NASAA

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August 31, 2015

Submitted electronically to DRTaskForce@finra.org

Barbara Black, Chair
FINRA Dispute Resolution Task Force
FINRA Dispute Resolution
One Liberty Plaza
165 Broadway
27th Floor
New York, NY 10006

RE: NASAA Comments on Expungement of Matters from the Central Registration Depository ("CRD")

Dear Ms. Black:

On behalf of the North American Securities Administrators Association ("NASAA"),[1] I hereby submit the following comments summarizing NASAA's position on the expungement of customer complaint information from the CRD system. NASAA has a long-standing interest in ensuring that there is no compromise in the integrity of the information housed on CRD and its investment adviser equivalent, the Investment Adviser Registration Depository ("IARD").[2] Each system contains the information filed with state securities administrators by applicants for registration as broker-dealers, investment advisers, and their representatives. State securities administrators are obligated under state securities and public record laws to ensure that records are maintained in accordance with those laws, which almost universally require the retention of all information filed as part of a registration application and amendments to the application.

NASAA has gained a unique expertise in this area, as we have been involved in developing—and reforming—the expungement process since its inception.[3] Following an

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as the forum for these regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

[2] FINRA, NASAA, and state securities regulators developed the CRD system collaboratively. The IARD is an electronic filing system for investment advisers sponsored by the Securities and Exchange Commission and NASAA, with FINRA serving as the developer and operator of the system. NASAA partners with FINRA in the development, operation, and maintenance of the IARD. *See* www.iard.com.

[3] NASAA has commented on FINRA Rule proposals in connection with expungement. *See, e.g.,* Letter from Joseph Borg, NASAA President, to Barbara Sweeney, Secretary NASD Regulation, Inc., Re, Request for Comments – 01-65 Proposed Rules and Policies Relating to the Expungement of Information from the Central Registration Depository (December 31, 2001) *available at*

arduous multi-year process during which NASAA and its members worked together with FINRA to establish limited circumstances under which customer complaint information could be removed from the CRD system by a court order, NASAA agreed to a very limited expungement process memorialized in the provisions of NASD Rule 2130, which was approved by the SEC on December 16, 2003.[4] Rule 2130 and its subsequent recodification as the current FINRA Rule 2080 set forth the standards under which NASAA agreed that the extraordinary remedy of expungement of information from the CRD system could be warranted. These standards were limited by necessity to ensure that this extraordinary remedy would be applied judiciously.

Unfortunately, we have watched this extraordinary remedy, designed to be exercised in only the most deserving of circumstances, become a routine, everyday occurrence. Since 2011, over two thousand arbitration matters have resulted in expungement recommendations through the Rule 2080 process with the majority occurring in 2013 and 2014. Put into perspective, between 2011 and 2014 the total number of arbitration matters filed with FINRA is approximately 16,500,[5] meaning expungement was granted in at least 12% of all the arbitrations filed with FINRA during that time period. Further, in 2003, NASAA noted that the pre-Rule 2080 expungement framework allowed expungements based on the one-sided arguments of the broker.[6] In 2015, despite the current framework that we hoped would alleviate these concerns, expungements granted based on one-sided interests have endured and arguably thrived.

In light of expungement's evolution from an extraordinary remedy into routinely granted relief, the process and standards applicable to expungement must be significantly improved—or completely abandoned. If the expungement system remains unchanged, the integrity of the regulatory data and information contained in the CRD system will suffer. The regulatory information and data in the CRD system contains the critical information that allows the

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http://www.nasaa.org/wp-content/uploads/2011/07/95-Letter.37262-47637.pdf ("NASAA 2001 Letter"); Letter from Deborah Bortner, NASAA CRD Steering Committee Co-Chair, to Margaret H. McFarland, Deputy Secretary, U.S. Securities and Exchange Commission, Re, File No. SR-NASD-2002-168; Proposed Rule 2130 Concerning the Expungement of Customer Dispute Information from CRD (June 4, 2003) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/82-ProposedNASDRule-202130.37775-72237.pdf ("NASAA 2003 Letter"); Letter from Karen Tyler, NASAA President, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, Re, Release No. 34-57572; File No. SR-FINRA-2008-010, Notice of Filing of Proposed Rule Change Relating to Amendments to the Codes of Arbitration Procedure To Establish New Procedures for Arbitrators To Follow When Considering Requests for Expungement Relief (April 24, 2008) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/31-Release-No34-57572SR-FINRA-2008-010NASAA.pdf ("NASAA 2008 Letter"); Letter from Andrea Seidt, NASAA President, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, Re, Release No. 34-71959, File No. SR-FINRA-2014-020 Notice of Filing of a Proposed Rule Change To Adopt FINRA Rule 2081 (Prohibited Conditions Relating to Expungement of Customer Dispute Information) (May 14, 2014) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-Release-No-34-71959-File-No-SR-FINRA-2014-020.pdf ("NASAA 2014 Letter").

[4] SEC Release No. 34-48933; File No. SR-NASD-2002-168, Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1, Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2, Thereto, Relating to Proposed NASD Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System (December 16, 2003) *available at* https://www.sec.gov/rules/sro/34-48933.htm.

[5] *See* http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics.

[6] NASAA agreed with the three limited criteria, though advocated for their clarification. *See* NASAA 2003 Letter.

investing public to make informed decisions about financial professionals and allows regulators to assess the qualifications of an applicant to become and remain licensed, while enabling financial service firms to evaluate, hire, and trust representatives with customers' financial futures. Given its clear importance, confidence in this information is critical to regulators, investors, and the industry alike.

Expungement is a Regulatory Determination Currently Misplaced Within the FINRA Rule 2080 Arbitration Framework.

Under state law, regulators have the authority and the duty to maintain and control regulatory and licensing records. Thus, the determination to remove—or expunge—any part of a record is clearly a regulatory matter. Through the use of uniform forms and corresponding rules, state regulators, FINRA, and the SEC designed a framework that sets forth when and how regulatory information, including customer complaints, must be reported to regulators. The Uniform Application for Securities Industry Registration or Transfer ("Form U4") provides the registration and disclosure standards for brokers as well as investment adviser representatives. The current expungement process, while not originally envisioned as it operates today, undermines these standards and effectively prevents regulators from fulfilling the statutory obligation to maintain legally mandated records. We were hopeful that an arbitration-based approach in the Rule 2080 framework—developed in response to the failures of prior expungement practices—would work as an appropriate substitute for direct regulator involvement. The process, however, has deteriorated to the point where a private third party often ignores rather than safeguards the important regulatory obligation to maintain fulsome, accurate records in the CRD. Further compounding the issues present in the current expungement framework is the fact that the Federal Arbitration Act and other state arbitration statutes impose limits by which the very parties responsible for safeguarding this important regulatory information can be part of the process.

FINRA Rule 2080 functions as much more than the procedural rule it was intended to be. Pursuant to the rule, arbitration panels are empowered to make findings of fact and expungement recommendations that are all too often based on uncontested testimony. These one-sided arguments form the basis for the criteria the panel is required to include as the reasons for the expungement recommendation. The end result being that with the inclusion of one or more of the enumerated criteria, a broker is relieved in nearly all circumstances of the obligation to name FINRA in the legal proceeding confirming the arbitration recommendation of expungement. As currently applied, the expungement process has expanded exponentially beyond its intended design to allow arbitrators to provide expungement in only three very limited circumstances—factual impossibility, lack of involvement, and false claims or allegations. These narrow circumstances were instances where NASAA agreed that the extraordinary remedy of expungement could be warranted and result in a recommendation by an arbitration panel to remove the complaint information. As the Rule 2080 system changed to become a routine component of the arbitration process for brokers, the lack of consideration for the regulatory foundation of the relief expanded in scope and worsened in impact.

In its 2008 adopting release, the SEC stated that "the ability for FINRA and the states to participate in the expungement process is critical so that information that should remain in the CRD is not expunged."[7] Currently, however, there is no advocate for the regulator's position as part of the expungement decision process, and despite training to the contrary, arbitrators routinely elevate the individual broker's concerns above regulatory imperatives. To become involved in these proceedings, state regulators must intervene in the expungement process at the point the broker is seeking to confirm an award before a court, well after the arbitration panel has already made a recommendation on expungement.[8] While state regulatory intervention was contemplated in the earlier days of the current expungement framework, the realities of a state regulator intervening has proven difficult, especially given the process constraints that exclude regulators from the initial arbitration proceedings and the timing challenges involved with notifying state regulators of the filing of the required court confirmation action.[9]

In too many instances, brokers choose to wholly ignore the 2080 arbitration framework altogether in attempts to expunge information from their CRD records. In doing so, brokers petition state courts for expungement—citing the court's equitable powers—that are often unfamiliar with the intricacies of CRD and the regulatory value of the information housed there.[10] When this occurs, FINRA is most often the named defendant while the state must seek leave to intervene. Most recently, a broker in California attempted to completely bypass the 2080 arbitration framework by petitioning the Los Angeles County Superior Court for the expungement of seven customer complaints. This broker attempted to do so anonymously by filing the case as *John Doe v. FINRA*. The court ultimately rejected the broker's arguments in support of expungement. However, this brazen attempt to circumvent the— albeit flawed—process serves as further evidence of a broken system with barriers that inhibit state regulators' opportunities to offer their positions on expungement requests.

It is critical that arbitration panels—or whomever else is determining the merits of an expungement request—consider the regulators' perspective in weighing whether a customer complaint should be expunged. The process, as designed, effectively charged the arbitrators with

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[7] SEC Release No. 34-58886; File No. SR-FINRA-2008-010, Self Regulatory Organizations; FINRA; Order Approving a Proposed Rule Change Amending the Codes of Arbitration Procedure to Establish Procedures for Arbitrators to Follow when Considering Requests for Expungement Relief (October 30, 2008) *available a*t http://www.sec.gov/rules/sro/finra/2008/34-58886.pdf.

[8] *See, e.g. Hernandez v. E*Trade Securities, LLC and FINRA*, Case No. 2014-0649, Penn. Ct. of Common Pleas (April 10, 2015) (appeal pending); *John Doe v. FINRA*, Case No. BC516756, Los Angeles County Superior Court (June 30, 2015); *In re the Matter of the Arbitration of Certain Controversies Between UBS Financial Services, Inc. and Karen Karrasch and Marshal Gibson and NASD Dispute Resolution*, Case No. 103188-07, Supreme Court of the State of New York, County of New York (2007); *In re the Matter of the Arbitration Between Elizabeth Johnson and Summit Equites, Inc. and Peter O' Neill and NASD, Inc*., Case No. 104034-07, Supreme Court of the State of New York, County of New York (2007); *Application of Mary Ellen Kay For an Order Pursuant to Article 75 of the CPLR Confirming an Arbitration Award against Loretta D. Abrams and the NASD*, Case No. 100235-07, Supreme Court of the State of New York, County of New York (2007).

[9] *See, e.g.*, enclosed letter from Owen Lefkon, Delaware Investor Protection Director, to Rick Ketchum, FINRA Chairman and CEO (May 21, 2015).

[10] *See, e.g., John Doe v. FINRA, supra*, note 8.

standing in the regulators' shoes when assessing an expungement request. In practice, however, this does not happen. The parties involved in an expungement hearing are usually the broker requesting expungement and the arbitration panel. The expungement hearings rarely involve any customer testimony, which is often the only source of information that may contradict the evidence presented by a broker. Obtaining a full, accurate picture of the events surrounding a complaint is necessary before an arbitration panel can make the requisite 2080 findings that are critical to a determination of whether expungement is warranted. While a customer theoretically can testify or otherwise participate in an expungement hearing, the hearing often occurs after the customer dispute has been settled, leaving the customer and his or her counsel little incentive to oppose or otherwise object to the expungement.[11] Precisely because a customer cannot be expected to adequately present and advocate a regulator's view in whether an arbitration or customer complaint has regulatory value and whether the matter should be expunged or remain available to regulators and the investing public, the arbitration panel was given that role under Rule 2080. Unfortunately, despite changes to the process optimistically adopted to bolster that role, the process has failed.

Since 2003, the Rule 2080 Expungement Framework Consistently Favors Interests of a Single Registrant Over CRD/IARD System Integrity, Regulatory Imperatives, and the Public Interest.

In 2003, NASAA agreed with the very limited expungement process for brokers, originally memorialized in the provisions of Rule 2130. NASAA agreed to the revised framework because the then "current policy of allowing an expungement *for any reason with no criteria* as long as it is supported by a court order, was intended to be a temporary solution to the arbitrator ordered expungement problem [which resulted in the 1999 moratorium[12]]."[13] At the time, Rule 2130 appeared to provide a better solution for expunging brokers' CRD records, as it was based on the limited circumstances of factual impossibility, lack of involvement, and false claims or allegations. Unfortunately, this framework has failed, and instead has been applied in a way that favors the interests of a single registrant over regulatory imperatives and the public interest.

Hoping for some improvement to the 2080 process, NASAA followed with interest the development of FINRA Rule 2081,[14] proposed in April 2014 and designed to supplement Rule

[11] Even when a customer is present at the hearing, there has been confusion on allowing the customer to be heard. See Susan Antilla, *A Murky Process Yields Cleaner Professional Records for Stockbrokers*, N.Y. Times, September 26, 2014, at B5, *available at* http://dealbook.nytimes.com/2014/09/25/a-murky-process-yields-cleaner-professional-records-for-stockbrokers/?_php=true&_type=blogs&module=BlogPost-Title&version=Blog%20Main&contentCollection=Legal/Regulatory&action=Click&pgtype=Blogs&region=Body&_r=1.

[12] Prior to the 1999 NASD-issued moratorium on expungements, arbitrators could order expungements without criteria and without a court order, which NASAA believes is both a violation of state public records laws and suboptimal for investors. *See* NASAA 2001 Letter.

[13] NASAA 2003 Letter.

[14] NASAA notes that in addition to the adoption of FINRA Rule 2081, FINRA also increased the specificity of arbitrator expungement guidance in late 2014. *See generally* The Neutral Corner, Volume 3 – 2014 at 12-14, 19-21 *available at* https://www.finra.org/sites/default/files/Neutral%20Corner_Volume%203_0.pdf.

2080 by explicitly prohibiting *quid pro quo* expungements. While Rule 2081 was a good first step in expungement reform, *quid pro quo* expungement has been an issue dating back to pre-moratorium expungements.[15] Rule 2081 was designed to prevent firms and their brokers from conditioning the settlement of customer complaints on the support of, or an agreement by a client not to object to, the expungement of the matter from the CRD. NASAA believes that such a rule is necessary to discourage firms and their associated persons from bargaining for the expungement of potentially valuable regulatory information that should remain available to regulators and employers, as well as customers and potential customers through BrokerCheck. Rule 2081 also helps reduce the incentives of filing meritless claims to use as leverage in settlement, where claimants file claims to sully a broker's record.

NASAA notes, however, that widely available guidance prior to Rule 2081's adoption did not suffice to ensure brokers did not attempt to engage in *quid pro quo* arrangements, and NASAA remains concerned about Rule 2081's enforceability and realistic effect. In reality Rule 2081 simply codified existing guidance from 2004 that prohibited conditioning settlement on an investor's agreement not to oppose expungement, a practice that had been occurring for over a decade.[16] Furthermore, despite updated guidance,[17] there is no requirement that the arbitrator actively determine that there was no *quid pro quo.* Without such proof, there remains no certainty that arbitrators are enforcing Rule 2081. While a first step in expungement reform, Rule 2081 is, at best, a small improvement to a very broken system.

<u>The Expungement Process Must Either be Abandoned or Revised to Include A Regulatory Component.</u>

Expungement of a broker's CRD record is an extraordinary remedy. If the remedy remains commonplace and continues to be routinely granted, it will contribute to a loss of confidence in the CRD system. Without significant reforms, the expungement process will continue to result in the deletion of critically valuable regulatory information from the CRD. If such information continues to be removed without meaningful consideration as to its regulatory value, regulators, industry, and investors can no longer trust that the data in the CRD contains all of the critical information necessary to make licensing and hiring decisions or to determine which financial professional to trust.

The current system of expungement must at a minimum be reformed and include regulatory participation. While large-scale reform will take time, NASAA recommends the

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[15] *See* NASAA 2001 Letter; *see also* NASAA 2003 Letter.

[16] To prohibit such practices, FINRA issued a Notice to Members in 2004 cautioning its members against the use of affidavits in expungement proceedings, the basis of which are bargained-for-consideration rather than fact. Notice to Members 04-43 (June 2, 2004), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003015.pdf.

[17] Letter from Victoria L. Crane, Associate General Counsel, FINRA, to Kevin O'Neill, Deputy Secretary, U.S. Securities and Exchange Commission, Re, File No. SR-FINRA-2014-020 Prohibited Conditions Relating to Expungement of Customer Dispute Information—Response to Comments (July 18, 2014) *available at* https://www.sec.gov/comments/sr-finra-2014-020/finra2014020-16.pdf (responding to the comments submitted in response to the FINRA Rule 2081 proposal).

Taskforce endorse certain short-term solutions, such as an expungement-only arbitration panel, with additional opportunities for regulatory participation. In the short-term, that could mean a pre-notice to state regulators during an ongoing arbitration or a standardized protocol for states when FINRA waives its role as a party. Prohibiting a broker from bypassing the 2080 expungement process would also be an important and effective short-term solution, as would adopting more substantive expungement requirements, including a clearer definition of the prongs outlined in Rule 2080 to reduce the arbitrators' discretion in defining and applying these standards. Ultimately, however, effective long-term solutions must be sought and thoroughly vetted and considered, including consideration of the creation of a regulatory forum in which to hear expungement requests. While, in NASAA's view, the issue of whether information should be expunged from the CRD is a regulatory determination, NASAA appreciates the role the Taskforce can play in bringing about some of the long overdue reforms necessary to fix a broken expungement system.

After over a decade of witnessing expungement's evolution from an extraordinary remedy into a commonplace practice in customer dispute arbitrations, NASAA fears that without significant improvements—most importantly an increased opportunity for regulatory participation—the expungement process may need to be completely abandoned. While in some—very limited—circumstances expungement is warranted, altogether discontinuing the expungement of records for arbitration-related matters (including settled customer claims) could provide an important benefit by changing the perception of brokers' records. While a broker record with no complaints is desirable and laudable from both a regulatory and investor protection perspective, currently there are brokers who have such a record as the result of actively pursuing the expungement process, thus diminishing the value for brokers whose records never had complaints. Abandoning the expungement process would, after a transition period, be the fairest approach for both investors and brokers, and it would restore confidence in the CRD system.

NASAA appreciates the opportunity to offer its comments to the Taskforce, and should you have any questions regarding the comments in this letter, please do not hesitate to contact Joseph Brady (jb@nasaa.org), NASAA Executive Director, or Valerie Mirko (vm@nasaa.org), NASAA Deputy General Counsel, via email or at 202-737-0900.

Sincerely,

NASAA President

Enclosed: Letter from Owen Lefkon, Delaware Investor Protection Director, to Richard Ketchum, FINRA Chairman and CEO, dated May 21, 2015

MATTHEW P. DENN
ATTORNEY GENERAL

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May 21, 2015

Richard G. Ketchum
Chairman and Chief Executive Officer
Financial Industry Regulatory Authority (FINRA)
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Re: CRD Expungement Process

Dear Mr. Ketchum:

As the Investor Protection Director for the State of Delaware, I write to highlight a troubling result in Delaware's effort to oppose the expungement of investor complaint information from the Central Registration Depository ("CRD") and to encourage FINRA to consider and propose reforms of the expungement process that will better safeguard such information, which is a public record of Delaware and many other jurisdictions who participate in CRD.

As you know, CRD is a unified registration database that is used by securities regulators nationwide. It houses information that is provided by broker-dealer agents on their application for securities industry registration (Form U-4), as well as information provided by an individual's former employer(s) on registration termination notices (Form U-5). These forms collect several pieces of information, including customer complaints, that are critical to vetting the qualifications of applicants and policing the securities industry. Although CRD is administrated by FINRA (pursuant to an agreement with the North American Securities Administrators Association ("NASAA") on behalf of member states such as Delaware), the information housed in CRD belongs to each state in which an applicant registers.

The Delaware Investor Protection Unit (the "IPU") exists in order to, among other things, "prevent the public from being victimized by unscrupulous or overreaching broker-dealers, investment advisers or agents in the context of selling securities or giving investment advice." 6 *Del. C.* § 73-101. Ensuring the accuracy and consistency of legally required disclosures is critical to this mission. Customer complaint disclosures aid the IPU and other regulators in determining whether to oppose a securities license application or take disciplinary action against a broker, and the disclosures help investors to vet a broker and make informed choices. FINRA itself has emphasized that "[e]nsuring . . . CRD information is accurate and meaningful is essential to investors, who may rely on the information when making decisions about brokers with whom

they may conduct business," and "to regulators, who rely on the information to fulfill their regulatory responsibilities."[1]

In rare circumstances where a customer complaint disclosure has no meaningful investor protection or regulatory value, it may be appropriate to erase the disclosure from a registrant's CRD record. This process, known as expungement, is subject to strict criteria intended to ensure that expungement remains a rare and "extraordinary remedy."[2] However, it is clear that expungement has not been as rare or extraordinary as FINRA, the SEC, and states have intended it to be. I am greatly concerned by the potential for expungements to be granted under circumstances that lack the rigor and scrutiny such "extraordinary" relief should entail, notwithstanding recent reform efforts.[3] Indeed, a case in which Delaware recently intervened to oppose expungement is an example of just such a circumstance.

Last spring, Delaware received word that a broker, Marcus Hernandez, sought to confirm a recommendation issued by a sole FINRA arbitrator for the expungement of eight customer complaints from Mr. Hernandez's CRD record. The expungement claim was filed years after the customer complaints had been reported and named only Mr. Hernandez's former firm. No customers received notice of or were provided an opportunity to participate in the proceeding, which was conducted without opposition, contrary evidence, or cross-examination. The arbitrator's recommendation was supported by a cursory statement that largely treated the eight complaints as a whole, appearing to rely on the fact that the complaints concerned auction rate securities, or "ARS," a product rendered illiquid in early 2008. These findings did not adequately account for the individualized nature of the complaints at issue, some of which alleged deceit and unauthorized trading.

Particularly troubling was the fact that expungements of two of the complaints were denied by prior FINRA arbitration panels. In particular, one of these (the "Relitigated Expungement") was hotly litigated in a protracted proceeding that resulted in a finding of personal financial liability against Mr. Hernandez.

Based on these and other deficiencies in the expungement proceeding and recommendation, the Delaware Attorney General determined to intervene in the confirmation proceeding—commenced by Mr. Hernandez in Pennsylvania state court[4]—in order to oppose expungement. As you are likely aware, FINRA denied Mr. Hernandez's request for a Rule 2080 waiver and also appeared in the confirmation proceeding, objecting to confirmation of the recommendation only as to the Relitigated Expungement.

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1 *See* Notice to Arbitrators and Parties on Expanded Expungement Guidance (Updated December 2014), available at https://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance.

2 *Id.*

3 I was pleased when the SEC last year approved new FINRA Rule 2081, which strengthens the expungement process by prohibiting a customer settlement from including an agreement to support or not oppose expungement.

4 *Hernandez v. E*Trade, et al.*, No. 2014-06945 (Pa. Com. Pl.)

Notwithstanding Delaware's emphatic opposition to expungement of any of the customer complaints, the court in *Hernandez* issued a summary order confirming the expungement recommendation (though carving out the Relitigated Expungement).[5] While the court's order was not accompanied by an opinion, it is likely that Mr. Hernandez's success was due in large part to the fact that arbitration awards are accorded nearly unreviewable deference in the courts.

The current expungement process contemplates that state securities regulators will play a gate-keeping role. In approving FINRA Rules 12805 and 13805, which concern expungement requests, the SEC emphasized its expectation that regulators would appear in court to ensure that unwarranted expungements do not get confirmed.[6] This opportunity was intended to serve as an important protection against abuse. However, Delaware's experience in *Hernandez* demonstrates the limitations of this safeguard. Even in the face of opposition by the Delaware Attorney General, the court in *Hernandez* confirmed nearly every expungement that was sought.

Simply put, it is not practical for the integrity of the expungement system to depend on the willingness and ability of states like Delaware to litigate each objectionable case. Aside from confronting the onerous legal burden that favors arbitration awards, a state securities regulator who wishes to oppose an expungement recommendation must be prepared to dedicate substantial resources to the cause. Thus, the notion of regulator involvement is not simply a matter of a state raising its hand in objection, but rather making a decision to devote scarce resources to what may turn out to be protracted litigation. For example, we estimate that Delaware invested in excess of 400 attorney hours (excluding supervisory time and time yet to be spent at the appellate stage) in the *Hernandez* matter, which entailed extensive briefing on complex issues of law as well as discovery and motion practice. This significant resource allocation, together with the legal challenges posed by the arbitration-review posture of expungement cases, makes it little wonder that regulator intervention in such proceedings is rare.

In fact, the *Hernandez* case highlights a particularly troubling type of expungement that has become prevalent in recent years. That is, expungements granted in arbitrations between brokers and firms without notice to the complaining customer(s). In such a case, the broker's expungement case proceeds essentially *ex parte* without being contested by any interested adversary. In the absence of contrary evidence or cross-examination, it seems that expungement requests under these circumstances often enjoy rubber-stamped approval. When dressed as arbitration awards, these expungement recommendations are difficult or impossible to successfully oppose in the courts, a fact highlighted by the result in *Hernandez.*

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[5] On May 7, 2015, the Attorney General appealed from this order. That appeal is pending.

[6] *See* S.E.C. Release No. 58886, 2008 WL 4825957, at *6 n.51 (Oct. 30, 2008) (emphasizing that the ability for FINRA and the states to participate in the expungement process by intervening in confirmation actions "is critical so that information that should remain in CRD is not expunged" and expressing the "expect[ation] that all regulators will take these responsibilities seriously"), available at https://www.sec.gov/rules/sro/finra/2008/34-58886.pdf.

Of course, even when customers are notified that expungement relief is sought, they will not necessarily participate or oppose. That is because their interests are affected mostly, if not only, by the disposition of their claim for monetary or other relief, not by the visibility of their complaint to others. Thus, regulators such as the Delaware IPU, acting on behalf of the public whom we are charged to protect, are critical stakeholders in the expungement process. For this reason, the lack of opportunity for regulators to participate in the expungement process before the confirmation stage warrants serious reconsideration.[7]

I am grateful for FINRA's past and ongoing efforts to work with state securities regulators (including my staff) and the SEC to reform the expungement process. But in light of the result in *Hernandez*, I call on FINRA to redouble this effort in order to ensure the system does not permit the unwarranted removal of important disclosures that are part of states' public records, particularly in the face of regulator opposition.

We support the SEC's call in its release approving Rule 2081 for FINRA to conduct "a comprehensive review of its expungement rules and procedures."[8] We also agree with many of the suggestions put forth by NASAA in its May 14, 2014 comment letter to the SEC regarding Rule 2081.[9] In considering reforms, I urge FINRA to work with NASAA and state securities regulators to implement changes that will enable Delaware and others to meaningfully participate and oppose expungements, where warranted. The current arbitral award paradigm (entailing the nearly unreviewable deference awards receive in the courts), coupled with the ability of brokers to obtain effectively *ex parte* review and approval of expungement requests, frustrate the objective of making expungements rare and exceptional.

Put simply, given the important investor protection value of full and complete disclosures, expungement should be tough to get and easy to oppose. Today, it is the opposite. Regulators—as defenders of the investing public—should be enabled, rather than inhibited, from performing their policing function in this space. I call on FINRA to work on proposing reforms that will satisfy these imperatives and address the shortcomings of the current expungement process.

I would be pleased to make myself and my staff available to discuss or contribute to the creation of any new rules or policies that will improve the CRD expungement process and

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[7] As you may know, the Delaware IPU receives notice of an expungement request only once NASAA has been notified by FINRA that FINRA has received a request under Rule 2080 to waive the requirement that it be named in a proceeding to confirm the expungement award. We have no notice of nor ability to participate in the underlying expungement arbitration, nor any ability to be notified of (and thus participate in) a proceeding to confirm an expungement award if FINRA grants a Rule 2080 waiver.

[8] S.E.C. Release No. 72649, 2014 WL 3613217, at *7 (July 22, 2014), available at https://www.sec.gov/rules/sro/finra/2014/34-72649.pdf.

[9] May 14, 2014 letter from NASAA to Elizabeth M. Murphy, Secretary of the Securities and Exchange Commission, Re: Release No. 34-71959, File Number SR-FINRA-2014-020, available at http://www.sec.gov/comments/sr-finra-2014-020/finra2014020-12.pdf.

bolster the integrity of the system. Please feel free to contact me or Deputy Attorney General Jeff Drobish at (302) 577-8424. Until then, thank you for all you continue to do to protect investors.

Very truly yours,

Owen Lefkon
Investor Protection Director

cc: Derek Linden, Executive Vice President, FINRA Registration and Disclosure
Joseph Brady, General Counsel/Acting Executive Director, NASAA
Commissioners of the Securities and Exchange Commission, c/o Mary Jo White, Chair
Stephen Luparello, Director, SEC Division of Trading and Markets