

November 18, 2002

Ms. Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001

**Re: File No. SR-NASD-2002-168- Proposed Rule 2130 Governing Expungement of  
Customer Dispute Information From the Central Registration Depository (CRD System)**

Dear Ms. England:

Pursuant to Section 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Shirley H. Weiss, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8844; e-mail [Shirley.Weiss@nasd.com](mailto:Shirley.Weiss@nasd.com). The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney  
Senior Vice President  
and Corporate Secretary

Enclosures

cc: Elizabeth C. Badawy

File No. SR-NASD-2002-168  
Consists of 1146 Pages  
November 18, 2002

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act"), the National Association of Securities Dealers, Inc. ("NASD") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to adopt Rule 2130 governing the expungement of customer dispute information from the Central Registration Depository (CRD<sup>®</sup> or CRD system) and various internal guidelines to be adopted by NASD regarding the handling of requests to expunge customer dispute information from the CRD system. Below is the text of the proposed rule change. Proposed 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.

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

(A) the claim, allegation or information is without factual basis;

(B) the complaint fails to state a claim upon which relief can be granted or is frivolous; or

(C) the information contained in the CRD system is defamatory in nature.

(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.

\* \* \* \* \*

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Governors of NASD at its meeting on September 26, 2002, which authorized the filing of the rule change with the Commission. Counsel for The Nasdaq Stock Market, Inc. and NASD Dispute Resolution, Inc. have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of

Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Shirley H. Weiss, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8844.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

The purpose of the proposed rule change is to establish procedures for expunging customer dispute information from the CRD system. The proposed rule will require all directives to expunge customer dispute information from the CRD system to be confirmed by or ordered by a court of competent jurisdiction. The proposed rule includes any such directives that may be in: (1) judicial proceedings seeking expungement (including proceedings seeking expungement relief resulting from settlements in disputes between public customers and member firms or their associated persons in which the parties agree to expungement of customer dispute information as part of the settlement); (2) arbitration awards rendered in disputes between public customers and member firms or their associated persons in which the parties agree to expunge customer dispute information as part of the settlement and then present the settlement to the

arbitration panel for inclusion in a stipulated award; and (3) arbitration awards issued after a decision on the merits.

The proposed rule also will require member firms and associated persons seeking expungement to name NASD as an additional party in any judicial proceeding seeking expungement relief or confirming an arbitration award containing expungement relief. The proposed rule will state that NASD will participate in such judicial proceedings and will oppose expunging dispute information in such judicial proceedings unless the arbitrators or the court has made specific findings that the subject matter of the claim or the information in the CRD system: (1) is without factual basis (i.e., is factually impossible or clearly erroneous); (2) fails to state a claim upon which relief can be granted or is frivolous); or (3) is defamatory in nature.

The proposed rule will also permit member firms and associated persons to ask NASD to waive the requirement to name NASD as a party on the basis that the expungement order meets at least one of the standards for expungement articulated in the proposed rule. This will save members and NASD time and expense by enabling NASD to review the findings of the arbitrators or court and determine to waive participation in the judicial proceeding if NASD determines that the findings made by the arbitrators or the court meet at least one of the standards in the rule. If the expungement order fails to meet at least one of the standards in the rule, NASD will participate in the judicial proceeding and oppose the expungement.

Under the proposed rule, NASD will retain discretion not to oppose expungement relief in exceptional cases where the basis for the expungement does not fall within one of the three standards. NASD would exercise such discretion only if it determines that the expungement is meritorious and would have no material adverse effect on investor protection, the integrity of the CRD system or regulatory requirements.

The CRD system is an on-line registration and licensing system for the U.S. securities industry, state and federal regulators, and self-regulatory organizations ("SROs"). The CRD system contains broker-dealer information filed on Forms BD and BDW and information on associated persons filed on Forms U-4 and U-5. The CRD system also contains information filed by regulators via Form U-6. The CRD system contains administrative information (personal, organizational, employment history, registration and other information) and disclosure information (criminal matters, regulatory disciplinary actions, civil judicial actions, financial information, and information relating to customer disputes) filed on these forms. For purposes of this rule, "customer dispute information" includes customer complaints, arbitration claims, and court filings made by customers, and the arbitration awards or court judgments that may result from those claims or filings. This category of information contains allegations that a member or one or more of its associated persons has violated securities laws, regulations, or rules.

NASD operates the CRD system pursuant to policies developed jointly with the North American Securities Administrators Association ("NASAA"). NASD works with the SEC, NASAA, other members of the regulatory community, and member firms to establish policies and 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. NASAA and some states have taken the position that information in the CRD system is a record of any state that uses the information to make a licensing decision, and that state laws generally do not permit information to be expunged once it has been filed on the CRD system, absent a court order that explicitly directs expungement.

Since the inception of the CRD system in 1981, NASD generally has honored court-ordered expungements and, until, January 1999, NASD also honored arbitrator-ordered expungements that were contained in final awards. In January 1999, after consultation with NASAA, NASD imposed a moratorium on arbitrator-ordered expungements from the CRD system.<sup>1</sup> Under the moratorium, which is still in effect, NASD will not expunge information from the CRD system 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>2</sup>

Since imposing the moratorium, NASD has been considering how to craft an approach to expungement that would allow NASD, in its capacity as an SRO and as operator of the CRD system, effectively to challenge expungement directives that might diminish or impair the integrity of the system and to ensure the maintenance of essential information for regulators and investors.<sup>3</sup> Such an approach necessarily requires NASD to balance three competing interests: (1) the interests of NASD, the states, and other regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations; (2) the interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when

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<sup>1</sup> The moratorium was announced in *Notice to Members 99-09*.

<sup>2</sup> Under existing CRD policy, and consistent with the 1999 moratorium, NASD may execute, without a court order, arbitration awards rendered in disputes between registered representatives and firms that contain expungement directives in which the arbitration panel states that expungement relief is being granted because of the defamatory nature of the information. These expungements are not covered by the moratorium and will not be covered by the proposed rules and policies.

<sup>3</sup> In July 1999, NASD issued *Notice to Members 99-54* seeking comment on possible approaches to addressing arbitrator-ordered expungements of information from the CRD system.



appropriate; and (3) the interests of investors in having access to accurate and meaningful information about brokers with whom they conduct, or may conduct, business.

NASD is cognizant of the importance of ensuring that the expungement policy 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. NASD and other regulators participating in the CRD system agree that expungement is extraordinary relief, and that courts granting expungement relief under the existing rules and procedures may not fully consider all of the competing interests referenced above. NASD believes that the additional safeguards and procedures proposed herein will allow fact finders and NASD to consider all competing interests before directing or granting expungement of customer dispute information from the CRD system.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change is designed to accomplish these ends by allowing fact finders and NASD to consider all competing interests before directing or granting expungement of customer dispute information.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In October 2001, NASD published *Notice to Members 01-65* ("*NtM 01-65*" or "*Notice*") requesting comment on the establishment of certain criteria that must be met, and procedures that must be followed, before NASD would expunge certain information from the CRD system pursuant to an expungement order. *NtM 01-65* encouraged members, investors, registered representatives, and other interested persons to comment. NASD proposed in *NtM 01-65* that the CRD system expunge customer dispute information only if certain criteria are met and certain protocols followed. Specifically, NASD requested comment on whether expungement of customer dispute information from the CRD system should generally be limited to cases where the expungement order is based on a finding by 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"; (2) the claim is without legal merit; or (3) the information contained in the CRD system is determined to be defamatory in nature.

NASD also sought 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 or from a settled matter; (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 the *Notice*; and (3) the adoption of a rule or Interpretive Material that clearly articulates NASD'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 the *Notice*.

*NtM 01-65* provided members and other interested parties with a checklist of four questions that they could use to respond to the request for comment in addition to, or in lieu of, sending written comments. NASD noted that the checklist did not cover all aspects of the proposal, and it encouraged commenters to provide written comments, as necessary. NASD extended the comment period from November 24, 2001 to December 31, 2001. NASD received a total of 579 responses to the *Notice*. A copy of *NtM 01-65* is attached as Exhibit 2. Copies of the comment letters are attached as Exhibit 3.

Forty of the 579 responses to *NtM 01-65* consisted solely of written comments. A significant percentage of the remaining 539 commenters identified themselves as registered representatives associated with NASD member firms, and these commenters overwhelmingly opposed the imposition of any additional substantive or procedural obligations before expungement of customer dispute information could be effected. Commenters responded to the four questions as follows:<sup>4</sup>

Question 1 asked: "Should [NASD] adopt a rule that would require members to provide notice to [NASD] and make [NASD] a party to the proceeding before seeking a court order directing expungement or a confirming of an arbitration award that contains an expungement directive?" Forty commenters answered "yes," 495 commenters answered "no," and four commenters did not answer this question.

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<sup>4</sup> Some commenters submitted duplicate responses to the questions; NASD considered these as one vote per question. For those commenters who changed their answers to the questions in a second response, NASD considered only the second response. NASD staff also notes that not all commenters responded to each question.

Question 2 asked: "Should [NASD] 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 *NtM* (*i.e.*, factually impossible/clear error; without legal merit; and defamatory in nature) appropriate?" Fifty-one commenters answered "yes," 483 commenters answered "no," and five commenters did not answer this question.

Question 3 asked: "Should [NASD] 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?" Eighty-eight commenters answered "yes," 441 commenters answered "no," and 10 commenters did not answer this question.

Question 4 asked: "Should [NASD] adopt a rule or Interpretive Material that would explicitly articulate [NASD'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 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*?" Forty-eight commenters answered "yes," 483 commenters answered "no," and eight commenters did not answer this question.

Of the 40 commenters who responded by letter, 25 were NASD members or persons associated with NASD members.<sup>5</sup> NASAA, the Securities Industry Association ("SIA"), the Public Investors Arbitration Bar Association ("PIABA"), the National Association of Investment Professionals ("NAIP") also commented, as did a number of non-industry persons who have an

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<sup>5</sup> A number of commenters did not identify any affiliation.

interest in the arbitration process. There was a wide variance in these comments, ranging from approval of some or all of the proposed procedures to total disapproval. Among the concerns raised by commenters were: the proposed procedures requiring court confirmation would be burdensome and costly; mandatory court confirmation and naming NASD as a party would undermine the arbitration process; the proposed procedures would create a conflict of interest between firms and representatives in settlements because the firm might wish to settle a case, regardless of its merits, thereby precluding the representative from obtaining an expungement; and the proposed criteria for expungement were too vague and/or too restrictive.

Some of these commenters recommended new requirements in the arbitration process to handle expungement requests. For example, it was suggested that arbitrators be required to decide claims 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 an agreement between the parties. Another suggestion was to require claimants to attest that they are bringing the claim in good faith and to give arbitrators the authority to award sanctions against claimants who bring claims in bad faith or without a reasonable basis. Some commenters suggested that a party submitting a stipulated award containing a recommendation for expungement to a court for confirmation should attach an affidavit setting forth facts constituting "factual impossibility" and/or "clear error."

Based on the comments to *NtM 01-65*, NASD is proposing to retain the core substantive requirements of the expungement program described in *NtM 01-65*, but is proposing certain modifications to the program proposed in the *Notice*. NASD recognizes that any expungement program requires a balancing of competing interests. NASD believes that the proposed rule will help to ensure that information submitted to and maintained on the CRD system is accurate and

complete; give regulators the broad access to customer dispute information that they need to fulfill their regulatory responsibilities; give individuals in the brokerage community a fair process that protects their reputations and permits expungement from the CRD system when appropriate; and gives investors access to accurate information about brokers with whom they conduct, or may conduct, business.

NASD has incorporated the following modifications based on its review of the comments. NASD proposes to modify the three broad categories proposed in *NtM 01-65*: "without factual basis," "without legal merit," and "defamatory in nature." The "without factual basis" standard would include, as identified in the *Notice*, the "factually impossible" and "clear error" standards. Of the three categories proposed, the "without legal merit" standard drew the most comments, ranging from claims that it is too narrow, too broad, or too vague. To address those comments, NASD proposes to change the "without legal merit" standard to a standard of "failure to state a claim upon which relief can be granted" or "frivolous." NASD proposes to retain the "defamatory in nature" standard proposed in *NtM 01-65*. Although this standard was the subject of many comments, it has been used successfully in the arbitration forum in registered representative/member firm arbitrations, and NASD believes that it is appropriate as proposed.

NASD proposed in *NtM 01-65* to limit expungement relief in stipulated awards to cases involving "factual impossibility" or "clear error" on the basis that persons in those circumstances 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. In excluding the other two grounds for expungement from its initial proposal, NASD noted that it believed that it was unlikely that claimant or claimant's counsel would agree that the claim or information at issue was lacking in

legal merit or was defamatory in nature. In response to comments, NASD proposes to modify the original proposal to allow expungement relief in stipulated awards (or on the basis of a settlement) based on all three grounds, with a uniform requirement that there be specific judicial or arbitral findings in all such cases. In connection with making the required arbitral findings in such cases, NASD will explore the use of telephonic versus in-person hearings, as well as the option of making a decision based on briefs and affidavits from the parties and relevant third parties.

In response to 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 and serving NASD with the appropriate court papers, NASD proposes to retain these requirements, but it further proposes to permit parties to ask NASD to waive the requirement that it be made a party upon a showing that the expungement relief being requested is within the established standards. This will save members and NASD time and expense by enabling NASD to review the findings of the arbitrators or court and determine to waive participation in the judicial proceeding if the findings meet at least one of the standards in the rule. If the expungement order fails to meet at least one of the standards in the rule, NASD will participate in the judicial proceeding and oppose the expungement. NASD also proposes to retain discretion not to oppose expungement relief in exceptional cases where the basis for the expungement does not fall within one of the three standards. NASD would exercise such discretion only if it determines that the expungement is meritorious and would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.

After reviewing the comments, NASD also determined not to adopt a rule or Interpretive Material that would explicitly articulate NASD'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 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*. NASD believes that it currently has authority under Rule 2110 to bring a disciplinary action against NASD members and their associated persons who contravene the standards set forth in NASD's proposed rule and policies. NASD will revisit this issue in the future should it appear that such a rule is necessary.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. *Notice to Members 01-65*.
3. Comments received in response to *Notice to Members 01-65*.



Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD

BY: \_\_\_\_\_  
Barbara Z. Sweeney, Senior Vice President  
and Corporate Secretary

Date: November 18, 2002

**EXHIBIT 1**

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-NASD-2002-168)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by NASD Relating to Proposed Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository (CRD System)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 18, 2002, NASD filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to adopt Rule 2130 governing the expungement of customer dispute information from the Central Registration Depository (CRD<sup>®</sup> or CRD system) and various internal guidelines to be adopted by NASD regarding the handling of requests to expunge customer dispute information from the CRD system. Below is the text of the proposed rule change. Proposed new language is underlined.

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<sup>1</sup> 15 U.S.C. § 78s(b)(1).

<sup>2</sup> 17 CFR § 240.19b-4.

**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.

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

(A) the claim, allegation or information is without factual basis;

(B) the complaint fails to state a claim upon which relief can be granted or is frivolous; or

(C) the information contained in the CRD system is defamatory in nature.

(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.

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

The purpose of the proposed rule change is to establish procedures for expunging customer dispute information from the CRD system. The proposed rule will require all directives to expunge customer dispute information from the CRD system to be confirmed by or ordered by a court of competent jurisdiction. The proposed rule includes any such directives that may be in: (1) judicial proceedings seeking expungement (including proceedings seeking expungement relief resulting from settlements in disputes between public customers and member firms or their associated persons in which the parties agree to expungement of customer dispute information as part of the settlement); (2) arbitration awards rendered in disputes between public customers and member firms or their associated persons in which the parties agree to expunge customer dispute information as part of the settlement and then present the settlement to the

arbitration panel for inclusion in a stipulated award; and (3) arbitration awards issued after a decision on the merits.

The proposed rule also will require member firms and associated persons seeking expungement to name NASD as an additional party in any judicial proceeding seeking expungement relief or confirming an arbitration award containing expungement relief. The proposed rule will state that NASD will participate in such judicial proceedings and will oppose expunging dispute information in such judicial proceedings unless the arbitrators or the court has made specific findings that the subject matter of the claim or the information in the CRD system: (1) is without factual basis (i.e., is factually impossible or clearly erroneous); (2) fails to state a claim upon which relief can be granted or is frivolous); or (3) is defamatory in nature.

The proposed rule will also permit member firms and associated persons to ask NASD to waive the requirement to name NASD as a party on the basis that the expungement order meets at least one of the standards for expungement articulated in the proposed rule. This will save members and NASD time and expense by enabling NASD to review the findings of the arbitrators or court and determine to waive participation in the judicial proceeding if NASD determines that the findings made by the arbitrators or the court meet at least one of the standards in the rule. If the expungement order fails to meet at least one of the standards in the rule, NASD will participate in the judicial proceeding and oppose the expungement.

Under the proposed rule, NASD will retain discretion not to oppose expungement relief in exceptional cases where the basis for the expungement does not fall within one of the three standards. NASD would exercise such discretion only if it determines that the expungement is

meritorious and would have no material adverse effect on investor protection, the integrity of the CRD system or regulatory requirements.

The CRD system is an on-line registration and licensing system for the U.S. securities industry, state and federal regulators, and self-regulatory organizations ("SROs"). The CRD system contains broker-dealer information filed on Forms BD and BDW and information on associated persons filed on Forms U-4 and U-5. The CRD system also contains information filed by regulators via Form U-6. The CRD system contains administrative information (personal, organizational, employment history, registration and other information) and disclosure information (criminal matters, regulatory disciplinary actions, civil judicial actions, financial information, and information relating to customer disputes) filed on these forms. For purposes of this rule, "customer dispute information" includes customer complaints, arbitration claims, and court filings made by customers, and the arbitration awards or court judgments that may result from those claims or filings. This category of information contains allegations that a member or one or more of its associated persons has violated securities laws, regulations, or rules.

NASD operates the CRD system pursuant to policies developed jointly with the North American Securities Administrators Association ("NASAA"). NASD works with the SEC, NASAA, other members of the regulatory community, and member firms to establish policies and 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. NASAA and some states have taken the position that information in the CRD system is a record of any state that uses the information to make a licensing decision, and that state laws generally do not

permit information to be expunged once it has been filed on the CRD system, absent a court order that explicitly directs expungement.

Since the inception of the CRD system in 1981, NASD generally has honored court-ordered expungements and, until, January 1999, NASD also honored arbitrator-ordered expungements that were contained in final awards. In January 1999, after consultation with NASAA, NASD imposed a moratorium on arbitrator-ordered expungements from the CRD system.<sup>3</sup> Under the moratorium, which is still in effect, NASD will not expunge information from the CRD system 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>

Since imposing the moratorium, NASD has been considering how to craft an approach to expungement that would allow NASD, in its capacity as an SRO and as operator of the CRD system, effectively to challenge expungement directives that might diminish or impair the integrity of the system and to ensure the maintenance of essential information for regulators and investors.<sup>5</sup> Such an approach necessarily requires NASD to balance three competing interests: (1) the interests of NASD, the states, and other regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations;

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<sup>3</sup> The moratorium was announced in *Notice to Members 99-09*.

<sup>4</sup> Under existing CRD policy, and consistent with the 1999 moratorium, NASD may execute, without a court order, arbitration awards rendered in disputes between registered representatives and firms that contain expungement directives in which the arbitration panel states that expungement relief is being granted because of the defamatory nature of the information. These expungements are not covered by the moratorium and will not be covered by the proposed rules and policies.

<sup>5</sup> In July 1999, NASD issued *Notice to Members 99-54* seeking comment on possible approaches to addressing arbitrator-ordered expungements of information from the CRD system.

(2) the interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate; and (3) the interests of investors in having access to accurate and meaningful information about brokers with whom they conduct, or may conduct, business.

NASD is cognizant of the importance of ensuring that the expungement policy 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. NASD and other regulators participating in the CRD system agree that expungement is extraordinary relief, and that courts granting expungement relief under the existing rules and procedures may not fully consider all of the competing interests referenced above. NASD believes that the additional safeguards and procedures proposed herein will allow fact finders and NASD to consider all competing interests before directing or granting expungement of customer dispute information from the CRD system.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change is designed to accomplish these ends by allowing fact finders and NASD to consider all competing interests before directing or granting expungement of customer dispute information.



(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In October 2001, NASD published *Notice to Members 01-65* ("*NtM 01-65*" or "*Notice*") requesting comment on the establishment of certain criteria that must be met, and procedures that must be followed, before NASD would expunge certain information from the CRD system pursuant to an expungement order. *NtM 01-65* encouraged members, investors, registered representatives, and other interested persons to comment. NASD proposed in *NtM 01-65* that the CRD system expunge customer dispute information only if certain criteria are met and certain protocols followed. Specifically, NASD requested comment on whether expungement of customer dispute information from the CRD system should generally be limited to cases where the expungement order is based on a finding by 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"; (2) the claim is without legal merit; or (3) the information contained in the CRD system is determined to be defamatory in nature.

NASD also sought 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 or from a settled matter; (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 the *Notice*; and (3) the adoption of a rule or Interpretive Material that clearly articulates NASD'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 the *Notice*.

*NtM 01-65* provided members and other interested parties with a checklist of four questions that they could use to respond to the request for comment in addition to, or in lieu of, sending written comments. NASD noted that the checklist did not cover all aspects of the proposal, and it encouraged commenters to provide written comments, as necessary. NASD extended the comment period from November 24, 2001 to December 31, 2001. NASD received a total of 579 responses to the *Notice*. A copy of *NtM 01-65* is attached as Exhibit 2. Copies of the comment letters are attached as Exhibit 3.

Forty of the 579 responses to *NtM 01-65* consisted solely of written comments. A significant percentage of the remaining 539 commenters identified themselves as registered representatives associated with NASD member firms, and these commenters overwhelmingly opposed the imposition of any additional substantive or procedural obligations before expungement of customer dispute information could be effected. Commenters responded to the four questions as follows:<sup>6</sup>

Question 1 asked: "Should [NASD] adopt a rule that would require members to provide notice to [NASD] and make [NASD] a party to the proceeding before seeking a court order

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<sup>6</sup> Some commenters submitted duplicate responses to the questions; NASD considered these as one vote per question. For those commenters who changed their answers to the questions in a second response, NASD considered only the second response. NASD staff also notes that not all commenters responded to each question.

directing expungement or a confirming of an arbitration award that contains an expungement directive?" Forty commenters answered "yes," 495 commenters answered "no," and four commenters did not answer this question.

Question 2 asked: "Should [NASD] 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 *Notice* (*i.e.*, factually impossible/clear error; without legal merit; and defamatory in nature) appropriate?" Fifty-one commenters answered "yes," 483 commenters answered "no," and five commenters did not answer this question.

Question 3 asked: "Should [NASD] 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?" Eighty-eight commenters answered "yes," 441 commenters answered "no," and 10 commenters did not answer this question.

Question 4 asked: "Should [NASD] adopt a rule or Interpretive Material that would explicitly articulate [NASD'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 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*?" Forty-eight commenters answered "yes," 483 commenters answered "no," and eight commenters did not answer this question.

Of the 40 commenters who responded by letter, 25 were NASD members or persons associated with NASD members.<sup>7</sup> NASAA, the Securities Industry Association ("SIA"), the Public Investors Arbitration Bar Association ("PIABA"), the National Association of Investment Professionals ("NAIP") also commented, as did a number of non-industry persons who have an interest in the arbitration process. There was a wide variance in these comments, ranging from approval of some or all of the proposed procedures to total disapproval. Among the concerns raised by commenters were: the proposed procedures requiring court confirmation would be burdensome and costly; mandatory court confirmation and naming NASD as a party would undermine the arbitration process; the proposed procedures would create a conflict of interest between firms and representatives in settlements because the firm might wish to settle a case, regardless of its merits, thereby precluding the representative from obtaining an expungement; and the proposed criteria for expungement were too vague and/or too restrictive.

Some of these commenters recommended new requirements in the arbitration process to handle expungement requests. For example, it was suggested that arbitrators be required to decide claims 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 an agreement between the parties. Another suggestion was to require claimants to attest that they are bringing the claim in good faith and to give arbitrators the authority to award sanctions against claimants who bring claims in bad faith or without a reasonable basis. Some commenters suggested that a party submitting a stipulated award containing a recommendation for expungement to a court for

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<sup>7</sup> A number of commenters did not identify any affiliation.

confirmation should attach an affidavit setting forth facts constituting "factual impossibility" and/or "clear error."

Based on the comments to *NtM 01-65*, NASD is proposing to retain the core substantive requirements of the expungement program described in *NtM 01-65*, but is proposing certain modifications to the program proposed in the *Notice*. NASD recognizes that any expungement program requires a balancing of competing interests. NASD believes that the proposed rule will: help to ensure that information submitted to and maintained on the CRD system is accurate and complete; give regulators the broad access to customer dispute information that they need to fulfill their regulatory responsibilities; give individuals in the brokerage community a fair process that protects their reputations and permits expungement from the CRD system when appropriate; and gives investors access to accurate information about brokers with whom they conduct, or may conduct, business.

NASD has incorporated the following modifications based on its review of the comments. NASD proposes to modify the three broad categories proposed in *NtM 01-65*: "without factual basis," "without legal merit," and "defamatory in nature." The "without factual basis" standard would include, as identified in the *Notice*, the "factually impossible" and "clear error" standards. Of the three categories proposed, the "without legal merit" standard drew the most comments, ranging from claims that it is too narrow, too broad, or too vague. To address those comments, NASD proposes to change the "without legal merit" standard to a standard of "failure to state a claim upon which relief can be granted" or "frivolous." NASD proposes to retain the "defamatory in nature" standard proposed in *NtM 01-65*. Although this standard was

the subject of many comments, it has been used successfully in the arbitration forum in registered representative/member firm arbitrations, and NASD believes that it is appropriate as proposed.

NASD proposed in *NtM 01-65* to limit expungement relief in stipulated awards to cases involving "factual impossibility" or "clear error" on the basis that persons in those circumstances 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. In excluding the other two grounds for expungement from its initial proposal, NASD noted that it believed that it was unlikely that claimant or claimant's counsel would agree that the claim or information at issue was lacking in legal merit or was defamatory in nature. In response to comments, NASD proposes to modify the original proposal to allow expungement relief in stipulated awards (or on the basis of a settlement) based on all three grounds, with a uniform requirement that there be specific judicial or arbitral findings in all such cases. In connection with making the required arbitral findings in such cases, NASD will explore the use of telephonic versus in-person hearings, as well as the option of making a decision based on briefs and affidavits from the parties and relevant third parties.

In response to 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 and serving NASD with the appropriate court papers, NASD proposes to retain these requirements, but it further proposes to permit parties to ask NASD to waive the requirement that it be made a party upon a showing that the expungement relief being requested is within the established standards. This will save members

and NASD time and expense by enabling NASD to review the findings of the arbitrators or court and determine to waive participation in the judicial proceeding if the findings meet at least one of the standards in the rule. If the expungement order fails to meet at least one of the standards in the rule, NASD will participate in the judicial proceeding and oppose the expungement. NASD also proposes to retain discretion not to oppose expungement relief in exceptional cases where the basis for the expungement does not fall within one of the three standards. NASD would exercise such discretion only if it determines that the expungement is meritorious and would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.

After reviewing the comments, NASD also determined not to adopt a rule or Interpretive Material that would explicitly articulate NASD'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 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*. NASD believes that it currently has authority under Rule 2110 to bring a disciplinary action against NASD members and their associated persons who contravene the standards set forth in NASD's proposed rule and policies. NASD will revisit this issue in the future should it appear that such a rule is necessary.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds

such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz  
Secretary