

NASD Notice to Members 99-54

NASD Regulation Seeks Comment On Issues Relating To Arbitrator-Ordered Expungements Of Information From The Central Registration Depository; **Comment Period Expires July 30, 1999**

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Executive Summary

NASD Regulation, Inc. (NASD Regulation[®]) is seeking comment from National Association of Securities Dealers, Inc. (NASD[®]) members and other interested parties on issues relating to the expungement of information from the Central Registration Depository (CRDSM) that is ordered by arbitrators. In *Notice to Members 99-09*, NASD Regulation announced that it was imposing a moratorium on the expungement of certain information from the CRD system based on a directive contained in an arbitration award. Under the terms of the moratorium, which became effective January 19, 1999, NASD Regulation is not expunging information from the CRD system that is ordered by arbitrators in an award rendered in a dispute between a public customer and a registered representative or a firm unless the award has been confirmed by a court of competent jurisdiction.

Questions concerning this *Notice* may be directed to Ann E. Bushey, Assistant Director, CRD/Public Disclosure, NASD Regulation, at (301) 590-6389; Mary M. Dunbar, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8252; or Richard E. Pullano, Associate Director and Counsel, CRD/Public Disclosure, NASD Regulation, at (301) 212-3789.

Request For Comment

NASD Regulation is seeking comment on the issues of arbitrator-ordered expungements and the moratorium on such expungements imposed in January 1999. NASD Regulation encourages all interested parties to comment on this matter. Comments should be mailed to:

Joan C. Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

or e-mailed to:
pubcom@nasd.com

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

Comments must be received by July 30, 1999. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission (SEC).

Background And Discussion

The CRD system is an electronic registration and licensing system that contains information used by the SEC, NASD, other self-regulatory organizations (SROs), and state securities regulators to make licensing and registration decisions, among other things. The information on the CRD system includes criminal information (e.g., indictments and convictions for certain criminal offenses), disciplinary information (e.g., sanctions imposed by regulators), customer complaints and arbitration awards that meet specified criteria, certain categories of employment terminations, and other information.

Generally speaking, the information on the CRD system is submitted by registered broker/dealers and regulatory authorities (e.g., SEC, state securities regulators, and SROs) in response to questions on forms that are designed to elicit and collect information that is relevant to regulators in connection with their licensing and enforcement activities and to investors who are considering whether to do business with a firm or an associated person. NASD Regulation recognizes that accurate and complete reporting on these forms is an important aspect of investor protection.

As noted in *Notice to Members 99-09*, during this moratorium, NASD Regulation is continuing to execute court-ordered expungements, including any expungement order contained in an arbitration award that is confirmed by a court of competent jurisdiction.

In addition, NASD Regulation is continuing to expunge information from the CRD system based on expungement directives in arbitration awards rendered in disputes between firms and current or former associated persons, where arbitrators have awarded such relief based on the defamatory nature of the information in the CRD system. To qualify for this exception from having an award confirmed in court, the dispute must be **between a firm and a current or former associated person and arbitrators must clearly state in the "Award" section of the award that they are ordering expungement relief based on the defamatory nature of the information in the CRD system.** (Arbitrators, however, are not required to state explicitly in the award that they have found that all of the elements required to satisfy a claim in defamation under governing law have been met.)

As discussed in *Notice to Members 99-09*, NASD Regulation imposed this moratorium after discussions with the North American Securities Administrators Association (NASAA). NASD Regulation operates the CRD system in accordance with an agreement with NASAA. Although this agreement expressly addresses court-ordered expungements, it does not specifically address arbitrator-ordered expungements. NASD Regulation believes that expungement of information from the CRD system that is ordered by an arbitrator and contained in an award should be afforded the same treatment as a court-ordered expungement. NASAA disagrees with this position and has informed NASD Regulation that it does not believe that arbitrator-ordered

expungements should be afforded the same treatment as court-ordered expungements. NASAA has informed NASD Regulation that, in its opinion, according to various state laws, information submitted to the CRD system is deemed to have been filed with each state in which the subject person or entity seeks to be registered.

Therefore, according to NASAA, information in the CRD system that may be the subject of an arbitrator-ordered expungement is in many cases a state record, and some state laws currently do not recognize the authority of an arbitrator to expunge a state record or do not otherwise permit such expungements because of state recordkeeping requirements. NASAA has provided one attorney general opinion that it believes supports its view. See Advisory Legal Opinion issued by Robert A. Butterworth, Attorney General of the State of Florida, AGO 98-54 (August 28, 1998) regarding records obtained from the securities dealers association's central depository.¹

NASD Regulation is seeking comment on possible approaches that would address the interests of parties to an arbitration in having an arbitrator's expungement order effected (or given some meaningful effect), which ordinarily requires erasing or physically removing information on the CRD system, while at the same time complying with any applicable state recordkeeping laws and maintaining the integrity of the CRD system. Several such approaches are described in this *Notice*.

NASD Regulation recognizes that the information on the CRD system has important investor protection implications, provided it is complete and accurate. Therefore, such information should not be expunged without good reason (e.g., a finding that expungement relief is necessary because information on the CRD system is defamatory in nature, misleading, inaccurate, or

erroneous). Accordingly, NASD Regulation also seeks comment on an approach that contemplates the establishment of standards for arbitrators to consider in ordering expungement. Under this approach, the arbitrators' award would have to state the basis for the expungement order before NASD Regulation would expunge the information from the CRD system in the absence of a court order.

NASD Regulation requests comment on these approaches, suggestions for other alternatives, and comment from members and other interested parties on all of the issues implicated by arbitrator-ordered expungements.

Should consent awards (i.e., those containing expungement directives) be treated differently than awards issued after full consideration of the merits of the dispute?

As a threshold matter, NASD Regulation specifically seeks comment on the treatment of "consent awards" or "stipulated awards" that contain expungement directives. These are awards that essentially reflect the parties' settlement of a dispute. Parties then request that arbitrators capture the terms of the settlement in an award that arbitrators issue by consent of the parties. In such cases, arbitrators typically are issuing an award at the parties' (joint) request and have not made any finding on the merits of the dispute.² NASD Regulation seeks comment on whether expungement directives contained in these awards should be given the same treatment as awards that are rendered by arbitrators after full consideration of all of the pleadings, evidence, arguments, etc. NASD Regulation requests that commenters consider whether it is appropriate to establish standards that would have to be met before NASD Regulation would execute consent awards similar to the standards discussed in *Approach Four* on the following page.

Approach One: *Could the interests of parties in arbitration be met if there were no disclosure of the information ordered expunged through the NASD's Public Disclosure Program?*

Under this approach, information that is ordered expunged by arbitrators would remain on the CRD system, but would not be disclosed through the NASD's Public Disclosure Program. Since the information remains on the CRD system, however, and because it would be deemed by some states to be a state record notwithstanding the expungement order, it may still be disclosed by a state pursuant to that state's public records law, which is a state's equivalent of the federal Freedom of Information Act statute.³ Some states' public records laws are very broad in scope, and permit release of all information contained in state records – including all CRD records, even if they have been ordered expunged by an arbitrator.

Approach Two: *Could the interests of parties in arbitration be met if a "legend" were placed on information that has been ordered expunged by arbitrators?*

Under this approach, information that is ordered expunged by arbitrators would remain on the CRD system, but would clearly be identified as information that has been ordered expunged by an arbitrator or a panel of arbitrators through the use of a standard legend (e.g., the legend might state "A panel of arbitrators has determined that the above information is factually inaccurate, defamatory, or without merit and has ordered the information expunged from the CRD system."). A state that has determined that it must disclose the information, notwithstanding the arbitrators' expungement order, may continue to disclose the information; however, under this approach, the information would carry a legend indicating that it had been ordered expunged from the CRD system.

The NASD, on the other hand, consistent with its practice before the moratorium, would not disclose this information through its Public Disclosure Program.⁴

Approach Three: *Could state recordkeeping requirements be satisfied through the use of alternate media?*

This approach contemplates satisfying certain state recordkeeping requirements through the use of a hard copy equivalent, microfilm, or other medium. Under this approach, NASD Regulation would propose to provide an equivalent copy of any CRD record that a state is required to keep if that record is the subject of an expungement order issued by an arbitrator. Once the equivalent of the CRD record has been provided to a state, NASD Regulation would execute the expungement order and physically remove the relevant information from the CRD system.

NASD Regulation seeks comment on this alternative, because it appears that some states may have flexibility in the form or medium in which they maintain records that are required to be retained. See, e.g., Cal. Corp. Code Sect. 31506 (1997), which provides the Securities Commissioner with the discretion to maintain copies of records "on microfilm or in other form" provided those records are certified by the Commissioner. This statutory section further indicates that such records will be "accepted for all purposes as equivalent to the original" when so certified by the Commissioner. NASD Regulation requests that commenters provide specific support for this or any other proposed approach involving the use of alternative or equivalent records.

Approach Four: *Could resolution of this issue be facilitated by the establishment of standards to be followed by arbitrators before they order information expunged from the CRD system?*

This approach contemplates the establishment of standards that would have to be satisfied before NASD Regulation would execute an arbitrators' awards directing the expungement of information from the CRD system. This proposed approach differs from the approaches discussed above in that it contemplates that NASD Regulation would execute arbitrators' expungement orders (i.e., physically remove information from the CRD system) provided certain prescribed standards were met. The objectives of this alternative would be to provide some parameters for arbitrator-ordered expungements to ensure that investor protection is not compromised, and to give some indication of the arbitrators' reasons for granting such relief. Such an approach also would enhance the integrity of the CRD system by providing an additional mechanism to remove misleading, inaccurate, or erroneous information from the system. Because of the state record retention issues described above, this approach may have to be combined with *Approach Three* above for those states that are required to maintain all CRD records.

It is widely accepted that arbitrators should have the authority to award equitable relief.⁵ NASD Regulation believes that ordering expungement of information from the CRD system that is found to be defamatory, misleading, inaccurate, or erroneous, is equitable in nature and within an arbitrator's authority. Currently, however, neither the NASD's Code of Arbitration Procedure nor the arbitrator training materials explicitly address the granting of the equitable relief of expungement of information from the CRD system.⁶

Under this approach, NASD Regulation would establish standards for arbitrators to consider in ordering expungement. The arbitrators' award would have to state the basis for the expungement order before NASD Regulation would

expunge the information from the CRD system in the absence of a court order. For example, the standards could provide that arbitrators may include as equitable relief in an arbitration award an order directing that information be expunged from the CRD system provided that the arbitrators found, after considering the merits, that the claim against the person/firm was frivolous or groundless (*i.e.*, had no basis in fact), or was brought for an improper purpose (*e.g.*, to damage the reputation of the named person/firm). Such standards might also require that the named party specifically seek the expungement relief and that arbitrators not grant such relief on their own.

NASD Regulation seeks comment on these proposed standards and whether there are other standards that should be considered. Commenters may want to address whether any of the above approaches should be combined with another or with other approaches that may be suggested by a commenter.

Endnotes

¹This letter can be obtained from the State of Florida's Web site at:
<http://legal.firm.edu/opinions/index.html>.

²While parties may request an arbitrator to embody their settlement agreement in an award, the Code of Ethics for Arbitrators In Commercial Disputes, in Canon V(D), states that an arbitrator is not bound to sign a consent award "unless [the arbitrator is] satisfied with the propriety of the terms of the settlement."

³In this regard, the information would not truly be expunged because expungement typically requires the physical destruction or erasure of the record in question. Therefore, a true expungement would not leave any record in the CRD system that would be susceptible to disclosure to the public (either through the NASD's Public Disclosure Program or by a state under its public records laws) because the record would be physically removed from the CRD system. Moreover, because this approach would not result in the physical destruction of the CRD record, NASD Regulation may also be required to produce the full CRD record (including the information ordered expunged by arbitrators) in response to a subpoena.

⁴However, as discussed in note three above, NASD Regulation may also be required to produce the full CRD record (including the information ordered expunged by arbitrators) in response to a subpoena.

⁵See *Southland Corp. v. Keating*, 465 U.S. 1, 13 (1984).

⁶Training materials designed to educate arbitrators about the issues discussed in *Notice to Members 99-09* have been prepared and will be used in the next round of arbitrator training sessions administered by NASD Regulation.

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