**This Decision has been published by NASD's Office of Hearing Officers and should be cited as OHO Redacted Decision E1020040926-01.**

**NASD OFFICE OF HEARING OFFICERS**

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| DEPARTMENT OF ENFORCEMENT,<br><br>Complainant,<br><br>v.<br><br>RESPONDENT 1,<br><br>and<br><br>RESPONDENT 2,<br><br>Respondents. | Disciplinary Proceeding<br>No. E1020040926-01<br><br>**Hearing Panel Decision and Order Granting Complainant's Motion for Summary Disposition**<br><br>Hearing Officer – SW<br><br>Dated: April 12, 2007 |

**Respondent 2 violated IM-1000-1 and NASD Conduct Rule 2110 by failing to update his Form U-4 as alleged in count one of the Complaint. For the violation, Respondent 2 was fined $5,000 and required to re-qualify as a general securities representative and general securities principal.**

**Respondents 2 and 1 violated NASD Conduct Rule 2110 as alleged in counts two and three of the Complaint by executing settlement agreements in July 2003 and in September 2003, which included improper confidentiality provisions. For the violation, the Respondents were jointly and severally fined $2,500.**

## Appearances

Paul A. Hare, Esq., Senior Regional Attorney, and William A. St. Louis, Esq., Deputy Regional Chief Counsel, New York, NY, for the Department of Enforcement.

Respondent 1 for himself and Respondent 2.

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# DECISION

## I. PROCEDURAL BACKGROUND

### A. Complaint and Answer

On February 21, 2006, the Department of Enforcement ("Enforcement") filed a three-count Complaint against [Respondent 1] ("Respondent 1" or the "Firm"), and its president, [Respondent 2] ("Respondent 2"), (collectively, the "Respondents").

Count one of the Complaint alleges that Respondent 2 violated IM-1000-1 and NASD Conduct Rule 2110 by failing to amend his Uniform Application for Securities Industry Registration or Transfer ("Form U-4") from November 2002 through January 2006 to disclose that: (i) he was the subject of a pending civil action pursuant to which he could have been found to have violated investment-related statute(s) or regulation(s); (ii) he was the subject of a pending investment-related, consumer-initiated civil action; and (iii) he had settled an investment-related, consumer-initiated civil action for an amount in excess of $10,000. Counts two and three of the Complaint allege that the Respondents violated NASD Conduct Rule 2110 by executing settlement agreements in July 2003 and September 2003, which included improper confidentiality provisions.

The Respondents' Answer denied the allegations of the Complaint. With respect to count one of the Complaint, Respondent 2 denied that (i) the pending civil action could have resulted in a finding that he was liable under an investment-related statute or regulation, and (ii) the pending civil action was consumer-initiated. As to counts two and three of the Complaint, the Respondents argued that the confidentiality provisions in the July 2003 and September 2003 agreements were not intended to, and did not, impede NASD's investigation of the underlying matters.

## B. Motions for Summary Dispositon

On August 1, 2006, the Respondents filed a motion to strike or dismiss count three of the Complaint, contending that the Respondents' efforts to correct the language of the July 2003 settlement agreement by explicitly authorizing disclosure to NASD in a subsequent writing had obviated the issue. The Respondents filed a second motion, on October 24, 2006, seeking to dismiss counts two and three of the Complaint, arguing that the confidentiality provisions did not actually impede NASD's ability to conduct an investigation. The Respondents' motions to dismiss were treated as motions for summary disposition.[1] On August 1, 2006, Enforcement filed a motion for partial summary disposition as to counts two and three of the Complaint.

The Hearing Panel denied both of the Respondents' motions for summary disposition. For the reasons set forth below, the Hearing Panel granted Enforcement's motion for partial summary disposition as to counts two and three of the Complaint. The Hearing Panel continued the proceeding to a Hearing on the issue of sanctions for counts two and three of the Complaint, and as to liability and sanctions for count one of the Complaint.

The Hearing Panel, consisting of two former members of the District 9 Committee and the Hearing Officer, conducted a Hearing on November 16, 2006, in Jericho, NY. Subsequent to the Hearing, Enforcement filed a post-hearing brief on

[1] The NASD Code of Procedure does not expressly permit a "motion to dismiss," and pleadings denominated as such are treated as motions for summary disposition under NASD Procedural Rule 9264. See OHO Order 01-09 (C3A000056).

December 8, 2006, and the Respondents filed their post-hearing brief on January 8, 2007.[2]

## II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

### A. Jurisdiction

#### 1. Respondent 1

The Firm was approved as a member on November 8, 1995. (CX-1, p. 3). On February 21, 2006, when the Complaint was filed, Respondent 1 was a member of NASD.[3] (Id.).

#### 2. Respondent 2

Respondent 2 first became registered with a member firm as a general securities representative in November 1989. (CX-2, p. 14). On November 8, 1995, Respondent 2 became registered as a general securities principal and general securities representative with the Firm, and he was registered with the Firm when the Complaint was filed.[4] (CX-2, pp. 4-5).

### B. Background

#### 1. July 2003 Settlement Agreement with SC

In 2003, Respondent 2 was the president, director, compliance officer, and financial operations officer of the Firm, an online brokerage firm that executed clients' unsolicited orders for $9.95 per trade. (Tr. pp. 255, 257; CX-4, p. 1).

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[2] Hereinafter, Enforcement's exhibits presented at the Hearing will be designated as "CX-," the Respondents' exhibits will be designated as "RX-," and references to the transcript of the Hearing will be designated as "Tr. p."

[3] On May 26, 2006, after the Complaint was filed, the Firm was suspended for failure to file its annual audit report. (CX-1, p. 3).

[4] On July 14, 1997 and August 20, 2003, Respondent 2 became registered as the Firm's financial operations principal and equity trader, respectively. (CX-2, pp. 4-5). By June 1999, Respondent 2 acquired 75% or more of the ownership of the Firm. (CX-1, p. 2).

In June 2003, SC, a client of the Firm, filed a customer complaint with NASD because the Firm's clearing firm corrected an error in SC's margin rate, which resulted in a $14,698.92 negative adjustment to SC's account. (Tr. pp. 27, 258; RX-1; RX-3; RX-6). Upon receipt of SC's complaint, NASD began an investigation and sent a Rule 8210 request for information to Respondent 2 regarding SC. (CX-3).

Respondent 2 responded to NASD's inquiry in July 2003, stating that he and SC had reached a settlement, pursuant to which SC executed a general release in exchange for $7,349.46. (CX-4; CX-5). The Firm's clearing firm provided the Respondents with the form of the general release and paid one-half of the $7,349.46 settlement payment. (Tr. pp. 28, 259, 261-262). SC executed the general release on July 9, 2003. (CX-4; CX-5).

The July 2003 general release included a very broad confidentiality provision reading as follows:

> I also hereby agree not to divulge or cause my counsel or anyone in privity with me to divulge either directly or indirectly to any third party (a) the amount or terms of this settlement, (b) the facts or circumstances underlying this settlement and (c) all calculations prepared [by] me, my attorney, or others on my behalf relating to my account. (CX-5).

On January 14, 2004, the NASD staff wrote Respondent 2 asking him to explain why there was no clause in the general release permitting SC to discuss the matter with securities regulators. (CX-6, p. 1). The January 14, 2004 NASD letter included a copy of NASD Notice to Members 95-87, which sets forth acceptable and unacceptable examples of confidentiality provisions. (CX-6, pp. 2-3). NASD Notice to Members 95-87 provides, in part:

> Whenever a settlement agreement references confidentiality, the confidentiality clause should be written to expressly authorize the customer or other person to respond, without restriction or condition, to any inquiry about the settlement or its underlying facts and circumstances by any securities regulator, including the NASD. (CX-6, p. 2).

On January 20, 2004, Respondent 2 responded by sending NASD a copy of a letter also dated January 20, 2004 that Respondent 2 sent to SC stating that their agreement should not be construed to prohibit or restrict SC from responding to any inquiry from the SEC, NASD, or any other self-regulatory organization. (RX-8). In March 2004, the NASD staff confirmed that SC had received Respondent 2's January 20, 2004 letter. (Tr. p. 47).

Ultimately, the NASD staff determined that there was no basis for SC's complaint and acknowledged that the July 2003 settlement agreement did not prevent SC from speaking with NASD. (Tr. pp. 46, 74).

### 2. NASD's Discovery of the September 2003 Settlement Agreement with the Plaintiffs

In a subsequent letter to NASD, Respondent 2 volunteered that the SC agreement was the only settlement agreement with a customer that the Firm had executed and that any future agreements would include the requisite clause.[5] (RX-10).

To test Respondent 2's statement, the NASD staff searched various data bases, and discovered that, in connection with their purchase of stock in the Firm in 1999, two Panamanian companies, [] Financing Corp. and [] Holding (the "Plaintiffs"), had (i) filed a lawsuit against the Respondents in 2002, (ii) amended the lawsuit in 2003, and (iii)

[5] In a follow-up letter, dated January 30, 2004, the NASD staff member wrote that Respondent 2's January 20, 2004 letter, which corrected the language in the July 2003 Settlement Agreement, was not responsive to NASD's January 14, 2004 request because it did not provide an explanation for the original clause. (CX-8, p. 1). In a letter dated February 5, 2004, Respondent 2 responded to NASD's January 30, 2004 letter. (RX-10).

settled the lawsuit for $125,000 in 2003. (Tr. pp. 48-49, 52, 56; CX-10; CX-12). In March 2004, the same NASD staff member requested information from the Firm regarding the settlement with the Plaintiffs. (CX-12, p. 1).

***a. Plaintiffs' Initial Complaint***

In late 1998, when seeking funding to enhance the Firm's marketing efforts, Respondent 2 met with HS, an officer of an investment services company, and provided copies of private placement memoranda describing the Firm to HS for HS's clients.[6] (Tr. p. 271; CX-10, pp. 8, 117). On March 12, 1999, HS's clients, the Plaintiffs, each invested $200,000 in the Firm, with the expectation that the Firm would become a public company.[7] (CX-10, pp. 9, 35, 37). Due in part to the collapse of the securities market and the online securities industry during the period, the Firm was unable to meet the requirements to become a public company. (Tr. pp. 275-276; CX-10, p. 37).

On October 11, 2002, the Plaintiffs and HS filed a complaint in the United States District Court, Southern District of New York ("Initial Complaint"), which consisted of eight claims for relief and alleged, among other things, that the Respondents (i) had committed common law fraud, (ii) had violated SEC Rule 10b-5, and (iii) had violated Section 20(a) of the Securities Exchange Act of 1934 ("Exchange Act"). (CX-10, pp. 114, 123-127; CX-11, p. 2).

[6] The Firm's Private Offering Memorandum dated February 25, 1999 provided for the sale of a minimum of 1,000 units and a maximum of 3,000 units at $600 per unit. (RX-15). The Firm sold all of the units and raised approximately $1.8 million in the offering. (Tr. pp. 273-274).

[7] The Plaintiffs were professional investors with their principal place of business in Zurich, Switzerland. (Tr. pp. 271, 385-386). HS also invested $50,000 in the Firm. (Tr. pp. 271-272).

### *b. Plaintiffs' Amended Complaint*

On January 23, 2003, the Plaintiffs amended the Initial Complaint ("Amended Complaint") to eliminate, among other things, HS as a plaintiff and the claims based on SEC Rule 10b-5 and Section 20(a) of the Exchange Act. (CX-10, pp. 97-110). The Amended Complaint, however, retained the allegations of common law fraud.[8] (Id.).

### *c. September 2003 Settlement Agreement*

In September 2003, the Plaintiffs and HS executed a settlement with the Respondents, pursuant to which the Respondents paid the Plaintiffs $125,000. (CX-12, pp. 3-10). The confidentiality provision of the Settlement Agreement explicitly excluded governmental authorities, but not NASD, from its disclosure restrictions. (CX-12, p. 5). The provision reads as follows:

> [the Plaintiffs, HS, and his wife ES] agree that the terms of this Agreement shall be kept strictly confidential, and that they (and their respective employees or agents) shall not disclose this Agreement's terms to any third party except (a) as required by law in response to service of legal process, after first providing 20 days written notice of the legal process to the other Party; or (b) for necessary disclosures to their attorneys, accountants, insurers, shareholders, or governmental authorities, on a confidential basis if permitted by law. (Id.).

Counsel for the Respondents and counsel for the Plaintiffs negotiated the terms of the Settlement Agreement, and Respondent 2 executed the Settlement Agreement without changes. (Tr. pp. 277-278, 281). Respondent 2 testified that, based on his discussion with his counsel, he did not believe that the Plaintiffs were customers of the Firm. (Tr. pp. 278, 283). Respondent 2, however, admitted that he retained different counsel for

[8] In the Amended Complaint, the Plaintiffs alleged that Respondent 2 made oral misrepresentations that the Firm (i) earned $1 million in 1998, (ii) was executing a minimum of 200 trades a day, and (iii) intended to register its stock, including the Plaintiffs' stock, to become a public company. (CX-10, pp. 91-92, 99-100; CX-11, pp. 14-15).

regulatory matters and that he did not formally seek advice from his regulatory counsel regarding what, if any, Form U-4 disclosures were required because of the Plaintiffs' Initial Complaint, Amended Complaint, or Settlement Agreement.[9] (Tr. p. 323; RX-19). In any event, Respondent 2 erroneously assumed that the confidentiality provision's exception for governmental authorities included NASD. (Tr. p. 32; RX-19).

In letters dated April 30, 2004 and May 7, 2004, the Respondents' counsel provided the NASD staff with copies of the Plaintiffs' Initial Complaint, the Amended Complaint, and the Settlement Agreement. (RX-13; RX-14).

### C. Count One of the Complaint: Respondent 2 Failed to Update his Form U-4 to Disclose the Plaintiffs' Initial Complaint, Amended Complaint and Settlement Agreement

Count one of the Complaint alleges that Respondent 2 violated IM-1000-1 and NASD Conduct Rule 2110 by failing to amend his Uniform Application for Securities Industry Registration or Transfer Form ("Form U-4") from November 2002 through January 2006 to disclose (i) the Plaintiffs' Initial Complaint, (ii) the Amended Complaint, and (iii) the Settlement Agreement.[10] Specifically, the Complaint alleges that Respondent 2 should have updated his answers to Questions 14H and 14I of Form U-4.[11]

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[9] To the extent that Respondent 2 attempted to articulate an advice of counsel defense, the Hearing Panel finds that he did not meet the requirements for such a defense. To establish an affirmative defense of reliance on advice of counsel, a respondent is required to show: (1) a request for advice of counsel on the legality of a proposed action; (2) full disclosure of the relevant facts to counsel; (3) receipt of advice from counsel that the action to be taken will be legal; and (4) reliance in good faith on counsel's advice. See e.g., William H. Gerhauser, Sr., Exchange Act Rel. No. 40639, at 12 n.26, 1998 SEC LEXIS 2402 at *24 n.26 (Nov. 4, 1998). In any event, the defense is inapplicable when scienter is not an element of the violation, see Louis Feldman, Exchange Act Rel. No. 34933, at 5 (Nov. 3, 1994), and scienter is not a required element of an NASD Conduct Rule 2110 violation.

[10] The Complaint does not allege that Respondent 2's failure to amend his Form U-4 was willful within the meaning of Article III, Section 4(f) of the NASD By-Laws, and the Hearing Panel makes no such finding.

[11] Questions 14H and 14I and the Explanation of Terms of Form U-4 remained basically the same from 2002 through 2006. (CX-14, pp. 2-3, 21, 39-40, 53, 67-68, 78).

Article V, Section 2(c) of the NASD By-Laws provides that every application for registration filed with NASD shall be kept current at all times by supplementary amendments, via electronic process or such other process as NASD may prescribe to the original application. Such amendment to the application shall be filed with NASD not later than 30 days after learning of the facts or circumstances giving rise to the amendment.

IM-1000-1 provides that "[t]he filing with [NASD] of information with respect to membership or registration as a Registered Representative which is incomplete or inaccurate so as to be misleading, or which could in any way tend to mislead, or the failure to correct such filing after notice thereof, may be deemed to be conduct inconsistent with just and equitable principles of trade. . ."

**1. Question 14H(2) of Form U-4**

Question 14H(2) of Form U-4, under a section entitled Civil Judicial Actions, inquires, in part, "[a]re you named in any pending investment-related civil action that could result in a 'yes' answer" to the question "[h]as any domestic or foreign court ever . . . found that you were involved in a violation of any investment-related statute(s) or regulation(s)?" (CX-14, p. 78). The Explanation of Terms of Form U-4 define "investment-related" as "pertain[ing] to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association)." (CX-14, p. 68).

There is no dispute that: (i) the Plaintiffs filed the Initial Complaint, which alleged that the Respondents violated SEC Rule 10b-5 and Section 20(a) of the Exchange

Act of 1934; (ii) SEC Rule 10b-5 and Section 20(a) of the Exchange Act are investment-related statutes or regulations as defined in Form U-4; (iii) Respondent 2 was aware on or about October 11, 2002 that the Initial Complaint had been filed; (iv) Form U-4 explicitly provides that applicants are under a continuing obligation to amend and update information required by Form U-4 as changes occur; and (v) Respondent 2 failed to update his Form U-4 to disclose the Plaintiffs' Initial Complaint.

Respondent 2 credibly testified that he believed, and his counsel had advised, that he would not be found to have violated investment-related statutes or regulations. Nevertheless, the Hearing Panel finds that Question 14H(2) of Form U-4 is not a subjective question, and accordingly, Respondent 2's subjective belief is not relevant as to liability.

Question 14(H)(2) of Form U-4 asks whether one is named in a civil action that "could" result in a yes answer. The Hearing Panel finds that because the Plaintiffs' Initial Complaint objectively could have resulted in a finding that Respondent 2 was involved in the violation of an investment-related statute or regulation, Respondent 2 should have updated his Form U-4 to answer "yes" to Question 14H(2) within 30 days of the notice of the filing of the Initial Complaint.[12] By failing to update his Form U-4 to disclose the Initial Complaint, Respondent 2 violated NASD Conduct Rule 2110 and IM-1000-1.

[12] Because the allegations regarding SEC Rule 10b-5 and Section 20(a) of the Exchange Act of 1934 were explicitly excluded from the Amended Complaint, Enforcement did not argue that the Amended Complaint expressly alleged a violation of investment-related statutes or regulations. (Tr. pp. 366-367).

### 2. Question 14I of the Form U-4

Question 14I(1) of Form U-4, under a section entitled Customer Complaints, inquires "[h]ave you ever been named as a respondent/defendant in an investment-related, consumer-initiated arbitration or civil litigation which alleged that you were involved in one or more sales practice violations and which: (a) is still pending, or; (b) resulted in an arbitration award or civil judgment against you, regardless of amount, or; (c) was settled for an amount of $10,000 or more?" (CX-14, pp. 21, 53, 78).

The majority of the material facts are undisputed: (i) the Plaintiffs filed the Initial Complaint and the Amended Complaint regarding investments, i.e., the stock of the Firm; (ii) the Initial Complaint and Amended Complaint included fraud allegations, i.e., sales practice violations;[13] (iii) the Plaintiffs reached a settlement of the allegations for $125,000; (iv) Respondent 2 was aware of the existence of the Plaintiffs' Initial Complaint, the Amended Complaint, and the Settlement Agreement; and (v) Respondent 2 failed to update his Form U-4 to disclose the Plaintiffs' Initial Complaint, Amended Complaint, or the Settlement Agreement.

The only dispute between the Parties is whether the lawsuits and the settlement were "consumer-initiated" within the meaning of Form U-4. An NASD guide entitled Form U4 and U5 Interpretative Questions, which is available on NASD's public website, reads, in part:[14]

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[13] Form U-4 defines "sales practice violations" as including "any conduct directed at or involving a customer which would constitute a violation of: any rules for which a person could be disciplined by any self-regulatory organization; any provision of the Securities Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale or purchase of a security or in connection with the rendering of investment advice." (CX-14, p. 68).

[14] http://www.nasd.com/RegulatorySystems/CRD/FilingGuidance/NASDW_005243, under the section entitled "14I Generally."

> Q2: Who is included in the term "consumer?"
>
> A2: The term includes a current, former, or prospective customer or person who can act for such person by law or contract, including an executor, conservator, or a person holding a power of attorney. An example of a person who is not a "consumer" is a customer's relative who does not hold a power of attorney. (08/05/98).

Enforcement argued that the plain language of Form U-4, supplemented by instructive material from NASD and relevant case law, demonstrates that the Plaintiffs' Initial Complaint, Amended Complaint, and Settlement Agreement were consumer-initiated. Specifically, Enforcement argued that the Plaintiffs were customers of the Firm and therefore consumers.

Respondent 2 argued that he was not required to disclose the foregoing information because the Plaintiffs were not customers of the Firm. To support his view, Respondent 2 testified that the Plaintiffs (i) never spoke directly with him, (ii) never completed account statements for the Firm, and (iii) were professional investors who had no other dealings with the Firm. (Tr. pp. 272, 283, 286).

The case law is clear that the absence of account statements does not preclude a finding that an entity is a customer of a broker-dealer. In First Montauk Sec. Corp. v. Four Mile Ranch Dev. Co., Inc., the court held that the term "customer" is not limited to investors holding accounts with the member firm.[15] Likewise, in Oppenheimer & Co. v. Neidhert, the court found that investors who were defrauded by a representative of a member firm were customers of that firm under the NASD Arbitration Code, despite the fact that the investors never opened a formal account with the firm.[16]

[15] 65 F. Supp 2d 1731, 1381 (D.D. Fla. 1999).

[16] 56 F.3d 352, 358 (2nd Cir. 1995).

On the other hand, in Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.,[17] the Eighth Circuit Court of Appeals noted that the definition of "customer" was not meant to apply to every sort of financial service an NASD member may provide. In Fleet, the court determined that a company that only received banking and general financial advice from an NASD member firm and did not receive any investment or brokerage services was not a customer of the member firm.

Although not all services provided by an NASD member firm would constitute a customer relationship, the Hearing Panel finds that an NASD member who acts as both the issuer of stock and the seller of stock in a transaction with a third party is providing a service similar to an investment or brokerage service and thereby creates a customer relationship with the third party. Accordingly, the Respondents' sale of the Firm's stock to the Plaintiffs created a customer relationship and the Plaintiffs' lawsuits and settlement were consumer-initiated for purposes of Form U-4. Consequently, the Hearing Panel finds that, although Respondent 2 did not believe that the Plaintiffs were customers for purposes of Form U-4, Respondent 2 was required to update his Form U-4 to disclose the Initial Complaint, the Amended Complaint, and the Settlement Agreement by answering "yes" to Question 14I, and that his failure to do so violated NASD Conduct Rule 2110 and IM-1000-1.[18]

[17] 264 F.3d 770, 772 (8th Cir. 2001).

[18] DBCC v. Prewitt, Complaint No. C07970022, 1998 NASD Discip. LEXIS 37 (NAC Aug. 17, 1998) (Conduct Rule 2110 prohibits associated persons from failing to disclose information required by Form U-4); see also DOE v. Zdzieblowski, Complaint No. C8A030068, 2005 NASD Discip. LEXIS 3 (NAC May 3, 2005).

## D. Counts Two and Three of the Complaint: The Respondents Implemented Impermissible Confidentiality Provisions

Counts two and three of the Complaint allege that the Respondents violated NASD Conduct Rule 2110 by executing settlement agreements in July 2003 and September 2003, which included improper confidentiality provisions.

### 1. Summary Disposition Motion Granted as to Liability for Counts Two and Three of the Complaint

In a summary disposition motion filed on August 1, 2006, Enforcement alleged that there was no genuine dispute about the law or facts. Enforcement argued that it was entitled to summary disposition because: (i) confidentiality provisions of settlement agreements must "expressly authorize the customer or other person to respond, without restriction or condition, to any inquiry about the settlement or its underlying facts and circumstances by any securities regulator, including NASD," and the lack of such express language violates NASD Conduct Rule 2110;[19] and (ii) the two settlement agreements executed by the Respondents, i.e., the July 2003 Settlement Agreement with SC and the September 2003 Settlement Agreement with the Plaintiffs, failed to include the requisite express language.

Pursuant to NASD Procedural Rule 9264(d), a Hearing Panel may grant a motion for summary disposition when "there is no genuine issue with regard to any material fact and the party that files the motion is entitled to summary disposition as a matter of law." This is identical to the standard under Rule 56(c) of the Federal Rules of Civil Procedure ("Fed. R. Civ. P.") governing summary judgments. It is well established under Fed. R.

[19] NASD Notice to Members 95-87 (Oct. 1987).

Civ. P. 56 that the moving party bears the initial burden of showing "the absence of a genuine issue of material fact."[20]

The substantive law governing the case will identify those facts that are material and "only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment."[21] Factual disputes that are irrelevant or unnecessary will not be counted.[22] If the moving party meets the initial burden, the opposing party must come forward with specific facts "showing that there is a genuine issue for trial."[23]

The Respondents argued that they did not intend the settlement agreements to impede any NASD investigation and that the agreements did not actually impede any NASD investigation because NASD was aware of the matters before the confidentiality provisions were executed and/or continued its investigation of the matters after the provisions were executed. Accordingly, the Respondents argued that the confidentiality provisions, although not expressly permitting disclosure to NASD, did not violate NASD Conduct Rule 2110.

Restrictive language similar to the type in the two settlement agreements is problematic for self-regulatory organizations, such as NASD, because such organizations do not have the legal authority to compel cooperation by customers or other persons not subject to the organization's jurisdiction. Accordingly, the Hearing Panel finds that confidentiality provisions that fail to expressly permit disclosure to NASD violate NASD Conduct Rule 2110 because such restrictive provisions are likely to raise an issue with

[20] Celotex Corp. v. Catrett, 477 U.S. 317, 321 (1986).
[21] Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248 (1986).
[22] Id.

the customers or third party and thereby impede NASD's ability to perform its regulatory responsibilities. Noting that NASD Notice to Members 95-87 had expressly put the Respondents on notice that NASD Conduct Rule 2110 was interpreted to require express language permitting disclosure to NASD in confidentiality provisions, the Hearing Panel found that Enforcement had met its burden of showing the absence of a genuine issue of material fact, and granted Enforcement's summary disposition motion.

**2. Hearing**

At the Hearing, Respondent 2 (i) described in greater detail the circumstances surrounding the execution of the settlement agreements, (ii) testified that he relied on knowledgeable individuals to draft the agreements, and (iii) admitted that he made no attempt to review or revise the agreements. Respondent 2 also acknowledged that, although he was the Firm's compliance officer, he was not aware of NASD Notice to Members 95-87 regarding confidentiality provisions until the NASD staff brought it to his attention in January 2004. (Tr. pp. 260-261). The Hearing Panel noted that in 2003 the securities industry was still adjusting to the rules concerning confidentiality provisions, which led NASD to issue another notice to members in 2004, after these events, reminding members and associated persons of the requirements regarding confidentiality provisions.[24]

The Hearing Panel confirmed its earlier findings that the Respondents violated NASD Conduct Rule 2110 by executing impermissible confidentiality provisions.

[23] Matsushita Elec. Indus. Corp., Ltd. v. Zenith Radio Corp., 475 U.S. 574, 586 (1986).

[24] NASD Notice to Member 04-44 (June 2004).

## III. SANCTIONS

### A. Respondent 2 Failed to Update his Form U-4

For filing a false, misleading, or inaccurate Form U-4, the NASD Sanction Guidelines recommend a fine ranging from $2,500 to $50,000, as well as the consideration of a five to 30-business day suspension in any or all capacities.[25] In egregious cases, the Guidelines recommend consideration of a longer suspension, of up to two years, or a bar.[26] The applicable principal considerations are: (1) the nature and significance of the information at issue; and (2) whether failure resulted in a statutorily disqualified individual becoming or remaining associated with a firm.[27]

Enforcement recommended a $10,000 fine and a 20-day suspension, in part, because of Respondent 2's prior disciplinary history.[28]

In determining what sanctions should be imposed for the failure to update timely the Form U-4, the Hearing Panel considered the nature of the omitted information, i.e., a lawsuit was filed, amended, and settled. The Hearing Panel also noted that the failure to update the Form U-4 did not result in a statutorily disqualified individual being associated with a firm.

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[25] NASD Sanction Guidelines, pp. 77-78 (2006).

[26] Id.

[27] Id.

[28] On October 27, 1999, the Respondents executed an AWC and were fined $7,050, jointly and severally, and the Firm was separately fined $2,500 for the Firm's failure to: (i) properly report transactions in NASDAQ and OTC Bulletin Board; (ii) properly report transactions to ACT; and (iii) comply with the free-riding and withholding interpretation. (CX-2, pp. 47-48). On April 17, 2000, the Respondents executed an AWC and were fined $12,500 for (i) failing to comply with NASD continuing education requirements, (ii) failing to provide notice of the departure of three principals of the Firm, and (iii) conducting a securities business without the Firm maintaining its minimum net capital requirement. (CX-2, pp. 32-33). On November 17, 2003, the Respondents executed an AWC and were fined $2,500 for permitting an unregistered individual to act in a registered capacity. (CX-2, p. 68).

The Hearing Panel finds that Respondent 2 was not attempting to conceal the lawsuits or settlements. Respondent 2 failed to update his Form U-4 primarily because he focused on the substance of the lawsuit and its settlement, while failing to consider critically the impact of the lawsuit on his disclosure obligations. Respondent 2 essentially ran a "one man band," was understaffed, and acted negligently rather than intentionally.

The Hearing Panel, therefore, concludes that Respondent 2 should be fined $5,000 and required to re-qualify as a general securities representative and a general securities principal.

**B. The Respondents Executed Impermissible Confidentiality Provisions**

For impermissible confidentiality provisions, the NASD Sanction Guidelines recommend a fine ranging from $2,500 to $50,000, as well as the consideration of a one-month to two-year suspension in any or all capacities.[29] In egregious cases, the Guidelines recommend consideration of a bar.[30]

The applicable principal considerations are: (1) nature of restriction contained in confidentiality clause; (2) whether respondent voluntarily released customer from terms of confidentiality agreement without regulatory intervention; and (3) whether respondent released customer from terms of confidentiality agreement (as applied to cooperation with regulatory authorities) after regulator advised respondent to do so.[31]

The Hearing Panel noted that: (1) although the July 2003 agreement, as prepared by the Firm's clearing firm, had a broad nondisclosure provision, prohibiting disclosure

[29] Guidelines at 34.
[30] Id.
[31] Id.

to any third party, Enforcement explicitly acknowledged that the agreement did not impede its investigation; (2) the Plaintiffs' September 2003 Settlement Agreement, as prepared by counsel, contained a narrower nondisclosure provision that explicitly provided disclosure to governmental authorities; (3) when advised of the confidentiality issue with the July 2003 Settlement Agreement, the Respondents promptly released customer SC from the terms of the confidentiality agreement; and (4) Respondent 2 credibly testified that had the NASD staff informed him that the Plaintiffs were not cooperating because of the terms of the September 2003 Settlement Agreement, he would have explicitly released the Plaintiffs from the terms of the confidentiality agreement. The Hearing Panel specifically finds that Respondent 2 did not try to mislead the NASD staff when he volunteered the information that the SC agreement was the only settlement agreement with a customer because Respondent believed the Plaintiffs were not customers. Respondent 2's belief was a good faith mistake and was not deemed by the Hearing Panel to be an aggravating factor.

For counts two and three of the Complaint, Enforcement proposed as a single sanction that the Firm be censured and fined $1,000, and that Respondent 2 be fined $10,000.

The Hearing Panel finds that it was not the Respondents' intent to prevent NASD from investigating the Respondents in any manner and that the settlement agreements did not, in fact, prevent NASD from investigating the underlying matters. The Respondents were simply negligent and focused on resolving the underlying dispute quickly and efficiently without considering the particular language of the confidentiality provisions. The Respondents also reasonably believed that the settlement agreements prepared by the

clearing firm and by their counsel would be in compliance with any applicable NASD rules.[32]

For both counts two and three of the Complaint, the Hearing Panel concludes that the Respondents should be jointly and severally fined $2,500.

## IV. CONCLUSION

With respect to count one of the Complaint, the Hearing Panel finds that Respondent 2 violated IM-1000-1 and NASD Conduct Rule 2110 by failing to amend his Form U-4 to disclose that he was the subject of a pending investment-related, consumer-initiated civil action, and fines Respondent 2 $5,000 and orders that he re-qualify as a general securities representative and general securities principal.

With respect to counts two and three of the Complaint, the Hearing Panel finds that the Respondents violated NASD Conduct Rule 2110 by executing settlement agreements in July 2003 and in September 2003, which included improper confidentiality provisions, and hereby imposes a joint and several fine of $2,500.

Finally, the Respondents shall jointly and severally pay costs in the amount of $3,540.14, which includes an administrative fee of $750 and transcript costs of

[32] Department of Enforcement v. Fergus, No. C8A990025, 2001 NASD Discip. LEXIS 3, at *46-47 (NAC May 17, 2001) (In analyzing whether reliance on counsel may mitigate sanctions under the Sanction Guidelines, the test is "[w]hether the respondent demonstrated reasonable reliance on competent legal or accounting advice").

$2,790.14. The sanctions shall become effective on a date set by NASD, but not less than 30 days after this Decision becomes the final disciplinary action in this matter.[33]

**HEARING PANEL.**

by:_____
Sharon Witherspoon
Hearing Officer

Date: Washington, DC
April 12, 2007

[33] The Hearing Panel considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.