UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
INVESTOR ADVOCATE

February 15, 2018

Submitted Electronically

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, CA 20006-1506

RE: Regulatory Notice 17-42

Dear Ms. Asquith:

The Office of the Investor Advocate[1] at the Securities and Exchange Commission ("Commission" or "SEC") appreciates this opportunity to provide comments in regard to the issues raised in the Financial Industry Regulatory Authority, Inc.'s ("FINRA") Regulatory Notice 17-42 (the "Notice").[2] As described in the most recent Annual Report on Activities from our Office,[3] the SEC Office of the Investor Advocate and the SEC Ombudsman have a strong interest in proposed rule changes involving broker-dealer information contained in the online Central Registration Depository ("CRD") because it plays such a key role in protecting investors. Securities industry regulators rely on data in CRD for licensing and enforcement activities and much of the information in CRD is ultimately made available to the public through BrokerCheck, a free research tool available on FINRA's website.

I. Introduction

The Notice describes potential changes to the process for expunging records from the CRD. The notable changes could include, among many changes discussed in the Notice: (1) creating a limitations period for brokers and firms to request expungement from FINRA; (2) establishing a roster of attorney arbitrators with specialized experience; (3) requiring arbitrator panels to unanimously agree to award

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[1] Pursuant to Section 4(g)(4) of the Securities Exchange Act of 1934, 15 U.S.C. § 78d(g)(4) (2012), the Office of the Investor Advocate at the Securities and Exchange Commission is responsible for, among other things, analyzing the potential impact on investors of proposed rules of self-regulatory organizations. In furtherance of this objective, we routinely review and examine the impact on investors of proposed rulemakings of SROs, including those issued by FINRA, and make recommendations to the SROs proposing those rulemakings. As appropriate, we make formal recommendations and/or utilize the public comment process to help ensure that the interests of investors are fully considered as rules are adopted.
[2] FINRA, REG. NOTICE 17-42, PROPOSED AMENDMENTS TO THE CODES OF ARB. PROC. RELATING TO REQUESTS TO EXPUNGE CUSTOMER DISP. INFO. (Dec. 2017), http://www.finra.org/industry/notices/17-42 [hereinafter NOTICE 17-42].
[3] SEC, OFF. OF THE INV. ADVOC., REP. ON ACTIVITIES, FISCAL YEAR 2017 (2017), at 27-30, https://www.sec.gov/advocate/reportspubs/annual-reports/sec-investor-advocate-report-on-activities-2017.pdf.

expungement; (4) potentially increasing the fees that brokers or firms must pay when requesting expungement; and (5) requiring the arbitrator panel to unanimously find and attest that the case has no investor protection or regulatory value. We understand that this proposal is one in a series of regulatory initiatives that FINRA is considering with respect to the expungement process and that FINRA staff has been working with the North American Securities Administrators Association ("NASAA") on various expungement issues, including potential amendments to the existing regulatory review process.

The Office of the Investor Advocate has reviewed the Notice and the comments received to date. In brief, we believe that FINRA's existing expungement framework, the standard of which is laid out in FINRA Rule 2080, needs substantive improvements and additional regulatory input in order to better serve the interests of retail investors. As a first step in a larger review, we commend FINRA for proposing procedural changes that should benefit retail investors. We are hopeful that the proposed changes will help expungement become the extraordinary remedy it was meant to be, and we encourage FINRA to continue working with NASAA and other interested parties on further refining and improving the expungement process.

That said, we are concerned that the proposed enhancements to the expungement process may cause brokers to seek to avoid the Rule 2080 process entirely, and instead request expungement of their records directly from a court of competent jurisdiction. We would not want to see significant forum-shopping in response to this rulemaking, and we recommend FINRA evaluate, as part of this rulemaking, whether there are ways to prevent brokers from going outside the enhanced expungement framework.

Further, we must note our concerns regarding the proposed requirement that, in order to recommend expungement, the arbitrators must also unanimously attest that the dispute has no investor protection or regulatory value. We believe that "investor protection" and "regulatory value" are relatively vague terms that could be interpreted differently and applied inconsistently by arbitrators. In particular, it is not clear from the Notice how FINRA arbitrators will appropriately assess regulatory value. We believe the proposal could be strengthened by providing greater clarity with respect to these terms, and FINRA should provide a framework for how these terms should be interpreted and applied by arbitrators.

Similarly, we are concerned that it may be premature to apply the expungement process to customer complaints that did not proceed to arbitration. In our view, FINRA should assess whether its many proposed modifications to the expungement process work as intended before expanding its process to this class of customer complaints.

II. Background

Prior to the 1980s, there was no centralized electronic database for broker-dealer registration. FINRA's predecessor, the National Association of Securities Dealers ("NASD"), originally developed the CRD database in conjunction with NASAA to centralize registration for the broker-dealer industry.[4]

[4] *See, e.g.*, NASAA, CRD & IARD, http://www.nasaa.org/industry-resources/investment-advisers/crd-iard (last visited Feb. 8, 2018).

When implemented in 1981, CRD consolidated a multi-state, paper-based registration process into a single, nationwide filing process and computer system.[5] Information in CRD is obtained through forms that registered representatives, broker-dealers, and regulators complete as part of the securities industry registration and licensing process.[6] In 1988, the NASD established its first public disclosure program to provide investors with important information about the professional background, business practices, and the conduct of NASD members and their associated persons.[7] This information about securities professionals, now distributed through FINRA's BrokerCheck program, was and continues to be derived from the CRD database.

Prior to 1999, arbitrators could order expungements of records from CRD without criteria and without a court order.[8] As applied by the NASD, arbitrator-ordered expungement of information from CRD was afforded the same treatment as a court-ordered expungement.[9] NASAA disagreed with this application, asserting that information in CRD constitutes state records and, due to state recordkeeping requirements, only a court of competent jurisdiction has the authority to order the destruction of state records. As a result of these discussions, in January 1999, NASD imposed a moratorium on arbitrator-awarded expungement of customer dispute information from CRD unless confirmed by a court of competent jurisdiction.

In 2001, NASD sought public comment on proposed safeguards and procedures for its expungement process, including what minimum criteria would need to be present for arbitrators to determine that expungement was appropriate, such as a finding that the customer's claim was without legal merit.[10] Building on this, in 2003, NASD received Commission approval to adopt Rule 2130 (now FINRA Rule 2080), which established procedures guiding the expungement process.[11] Since 2003, the procedures have been further refined through FINRA guidance, interpretations, and rulemakings.

At the time of Rule 2130's adoption, expungement was envisioned as an extraordinary remedy.[12] As currently applied, it appears that expungement is far from extraordinary, necessitating the changes in this proposal. Analysis conducted by FINRA[13] and the Public Investors Arbitration Bar Association

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[5] *See* OFF. OF INV. EDUC. & ADVOC., STUDY & RECOMMENDATION ON IMPROVED INV. ACCESS TO REGISTRATION INFO. ABOUT INV. ADVISERS & BROKER-DEALERS (Jan. 2011), at 13-14, https://www.sec.gov/news/studies/2011/919bstudy.pdf.
[6] *See id.*
[7] *See* FINRA NOTICE TO MEMBERS 02-74 (Nov. 2002), at 799, http://www.finra.org/sites/default/files/NoticeDocument/p003441.pdf.
[8] *See* NASD NOTICE TO MEMBERS 99-09 (Feb. 1999), at 47, https://www.finra.org/sites/default/files/NoticeDocument/p004582.pdf.
[9] *Id.*
[10] NASD NOTICE TO MEMBERS 01-65 (Dec. 2001), at 563, http://www.finra.org/sites/default/files/NoticeDocument/p003745.pdf.
[11] *See* Order Granting Approval to Amendment No. 2 to Proposed NASD Rule 2130, Exchange Act Release No. 48,933, 68 Fed. Reg. 74,667 (Dec. 24, 2003), https://www.gpo.gov/fdsys/pkg/FR-2003-12-24/pdf/03-31646.pdf [hereinafter Rule 2130 Order].
[12] *See* Comment Letter from Karen Tyler, President, NASAA, to Nancy M. Morris, Sec'y, SEC (Apr. 24, 2008), http://www.nasaa.org/wp-content/uploads/2011/07/31-Release-No34-57572SR-FINRA-2008-010NASAA.pdf.
[13] NOTICE 17-42, *supra* note 2, at 14.

("PIABA")[14] shows that the vast majority of expungement requests are granted. Over the years, FINRA has adopted procedural rules, published articles in *The Neutral Corner* to educate arbitrators, created the publicly available Expanded Expungement Guidelines page on its website, and has taken other steps, none of which have stemmed the high percentage of expungements granted by arbitrators. In 2015, NASAA expressed why, in its view, the current expungement framework does not work:

> It is critical that arbitration panels—or whomever else is determining the merits of an expungement request—consider the regulators' perspective in weighing whether a customer complaint should be expunged. The process, as designed, effectively charged the arbitrators with standing in the regulators' shoes when assessing an expungement request. In practice, however, this does not happen. The parties involved in an expungement hearing are usually the broker requesting expungement and the arbitration panel. The expungement hearings rarely involve any customer testimony, which is often the only source of information that may contradict the evidence presented by a broker . . . . While a customer theoretically can testify or otherwise participate in an expungement hearing, the hearing often occurs after the customer dispute has been settled, leaving the customer and his or her counsel little incentive to oppose or otherwise object to the expungement. Precisely because a customer cannot be expected to adequately present and advocate a regulator's view in whether an arbitration or customer complaint has regulatory value . . . the arbitration panel was given that role under Rule 2080. Unfortunately, despite changes to the process optimistically adopted to bolster that role, the process has failed.[15]

III. Analysis

The Exchange Act requires that the rules of a registered securities association such as FINRA be designed to protect investors and the public interest.[16] In our view, several of the proposed amendments will enhance investor protection and we welcome their inclusion.[17] It makes sense to require the three arbitrators to unanimously agree to recommend expungement, to have FINRA codify the rights of investors to participate in expungement hearings, and to create a special panel to review customer complaints where the underlying arbitration was not decided on the merits.

We are also encouraged that FINRA staff has been working with NASAA on expungement issues. The states, as co-owners of CRD and advocates for investor protection, should be viewed as primary stakeholders in the expungement process. Thus, as FINRA works to finalize these

[14] *See, e.g.*, PIABA Report: Data Show That FINRA Efforts to Slow Expungement of Broker Misconduct Has Failed (Oct. 20, 2015), https://piaba.org/sites/default/files/newsroom/2015-10/PIABA%20Press%20Release,%20Expungement%20Study%20Update.pdf [hereinafter PIABA Report].
[15] *See* Comment Letter from William Beatty, President, NASAA, to FINRA Dispute Resolution Task Force (Aug. 31, 2015), at 4-5, http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/07/NASAA-Expungement-Letter-enclosure.pdf [hereinafter NASAA Letter].
[16] *See* 15 U.S.C. § 78o-3(b)(6) (2010).
[17] From our review it appears that some changes, at least as currently proposed, may have little to no direct impact on investor protection, such as the increased filing fees for brokers seeking expungement. Therefore, we will limit our discussion to the matters most likely to impact investors.

enhancements, we recommend that FINRA give further consideration to the policies and procedures outlined by NASAA in its August 2015 letter to the FINRA Dispute Resolution Task Force, namely pre-notice to state regulators during an ongoing arbitration or a standardized protocol for states when FINRA waives its role as a party.[18]

With respect to the current proposal, we believe there are a few ways in which FINRA can enhance its proposed rule to better serve investors. We believe the proposal can be strengthened to prevent avoidance and promote consistent application of the rule. We also caution against immediately extending the expungement process to customer complaints that did not result in arbitration.

Unanimity of Rule 2080(b)(1) Finding

Proposed Rules 12805(b) and 13805(b) state that when deciding a request for expungement of customer dispute information, the arbitrators on an expungement panel must agree unanimously to grant expungement. The current process only requires a majority of arbitrators. In our view, this proposal will positively impact investor protection because it will provide a greater assurance that only meritless complaints are expunged, and we are hopeful that this requirement will encourage brokers to only seek expungement when the underlying customer dispute information is meritless. We are also hopeful that the percentage of cases that result in a recommendation of expungement will decline.

Codifying Expanded Expungement Guidance

FINRA's Expanded Expungement Guidance webpage provides guidance to arbitrators on the importance of allowing investors and their counsel to participate in the expungement hearing. It enumerates that arbitrators should: (1) allow the investor and their counsel to appear at the expungement hearing; (2) allow the investor to testify (telephonically, in person, or other method) at the expungement hearing; (3) allow the *pro se* investor or the investor's counsel to introduce documents and evidence at the expungement hearing; (4) allow the *pro se* investor or the investor's counsel to cross-examine the broker and other witnesses called by the party seeking expungement; and (5) allow the *pro se* investor or the investor's counsel to present opening and closing arguments if the panel allows any party to present such arguments.[19]

Proposed Rule 13805(c) codifies the first two enumerated items from the Expanded Expungement Guidance webpage. Specifically, it states that the investor may appear at the expungement hearing, and the investor may appear at the expungement hearing by telephone if the customer chooses to do so. Since expungement hearings in FINRA's forum are typically one-sided with no party arguing against expungement, we strongly support this provision because it signals to arbitrators that investors are critical stakeholders in FINRA's expungement process. This is especially important because FINRA's attempts to educate arbitrators about its regulations, policies, and

[18] NASAA Letter, *supra* note 15, at 7.
[19] *Notice to Arbitrators and Parties on Expanded Expungement Guidance*, FINRA, https://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance (last updated Sept. 2017).

procedures, including the importance of allowing retail investors to participate in the expungement process, have not always been heeded.[20]

We suggest that FINRA amend proposed Rule 13805(c) to include all five of the rights of investors and their counsel as identified on the Expanded Expungement Guidance webpage, as well as any other rights that FINRA considers important for investors to exercise when participating in expungement hearings. At a minimum, investors and their counsel should have the following rights added to proposed Rule 13805(c):

- Introduce evidence at the expungement hearing;
- Cross-examine the broker and witnesses introduced by the broker in the expungement hearing; and
- Present opening and closing arguments if the panel allows any party to present such arguments.

Codifying all five investor rights enumerated on the Expanded Expungement Guidance webpage will ensure that the remaining three investor rights are not misinterpreted by arbitrators as mere suggestions rather than as FINRA mandates.

Special Panel Review of Cases That Do Not Close On the Merits

Pursuant to proposed Rules 12805(a) and 12806, if a customer-initiated arbitration ends before the hearings on the merits concludes, any expungement request will be decided by a new three-person panel selected from the Expungement Arbitration Roster. The arbitrators on this roster will be provided expanded training that would emphasize that the panel "would need to review more proactively the request and documentation and, if necessary, ask questions and [ask] for more information, before making a decision."[21]

We support this proposed amendment because FINRA's data shows that for customer complaints where there was an arbitration not decided on the merits, the expungement rate is 88 percent,[22] which is simply too high for an *extraordinary* remedy. As FINRA states in the Notice, the special arbitrator roster may be able to "better understand the unique nature of this extraordinary remedy and the importance of maintaining the integrity of the public record."[23] We believe that a more proactive, engaged arbitration panel may be able to conduct a more robust review of the facts before deciding whether one of the Rule 2080 prongs are present. As a result, we believe the creation of the special

[20] *See, e.g.*, *Royal Alliance Associates v. Liebhaber*, 206 Cal. Rptr. 3d 805, 808 (Cal. Ct. App. 2016). In that case, the retail investor was not permitted to participate in the underlying expungement hearing. When the investor objected, the arbitrators on the panel errantly concluded that the proper process was followed. The California appellate court ruled that investors have a right, as a matter of fairness, to challenge a broker's efforts to seek expungement.
[21] NOTICE 17-42, *supra* note 2, at 22 n.38.
[22] *Id.* at 14.
[23] *Id.* at 10.

panel with additional training and a proactive fact-finding approach is an improvement to the current expungement process.

Simplified Arbitration Expungement Requests

Proposed Rule 13800(f) provides that a broker may only request expungement of customer dispute information at the conclusion of a simplified arbitration, and that a panel from the Expungement Arbitrator Roster would consider and decide the expungement request. FINRA states that holding the expungement hearing during the arbitration "delays the customer's case and the rendering of an award in the customer's simplified case" and the proposal would "ensure that expungement requests would not be heard during the simplified case."

We support this proposed amendment, and we applaud FINRA's efforts to make the arbitration process faster and more efficient for retail investors. Although most investors and their counsel may not have an incentive to participate in expungement hearings, some may want to do so, including investor participants in FINRA's simplified arbitration forum. Accordingly, it is critical that FINRA inform the investor about the pending expungement request and permit the investor to participate in that matter.

Regulatory Notice 17-42 asks whether the single arbitrator in a simplified arbitration should be permitted to decide an expungement request in lieu of the panel of three arbitrators. In our view, the arbitrator in a simplified arbitration should not be permitted to decide an expungement request alone because it will be easier for a broker to convince one arbitrator, rather than a panel of three arbitrators, to recommend expungement. We recognize that the arbitrator who conducts the simplified arbitration may be able to provide valuable insights to an expungement panel related to the same customer dispute and, as such, we have no objection to the addition of this arbitrator to the panel.

Broker Avoidance of FINRA Rule 2080 Expungement

Regulatory Notice 17-42 asks whether commenters believe that named associated persons would request expungement in every case to preserve the right to have the expungement claim heard and decided. As noted above, we believe that this proposal could have an unintended, almost opposite effect: brokers may choose to avoid the newly enhanced FINRA expungement process and instead file their request for expungement directly with a court of law. Accordingly, we recommend that FINRA amend its Code to prohibit brokers from sidestepping its dispute resolution forum by filing a request for expungement directly with a court of competent jurisdiction.

Under the current expungement framework, brokers who request expungement from FINRA may expect a one-sided hearing and an award of expungement most of the time. This arbitration award is then submitted to a court of law, often with FINRA waiving its right to oppose the expungement request and without the participation of the investor who initiated the complaint. The award is usually granted deference by the court pursuant to the Federal Arbitration Act. Thus, it would appear that the current arbitration-based framework results in decisions tilted in the broker's favor.

Because this proposal raises the bar for brokers seeking Rule 2080 expungement, some brokers may seek to avoid FINRA's new process altogether. If the proposed rules go into effect, brokers seeking an expungement award from FINRA will face heightened requirements: (a) a potentially higher

fee; (b) new procedural requirements, including time limitations; and (c) the unanimous decision to recommend expungement. Then, after the broker satisfies these requirements, the broker must still file a request for expungement with a court of competent jurisdiction. NASAA's comment notes that, even under the current rules that tend to work in brokers' favor, "more and more brokers are bypassing the Rule 2080 process entirely by going directly to court."[24] We believe this trend is likely to continue or accelerate under the new rules because a broker may prefer to simply proceed directly to the courthouse with their request, rather than attempt to meet these enhanced standards. Therefore, to avoid unintended outcomes, FINRA should consider ways that its rules may discourage brokers from sidestepping its dispute resolution forum by filing requests for expungement directly with a court.

Unanimity of "No Investor Protection or Regulatory Value" Finding

Proposed Rules 12805(b) and 13805(b) provide that when deciding a request for expungement of customer dispute information, the arbitrators on an expungement panel must make a finding in the award that the dispute has no investor protection or regulatory value. We appreciate the apparent intent behind this rule – to raise the bar and make expungement a more extraordinary remedy than it already is in practice.

As noted above, however, we believe this requirement could be strengthened by FINRA providing greater clarity regarding the terms "investor protection" and "regulatory value" because they are relatively vague terms that could be interpreted differently and applied inconsistently by arbitrators. We are especially concerned about how arbitrators will assess the term "regulatory value" because arbitrators are not regulators and they are not guided by regulatory concerns.[25] We recognize that these terms have been used by FINRA in communications with arbitrators in the past,[26] but that does not mean that arbitrators fully understand what they mean as terms of art. Because of this, FINRA should also provide a framework for how these terms should be interpreted and applied by arbitrators.[27]

[24] Comment Letter from Joseph Borg, President, NASAA, to Marcia E. Asquith, FINRA (Feb. 5, 2018), at 7, http://www.finra.org/sites/default/files/17-42_NASAA_comment.pdf.

[25] All customer dispute information has presumptive *de facto* investor protection and regulatory value because firms are required to report this data to FINRA via the uniform registration forms.

[26] *See, e.g.*, FINRA, THE NEUTRAL CORNER, *A Closer Look at Expungement: Asking the Right Questions* (Vol. 4, 2013), at 6, http://www.finra.org/sites/default/files/Publication/p410646.pdf.

[27] Our concerns have a historical basis. In 2003, FINRA's predecessor, the NASD, dismissed concerns that Rule 2130 (Rule 2080) would make expungement easier to obtain because, as noted in the SEC order approving the rule, "arbitrators will know the standards for expungement relief under proposed Rule [2080], because they will have received appropriate training, and . . . arbitrators will only grant expungement relief based on those standards." Rule 2130 Order, *supra* note 11, at 74,670. This assessment has subsequently proven to be misguided. As NASAA noted in their August 2015 letter to the FINRA Dispute Resolution Task Force, arbitrators have been empowered under the Rule 2080 framework to serve as a substitute for direct regulator involvement in the expungement process, but they are third-parties who "routinely elevate the individual broker's concerns above regulatory imperatives." NASAA Letter, *supra* note 15, at 4. Just last year, FINRA observed the "practice of brokers continually being granted expungement of their disciplinary histories from industry databases," an observation supported by FINRA and PIABA data that show that arbitrators grant expungement in the vast majority of cases. Antoinette Gartrell, *FINRA to Address Expungement Issues, Arbitration Chief Says*, BNA (Mar. 21, 2016), http://www.bna.com/finra-address-expungement-n57982068766; NOTICE 17-42, *supra* note 2; PIABA Report, *supra* note 14.

Complaints That Do Not Result In an Arbitration Claim

Under the proposal, FINRA permits the expungement of customer complaints reported to FINRA that did not result in an arbitration claim.[28] The proposal requires a broker to file an expungement request: (a) within one year from the date that the firm initially reported the customer complaint to CRD; or (b) if the firm reported the complaint to FINRA before the effective date of the proposal, within six months from the effective date of the proposal.[29]

We do not believe that now is the time to expand the Rule 2080 expungement process to claims that did not result in arbitration. With this proposal, FINRA is taking substantial steps at refining the expungement process. We would prefer to see the results of the new process before introducing an entirely new class of complaints to the mix. We recommend that FINRA first assess whether the Expungement Arbitrator Roster is performing as expected with arbitrated complaints that do not conclude on the merits, and whether further modifications to the roster's training program are necessary.

IV. Conclusion

While we commend FINRA for proposing procedural changes that should benefit retail investors, we are concerned that the proposal could incentivize brokers to avoid the Rule 2080 expungement process entirely and instead file requests for expungement directly with the courts. We encourage FINRA to consider how to best mitigate this risk and limit the circumstances where a broker can circumvent the Rule 2080 process. We are also concerned that arbitrators, as non-regulator third-parties, will not understand the regulatory terms "investor protection" and "regulatory value" as terms of art. We encourage FINRA to provide greater clarity with respect to these terms and develop a framework to guide how these terms should be interpreted and applied by arbitrators. On the whole, however, we are largely supportive of the proposed procedural changes contained in the Notice and we wish to see FINRA, after reviewing all the comments and consulting with NASAA, move quickly in seeking Commission approval for these rules.

Should you have any questions, please do not hesitate to contact either of us, or Senior Counsel Adam Moore, at (202) 551-3302.

Rick A. Fleming
Investor Advocate

Tracey L. McNeil
Ombudsman

[28] NOTICE 17-42, *supra* note 2, at 7.
[29] *Id.*