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ROAD TO EXPUNGEMENT

Expungement relief for brokers is a creature of regulatory creation and, as such, regulatory changes to the process have naturally, but continually, emphasized the extraordinary nature of expungement relief and made it more difficult and expensive to obtain. Authors Howard Elisofon and Grant Cornehl discuss the modern history of expungement relief, intervention tactics by state regulators, and the struggle to maintain a balance between investor protection and the individual broker's right to fair treatment..... 1

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The Road to Expungement Grows Longer

By Howard R. Elisofon, Grant R. Cornehl*

Introduction

A good reputation is the most valuable asset for any firm or registered person in the securities industry. So what can a broker and his or her firm do when a customer damages their reputations with false accusations of wrongdoing?

Since the Central Registration Depository® ("CRD") system was first created in 1981, the Financial Industry Regulatory Authority ("FINRA") and its predecessor, the National Association of Securities Dealers ("NASD"),¹ have allowed member firms and associated registered persons to seek expungement of information concerning disputes with customers. But since 1999, the road to expungement has become much longer.

FINRA has introduced numerous procedural safeguards designed to protect the integrity of the CRD and ensure that legitimate dispute information significant to investors and securities regulators will not be expunged. Expungement is intended to be the exception, not the rule, and the expungement of information from the CRD has progressively become more difficult. This article provides an overview of that progression and the current requirements for the

expungement of customer dispute information.²

What is the CRD?

FINRA operates the CRD, which is an online registration and licensing system for the U.S. securities industry. The CRD contains information gathered from state and federal securities regulators and self-regulatory organizations such as FINRA and its member firms. The CRD provides information concerning member firms, as well as their associated persons, and includes administrative information, such as current registrations and employment history, as well as disclosure information concerning criminal and disciplinary history, civil litigation, and customer disputes.³

Recently, FINRA has sought to significantly expand the information available to the public through its BrokerCheck online system. The BrokerCheck database is derived from the information in the CRD and allows investors to research the professional backgrounds of current and former registered brokerage firms and associated persons.⁴ Among other things, FINRA has sought to require reporting of customer disputes on an associated person's Form U4, even where the associated person

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has not been named as a party to the dispute.⁵ FINRA Rule 8312, which became effective November 30, 2009, expands available information concerning regulatory actions taken against persons who are no longer in the securities industry.⁶

The CRD serves as a report card on the reputation of firms and industry professionals. FINRA encourages investors to consult BrokerCheck "when choosing whether to do business or continue to do business with a particular broker or brokerage firm."⁷ For this reason, member firms and associated persons have a strong interest in clearing their good names through the expungement of unwarranted customer dispute information from the CRD. On the other hand, FINRA has continually sought to balance this interest with the need to protect investors by ensuring the integrity of the information available through the CRD system.⁸

The Evolution of the Expungement Process
Judicial Confirmation Required

From the creation of the CRD system in 1981 until 1999, the NASD would expunge information from the CRD system on the basis of an arbitration award directing such relief.⁹ NASD took the position that "expungement of information from the CRD system

that is ordered by an arbitrator and contained in an award should be afforded the same treatment as a court-ordered expungement."¹⁰ In 1999, under pressure from securities regulators, the NASD agreed to a moratorium on the expungement of information in customer disputes, "unless the award has been confirmed by a court of competent jurisdiction."¹¹

Since 1999 FINRA has required members and associated persons to obtain court orders directing expungement or confirming an arbitration award containing an expungement directive.¹² This requirement was later made permanent and codified as NASD Rule 2130,¹³ and currently appears in FINRA Rule 2080, which states that "[m]embers or persons seeking to expunge information from the CRD system arising from disputes with customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief."¹⁴ Following the Rule 2080 procedures occasions further delay and adds an additional layer of costs for brokers and firms who seek expungement of customer dispute information.

Currently, a party who seeks a court order directing expungement or

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confirming an award that contains an expungement directive must notify FINRA and must name FINRA as an additional party unless FINRA waives that requirement.¹⁵ Upon receipt of a request for a waiver, FINRA staff will notify each of the states in which the individual is registered or is seeking registration that the individual is seeking expungement and has submitted a waiver request.¹⁶

Specific Arbitral Findings Required

Many customer disputes are resolved through settlement and respondents frequently seek the claimant's consent to expungement as part of the settlement.¹⁷ But some claimants and their counsel felt pressure to consent to a stipulated award containing an expungement directive in exchange for monetary compensation, even where they believed that the firm or the individual broker was culpable. As one attorney explained, "even if you and your client thought the guy was guilty as sin you would still do it, because you wouldn't get money unless you agreed to that."¹⁸

Some observers were concerned that arbitrators would routinely approve such stipulated awards on the basis of affidavits submitted by the parties without considering whether the request for expungement was justified.¹⁹ In 2004, the NASD warned that members and associated persons who "negotiate settlements with customers in return for exculpatory affidavits that the member or associated person knows or should know are false or misleading" would be "subject to disciplinary action," including possible criminal sanctions.²⁰

FINRA Rule 2080(b)(1), which took effect in 2004, was intended to curtail such settlement practices by presenting three legitimate grounds for expungement, any one of which would trigger relief: (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.²¹ FINRA would waive its right to be named as a party to an action seeking judicial confirmation if an expungement award was based on "an affirmative finding that the expungement meets one or more of the standards in the rule."²²

FINRA Rule 2080 does not expressly require the arbitrators to affirmatively find that one or more of the grounds for expungement have been met, and indeed contemplates situations in which expungement relief would be "based on judicial or arbitral findings other than those described" in the Rule.²³ However, from the outset, it was expected that a party seeking expungement would request such relief from the panel of arbitrators, who would then decide whether to direct expungement on the basis of one of the three standards set forth in the Rule.²⁴ The arbitrators were expected to state whether expungement was granted and the basis for the award.²⁵ Where the parties settled their dispute, expungement would require a stipulated award containing affirmative findings that expungement is based on one or more of the standards set forth in the Rule and setting forth "the basis on which the expungement relief was granted."²⁶

The arbitrators could require "the submission of documents or a brief evidentiary hearing to gather the information necessary to make such findings," but were not expressly required to do so.²⁷ "In such cases, FINRA expected that arbitrators would examine the amount paid and any other terms and conditions of the settlement that might raise concerns about the associated person's behavior before awarding expungement."²⁸

State Regulatory Intervention

In 2007, at least two state regulators became concerned that expungement was being routinely granted in the absence of affirmative findings that

such relief was warranted. These regulators included New York's then-newly elected Attorney General, Andrew Cuomo, and the Maryland Securities Commissioner, Melanie Lubin. Contrary to FINRA's expectation, it appeared that some arbitrators continued to rubber-stamp stipulated awards drafted by the parties that included expungement relief, without inquiring into the facts of the case or the terms of the settlement.²⁹ In such awards, the panel of arbitrators typically satisfied the letter of FINRA Rule 2080 by stating that one or more of the standards in the Rule had been met, without further explanation.³⁰

Starting in 2007, the New York Attorney General and the Maryland Securities Commissioner moved to intervene in a number of cases where individuals sought to confirm an award directing expungement of customer dispute information from their CRD records.³¹ In these cases, the New York Attorney General argued that the arbitrators failed to comply with FINRA Rule 2080 by failing to provide affirmative findings of fact to support the recommendation of expungement.³²

Required Hearing and Written Explanation for Award Required

The New York Attorney General's efforts to oppose confirmation were largely unsuccessful. Several courts recognized that "traditionally, there is no mandate that an arbitrator give any reason for an award,"³³ and concluded that "for judicial confirmation, there is no requirement for the arbitrator to make any of the specific findings listed in the Rule."³⁴ One court observed that nothing in FINRA Rule 2080 "tells the court what it must find or what the arbitrator must find for a court to confirm" an award directing expungement.³⁵ Nor is there any requirement in Rule 2080 that the arbitrators hold a hearing on the issue of expungement.³⁶ Only one court refused to confirm the awards presented to it, but even that court stated that it would confirm the awards

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if the panels provided "amended awards containing specific affirmative factual findings in each case justifying the expungement recommendations, along with the portions of the record on which those findings are based," to enable the court to review the award.³⁷

The New York Attorney General's intervention did, however, influence FINRA to change its procedures again. In a proposed rule change in October 2008, FINRA referenced several of the New York cases and proposed a new rule that would require a hearing on the record and a written explanation by the arbitrators of the reasons for expungement relief.³⁸

Effective January 26, 2009, FINRA instituted "new procedures for arbitrators to follow when considering requests for expungement relief under NASD Rule 2130," now FINRA Rule 2080.³⁹ The procedures were intended to "ensure that arbitrators have the opportunity to consider the facts that support or weigh against a decision to grant expungement," and "add transparency to the process."⁴⁰ These procedures have been codified in FINRA Rule 12805, which, among other things, requires the panel to hold a recorded hearing session on the issue of expungement and to indicate which of the three Rule 2080 grounds for expungement serve as the basis for the expungement order.⁴¹ Moreover, the arbitrators must "provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case."⁴²

Conclusion

For brokers and firms who seek to expunge customer dispute

information from the CRD, such relief has never been more difficult to obtain. The requirements for obtaining expungement of customer dispute information have significantly increased since 1999, with FINRA adding new procedural hurdles to "challenge expungement directives that might diminish or impair the integrity of the system and to ensure the maintenance of essential information for regulators and investors."⁴³

Expungement is still available, but at the cost of significant time and expense. At the same time, FINRA continues to recognize the competing "interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate."⁴⁴ Nevertheless, FINRA has made clear that expungement should be the exception, not the rule. FINRA believes that "the new procedures that arbitrators must follow when considering requests for expungement will add transparency and procedural safeguards designed to ensure that the extraordinary relief of expungement is granted only under appropriate circumstances."⁴⁵

To date there do not appear to have been any judicial decisions confirming or denying an expungement directive made pursuant to the latest FINRA directives. It remains to be seen whether the new FINRA Rule 12805, which took effect at the beginning of 2009, will achieve its goal of eliminating expungement as a routine feature of settlements in customer disputes and limiting expungement to cases where an arbitration panel has made the necessary examination

and determined that expungement is warranted by the facts. Parties who seek expungement should expect greater scrutiny of the basis for such relief from arbitration panels.

The new FINRA procedures should not be allowed to result in increased judicial scrutiny of awards granting expungement relief. Judicial review of arbitration awards should be limited to ensuring that the arbitrators complied with the procedural requirements of FINRA Rules 12805 and 2080, rather than a *de novo* review by the court whether the facts of the case justify expungement.

Attorneys who represent member firms and their associated persons should remember that "[j]udicial review of an arbitrator's award is extremely limited, and once an issue has been decided by an arbitrator, questions of law and fact are not within the power of the judiciary to review."⁴⁶ A judicial decision that refuses to confirm an award directing expungement on the grounds that it was not warranted by the facts of the case would in effect substitute the court's judgment for that of the arbitrators and would be "an impermissible modification of the award that affect[s] the substantive rights of the parties."⁴⁷

Finally, it remains to be seen whether the enhanced fact-finding procedures mandated by FINRA Rule 12805 will satisfy the concerns of state regulators such as the New York State Attorney General and the Maryland Securities Commissioner or whether they will seek to intervene in cases where the requirements of FINRA Rules 12805 and 2080 arguably have not been met.

Footnotes

1. FINRA was created in July 2007 through a consolidation of the National Association of Securities Dealers ("NASD") and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. See <http://www.finra.org/about/finra/> (site visited June 10, 2010).

2. Expungement of information arising out of industry disputes between member firms and their associated persons are governed by different procedures that are beyond the scope of this article. For more information about these procedures, see John Nachmann, "Expungement of Information from the Central Registration Depository in Intra-Industry Disputes," *The Neutral Corner*, Vol. 2 (FINRA 2010).

3. See NASD Notice to Members 04-16 (March 2004) at 212.

4. See <http://www.finra.org/Investors/Tools/Calculators/BrokerCheck/index.htm> (site vis-

ited June 9, 2010).

5. FINRA Regulatory Notice 08-20 (April 2008) at 2.

6. FINRA Regulatory Notice 09-66 (November 2009) at 2.

7. See <http://www.finra.org/Investors/Tools/Calculators/BrokerCheck/index.htm> (site visited June 9, 2010).

8. See Exchange Act Release No. 34-59771 (April 15, 2009), at 7 ("NASD Rule 2130 serves to enhance the integrity of information in the CRD system and to further ensure that investor protection is not compromised when arbitrators order expungement of information from a CRD record.");

9. See Exchange Act Release No. 34-47435 (March 4, 2003) at 4.

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10. NASD Notice to Members 99-09 (Feb. 1999) at 48.

11. *Id.* at 47.

12. *See id.* An exception to the judicial confirmation requirement continues to exist in industry disputes where the panel of arbitrators states that the reason for expungement is the defamatory nature of the information. *See* Exchange Act Release No. 34-58886 (Oct. 30, 2008), at 5 ("The proposed rule change would not affect FINRA's current practice of permitting expungement, without judicial intervention, of information from the CRD as directed by arbitrators in intra-industry arbitration awards that involve associated persons and member firms based on the defamatory nature of the information ordered expunged.")

13. *See* NASD Notice to Members 04-16 (March 2004) at 211.

14. FINRA Rule 2080(a).

15. *See* FINRA Rule 2080, NASD Notice to Members 04-16 (March 2004) at 214.

16. *See* NASD Notice to Members 04-16 (March 2004) at 214.

17. *See* Exchange Act Release No. 34-58886 (Oct. 30, 2008), at 4 ("it is more common for arbitrators to order expungement at the request of a party to facilitate the settlement of a dispute.")

18. *See* "NASD Names Itself a Party to Expungement Proceedings in New Rule," *Securities Week* (March 15, 2004), at 1; *see also* NASD Notice to Members 04-43 (June 2004) at 554 (describing "instances in which claimants and respondents appear to be settling customer claims for monetary compensation to the claimant in return (at least in part) for a customer affidavit that absolves one or more of the respondents of responsibility for any alleged wrongdoing.")

19. *See* "NASD Names Itself a Party to Expungement Proceedings in New Rule," *Securities Week* (March 15, 2004), at 1.

20. *See* NASD Notice to Members 04-43 (June 2004), at 555, 554.

21. FINRA Rule 2080(b)(1), *see also* Exchange Act Release No. 34-58886 (Oct. 30, 2008), at 3.

22. *See* FINRA Notice to Members 04-16 (March 2004) at 214.

23. *See* FINRA Rule 2080(b); *see also* Exchange Act Release No. 34-58886 (Oct. 30, 2008), at 3 ("If expungement relief is based on a judicial or arbitral finding other than those above, FINRA may also waive the requirement to be named as a party if it determines that the expungement relief and accompanying findings on which it is based are meritorious and that expungement would not have a material adverse effect on investor protection, the integrity of the CRD, or regulatory requirements.")

24. *See* FINRA Notice to Members 04-16 (March 2004) at 213.

25. *See id.*

26. *See id.* at 214.

27. *See id.*

28. Exchange Act Release No. 34-58886 (Oct. 30, 2008), at 4, *citing* NASD Notice to Members 04-43 (June 2004).

29. *See id.*

30. *See, e.g., Kay v. Abrans*, 19 Misc.3d 371, 372-73, 853 N.Y.S.2d 862, 863-64 (Sup. Ct. N.Y. County 2008); *Walker v. Counelly*, 21 Misc.3d 1123(A), 2008 WL 4754138, *3 (Sup. Ct. N.Y. County 2008); *BNY Inv. Ctr. Inc. v. Bacclus*, Index No. 0109678/2007, 2008 N.Y. Misc. LEXIS 7230, at **2 (Sup. Ct. N.Y. County June 13, 2008).

31. *See, e.g., Karsner v. Lothian*, 532 F.3d 876 (D.C. Cir. 2008); *Kay*, 19 Misc.3d at 372, 853 N.Y.S.2d at 863; *Walker*, 2008 WL 4754138, at *1. Most of these courts recognized the regulator's right to intervene. *See, e.g., Karsner*, 532 F.3d at 887 (reversing district court's denial of intervention as of right); *Johnson v. Summit Equities, Inc.*, Index No. 104034/07, 2007 N.Y. Misc. LEXIS 8087, at *11-14 (Sup. Ct. N.Y. County Nov. 15, 2007) (the only case to deny intervention, the court confirmed the award and denied the motion to intervene as moot. *See Kay*, 19 Misc.3d at 377, 853 N.Y.S.2d at 867).

32. *See, e.g., Walker*, 2008 WL 4754138, at *3; *BNY*, 2008 N.Y. Misc. LEXIS 7230, at **3. In *Karsner*, the Maryland Securities Commissioner argued that the expungement directive should not have been confirmed because the panel "recommended" expungement rather than directing expungement as literally required by FINRA Rule 2080(a). *See* 532 F.3d at 886.

33. *See Kay*, 19 Misc.3d at 376, 853 N.Y.S.2d at 866; *see also BNY*, 2008 N.Y. Misc. LEXIS 7230, at **4 ("It is well settled under both the federal and state [arbitration] statutes that the arbitrator is not obligated to explain the basis of the award.")

34. *Kay*, 19 Misc.3d at 376, 853 N.Y.S.2d at 866.

35. *See Kay*, 19 Misc.3d at 375, 853 N.Y.S.2d at 865.

36. *See Walker*, 2008 WL 4754138, at *6.

37. *See Johnson v. Summit Equities, Inc.*, 22 Misc.3d 631, 668, 864 N.Y.S.2d 873, 901 (Sup. Ct. N.Y. County 2008). The *Karsner* case was settled after remand as result of a consent order entered into by *Karsner* and the Maryland Securities Commissioner in December 2008. On December 11, 2008, the district court issued an order which vacated the order confirming the award of expungement relief and dismissed *Karsner's* petition to confirm the award granting expungement of his CRD record. *See Securities Arbitration Alert, SAC Ref. No. 2009-13-01*.

38. *See* Exchange Act Release No. 34-58886 (Oct. 20, 2008), at 4-5.

39. FINRA Regulatory Notice 08-79 (Dec. 2008) at 1.

40. *Id.* at 2.

41. *See* FINRA Rule 12805.

42. *See id.*

43. *See* Exchange Act Release No. 34-47435 (March 4, 2003) at 4.

44. *Id.*

45. *See* Exchange Act Release No. 34-59771 (Apr. 15, 2009), at 7.

46. *Goldstein v. Preisler*, 24 A.D.3d 441, 442, 805 N.Y.S.2d 647, 649 (2d Dep't 2005).

47. *See id.* (holding that trial court erred in denying confirmation of portion of stipulated award that recommended expungement).

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