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EXPERT ANALYSIS

Clearing the Record: Examining the Expungement Process

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Working with the public in any profession comes with its risks. Regardless of the level of service, unwanted litigation and customer complaints are, unfortunately, a cost of doing business for many professionals.

That reality is especially true for financial professionals who provide recommendations related to how customers should manage their money. Whether a recommendation was suitable or not, financial professionals always face the risks that an unhappy customer may assert claims in an effort to recover losses.

Once a customer complaint is made, it becomes a disclosure event, which will be reported on a registered representative's professional record. Notably, disclosure events, such as customer complaints, are publicly available. As such, any customer or potential customer has ready access to certain customer complaint information.

With limited exception, disclosure events cannot be removed from a representative's record. The limited basis to remove a disclosure event is through a process called expungement.

Obtaining an expungement, thereby clearing one's industry record of information related to a customer complaint, is surely not a topic considered by most industry professionals on a daily basis. The rules surrounding the expungement process should be known by all industry professionals, though, as a means of risk management to effectively prepare for or prevent any customer complaints that could arise.

The Securities and Exchange Commission approved a rule in February that was proposed by the Financial Industry Regulatory Authority. The new Rule 2081 addresses FINRA's ongoing concerns regarding the expungement process and the movement toward a more difficult path by which registered representatives seek to obtain an expungement of their record. The new rule explicitly prohibits the conditioning of any settlement agreements between industry professionals and public customers on the expungement of the representative's record.

THE CENTRAL REGISTRATION DEPOSITORY SYSTEM

The Central Registration Depository is the "licensing and registration system for the U.S. securities industry and its regulators." The information contained within the CRD system is populated from the mandatory forms completed by registered representatives, broker-dealers and regulators.

Registered representatives are likely familiar with the U-4 form, which is the uniform application for securities industry registration submitted to FINRA. The U-4, for instance, requires the disclosure of various types of information, including disciplinary history and personal identification information.

Given the wealth of information contained in the CRD system, it is imperative that the records are accurate and complete. Indeed, the CRD system is often used by regulators in performing their duties, as well as potential employers of registered representatives, in making hiring decisions. In addition, the CRD system is the source from which FINRA gathers information that is revealed to the public through a resource called BrokerCheck.

Among the various tools found on FINRA's website, "BrokerCheck is a free tool to help investors research the professional backgrounds of brokerage firms and brokers currently or formerly registered with FINRA or a national securities exchange, as well as current or former investment adviser firms and representatives."[1]

Whether a recommendation was suitable or not, financial professionals always face the risks that an unhappy customer may assert claims in an effort to recover losses.

BrokerCheck is described as "part of FINRA's ongoing efforts to help investors make informed choices about the FINRA-registered brokers and brokerage firms with which they may wish to do business, as well as to provide 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 and about whom investors may wish to learn relevant information."[2]

While many registered representatives are intimately familiar with BrokerCheck, for others, a short synopsis is valuable to understand the potential importance of the changes to the expungement rule. Some of the information available to the public through BrokerCheck includes a registered representative's employment background, criminal information, disciplinary information and customer complaints. In regard to customer complaints, BrokerCheck permits the public to access many details that registered representatives may not be aware of, including the allegations of a specific customer complaint, the product type and the settlement amount.

The following is an example of the type of customer complaint information that is often disclosed on BrokerCheck:

> Customer Dispute – Settled
>
> *Allegations:* Alleged unsuitable investment in November 2007. The action was settled with a compromise without representation of fact or opinion made by the claimant.
>
> *Alleged Damages:* $110,000
>
> *Status:* Settled
>
> *Settlement Amount:* $55,000
>
> *Individual Contribution Amount:* $0

As reflected by the above example, this particular customer case settled and the arbitration panel did not make a finding of wrongdoing by the representative. On its surface, this reported

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event seems nothing more than a business decision to resolve the dispute in light of escalating defense costs.

From a business perspective, this appears to be a good outcome. A potential customer, however, may have a different interpretation. The customer may focus on the fact that it was a five-figure settlement or that the claimant settled for 50 percent of their alleged damages to resolve the dispute. Thus, it is important to note that this information is readily available for the public to review and draw conclusions. That is, unless the representative seeks and successfully obtains an expungement.

HISTORY OF THE EXPUNGEMENT PROCESS

Customer complaint information can be "expunged" from the representative's BrokerCheck report if the proper protocols are followed. It is these expungement protocols which have been addressed through the adoption of Rule 2081.

Based on the history of rule changes related to registered representatives' public records, it is not surprising that the new rule adopted by FINRA reveals an effort to promote more information being included on one's public record, and less ability to have that information removed.

In its infancy, the rules governing expungement were far less strict than today's incarnation. Prior to 1999, expungement could be directed by an arbitration panel. A moratorium was placed on that practice in 1999, however, and was never lifted. From that point forward, expungements could only be granted by a court of competent jurisdiction.

The new Rule 2081 explicitly prohibits the conditioning of any settlement agreements between industry professionals and public customers on the expungement of the representative's record.

From FINRA's perspective, the then prevailing standard was not without its shortfalls. One of the loopholes that developed was arbitrations could be settled, predicated on an agreement that claimants would not oppose a registered representative's subsequent efforts to seek expungement from a court of competent jurisdiction.

The end result was that registered representatives would initiate unopposed petitions for expungement in state court, and these were often rubber-stamped by the judge, considering there was no opposition to the petition. The judge's order would then be submitted to FINRA, which would expunge the representative's record.

In direct response to this practice, FINRA adopted Rule 2130 in 2004. One of the most significant changes present in Rule 2130, which remains in effect to date, was the need to name FINRA as an additional party and serve FINRA with all appropriate documents.

This requirement had somewhat of a chilling effect on prospective expungements, as the presence of FINRA as a party challenging an expungement petition in state court was often seen as a death knell to the request. Rule 2080 has since superseded Rule 2130, but the process and standards to be followed in seeking an expungement remain essentially unchanged.

Under Rule 2080, brokers who wish to have customer dispute information removed from their public CRD record must petition a court of competent jurisdiction for an order directing expungement or confirming a FINRA arbitration award containing expungement relief. Practically speaking, if the court grants the petition, then the order is submitted to FINRA for processing the expungement. FINRA's role, or lack thereof, in the petition is a crucial factor in determining whether the petition will be granted.

Under Rule 2080, a petitioner seeking an order directing expungement must also name FINRA as a party to the petition and serve FINRA with any relevant documents, unless FINRA waives

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those requirements. Having FINRA agree to waive its right to participate as a party is often seen as the crucial step toward a successful expungement. This obviously begs the question: When will FINRA waive its right to be named as a party to the subsequent court proceeding?

The short answer is that FINRA will typically waive its right to be named as a party when an arbitration panel makes an affirmative finding that expungement is warranted. In 2008, FINRA adopted Rule 12805 establishing the steps arbitration panels must take before granting an expungement. Specifically, the rule requires that arbitrators hold a hearing to consider whether the expungement is appropriate under the particular facts of the case.

In regard to settled matters, the rule requires the panel to review any settlement documents, specifically considering any money paid and the terms of the agreement. Finally, if the panel determines that expungement is appropriate, it must indicate which of Rule 2080's grounds for expungement, discussed below, is the basis for the decision, and provide an explanation for its decision.

FINRA has stated that the above-mentioned procedures are intended to ensure that expungement occurs only when there has been an affirmative finding by a judge or arbitration panel that:

- 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.[3]

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FINRA has also recently taken steps in regard to arbitrator training and education to ensure that expungements are only granted under certain circumstances. For example, arbitrators must participate in a mandatory expungement course which "emphasizes the extraordinary nature of expungement and the important role of arbitrators in maintaining the integrity of the information in the CRD system."[4]

In addition, in 2013, FINRA published its Notice to Arbitrators and Parties on Expanded Expungement Guidance, explicitly advising arbitrators to ask anyone seeking expungement whether the settlement was conditioned upon the customer's agreement not to oppose the request for expungement.

Again, practically speaking, FINRA will normally only waive the requirement to be named as a party to the expungement proceeding when an arbitration panel, under Rule 12805, makes such an affirmative finding after a hearing on the merits. Absent such findings, it should be expected that FINRA will not waive its right to be a party in the subsequent court proceeding, and will actually oppose the expungement petition.

Despite the extensive efforts FINRA has taken to limit the expungement process, the adoption of Rule 2081 intimates that there are still concerns about the process whereby registered representatives seek to have information removed from their records. In particular, this new rule addresses FINRA's concern about registered representatives potentially requiring public customers to agree not to oppose expungement as a condition of settlement.

In other words, the rule explicitly prohibits parties from using a claimant's agreement not to oppose, and often not to participate, in the registered representative's expungement hearing before the arbitration panel, as a term of settlement. Under Rule 2081, the expungement of a broker's record cannot be a part of future settlement agreements between complaining customers and their brokers.

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The rule provides 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 consent to, or not to oppose, the member's or associated person's request to expunge such customer dispute information from the CRD system."

In Regulatory Notice 14-31, FINRA confirmed this new "prohibition applies to both written and oral agreements, and to agreements entered into during the course of settlement negotiations, as well as to any agreements entered into separate from such negotiations." FINRA also said any settlements involving customers' disputes are subject to this rule, and not only those related to arbitration claims.

Based on the adoption of this new rule and the history of the expungement process, it is expected that the process will continue to become more complex, with the ultimate goal of providing greater disclosure and less opportunity for expungement. In today's increasingly litigious climate, it is imperative that registered representatives take the time to be proactive, to ensure satisfactory customer service and to avoid customer complaints.

NOTES

[1] FINRA BrokerCheck, http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

[2] FINRA BrokerCheck, About BrokerCheck Reports, http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/P015175.

[3] *See* FINRA Rule 2080.

[4] FINRA BrokerCheck, FINRA Arbitrator Training Online Learning Courses, https://www.finra.org/ArbitrationAndMediation/Arbitrators/Training/AdvancedTraining/P124939.

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