

September 3, 2008

Florence Harmon
Deputy Secretary
U. S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. SR-FINRA-2008-010 – Proposed Rule Change to Adopt Rule 12805 of the Code of Arbitration Procedure for Customer Disputes and Rule 13805 of the Code of Arbitration Procedure for Industry Disputes to Establish New Procedures for Arbitrators to Follow When Considering Requests for Expungement Relief; Response to Comments

Dear Ms. Harmon:

At the request of Securities and Exchange Commission (“SEC”) staff, the Financial Industry Regulatory Authority, Inc. (“FINRA”) is submitting this supplemental response to the comment letters received by the SEC with respect to the above rule filing.¹ FINRA is responding to a comment letter received after the filing of FINRA’s initial response² and, in response to the staff’s request, is expanding portions of its initial letter. In this rule filing, FINRA is proposing to adopt Rule 12805 of the Code of Arbitration Procedure for Customer Disputes (“Customer Code”) and Rule 13805 of the Code of Arbitration Procedure for Industry Disputes (“Industry Code”) (collectively, the “Codes”) to establish new procedures that arbitrators must follow when considering requests for expungement relief under Rule 2130.³

The SEC received 12 letters.⁴ Six commenters support the proposal⁵ and five oppose it.⁶

¹ FINRA’s initial response to comments was submitted on June 11, 2008.

² See comment letter submitted by William A. Jacobson, Associate Clinical Professor, Director, Cornell Securities Law Clinic, Cornell Law School, dated June 17, 2008.

³ See Securities Exchange Act Rel. No. 57572 (March 27, 2008), 73 FR 18308 (April 3, 2008) (File No. SR-FINRA-2008-010, Notice of Filing of Proposed Rule Change to Establish New Procedures that Arbitrators Must Follow when Considering Expungement).

⁴ Comment letters were submitted by Seth E. Lipner, Professor of Law, Bernard M. Baruch College, CUNY, and Member Deutsch Lipner, dated April 8, 2008 (“Lipner letter”); Steven B. Caruso, Maddox Hargett Caruso, P.C., dated April 8, 2008 (“Caruso letter”); Jill Gross, Director, Pace University, Investor Rights Clinic, and Teresa Milano, dated April 15, 2008 (“Gross and Milano letter”); Raghavan Sathianathan, dated April 17, 2008 (“Sathianathan letter”); William A.

Four commenters assert that expungement decisions should only be made by regulators,⁷ and two commenters question whether arbitrators should be allowed to make expungement decisions.⁸ These comments fall within the purview of Rule 2130 (Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository ("CRD") System), which was approved by the SEC in December 2003.⁹ FINRA is not proposing to amend Rule 2130. Therefore, these comments are outside the scope of the rule filing. FINRA notes, however, that Rule 2130 requires a firm or associated person petitioning a court for expungement relief or seeking judicial confirmation of an arbitration award containing expungement relief to name FINRA as a

Jacobson, Associate Clinical Professor, Director, Cornell Securities Law Clinic, Cornell Law School and Arthur A. Andersen III, dated April 23, 2008 ("Jacobson and Andersen letter"); Barbara Black, Charles Hartsock Professor of Law, director of Corporate Law Center, University of Cincinnati dated April 24, 2008 ("Black letter"); Karen Tyler, President, North American Securities Administrators Association, North Dakota Securities Commissioner, dated April 24, 2008 ("NASAA letter"); Scott R. Shewan, Born, Pape Shewan, LLP, dated April 24, 2008 ("Shewan letter"); Barry D. Estell, dated May 7, 2008 ("Estell letter"); Brian N. Smiley, Smiley Bishop Porter LLP, dated May 8, 2008 ("Smiley letter"); Laurence S. Schultz, President, Public Investors Arbitration Bar Association, dated May 16, 2008 ("PIABA letter"); and William A. Jacobson, Associate Clinical Professor, Director, Cornell Securities Law Clinic, Cornell Law School, dated June 17, 2008.

⁵ See Caruso, Gross and Milano, NASAA, Shewan, Smiley and PIABA letters. While NASAA supports the proposal, NASAA states that it does not go far enough. Smiley supports the proposal and notes that NASAA's letter makes valid points that should be adopted eventually. Shewan supports the proposal and suggests, as do other commenters that expungement be eliminated in its entirety, and/or that expungement decisions be made by regulators, not arbitrators. PIABA supports the proposal and makes suggestions that we address later in this response.

⁶ See Lipner, Sathianathan, Jacobson and Andersen (two letters submitted on behalf of Cornell Securities Law Clinic – one by Jacobson and Andersen and one by Jacobson), Black, and Estell letters.

⁷ See Lipner, Black, Shewan, and PIABA letters.

⁸ See the Jacobson and Andersen letter which contends that the rule proposal fails to suggest that arbitrators are qualified to determine the regulatory value of a CRD record, and the Caruso letter which expresses concerns about whether arbitrators should be entrusted with the authority to recommend expungement.

⁹ See Securities Exchange Act Rel. No. 48933 (December 16, 2003), 68 FR 74667 (December 24, 2003), (File No. SR-NASD 2002-168, 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).

party in the court proceeding and serve FINRA with all appropriate documents, unless FINRA waives this requirement. Therefore, FINRA is able to conduct a regulatory review of all such waiver requests and/or participate in the judicial expungement proceeding. Moreover, FINRA has established a process in conjunction with the implementation of Rule 2130 whereby it provides States with all such requests and petitions so that they also have an opportunity to review them and/or participate in the proceeding.¹⁰

Three commenters were concerned that FINRA does not require a firm to report on an associated person's Form U4 (Uniform Application for Securities Industry Registration or Transfer) that a customer has alleged a sales practice violation in an arbitration claim unless the associated person is named as a respondent.¹¹ While that issue also is outside the scope of this proposal, FINRA notes that, in April 2008, FINRA sought comment on proposed changes to Form U4 and Form U5 (Uniform Termination Notice for Securities Registration). One of the proposed changes would revise the customer complaint questions to elicit reporting of allegations of sales practice violations made in arbitrations or civil litigations against registered persons not named as parties in those proceedings.¹² The proposed revisions would require firms to treat these matters as customer complaints.

One commenter contends that the proposal may enable a party requesting expungement to use expungement findings against a customer in a subsequent proceeding for, among other matters, defamation or malicious prosecution, based on the doctrine of collateral estoppel.¹³ The commenter requests that the rule proposal be modified to ensure that expungement findings cannot be used collaterally outside the expungement process. In its initial response to comments, FINRA stated that it does not believe that it is appropriate to revise the proposal in this manner.¹⁴ The commenter submitted a subsequent letter reiterating his position.¹⁵ Having considered the

¹⁰ See *Notice to Members 04-16* (April 2004) (NASD Adopts Rule 2130 Regarding Expungement of Customer Dispute Information From The Central Registration Depository).

¹¹ See Lipner, Shewan and Estell letters. The Shewan letter notes that FINRA has requested comments on a proposal to address this issue.

¹² See Regulatory Notice 08-20 (Proposed Changes to Forms U4 and U5). The comment period has ended, and FINRA expects to file these changes with the Commission shortly.

¹³ See Jacobson and Andersen letter.

¹⁴ FINRA stated that: (1) FINRA does not have the authority to dictate how parties may use an arbitral finding after the arbitration has concluded; (2) other forums, particularly state and federal courts, are not bound to accept FINRA's determination with respect to the collateral use of arbitral findings even if it made recommendations in this area; and (3) expungement findings should be treated in the same manner as any other arbitral findings.

¹⁵ See comment letter submitted by William A. Jacobson, Associate Clinical Professor, Director, Cornell Securities Law Clinic, Cornell Law School, dated June 17, 2008.

commenter's concerns, FINRA continues to believe that it would be inappropriate to prohibit the collateral use of expungement findings. In addition to the reasons stated in our prior response, FINRA believes that associated persons should not be prohibited from initiating such actions in appropriate circumstances. In addition, FINRA is concerned that modifying the proposal to prohibit collateral use of expungement findings could result in associated persons who are respondents asserting counterclaims against customers to preserve their ability to have these claims resolved. In response to the commenter's concern that customers who settle may subsequently be subject to such actions, FINRA believes that the high evidentiary standard applied in such cases and the fact that most customers are represented by counsel are sufficient safeguards against such possible abuse. For these reasons, FINRA declines to amend the proposal to prohibit collateral use of expungement findings.

One commenter asserts that the proposal does not guide arbitrators on how to apply Rule 2130.¹⁶ The commenter states that further guidance and arbitrator training on the substance of the rule are crucial. As noted above, FINRA is not proposing amendments to Rule 2130. Accordingly, this comment is outside the scope of the rule filing. To the extent the commenter is stating that guidance to arbitrators should accompany the proposed procedural rules, FINRA intends to: (1) enhance its online arbitrator expungement training program;¹⁷ (2) publish an article in *The Neutral Corner* explaining the new rule;¹⁸ and (3) conduct a call-in workshop for arbitrators and mediators to allow FINRA neutrals to ask questions about the new rules.¹⁹

Two commenters express a concern regarding the use of expungement as a condition of settlement of customer disputes.²⁰ FINRA has expressly stated that

¹⁶ See NASAA letter.

¹⁷ This mandatory, online course provides an overview of the expungement process. Specifically, the course explains the role of the CRD system, gives an in-depth review of Rule 2130, and discusses the specific findings arbitrators must make in order for FINRA to waive its right to oppose the expungement request in court. There is an examination at the conclusion of the course, and a grade of 80 percent or greater is required to successfully pass the course. Arbitrators who have taken the course would not be required to repeat it if the proposed rule change is approved.

¹⁸ *The Neutral Corner* is a newsletter designed to provide FINRA arbitrators and mediators with current updates on important rules and procedures within securities dispute resolution. *The Neutral Corner* is provided to FINRA neutrals at no cost and is also available on FINRA's website.

¹⁹ FINRA provides periodic call-in workshops to its arbitrators and mediators relating to dispute resolution subjects and makes the workshops available to the public on its website.

²⁰ See Jacobson and Anderson and PIABA letters.

expungement should be an extraordinary remedy²¹ and has addressed the use of customer affidavits in settlements leading to stipulated awards.²² The rule proposal is an additional step in FINRA's continuing effort to ensure that arbitrators evaluate fully each request for expungement. Specifically, the proposed rule would require arbitrators to review settlement documents and consider the amount of payments made to any party as well as any other terms and conditions of the settlement. At the conclusion of this review, the arbitrators would be required to provide a written explanation of the reasons for finding that one or more of the grounds for expungement apply to the facts of the case.

Two commenters advocate requiring arbitrators to apply a presumption against expungement to the evidence presented at the hearing.²³ One of these commenters contends that the payment of a settlement exceeding the \$10,000 reporting threshold on Forms U4 and U5 should raise a presumption that expungement is not appropriate.²⁴ FINRA is not proposing to amend the evidentiary standards in the Codes; therefore, these comments are outside the scope of the rule filing. Nonetheless, the rule proposal sets forth procedures that FINRA believes will require arbitrators to evaluate fully whether the party requesting expungement has met the criteria promulgated under Rule 2130, and requires the arbitrators to set forth a written explanation of why they are ordering expungement. Therefore, FINRA declines to amend the proposal as requested.

One commenter raised issues about arbitrators exceeding their authority when considering requests for expungement.²⁵ As noted, FINRA will revise its arbitrator training to include guidance on the proposed rule change.

²¹ See, e.g., *Notice to Members 01-65* (October 2001) (NASD Seeks Comment On Proposed Rules And Policies Relating To Expungement Of Information From The Central Registration Depository).

²² See *Notice to Members 04-43* (June 2004) (Members' Use of Affidavits in Connection with Stipulated Awards and Settlements to Obtain Expungement of Customer Dispute Information under Rule 2130).

²³ See NASAA and PIABA letters.

²⁴ See PIABA letter.

²⁵ See NASAA letter.

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In conclusion, FINRA believes that the proposed rule change adds procedural safeguards that serve to ensure that expungement awards are granted only under appropriate circumstances. The proposal is consistent with FINRA's investor protection mission, and should be approved. If you have any questions, please contact me, by telephone at (212) 858-4481 or email at margo.hassan@finra.org, or Jean Feeney, Vice President and Chief Counsel, by telephone at (202) 728-6959 or email at jean.feeney@finra.org.

Very truly yours,

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Counsel