

Notice to Members

JUNE 2004

SUGGESTED ROUTING

Legal & Compliance
Registered Representatives
Senior Management

KEY TOPICS

Affidavits
Arbitration
Central Registration Depository System
(CRD® or CRD system)
Confidentiality Provisions
Dispute Resolution
Rule 2110
Settlement Agreements

GUIDANCE

Settlement Agreements

Impermissible Confidentiality Provisions and Complaint
Withdrawal Provisions in Settlement Agreements

Executive Summary

The purpose of this *Notice* is to remind members that the use of certain provisions in settlement agreements with customers or other persons that impede, or have the potential to impede, NASD investigations and the prosecution of NASD enforcement actions violates NASD Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business. Specifically, some member firms continue to use confidentiality provisions that prohibit or restrict the customer or other person from disclosing the settlement terms and the underlying facts of the dispute upon inquiry to NASD or other securities regulators, despite repeated NASD communications cautioning members against this practice.¹ In addition, some member firms require customers to withdraw complaints filed with NASD or other securities regulators as a condition to settlement, or require customers to provide false or misleading affidavits that repudiate or otherwise contradict earlier factual claims made by such customers, in contravention of NASD rules. Accordingly, members and their associated persons are reminded that the use of such confidentiality provisions or complaint withdrawal provisions, or compelling customers or other persons to provide false or misleading affidavits, violates Rule 2110.

Questions/Further Information

Questions concerning this *Notice* generally may be directed to Shirley H. Weiss, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8844. Questions concerning appropriate language for settlement agreements may be directed to a member firm's local NASD District Office.

Background

Recent NASD examinations have revealed that, despite repeated cautioning, some members continue to use settlement agreements with customers and other persons that impede NASD investigations and the prosecution of NASD enforcement actions. In this regard, some members require customers and other settling parties to agree to overly broad confidentiality provisions in settlement agreements as a condition of settlement. In addition, some firms require customers and other persons to withdraw pending complaints with NASD or other regulators as a condition to settlement, or require customers or other persons, as a condition to settlement, to submit affidavits or other statements that falsely or misleadingly repudiate or otherwise contradict prior claims or complaints. Member firms and their associated persons are reminded that these practices constitute conduct inconsistent with just and equitable principles of trade in violation of Rule 2110.²

Impermissible Confidentiality Provisions

Although the exact wording of the overly broad confidentiality or nondisclosure provisions may differ, the intended effect of these impermissible provisions is to prohibit, limit, or discourage customers or other persons from disclosing the settlement terms or the underlying facts of the dispute in question to NASD or other securities regulators upon inquiry.

In many instances, the settlement agreements contain confidentiality provisions that require regulatory authorities to obtain a court order or subpoena, or pursue some other legal process, before the parties are permitted to disclose the terms of the settlement or the underlying facts of the dispute to the regulator. Such restrictive language is especially problematic for self-regulatory organizations (SROs), such as NASD, that do not have the legal authority to compel cooperation by customers or other persons not subject to the SROs' jurisdiction.

In other cases, the settlement agreements contain language prohibiting customers or other parties from testifying about the settlement terms or the facts underlying the settlement. Since NASD and other securities regulators rely upon testimony to conduct investigations and prosecute enforcement actions, settlement terms that prevent customers from testifying on a matter also may significantly impede SROs' ability to regulate the securities industry.

Other problematic settlement agreements contain language requiring customers or other settling parties to provide notice to the member firm before providing information to NASD or any other regulatory authority upon inquiry or before testifying about the settlement terms before NASD or other regulators. Again, such language has the potential to discourage customers or other settling parties from cooperating with NASD and other regulators.

Impermissible Complaint Withdrawal Provisions

Although the exact wording of the complaint withdrawal provisions may vary, the intended effect is to make withdrawal of a pending complaint filed with NASD or other regulatory agency a condition of settlement. Like the impermissible confidentiality provisions, such complaint withdrawal provisions have the potential to hamper NASD and other regulators from carrying out their regulatory mandates.

Procuring False or Misleading Affidavits as a Condition to Settlement

It is impermissible, as a condition to settling a customer complaint, for a member to require a settling customer or other person to provide an affidavit or other statement that contains false or otherwise misleading or inaccurate information concerning the facts underlying the customer's complaint. In addition to violating the firm's responsibility under Rule 2110 to observe high standards of commercial honor and just and equitable principles of trade, as well as applicable state and federal criminal laws, such statements have the effect of frustrating or otherwise impeding the ability of NASD and other securities industry regulators to investigate and prosecute violations of NASD rules and the securities laws.³

Acceptable Confidentiality Provisions

It is not NASD's intent to preclude members from entering into settlement agreements that include acceptable confidentiality provisions. As discussed in *Notice to Members 95-87*, confidentiality provisions in settlement agreements should be written to expressly authorize the customer or other person to respond, without restriction or condition, to any inquiry regarding the settlement or its underlying facts by any regulator, including NASD. The following is an example of an acceptable confidentiality provision:

Any non-disclosure provision in this agreement does not prohibit or restrict you (or your attorney) from responding to any inquiry, or providing testimony, about this settlement or its underlying facts and circumstances by, or before, the Securities and Exchange Commission (SEC), NASD, any other self-regulatory organization, or any other federal or state regulatory authority.

Further, a settlement may not be conditioned on the withdrawal of a complaint pending with NASD or any other regulatory authority nor may a settlement be conditioned upon the customer submitting a statement, whether or not under oath, that falsely or misleadingly repudiates or contradicts the factual allegations underlying the original complaint.

Suggested Notice to Parties to a Past Settlement Agreement to Clarify that the Agreement Does Not Prohibit Disclosure to Regulatory Authorities

Members are strongly encouraged to promptly review and correct those settlement agreements that contain confidentiality provisions that prohibit or discourage customers or other persons from disclosing the settlement terms or the underlying facts of the dispute to NASD or any other securities regulator upon inquiry or that require withdrawal of a pending complaint filed with NASD or any other regulatory authority. The following is an example of a notice to customers or other parties to correct past settlement agreements containing impermissible confidentiality or complaint withdrawal provisions:

You are hereby notified that the Settlement Agreement you executed with this firm on [insert date], should not be construed to prohibit or restrict you (or your attorney) from responding to any inquiry, or providing testimony, about this settlement or its underlying facts and circumstances by, or before, the Securities and Exchange Commission (SEC), NASD, any other self-regulatory organization, or any other federal or state regulatory authority, or to require you to withdraw any complaint previously filed with any such regulatory authority.

Conclusion

Members are reminded that the use of overly broad confidentiality provisions or complaint withdrawal provisions in settlement agreements, or compelling customers or other persons to provide false or misleading affidavits, as further described in this *Notice*, constitutes conduct inconsistent with just and equitable principles of trade, which may result in NASD disciplinary proceedings for violation of Rule 2110. Members should immediately review any standard form of settlement agreement to ensure that it does not in any way prohibit or discourage the parties to the agreement from disclosing, or testifying about, the settlement terms and/or the underlying facts of the dispute to, or before, NASD or any other regulator upon inquiry, require withdrawal of pending complaints with any regulatory authority as a condition of settlement, or compel the submission of a false or misleading statement or affidavit concerning the facts underlying the customer's complaint.

Members also should immediately review any past settlement agreements to ensure that they do not contain any such impermissible provisions and are otherwise consistent with this *Notice*. In the event a member identifies any such provisions, the member is encouraged to send a notice to the parties advising them that they are not restricted under the terms of the settlement from speaking with, or otherwise disclosing information regarding the settlement to, any regulatory authority upon inquiry.

Endnotes

- 1 See *Notice to Members 95-87* (October 1995), *Notice to Members 86-36* (May 1986), and NASD Regulatory and Compliance Alerts (June 1994 and July 1995).
- 2 Examples of enforcement actions taken by NASD against members concerning impermissible confidentiality and complaint withdrawal provisions include:
 - ▶ In the Matter of Stratton Oakmont, Inc., 1997 SEC LEXIS 562, 52 S.E.C 1170 (Mar. 12, 1997). The SEC sustained NASD's finding of violations of Article III, Section 1 of the NASD Rules of Fair Practice (the predecessor to NASD Rule 2110) based on unacceptable confidentiality provisions requiring that, prior to cooperating with NASD, a customer provide: (1) ten days advance notice to counsel for Stratton and its account executives; and/or (2) a statement or testimony to Stratton and/or its attorneys and attorneys for the account executives.
 - ▶ In the Matter of William Edward Daniel, Exch. Act Rel. No. 28408, 50 S.E.C. 332, 335-36 (1990). The SEC upheld NASD's finding that registered representative violated Rule 2110 where he conditioned payment of restitution on customer's withdrawal of a complaint filed with NASD. The SEC noted, "an integral aspect of the statutory scheme for regulating broker-dealers and protecting investors is the responsibility of SROs such as NASD to investigate allegations that members and their associated persons have engaged in misconduct and to impose sanctions when appropriate."
- 3 While we understand that members and associated persons may procure affidavits and other statements in connection with applications for expungement under NASD Rule 2130, it is impermissible to submit affidavits, the content of which is the product of bargained-for consideration as opposed to the truth. Members are advised to review *Notice to Members 04-43* in this regard.

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