

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal and Compliance
Operations
Senior Management

NASD Rule 3070

NASD Files Proposal to Amend Rule 3070 to Require Filing of Criminal and Civil Complaints and Arbitration Claims with NASD; Revises Letters Sent When Determination Made to Close an Investigation Without Further Action

KEY TOPICS

NASD Rule 3070
NASD Rule 2110

Executive Summary

NASD has undertaken two initiatives to improve the quality and flow of information to it about allegations of broker misconduct. First, on August 14, 2002, NASD filed with the Securities and Exchange Commission (SEC) a rule proposal to amend NASD Rule 3070 to require members promptly to file with NASD copies of certain criminal and civil complaints and arbitration claims that name a member or an associated person as defendant or respondent. Specifically, the proposed rule change would require members to file with NASD copies of (1) any criminal complaints filed against the member or plea agreements entered into by the member that are covered by the rule; (2) any securities or commodities-related private civil complaints filed against the member; (3) any arbitration claim against the member; and (4) any criminal complaint or plea agreement, private civil complaint or arbitration claim against an associated person that is reportable under Question 14 on Form U-4, irrespective of any dollar threshold requirements that question imposes for notification. Members would not be required to file copies of any arbitration claims filed in the NASD Dispute Resolution forum. NASD recently began to review copies of claims filed in that forum for possible regulatory response.

Second, NASD has revised the letters it sends to customers and members when a determination is made to close an investigation without disciplinary action. The revised letters state that a determination by NASD not to take action against a member or a member's associated person has no evidentiary weight in any mediation, arbitration, or judicial proceeding. Further, NASD considers it inconsistent with just and equitable principles of trade (Rule 2110) for a member or a member's associated person to attempt to introduce such a determination into evidence in any of those proceedings.

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The text of the proposed amendments to Rule 3070 is attached. Comments on the proposal should be directed in writing to the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

Questions concerning this Notice should be directed to Philip Shaikun, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

Background and Discussion

Rule 3070

Rule 3070 currently requires, among other things, that a member report to NASD when it is a defendant or respondent in felony criminal proceedings, certain misdemeanor criminal proceedings, or in certain civil or arbitration actions. As to the latter, Rule 3070(a)(7) requires that a member report to NASD when the member or a person associated with the member is a defendant or respondent in securities or commodities-related civil litigation or arbitration only when the proceeding has been disposed of by a judgment, award or settlement in an amount exceeding either \$15,000 (if the defendant or respondent is an associated person) or \$25,000 (if the defendant or respondent is the member). No existing rules require a member routinely to file copies with NASD of complaints filed against it in any legal proceedings.

Similar to Rule 3070, Question 14 on Form U-4 requires notice that an associated person has been **charged** or convicted of a felony or certain misdemeanors. It further requires notice that an associated person has been named as a respondent or defendant in a

consumer-initiated arbitration or civil litigation involving a sales practice violation that is pending, resulted in a judgment, settled for \$10,000 or more, or contains a claim for compensatory damages of at least \$5,000. However, Form U-4 does not require that the member or associated person file with NASD a copy of the complaint that initiates such proceedings or any plea agreements to resolve reportable criminal charges.

By requiring members to file with NASD copies of certain criminal and civil complaints and arbitration claims, the proposed amendments to Rule 3070 will provide NASD with additional sources of pertinent information regarding broker misconduct. As a result, NASD can enhance investor protection efforts by promptly taking appropriate regulatory action to address specific allegations and to prevent similar or related misconduct in the future. Moreover, the information can be combined with other sources of regulatory intelligence to identify patterns and trends at the earliest possible stage, thereby deploying resources to higher risk areas that better protect investors. With respect to associated persons, it is important to receive copies of complaints and claims reportable under Question 14 on Form U-4, even when they fall below specified dollar thresholds, as such matters may also point to trends or otherwise flag conduct where regulatory action might be warranted.

NASD now makes copies, at its own expense, of all arbitration claims filed in the NASD Dispute Resolution forum. Those claims are forwarded after copying to a unit within NASD that reviews the allegations in the claims for possible regulatory action.

NASD would treat similarly copies of other complaints, claims and plea agreements required to be filed with NASD under the rule proposal.

The rule proposal minimizes the burden on members in that the rule requires only the filing of those complaints and claims most likely to reveal information to assist NASD's regulatory mission. For example, members would not be required to file private civil litigation complaints or arbitration claims that do not relate to securities or commodities-related conduct. Furthermore, as discussed above, the proposal would not require members to file with NASD any arbitration claims that are originally filed in the NASD Dispute Resolution forum. NASD is already incurring the cost to make copies of those claims and will continue to do so under the proposal.

Content and Use of Close-Out Letters

In a related initiative, NASD recently revised the letters that are sent to customers and members when a determination is made to close an investigation without further disciplinary action. This step was taken after NASD learned that some customers chose not to bring allegations to the attention of NASD out of concern that a letter declining further action would be offered as exculpatory evidence in an arbitration, mediation, or judicial proceeding.

NASD is not litigating a private arbitration claim when it conducts a regulatory review. As a result, the revised letters now state NASD's contention that a determination not to take action

against a member has no evidentiary weight in a subsequent proceeding, such as mediation, arbitration, or a judicial action. In addition, NASD now gives the customer the option not to receive a close-out letter. To opt out, a customer must notify NASD of this decision in writing or by e-mail. In the event a customer does opt out, NASD will not issue a final close-out letter.

Furthermore, the revised letters warn that NASD considers it inconsistent with just and equitable principles of trade (Rule 2110) for a member or associated person to attempt to introduce the letter, or the fact that NASD declined further action, as evidence in a subsequent legal proceeding. NASD's decision to close an investigation without further action can result from many factors unrelated to the merits of a complaint, such as jurisdictional limitations or the existence of an ongoing or completed enforcement action by another law enforcement or regulatory agency. As such, NASD considers it unethical and potentially misleading to suggest to an adjudicator or mediator that NASD's determination is probative evidence in a dispute on the merits of a related claim.

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ATTACHMENT A

Proposed Amendment to NASD Rule 3070

Additions are underlined. Deletions are in brackets.

3070. Reporting Requirements

(a) through (c) No change.

(d) Nothing contained in [paragraphs (a), (b) and (c) of] this Rule shall eliminate, reduce, or otherwise abrogate the responsibilities of a member or person associated with a member to promptly file with full disclosure, required amendments to Form BD, Forms U-4 and U-5, or other required filings, and to respond to [the Association] NASD with respect to any customer complaint, examination, or inquiry.

(e) Any member subject to substantially similar reporting requirements of another self-regulatory organization of which it is a member is exempt from [the provisions] paragraphs (a), (b) and (c) of this Rule.

(f) Each member shall promptly file with NASD copies of:

(1) any indictment, information or other criminal complaint or plea agreement for conduct reportable under paragraph (a)(5) of this Rule;

(2) any complaint in which a member is named as a defendant or respondent in any securities or commodities-related private civil litigation;

(3) any securities or commodities-related arbitration claim filed against a member in any forum other than the NASD Dispute Resolution forum;

(4) any indictment, information or other criminal complaint, any plea agreement, or any private civil complaint or arbitration claim against a person associated with a member that is reportable under question 14 on Form U-4, irrespective of any dollar thresholds Form U-4 imposes for notification, unless, in the case of an arbitration claim, the claim has been filed in the NASD Dispute Resolution forum.