Public Investors Arbitration Bar Association

May 16, 2008

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2008-010
Proposed FINRA Customer Code Rule 12805
New Expungement Procedures

Dear Ms. Morris:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") to comment on the above-referenced rule change concerning expungement proceedings before FINRA arbitration panels.[1] PIABA strongly supports this rule change as a step in the right direction. However, we encourage FINRA and the SEC to continue to work toward restoring the integrity of the Central Registration Depository ("CRD") system.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules which govern the arbitration process. PIABA members are regular users of the CRD system and believe that all public investors should have free and unfettered access to information about their brokers.

The CRD System

PIABA is deeply concerned about the lack of integrity of the CRD system. The CRD system forms the underpinning of FINRA's Broker Check system. As such, it is used by public investors who desire to obtain information about their broker, or about a broker to whom they are considering entrusting their life's savings. Self-regulatory organizations and state regulators utilize the system in carrying out their regulatory functions, and the CRD system is jointly owned by FINRA and the North American Securities Administrators Association

[1] The FINRA filing also proposed Rule 13805 for the Industry Code; as an advocate for the public investor, PIABA is primarily concerned with proposed Rule 12805 for the Customer Code.

("NASAA"). The accuracy and integrity of the system are of utmost importance to the public.

Unfortunately, the CRD system falls far short of the accuracy which its users have a right to expect. A number of factors have contributed to this. One problem has been the "loophole" which permits non-reporting of claims against brokers who are not named as parties in the caption of a court action or arbitration proceeding. FINRA has recently taken steps toward closing that loophole, which will be the subject of another comment letter. Another problem has been, quite simply, failure to report. We note with approval that FINRA has increased its disciplinary filings against firms and brokers that refuse or neglect to make timely reports to the CRD.

A third factor which has undermined the CRD system's integrity has been the proliferation of expungements procured as a condition of settlement of customer claims. As detailed below, it became commonplace for brokers to demand that a public investor stipulate to an arbitral award of expungement as a condition to payment of a monetary settlement, and arbitration panels routinely signed these stipulated awards. Thus, users of the CRD system could have no faith in the accuracy and integrity of the system. It is this problem which the proposed rule seeks to address.

Expungement Procedures

Virtually everyone agrees that expungement should be an extraordinary remedy to be invoked only in extreme cases. Both the regulators and the public are entitled to know a broker's record. For this reason, it is important that expungement requests be subjected to considerable scrutiny. The record should not be wiped clean simply because a case has settled, or even because a case was eventually found to be without merit.

PIABA has been advocating for better expungement procedures for many years.[2] Prior to 2004, there were no rules providing guidance to arbitrators as to when expungement of a broker's record might be appropriate. As a result, arbitrators' decisions concerning expungement were often inconsistent and arbitrary. Moreover, it had become commonplace for industry respondents in FINRA arbitrations to demand, as a condition of a monetary settlement, that the

[2] *See*, e.g., Letter of Phillip M. Aidikoff, President of PIABA, to Barbara Sweeney, NASDR, dated December 26, 2001 ("Aidikoff Letter"); Letter of Charles W. Austin, Jr., Executive Vice President of PIABA, to Margaret H. McFarland, SEC, dated March 28, 2003 ("Austin Letter"). PIABA's comment letters are accessible through www.piaba.org.

investor claimant stipulate to an award of expungement. PIABA was on record as stating that this was the most "pernicious and insidious aspect of the expungement system."[3]

In response, the NASD promulgated Rule 2130 of the NASD Conduct Rules, which was intended to halt the practice of routinely granting expungements by stipulated awards in connection with settlements of valid claims. Pursuant to the Rule, an expungement could only be granted upon an affirmative arbitral or judicial finding that:

1. The claim, allegation or information is factually impossible or clearly erroneous;

2. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or

3. The claim, allegation, or information is false.

A premise behind this rule was that the requirement of these findings would minimize the incidence of stipulated expungements. While expressing doubt that the rule change would accomplish all it was supposed to, PIABA supported the rule as an improvement upon the system which then existed.[4]

Unfortunately, PIABA's concerns were well founded. While there was a decrease in the number of stipulated expungements, industry respondents continued to find ways to convince some public investors to stipulate to the predicate facts in connection with settlements. In many cases, respondents paid significant monies to settle a matter where the settlement included a stipulated award reciting that the claim was "factually impossible," or "false."

To compound the problem, arbitration panels generally signed the stipulated expungement award without taking any demonstrated steps to satisfy themselves that the case before them was in fact without merit.

PIABA undertook a study of all of the NASD customer-member arbitration awards issued during the calendar year 2006.[5] We learned that 71% of

[3] Austin Letter, *supra* note 2, p. 1.

[4] *Id*.

[5] *See* PIABA Press Release of September 24, 2007, at www.piaba.org.

the stipulated awards submitted to NASD panels that year requested expungement of the complaint from a broker's CRD record. Even more disturbing was the fact that 98% of the expungement requests by stipulation or settlement were granted by the NASD panels. In calendar year 2006 alone, one broker had eighteen (18) separate customer complaints expunged from his record by 18 separate NASD panels. In essence, a broker who paid 18 customers to settle their claims ended up with a clean record.

What was especially disturbing about this trend was that, in nearly all of the cases, the panels apparently accepted the parties' stipulation without performing any investigation into whether the cases were meritorious, or whether money had even been paid in connection with the dismissal of the claims. Regulators and investors were being denied the ability to get a true picture of a broker's record; yet there was no indication anyone had vetted the stipulations to make sure they had some relation to the truth.

The Proposed Rule

The rule proposal fills a void in the Code of Arbitration Procedure and addresses many of the problems with the current expungement system.

- The rule requires a recorded hearing regarding whether expungement is appropriate. It is no longer enough that the parties agree to expungement, or that the parties recite a predicate fact such as "the claim is false."

- The panel is to review settlement documents to determine whether monetary compensation was given. While we agree this is a step in the right direction, we also believe that the payment of a settlement in an amount which exceeds the $10,000 reporting threshold on Forms U-4 and U-5 should at least raise a presumption that expungement is not appropriate.[6] Further, PIABA believes there should be an express presumption in all cases that claims should not be expunged on the CRD record unless the person seeking expungement is able to overcome the presumption by a preponderance of the evidence.

- The rule requires the panel to explain in writing why expungement should be granted. This will provide a reviewing

[6] We note that FINRA has proposed an increase in this minimum reporting requirement to $15,000. *See* FINRA Regulatory Notice 08-20.

court, as well as interested regulators, with information upon which to base their decisions.

- The costs for a hearing seeking expungement must be charged against the party seeking expungement. This is only fair, as there is no reason to saddle an investor claimant with this expense.

It is of critical importance that the arbitration panels have clear guidance when considering expungement requests. Between proposed Rule 12805 and Conduct Rule 2310, the panels will be in a much better position, substantively and procedurally, to strike the appropriate balance between the broker's right to be free of frivolous claims and the public's right to know. This is a major improvement over the existing system, and PIABA supports the rule change.

PIABA Proposal – Regulators, Not Arbitrators, Should Perform This Function

In essence, the CRD system is owned by the self-regulatory organizations and by the state regulators. While we believe the public must have full disclosure of a broker's record, it may well be argued that the regulators have the greatest interest in the integrity of the system and the accuracy of the information reflected in the CRD. We therefore encourage FINRA, the SEC, and NASAA to explore ways of taking expungement decisions out of the hands of arbitrators altogether.

FINRA arbitration is, at root, a private dispute resolution mechanism. The purpose of FINRA customer arbitrations is to resolve disputes between investors and the members of the securities industry. This purpose stands in stark contrast to the mission of the regulators. Regulators are tasked with upholding the rules governing the industry and with meting out discipline against those who violate the rules.

Given the contrasting duties and missions of the arbitrator and the regulator, it makes little sense to entrust arbitrators with decisions which really should be made by regulators. This does not leave arbitrators completely out of the regulatory process, nor should it. At the beginning of every arbitration hearing, the panel chairperson advises that parties that the panel is entitled to make a disciplinary referral to FINRA if the panel determines that a statute or rule has been violated. FINRA takes such referrals seriously and commences its own investigation and proceedings to determine whether disciplinary action is appropriate.

Panels should have the same referral abilities with regard to expungements – but they should not be the final decision-makers. In a contested hearing, panels could recommend that FINRA consider expungement if the panel found that one of the Rule 2310 grounds was satisfied. In the case of a settlement, the panel could hold a hearing as contemplated by Rule 12805 to determine whether the factual predicates for such a referral could be made.

To implement this approach, PIABA proposes the formation of a regulatory tribunal which would make the final recommendation regarding expungement. We understand that this proposal would require additional work on the part of the regulators involved. It may be that NASAA, as an owner of the CRD system, would be interested in operating such a tribunal. Alternatively, the function may fall to FINRA. Currently, the self-regulatory organizations and state regulators have delegated this important regulatory task to arbitrators who have no regulatory training, experience, or inclination. The experiment has failed. The result, sadly, has been a CRD system which is completely untrustworthy. We encourage FINRA, the SEC, and NASAA to consider a structure which will shift this regulatory function to the regulators, where it belongs.

Conclusion

PIABA supports the proposed rule as a vast improvement over the present state of affairs. Thank you once again for the opportunity to comment on this proposed rule.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

s/Laurence S. Schultz
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President, 2007-2008

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