance on a lesser standard of proof (e.g., a preponderance of the evidence) would give the factfinder too much leeway to impute a state of mind "based on [the factfinder's] own predilections rather than the evidence."²⁴

Since arbitration proceedings are virtually unreviewable in the courts, it is particularly important to stress that arbitrators not defeat the mission of Form U-5 disclosures - to ensure that information regarding the termination of registered representatives is communicated to prospective employers in the securities industry - by holding a member firm liable for defamation on a mere inference from the evidence that the firm may have believed that the information was false at the time the disclosure was made. Adopting the "clear and convincing evidence" standard would provide member firms with additional assurance that they will be accorded the necessary immunity for statements made in Form U-5 and other mandatory disclosures unless they have acted in bad faith.

4. Requiring a registered person, compliance officer or lawyer to sign covered forms on behalf of the member firm would impose significant administrative burdens on member firms without any appreciable improvement in the quality of disclosure.

The Association opposes any proposal that the person signing Form U-5 (or any other form covered under the Rule) be a registered person, a compliance officer or an attorney. Member firms are already obligated, under the NASD By-Laws, to disclose information regarding terminated employees as required in Form U-5 and other covered forms and are subject to discipline for failure to do so. Firms have therefore established their own internal procedures for the collection and reporting of information regarding terminated employees within the allotted thirty-day time period, typically through their human resources departments, in order to comply with their obligations under the NASD rules.

Requiring the signature of a registered person, compliance officer or attorney - who may have no independent knowledge of the events resulting in the employee's termination - imposes an additional step on member firms the only appreciable effect of which would, in most cases, be to delay disclosure of relevant information to the NASD. In the absence of any reason to believe that imposing a signature requirement is likely to improve the quality of disclosure contained in a covered form, the Association believes that NASD Regulation should refrain from the temptation to "micromanage" the internal policies of member firms.

B. Requiring member firms to provide terminated employees with a copy of Form U-5 or any amendments prior to filing could result in the delayed disclosure of relevant information.

The Association is very concerned with the proposed requirement that member firms provide terminated employees with an opportunity to review Form U-5 and any amendments thereto prior to submission to the NASD.²⁵ A mandatory ten-day advance review period could result in the delayed disclosure of relevant information that could otherwise be made available to regulators and other member firms in a more timely fashion.

While permitting an employee to review the contents of his or her Form U-5 prior to filing would not be objectionable in all cases, the Association believes that member firms should retain the discretion to determine when affording their employees an opportunity to review the form is likely to be appropriate. Member firms are under a duty accurately to disclose information regarding terminated employees in Form U-5 and other covered forms and therefore have a strong incentive to allow an employee to review his or her Form U-5 when the employee's comments are likely to improve the quality of disclosure in the final draft.

In some cases, however, the facts surrounding an employee's termination may be sufficiently clear that prior consultation with an employee is unnecessary to achieve the purposes of the form - for example, when an employee has patently engaged in conduct violating NASD Rules or the firm's internal policies. Requiring member firms to provide an employee with a full ten days to review the form prior to filing under such circumstances would only serve to delay the provision of relevant information to regulators and other member firms.²⁶

C. Mandating mediation or arbitration for pre-filing disputes concerning Form U-5 disclosures would defeat the purposes of the form by encouraging disputes, would jeopardize the ability of employers to conduct adequate investigations into employee misconduct and would unnecessarily delay disclosure of important information.

The Association also opposes the adoption of an expedited arbitration or mediation procedure for resolving disputes concerning disclosures contained in Form U-5 before the form is filed with the CRD. The availability of pre-filing procedures will, in our view, encourage terminated employees to raise disputes over minor issues that would otherwise go uncontested and may pressure member firms to dilute or to eliminate allegations regarding the conduct of terminated employees in order to avoid becoming embroiled in potentially lengthy and expensive pre-filing proceedings.

Pre-filing mediation or arbitration proceedings may also jeopardize ongoing internal or regulatory investigations by "tipping off" other employees that such investigations are taking place. A member firm should not be forced to divulge information gathered in the course of an ongoing investigation in a mediation or arbitration proceeding - and thus risk the spoliation of additional evidence of employee misconduct - simply because one

employee resigns and calls for immediate, expedited mediation or arbitration to resolve a dispute over his or her Form U-5.²⁷

Furthermore, the appropriateness of the statements on the Form U-5 may in many circumstances require resolution of complicated questions of fact that are not susceptible of fair determination in a highly expedited proceeding. For example, where the employee claims the termination was retaliation for "whistle blowing" and the member firm believes the discharge is fairly attributable to the employee's own noncompliance with required procedures, a compressed arbitration or mediation proceeding cannot conceivably succeed in adjudicating the dispute in thirty days; indeed, it can frequently take more than thirty days for the parties to select the arbitrator. Pre-filing proceedings may consequently delay the timely availability of information regarding terminated employees to other member firms of the securities industry and to interested members of the public.

D. Paragraph (a)(1) of the Rule unnecessarily restates member firms' substantive obligation to provide accurate disclosure and may result in the misinterpretation of the effect of the Rule in other proceedings.

The Association suggests revising paragraph (a)(1) of the Rule to eliminate the reaffirmation of member firms' obligation to make accurate statements in mandatory disclosures,²⁸ and instead to state that the purpose of the Rule is to assist member firms in fulfilling their disclosure obligations. This proposed change would provide arbitrators with sufficient guidance as to the policy reasons underlying the Rule without unnecessarily suggesting that the Rule imposes additional substantive obligations on member firms or has any effect in other proceedings.

In the Association's view, the Rule should not restate member firms' obligation to make accurate statements in Form U-5 and other mandatory disclosures. As the Notice observes, member firms are already subject to disciplinary proceedings for false statements made in such mandatory disclosures.²⁹ Since it is not the intent of the Rule to impose additional or higher disclosure obligations on member firms,³⁰ inclusion of the proposed language, as stated, would seem somewhat redundant and potentially confusing to those unfamiliar with the NASD Rules.

E. NASD Regulation should consider modifying the Form U-5 to reduce the opportunities for disputes concerning disclosures required by the Form.

As previously noted, the current Form U-5 requires disclosure by member firms that is not limited either to objective verifiable facts or to a check-the-box choice of unambiguous prescribed categories. The form obligates member firms to furnish a narrative explanation whenever the employee's termination is described as "permitted to resign," "discharged," or "other" (Item 12), and it requires an additional narrative whenever the employee was "under internal review" at the time of termination (Item 15 and Sections 7 and 9 of DRP-5). Such free-form explanatory material generates disputes,

and can lead to claims of defamation, however unmerited, arising from the member firm's choice of words and phrases.

Reducing the occasions and opportunity for disputes over required disclosures is likely to provide a greater long-term benefit to both member firms and employees than would clarifying the extent of immunity afforded member firms with respect to such disclosures and the standard of proof applicable to defamation claims arising from them.

The Association understands that NASD Regulation has undertaken a review of the current Form U-5 and encourages NASD Regulation to complete that review promptly.³¹ The Association strongly urges NASD Regulation as part of its ongoing review of the form to give careful consideration to modifications that would achieve the objective of reducing the opportunities for disputes over required disclosures in the first place. This could likely be accomplished by focusing on verifiable facts regarding an employee's conduct rather than unproven allegations, limiting the circumstances in which narrative explanations are required and offering a greater choice of unambiguous prescribed categories that pertain to the terminated employee's conduct.

In the Association's view, requests for narrative explanations should be confined to objective facts regarding the circumstances of the employee's termination or any investigation into the employee's conduct, and should avoid requiring member firms to speculate as to the specific nature of alleged misconduct. The important purposes of Form U-5 disclosures, furthermore, at least with respect to Item 12 concerning the circumstances of the termination, could readily be achieved without need for any narrative explanation in most instances if the form included prescribed categories to be checked that would furnish the objective facts pertaining to the termination. Such additional categories could include whether the termination was attributable to job performance (thereby distinguishing downsizing or other layoffs from other discharges), and if so, various other information, such as whether the employee is alleged (or has been determined) to have engaged in dishonest or illegal conduct, failed to comply with internal policies, engaged in conduct that adversely affected customers or other counterparties, and/or failed to supervise others. A revised form could also include disclosure, if known to the member firm, that the employee disputes or concurs in the material facts upon which the termination was predicated.

Any revision of the Form U-5 should also address ambiguities raised by the text of current Items 14 and 15, which by referring to "the individual" involved in an investigation or under internal review excludes the equally likely circumstance that the terminated employee is one of several people to whom those phrases may apply. If sufficient additional objective categories are provided in a revised Item 12, existing Item 15 could be eliminated in its entirety; that change would in turn avoid triggering the obligation to complete the DRP-5, with its two narrative statements, for instances of "internal review" as distinguished from actual disciplinary, customer complaints and other proceedings (with respect to which a DRP-5 would continue to be required).

NASD Regulation may also wish to consider drafting Questions and Answers, similar to those prepared by the Municipal Securities Rulemaking Board ("MSRB"),³² which would identify and provide suitable responses for frequently occurring situations. Such sample disclosure language would assist firms in providing the appropriate degree of disclosure required in NASD forms and other materials and would reduce disputes arising over the nuances of individual words or the way particular statements are phrased.

F. NASD Regulation should adopt the immunity and standard of proof provisions, which are critical to ensuring full disclosure regarding terminated employees, on a permanent basis without further need for renewal.

The Association appreciates NASD Regulation's proposal to test the efficacy of the proposed Rule on a four-year pilot basis before making a final determination as to whether the various components of the proposed Rule have sufficiently improved Form U-5 and other mandatory disclosure to warrant their adoption. Testing the Rule in a pilot program would be particularly desirable if NASD Regulation were to adopt the objectionable provisions of the Rule - such as the proposed ten-day advance review period and the proposed expedited arbitration or mediation procedures. The pilot program could also be used to assess the efficacy of any amendments made to the Form U-5, as suggested in this letter.

It is important, however, to distinguish the various components of the Rule designed to help minimize disputes with respect to the content of Form U-5 from the confirmation of the applicability of a uniform standard of qualified immunity and the associated standard of proof, which is intended to encourage candid and accurate disclosure of information regarding terminated employees. Accordingly, the Association suggests that NASD Regulation adopt the immunity and standard of proof provisions of the Rule on a permanent basis and adopt the remaining provisions, if any, subject to renewal in four years.

III. Conclusion

We would be pleased to discuss any of the comments in this letter with the staff of NASD Regulation. Please do not hesitate to contact the undersigned (at 212-440-9459) or Sarah M. Starkweather (at 212-440-9407) of the Association, or Richard F. Ziegler (at 212-225-2430), Giovanni P. Prezioso (at 202-974-1650) or Onnig H. Dombalagian (at 202-974-1544) of our special counsel, Cleary, Gottlieb, Steen & Hamilton, if you should have any questions or comments.

Sincerely,

Paul Saltzman
Senior Vice President and General Counsel
The Bond Market Association

cc: The Honorable Arthur Levitt, Chairman, *Securities and Exchange Commission*
The Honorable Norman S. Johnson, Commissioner, *Securities and Exchange Commission*
The Honorable Isaac Hunt, Jr., Commissioner, *Securities and Exchange Commission*
The Honorable Laura Unger, Commissioner, *Securities and Exchange Commission*
The Honorable Paul Carey, Commissioner, *Securities and Exchange Commission*
Richard R. Lindsey, Director, Division of Market Regulation,
Securities and Exchange Commission
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Frank Zarb, Chairman, *National Association of Securities Dealers, Inc.*
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Mary L. Schapiro, President, *NASD Regulation, Inc.*
Elisse B. Walter, Executive Vice President, Law and Regulatory Policy, *NASD Regulation, Inc.*
John M. Ramsay, Deputy General Counsel, Office of General Counsel, *NASD Regulation, Inc.*
Members of the Board of Directors
Members of the Litigation Advisory Committee
Selected Staff *The Bond Market Association*

1 The Association represents approximately 200 securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. More information about the Association can be found at its Internet website <http://www.bondmarkets.com>.

This letter was prepared by Association staff with the assistance of special outside counsel, and has been circulated and reviewed by various committees. The Association's comments have been coordinated by our Litigation Advisory Committee, comprised of legal representatives of approximately 28 member firms, representing all sectors of the bond market community.

2 Throughout this letter, references to "qualified immunity" should also be read to refer to the associated standard of proof required to overcome such immunity unless otherwise inappropriate in the context.

3 See NASD Regulation, NASD Regulation Request for Comment 97-77, in Notices Members 661 (Nov. 1997) (the "Notice").

4 See Anne H. Wright, Form U-5 Defamation, 52 Wash. & Lee L. Rev. 1299, 1309-1312 (1995). This generally useful article unfortunately misapprehends the nature of the problem encountered by member firms, by focusing exclusively on the handful of defamation damage awards entered against such firms but disregarding the burden and

expense firms necessarily incur in defending against the far larger number of meritless claims.

5 See NASD, Notice to Members 88-67, in Notices to Members 291 (Sept. 1988); *infra* note 7.

6 See Donald P. Duffala, Annotation, Defamation: Loss of Employer's Qualified Privilege to Publish Employee's Work Record or Qualification, 24 ALR4th 144 (1983) (collecting cases). This general principle is supported in the context of disputes between member firms and terminated employees with respect to statements made in an employee's Form U-5. See, e.g., *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704 (7th Cir. 1994); *Fahnestock & Co., Inc. v. Waltman*, 935 F.2d 512 (2d Cir.), cert. denied, 502 U.S. 942 (1991), and cert. denied, 502 U.S. 1120 (1992); *Culver v. Merrill Lynch & Co., Inc.*, 1995 WL 422203 (S.D.N.Y. July 17, 1995); *Herzfeld & Stern, Inc. v. Beck*, 175 A.D.2d 689, 572 N.Y.S.2d 683 (N.Y. App. Div. 1st Dep't 1991), appeal dismissed, 79 N.Y.2d 914, 590 N.E.2d 251 (N.Y. 1992). Those of the above-cited cases reviewing NASD arbitration awards (where the arbitrators' determinations as to the applicable degree of immunity may be reconsidered only if the arbitrators acted in "manifest disregard of the law," see *infra* note 8), however, often analyze only the issue whether a member firm is entitled to absolute immunity with respect to an alleged defamatory statement and do not reach the question whether qualified immunity would apply.

7 See *supra* note 5; see also 52 Wash. & Lee L. Rev. at 1328 (discussing applicability of SRO disciplinary hearings to firms that fail adequately to report misconduct on Form U-5).

8 See *Willemijn Houdstermaatschappij, BV v. Standard Microsystems Corp.*, 103 F.3d 9 (2nd Cir. 1997) (noting that the conclusions of law reached by arbitrators are subject to limited review under a "manifest disregard of the law" standard).

9 See *infra* Part II.A.1 and II.A.2.

10 See, e.g., *Barr v. Matteo*, 360 U.S. 564, 570-75 (1959); *Petty v. General Accident Fire & Life Ins. Corp.*, 365 F.2d 419, 421 (3d Cir. 1966); *Sacks v. Stecker*, 60 F.2d 73, 75 (2d Cir. 1932). See also Restatement (Second) of Torts §§ 587-588 (1977) (conferring absolute immunity for statements made by parties in, or witnesses to, a judicial proceeding or in communications preliminary to a judicial proceeding, if the matter has some relation to the proceeding). A member firm, of course, should also be entitled to absolute immunity with respect to a statement contained in Form U-5 or any other mandatory disclosure under applicable federal or state law when a statement or the entire form or document has been published in the course of a judicial, quasi-judicial or other administrative proceeding (or in communications preliminary to a proposed proceeding) and is otherwise material and pertinent to the questions raised in the proceeding.

In addition, if, as noted in Part II.C below, NASD Regulation establishes a pre-filing mediation or arbitration procedure for resolution of disputes concerning mandatory

disclosures, any statements approved for inclusion in such mandatory disclosures should be absolutely privileged.

11 See NASD Rule 1150(b)(1) (proposed rule) (setting forth the scope of the qualified immunity afforded member firms).

12 See NASD Rule 1150(b)(2) and (3) (proposed rule) (limiting member firms' liability for alleged untrue statements solely to defamation claims).

13 See, e.g., *Nieminski v. John Nuveen & Co. Inc.*, 1997 WL 43241 (N.D. Ill. Jan. 23, 1997) (raising tort claims for false light and intentional infliction of emotional distress, in addition to libel, predicated on the assertion that statements made in Form U-5 were false).

14 See NASD Rule 1150(c)(3) (proposed rule) (limiting "covered forms" with respect to which a member firm is entitled to qualified immunity to forms or notices required under the NASD By-Laws). Such compulsory disclosures should include disclosures mandated by regulatory or administrative bodies that do not directly oversee a member firm's operations, but that have the power to require production of forms and other documents, or to require publication of statements, regarding terminated employees - e.g., the Equal Employment Opportunity Commission, the New York State Division of Human Rights.

15 NYSE Form RE-3 requires NYSE member firms to report and provide details with respect to suspensions and terminations for cause of non-registered persons. See NYSE Information Memo 97-21 (Apr. 21, 1997). To the extent that such disclosures may contain alleged untrue statements about a terminated representative whose claims may be adjudicated in a NASD-sponsored arbitration proceeding, it would be appropriate to afford members qualified immunity for such statements.

16 See NASD Rule 1150(c)(1) (proposed rule) (limiting the "appropriate persons" to whom member firms may disseminate statements regarding a former employee without jeopardizing their qualified immunity to federal and state governmental or regulatory authorities, SROs, employers and prospective employers, and any person who requests information concerning the employee and as to whom the firm has a legal obligation to provide such information, or any person who has a legal obligation to obtain such information).

17 It is the Association's understanding that member firms would not lose their qualified immunity under the Rule with respect to statements disseminated by them to an "appropriate person" if such statements are subsequently republished by someone else to someone who is not an "appropriate person" - for example, if a state securities regulator gives a copy of a registered representative's Form U-5 to a member of the press to whom the member would not otherwise disseminate the statements. The Association, however, encourages NASD Regulation to confirm this understanding in any commentary to the Rule.

18 See, e.g., *Shaw v. R.J. Reynolds Tobacco Co.*, 818 F. Supp. 1539, 1542-43 (M.D. Fla. 1993), *aff'd*, 15 F.3d 1097 (11th Cir. 1994); *LaScola v. US Sprint Communications*, 739 F. Supp. 431, 437-38 (N.D. Ill. 1990), *aff'd*, 946 F.2d 559 (7th Cir. 1991).

19 Pension funds, for example, may be prohibited from dealing with a registered representative of a member firm unless the firm provides the fund with all relevant information regarding its registered representatives; courts may disagree, however, as to whether such a requirement or a similar requirement would constitute a legal duty to obtain copies of covered forms or information contained therein. Furthermore, the Rule does not provide member firms with any guidance as to how to make this determination (e.g., whether an opinion of counsel would be required).

20 See NASD Rule 1150(b)(3) (proposed rule) (providing that qualified immunity may be overcome upon a showing either that the member firm knew at the time a statement was made that it was false in any material respect or that the firm acted in reckless disregard as to the statement's truth or falsity).

21 The Association recommends that the Rule be clarified to provide that claimants may overcome a member firm's qualified immunity only in connection with alleged material falsehoods. Member firms must complete Form U-5 without necessarily possessing full knowledge of the circumstances of an employee's conduct and should not lose their immunity from liability for statements that they believed to be true in all material respects.

As proposed, the Rule already acknowledges that members may be held liable for claims related to an alleged untrue statement if "the defending party knew at the time that the statement was made that it was false in any material respect." See Rule 1150(b)(3)(A) (emphasis added) (proposed rule). Conforming changes should, however, be made to paragraph (b)(2) of the Rule (as well as paragraph (b)(3)(B) of the Rule, if NASD Regulation ultimately decides to adopt the lesser "reckless disregard" standard contained therein).

22 See, e.g., Item 15 of, and Question 7 on Disclosure Reporting Page 5 ("DRP-5") of, Form U-5. For example, if an employee were to resign from a member firm shortly after the firm had commenced an internal investigation into the employee's alleged padding of his or her expense account based on unsubstantiated, anecdotal information, the firm would be unlikely to pursue an investigation or to sue the former employee to recover the misappropriated funds and would therefore never have occasion to complete its internal inquiry into, or to question the terminated employee about, the alleged misappropriation. The firm, however, would still be required to report on the employee's Form U-5 that the employee was the subject of an internal investigation at the time of his or her termination for alleged misappropriation of funds, even though the firm may have limited evidence to support such an allegation at the time the form is completed. Under such circumstances, the Association does not believe it would be appropriate to hold the member firm liable for having made such a statement on the form.

23 See, e.g., *Culver v. Merrill Lynch & Co., Inc.*, 1995 WL 422203 at *5 (S.D.N.Y. July 17, 1995) (conferring absolute immunity with respect to statements made in Form U-5); *Herzfeld*, 175 A.D.2d at 691-92, 572 N.Y.S.2d at 685 (same). The Supreme Court, for example, has interpreted the element of "actual malice" that must be established to hold a defendant liable for alleged defamatory statements made in contexts implicating First Amendment interests, see *New York Times Co. v. Sullivan*, 376 U.S. 254, 280 (1964), to require an inquiry into the defendant's subjective awareness of a statement's probable falsity at the time the statement was made, rather than a determination whether the defendant acted with gross negligence or wanton misconduct. See, e.g., *St. Amant v. Thompson*, 390 U.S. 727, 731 (1968) (requiring "sufficient evidence that the defendant in fact entertained serious doubts as to the truth of his publication" to establish "actual malice"); *Garrison v. Louisiana*, 379 U.S. 64, 74 (1964) (requiring "a high degree of awareness of . . . probable falsity" to establish "actual malice").

In the event that NASD Regulation declines to adopt an "actual knowledge" standard as described above, it should consider a standard based upon a finding of "actual malice" as an alternative.

24 Robert D. Sack, *Libel, Slander and Related Problems* § 5.5.3.1, at 307 (Robert D. Sack & Sandra S. Baron eds., Practising Law Institute 2d ed. 1994).

25 See NASD Rule 1150(a)(2) and (3) (proposed rule).

26 Furthermore, if an advance review period is adopted, the Rule should afford member firms absolute immunity from liability to an employee if the employer amends the draft of a covered form substantially to incorporate any comments offered by the employee during the review period, or if the terminated employee indicates that he or she has no objection to the statements made in a form. See NASD Rule 1150(a)(4) (proposed rule) (providing that an employee's failure to respond to a notice delivered pursuant to the ten-day advance review provisions would not constitute a waiver of his or her rights). It would defy common sense to hold a member firm liable for statements made in a covered form about a former employee if the employee had reviewed the form and the firm reasonably believed that any objections to statements made in the form had been resolved.

27 If NASD Regulation ultimately determines that the availability of expedited mediation or arbitration proceedings is desirable, the Association would recommend that members be entitled to absolute immunity for any statements approved by the mediator or arbitrators for inclusion in Form U-5. Terminated employees should not be entitled to a second opportunity to challenge Form U-5 disclosures if it has previously been determined in an arbitration or mediation proceeding that the member was justified in including such statements in the form.

28 See NASD Rule 1150(a)(1) (proposed rule).

29 See *supra* note 5.

30 See Notice at 662.

31 See Exchange Act Release No. 39,322 (Nov. 13, 1997), 62 Fed. Reg. 62,391 (Nov. 21, 1997) (notice of filing of proposed NASD rule change relating to the amended interpretation of IM-8310-2, release of disciplinary information and the implementation of interim pages in Forms U-4 and U-5).

32 See Interpretations to MSRB Rules G-37 and G-38.