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PROFESSIONAL MALPRACTICE

Brokers Must Work Harder To Keep Their Records Clean

NASD rule creates additional hurdles for expungement of customer dispute information

By Aaron Buser

A clean record and good reputation is desirable for most any professional, and stockbrokers are no exception. A clean record and good reputation make it more likely for brokers to maintain current customers, grow their business by gaining new customers and advance their professional careers. Undeniably, a clean record and good reputation also makes brokers more desirable to potential employers. Indeed, potential customers and employers may shy away from investment professionals who have a history of customer complaints, arbitration/litigation claims and disciplinary actions.

Accordingly, National Association of Securities Dealer (NASD) Rule 2130

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is of significant interest to brokerage firms, brokers and the investing public since it, in essence, makes the removal of customer complaints and arbitration/litigation actions from a broker's public record much more difficult, but not unattainable.

Broker 'Scouting Reports'

The NASD maintains a computerized record of the backgrounds, qualifications employment and complaint/disciplinary history of thousands of registered representatives (brokers) and brokerage firms. The arrangement is referred to as the Central Registration Depository (CRD). To borrow a sports analogy, the CRD System is very much like a "scouting report" of brokers.

The CRD system, which is operated by NASD's Regulatory Services and Operations Division, is an electronic registration and licensing system for the United States securities industry and its federal and state regulators and self-regulatory organizations (SROs). The NASD maintains and manages the CRD system jointly with the North American Securities Administrators Association (NASAA), which is an association of state and other securities regulators located throughout the country.

Notably, the CRD system contains

information listed on a broker's Uniform Application for Securities Industry Registration or Transfer (Form U-4) and Uniform Termination Notice for Securities Industry Registration (Form U-5) and a brokerage firm's Uniform Application for Broker-Dealer Registration (Form BD) and Uniform Request for Broker-Dealer Withdrawal (Form BDW). These forms not only necessitate the extensive disclosure of personal, employment and registration information, but also the disclosure of customer complaints, civil judicial actions, bankruptcies and criminal and regulatory investigations and violations. It is mandatory that brokers and brokerage firms keep their particular information accurate and up to date. For example, if a broker is formally named as a respondent in an arbitration proceeding commenced by a customer it must be reported on the broker's Form U-4. Accordingly, the complaint is then electronically recorded on the broker's CRD and becomes a matter of public record, which is available for the public to obtain and review.

Today, it is easier than ever for the investing public (and even potential employers) to obtain background information regarding a broker. This can be done by accessing the NASD "BrokerCheck" program located on the NASD's Web site, www.nasdr.com. As such, it is critical that brokers, brokerage firms and the investing public understand NASD Rule 2130 — the new rule relating to the expungement and removal of negative information from a broker's

permanent record.

Old School v. New School

Under the "old rule," court-ordered expungements were commonly acceptable and allowed. In addition, expungement orders from arbitrators that met certain conditions were also permissible.

On Jan. 19, 1999, the NASD issued NASD Notice to Members 99-09 (NTM 99-09), thereby imposing a moratorium on arbitrator-ordered expungements from the CRD system. Pursuant to NTM 99-09, the NASD would expunge information that was ordered by arbitrators in an award rendered in a dispute between a public customer and a firm or its associated broker only when a court of competent jurisdiction confirmed the award (Old Rule). See, NTM 99-09.

On Dec. 16, 2003, the Securities and Exchange Commission (SEC) approved new NASD Rule 2130 (New Rule) concerning the expungement of customer dispute information from the CRD. SEC 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, 68 Fed. Reg. 74667 (Dec. 24, 2003), Exchange Act Release No. 48933 (File No. SR-NASD-2000-168 (Dec. 16, 2003)), 68 Fed. Reg. 74667 (Dec. 24, 2003). The effective date of the New Rule was April 12, 2004 (i.e., any customer complaints and arbitration/litigation proceedings filed on or after April 12, 2004, would be subject to the New Rule).

On March 4, 2004, the NASD issued NASD Notice to Members 04-16 (NTM 04-16) regarding the adoption of the New Rule. The New Rule makes permanent the moratorium imposed by the Old Rule, requiring that a court must confirm any arbitration order before customer dispute information can be removed from the CRD system. Under the New Rule, "customer dispute information" includes customer complaints, arbitration claims, and court filings made by customers, and the arbitration

awards of court judgments that may result from those claims or filings. See, NTM 04-16. Customer dispute information generally contains allegations that a broker and/or brokerage firm has violated securities laws, rules or regulations. The New Rule does not apply to information concerning intra-industry disputes between firms and brokers with no customer party that typically has been reported on Form U-5 in response to the "Reason for Termination" question or the Internal Review or Termination Disclosure questions and associated disclosure reporting page(s).

In addition, the New Rule requires that a party seeking expungement relief in an arbitration proceeding must ask for such expungement in his prayer for relief. Subsequently, the arbitrators would have to make an affirmative arbitral finding that expungement relief was based upon one or more of the three standards designated in the New Rule. Specifically, the expungement relief must be based on an affirmative arbitral finding that:

- 1) the claim, allegation, or information is factually impossible or clearly erroneous;
- 2) the broker/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.

If parties decide to settle an arbitration, they can jointly ask the arbitration panel for a stipulated award and request that the panel make an affirmative finding and order expungement based upon one or more of the above-noted standards. Under the New Rule, the arbitrators may require the submission of additional documents or a brief evidentiary hearing to gather the information necessary to make such a finding.

Customer Affidavits

Parties to such settlements must be aware of the NASD's position regarding the use of affidavits in connection with stipulated awards and settlements to

obtain expungement of customer dispute information under the New Rule.

The NASD has commented in NASD Notice to Members 04-43 (NTM 04-43) that it is concerned about situations in which parties appear to be settling customer claims for monetary compensation to the complaining party in return (at least in part) for a customer affidavit that absolves a broker of responsibility for wrongdoing. See, NTM 04-43. Such affidavits, attested to in connection with settlements that often are incorporated into stipulated awards, appear to the NASD to be inconsistent on their face with initial claims and terms of settlements. The NASD has cautioned brokerage firms and brokers that the submission of such affidavits in which the content is the product of a bargained for consideration as opposed to the truth may result in a "panoply of application sanctions, including possible disciplinary action for violation of NASD Rules, including Rule 2110, and other penalties, including possible criminal sanctions." See, NTM 04-43. Indeed, the NASD has further cautioned that even individuals who are not subject to NASD jurisdiction who submit false affidavits also are subject to significant sanctions from the arbitration panel or court, law enforcement agencies, state bar associations or other attorney disciplinary bodies (in the case of attorneys). See, NTM 04-43. Accordingly, parties and their attorneys need to proceed with caution.

Further Scrutiny

The New Rule also requires that a party seeking a court order for expungement must name the NASD as an additional party and serve the NASD with all appropriate documents unless the NASD waives that requirement. To obtain the NASD's waiver, the party seeking expungement must send a waiver request, the arbitration award and any other relevant documents (such as the settlement agreement and any related affidavits) to the NASD. Brokers who are sued in court (rather than arbitration) will not be able to avail themselves of the New Rule's waiver provision, and will be obligated to name the NASD as a

party in all circumstances. Upon receipt of a request for waiver, the NASD will notify the states where the individual seeking expungement is registered (or seeking registration) of the expungement notice/waiver request. States may then choose to intervene if they have concerns regarding whether investor protection or regulatory issues will be fairly considered.

The NASD will then examine the situation and will waive the requirement to be named as a party if the NASD determines that the expungement relief is based upon an affirmative finding that the expungement meets one or more of

the above-referenced standards. See, NTM 04-16. The NASD will generally participate in the court confirmation proceeding and oppose confirmation of the expungement directive if the expungement order does not meet at least one of the above-specified standards.

In addition to the three above-noted standards, the NASD may also waive the requirement to name the NASD as a party (in its sole discretion and under extraordinary circumstances) if it determines that:

1) the expungement relief and accompanying findings on which it is

based are meritorious; and

2) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements. See, Rule 2130 and NTM 04-16.

The Bottom Line

Plainly, NASD Rule 2130 makes it more difficult for brokers to clear their records of customer dispute information. However, the hurdles can certainly be cleared and expungement is not impossible to obtain in this "Brave New World." ■