Cornell University
Cornell Law School

William A. Jacobson, Esq.
Associate Clinical Professor
Director, Securities Law Clinic
G57 Myron Taylor Hall
Ithaca, New York 14853
t. 607.254.8270
f. 607.255.3269
waj24@cornell.edu

April 23, 2008

Via Electronic Filing

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

RE: SR-FINRA-2008-010
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

Dear Ms. Morris:

Thank you for the opportunity to comment on the Rule Proposal of the Financial Industry Regulatory Authority ("FINRA") to enact Rule 12805 of the Customer Code and Rule 13805 of the Industry Code Relating to Amendments to the Codes of Arbitration Procedure to Establish New Procedures for Arbitrators to Follow When Considering Requests for Expungement Relief (the "Proposed Rule"). The Cornell Securities Law Clinic (the "Clinic") is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, see http://securities.lawschool.cornell.edu.

The Proposed Rule would require arbitrators to (i) hold recorded hearing sessions regarding the appropriateness of expunging from the Central Registration Depository (the "CRD") a record about the party seeking expungement (the "Requesting Party"), (ii) review any settlement relating to the expunged record, (iii) indicate which of the Rule 2130 substantive grounds for expungement justifies the order and provide a brief written explanation, and (iv) assess forum fees for hearing sessions solely regarding expungement against the Requesting Party. While the Clinic recognizes that the Proposed Rule might deter certain instances of expungement, the Clinic opposes the Proposed Rule as drafted for the following reasons:

First, the Proposed Rule may have the unintended consequence of enabling the Requesting Party to use expungement findings against the customer in subsequent proceedings based on the doctrine of collateral estoppel. The Clinic vigorously opposes the Proposed Rule unless the SEC ensures that the expungement findings cannot be used collaterally outside the expungement process itself. Second, expungement permanently deletes from the CRD information relevant to the regulatory function of the SEC, FINRA, and the states, and renders

the CRD an unreliable and incomplete source of information. The concept of expungement is based on the anachronistic view that the CRD is the sole database containing the information which the Requesting Party seeks to delete. In reality, both the arbitration award granting expungement and the court order confirming expungement will be available in public databases, leaving only the regulators who rely upon the CRD in the dark as to the allegations giving rise to the dispute. Third, the Proposed Rule inadequately attempts to remedy flawed, overly broad substantive standards by attaching procedural safeguards.

A. The Clinic Supports FINRA's Goal of Reducing Expungement Abuses

FINRA correctly believes that the current expungement system requires an overhaul, but the Proposed Rule is a grossly inadequate solution. When FINRA[1] initially began allowing expungement, it considered expungement "an extraordinary remedy . . . that clearly is not appropriate in all circumstances." NASD Notice to Member 01-65. Yet, FINRA has become concerned that firms offer settlements on condition that customers agree to expungement of complaints.[2] The *New York Times* conducted a study of BrokerCheck, FINRA's free service that allows investors to examine certain broker records, and found that many complaints against brokers had been erased pursuant to settlements.[3] The Public Investors Arbitration Bar Association (PIABA) also expressed concern after finding that FINRA allowed records to be expunged in over 98% of arbitration awards during 2006 in which the broker requested the claim be removed from that broker's record in exchange for private settlement. PIABA also found that over 71% of such awards were not based on analysis by the arbitrators.[4] Thus, while expungement may have started as an "extraordinary remedy," it has now become quite ordinary.

Despite these problems, the Proposed Rule does not change the existing substantive grounds upon which arbitrators may grant expungement. Rule 2130 allows expungement where arbitrators find 1) that a claim or allegation is factually impossible or clearly erroneous, 2) that the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds, or 3) that the claim, allegation or information is false. FINRA contends that the procedures of the Proposed Rule will ensure that expungement only occurs within the grounds of Rule 2130.

The Clinic believes that the Proposed Rule's procedures would deter certain overuses of expungement, particularly in settlements. Allowing the parties to agree to expunge a record clearly does not satisfy FINRA's regulatory goals because "the investing public and regulators have interests in maintaining customer dispute information within the CRD system that may not be considered when two private parties agree to settle . . . and to expunge information relating to

---

[1] To avoid confusion, this Comment Letter refers to both FINRA and NASD as "FINRA."
[2] Dan Jamieson, FINRA Pushes Expungement Rule, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20071214/REG/71214013/-1/rss02&rssfeed=rss02.
[3] Lynnley Browning, Site That Tracks Brokers Questioned on Erased Cases, N.Y. Times, http://www.nytimes.com/2007/12/14/business/14regulate.html?_r=1&dlbk&oref=slogin.
[4] New York Times Exposes Deficiencies in FINRA's BrokerCheck Report, http://investorswatchdog.com/blog/investorswatchblog/?p=58.

that suit or arbitration claim from the CRD system." NASD Notice to Members 01-65. Requiring arbitrators to hold hearings regarding the appropriateness of expungement, indicate which Rule 2130 ground justifies the order, and include a written explanation, should decrease the frequency with which arbitrators award expungement without considering the merits of the claim. Factual findings regarding the grounds for expungement may reveal inconsistent stipulations in settlement agreements where arbitrators might otherwise "order expungement at the request of a party to facilitate settlement" or where the terms of a settlement might "require the customer to consent to (or not oppose) the entry of a stipulated award containing an order of expungement." Rule Proposal at 9. Furthermore, the complex procedures and the requirement that the requesting party pay all fees related to the expungement hearing might deter Requesting Parties from seeking expungement in all but the most meritorious cases.

While ignoring expungement's fundamental problems, the deterrence benefit of the Proposed Rule does serve FINRA's regulatory goals. Keeping as many records as possible in the CRD enables regulators to monitor violations and benefits investors. Since FINRA itself specified that expungement "should be used only when the expunged information has no meaningful *regulatory* or *investor protection* value,"[5] any limitations on expunging records with regulatory value should be encouraged.

B. Nonetheless, the Clinic Opposes the Proposed Rule As Drafted Because of Possible Unintended Negative Consequences for Investors

Despite some positive benefits, the Proposed Rule may cause a significant unintended negative consequence for investors. The written findings required by the Proposed Rule may bind customers to future liability to Requesting Parties under causes of action such as defamation, malicious prosecution, or abuse of process, through the operation of the doctrine of collateral estoppel. Collateral estoppel prevents a party from re-litigating issues that were determined in a prior action. Under federal law, collateral estoppel applies when 1) the identical issue was raised in the previous proceeding, 2) the issue was actually litigated and decided in that proceeding, 3) the party had full and fair opportunity to litigate the issue, and 4) the resolution of that issue was necessary to support a valid judgment on the merits of that prior case.[6] Before the Proposed Rule, collateral estoppel could not operate in the expungement context because Requesting Parties could not prove the second element; without an express finding, Requesting Parties could not show that an issue was actually litigated and decided.

While FINRA certainly would not have intended this result, the Proposed Rule may allow each element of collateral estoppel to be satisfied as to the issue of the customer claim's validity. Provided that the Requesting Party seeks expungement, the Proposed Rule *requires* the issue to be raised. The Proposed Rule also *requires* that the issue be litigated and decided since there would now be a written finding on the issue. Moreover, at least the first and third substantive

---

[5] Rule 2130 Frequently Asked Questions, http://www.finra.org/RegulatorySystems/CRD/FilingGuidance/p005224.

[6] See Ball v. A.O. Smith Corp., 451 F.3d 66, 69 (2d Cir. 2006).

grounds of Rule 2130 *require* a determination of the merits of the claim because arbitrators must determine whether that claim is "clearly erroneous" or "false."

Customers also will have an opportunity to litigate, satisfying the third prong of collateral estoppel, even though the nature of expungement makes customers unlikely to actively do so. The value of preserving a record in the CRD accrues not to the individual customer but to the regulatory system as a whole via its long-term effect on investor protection. Investors in a given arbitration will, rationally, focus upon their own recoveries; assenting to an expungement request may *increase* a settlement because the Requesting Party may settle for a higher amount in exchange for expungement. In its discussion of the Proposed Rule, FINRA acknowledges that customers might even agree not to oppose an expungement request in exchange for a more favorable settlement; despite the possible negative consequences, the Proposed Rule does not prevent such agreements.

A Requesting Party might attempt to bring several claims that could rely upon the expungement findings that the allegations of the claim had no merit, such as actions for malicious prosecution or defamation. Establishing a *prima facie* case for malicious civil prosecution requires, among other elements, demonstrating that the claim was terminated favorably to the plaintiff and that there was no probable cause for the original proceedings.[7] The Proposed Rule's hearing and written findings, which might involve a determination that the public investor's claim was "false," arguably satisfies both elements. So long as the other elements of collateral estoppel are satisfied, the Requesting Party may attempt to use this determination offensively to prove liability under this cause of action. Alternatively, a Requesting Party may attempt to bring a defamation claim against the public investor based on the allegations contained in the case if such allegations were made to third parties and similarly use collateral estoppel to foreclose re-litigation of defamation's falsity element.[8]

These consequences could be so harmful to investors that the Clinic firmly opposes the Proposed Rule unless this problem is fixed. If the SEC decides to approve the Proposed Rule, the SEC should require FINRA to modify the Proposed Rule to ensure that the expungement finding cannot be used collaterally outside the expungement process itself.

C. More Importantly, the SEC Should Bar Expungement to Preserve the Regulatory Purpose of the CRD

The Clinic understands that FINRA may at this time seek only to add procedural safeguards to the existing expungement system. However, the Clinic contends that procedural limitations cannot remedy a system that is fundamentally flawed. Expungement of records from the CRD is inconsistent with the CRD's regulatory purpose. Moreover, Rule 2130's existing

---

[7] See Rothstein v. Carriere, 373 F.3d 275, 282 (2d Cir. 2004).

[8] A defamation suit might rely on the finding of falsity in proving a false statement was published with negligence or greater fault. See Peters v. Baldwin Union Free School. Dist., 320 F.3d 164, 169 (2d Cir. 2003).

substantive grounds have made this problem worse by enabling expungement in circumstances even FINRA did not intend.

a. Expungement Undermines Fundamental Regulatory Goals

The Clinic fundamentally opposes expungement from the CRD because expunging records undermines regulatory effectiveness and confuses the CRD's role as both a regulatory tool and a public disclosure device. Expungement undermines FINRA's statutory purpose and self-proclaimed regulatory goals—establishing policies and procedures "reasonably designed to ensure that information submitted to and maintained in the CRD system is *accurate* and *complete*." Rule Proposal at 7. Expunging *any* previously reportable information from the CRD makes those records per se *inaccurate* and *incomplete*, and is thus inappropriate.

The CRD was developed prior to the internet age and prior to the availability of alternative publicly available databases reflecting claims made in securities arbitration. As a regulatory tool, the CRD was a uniquely comprehensive database which enabled regulators to have the most complete source of information regarding customer dispute information, among other things. Putting aside whether expungement makes regulatory sense, at least expungement achieved its stated goal, namely the elimination from the public record of the disputed entry. In the modern internet age, however, expungement is an anachronism because the data expunged from the CRD is available elsewhere.

Expungement leads to the strange result that the public can obtain more complete records through the internet and independent investigation than regulators can obtain via the CRD.[9] Though the CRD initially served as a unique information repository, online sources now enable public access to customer complaint information—even claims that have been expunged from the CRD. For example, under the Proposed Rule, there will be an arbitration award describing in detail the nature of the allegations. This arbitration award will remain available in arbitration award databases maintained by FINRA, PIABA, the Securities Arbitration Commentator, and legal research databases such as Westlaw, even if the record of the claim is expunged from the CRD. Similarly, there will be a court order confirming the award, which also will be available in multiple databases. Thus, the public can read about claims that have been expunged from the CRD. At the same time, regulators—whose records should be equal or superior to public databases—must rely on the inferior and incomplete CRD. FINRA must recognize that the CRD is no longer the unique source of information it once was. If expungement leaves the CRD incomplete, inaccurate, and inferior to public databases, the CRD no longer serves its intended regulatory purpose.

---

[9] "Pat Huddleston, a former branch enforcement chief at the Securities and Exchange Commission[,] . . . . has compiled what he calls his "whitewash list" and charges investors $49 and up for reports that describe arbitration proceedings or settlements, gleaned from public records, that FINRA has expunged." New York Times Exposes Deficiencies in FINRA's BrokerCheck Report, http://investorswatchdog.com/blog/investorswatchblog/?p=58.

Expungement also allows *arbitrators*—rather than regulators—to determine which records have regulatory value. Arbitrators, who direct their attention to the matter at hand, determine whether a claim is "false" or "clearly erroneous" and, consequently, whether the record of that claim will remain in the CRD. Nothing in the Rule Proposal suggests that arbitrators are qualified to determine the regulatory value of a record. The expungement process thus allows non-regulators to make decisions that have enormous regulatory implications. The Proposed Rule's hearing requirement also fails to adequately address this problem. The hearing will likely be dominated by the Requesting Party, who would receive an immediate benefit from an affirmative expungement finding. The customer is unlikely to actively contest the expungement finding because it does not directly bear upon that customer's immediate award. In anything, the customer might agree to (or at least not contest) expungement at the request of the Requesting Party in exchange for a higher settlement amount.

Recent changes to record-keeping requirements magnify this problem. At FINRA's request, the SEC recently issued a No-Action Letter whereby the SEC Staff decided not to recommend enforcement against member firms that rely on the CRD to satisfy Rule 17a-4 record retention requirements. See FINRA, SEC No-Action Letter, 2008 WL 783528 (Feb. 19, 2008). Under current practice, there will be no electronic or physical record of expunged records, causing regulators to forever lose information regarding expunged claims; if firms need not retain records that are in the CRD and those records are later expunged, those records are lost entirely. How FINRA can continue to tout the CRD as an adequate repository for the "comprehensive . . . information collected" by regulatory filings—as it did in its No-Action request—when FINRA *itself* permits the integrity of those records to be undermined, is a mystery.

A far superior solution would leave *all* reportable information on the CRD and instead create guidelines regarding what information is publicly available through BrokerCheck. If a customer claim were resolved in favor of the Requesting Party, that resolution would be noted in the CRD, and thereby provide regulators with a complete record. Regulators could still access all information and, for example, spot trends indicating potential regulatory problems. The current system enables such claims to be removed, making proactive monitoring more difficult. The Clinic acknowledges the argument that Requesting Parties might have a reputational interest in preventing public access to "factually impossible" or "false" claims or allegations. Putting aside the validity of this argument, FINRA can adequately satisfy this claimed interest by establishing guidelines as to which records are reflected on the *public disclosure system.* Removing the records from the CRD serves only to undermine FINRA's regulatory mission.

b. Inadequate Substantive Grounds Are More Problematic Than a Lack of Procedural Safeguards

The current grounds for expungement make the aforementioned problem worse by not accurately reflecting regulators' original goals. If expungement is to be allowed, the Clinic firmly believes that revisiting these substantive standards would be far more effective than attaching procedural safeguards to flawed underlying standards.

The current standards have deviated from FINRA's original position as to the appropriateness of expungement. FINRA was concerned about overly broad use and considered "expungement of a CRD record under any circumstances . . . an extraordinary remedy and should be used only when the expunged information has no meaningful regulatory or investor protection value."[10] In particular, FINRA noted the likelihood of abuse "where parties have agreed to expunge customer dispute information as part of a settlement." NASD Notice to Members 01-65.

In response, FINRA proposed Rule 2130. The initially proposed grounds were narrow, recognizing that expungement should only be available in limited circumstances. Awards could only be based on: 1) the subject matter of the claim's or information's involving a case of factual impossibility or clear error; 2) the claim in question's being without legal merit; or 3) the information in the CRD's being determined to be defamatory in nature. See NASD Notice to Members 01-65. The SEC amended these categories, finding the first too vague and concluding that "factual impossibility or clearly erroneous" had a clearer meaning to regulators and public investors.[11] The SEC revamped the second to be consistent with Form U-4, and removed defamation from the third to avoid encouraging defamation counterclaims.[12]

The resulting standards were broader and even more unprincipled, and FINRA's "Frequently Asked Questions" do little to dispel this confusion. The first and third grounds are particularly problematic. For the first—the claim is factually impossible or clearly erroneous—the only guidance FINRA provides is that this would provide a basis for expunging a claim against someone not employed by or associated with the member firm.[13] Yet, "clearly erroneous" is broader than "factual impossibility;" a claim might not be strictly *impossible* yet still *clearly erroneous*. A claim might be "clearly erroneous" when its facts clearly fail to justify it. While this example and the one given by FINRA both arguably fall within the same grounds, only FINRA's example reflects expungement's original purpose; because it was factually impossible for the individual to have been involved, preserving the record in the CRD offers substantially less investor protection benefit. On the other hand, expunging a claim that was "clearly erroneous" only because of insufficient facts or legal basis might still serve a regulatory benefit by revealing a potential problem with the Requesting Party, even if the particular claim is not justified as a basis for civil monetary relief.

This same criticism applies even more strongly to Rule 2130's third ground—that the claim, allegation, or information is "false." Rule 2130 does not specify whether "false" means false law, false facts, or merely false conclusions thereon. FINRA's guidance simply suggests that this covers cases where the adjudicator assesses the evidence and makes an affirmative

---

[10] Rule 2130 Frequently Asked Questions, http://www.finra.org/RegulatorySystems/CRD/FilingGuidance/p005224.
[11] SEC Release No. 34-48933, 68 Fed. Reg. 74667.
[12] See id.
[13] See Rule 2130 Frequently Asked Questions, http://www.finra.org/RegulatorySystems/CRD/FilingGuidance/p005224.

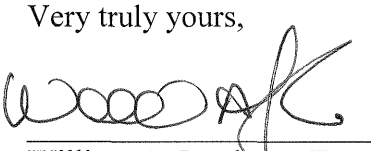
finding of falsity.[14] The example posed above could likewise fall within this exception, even though the mere fact that a customer brought a complaint might be of interest to regulators if the nature of the complaint forms a pattern when combined with other complaints about the registered representative, branch office, or firm. Thus, expunging a claim merely because arbitrators find it "false" is even more strongly at odds with FINRA's original intent that expungement be an "extraordinary" remedy that applies only when the expunged content has "no meaningful regulatory or investor protection value."[15]

Conclusion

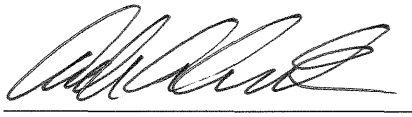
FINRA cannot effectively achieve its goal of protecting investors through accurate and complete records without reevaluating the existing expungement system. The Proposed Rule fails to do this and instead attempts to remedy underlying substantive problems with procedures that raise new issues for public investors. If the SEC is unwilling to revamp the expungement system and its substantive standards, the Clinic does believe that the Proposed Rule would deter certain misuses of expungement. Yet, the Clinic cannot support the Proposed Rule unless the SEC prevents the expungement finding from being used collaterally outside the expungement process itself.

Thank you again for the opportunity to comment on this rule proposal.

Very truly yours,



William A. Jacobson, Esq.
Associate Clinical Professor of Law
Director, Cornell Securities Law Clinic



Arthur A. Andersen III
Cornell Law School '08

[14] See id.
[15] See id.