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Ethical Concerns When Settlement Includes an Agreement About Expungement

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When a customer makes a complaint against his or her broker, oftentimes that complaint is reported on the broker's public record and made available to the public through the BrokerCheck system provided by the Financial Industry Regulatory Authority (FINRA). The National Association of Securities Dealers (NASD)[2] established BrokerCheck in 1998 to provide the public with information about the professional background, business practices, and conduct of brokers and brokerage firms.[3]

Understandably, brokers generally attempt to keep as clean a record as possible because potential clients may use BrokerCheck to decide whether to invest with a particular broker. To remove a complaint from his or her record, the broker must seek expungement of the complaint. If a broker has settled the complaint with the customer, the broker may seek the customer's cooperation in the expungement process. Over time, FINRA has made changes to its expungement procedures, which has created interesting ethical issues. This paper examines these expungement procedures and the ethical implications for a customer's attorney when a broker seeks a customer's cooperation in the process.

I. History of Expungement

A. The Central Registration Depository & BrokerCheck

BrokerCheck's information comes from the Central Registration Depository (CRD). The CRD system is the securities industry on-line registration and licensing system. Brokers submit a variety of forms to the CRD, including the Uniform Application for Securities Industry Registration and the Uniform Termination Notice for Securities Industry Registration. Notably, the CRD system also collects disclosure information about customer disputes. Customer disputes include customer complaints, arbitration claims, and court filings made by customers, and the arbitration awards or court judgments that may result from those claims or filings.[4]

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[2] On July 26, 2007, FINRA was created through the consolidation of NASD and the member regulation, enforcement and arbitration operations of the New York Stock Exchange. For ease of reference, this article generally refers to the NASD as FINRA throughout.

[3] *See* FINRA Regulatory Notice 10-34, "SEC Approves Changes to Expand the Information Released Through BrokerCheck and Establish a Process to Dispute (or Update) Information Disclosed Through BrokerCheck" (July 2010). In 1998, BrokerCheck was known as the Public Disclosure Program.

[4] *See* SEC Release No. 34-47435 (March 4, 2003) (Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System, File No. SR-NASD-2002-168).

Some information from the CRD appears in BrokerCheck's reports on brokers. Under FINRA Rule 8312, FINRA culls and discloses information from the CRD through BrokerCheck. Today, BrokerCheck provides information about approximately 1.3 million current and former FINRA-registered brokers and 17,400 current and former FINRA-registered brokerage firms.[5]

In addition to BrokerCheck, the CRD system's information also flows to others regulatory bodies. At present, FINRA operates the CRD system pursuant to policies developed jointly with the North American Securities Administrators Association (NASAA).[6] NASAA, along with some states, contends that because states use CRD information to make licensing decisions, the CRD system's information should be treated as public records. State laws generally do not permit information to be expunged once it has been filed on the CRD system without a court order explicitly directing the expungement.[7]

B. Expungement of Information from the CRD

FINRA has generally honored court-ordered expungement of information from the CRD system since its inception in 1981. For some time, FINRA had also honored arbitrator-ordered expungement of information from the CRD system. However, in January 1999, after consultation with NASAA, FINRA imposed a moratorium on arbitrator-ordered expungements of information from the CRD system.[8] This was in response to the concerns raised by NASAA that state records could only be properly expunged with a court order. After imposing the moratorium, FINRA required that an arbitration award directing expungement of customer dispute information must be confirmed by a court of competent jurisdiction before FINRA would expunge the information from the CRD system.[9]

After imposing the moratorium, FINRA examined its expungement procedures. In 2002, it proposed adopting NASD Rule 2130 to govern the expungement of customer dispute information from the CRD system. In the proposed rule, FINRA sought to balance three competing interests: [10]

> (1) the interests of [FINRA], the states, and other regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations; (2) the interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate; and (3) the interests of investors

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[5] *See* http://www finra.org/Investors/ToolsCalculators/BrokerCheck/ (last visited August 9, 2013).
[6] *See* SEC Release No. 34-47435.
[7] *Id*.
[8] *See* NASD Notice to Members 99-09, "NASD Regulation Imposes Moratorium On Arbitrator-Ordered Expungements of Information From The Central Registration Depository" (February 1999).
[9] *Id*.
[10] *See* SEC Release No. 34-47435, Section II.A.1.

> in having access to accurate and meaningful information about brokers with whom they conduct, or may conduct, business.

Foreseeing issues to come, FINRA stated that it was "cognizant of the importance of ensuring that the expungement policy does not have an overly broad chilling effect on the settlement process or inappropriately interfere with the arbitration process or arbitrators' authority to award appropriate remedies."[11]

The SEC approved NASD Rule 2130 in December 2003. The Rule codified the requirement that an arbitration award directing the expungement of customer dispute information be confirmed by a court of competent jurisdiction. The Rule further required that FINRA be named as a party to the confirmation proceeding unless it waived the requirement. Pursuant to the Rule, a broker would not be required to name FINRA as a party if certain requirements were met:[12]

> (1) Upon request, [FINRA] may waive the obligation to name [FINRA] as a party if [FINRA] determines that the expungement relief is based on affirmative judicial or arbitral findings that:
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> (A) the claim, allegation or information is factually impossible or clearly erroneous;
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> (B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or
>
> (C) the claim, allegation, or information is false.
>
> (2) If the expungement relief is based on judicial or arbitral findings other than those described above, [FINRA], in its sole discretion and under extraordinary circumstances, also may waive the obligation to name [FINRA] as a party if it determines that:
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> (A) the expungement relief and accompanying findings on which it is based are meritorious; and
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> (B) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.

In 2009, NASD Rule 2130 was adopted as part of the Consolidated FINRA Rulebook as FINRA Rule 2080.[13]

Importantly, this Rule falls within the "Duties and Conflicts" section of the FINRA Rulebook but not within the "Code of Arbitration Procedure for Customer Disputes" section. Indeed, until 2008, the Code of Arbitration Procedure did not even address expungement of customer dispute information. Arbitrators and parties operated without any guidelines or rules governing the arbitrators or their consideration of expungement requests. Moreover, because arbitration awards are not precedential and generally do not explain their reasoning, parties could

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[11] *Id*.
[12] *See* NASD Rule 2130(b).
[13] *See* FINRA Regulatory Notice 09-33, "SEC Approval and Effective Date for New Consolidated FINRA Rules" (June 2009).

not even find much guidance in past awards. NASD Rule 2130 (and later known as FINRA Rule 2080) only governed the process of confirming an arbitration award containing an expungement directive.[14] Its existence at least validated that arbitrators could direct expungement and suggested that expungement might be appropriate in the circumstances covered by NASD Rule 2130(1).

To provide guidance to parties and arbitrators, in March 2008, FINRA filed a proposed rule change with the SEC to adopt FINRA Rule 12805 to establish procedures for arbitrators considering expungement requests.[15] The SEC approved the Rule on October 30, 2008.[16] Under Rule 12805, arbitrators must do the following before granting an expungement request:

(a) Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. This paragraph will apply to cases administered under Rule 12800 even if a customer did not request a hearing on the merits.

(b) In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of a settlement.

(c) Indicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement order and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case.

(d) Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

In its discussion about the need for the rule proposal, FINRA commented that, in the case of settlements, it had expected arbitrators to review the terms and conditions of settlement, including the amount paid, before granting expungement.[17] Because arbitrators were not inquiring into the terms of settlement, FINRA adopted the Rule to provide more guidance.[18] FINRA viewed this change as "part of its 'continuing effort to ensure that arbitrators evaluate fully each request for expungement.'"[19]

Yet the new guidance in Rule 12805 did not cover all situations where a broker might legitimately seek to expunge a customer complaint from his or her record. Although FINRA

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[14] As discussed above, confirmation of the arbitration award is a necessary step in having the information ultimately expunged from the CRD system.

[15] *See* SEC Release No. 34-58886 (October 30, 2008) (Order Approving a Proposed Rule Change Amending the Codes of Arbitration Procedure to Establish Procedures for Arbitrators to Follow When Considering Requests for Expungement Relief, File No. SR-FINRA-2008-010).

[16] *Id*.

[17] *See Id*., p. 4.

[18] *Id*.

[19] *Id*. at p. 16.

Rule 12805 explains how *parties* to an arbitration may seek expungement, BrokerCheck also discloses customer dispute information even if the broker is not a party to the arbitration. For example, in certain cases a broker may be the subject of allegations of sales practice violations made in an arbitration claim but not named as a party to the arbitration. In such a case, the information about the arbitration claims is reportable on the broker's CRD record.[20]

To address this issue, FINRA is now considering how to implement appropriate procedures for brokers to seek expungement in cases where the broker is not a party to the arbitration. In this vein, in April 2012, FINRA sought comment on proposed *In re* expungement procedures.[21] The proposed *In re* expungement procedures would provide a mechanism whereby a broker may seek expungement of customer dispute information if the broker is not a party to the arbitration. At present no proposal has been filed with the SEC because FINRA continues to consider the appropriate procedure.

II. Expungement & Settlement

In cases where the parties have settled their dispute, brokers often ask arbitrators to direct expungement of customer dispute information, providing terms within the settlement agreement to facilitate that request. Over time, as the expungement process has changed, the customer's role in that process has changed as well. Customers have never had the ability to grant a broker's expungement request. Prior to the enactment of NASD Rule 2130, there was no requirement that arbitrators make any kind of affirmative finding before signing off on an expungement request. In the case of settlements, brokers would often seek the cooperation of customers in the preparation of stipulated awards. The parties would put the stipulated award before the arbitrators containing an expungment directive, which the arbitrators would then sign. The broker would then confirm the award in a court of competent jurisdiction either with the consent of the customer or by default if the customer did not appear.

NASD Rule 2130 began to change the landscape because the arbitrators were required to make an affirmative finding of fact supporting the expungement request or the broker risked FINRA objecting to the expungement directive at the confirmation stage. Brokers continued to seek the cooperation of customers in the process to varying degrees.

As the process of obtaining expungment has become more elaborate, the ethical issues have changed. Although many ethical issues may arise, the two most common concerns are whether certain settlement provisions may violate an attorney's obligation of candor toward the tribunal and whether an expungement may imply that the claimant's attorney knowingly filed a frivolous and meritless claim. Moreover, settlement negotiations pose unique ethical challenges because the ethical rules bind an attorney to accept a client's decision to settle a case. Each issue

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[20] *See* FINRA Regulatory Notice 12-18, "FINRA Requests Comment on Proposed New *In re* Expungement Procedures for Persons Not Named in a Customer-Initiated Arbitration" (April 2012).
[21] *See Id.*

is addressed below. It is important to note that the concerns raised differ if what is sought is customer cooperation in the expungement process compared to the customer not opposing the broker's request for expungement.

A. Candor Toward the Tribunal

In settling cases, lawyers must honor their obligation to be candid with any tribunal. This concept is codified in Rule 3.3 within the ABA Model Rules of Professional Conduct. Pursuant to the Rule, a lawyer may not knowingly "make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer."[22] The model rules define the term "tribunal" broadly; it specifically includes an arbitrator in a binding arbitration proceeding.[23] Additionally, a lawyer may not "offer evidence that the lawyer knows to be false."[24] For practitioners, candor issues may arise when negotiating terms associated with an expungement request. For example, if the broker seeks a customer's affirmative cooperation in his or her expungement request, counsel for the customer may be at risk of violating this Rule if cooperation would require him or her to state something untrue.

Indeed, many customers may have been pressured to make untrue statements as a condition of settlement. After enacting Rule 2130, FINRA discovered that brokers were seeking customer affidavits to support their expungement requests.[25] Specifically, there were instances where respondents (brokers and firms) would procure customer affidavits absolving one or more of the respondents of wrongdoing in exchange for monetary compensation.[26] The affidavits appeared to be "inconsistent on their face with the initial claim and terms of the settlement."[27] FINRA cautioned its members that if they used affidavits containing information that was bargained for, rather than the truth, they might be subject to sanctions and other penalties, including possible criminal sanctions for subornation perjury.[28] In a footnote, FINRA cautioned individuals who were not subject to FINRA jurisdiction that they may also be subject to sanctions from the arbitration panel, law enforcement agencies, state bar associations or other attorney disciplinary bodies, among others.[29]

To the extent a lawyer prepares or submits affidavits to an arbitration panel that contain false information, the lawyer has violated Model Rule 3.3. If a request for an affidavit is made in connection with settlement, such request should be refused and opposing counsel should be reminded of FINRA's directive against the use of such affidavits.

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[22] Model Rule 3.3(a)(1).
[23] *See* Model Rule 1.0(m).
[24] Model Rule 3.3(a)(3).
[25] *See* NASD Notice to Members 04-43, "Members' Use of Affidavits in Connection with Stipulated Awards and Settlements to Obtain Expungement of Customer Dispute Information under Rule 2130" (June 2004).
[26] *Id*.
[27] *Id*. at 554.
[28] *Id*.
[29] *Id*.

B. Meritorious Claims & Contentions

Some lawyers worry that brokers seeking expungement may expose them to disciplinary sanctions for filing meritless claims. As discussed below, this concern appears unfounded. As an initial matter, lawyers have an obligation to bring meritorious claims, codified by Model Rule 3.1. The Rule states that "a lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for extension, modification or reversal of existing law."

In connection with a settlement, there is concern that by not contesting an expungement request, a lawyer may be consenting to a finding under Rule 2080 that "the claim, allegation, or information is false." In turn, such a finding may equate to a finding that the lawyer filed a frivolous claim. This generally should not be the case for several reasons.

Rule 3.1 does not require a lawyer to believe the outcome of the case will be positive for his or her client. In fact, a claim may not be frivolous even if the lawyer believes that the client's position ultimately will not prevail, so long as there is a basis for asserting the claim.[30] Rule 3.1 focuses on the time of filing. A claim is not frivolous "merely because the facts have not first been fully substantiated or because the lawyer expects to develop vital evidence only by discovery."[31] The standard set forth in Rule 3.1 distinctly differs from the standard set forth in FINRA Rule 2080. The arbitrators' finding that the claim, allegation, or information is false is made after a hearing on the merits of the claim and does not examine the basis on which the attorney initially filed the claim.

With respect to the expungement hearing itself, the arbitration panel must make an affirmative finding of fact to support its expungement directive. In reviewing the 15 most recent expungement directives where the arbitrators decided the claim, allegation, or information was false, the factual rationale set forth would not have equated to a finding that the claim was frivolous. In each case, the factual basis offered appeared to be the result of a weighing of the sufficiency of the evidence, not the falsity (or frivolity) of the claims. One arbitration decision went to great lengths to discuss the standards that should be applied by arbitrators when deciding if a claim is false: "When an allegation is supported by some reasonable proof, even short of 'preponderance,' it cannot be said to be 'false.' Unfortunately, too many decisions improperly label claims as 'false' simply because they were not supported by a preponderance of the evidence."[32]

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[30] *See* Rule 3.1, comment 2. *See also*, ABA Comm. On Ethics & Prof'l Responsibility, Formal Op. 85-352 (1985) ("However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated.").

[31] *See* Rule 3.1, comment 2.

[32] In the Matter of Arbitration between Linda M. Gilliam v. SagePoint Financial, Inc. and Charles Van Mason, FINRA Dispute Resolution Number 12-03717 (July 19, 2013). This award contains a multi-page detailed explanation of the arbitrator's consideration of the expungement request.

Moreover, FINRA appears to have contemplated that once a claim is settled, customers will not participate in the expungement process, however, that does not change the fact that the broker must still meet the burden of proof set forth by the rule. When FINRA proposed Rule 2130, it responded to concerns that brokers would buy clean records as a part of the settlement process:[33]

> [FINRA] responded to this concern in Amendment No. 2 by asserting that the "affirmative determination" requirement imposed on arbitrators should foil attempts to "buy a clean record." Under the proposed standard, dismissal of a claim alone would not be a sufficient basis for ordering expungement. [FINRA] states that its arbitrator training materials will make clear that an expungement order must be premised on an *affirmative determination* by the arbitrator that the respondent was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. Without such an *affirmative finding*, [FINRA] would have no basis under this standard to waive its obligation to be named as a party in the court confirmation process.

In its proposal to adopt FINRA Rule 12805, the absence of the customer at the expungement hearing was discussed and dismissed as a concern:[34]

> Argument 2: If customer claimants do not participate in the expungement hearing, arbitrators will hear only the requesting party's position.
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> Response: FINRA noted that under the proposal, customers will continue to have the opportunity to attend and participate in expungement hearings in person or via telephone, and the customer may submit a written statement if he chooses not to participate or attend in person. In addition, FINRA vowed to take measures to ensure that arbitrators are prepared to perform the critical fact-finding that is required by the rule proposal, whether or not a customer is present at the hearing.

In the arbitrator training material on expungement, arbitrators are told that they must conduct fact finding even if there has been a settlement:[35]

> Before ordering expungement following a settlement, arbitrators are required to review the settlement documents, consider the amount paid to any party, and consider any other terms and conditions of the settlement that might raise concerns about the associated person's involvement in the alleged misconduct before awarding expungement. In order for arbitrators to perform this critical fact finding before granting expungement, Rules

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[33] *See* SEC Release No. 34-48933 (December 16, 2003) (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, File No. SR-NASD-2002-168).

[34] *See* SEC Release No. 34-58886..

[35] *See* FINRA Written Materials for Arbitrator Training Courses: Expungement, p. 19 (April 2011) (available at http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p125419.pdf).

12805 and 13805 require arbitrators to hold a recorded hearing session by telephone or in person. The requirement of a hearing session ensures that arbitrators consider the facts that support or weigh against a decision to grant expungement.

Lastly, in its proposal to adopt *In re* proceedings, FINRA stated that "the absence of a party at the *In re* expungement proceeding would not create a presumption that the absent party either consents to or opposes the expungement request."[36]

Since the burden rests with the broker to prove that the request for expungement falls within one of the enumerated grounds of FINRA Rule 2080, there should not be a requirement that the lawyer for the customer appear at the hearing and contest the expungement for fear that a finding will imply that the claim was frivolous. Indeed, research failed to reveal a single case where a lawyer was sanctioned by a bar association under such circumstances. Therefore, a settlement term that calls for the customer not to oppose the expungement request should not violate this ethical rule.

Conclusion

Expungement of customer dispute information from the CRD remains an extraordinary remedy. It should only be used "when the expunged information has no meaningful regulatory or investor protection value."[37] However, expungements are too readily granted by arbitrators. This does not appear to be simply a result of customers not opposing the expungement requests because they have settled their claims. This is more likely a result of arbitrators not understanding the standards pursuant to which expungements should be granted. Arbitrators should not be granting expungement requests based upon the insufficiency of the evidence presented regarding the allegations made in the arbitration claim. Customers do not have a burden of proof that must be met when a broker makes a request for expungement – the broker has the burden. The customer not proving their case is not a basis for expungement.

It is FINRA's responsibility to remove expungement entirely from the settlement process. FINRA took the first step in this direction when it cautioned firms against bargaining for fraudulent affidavits to support expungement requests. More often, brokers and their firms are now requiring that customers not oppose expungement requests as part of the settlement process. As discussed above, customer agreement not to participate in the expungement process does not raise the ethical concerns that active customer cooperation in the expungement process raises. However, it may still impede the arbitrators' ability to fulfill their role in this process and may have broader implications with respect to the integrity of the CRD system. FINRA has contemplated that customers may chose not to participate in the expungement hearing, and

[36] *See* FINRA Regulatory Notice 12-18, p. 8.
[37] *See* SEC Release No. 34-58886.

educates its arbitrators with respect to their responsibilities. However, FINRA does not appear to have addressed the fact that brokers and firms actively prevent customers from participating in expungement hearings through the settlement process. It remains important that the arbitrators receive effective training so that they fully understand the significance of an expungement request. However, if a customer wishes to assist in the process, they should be permitted to do so.