

# Public Investors Arbitration Bar Association

December 26, 2001

Via Federal Express

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NASDR, Inc.  
Office of the Corporate Secretary  
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Washington, DC 20006-1500

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Re: PIABA Comments on NTM 01-65

Dear Ms. Sweeney:

Please accept this as the Official Comment of the Public Investors Arbitration Bar Association (PIABA) and its 400+ members to the rule proposal concerning expungement set forth in NASDR Notice to Members 01-65.

First, PIABA would like to extend its appreciation to NASDR and other involved parties for the obvious good faith and significant amount of thought and effort put into drafting NTM 01-65 in order to create an expungement system which is fair but recognizes the importance of maintaining the integrity of the CRD system. Having thoroughly reviewed the rule proposal, however, PIABA does offer a few suggested modifications and clarifications.

### Stipulated Awards

PIABA agrees that expungement of arbitration claims from the CRD of either a member firm or associated person as the result of a stipulated or agreed award should be limited to instances of "factual impossibility" and/or "clear error" and further believes that the parenthetical examples of a situation which would meet those criteria<sup>1</sup> are sufficient to guide the

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<sup>1</sup> ("the associated person named in the proceeding did not work for the firm, or worked in a different office, and was named in error") (see p. 565).

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arbitrators as to when such an Award should be entered. However, PIABA suggests any Stipulated Award containing a recommendation of expungement should be accompanied by an affidavit executed by Claimants (or Claimants' counsel) setting forth the facts which constitute "factual impossibility" and/or "clear error" and that such affidavit should be referenced in, incorporated in and attached to the Award as part of the submission to the confirming court. Such a measure ensures that the "factual impossibility/clear error" standard is not being abused by the parties and serves to protect the beneficiary of the expungement by creating a permanent record of the facts exonerating him/her.

#### Awards After Hearing/Determination

- 1) "Factual Impossibility/Clear Error": See comments above.
- 2) "Without Legal Merit": PIABA believes this basis for expungement is too vague to be useful and should be changed to "completely without any legal or equitable merit" in recognition of the fact that arbitration - in both intent and design - is, and always has been, largely an equitable proceeding. To ignore the equitable merit of a claim is to deny the basically equitable nature of arbitration. Moreover, this standard should be equated with "frivolous" - a term well known in the law and aptly descriptive of the only type of complaint which should ever merit the extreme remedy of expungement from the public record. It should further be clarified for arbitrators that the "completely without any legal or equitable merit" standard would be deemed met in only the rarest of circumstances and should not be a basis for expungement in cases in which the investor simply fails to meet his/her burden of proving the claim by "a preponderance of the evidence."
- 3) "Defamatory in Nature": PIABA believes this proposed criterion has the most potential for abuse and other problems and should be modified.

The most obvious potential problem with incorporation of this criterion is the application of the appropriate law when the panel is making such a determination. As correctly noted in footnote 6 to NTM 01-65, various jurisdictions apply varying standards for determining whether statements constitute defamation. Likewise, whether any privilege attaches to statements made in the context of a quasi-judicial proceeding such as arbitration may differ from jurisdiction to jurisdiction. One can easily envision almost automatic post-award vacatur motions by both Claimants and Respondents challenging any finding of "defamatory in nature" on the grounds that the wrong law was applied.

Given the national publication of potentially defamatory statements via the CRD system, it is not difficult to imagine how these differing standards increase the possibility/likelihood of inconsistent application of this particular basis for expungement and/or could spawn an endless

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stream of secondary/collateral litigation simply to determine which law will apply. Which law will apply? The law of the state where the claimant resided at the time of the event or occurrence giving rise to the claim? The law of the state where the claimant resided when the claim was filed? If the claimant and his/her attorney reside in different states (which is not uncommon), the law of the state in which the claimant's attorney (who will often be the party responsible for the alleged defamatory statements) maintains his/her principal office? The potential for these problems is magnified when one takes into account the national presence of many member firms and the multi-state client base of many associated persons. These problems dictate that some framework be established for determining which law will be applied and who will make the final determination that statements in an arbitration claim were "defamatory in nature."

PIABA also believes that, absent some framework for making a determination of what constitutes "defamatory in nature" (and, perhaps, even in spite of such a framework), inclusion of this criteria in the context of customer-member claims threatens to produce an unwarranted and severe "chilling effect" on a customer's willingness to file otherwise meritorious and legitimate arbitration claims. Over the last several years, it has become automatic for respondents to request in their Statement of Answer an expungement of the claim from Respondent's CRD.<sup>2</sup> Under this proposal, these requests will now by necessity be accompanied by the requisite charges of "without legal merit" and/or "defamatory in nature" in order to justify the request for expungement. Allegations that claims are "without legal [or equitable] merit" are not particularly troublesome to PIABA, because, in fact, almost all Statements of Answer take the position that the claim is "without legal [or equitable] merit." A claim of "defamatory in nature," however, raises the specter that every customer claimant will be faced with defending charges of defamation, no matter how meritorious the claim. While the customer/claimant may feel comfortable in the veracity of his/her claim, and hence his/her likelihood of successfully defending a charge of "defamatory in nature," that same customer will nonetheless have to consider - at the outset - the additional hearing days (and hence, cost) involved in defending the claim in arbitration and the potential for a subsequent court proceeding involving a claim for defamation based on the Award should the panel find the claim to be "defamatory in nature."

Due to these myriad problems with the application of the "defamatory in nature" criterion and the chilling effect and additional cost to customers resulting from those problems, PIABA believes that the "defamatory in nature" criterion should be limited to intra-industry disputes in

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<sup>2</sup> PIABA understands that, given the availability over the last several years of expungement as a possible remedy, Respondents' counsel may fear a charge of malpractice if they don't request expungement.

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which part of the underlying claim is defamation, a not uncommon scenario. The rule should provide that the Panel will decide the claim of defamation based on the law of the state in which the party claiming defamation maintains his/her/its principal office, or in accordance with the terms of any agreement between the parties. Given that defamation is already a common basis for requesting expungement in associated person-member firm disputes, inclusion of the "defamatory in nature" criterion in those disputes does not act to impose any additional burdens or concerns than already exist. Removing "defamatory in nature" as a criterion in customer-member disputes removes the potential chilling effect discussed above.

If the "defamatory in nature" criterion is to exist as a basis for expungement in customer-member claims, then the law to be applied should be the law of the state in which the customer resides at the time of filing the Statement of Claim (the alleged defamatory act), the relief available for a finding of "defamatory in nature" should be limited to expungement of the claim from the prevailing party's CRD, and there should be an express prohibition against the prevailing party using the panel's finding of "defamatory in nature" as the basis for subsequent common-law claims of defamation. This can be accomplished by requiring that a finding of "defamatory in nature" be accompanied by a statement in the Award itself that the finding is meant to apply to the request for expungement only and, notwithstanding the law of issue and/or claim preclusion in any jurisdiction, the finding shall not serve as the basis for a subsequent claim of common-law defamation.

#### Notice and Confirmation

PIABA agrees that NASDR should: (a) be named a party to any court proceeding which involves a request for expungement; (b) be served with any proposed order confirming an award containing a recommendation of expungement (and the grounds therefore) or otherwise granting such relief (as in the case of a litigated - as opposed to arbitrated - matter; see footnote 11 to the NTM); and, (c) be given sufficient notice to contest entry of any such order. However, we are not confident that such a requirement can be enforced absent additional safeguards.

NASDR acknowledges, at footnote 17, that it would abide by an expungement directive lawfully ordered by the courts after a hearing on the merits. PIABA is aware of no state or federal laws which require that NASDR be made a party to, or given notice of, post-award confirmation proceedings or any other court proceeding between 2 private parties that would seek to order expungement of a CRD record. Accordingly, parties could simply ignore NASDR's mandate for service and prior notice, have the order of expungement entered in the Court, and NASDR (and the states who participate in maintaining the CRD system) would likely have no legal choice but to abide by the Court's ruling, because it would have no legitimate legal basis to challenge it on the grounds that the parties did not name NASDR as a party and provide advance notice of the request.

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While NASDR would likely have some sort of power to penalize the violating member firm and/or associated person under Conduct Rule 2110, it may very well not be in a position to reverse the effects of the expungement in the face of a lawfully entered court order. Moreover, to rely solely on the punitive power of NASDR inherent in Conduct Rule 2110 only increases the burden of oversight and enforcement on NASDR without any guarantee that the real problem - unwarranted expungements - is solved. Accordingly, PIABA suggests that, to more likely ensure parties' compliance with the "Service and Notice" provisions of the proposed rule, the rule should require that all Awards (which are, after all, what the court is confirming) containing a recommendation of expungement state explicitly that confirmation of the expungement recommendation is contingent upon the moving party(ies) naming NASDR as a party to any confirmation proceeding and serving NASDR with a copy of the confirmation request no later than the day on which the request is filed with the appropriate court. In such a scenario, even if the parties were to attempt to have the award confirmed without properly naming, serving and notifying NASDR, any order confirming the Award would by definition not be effective as to the recommendation of expungement and neither NASDR nor the states would not be obligated to expunge the CRD record.

The issue of how best to ensure compliance with the proposed "notice and service" obligations in those instances where a dispute is resolved outside of the arbitration arena altogether is considerably trickier. Obviously, NASDR has no authority to rewrite the rules of civil procedure among the 50 states or federal courts as to what constitute "necessary" and/or "proper" parties to litigation. In that setting, the parties could ignore the "notice and service" mandate of this rule proposal with impunity, and yet, NASDR and the states would likely have no legal alternative but to comply with the Court's order of expungement. In this instance, PIABA can conceive of no way to reliably ensure that parties comply with the "notice and service" provisions but to enact a Conduct Rule which encompasses the "notice and service" obligation. If a new Conduct Rule is to be adopted, it might as well encompass the "notice and service" obligations in the award confirmation setting as well as in those instances in which the dispute is resolved without the filing of an arbitration claim.

#### Adoption of Rule or Interpretive Material

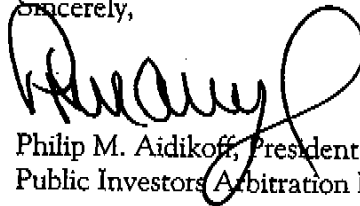
PIABA agrees that Conduct Rule 2110, as currently written, empowers NASDR to take appropriate action in response to member firms or associated persons who might inappropriately seek expungement relief. However, in light of the sea-change in expungement practices represented by the rule proposed in NTM 01-65 and the potential problems with the oversight and enforcement of the "notice and service" provisions, as discussed above, PIABA believes that the purpose of the proposed rule would be well served by the adoption of a new rule or interpretive material emphasizing the seriousness with which NASDR views the expungement issue and clarifying that Conduct Rule

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2110 (and the member firms' and associated persons' obligation to abide by it) empower NASDR to withhold expungement of the subject CRD if the terms of the new rule are not abided by.<sup>3</sup>

PIABA again expresses its appreciation of the thought and effort which went into drafting the rule proposed in NTM 01-65 and hopes the suggestions and comments contained herein are taken in the good-faith vein in which they were intended. We stand ready to respond to any further inquiries NASDR may have on this subject.

Sincerely,



Philip M. Aidikoff, President  
Public Investors Arbitration Bar Association

cc: Linda Feinberg (Via U.S. Mail)  
NASD Dispute Regulation, Inc.  
1735 K Street, Northwest  
Washington DC, CA 20006

PIABA (Via Telecopier Only)  
Board of Directors

Robin Ringo (Via Telecopier Only)

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<sup>3</sup> In light of the problems with administering and overseeing the "notice and service" provisions, as addressed herein, it seems that the more effective action would be the adoption of a rule rather than the issuance of new interpretive material.

**ACTION REQUESTED BY  
NOVEMBER 24, 2001**

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## Expungement

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### NASD Seeks Comment On Proposed Rules And Policies Relating To Expungement Of Information From The Central Registration Depository

**SUGGESTED ROUTING**

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representatives
- Legal & Compliance
- Operations
- Registration
- Senior Management

**KEY TOPICS**

- Central Registration Depository System
- Expungement

### Executive Summary

The National Association of Securities Dealers, Inc. (NASD®) requests comment on the establishment of certain criteria that must be met, and procedures that must be followed, before NASD Regulation would expunge certain information from the Central Registration Depository (CRD®) system pursuant to an expungement order. By way of background, information generally is expunged from the CRD system pursuant to a specific statutory requirement or a court order. While this practice is appropriate in most cases, NASD Regulation believes that refinements to this policy are necessary to address the expungement of customer dispute information (e.g., customer complaints or arbitration claims). With respect to customer dispute information, NASD Regulation believes that additional safeguards and procedures in the expungement process are necessary to ensure that investor protection interests are served before the extraordinary relief of expungement is granted.

Accordingly, NASD specifically seeks comment on whether it should generally limit expungement of customer dispute information from the CRD system to cases where an expungement order is based on a finding by a fact finder (i.e., either an arbitrator or a court) that (1) the subject matter of a claim or information in the system involves a case of factual impossibility or “clear error” (e.g., the associated person named in the proceeding did not work for the firm, or worked in a different office, and was named in error); (2) the claim in question is without legal merit; or (3) the information contained in the CRD system is determined to be defamatory in nature.

NASD also seeks comment on (1) specific procedures that would be required to be followed depending on whether the finding that is made results from a contested proceeding (e.g., an arbitration hearing or judicial proceeding) or from a settled matter (e.g., a stipulated award rendered in an arbitration forum or judicial proceedings based on a settlement); (2) the adoption of a rule amending the Code of Arbitration Procedure to require a finding in an arbitration award of one or more of the expungement criteria discussed in this *Notice*; and (3) the adoption of a rule or Interpretive Material that clearly articulates NASD Regulation’s authority to pursue disciplinary action against a member that or associated person who seeks to have information about an arbitration claim expunged after there has been an award rendered against that member or associated person by the arbitrators or seeks to expunge any arbitration award that does not contain an expungement order and a finding of at least one of the criteria set forth in this *Notice*.

### Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by November 24, 2001. Members and interested persons can submit their comments using the following methods:

- \* mailing in the checklist (Attachment A)
- \* mailing in written comments
- \* e-mailing written comments to [pubcom@nasd.com](mailto:pubcom@nasd.com)
- \* submitting comments using the online form at the NASDR Web Site ([www.nasdr.com](http://www.nasdr.com))

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## NASD Notice to Members 01-65—Request For Comment

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If you decide to submit comments using both the checklist and one of the other methods listed above, please indicate that in your submissions. The checklist and/or written comments should be mailed to:

*Barbara Z. Sweeney*  
*Office of the Corporate Secretary*  
*National Association of Securities Dealers, Inc.*  
*1735 K Street, NW*  
*Washington, DC 20006-1500*

**Important Note:** The only comments that will be considered are those submitted in writing or by e-mail.

Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation and/or NASD Dispute Resolution Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission (SEC) following public comment.

### Questions/Further Information

As noted above, written comments should be submitted to Barbara Z. Sweeney. Questions concerning this *NASD Notice to Members—Request For Comment* may be directed to Richard E. Pullano, Chief Counsel, CRD/Public Disclosure, NASD Regulation, at (240) 386-4821; or to Shirley H. Weiss, Office of General Counsel, NASD Regulation, at (202) 728-8844.

### Background

The CRD system is the registration and licensing system for the United States securities industry and its state and federal regulators and self-regulatory organizations.<sup>1</sup>

NASD Regulation and the North American Securities Administrators Association (NASAA) jointly administer the CRD system.<sup>2</sup> All broker/dealers registered with the SEC are required to file their registration forms (Form BD and Form BDW) through the CRD system. Such broker/dealers also are required to file the registration forms of any of their associated persons who are NASD-registered through the CRD system (Form U-4 and Form U-5). These registration forms require comprehensive reporting of administrative information (personal, organizational, employment, registration, and other information) and disclosure information (information about criminal, regulatory, and financial matters, including information relating to customer disputes). This final category of “customer dispute information” includes customer complaints, arbitration claims, court filings made by customers, and the arbitration awards or court judgments that may result from those claims. This category of information contains allegations that a member or one or more of its associated persons has engaged in some type of misconduct.

Regulators use the registration information, and other information contained in the CRD system,<sup>3</sup> to assist them in fulfilling their regulatory responsibilities, including making determinations about registration and licensing of firms and associated persons. Member firms use the CRD system to help them meet their registration, licensing, and certain other compliance obligations. Much of the information reported to the CRD system is made publicly available, either by NASD Regulation through its Public Disclosure Program (PDP) or

by the SEC and individual state securities administrators pursuant to applicable law.

In operating the CRD system, NASD Regulation has followed procedures designed to ensure that the information in the system is accurate and complete. In establishing these procedures, NASD Regulation is guided by its mission of protecting investors and by CRD policy established with NASAA and the SEC. As the operator of the system with primary responsibility for maintaining its integrity, NASD Regulation also has an obligation to consider compelling issues involving personal privacy and fundamental fairness. Accordingly, NASD Regulation, working with the SEC, NASAA, other members of the regulatory community, and member firms, has endeavored to establish procedures reasonably designed to ensure that information submitted to and maintained on the CRD system is accurate and complete. These procedures, among other things, cover expungement of information from the CRD system in narrowly defined circumstances. Expungement is a remedy provided by federal and state law in certain circumstances that usually is effected through a court order.

Since the inception of the CRD system in 1981, court-ordered expungements generally have been honored. Arbitrator-ordered expungements that met certain requirements also were honored until January 1999. In January 1999, after consultation with NASAA, NASD Regulation imposed a moratorium on arbitrator-ordered expungements from the CRD system. Under the moratorium, which is still in effect, NASD Regulation will not expunge information from the CRD system



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## NASD Notice to Members 01-65—Request For Comment

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based on a directive contained in an arbitration award rendered in a dispute between a public customer and a firm or its associated persons, unless that award has been confirmed by a court of competent jurisdiction.<sup>4</sup>

In July 1999, NASD issued *NASD Notice to Members 99-54* seeking comment on issues related specifically to arbitrator-ordered expungements. NASD sought comment on possible approaches that would address the interests of parties in arbitration in having arbitrators' expungement orders given some meaningful effect while still addressing state record-retention requirements and other issues. Among other things, *NASD Notice to Members 99-54* sought comment on whether NASD Regulation should establish specific standards that would have to be met before NASD Regulation would honor an expungement that was ordered by an arbitrator. The comments received in response to *NASD Notice to Members 99-54* were mixed, although most commenters were in favor of allowing arbitrator-ordered expungements, particularly if arbitrators had the benefit of standards to guide them in making such determinations. On the other hand, many commenters opposed allowing arbitrators to direct expungement because of concerns about arbitrator authority or training and state law issues, among other reasons.

### Discussion

Federal and state laws provide for expungement relief under very limited circumstances. In addition, persons may be granted an expungement remedy in a civil action (as a form of equitable relief) when, for example, harm is done to their reputations, or based on other equitable grounds.

Expungement of information from the CRD system also is appropriate in certain circumstances where it is not expressly required by applicable law or by a court order in a legal proceeding to which NASD Regulation is a party.

Expungement of information from the CRD system is an extraordinary remedy, however, that clearly is not appropriate in all circumstances. In addition, there is a potential for inappropriate use of the expungement process, particularly where parties have agreed to expunge customer dispute information as a part of a settlement. Both the investing public and regulators have interests in maintaining customer dispute information within the CRD system that may not be considered when two private parties agree to settle a civil suit or arbitration claim and to expunge information relating to that suit or arbitration claim from the CRD system.

Since the issuance of *NASD Notice to Members 99-54*, NASD Regulation has been considering how to craft an approach that would balance all of the competing interests associated with executing arbitrator-ordered expungements that include customer dispute information. Developing an approach has been a difficult undertaking, as it requires a balancing of at least three legitimate but sometimes competing interests. NASD Regulation, the states, and other regulators have an interest in retaining broad access to customer dispute information to fulfill their regulatory responsibilities; individuals in the brokerage community have an interest in securing a fair process that recognizes their stake in protecting their reputations and permits expungement from the

CRD system when appropriate; and investors have an interest in having access to information about brokers with whom they do business or may do business.<sup>5</sup> NASD Regulation also has been concerned about crafting an approach that does not have an overly broad chilling effect on the settlement process or inappropriately interfere with the arbitration process or arbitrators' authority to award appropriate remedies.

After considering the compelling interests at stake, NASD Regulation preliminarily has identified three bases that it believes warrant the extraordinary relief of expunging information from the CRD system. They include a finding that (1) factual impossibility or "clear error" exists (e.g., the associated person named in the proceeding did not work for the firm, or worked in a different office, and was named in error); (2) the claim is without legal merit; or (3) the information on the CRD system is defamatory in nature.<sup>6</sup> As discussed in more detail below, NASD is seeking comment on whether interested parties agree that findings falling into one of these three categories are a sufficient basis for expungement of information from the CRD system and whether additional categories should be considered. With respect to the first category, NASD Regulation is specifically interested in hearing interested parties' views on whether the "factual impossibility" category is clear and broad enough, or whether the category also should address "clear error" situations (e.g., when a customer or a regulator names one registered person at a firm, but intended to name another registered person). NASD Regulation also is interested in

commenters' views on what constitutes "clear error" or "factual impossibility."

NASD Regulation also generally believes that, before any customer dispute information is expunged, an independent fact finder should make a finding that expungement relief is warranted on one of these three bases. With respect to the second category (*i.e.*, claims that are found to be "without legal merit"), NASD Regulation emphasizes that merely prevailing in an arbitration or court proceeding would not, by itself, justify expungement. A fact finder would be required to make a specific finding that a claim was factually impossible, without legal merit, or defamatory in nature before NASD Regulation would execute any expungement directive. With respect to the third category, NASD is interested in commenters' views on whether fact finders should be required to find that information in the CRD system is defamatory in nature, or whether a finding that information is false or defamatory in nature would be a sufficient basis to expunge. NASD Regulation discusses below its preliminary views on specific categories of information that may be subject to expungement requests and proposed approaches/ criteria for expunging that information from the CRD system.

### **Expungement Of Customer-Initiated Complaints/ Arbitrations/Court Proceedings**

Expungement of customer dispute information is an especially difficult area given the competing interests involved.

NASD Regulation recognizes that, in some cases, allegations of

misconduct may be without merit or may falsely or mistakenly accuse associated persons of engaging in misconduct. Such allegations may unfairly tarnish the reputations of those associated persons and, as a result, associated persons increasingly are requesting expungement of the information as a form of equitable relief in connection with the resolution of these disputes. NASD Regulation also recognizes that some brokers and firms may inappropriately attempt to have meritorious or accurate information about their misconduct or alleged misconduct expunged from the CRD system.<sup>7</sup>

Most customer/broker disputes are resolved in arbitration or, alternatively, are settled by the parties without the involvement of a finder of fact. Typically, neither of these dispute resolution methods results in a record that explicitly identifies the rationale for granting expungement relief.<sup>8</sup> "Stipulated" (or consent) awards or settlements are a source of particular concern because typically there has been no hearing on the merits, no independent fact finder involved in the negotiations, and no rationale provided for the expungement. While there may be legitimate reasons for the expungement, those reasons generally are not provided in a stipulated award or settlement. Therefore, NASD Regulation is proposing that any approach dealing with the expungement of customer dispute information must address both expungement orders in arbitration awards after a hearing on the merits and "stipulated" or consent awards in which parties agree to expungement as part of the settlement and then present the settlement to the arbitrator for inclusion in an award.

### **Awards After Hearing/Determination<sup>9</sup>**

NASD Regulation believes that merely prevailing in an arbitration case is not, by itself, an appropriate ground for expunging the proceeding from the CRD system.<sup>10</sup>

Expungement is extraordinary relief that should be granted in limited circumstances only after a determination by an independent adjudicator that the matter in question meets at least one of the criteria established for expungement. As discussed above, NASD Regulation believes that the appropriate criteria for expunging customer dispute information may include a finding that: (1) factual impossibility or "clear error" exists (*e.g.*, the associated person named in the proceeding did not work for the firm, or worked in a different office, and was named in error); (2) the claim is without legal merit; or (3) the information on the CRD system is defamatory in nature. NASD Regulation proposes to execute arbitrators' directives to expunge customer dispute information from the CRD system only if one of these three findings is made and is expressly contained in the arbitration award. As discussed in more detail below, NASD Regulation also would require that all such directives be confirmed by a court of competent jurisdiction, and that NASD Regulation be given notice of any request for judicial confirmation or order of expungement<sup>11</sup> prior to submission to the court.

NASD Regulation believes that adverse arbitration awards (*i.e.*, arbitration awards against a firm or associated person) should not be expunged pursuant to a post-award settlement with the customer, even if that settlement

is approved by a court.<sup>12</sup> An adverse arbitration award represents a finding by independent arbitrators, after consideration of the merits, that a customer claim and allegations made therein are meritorious in full or in part, and justify an award to a customer. Such information is valuable to regulators, the investing public, and to other securities firms that may be potential employers of the subject of the award. NASD Regulation believes that this information should be in the CRD system, and that it may be a violation of Rule 2110 to seek expungement under these circumstances.

### **Stipulated Awards**

Because they originate as settlements between parties and generally do not involve independent fact finders in the entire process, “stipulated” or “consent” awards are especially difficult to address. As noted in *NASD Notice to Members 99-54*, pursuant to the Code of Ethics for Arbitrators in Commercial Disputes, arbitrators are not bound to sign a consent award unless the arbitrator is satisfied with the propriety of the terms of the settlement.<sup>13</sup> Nevertheless, concerns have been raised about the possibility of negotiated arrangements wherein a firm may agree to settle a claim filed by a customer against an associated person and the firm, provided the customer agrees to the inclusion of a directive to expunge all information about the claim from the associated person’s CRD record. In some cases, a customer claim/allegation may have merit and, therefore, should be reported on the uniform registration forms, included in the CRD system for use by regulators and broker/ dealers, and made

available to investors through NASD Regulation’s PDP. Expungement may be inappropriate under these circumstances.<sup>14</sup>

NASD Regulation believes that it would be appropriate to include expungement relief in stipulated awards only in cases involving factual impossibility or in which a party was mistakenly named (the “clear error” criterion). In those cases, such persons should be able to avail themselves of the settlement opportunity outside of arbitration, and then request that an arbitrator issue an award that incorporates the stipulated settlement and includes expungement relief for certain named parties. NASD Regulation is not proposing to include the other two criteria (without legal merit or defamatory in nature) as grounds for expungement in stipulated awards because, in NASD Regulation’s view, it is unlikely that claimants’ counsel would agree to such findings as part of a settlement and because NASD Regulation believes that a fact finder’s explicit determination that expungement is being ordered based on one of the three criteria discussed in this *Notice* is a necessary safeguard. NASD Regulation believes that settlements of customer complaints outside of the arbitration process that are reduced to stipulated court orders of expungement should be treated similarly. Accordingly, NASD Regulation proposes to execute expungement orders incorporating settlement agreements only if they are ordered by a court of competent jurisdiction and include a finding of factual impossibility or that the associated person whose information is to be expunged was named in clear error.<sup>15</sup>

### **Court Confirmation Of Expungement Orders**

Consistent with the practice announced in *NASD Notice to Members 99-54*, NASD Regulation proposes to continue to require that any arbitration award in a customer dispute containing an expungement order be confirmed by a court of competent jurisdiction before NASD Regulation will execute the order. This requirement also will apply to customer disputes settled outside of the arbitration process and submitted to a court as a stipulated order. NASD Regulation will review every such expungement order to determine whether the expungement criteria have been met. Accordingly, NASD Regulation proposes that any expungement rule would require parties seeking expungement pursuant to an arbitration award to name NASD Regulation as an additional party in the confirmation proceeding, and to serve NASD Regulation with the appropriate court papers.<sup>16</sup> If NASD Regulation determines that the expungement order meets the criteria set forth above, it will advise the court that it will not oppose expungement. On the other hand, if NASD Regulation determines that the expungement order does not meet the criteria, NASD Regulation will participate in the proceeding and oppose confirmation of the expungement portion of the arbitration award.<sup>17</sup> In addition, NASD Regulation will notify the states when NASD-registered firms or individuals provide notice to seek an expungement, and one or more states may choose to intervene in the confirmation or other judicial proceeding.

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## Summary

NASD Regulation believes that there should be a way to remove information that is factually impossible, without legal merit, or defamatory in nature from the CRD system, but that any such removal should be made only after certain criteria are met and certain protocols are followed. Accordingly, NASD seeks comment on the following proposals that are intended to establish those criteria/protocols.

## Proposed Rules/Actions

### **Adoption Of Customer Complaint/Arbitration Expungement Rule**

NASD specifically seeks comment on the following proposal.

NASD Regulation will expunge customer dispute information from the CRD system only under the following conditions:

#### **I. Judicial or Arbitral Findings**

##### **A. By hearing on the merits:**

Expungement resulting from a judicial or arbitral hearing on the merits must contain one of the following findings with respect to the person for whom expungement is ordered:

1. Factual impossibility/“clear error”
2. Without legal merit
3. Defamatory in nature

##### **B. By stipulated award:**

Expungement resulting from a stipulated award presented to an arbitrator for signature and containing an expungement order must contain a finding by the arbitrator(s) of factual

impossibility or clear error with respect to the associated person for whom expungement is ordered.

##### **C. Settlement of customer complaint without an award:**

Customer complaints that are settled and reduced to a settlement agreement that contains an expungement order will be expunged by NASD Regulation only if the settlement is approved by a court of competent jurisdiction, and the document signed by the court contains a finding that the associated person whose information is to be expunged was named in clear error.

#### **II. Notice and Court Confirmation**

All arbitrator-ordered expungements of customer dispute information must be confirmed by a court of competent jurisdiction. NASD Regulation will not expunge customer dispute information from the CRD system pursuant to a court confirmation of an arbitration award, or other judicial proceeding or a settlement agreement unless it receives notice and a copy of the proposed expungement order prior to its submission to the court,<sup>18</sup> and is named as a party to the proceeding with respect to the expungement issue. NASD Regulation reserves the right to oppose confirmation of an arbitration award (or, in any other proceeding, to oppose the issuance of an expungement order) if it determines that the expungement order does not contain one or more of the criteria set forth in Section I above.

#### **III. Otherwise Required by Law or Court Order**

In addition, NASD Regulation will expunge customer dispute information if required to do so by applicable law or a lawful court order that is binding upon NASD Regulation. NASD Regulation would have to be named as a party to any judicial proceeding where an order to expunge such information from the CRD system is sought.

NASD Regulation proposes to make determinations about what constitutes factual impossibility and “clear error.” As discussed above, examples of factual impossibility could include cases where it can be demonstrated that it was factually impossible for the associated person named in the proceeding to have committed the alleged misconduct (e.g., the associated person named in a proceeding did not work for the firm or worked in a different office and was named in error). Examples of “clear error” could include cases where a customer names one registered person at a firm, but intended to name another registered person or where a clerical or procedural error results in the naming of the wrong person). NASD specifically seeks comment on what circumstances or criteria should qualify for the “clear error” category.

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## ***Adoption Of A Rule Or Interpretive Material Articulating NASD Regulation's Authority For Violations Of Conduct Rule 2110***

NASD staff also seeks comment on whether to adopt a rule or Interpretive Material that would expressly articulate NASD Regulation's authority to pursue a disciplinary action (for violation of just and equitable principles of trade) against a member or an associated person who:

1. seeks to have information about an arbitration claim expunged after there has been an award rendered against that member by the arbitrators;<sup>19</sup> or
2. seeks to expunge any arbitration award that does not contain an expungement order and a finding of at least one of the criteria set forth above.

NASD Regulation's authority to pursue disciplinary actions against members for violations of Conduct Rule 2110 is quite broad and would encompass pursuing conduct that would undermine the regulatory function of fostering an effective dispute resolution system. Nevertheless, NASD comment on whether adopting an explicit rule or Interpretive Material may act as an additional deterrent to firms or associated persons who might inappropriately seek expungement relief.

## **Endnotes**

- 1 NASD Regulation and NASAA jointly developed the CRD concept, and they jointly set CRD policy.
- 2 NASAA is an association comprised of state and other securities regulators in the United States, as well as other securities regulators in North America. NASD Regulation was established in 1996 as a separate, independent subsidiary of the NASD. NASD Regulation has responsibility for the operation of the CRD system.
- 3 The CRD system also contains other administrative information (e.g., registration status with various regulators, qualification examination results) and disclosure information reported by participating regulators and the Department of Justice.
- 4 *NASD Notice to Members 99-09* announced the imposition of the moratorium and specifically noted that, under the moratorium, NASD Regulation would continue to expunge information from the CRD system based on expungement directives rendered in disputes between associated persons and firms where arbitrators have awarded such relief based on the defamatory nature of the information at issue. NASD Regulation is not proposing any changes to that limited exception (which also was discussed in *NASD Notice to Members 99-54*) or to the general requirement that awards rendered in disputes between customers and firms or their associated persons that provide expungement relief be confirmed by a court of competent jurisdiction.
- 5 While defamation actions brought by member firms are less likely to occur than actions brought by individuals, member firms also have an interest in protecting their reputations, and may seek appropriate relief against persons who make false statements about firms.
- 6 Generally, defamation requires a false statement about an individual that is published to a third party and harms the individual's reputation. Federal and state courts generally apply a standard of actual malice or reckless disregard for statements about public individuals, and a negligence standard for statements about private individuals, for recovery on a defamation claim. The elements of defamation and the applicable standard of fault may vary among the states.
- 7 With respect to the "alleged misconduct" category, NASD Regulation recognizes that information in the CRD system includes allegations of misconduct that have not yet been proven. Nevertheless, such allegations may have regulatory value as an early indicator of problems or as part of a larger pattern that may also include similar acts of misconduct that were found to have merit. Regulators understand the distinction between allegations and findings of misconduct, and NASD Regulation provides information through its PDP to inform the public of that distinction. Specifically, NASD Regulation informs requestors that customer complaints and other disclosure events may include allegations that have not been verified or proven to be true and that requestors should not assume that they are true. Moreover, with respect to pending regulatory/disciplinary actions that have been reported, requestors are informed that such items may be contested and ultimately withdrawn, dismissed, or otherwise resolved in favor of the broker.
- 8 Arbitrators are not required to provide the reasoning for a particular decision or award and typically do not do so.
- 9 This category includes cases that were decided on the papers, without a hearing.
- 10 In this situation, the appropriate course of action is the filing of an amendment through the CRD system to report that the arbitration has been completed and that the party prevailed in the arbitration.
- 11 While the majority of court orders that NASD Regulation receives confirm an arbitrator-ordered expungement award, NASD Regulation also receives court orders that order the expungement of customer dispute information when the parties went directly to court (and not to arbitration).

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12 NASD Regulation notes that an exception to this general policy would be where a court vacates an arbitration award and orders expungement as equitable relief.

13 See Canon V(D) of The Code of Ethics for Arbitrators in Commercial Disputes (reproduced on the NASD Dispute Resolution Web Site at [www.nasdadr.com/ethics\\_code.asp](http://www.nasdadr.com/ethics_code.asp)).

14 NASD Regulation is aware of allegations that firms have pressed customer/claimants into accepting expungement as a condition of settlement of arbitration proceedings. While we believe that the proposed rules would address these concerns, NASD Regulation would consider this practice to be a possible violation of Rule 2110.

15 As discussed in more detail below, under the approach being contemplated in this *NASD Notice to Members*, a member would be required to provide NASD Regulation with notice that it was seeking expungement and would be required to make NASD Regulation a party to that proceeding. NASD Regulation would either advise a court that it did not oppose expungement relief or would participate in the proceeding and oppose the requested relief. NASD Regulation would, of course, abide by an expungement directive lawfully ordered by the courts after a hearing on the merits.

16 This requirement would also apply to any other judicial proceeding that could result in an order for the expungement of customer dispute information from the CRD system.

17 As noted above, NASD Regulation would, of course, abide by an expungement directive lawfully ordered by the courts after a hearing on the merits.

18 A party seeking expungement relief should give notice prior to either the judicial proceeding in which the relief is requested or the judicial proceeding seeking to confirm an arbitration award ordering expungement.

19 NASD Regulation does not seek to preclude a member or associated person from seeking to vacate an arbitration award under the limited bases delineated in an appropriate state or federal statute.

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## ATTACHMENT A

### Request For Comment Checklist

We have provided below a checklist that members and other interested parties may use in addition to or in lieu of written comments. This checklist is intended to offer a convenient way to participate in the comment process, but does not cover all aspects of the proposal described in the *Notice*. We therefore encourage members and other interested parties to review the entire *Notice* and provide written comments, as necessary.

### Instructions

Comments must be received by **November 24, 2001**. Members and interested parties can submit their comments using the following methods:

- mailing in this checklist
- e-mailing written comments to [pubcom@nasd.com](mailto:pubcom@nasd.com)
- mailing in written comments
- submitting comments online at the NASDR Web Site ([www.nasdr.com](http://www.nasdr.com))

The checklist and/or written comments should be mailed to:

*Barbara Z. Sweeney*  
*Office of the Corporate Secretary*  
*NASD Regulation, Inc.*  
*1735 K Street, NW*  
*Washington, DC 20006-1500*

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## Proposed Amendments Concerning Expungement of Information for the CRD System

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|--|--|
| <p>1. Should NASD Regulation adopt a rule that would require members to provide notice to NASD Regulation and make NASD Regulation a party to the proceeding before seeking a court order directing expungement or a confirming of an arbitration award that contains an expungement directive?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p>  | <p>3. Should NASD Regulation execute arbitrators' directives to expunge customer dispute information from the CRD system if (1) arbitrators make specific findings in stipulated or consent awards; (2) arbitrators expressly include those findings in an award; and (3) a party confirms the award in a court of competent jurisdiction?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> |
| <p>2. Should NASD Regulation establish specific standards that must be met before it will execute orders directing it to expunge customer dispute information from the CRD system? Are the standards identified in the <i>Notice</i> (<i>i.e.</i>, factually impossible/clear error; without legal merit; and defamatory in nature) appropriate?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> | <p>4. Should NASD Regulation adopt a rule or Interpretive Material that would explicitly articulate NASD Regulation's authority to pursue disciplinary actions for violations of just and equitable principles of trade against a member or associated person who seeks to have information about an arbitration claim expunged after there has been an award rendered against that member by the</p>  |

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arbitrators or seeks to expunge any arbitration award that does not contain an expungement order and a finding of at least one of the criteria described in the *Notice*?

Yes  No  See my attached written comments

### Contact Information

Name: \_\_\_\_\_

Firm: \_\_\_\_\_

Address: \_\_\_\_\_

City \_\_\_\_\_

State/Zip: \_\_\_\_\_

Phone: \_\_\_\_\_

E-Mail: \_\_\_\_\_

### Are you:

An NASD Member

An Investor

A Registered Representative

Other: \_\_\_\_\_  
\_\_\_\_\_