



December 31, 2001

Barbara Sweeney  
Secretary  
NASD Regulation, Inc.  
1735 K Street  
Washington, DC 20006

RE: Request For Comments - 01-65 Proposed Rules And Policies Relating To  
Expungement Of Information From The Central Registration Depository

Dear Ms. Sweeney:

The North American Securities Administrators Association (“NASAA”)<sup>1</sup> appreciates the opportunity to respond to the National Association of Securities Dealers’, Inc. (“NASD”) request for comments on, “Proposed Rules and Policies Relating To Expungement of Information From the Central Registration Depository” (“NTM”).

As the joint managers of the CRD, NASAA and the states it represents are interested parties to this rule. We acknowledge that NASAA worked closely with the NASD over many months to produce this NTM. We are using this formal comment process to (1) support this NTM, (2) offer clarifications that we believe can improve this NTM, and (3) support the suggestion that NASD in its interpretive material make it clear that NASD has authority over those who attempt to abuse this rule. As stated numerous times in the NTM, “expungement is an extraordinary remedy,” and the discussion of criteria for its application ought reflect this extraordinariness.

**I. NASAA Supports The Specific, Limited Criteria Which Must Be Met Before Expungement Is Permitted.**

The current NTM is a product of years of discussion among many entities representing different interests with often-divergent goals. In short, the expungement debate illustrates the difficulty of sharing a database among industry, regulators and the investing public. We have worked very hard to try to strike a balance between treating

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<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots protection and efficient capital formation.

stockbrokers fairly and providing and preserving relevant information about stockbrokers for regulators and investors. The recent proliferation of privacy issues that have been raised because of advances in technology, set alongside the increasing number of retail investors that the states are charged to protect, increases the importance of adopting a fair, common sense expungement policy.

NASAA initiated, and for the past 5 years has continued this discussion, because we believe that allowing arbitrators to order expungement without objective standards violates our public records laws and is bad for investors. NASAA believes that under prior policy and practice, regulators and investors were denied access to important information about agents. Prior to the 1999 NASD-issued moratorium on expungements, many records were being expunged by agreement of the parties in *quid pro quo* settlements. Whether an agent was able to have his record expunged was often a matter of having a clever lawyer rather than the merits of the complaint. After extensive discussions, the NASD and NASAA, in their capacity as joint managers of CRD, agreed that the NASD would establish an interim moratorium on this policy and only honor court-ordered expungements and certain others based on defamation claims. Almost all parties agree that the moratorium was an imperfect and temporary solution to the problem and that the interested parties should strive for a better solution.

*NASAA Supports the Requirement that Expungements be Based on a Limited Set of Standards*

This NTM dramatically improves prior expungement policy because it clearly limits the situations where an agent can seek expungement to cases where: (1) the subject matter of the claim is factually impossible or in clear error, (2) the claim in question is without legal merit, or (3) the information is defamatory. The NTM also retains the very important requirement that a court of competent jurisdiction confirm that the standard for expungement has been met.

This NTM also addresses the area in which there is the most abuse: stipulations. By limiting expungement provisions in stipulations to claims where the subject matter of the claim is factually impossible or in clear error, we expect to see diminishing use of “stipulations” as expungement tactics. We also believe to be critical the requirement in the NTM that the arbitrator signing a stipulation must make a **finding** that the claim was factually impossible or in clear error. The reason expungement by stipulation is problematic is that the parties to a stipulation have no interest in whether the record is preserved or expunged. Now, arbitrators will be aware of their duty to perform the necessary inquiries to determine whether expungement is appropriate before they sign any expungement award.

*NASAA Supports the Requirement that Expungement be Court-Ordered*

NASAA strongly supports the NTM's requirement that the arbitration award be reviewed by a court and that the NASD be made party to the process. Because CRD customer complaint information is a state record, only a court has the authority to order the record deleted or altered from a state's designated record system. Further, the process as described in this proposal is consistent with the Federal Arbitration Act and fundamental legal principle that interested parties should be allowed to present their views to a court before they lose something of value. In this case, the "value" is preserving the right of the residents in each state to have access to information that allows them to make informed decisions about who to hire as caretakers for their money. Clearly information which is no longer of importance to a complainant in an arbitration can be of critical importance to another investor looking for an investment professional.

*CRD Customer Complaint Information is a State Record*

All state statutes provide that agents of broker-dealers must be licensed in a state in order to sell securities. This process is accomplished through the filing of various forms with the NASD (Forms U-4, U-5, and U-6)<sup>2</sup>. State regulations designate the CRD as the repository where that application is filed, processed and stored for the state.<sup>3</sup> All information filed on Forms U-4, U-5 and U-6 attaches to an individual's record. These forms also are stored separately in an electronic filing cabinet on Web CRD. All of this information is part of the state's official public record.

*NASD Arbitration Panels Cannot Direct State Officers How to Administer their Statutory Obligations*

The arbitration process is the method by which NASD members and investors have contracted to settle disputes. It is a non-judicial method of disposing of certain economic matters that can be settled outside a court of law. The main appeal of arbitration is that decisions can be made quickly and inexpensively. Because mandatory arbitration clauses are contained in virtually all new account agreements, investors, as a practical matter, have no choice but to agree if they wish to maintain margin accounts at brokerage firms. For this reason, mandatory arbitration has always been controversial.

The NASD arbitration panels, made up for the most part by non-lawyers, derive their authority from the contract. NASD panel members are not judicial officers under the federal or state constitutions or laws, and have no legal authority to direct a state official to expunge state records.

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<sup>2</sup> Agents file the Form U-4 to register and update their applications with regulators. Agents file the Form U-5 to inform regulators that they are terminating their registration. Regulators file a Form U-6 to report certain disciplinary information, including arbitration information, to be included on an agent's record.

<sup>3</sup> See e.g. BSLR ¶38,442, NEVADA, Sec. 90.355. *Applicant for licensing: Filing of documents and fees-- Required examination*; BSLR ¶61,618B, WASHINGTON, WAC 460-22B-030 *Registration procedure*; BSLR ¶57,401, UTAH, R164-4-1 *Broker-Dealer, Broker-Dealer agent, and issuer-agent licensing requirements*.

The process by which an arbitrator reaches a decision, compared to a court's decision-making process illustrates why states should not be forced to change their records based on a panel's award. NASD arbitrators do not have to articulate their legal reasoning in reaching their awards. Rather, they simply declare a winner and perhaps a few observations about the contested issue.<sup>4</sup> In contrast, a court must base its decision on statutory law or case law. Further, a court issues opinions that contain the judge's legal reasoning in forming an opinion. The initial trial decision can be appealed to a higher court. Both sound public policy and the delegation doctrine demand that alteration of state public records requires an order by a court of competent jurisdiction based on law, not on a non-judicial NASD arbitration panel's declaration.

*CRD Records are Subject to State Sunshine and Record Retention and Destruction Laws that Cannot be Overridden by an NASD Arbitration Panel*

CRD records are subject to each state's freedom of information act ("FOIA"). Under a typical state public record law, a securities division must disclose the disciplinary history of a salesperson to anyone requesting access under those laws. No order of an arbitration panel can supersede the laws of a state, or prevent a state agency from providing information under the state's sunshine laws to an investor researching the history of a person to whom he or she may entrust life savings.

As a matter of law, a state agency cannot delegate its FOIA responsibility by transferring custody of a record to the CRD. For example, Florida courts have held that that an official charged with the maintenance of records may not transfer actual physical custody of those records to a third party in an effort to avoid compliance with a request for inspection pursuant to the Public Records Act.<sup>5</sup> The Florida Attorney General believes that where a public agency (i.e., a state securities commission) has delegated its responsibility to maintain records necessary to perform its functions, such records will be deemed accessible to the public. In Florida, as in other states, the securities administrator cannot delegate his authority to delete records to a third party; absent an order from a court of competent jurisdiction, the public must be given access to the information.

State records also are subject to state retention and destruction laws. Because the CRD records are state records, the Forms U-4, U-5 and U-6s stored in the electronic filing cabinet, as well as an agent's composite record, are subject to the state record

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<sup>4</sup> According to NASD's Code of Arbitration Procedure Section 10330(e), the award shall contain: the names of the parties; the name of counsel, if any; a summary of the issues, including the type(s) of any security or product, in controversy; the damages and other relief requested, the damages and other relief awarded; a statement of any other issues resolved, the names of the arbitrators; the dates the claim was filed and the award rendered; the number and dates of hearing sessions; the location of the hearings; and the signatures of the arbitrators concurring in the award.

<sup>5</sup> *Tober v. Sanchez* 417 So. 2d 1053 (Fla. 3d DCA 1982), *review denied sub nom.*, *Metropolitan Dade County Agency v. Sanchez*, 426 So. 2d 27 (Fla. 1983).

retention laws. Florida statutes, for example, establish a program for the disposal of records without continuing legal, fiscal, administrative, or archival value pursuant to the retention schedules established by the records and information management program of the Division of Library and Information Services of the Department of State of Florida. The Florida Attorney General has opined that the expungement of CRD records must comply with schedules “adopted by the department [of Banking and Finance] and approved by the Department of State, and failure to adhere to those schedules could be construed as a violation of Chapter 119, Florida Statutes.”<sup>6</sup> Therefore the deletion of a CRD record in response to an arbitrator’s award would violate Florida law mandating the amount of time certain records should be maintained.

*The Requirement that NASD be Named as Party to the Award Assures that an Interested Party has an Opportunity to Address the Court About CRD Expungement Policy.*

Arbitration panels hear complaints by plaintiffs seeking money damages against their stockbrokers. In an arbitration hearing, the litigants are usually represented by attorneys. The stockbroker’s CRD record reflecting the complaint has no economic value to the plaintiff and thus is of no interest to the plaintiff’s attorney. The plaintiff’s attorney’s sole interest is in winning the highest dollar amount of damages for his client. To the extent he can use the CRD record as a bargaining chip, he will do so. These customer complaint records, however, are of paramount importance to regulators and the investing public. By requiring the NASD<sup>7</sup> to be named as a party to the court proceeding, a party interested in the record will have an opportunity to protect the CRD record before the court. Further, the NASD will be reviewing expungement awards that do not meet the guidelines announced in this proposal. This should deter stockbrokers from trying to avoid the standards the rule imposes to obtain an expungement.

*The Requirement that a Court of Competent Jurisdiction Review the NASD Arbitration Panel’s Award is Consistent with The Federal Arbitration Act Provision For Confirmation of the Arbitrator’s Award.*

The NASD arbitration process generally is governed by the Federal Arbitration Act (“FAA”), the NASD Code of Arbitration and state statutory and common law. The FAA is cognizant of the fact that arbitration panels will render decisions that need to be “confirmed,” “corrected” or “vacated” by a court of competent jurisdiction. The review of an arbitration panel’s award is particularly necessary when an arbitration panel makes a ruling that impacts the rights of an interested person who was not a party to the proceeding. The FAA allows the United States District Court in the district in which the award was made to vacate the award in certain circumstances. Courts have ruled that when a party asserts public policy as the basis for vacating an arbitration award, the court is required to make its own independent evaluation and need not defer to the arbitrator.<sup>8</sup>

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<sup>6</sup> See Attorney General’s Letter to Robert F. Milligan, August 28, 1998.

<sup>7</sup> The states also may choose to participate in opposing the award after the NASD provides them with notice of the award.

<sup>8</sup> *Transmarine Seaways Corp. of Monrovia v. Marc Rich & Co. A. G.* 480 F.Supp. 352, D.C.N.Y., 1979. June 15, 1979.

The NASD's interest in the record is based primarily on public policy reasons, mainly that the public investors and regulators have access to important information. It is consistent with the FAA to require a court order to review an arbitrator's expungement while at same time allowing the NASD the opportunity to oppose the expungement if the order does not meet the expungement standards.

It should also be noted that the FAA allows a party to ask the appropriate United States District Court to issue an order modifying or correcting the award. One ground upon which the court can correct an arbitration decision is “where the award is imperfect in matter of form *not affecting the merits of the controversy* [emphasis added].<sup>9</sup> As mentioned above, expungements of an NASD arbitration panel’s award do not *affect the merits of the controversy* between the litigants because the plaintiff has no interest in how his complaint is chronicled after the decision is rendered. A court acting under this provision, and after argument from the NASD, might “correct” the award to delete the expungement provision as a matter that should not have been decided by the arbitration panel.

NASAA is aware of certain industry comment that this NTM should not require the arbitration panel’s award to be reviewed by a court of competent jurisdiction. It is interesting to note that in cases where the arbitrators issue large awards to plaintiffs, the awards are invariably appealed to a court by the industry participants. Yet, these industry participants are now asking the regulators to forgo the same rights they enjoy. This seems particularly unjust considering the regulators are not parties to the underlying arbitration hearing.

## **II. Some Improvements And Clarifications Should Be Made To This NTM**

### *The NTM Should be Amended to Clarify Under What Circumstances Expungement Should be Permitted*

While NASAA supports allowing an agent to seek to have defamatory information expunged from his CRD record, we are concerned with the NTM’s vague terminology and unclear standard of proof with regard to defamation. As mentioned earlier, NASAA supports the use of limited, specific criteria in order to simplify and clarify the process of expungement. The NASD’s choice to use “defamatory in nature” as the criterior rather than simply defining what that means defeats this objective. NASD seeks to clarify what it means by defining defamation in footnote 6 of the NTM.<sup>10</sup> Because almost all of the 650,000 agents nationwide are not "public individuals" as that

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<sup>9</sup> FAA, 9 USCA 11.

<sup>10</sup> Footnote 6 reads “Generally, defamation requires a false statement about an individual that is published to a third party and harms the individual’s reputation. Federal and state Courts generally apply a standard of actual malice or reckless disregard for statements about public individuals, and a negligence standard for statements about private individuals, for recovery on a defamation claim. The elements to defamation and the applicable standard of fault may vary among the states.”

term is defined by law, this NTM would only require that an agent show that the complainant client was negligent in bringing his action and that this false complaint harmed the agent's reputation. We believe this is overly broad and would allow too much important information to be expunged from the CRD.

This weak standard for defamation is particularly inappropriate in the area of stockbroker complaints. The public is not adequately protected if we allow the expungement of a complaint that an arbitration panel thought was only 51% more likely to be false than true and where the panel felt the complainer was 51% negligent in making the claim.

The common sense and mainstream solution to this problem is for the NASD to delete the use of the phrase "defamatory in nature" and the definition currently found in footnote 6. In place of the "defamatory in nature" criteria the NASD should use a more commonly accepted definition of defamation. Webster's dictionary defines "defame" as "to attack or injure the reputation or honor of by false malicious statements." Alternatively, Black's Law Dictionary provides that defamation is "the offense of injuring a person's character, fame or reputation by false and malicious statements." It is important to note that both the colloquial and legal definitions of defamation require that the statement be made with **malice**, which at the very least requires that the statement was an intentional (rather than negligent) wrongful act.

Consistent with regulatory efforts to use "plain english," NASAA suggests allowing an agent to seek expungement relief "where an individual, knowing it to be false, makes a claim against an agent that harms the agent's reputation."

#### *Complaints Without Legal Merit*

NASAA also agrees that an agent should be able expunge a complaint that should not have been brought because the investor never had a legally valid claim or a right to bring the complaint. The NTM attempts to capture this standard by allowing expungement when the claim in question is "without legal merit." NASAA believes that the NASD should clarify and perhaps provide examples of precisely what it means by the use of the phrase "without legal merit."

Initial drafts of this NTM provided that "frivolous" claims could be expunged. Because "frivolous" is a vague term, we believed that it would be beneficial to move to a more clear "without legal merit" standard. After further examination, we have concluded that "without legal merit" is, in fact, a murkier legal concept than "frivolous." NASAA believes that the criteria for expungement should be based on the motives and duty of the person bringing the complaint rather than looking to the ultimate success or failure of the complaint.

The federal court system has struggled over similar concerns. In order to discourage spurious lawsuits and deter unnecessary litigation, the courts enunciated and have clarified "Rule 11." Rule 11 generally provides that a plaintiff and his or her lawyer can be liable for bringing a lawsuit for an improper reason based on claims that are not warranted by existing law. One reason Rule 11 has high standards is that the law encourages plaintiffs to be private district attorneys where there are not enough public resources to police certain activities. If Rule 11 were applied liberally, a plaintiff of limited means with a meritorious case against an environmental polluter might not bring the case if he or she thought that he or she could be liable for the other party's sizable legal fees.

Similarly, because the information contained in a customer complaint is so important to regulators and other investors, a complaint only should be expunged after the stockbroker demonstrates a high standard in showing that the claim was without legal merit. The NASD should clarify to arbitrators that in order for an agent to succeed under the standard "without legal merit" he or she must meet a set of requirements similar to those under Rule 11. NASAA volunteers to help create this set of guidelines. In any event, the NASD must provide more guidance as to the meaning of "without legal merit." The statement in this NTM "that merely prevailing in an arbitration case is not, by itself, an appropriate ground for expunging the proceeding from the CRD system" is not sufficient guidance. The NASD also should consider providing some specific examples that would not qualify for expungement. For example, arbitrators should be informed that in order to expunge a complaint from CRD, an agent must meet a higher standard than that required for a motion for summary judgment.<sup>11</sup> A motion for summary judgment generally requires there to be no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. The NASD should clarify that a similar summary judgment type decision in an arbitration award can not alone permit the information to be expunged.

### **III. NASAA Supports Adoption Of A Rule Of Interpretive Material Articulating NASD Regulation's Authority For Violations Of Conduct Rule 2110.**

NASAA supports the NASD proposal to adopt a rule or interpretive material ("IM") that would expressly articulate NASD Regulation's authority to pursue a disciplinary action against a member or an associated person who seeks to expunge an arbitration award that does not contain an expungement order and a finding of one the three criteria articulated in this NTM. Although the NASDR may have broad authority to pursue its members for conduct that would undermine the regulatory function of fostering an effective dispute resolution system, it is important that agents be put on

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<sup>11</sup> See Rule 56, Summary Judgment, Federal Rules of Civil Procedure.



notice of these rules. This new rule or IM will have a positive *in terrorem* effect on those who might be tempted to seek to launder their records.

Many states also have provisions in their statutes and regulations that hold a violation of an SRO regulation to be a violation of state regulations. By adopting an NASD rule or IM, most states would have jurisdiction to take action against these agents for violation of NASD rules, and will be able to assist the NASD in assuring that the expungement process is not abused.

#### **IV. Conclusion**

NASAA congratulates the NASD for offering this well thought out, equitable solution to the very complex expungement issue. The proposals in this NTM are a significant improvement over the status quo policy that came out of the NASDR's 1999 moratorium. The result of this NTM also will require that NASD arbitrators be trained to apply these standards correctly. As co-managers of the CRD system, NASAA would like to assist the NASD in the development of training materials for their arbitrators and members. NASAA appreciates the opportunity to provide guidance and comments on issues of investor protection. If I can be of further assistance, please contact me at 334-242-2984. Thank you.

Sincerely,

A handwritten signature in black ink, appearing to read "Joseph Borg". The signature is stylized with a large initial "J" and a long, sweeping underline.

Joseph Borg  
NASAA President  
Alabama Securities Commissioner