In the Superior Court of Pennsylvania

Nos. 1316, 1639 EDA 2015

MARCUS HERNANDEZ,
Deemed Appellant,

v.

E*TRADE SECURITIES, LLC and
FINANCIAL INDUSTRY REGULATORY AUTHORITY, INC.,
Appellees,

AND

MATTHEW P. DENN, ATTORNEY GENERAL
FOR THE STATE OF DELAWARE,
Deemed Appellee.

BRIEF FOR AMICUS CURIAE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Appeal from the Order dated April 10, 2015 Issued by the Court of Common Pleas, Montgomery County, C.A. No. 2014-06945.

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INTEREST OF AMICUS CURIAE

The North American Securities Administrators Association, Inc. ("NASAA") is the non-profit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including the securities regulators in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico. Formed in 1919, NASAA is the oldest international organization devoted to protecting investors from fraud and abuse in connection with the offer and sale of securities.

NASAA members' fundamental mission is protecting investors and the members' principal activities include registering certain types of securities, licensing the firms and agents who offer and sell securities, investigating violations of state law, and, where appropriate, instituting enforcement actions. NASAA and its members also educate the public about investment fraud and advocate for the adoption of strong, fair, and uniform securities laws and regulations at both the state and federal level.

NASAA supports the work of its members by coordinating multi-state enforcement actions, offering training programs, publishing investor education materials, and presenting the views of its members in testimony before Congress and in comment letters to regulatory agencies on matters of securities regulation. Another core function of the association is to represent the membership's interests,

as *amicus curiae*, in significant cases involving the interpretation and application of state and federal securities laws and the rights of investors.

NASAA also plays an important policy role in supporting the state securities regulators' licensing function of broker-dealers and stockbrokers. To that end, NASAA and the Financial Industry Regulatory Authority ("FINRA") (formerly the National Association of Securities Dealers or "NASD")[1] developed a centralized system used by state securities regulators and other regulators to process applications for securities industry licenses.[2] This system, which is jointly administered by NASAA and FINRA, is known as the Central Registration Depository ("CRD"). State securities regulators use the records maintained within the CRD in large part to make licensing decisions in their respective jurisdictions. Registration, licensing, and disclosure information for more than 600,000 individual stockbrokers is stored in the CRD. At issue in this matter is when, and under what specific circumstances, customer complaint information may be expunged, or inalterably removed, from the records of the CRD. Protecting the integrity of the information contained in the CRD system for the benefit of

[1] In 2007, NASD merged with the regulatory arm of the New York Stock Exchange forming FINRA. In this brief, FINRA and NASD will be used interchangeably.

[2] The Maloney Act of 1938, 15 U.S.C. § 78o-3, *et seq.*, authorized the U.S. Securities and Exchange Commission ("SEC") to register and delegate certain regulatory powers to self-regulatory organizations in the securities industry. The SEC has delegated to FINRA certain regulatory powers over broker-dealers required to register under the Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(11).

regulators, who rely on the system in carrying out their licensing responsibilities, and the investing public, who are encouraged to investigate the backgrounds of potential financial advisors before relying on them for investment advice, is of significant interest to NASAA and its members.

SUMMARY OF THE ARGUMENT

Following an 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. Rule 2130 and its subsequent recodification as the current FINRA Rule 2080, FINRA Manual, Rule 2080, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8468 ("FINRA Rule 2080"), sets forth the standards under which the state securities regulators agreed that the extraordinary remedy of expungement of information from the CRD system could be warranted.[3] These standards were limited by necessity to ensure that this extraordinary remedy would be applied judiciously, given the critical importance of the information housed in the CRD.

[3] FINRA Rule 2080 is substantively identical to NASD Rule 2130.

The process that produced the recommendation of expungement that Mr. Hernandez now seeks to confirm fails to comply with the standards laid out in the FINRA expungement rules and wholly fails to comport with the intent of a rule designed to limit the deletion of valuable regulatory information to three very specific factual circumstances. The recommendation of expungement at issue here is the product of a flawed process in which the fundamental principles of collateral estoppel and adversarial fact-finding were ignored, enabling an arbitrator charged with making specific factual determinations to reach critical determinations after being presented with only one side of the story. Given these fatal flaws, the Court should not confirm the recommendations of expungement.

ARGUMENT

I. Expungement is an extraordinary remedy to be granted solely in limited circumstances.

The issue of removing information from the CRD has been a matter of concern to state securities regulators for many years.[4] Expungement is the process

[4] Over the years, NASAA has commented on numerous rule proposals regarding expungement. *See, e.g.*, Letter from Joseph Borg, NASAA President, to Barbara Sweeney, Sec'y NASD Regulation, Inc. (December 31, 2001) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/95-Letter.37262-47637.pdf (regarding Request for Comments – 01-65 Proposed Rules and Policies Relating to the Expungement of Information from the Central Registration Depository); Letter from Deborah Bortner, NASAA CRD Steering Comm. Co-Chair, to Margaret H. McFarland, Deputy Sec'y, U.S. Sec. and Exch. Comm'n (June 4, 2003) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/82-ProposedNASDRule-202130.37775-72237.pdf (regarding File No. SR-NASD-2002-168; Proposed Rule 2130 Concerning the Expungement of Customer Dispute Information from CRD); Letter from Karen

by which information is deleted from state public records maintained in the CRD—in this instance, information used by regulators to make licensing decisions, by investors to select trustworthy stockbrokers, and financial firms in making hiring decisions. For years, stockbrokers were able to obtain expungements almost as a matter of course, regardless of their culpability and without due consideration of the value of the expunged information to regulators, investors, and brokerage firms. FINRA Rule 2080 represents an attempt to limit the instances in which expungement is granted by (1) imposing strict procedural and substantive standards on arbitration panels entertaining requests for expungements, and by (2) creating an expectation that states will be permitted to intervene to help ensure that these procedural and substantive safeguards are properly applied.

The regulatory information and data maintained in the CRD system contains the critical information that allows the investing public to make informed decisions about financial professionals, allows regulators to assess the qualifications of an

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Tyler, NASAA President, to Nancy M. Morris, Sec'y, U.S. Sec. and Exch. Comm'n (April 24, 2008) *available at* http://www.nasaa.org/wp-content/uploads/2011/07/31-Release-No34-57572SR-FINRA-2008-010NASAA.pdf (regarding 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); Letter from Andrea Seidt, NASAA President, to Elizabeth M. Murphy, Sec'y, U.S. Sec. and Exch. Comm'n (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 (regarding 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)).

applicant to become and remain licensed, and allows financial service firms to evaluate, hire, and trust representatives with customers' financial futures. Further, state securities administrators are obligated under state securities and public record laws to ensure that records housed in the CRD 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. Given its clear importance, confidence in this information is critical to regulators, investors, and the industry alike. However, for too many years customer dispute information was routinely expunged from the CRD system based on awards issued by arbitration panels without court confirmation. NASAA was concerned that expungements were being improperly used to conceal stockbroker misconduct. NASAA objected to this practice, believing that arbitration panels do not and should not have the authority to enter awards that result in the destruction of state records. The problem became so serious that, in 1999, NASD and NASAA agreed to impose a moratorium on all arbitrator-ordered expungements issued in disputes between public customers and stockbrokers, while rules regarding expungements were evaluated. *See* NASD Notice to Members 99-09 (Feb. 1999), *available at* https://www.finra.org/file/notice-members-99-09.

In July 1999, the NASD published Notice to Members 99-54 to solicit comments on several different proposals that would allow the expungement of

some information from the CRD, while at the same time complying with applicable state record laws. *See* NASD Notice to Members 99-54 (July 1999), *available at* https://www.finra.org/file/notice-members-99-54. The NASD noted that its objective was to "provide some parameters for arbitrator-ordered expungements to ensure that investor protection is not compromised and to give some indication of the arbitrators' reasons for granting such relief." *Id.* at 353. The NASD also affirmed that expungement is extraordinary relief, to be granted in limited circumstances and only after a determination that the matter satisfies at least one of three specific criteria. *See* NASD Notice to Members 01-65, 566 (Nov. 2001), *available at* https://www.finra.org/industry/notices/01-65.

NASD subsequently filed a formal rule proposal, which the SEC approved as Rule 2130. *See* Order Granting Approval of Proposed Rule Change Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System, 68 Fed. Reg. 74,667 (Dec. 24, 2003). The SEC found Rule 2130 to be "a clear improvement over the [then] current system for the expungement of information from the CRD system" and that it would "ensure that investors and regulators have access to more accurate information through the CRD system." *Id.* at 74,671. The SEC recognized that an improper expungement would adversely affect "the integrity of the CRD system, and regulatory requirements." *Id.* at 74,668. In order for the CRD to be an effective regulatory

tool, the SEC noted, it is important that "regulators be able to examine the entirety of a registered person's record, *with the limited exceptions as proposed.*" *Id.* at 74,670 (emphasis added).

In its adopting release, the SEC specifically addressed the "serious concern that valuable information is being expunged from the CRD system," *id.* at 74,671-672, concluding that the rule would help ensure that "only information that is not valuable to regulators and investors is expunged from the CRD System." *Id.* at 74,672. In response to concerns raised during the comment period that stockbrokers were taking advantage of the extraordinary remedy of expungement, the SEC observed that requiring arbitrators and judges to make an affirmative determination under the rule before issuing an expungement order would greatly reduce the "ability of members and associated person's to 'buy clean records.'" *Id.*

The rule establishes a process whereby a FINRA arbitration panel is required to find that expungement is warranted based on the existence of one or more of three substantive criteria set forth in the rule. Such a finding will likely result in FINRA's waiver of an appearance to contest any subsequent effort to confirm the expungement award in a court of competent jurisdiction. The standards listed in the rule are as follows: (A) the claim, allegation, or information is factually impossible or clearly erroneous; (B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation,

or conversion of funds; or (C) the claim, allegation, or information is false. *See* FINRA Rule 2080(b)(1); *see also* NASD Notice to Members 04-16 (March 2004), *available at* http://www.finra.org/sites/default/files/NoticeDocument/p003235.pdf (the arbitrators decide "whether to grant expungement on the basis of one or more of the standards in Rule 2130") ("NTM 04-16").

Over time, FINRA has re-codified Rule 2130 as Rule 2080 without any substantive change and has supplemented the rule with regulatory notices to its members emphasizing its important procedural and substantive requirements. *See*, *e.g.*, NTM 04-16; FINRA Regulatory Notice 08-79 (Jan. 26, 2009), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_08-79.pdf; FINRA Notice to Arbitrators and Parties on Expanded Expungement Guidance (updated Sept. 2015), *available at* https://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance. NTM 04-16 further provided that even if the arbitrators dismissed the customer's claim, the panel still should consider whether or not to grant expungement relief. This is consistent with earlier pronouncements by FINRA that dismissal of a claim is not in and of itself a reason to order expungement. *See* NTM 04-16. Even if the parties settle their dispute, arbitrators must still make an affirmative finding under the rule, and they should conduct an evidentiary hearing or require the submission of documents to the extent necessary. *Id.* Thus, the rule intends that panels must

develop an adequate record through a hearing or other means before ruling on a request for expungement.

In practice, most expungement requests are made in the course of an arbitration proceeding during which the arbitral panel makes a determination as to whether expungement is warranted based upon the three factors laid out in Rule 2080(b)(1)(A-C). After such a determination is made and an award recommending expungement is issued explaining the basis for its recommendation of expungement, the individual must then seek confirmation of the award in a court proceeding, naming FINRA as a party, unless FINRA waives this requirement under the rule. *See* FINRA Rule 2080(b). While the rule does not require individuals seeking to confirm an award recommending expungement to name the relevant state regulators, working with FINRA, NASAA has developed a procedure under which the state securities regulators in the states in which the stockbroker is registered are notified of and can assess these requests. Generally such notification is provided prior to FINRA making its determination as to whether it will grant a waiver to being named in the confirmation suit. *See* NTM 04-16.

The state-notification process provides the relevant state securities regulators with an opportunity to review expungement requests and potentially seek leave of court to intervene in the confirmation proceedings if desired, which was

contemplated when the rule was initially adopted. *See* 68 Fed. Reg. at 74,671 ("[A]s a further means to ensure that the court is made aware of the investor protection and regulatory implications of an expungement, NASD noted that *states will be able to intervene* if they have concerns regarding whether investor protection or regulatory issues have been fairly considered by the NASD." (emphasis added)). In the instant matter, after receiving such notice, the Delaware Attorney General intervened to contest this expungement request.

II. The "award" recommending expungement should not be confirmed because the process in this case did not comport with the requirements or intent of FINRA Rule 2080.

The Delaware Attorney General intervened in this matter to contest the confirmation of the recommendation of expungement of eight customer complaints contained in an arbitration award obtained by Mr. Hernandez from a sole arbitrator in a dispute limited to Mr. Hernandez and E*Trade Financial, his former employer. In the Court below, Delaware presented its concerns regarding circumstances and irregularities presented by Mr. Hernandez's requests for expungement. These issues make clear that in seeking expungement of these eight customer complaints, Mr. Hernandez wanted only to sanitize his CRD record and shield from the public past complaints from customers, neither of which comport with the requirements or the intent of Rule 2080.

One of the complaints that Mr. Hernandez sought to expunge had been fully heard and denied in a prior arbitration. Specifically, the Horowitz Complaint was fully arbitrated and the arbitration panel refused to recommend the expungement of the matter from Mr. Hernandez's record. The Court below correctly found that Mr. Hernandez was collaterally estopped from now seeking to confirm a recommendation of expungement of the Horowitz Complaint obtained in a subsequent arbitration because the matter had already been fully litigated. The Court below correctly found that the prior denial of Mr. Hernandez's expungement request in the initial arbitration on the merits of the complaint satisfied all of the requirements of collateral estoppel. As the Pennsylvania Superior Court has held, "[c]ollateral estoppel, or issue preclusion, is a doctrine which prevents re-litigation of an issue in a later action, despite the fact that it is based on a cause of action different from the one previously litigated." *Balent v. City of Wilkes–Barre*, 669 A.2d 309, 313 (Pa. Super. 1995). Further:

> Collateral estoppel applies if (1) the issue decided in the prior case is identical to one presented in the later case; (2) there was a final judgment on the merits; (3) the party against whom the plea is asserted was a party or in privity with a party in the prior case; (4) the party or person privy to the party against whom the doctrine is asserted had a full and fair opportunity to litigate the issue in the prior proceeding and (5) the determination in the prior proceeding was essential to the judgment.

Weissberger v. Myers, 90 A.3d 730, 733 (Pa. Super. 2014) (citing *Catroppa v. Carlton*, 998 A.2d 643, 646 (Pa. Super. 2010). The Court below correctly found that all the elements of collateral estoppel were satisfied because:

> [T]he identical issue whether the Horowitz customer complaint against Hernandez should be expunged was decided in the prior arbitration. The 2010 award from the arbitrator was unappealed and, thus, a final judgment on the merits. The party, Hernandez, against whom the doctrine is being asserted, was the same in both the 2010 and 2013 arbitration proceedings. Lastly, Hernandez had a full and fair opportunity to litigate the issue in the prior proceedings.

Tr. Ct. Order at 15. Because the Horowitz Complaint was fully litigated *on the merits* and expungement was denied, the reliability of the second award recommending expungement is called into question.

One of the goals of Rule 2080 is to ensure that the extraordinary remedy of expungement is only granted when truly warranted and where such information no longer has regulatory value. The three substantive standards laid out in the rule represent the three circumstances in which a customer complaint can justifiably be deleted from CRD. In the Horowitz matter, the first arbitration panel held a complete proceeding on the merits of Mr. Horowitz's complaints against Hernandez and his employer and found that violations had occurred and awarded Mr. Horowitz damages accordingly—and expressly *denied* the expungement request, showing that the standards of Rule 2080 were *not* satisfied. In the second award—obtained years later without the benefit of the participation of any party

with an interest opposed to his request—that Mr. Hernandez now seeks to confirm, the arbitrator somehow found that Horowitz's claims against Hernandez satisfied Rule 2080's requirements. Not only does this "finding" violate the legal principle of collateral estoppel, it defies logic how any adjudicator could reach such a conclusion under the after-the-fact, unopposed, unsubstantiated, overruling circumstances surrounding this attempted second bite at the proverbial apple.

There is certainly regulatory value in maintaining information concerning an action brought against a stockbroker in which he is found liable to his customer for damages. A regulator making licensing decisions would find this to be valuable information, as would a firm considering hiring Mr. Hernandez, and most importantly, as would an investor who may be considering Mr. Hernandez as his or her new stockbroker. Rule 2080 was designed to protect such information from expungement, however, a court order confirming the expungement recommendation here would fail to fulfill the goal Rule 2080 was designed to accomplish.

The Horowitz Complaint is not the only customer complaint in this matter that presents problems related to the intent and purpose of Rule 2080. The method by which Hernandez sought to expunge all of these complaints and the process that led to the recommendation of expungement raises significant concerns. As discussed above, the purpose of Rule 2080 was to ensure that important

information housed in the CRD was not expunged before the merits of doing so were fully considered, and as the SEC has stated, "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." 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, Securities Act Release No. 34-58886, FINRA File No. SR-FINRA-2008-010, 73 Fed. Reg. 66,086 (proposed Nov. 6, 2008), *available at* http://www.sec.gov/rules/sro/finra/2008/34-58886.pdf. Before information can be expunged from CRD, the rule contemplates an opportunity for an opposing position regarding the expungement to be heard. Implicitly, the rule *requires* an opposing position to be presented, because otherwise an arbitration panel cannot make the requisite factual findings required in the rule if it only hears the facts of the matter from the side of the party seeking expungement.

Here, there was no advocate during the expungement decision process to ensure that the arbitrator heard the regulators' or the customers' positions concerning the expungement request. In this particular arbitration proceeding, a sole arbitrator considered Mr. Hernandez's request for the expungement of eight complaints. In making the factual determination necessary to recommend expungement the arbitrator heard only Mr. Hernandez's side of the story. The

original complaints of the customers were not before the arbitrator, two of which had already been fully litigated on the merits.[5] The customers who lodged complaints against Mr. Hernandez were not notified of his request to remove their complaints from his record so not only did they not participate, they were not given the opportunity to participate.

While Mr. Hernandez's former firm, E*Trade, was part of the expungement proceedings here, his former employer had no incentive to expend resources necessary to oppose the requests or present any facts that may have cut against Mr. Hernandez's version of events as presented to the arbitrator. In fact, as the trial court noted, E*Trade, in the Wechsler matter, fully litigated the customer's complaints and requested expungement relief for Mr. Hernandez. Tr. Ct. Order at 15. Because E*Trade had previously sought expungement on Mr. Hernandez's behalf in the Wechsler matter, the firm certainly had no incentive to oppose the expungement requests here.

Simply put, Hernandez received a recommendation of expungement for eight customer complaints after presenting only his version of events. While Mr. Hernandez may have followed the procedures set forth by Rule 2080, in this circumstance, the spirit of the rule, which treats expungement as an extraordinary

[5] In addition to the Horowitz Complaint, the substance of the Wechsler Complaint had already been the subject of an arbitration between Mr. Hernandez's customer and E*Trade in which an award was entered against E*Trade. *See* Tr. Ct. Order at 15.

remedy, was entirely ignored by the arbitrator. There is no other explanation as to why an arbitrator would agree to remove all eight customer complaints hearing no evidence opposing such expungements. No party to the arbitration that resulted in the expungement recommendation that Mr. Hernandez now seeks to confirm had any incentive to oppose his request—the customers were not notified, let alone asked to present their views and no regulators were able to argue that the complaints Mr. Hernandez sought to expunge had regulatory value. Essentially, there was nothing in dispute during this arbitration.

Rule 2080 was designed and specifically implemented to ensure that important regulatory information was not removed from the CRD in response to recognized flaws in the then-existing system. Working together, federal and state regulators determined that the extraordinary remedy of expungement would be permissible if one of the three limited factual circumstances laid out in Rule 2080, and again in FINRA's Arbitration Rules, *see* FINRA Rule 12805, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7229 (arbitration standards governing customer disputes); *see also* FINRA Rule 13805, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7230 (arbitration standards governing industry disputes), were present. At the time, regulators agreed to allow arbitrators to determine whether these factual

circumstances are present in the course of an arbitration involving an actual dispute between the customer and the stockbroker.[6] In that context, each side would be able to present evidence in support of and in opposition to the claims. The United States' judicial system is built on this adversarial process, as it assists finders of fact in reaching their determinations. *See*, *e.g.*, Jerold H. Israel, *Cornerstones of the Judicial Process*, 2 KAN. J.L. & PUB. POL'Y 5, 12-13 (1993). This was implicitly recognized in the expungement context when the requisite factual determination was placed in the arbitrators' hands and where arbitrators have been instructed to hold hearings on the appropriateness of expungement. *See* FINRA Rule 12805; FINRA Rule 13805.

Here, the expungement process broke down. Mr. Hernandez was able to present his one-sided version of events regarding eight customer complaints—most disturbingly two of which had already been fully litigated on their merits—seeking that they be removed permanently from his CRD record. In a securities industry built upon the foundation of complete and adequate disclosure of relevant information, Mr. Hernandez was able to get important information deleted without any consideration as to the regulatory value of that information and without any presentation of facts that may have been contrary to his position. The

[6] FINRA Rules now allow for a broker to name his or her firm as a respondent in an expungement proceeding, but the same substantive standards apply before expungement can be recommended.

expungement recommendation that he now seeks to confirm was the product of a fatally flawed proceeding, which this court should not confirm.

CONCLUSION

For the reasons set out above, the decision of the trial court should be affirmed in part and reversed in part.

Respectfully Submitted,

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Date: October 8, 2015

CERTIFICATE OF COMPLIANCE PURSUANT TO APPELLATE RULE OF PROCEDURE 2135(d)

The undersigned hereby certifies that the foregoing Brief of Amicus Curiae complies with the word count limits in Pa. R.A.P. 2135(a) applicable to the principal brief of the deemed appellee. This Brief contains 4,204 words, excluding those portions of the Brief containing supplementary matter as authorized by Pa. R.A.P. 2135(b).

Date: October 8, 2015

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CERTIFICATE OF SERVICE

I, Jarad W. Handelman, Esquire, hereby certify that I caused a true and correct copy of the foregoing Brief for Amicus Curiae North American Securities Administrators Association, Inc. to be served upon the following persons through the Court's electronic filing system and via first class mail, postage prepaid:

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