

January 6, 2014

The Honorable Jack Reed
United States Senate
728 Hart Senate Office Building
Washington, DC 20510

The Honorable Charles E. Grassley
United States Senate
135 Hart Senate Office Building
Washington, DC 20510

Dear Senators Reed and Grassley:

Thank you for your December 16 letter regarding concerns raised in a recently published study by the Public Investors Arbitration Bar Association (PIABA) about the expungement of customer dispute information from the publicly-available records of brokers maintained by FINRA. In that study, PIABA expressed particular concern about the number of instances in which brokers were granted expungement in arbitration claims that were settled.

FINRA created the Central Registration Depository (CRD®)¹ and BrokerCheck and has consistently sought to maintain the accuracy and integrity of the information in those databases. FINRA has made its efforts to address arbitration expungement a priority from a regulatory and policy standpoint. While it is important to note that the number of arbitration-originated expungements of customer dispute information (850) is relatively small compared to the total number of arbitration proceedings (17,635) reported in CRD during the period covered by the PIABA study, any inappropriate reduction in the amount of broker disclosure to investors is of serious concern to FINRA.

Before addressing the specific points in your letter, we will provide some background information to help frame these important issues.

BrokerCheck

BrokerCheck is part of FINRA's ongoing effort to help investors make informed choices about the FINRA-registered brokers and brokerage firms with which they may conduct business. BrokerCheck also provides the public with access to information about formerly registered brokers who, although no longer in the securities industry in a registered capacity, may work in other investment-related industries or may seek to attain other positions of trust with potential investors. Through BrokerCheck and the

¹ The Central Registration Depository concept was collaboratively developed with the North American Securities Administrators Association (NASAA). A CRD Steering Committee, with representatives from NASAA, state securities regulators and FINRA, oversees FINRA's operation of the CRD system. The CRD system is the source of the information that is provided to the public through FINRA's BrokerCheck program.

Investment Adviser Public Disclosure (IAPD) system, operated by FINRA under contract with the Securities and Exchange Commission (SEC), and in collaboration with the North American Securities Administrators Association (NASAA) and state securities regulators, FINRA makes available to the public more comprehensive information on investment professionals than is available for doctors, lawyers, accountants and other professionals.

In the last five years, FINRA has dramatically expanded the scope of information available in BrokerCheck, starting with a requirement that broker records include complaints of sales practice violations involving the broker, even if he or she was not named as a party to the action. Broker records are now available in BrokerCheck for ten years after the brokers leave the industry (up from two years), and brokers who are the subject of disciplinary actions remain on BrokerCheck permanently. FINRA has also made BrokerCheck more accessible on its website, and has changed the “look and feel” of the database to be more investor-friendly.

The Expungement Framework

FINRA’s long-held position is that, while expungement of customer dispute information is an extraordinary measure, it is nevertheless appropriate in limited circumstances. In general, FINRA believes that expungement is appropriate in cases where there is a finding by an adjudicator that the information being expunged is false, clearly erroneous or otherwise has no meaningful investor protection or regulatory value. FINRA’s efforts in developing rules and policies in the expungement area are guided by these fundamental principles.

Rules 2080 and 12805

FINRA has consistently worked to ensure that expungement of customer dispute information occurs only after a neutral adjudicator (arbitrator or judge) concludes that expungement is appropriate. In 2004, following SEC approval, FINRA implemented Rule 2080 (formerly Rule 2130), which establishes procedures for seeking expungement of customer dispute information from CRD. Rule 2080 was developed in close consultation with representatives of NASAA and state regulators. The rule codified existing practice that all such expungement directives be ordered or confirmed by a court, and requires that members and associated persons seeking such a court order or confirmation name FINRA as a party. The rule allows FINRA to waive the obligation to be named as a party if expungement is based on an affirmative arbitral or judicial finding that the claim is false, factually impossible or clearly erroneous, or that the broker was not involved in the alleged violation.

Expungement can be recommended by an arbitration panel, or ordered by a court, depending on the forum in which the customer dispute was brought. FINRA lacks the authority to force state or federal courts to comply with Rule 2080, but it does have authority over securities brokers, and over the FINRA arbitration forum, and FINRA has implemented rules governing arbitrators’ consideration of expungement requests.

In situations where arbitrators consider expungement after hearing the merits of the dispute, they will have heard testimony, reviewed evidence, and considered arguments

by the parties. In contrast, in those cases that are settled before a merits hearing (the focus of the PIABA study), where the record is not developed, FINRA changed its rules in 2008 to require arbitrators to perform fact finding before considering expungement requests and to provide transparency to the expungement process. Specifically, FINRA adopted Rules 12805 and 13805 to require arbitrators to:

- hold a recorded hearing regarding the appropriateness of expungement;
- review settlement documents, and consider the amount of payments made to any party, and any other terms and conditions in cases involving settlements; and
- indicate in the award which of the grounds in Rule 2080 is the basis for their expungement recommendation and provide a brief written explanation of the reasons for recommending the expungement.

The PIABA Study

PIABA's principal finding was that arbitrators grant brokers' expungement requests over 90 percent of the time in cases resolved by settlement or stipulated award and the broker requests expungement as part of the settlement or stipulation. PIABA noted a significant increase in the number of expungement requests over the period of the study (January 1, 2007 to December 31, 2011), which it acknowledged was attributable, in large part, to the 2009 change to the uniform registration forms that required brokers to report allegations of wrongdoing made by customers in arbitration claims, even if the broker was not named as a party in the claim.

In such cases, investors may stipulate to the expungement request or declare that they are not opposed to such relief. In addition, the investor who brought the underlying claim rarely exercises his or her right to attend the required expungement hearing. We understand from attorneys who regularly represent investors that the terms of settlements often require an investor to consent to expungement relief or at least agree not to oppose expungement, meaning that the arbitrators may hear only one side of an expungement request—the broker's.

As discussed above, FINRA shares PIABA's concerns over expungement in cases involving settlements or stipulated awards. It is important to note, however, that these cases are a small part of the total number of arbitration cases reported through the CRD system.

During the five-year period covered by the PIABA study (and using the annual figures PIABA reports), customers initiated 17,635 arbitration cases against securities firms or brokers. Over that same five-year period, FINRA received and executed fewer than 850 court orders for expungement that confirmed arbitrator recommendations. This is due, in no small part, to FINRA Rules 2080 and 12805, the latter rule being in effect during the majority of the time period covered by the study.

Nevertheless, we remain extremely concerned over the inordinately high percentage of expungement relief granted by arbitrators in settled cases, and we have reviewed the PIABA recommendations carefully.

FINRA's Response to Expungement Requests/Recommendations

The manner in which FINRA addresses an expungement request depends on the type of case generating the request, and other facts unique to each request, but they generally fall into two categories. The first broad category involves those situations in which a neutral fact finder, usually an arbitrator, recommends expungement after a proceeding. The other situation involves cases that proceed directly to court where there has been no prior review of the facts and circumstances associated with the dispute or the specific request for expungement. Both categories are described in more detail below.

1. Requests Pursuant to a Waiver Under FINRA Rule 2080:

As discussed above, FINRA Rule 2080 requires that FINRA members and associated persons seeking a court order to obtain expungement or to confirm an arbitration award recommending expungement name FINRA as a party. Members and associated persons may request that FINRA waive that obligation. FINRA typically is asked to waive being named as a party to confirmations of arbitration awards. As described later in this letter, FINRA reviews the facts and circumstances underlying the waiver request, including the recommendation of the fact finder (usually an arbitrator), and information about the underlying claims and settlement (if applicable). FINRA also forwards this information to the states where the individual is registered. FINRA typically waives the requirement to be named in cases where FINRA determines that the arbitration award includes appropriate findings and meets the requirements of FINRA's rules. In cases where FINRA determines that the proposed expungement is not consistent with FINRA rules, FINRA denies the broker's request to waive naming FINRA, resulting in FINRA being named as a party to litigation seeking expungement, if the matter proceeds to court.

Between April 2004 (when FINRA Rule 2080 became effective) through December 23, 2013, FINRA denied requests for waivers in 57 cases affecting the records of 67 brokers. FINRA has attached Exhibit A which lists the cases in which FINRA denied requests for a waiver, including whether the matter was ultimately expunged. For those cases involving arbitration, we have also provided the arbitration awards, which contain detailed descriptions of each of these cases.

2. Expungement Matters Proceeding Directly to Court

Some brokers who have secured arbitration awards containing expungement relief elect not to seek a waiver, and instead proceed directly to court to confirm the award, naming FINRA as a party. In these cases, FINRA requests the same background information about the underlying arbitration claim, and determines whether, in cases where there is an award, the award meets the requirements of FINRA rules. If the award meets the requirements, FINRA advises the court that it does not oppose expungement, and will execute an expungement order if issued by the court.

In addition, brokers may seek to obtain expungement relief by suing FINRA directly (without first going to arbitration). FINRA treats these court-originated cases in the same manner: FINRA does not oppose expungement of customer dispute information brought in court if the proposed expungement order meets the requirements of FINRA rules. If

these cases result in court orders of expungement, FINRA executes these orders and expunges the customer dispute information.

If FINRA determines that the arbitration award or proposed court order is not consistent with FINRA rules, FINRA may oppose expungement in court. If the court nonetheless orders expungement, FINRA executes the order.

From April 2004 to the present, FINRA opposed expungement in approximately 35 court cases in which no advance waiver was sought, or where the broker submitted the waiver request, but proceeded to court before FINRA responded. FINRA has attached a list of these cases, and their results, in Exhibit B.

PIABA Recommendations

Below we will outline the five key recommendations presented by PIABA and describe the actions taken or planned by FINRA relative to each recommendation.

PIABA Recommendation # 1: FINRA should file a proposed rule change making it a violation of FINRA Rule 2010 for respondents, as part of settlement discussions, to negotiate for claimants to agree to not oppose expungement relief, to agree to expungement relief, or to withdraw their claims against associated persons. At a minimum, FINRA should issue a regulatory notice advising member firms and associated persons that bargaining for claimants to agree to expungement or to agree not to oppose expungement in settlement negotiations constitutes a violation of Rule 2010.

We are presently developing rule changes that would prohibit the practice of conditioning settlements on an investor's agreement not to oppose expungement. While the suggestion to include such conditions in exchange for additional settlement compensation does not always originate with the brokerage firm or broker, this practice may interfere with the arbitrators' ability to independently determine the appropriateness of expungement and make the requisite affirmative finding.

PIABA Recommendation # 2: FINRA needs to significantly improve the training arbitrators receive concerning requests for expungement relief. That training should include an emphasis on the critical importance of the integrity of the disclosure information on the CRD system.

Since the adoption of Rule 2080 in 2004, FINRA has required all arbitrators to take a training course on expungement, or be dropped from the arbitrator pool. Among other matters, the training materials remind arbitrators that "expungement of a CRD record under any circumstances is an extraordinary remedy and should be used only when the expunged information has no meaningful regulatory or investor protection value." FINRA updated the arbitrator training materials in 2008 to incorporate the additional requirements of Rules 12805 and 13805.

Recently, FINRA completely revamped arbitration expungement training; the revised training will be available on FINRA's website in February 2014. The training increases the

emphasis on the importance of CRD and BrokerCheck, and the arbitrator's critical role in maintaining the integrity of disclosure information contained on the system. The revamped training also addresses some of the suggestions made in PIABA's third recommendation below, about the materials arbitrators should review when considering expungement requests.

In addition to the mandatory training, FINRA staff periodically provides additional guidance to arbitrators about expungement. In the fourth quarter of 2013, we sent arbitrators a notice and published on our website guidance for parties and arbitrators concerning expungement requests. This guidance (attached as Exhibit C) is available on FINRA's website:

<http://www.finra.org/arbitrationandmediation/arbitration/specialprocedures/expungement/>.

The guidance emphasizes the extraordinary nature of expungement relief and advises arbitrators to consider the importance of the information in the CRD system to regulators, firms, and investors when considering requests for expungement. FINRA also created a companion online Neutral Workshop on expungement, which further emphasizes the revised expungement guidance. The audio file is available on FINRA's website at:

<http://www.finra.org/ArbitrationAndMediation/Arbitrators/CaseGuidanceResources/DisputeResolutionAudioFiles/index.htm>.

Finally, Volume 4-2013 of the *Neutral Corner*, a FINRA publication distributed to arbitrators and published on our website, focuses on the topic of expungement. A copy of the Neutral Corner article is attached as Exhibit D, and is available online at:

<http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtor/documents/arbmed/p410646.pdf>.

FINRA will monitor the effectiveness of the training and guidance on an ongoing basis and make any necessary additions or changes.

PIABA Recommendation # 3: *FINRA should also attempt to ensure that arbitrators make the necessary inquiry during expungement hearings, particularly those arising from settlements at which neither claimants nor their counsel appear. That required inquiry should include the following:*

- 1. Asking an associated person whether he or she has other customer complaints pending, and if so, the number;***
- 2. Examining the associated person's CRD;***
- 3. Inquiring of the associated person whether he or she is or has been the subject of any regulatory proceedings and if so, the outcome;***
- 4. Inquiring whether the associated person has previously requested expungement relief and if so, the number of times it was granted or denied; and***
- 5. Inquiring whether in the settlement with the claimant having the claimant agree to not oppose expungement, agree to expungement relief, or withdraw his or her claim against the associated person was bargained for or required.***

The guidance FINRA distributed to arbitrators earlier this year urges arbitrators to: (1) request any documentary or other evidence they believe is relevant to the expungement

request, particularly in cases that settle before an evidentiary hearing or in cases where only the requesting party participates in the expungement hearing, (2) to ask the broker requesting expungement to provide a current copy of the BrokerCheck report (which discloses other customer complaints, and regulatory proceedings, as suggested by PIABA) and, (3) in settled matters, to inquire whether the firm or broker conditioned settlement of the arbitration upon agreement by the investor not to oppose the broker's request for expungement, also as suggested by PIABA.² The guidance reminds arbitrators to identify in the award the specific documentary or other evidence that they relied upon when recommending expungement.

To assist arbitrators in fulfilling the practices identified in the expungement guidance, FINRA has revised the checklist used by arbitrators to report their findings to FINRA. That checklist, the Award Information Sheet, contains questions designed to ensure that arbitrators are aware of the best practices outlined in the new guidance. The Award Information Sheet (attached as Exhibit E) is available online at: <http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbion/documents/arbmed/p009465.pdf>. Early results indicate that arbitrators are following the guidance but as we monitor expungement awards going forward, we will consider adopting some of the best practices as requirements.

PIABA Recommendation # 4: FINRA needs to play a more active role in arbitrators' rulings on motions for expungement relief. A proposed rule change should include the requirement that the hearing on any motion for expungement relief be scheduled no sooner than 60 days after service of the motion on the customer and FINRA. Upon receipt of any motion for expungement relief and any settlement agreement, FINRA should provide those documents to the securities commissioner for the state in which the case was filed. The amended procedures should provide for FINRA and the designee of the state securities commissioner to have the right to appear at the hearing on the motion for expungement relief and to oppose expungement relief when such opposition is appropriate.

PIABA's recommendation is premised upon the participation of FINRA and state regulators in the expungement hearing conducted by the arbitrators, in advance of the arbitration award. Permitting non-parties to participate in private, contractual arbitration proceedings poses significant problems that make this recommendation impractical, and possibly threatens the ability of FINRA Dispute Resolution to operate a neutral arbitration forum. There are both federal and state arbitration statutes that impact the conduct of arbitration proceedings. Given the impracticality of allowing third parties to participate in expungement proceedings before the arbitrators, there is no need to adjust the scheduling of expungement hearings as suggested by PIABA.

FINRA notes that notwithstanding expungement relief contained in an arbitration award, no expungement is executed unless ordered by a court, where PIABA's recommendation has no impact. FINRA raises this point not to diminish the importance of PIABA's findings, but to illustrate that the expungement issue is broader than just arbitration, and

² FINRA Rules 12805 and 13805 already require arbitrators considering expungement requests to review settlement agreements, and consider amounts paid, and other terms and conditions of settlement.

that FINRA's response is multi-pronged. FINRA has an active and ongoing litigation program to oppose expungement in court cases where FINRA determines its rules would be violated, and where FINRA believes there is a meaningful chance of success that outweighs the negative impact if the case is lost. FINRA would like to provide two examples, one that FINRA lost, and the other that FINRA ultimately won.

Jason Schall v. FINRA (Civil Action No.: 2011-CP-40-8489, Court of Common Pleas for Richland County, South Carolina): This case arose from a settled arbitration case between a broker and his former firm, which was settled and included expungement relief for multiple customer complaints, arbitrations and lawsuits. Notwithstanding the findings made by the arbitrators in the award, FINRA vigorously opposed confirmation, on the ground that the arbitrators failed to comply with FINRA rules, and that they exceeded their authority in ordering expungement of customer complaints involving other employers who were not parties to the arbitration, and of a customer arbitration that at the time of the award was pending before a different arbitration panel. Following several rounds of briefing, and a lengthy court hearing, the court confirmed the arbitration award and ordered all of the complaints to be expunged. In confirming the arbitration award, the court applied the applicable law holding that arbitration awards cannot be overturned by courts except under very, very limited circumstances, even where the arbitrators may have been wrong.

Edwin "Mike" Lickiss v. FINRA (Superior Court for Contra Costa County, California, Case No. N11-0457): In this case, a broker sued FINRA to expunge 17 aged customer arbitration cases and settled complaints from his BrokerCheck record. FINRA litigated this case for over two years, through five state and federal courts, including the California Court of Appeals. In the course of this case, the Court of Appeals issued an opinion holding that courts have no obligation to follow FINRA expungement rules, and that they have inherent equitable authority to order expungement of customer dispute information. A copy of this opinion, which has been cited by other courts, is attached as Exhibit F. FINRA persisted, notwithstanding this opinion, and took the case to trial, where the court ultimately sided with FINRA and denied Lickiss' expungement request.

We are including these cases to illustrate the broad scope of expungement requests that FINRA receives, and the different legal standards that may apply in different cases. Arbitration awards are subject to a very limited judicial review under the Federal Arbitration Act and state arbitration statutes, and generally cannot be overturned unless there is evidence of bias or misconduct. FINRA rules apply to the firms and brokers it regulates, but they do not bind state or federal courts, which may apply a different standard to review expungement requests. FINRA will continue to oppose expungements in appropriate cases to protect the integrity of the CRD system and BrokerCheck and to establish and maintain precedents that support FINRA's legal arguments.

PIABA Recommendation # 5: *FINRA also needs to review and critically assess settlement agreements. In cases resolved by settlement, FINRA should require respondents to provide to FINRA the settlement agreement along with the motion for expungement relief. FINRA needs to review and critically assess all motions for expungement relief, particularly those made in cases resolved by settlement.*

FINRA reviews these materials after the award is issued, as part of its decision whether or not to waive being named in a confirmation proceeding. FINRA's website instructs parties seeking expungement to include all relevant materials, including settlement agreements if applicable, when submitting a waiver request. These instructions can be found at: <http://www.finra.org/industry/compliance/registration/crd/filingguidance/p005224>. If the broker submits a waiver request without these materials, FINRA notifies the broker that a decision on the waiver request will not be made without the materials. FINRA reviews all expungement requests and accompanying materials to determine if they comply with FINRA Rule 2080, and 12805 or 13805. In cases where the award fails to comply with the applicable rules, FINRA requires the broker to resolve any noncompliance before FINRA will agree to not oppose expungement.

Legislation

FINRA is currently engaged in a comprehensive review of its expungement rules and procedures, including the PIABA study and recommendations. This review includes engagement with NASAA, state regulators and other constituents. At this stage, FINRA does not believe a legislative solution is necessary. However, as we complete this review, and develop proposals to address the concerns regarding expungement in settled matters and other issues in this area, we will keep you and your staff informed and—if we find that legislation is needed—we will not hesitate to present this determination to you.

We appreciate the opportunity to provide you with information about FINRA's expungement policies, and look forward to working with you as we continue to make improvements to the expungement process and further enhance investor protections. I cannot emphasize enough how seriously FINRA views these issues and hope to meet with you both soon to continue this important discussion.

Sincerely,



Richard G. Ketchum
Chairman and CEO