

September 11, 2003

**VIA MESSENGER**

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Room 6184, Mail Stop 6-9  
Washington, D.C. 20549

**Re: File No. SR-NASD-2002-168- Amendment No. 2 to Proposed Rule 2130  
Governing Expungement of Customer Dispute Information From the Central  
Registration Depository**

Dear Mr. Katz:

This letter responds to the comment letters received by the Securities and Exchange Commission ("SEC" or "Commission") in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-2002-168 relating to proposed Rule 2130 governing the expungement of customer dispute information from the Central Registration Depository ("CRD<sup>®</sup>"). The proposed rule change and Amendment No. 1 thereto were published for comment on March 10, 2003.<sup>1</sup>

The Commission received letters from 21 commenters in response to the proposed rule change.<sup>2</sup> This letter addresses the commenters' concerns.

**Background**

By way of background, in *Notice to Members ("NtM") 99-09* (February 1999), NASD announced that, after discussions with the North American Securities Administrators Association ("NASAA") regarding arbitrator-ordered expungements, NASD was imposing a moratorium on arbitrator-ordered expungements of information from the CRD system. The *NtM* announced that the moratorium would start on January 19, 1999. The moratorium, which is still in effect, provides that NASD will not expunge information from the CRD system based on a directive contained in an arbitration award rendered in a dispute

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<sup>1</sup> Release No. 34-47435 (March 4, 2003); 68 F.R. 11435 (March 10, 2003). The public comment period announced in the Federal Register expired on March 31, 2003. This Amendment No. 2 includes responses to all commenters.

<sup>2</sup> The list of Commenters is attached as Exhibit 1.

involving a public customer and a firm or associated person, unless the award has been confirmed by a court of competent jurisdiction. The moratorium does not place any limitations on the basis for the court-ordered expungement. Since the moratorium was put into place, NASD has twice sought comment from its members and other interested parties, including public investors, on the appropriate standard for expunging customer dispute information from the CRD system based on a directive contained in an arbitration award.

In *NtM 99-54* (July 1999), NASD sought comment on possible approaches that would give arbitrators' expungement orders some meaningful effect while still addressing state record-retention requirements and other issues. Among other things, NASD sought comment on whether NASD should establish specific standards for honoring arbitrator-awarded expungements.

The comments were mixed. Many commenters favored allowing arbitrator-ordered expungements, particularly if arbitrators had the benefit of standards to guide them in making such determinations, and many commenters opposed allowing arbitrator-ordered expungements because of concerns about arbitrator authority or training and state law issues, among other reasons. In response, NASD attempted to craft an approach that would balance the interests of regulators, who have an interest in retaining broad access to customer dispute information to fulfill their regulatory responsibilities; individuals in the brokerage community, who have an interest in securing a fair process that recognizes their stake in protecting their reputations and permits expungement when appropriate; and public investors, who have an interest in having access to relevant information about brokers with whom they do business or may do business.

In *NtM 01-65* (October 2001), NASD reaffirmed that merely prevailing in an arbitration case was not, in and of itself, an appropriate ground for expunging information about the proceeding from the CRD system. NASD also stated its belief that adverse arbitration awards (i.e., awards in which customers prevailed on claims against an industry party) should not be expunged pursuant to a post-award settlement with the customer. NASD proposed expunging customer dispute information from the CRD system only if an arbitrator ordered expungement based on one of three specific findings and a court of competent jurisdiction confirmed the arbitrator's directive. To monitor expungements, NASD would require that it be named as a party in the court confirmation proceeding, and would oppose any expungement that did not meet one of the standards. NASD preliminarily identified three bases for expungement: a finding of factual impossibility or clear error; the claim is without legal merit; or the information on the CRD system is defamatory in nature.

NASD received 579 responses to *NtM 01-65*. NASD addressed the concerns of these commenters in its Notice of Filing of Proposed Rule Change and Amendment No. 1.<sup>3</sup> Based on the comments, NASD proposed retaining the core substantive requirements of the expungement program described in *NtM 01-65*, with certain modifications to the three

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<sup>3</sup> Release No. 34-47435 (March 4, 2003), 68 FR 11435 (March 10, 2003).

categories described in *NtM 01-65*. NASD proposed that the "without factual basis" would include the "factually impossible" and "clear error" standards. To address comments that the "without legal merit" standard was too narrow, too broad, or too vague, NASD proposed a standard of "failure to state a claim upon which relief can be granted" or "frivolous." NASD retained the "defamatory in nature" standard, noting that it has been used successfully in the arbitration forum in arbitrations involving claims brought by registered representatives against firms. NASD made stipulated awards subject to the same requirements as litigated awards.

NASD also addressed commenters' concerns about the burdens and costs in naming NASD as an additional party in any judicial proceeding seeking expungement relief or confirming an arbitration award containing expungement relief. NASD modified its proposed rule to allow NASD to waive participation in advance upon a showing that the expungement relief being requested meets one of the standards in the rule.

### **Proposed Amendments to Rule 2130**

After considering all of the comments, which are discussed below, NASD has determined to amend the grounds upon which NASD may waive the obligation to be named as a party to court confirmation proceedings. NASD believes that the amended proposed Rule 2130 appropriately addresses the commenters' concerns. Deleted language is in brackets; new language is underlined.

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### **2130. Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD System)**

(a) Members or associated persons seeking to expunge information from the CRD system arising from disputes with [public] customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief.

(b) Members or associated persons petitioning a court for expungement relief or seeking judicial confirmation of an arbitration award containing expungement relief must name NASD as an additional party and serve NASD with all appropriate documents unless this requirement is waived pursuant to subparagraph (1) or (2) below.

(1) Upon request, NASD may waive the obligation to name NASD as a party if NASD determines that the expungement relief is based on affirmative judicial or arbitral findings that:

(A) the claim, allegation, or information is [without factual basis] factually impossible or clearly erroneous;

(B) the [complaint fails to state a claim upon which relief can be granted or is frivolous] registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or

(C) the [information contained in the CRD system is defamatory in nature] claim, allegation, or information is false.

(2) If the expungement relief is based on judicial or arbitral findings other than those described above, NASD, in its sole discretion and under extraordinary circumstances, also may waive the obligation to name NASD as a party if it determines that:

(A) the expungement relief and accompanying findings on which it is based are meritorious; and

(B) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.

(c) For purposes of this rule, the terms "sales practice violation," "investment-related," and "involved" shall have the meanings set forth in the Uniform Application for Securities Industry Registration of Transfer ("Form U4") in effect at the time of issuance of the subject expungement order.

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### **Issues Raised in Comment Letters**

The Public Investors Arbitration Bar Association ("PIABA") stated its belief that Rule 2130, as initially proposed, represents a significant step toward maintaining the integrity of the CRD system and, on balance, endorsed it and urged its adoption. NASAA generally supported the need for the rule and the criteria it establishes, but suggested that the criteria be imposed directly on NASD members and arbitration panels. Other commenters were generally concerned that Rule 2130, as initially proposed, would have an adverse effect on the CRD system, arbitration claimants, and the arbitration process.

NASD agrees with commenters that the value of the CRD system to public investors, regulators, and the securities industry should not in any way be diminished by the inappropriate expungement of customer dispute information. Some commenters contended that nothing should be expunged from the CRD system, and, therefore, NASD should not have any rule whatsoever governing the circumstances under which NASD will expunge

customer dispute information. This view may be based on an underlying assumption that, if there is no rule permitting some expungement relief, NASD will not expunge customer dispute information from the CRD system. This assumption is incorrect. Even in the absence of an NASD rule, courts have the power to order expungements, and both NASD and the States are subject to court orders.

Some commenters contended that the mere existence of an NASD rule governing expungement will encourage registered persons to seek expungements and make expungement easier to obtain. NASD does not agree. These commenters may not have considered the fact that NASD currently expunges information from the CRD system when ordered to do so by a court of competent jurisdiction, and that court-ordered expungements currently are not subject to any NASD limitations or standards.<sup>4</sup> Under the moratorium, registered persons seeking expungement relief need only obtain a court order to expunge or court confirmation of an arbitration award granting expungement relief. Under the proposed rule, NASD will have the opportunity to review the basis for expungement and to oppose an expungement in court unless there is a specific finding that the expungement meets one of the prescribed standards.

Some commenters suggested that arbitrators should have sole authority and complete discretion to order expungement. They suggested that NASD's and the States' proposed role in the court confirmation process would undermine arbitrators' credibility. To the contrary, the critical element in this process is NASD's reliance on fact finders, especially arbitrators, to find that the expungement relief is based on one of the standards in the proposed rule. NASD and NASD Dispute Resolution have confidence in the ability of arbitrators to evaluate the evidence and award expungement relief in appropriate cases. NASD Dispute Resolution will provide training to arbitrators regarding the standards for expungement that will not trigger NASD opposition. As a number of commenters stated, the securities industry and public investors trust arbitrators to deal with complex legal issues on a routine basis. Their decisions often involve complicated fact patterns, multiple respondents, and large sums of money. Under proposed Rule 2130, NASD will rely on arbitrators' findings and waive participation in the court confirmation process if arbitrators have appropriately awarded expungement.

NASD's and the States' opportunity to participate in the court confirmation proceeding is an additional safeguard to ensure that courts are aware of the standards under which NASD has agreed to expunge customer dispute information. There is currently no consistent process in place to ensure that courts are made aware of the investor protection and public policy considerations implicated by expungement of customer dispute information and the investor protection and regulatory concerns relating to expungement. The proposed rule gives NASD and the States the opportunity to participate in judicial

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<sup>4</sup> NASD has, since the inception of the CRD system, executed expungements involving customer dispute information based on a court order or (since the imposition of the moratorium in 1999) court confirmation of an arbitration award directing expungement. These court orders included expungement relief granted in cases involving both settlements and hearings on the merits.

proceedings and make courts fully aware of investor protection and regulatory concerns relating to inappropriate expungements.

Some commenters contended that the proposed procedures will be economically prohibitive. The current requirement under the moratorium to obtain a court order will continue under the proposed rule and procedures. NASD recognizes that the additional step of naming NASD as a party may involve additional costs. In an effort to minimize costs to the parties, NASD may waive participation in the court confirmation process prior to filing with the court if the parties give NASD a copy of the award to review and the arbitrators have ordered expungement based on one of the standards in the rule. The availability of this waiver process should limit any additional costs to the parties.

NASD cannot predict the effect of the proposed rule on settlements. Some commenters suggested that the proposed rule will discourage settlements, since the parties will no longer have total control over whether information about the arbitration will be expunged. Compliance with the proposed rule may have this effect, since NASD will oppose expungement relief that does not meet one of the standards in proposed Rule 2130.<sup>5</sup> Under the current moratorium, it is possible that respondents may agree to pay damages as a *quid pro quo* for expungement and obtain court confirmation of the expungement. NASD believes that the proposed rule will reduce, if not eliminate, the risk of expunging information that is critical to investor protection and regulatory interests as a condition in settlement negotiations. The potential dampening effect on settlements must be weighed against the integrity of the information in the CRD system, and the ability of public investors and regulators to examine the entirety of a registered person's record, with the limited exceptions as proposed.

Based on commenters' concerns, however, NASD has determined to modify the language describing the standards under which NASD may waive participation in the court confirmation process. Currently, there is no provision in the Code of Arbitration Procedure that either permits or prohibits motions. Commenters have expressed concern that the "complaint fails to state a claim upon which relief can be granted" standard, which parallels a motion to dismiss made in federal court, could be interpreted to authorize arbitrators to grant such motions in arbitration. NASD did not intend for the proposed rule to have any effect on the authority of arbitrators to grant or deny motions to dismiss a claim prior to a hearing on the merits. Therefore, NASD has determined to eliminate the "complaint fails to state a claim upon which relief can be granted" and replace it with a more objective standard based on CRD reporting requirements. This standard would require an affirmative arbitral or judicial finding that the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. Such a finding would be consistent with the registered representative reporting "No" answers to current Question 14I (1) of the Form U4. Should arbitrators make the required finding, no logical basis would exist for reporting the underlying complaint and other information on an individual's CRD record. This revised standard eliminates any unintended

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<sup>5</sup> States will also have the opportunity to oppose.

implications for the arbitration process, while preserving the intended substantive effect of the standard.

Under this standard, dismissal of a claim would not be a sufficient basis for ordering expungement. NASD arbitrator training materials will make clear that an expungement order must be premised on an affirmative determination by the arbitrators that the respondent was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. Without such an affirmative finding, NASD would have no basis under this standard to waive its obligation to be named as a party in the court confirmation process.

Commenters were also concerned that the "defamatory in nature" standard would encourage respondents to counterclaim for defamation and require claimants to defend such claims, thereby creating undue burdens on public investors in the arbitration process. Some commenters correctly noted that claims in arbitration are privileged and therefore immune from suit. NASD believes that the proposed rule should not substantially affect either the substance or procedure of an arbitration proceeding and should not place any undue burden on claimants in the arbitration process. Thus, to avoid the possibility that that this standard might result in additional counterclaims for defamation, NASD has determined to replace it with a requirement that the arbitrator or adjudicator make a finding that the claim, allegation, or information is "false."

The third change involves the "without factual basis" standard. To address the concern expressed by some commenters that this language is overly vague, NASD proposes replacing the "without factual basis" standard with a "factual impossibility or clearly erroneous" standard as originally described in in *NtM 01-65*. This is a standard that has a clear meaning to regulators and public investors and was favored by a number of commenters. This standard, for example, would enable an individual who has been erroneously named in an arbitration because he or she was not even employed by the member firm during the relevant time, to obtain expungement of a dismissed complaint.

NASD and NASAA agree that CRD information should be expunged only on the basis of specific, limited criteria. NASD and NASAA, however, differ on the procedural approach to expungement. NASAA suggests that NASD adopt a rule that provides that NASD members may seek expungement only if their case meets one of the three criteria. NASD does not believe that such an approach is necessary to achieve the objectives of the proposed rule. Federal and state courts, that are fully informed about the investor protection and regulatory implications of a proposed expungement order, should be trusted to make the proper decision.

NASD believes imposing substantive requirements on arbitrators via the Code of Arbitration Procedure would be inappropriate. In no other instance does the Code of Arbitration Procedure impose limitations on arbitrators' ability to decide a legal issue. Arbitrators will know the standards for expungement relief under proposed Rule 2130,

because they will have received appropriate training, and members and associated persons will know that arbitrators will only grant expungement relief based on those standards. Therefore, although the proposed rule does not place any specific obligations on arbitrators or respondents, all parties and arbitrators will be aware of the standards under which expungement relief should be granted, and both NASD and NASAA will achieve the desired goal that only appropriate expungements occur.

As more fully explained above, under proposed Rule 2130, NASD will participate in the court confirmation proceeding and oppose confirmation of the expungement portion of the arbitration award if the expungement order does not meet one of the specified criteria. Assertions by some commenters that NASD will not appropriately oppose expungement relief are without merit or supporting evidence. NASD has an obligation as a self-regulatory organization to fulfill all of its regulatory obligations, and it will be subject to Commission oversight in its administration of the proposed rule. As a further means to ensure that the court is made aware of the investor protection and regulatory implications of an expungement, States will be able to intervene if they have concerns regarding whether investor protection or regulatory issues will be fairly considered.

Underlying this rule proposal is NASD's commitment to maintaining a CRD system that gives public investors access to accurate information about brokers with whom they conduct, or may conduct business, gives regulators accurate information about registered persons and maintains the integrity of the arbitration process and the ability of public investors to use arbitration as a means of resolving disputes. NASD recognizes that expungement of a CRD record under any condition is an extraordinary remedy and should only be used when the expunged information has no meaningful regulatory value. Although there are competing interests at stake between public investors, broker-dealers and their associated persons, and regulators, all of these groups have an interest in a CRD system that contains accurate and meaningful information. NASD believes that the proposed rule accomplishes that goal. It will protect investors' ability to review meaningful data about the members and associated persons with whom they do or plan to do business by permitting customer dispute information to be expunged from the CRD system only when arbitrators and a court have affirmatively found that the information, claim, allegation, or information is factually impossible or clearly erroneous; false; or that the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds.

Following Commission approval of proposed Rule 2130, NASD will announce the approval of the Rule in a Notice to Members, which also will announce the effective date of Rule 2130. The Notice to Members will announce that the requirements of Rule 2130 will apply to all arbitrations or civil lawsuits filed on or after the effective date. Therefore, NASD will oppose any request to expunge customer dispute information from the CRD system that has its basis in an arbitration or civil lawsuit filed on or after the effective date if such request does not meet the requirements of Rule 2130. All requests to expunge customer dispute information from the CRD system arising from arbitrations or civil

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lawsuits filed before the effective date of the rule, including any settlements arising therefrom, will continue to be subject to the terms of the moratorium in effect as of January 19, 1999.

Very truly yours,

Shirley H. Weiss  
Associate General Counsel

cc: Elizabeth Badawy  
Christopher Stone

**EXHIBIT 1**

**LIST OF COMMENTERS ON PROPOSED RULE 2130 GOVERNING  
EXPUNGEMENT OF CUSTOMER DISPUTE INFORMATION FROM THE  
CENTRAL REGISTRATION DEPOSITORY (CRD SYSTEM)**

1. Anonymous (June 9, 2003)
2. Barry D. Estell, Attorney at Law (March 28, 2003)
3. Finance 500 (May 19, 2003)
4. Joel A. Goodman and Stephen Krosschel, Goodman & Nekvasil, P.A. (March 29, 2003)
5. Lance Hicks (May 19, 2003)
6. Dan Jamieson (April 25, 2003)
7. David Macias (June 10, 2003)
8. Helen Mangano (March 28, 2003)
9. C. Thomas Mason, JD, CEBS, CFP (March 31, 2003)
10. Steven K. McGinnis (May 19, 2003)
11. Donald G. McGrath, Esq., McGrath & Polvino, PLLC (March 27, 2003)
12. Tammy McQuade (June 7, 2003)
13. John J. Miller, Esq. (March 30 and 31, 2003)
14. North American Securities Administrators Association (June 4, 2003)
15. Partnervest Securities, Inc. (May 19, 2003)
16. Public Investors Arbitration Bar Association (March 28, 2003)
17. Alan L. Sachs, Esq. (March 28, 2003)
18. Securities Industry Association (March 31, 2003)

19. Gerald S. Siegmyer, Siegmyer, Oshman & Geddie, L.L.P. (April 7, 2003)
20. Steven M. Sherman (March 31, 2003)
21. Woska & Hasbrook (March 31, 2003)