



The Long And Winding Road: FINRA Expungements And Proposed Rule 2081

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The Central Registration Depository

- ▶ **The CRD is the financial service professional's permanent record:**
 - **customer complaints;**
 - **arbitration claims;**
 - **court filings.**

Case History

- ▶ **Joe Broker named as Broker of Record**
- ▶ **Accused of suitability issues**
- ▶ **In reality not broker of record**
- ▶ **No involvement**
- ▶ **Firm settled for more than \$15,000**

U-4 Disclosure Requirements

Have you ever been named as a respondent/defendant in an *investment-related, consumer-initiated arbitration or civil litigation which alleged that you were involved in one or more sales practice violations* and which was settled, on or after May 18, 2009, for an amount of \$15,000 or more?

U-4 Disclosure Requirements

- ▶ The arbitration or civil litigation is reportable if all of the following six criteria are met:
 1. Consumer – initiated
 2. Investment – related
 3. Individual named as respondent/defendant (or alleged to have engaged in a sales practice violation)
 4. Alleged individual involvement in any sales practice violation
 5. Settled on or after May 18, 2009
 6. Settled for \$15,000 or more

Proposed Disclosure

“Upon extensive examination of the facts, it was determined that Mr. Broker was never the broker of record for the client thus the allegation is unfounded and he has no liability or culpability with regard to this case. Mr. Broker did not contribute to the consideration paid by the firm to settle the matter”

FINRA’S Expungement Framework

FINRA Rule 2080 (formerly NASD Rule 2130)

**FINRA has long described expungement as an
“extraordinary remedy”**

FINRA May Waive Participation

- ▶ The claim, allegation or information is factually impossible or clearly erroneous;
- ▶ The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or
- ▶ The claim, allegation or information is false.

The Recipe

- ▶ Settlement agreement
- ▶ No FINRA participation
- ▶ Federal Court would approve

All Good Things Must Come to an End

In 2008, FINRA adopted FINRA Rule 12805 to require arbitrators to perform additional fact finding before recommending expungement of customer dispute information from the CRD system.

The Adoption of FINRA Rule 12805

To expunge, arbitrators must:

- ▶ Review settlement documents;
- ▶ Review the amount of payments made to any party, and any other terms and conditions of the settlement;
- ▶ Indicate in the award which of the grounds in FINRA Rule 2080 serves as the basis for their expungement recommendation, and;
- ▶ Provide a brief written explanation of the reasons for recommending expungement.

FINRA Comments Suggesting Expanded Expungement Requirements

FINRA has also made various comments in proposals and notices stating that expungement relief can only be granted when the information being expunged *“has no meaningful investor protection or regulatory value.”*

Proposed FINRA Rule 2081

In 2013, FINRA sent to arbitrators and published on its website guidance stating that, in determining whether to recommend expungement relief in settled arbitration claims, arbitrators should inquire whether a party conditioned settlement on an agreement not to oppose a request for expungement relief.

Proposed FINRA Rule 2081

The proposed rule change would, for instance:

- ▶ *Preclude a firm or associated person from conditioning the settlement of a customer's claim on the customer's agreement to consent to, or not to oppose, the firm's or associated person's request for expungement;*
- ▶ *Would preclude a firm or associated person, following a settlement of the dispute at issue, from compensating the customer in return for the customer not opposing the firm's or associated person's expungement request.*

PIABA

“FINRA has taken steps in the past to discourage the practice of conditioning settlements on the customer's consenting to or not opposing expungement, this practice nonetheless persists and remains a threat to the transparency and integrity of the CRD.”

The Practical Effect of Rule 2081

- ▶ The Respondent/ Respondents intend to seek expungement relief;
- ▶ The Respondent/ Respondents has/have not paid any consideration in relation to the expungement request;
- ▶ The request for expungement was not a condition of the settlement agreement.

THE LONG AND WINDING ROAD: FINRA EXPUNGEMENTS AND PROPOSED RULE 2081¹

Introduction

Over the last few years, the chorus of voices demanding a change in the way FINRA handles expungements has grown louder. From Iowa Senator Charles Grassley² to the influential Public Investors Arbitration Bar Association (PIABA), concerns have been raised that it has been too easy for brokers and other financial services professionals to scrub customer complaints from FINRA's Central Registration Depository. Regardless of the fact that from 2007 through 2012 FINRA granted expungements in less than 5% of cases (838 out of 17,765 cases),³ FINRA, in 2014, has made a proposal to the Securities and Exchange Commission to adopt Rule 2081, which will make expungements more difficult to obtain.⁴ This presentation provides an overview of FINRA's approach to handling expungements and what the industry can expect if Rule 2081 is implemented.

The Central Registration Depository

Every financial services professional who is licensed to sell securities in this country has a "CRD" number.

1 By Jeffrey J. Hines, Esquire and George S. Mahaffey Jr., Esquire.

2 See <http://www.grassley.senate.gov/news/news-releases/grassley-reed-seeks-answers-expungement-investor-complaints>.

3 See <http://www.finra.org/Newsroom/NewsReleases/2013/P365846>.

4 See www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p485128.pdf

CRD stands for Central Registration Depository, which is a central licensing and registration database that contains the registration records of over 6,800 broker-dealers and 660,000 securities representatives. The CRD contains information about registered personnel, including customer complaints, arbitration claims, and court filings made by customers, and the arbitration awards or court judgment that may result from those claims or filings – what is commonly called “customer dispute information.”⁵

FINRA'S Expungement Framework

Brokers who wish to have customer dispute information removed from the CRD system must seek expungement – which FINRA has long described as an “extraordinary remedy” (see footnote 14, *infra*) – pursuant to FINRA Rule 2080 (formerly NASD Rule 2130).⁶ FINRA Rule 2080 provides that firms and associated persons seeking expungement of customer dispute information from the CRD system must name FINRA as a party and obtain a court order that either directs expungement or confirms an arbitration award containing expungement relief. Upon request, FINRA may waive the obligation to name it as a party if FINRA determines under Rule 2080 that the expungement relief is based on an affirmative judicial or arbitral

5 See Notice to Members (“NTM”) 04-16 (March 2004).

6 See Securities Exchange Act Release NO. 48933 (December 16, 2003), 68 FR 74667 (December 24, 2003), (Order Approving File No. SR-NASD-2002-168).

finding that one of three elements are present:

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

The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or
The claim, allegation or information is false.⁷

Interestingly, under the plain language of Rule 2080(a), the only requirement for expungement seems to be that the party seeking expungement “obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief.” This appears to be at odds with later guidance provided by FINRA, including in its “Expanded Expungement Guidance,”⁸ where FINRA emphasizes the need to find one of the three elements listed above. In actuality, Rule 2080 does not appear to require a finding of the three elements in order to grant expungement relief (the three elements only relate to the waiver requirement pertaining to FINRA),⁹ although FINRA continues to intimate that arbitrators must describe which of the three elements are present to support expungement.¹⁰

Problems Associated With FINRA Rule 2080

The above notwithstanding, FINRA has continued to express concern at the practice of firms and associated persons conditioning settlement agreements for the purpose of obtaining expungement relief. Essentially, FINRA takes issue with what it perceives as defense counsel “purchasing” expungements while settling cases. FINRA has taken certain steps over the years to address these concerns, including adopting NASD Rule 2130 in 2004 (FINRA was formerly known as the NASD, or the National Association of Securities Dealers) which stated that the Rule’s affirmative determination requirement imposed on arbitrators would reduce, if not eliminate, the risk of expunging information that is critical to investor protection and regulatory interests based on an agreement between the parties. FINRA also cautioned associated persons and firms that

⁷ See FINRA Rule 2080(b)(1)(A)-(C).

⁸ See Notice to Arbitrators and Parties on Expanded Expungement Guidance, available at <http://www.finra.org/arbitrationandmediation/arbitration/specialprocedures/expungement/>.

⁹ Courts have determined that Rule 2080 does not provide a substantive test that must be met in order to obtain expungement, rather, it is a procedural rule that “does not provide any substantive criteria as to when expungement would be appropriate.” See *Lickiss v. FINRA*, 208 Cal.App.4th 1125, 1135 (Cal. 2012).

¹⁰ See www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbors/documents/arbmed/p016853.pdf. In particular, see page 6 of 11.

negotiating settlements with customers in return for exculpatory affidavits that the firm or associated knows or should know are false or misleading was a violation of FINRA Rules.¹¹

The Adoption Of FINRA Rule 12805

In 2008, FINRA adopted FINRA Rule 12805 to require arbitrators to perform additional fact finding before recommending expungement of customer dispute information from the CRD system.¹² FINRA Rule 12805 requires arbitrators, among other things, to do the following when presented with a request for expungement:

Review settlement documents;

Review the amount of payments made to any party, and any other terms and conditions of the settlement; Indicate in the award which of the grounds in FINRA Rule 2080 serves as the basis for their expungement recommendation, and;

Provide a brief written explanation of the reasons for recommending expungement.

In implementing this Rule, FINRA believed the requirements listed above would alleviate any concerns over arbitrators recommending expungement under what might appear to be questionable facts and circumstances.¹³

FINRA Comments Suggesting Expanded Expungement Requirements

In addition to the requirements of Rules 2080 and 12805, FINRA has also made various comments in proposals and notices stating that expungement relief can only be granted when the information being expunged “*has no meaningful investor protection or regulatory value.*”¹⁴ This language has always been viewed as problematic since a claim could be found to be factually impossible, clearly erroneous, or false under Rule 2080, and yet the claim could relate to an issue of “meaningful investor protection or regulatory value” that would preclude expungement. Importantly, FINRA has not announced that this language is a necessary element for granting expungement relief, but it is something to be mindful of as we have

¹¹ See NTM 04-43 (June 2004).

¹² See Securities Exchange Act Release No. 58886 (October 30, 2008), 73 FR 66086 (November 6, 2008) (Order Approving File No. SR-FINRA-2008-010).

¹³ See Securities Exchange Act Release No. 57572 (March 27, 2008), 73 FR 18308 (April 3, 2008) (Notice of Filing File No. SR-FINRA-2008-010).

¹⁴ See Notice to Arbitrators and Parties on Expanded Expungement Guidance, available at <http://www.finra.org/arbitrationandmediation/arbitration/specialprocedures/expungement/>.

seen arbitration panels mention it at hearings and in telephone conferences when considering the issue of expungement.

Proposed FINRA Rule 2081

Despite the steps it has taken previously, FINRA continues to be concerned about whether firms and associated persons should be prohibited from otherwise compensating customers in return for the customer's agreement not to oppose expungement of customer dispute information from the CRD system. As a result, in 2013, FINRA sent to arbitrators and published on its website guidance stating that, in determining whether to recommend expungement relief in settled arbitration claims, arbitrators should inquire whether a party conditioned settlement on an agreement not to oppose a request for expungement relief.¹⁵

Following that, FINRA proposed adopting Rule 2081, which would provide that no member or associated person shall condition or seek to condition settlement of a dispute with a customer on, or to otherwise compensate the customer for, the customer's agreement to agree or not oppose the member's or associated person's request to expunge such customer dispute information from the CRD system.¹⁶

Rule 2081's proposed prohibition would apply to both written and oral agreements and agreements entered into during the course of settlement negotiations, as well as to any agreements entered into separate from such negotiations. The proposed rule change would, for instance: (1) preclude a firm or associated person from conditioning the settlement of a customer's claim on the customer's agreement to consent to, or not to oppose, the firm's or associated person's request for expungement; and (2) would preclude a firm or associated person, following a settlement of the dispute at issue, from compensating the customer in return for the customer not opposing the firm's or associated person's expungement request.

15 Id.

16 The proposed rule change would not affect the processes relating to requests for expungement relief set forth in FINRA Rules 2080, 12805 and 13805. Thus, if an arbitration panel is considering the appropriateness of expungement in accordance with FINRA Rule 12805, a customer could express support for, or opposition to the firm's or associated person's request for expungement as part of the recorded hearing session required by that Rule.

Not surprisingly, the plaintiff's bar supports the idea of adopting Rule 2081,¹⁷ with PIABA declaring that while "FINRA has taken steps in the past to discourage the practice of conditioning settlements on the customer's consenting to or not opposing expungement, this practice nonetheless persists and remains a threat to the transparency and integrity of the CRD."¹⁸ Of course PIABA does not believe that the new rule would go far enough, suggesting instead that expungements should be done away with, but the organization believes Rule 2081 would be a good first step in curtailing the efforts of defense attorneys to "cleanse" the records of rogue financial services professionals.

The Practical Effect Of Rule 2081

It is unclear at present what the final decision of the SEC will be. To the extent that Rule 2081 is adopted, it may result in closer scrutiny of cases, allegations, and documents and ultimately make it slightly more difficult to obtain expungement, though it is likely parties will continue to seek expungement in much the same way they did before Rule was adopted (with a few differences). For instance, if Rule 2081 is adopted, it will likely be useful for parties seeking expungement to include certain language in settlement agreements that states some or all of the following:

The Respondent/Respondents intend to seek expungement relief;

The Respondent/Respondents has/have not paid any consideration in relation to the expungement request; The request for expungement was not a condition of the settlement agreement.

Including the above language (or something similar), would allow defense counsel to work within the language of Rule 2081 and assist in obtaining expungements, assuming FINRA does not further alter or narrow the expungement framework.

17 See [https://piaba.org/system/files/comment_letter_pdfs/SR-FINRA-2014-020%20\(May%2013,%202014\).pdf](https://piaba.org/system/files/comment_letter_pdfs/SR-FINRA-2014-020%20(May%2013,%202014).pdf).

18 Id. at 1.

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Mr. Hines joined the firm as a partner in 2003. He was formerly the managing principal of a regional law firm's District of Columbia and Virginia offices. Mr. Hines is licensed in Maryland, the District of Columbia and Virginia, and has represented clients in trials and appeals in all three jurisdictions. His areas of practice include professional malpractice, toxic tort and environmental litigation, pharmaceutical litigation, product liability, and commercial, securities and employee litigation.

Mr. Hines defends broker-deals and individual financial services professionals in customer dispute cases filed with FINRA, as well as investigations undertaken by FINRA. To that end, Mr. Hines has prepared responses to FINRA's Enforcement Department and has defended respondents in Rule 8210 examinations. Mr. Hines also frequently lectures on FINRA issues including the potential impact on the securities industry of various new rules proposed by FINRA and the Securities and Exchange Commission.

Practice Areas

- Product Liability; Pharmaceutical and Medical Device Litigation
- Toxic Tort and Environmental Litigation
- Professional Liability
- Employment Litigation
- FINRA Litigation

Honors and Awards

- Best Lawyers in America - "Lawyer of the Year" Award for Baltimore Legal Malpractice Law - Defendants (2014)
- Best Lawyers in America - "Lawyer of the Year" Award for Baltimore Mass Tort Litigation/Class Actions - Defendants (2013)
- Best Lawyers in America - "Lawyer of the Year" Award for Baltimore Legal Malpractice Law - Defendants (2012)
- AV Preeminent Rated, Martindale Hubbell (1994 - 2013)
- Best Lawyers in America - Legal Malpractice Law, Defendants (Baltimore, Maryland 2003 - 2014)
- Best Lawyers in America - Legal Malpractice Law - Defendants - Legal Ethics (Baltimore, Maryland 2011 - 2014)
- Best Lawyers in America - Mass Tort Litigation/Class Actions - Defendants (Baltimore, 2013-2014)
- Best Lawyers in America - Product Liability Litigation - Defendants (Baltimore, Maryland 2011 - 2014)
- Maryland Super Lawyers - Product Liability Defense (2008 - 2011, 2013)

Education

- University of Maryland (B.S. 1981)
- University of Maryland, School of Law (J.D., with Honors, 1985)