

the Act,<sup>11</sup> in particular, in that it provides for the equitable allocation of reasonable dues, fees and other charges among members and issuers and other persons using any facility or system which the NASD operates or controls. The proposed rule change recognizes the economies of scale and scope associated with higher volumes of trade reports, and will make it more economical for many market participants to use ACT for reporting their trading activity in exchange-listed securities. The proposed rule change is similar in structure to discounts implemented by Nasdaq for Nasdaq-listed stocks within the past year.<sup>12</sup>

#### *B. Self-Regulatory Organization's Statement on Burden on Competition*

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

#### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

Written comments were neither solicited nor received.

### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

The proposed rule change has become effective pursuant to section 19(b)(3)(A)(ii) of the Act<sup>13</sup> and subparagraph (f)(2) of Rule 19b-4 thereunder,<sup>14</sup> because it establishes or changes a due, fee, or other charge imposed by NASD. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC

20549-0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. SR-NASD-2003-170. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-2003-170 and should be submitted by January 14, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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**BILLING CODE 8010-01-P**

### **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-48933; File No. SR-NASD-2002-168]

#### **Self-Regulatory Organizations; National Association of Securities Dealers, Inc; 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**

December 16, 2003.

#### **I. Introduction and Description of the Proposal**

On November 19, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the

Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change that would: (1) Require all directives to expunge customer dispute information from the Central Registration Depository ("CRD" or "CRD system") to be confirmed by or ordered by a court of competent jurisdiction; (2) require member firms and associated persons seeking expungement to name NASD as an additional party in any judicial proceeding seeking expungement relief or confirming an arbitration award containing expungement relief; and (3) permit member firms and associated persons to ask NASD to waive the requirement to name NASD as a party on the basis that the expungement order meets at least one of the standards for expungement articulated in the proposed rule.

On January 28, 2003, NASD submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on March 10, 2003.<sup>4</sup> The Commission received 28 comments on the proposal from a wide range of sources. The NASD responded to these comments by amending the filing on September 11, 2003.<sup>5</sup> This order approves the proposed rule change, as amended by Amendment No. 1. In addition, the Commission is publishing a notice to solicit comment on and is simultaneously approving, on an accelerated basis, Amendment No. 2 to the proposal. Below is the text of the proposed rule change, as amended by Amendment No. 2. Deletions of the proposed rule text, which was published in the Notice, appear in [brackets]; proposed rule language to be added by Amendment No. 2 appears in *italics*.

\* \* \* \* \*

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter, dated January 28, 2003, from Patrice M. Gliniecki, Vice President and Deputy General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission ("Amendment No. 1").

<sup>4</sup> See Securities Exchange Act Release No. 47435 (March 4, 2003), 68 FR 11435 ("Notice").

<sup>5</sup> See letter from Shirley H. Weiss, Associate General Counsel, Office of the General Counsel, NASD, to Jonathan G. Katz, Secretary, Commission (September 11, 2003) ("Amendment No. 2"). In Amendment No. 2, the NASD made certain changes to its proposed rule text in response to comments received by the Commission in connection with the filing. The Amendment No. 2 rule text changes are published in their entirety and discussed at length below.

<sup>11</sup> 15 U.S.C. 78o-3(b)(5).

<sup>12</sup> See Securities Exchange Act Release Nos. 47661 (April 10, 2003), 68 FR 19045 (April 7, 2003) (SR-NASD-2003-51) and 47919 (May 23, 2003), 68 FR 32788 (June 2, 2003) (SR-NASD-2003-86).

<sup>13</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

<sup>14</sup> 17 CFR 240.19b-4(f)(2).

<sup>15</sup> 17 CFR 200.30-3(a)(12).

2130. Obtaining an Order of Expungement of Customer Dispute Information From the Central Registration Depository (CRD System)

(a) Members or associated persons seeking to expunge information from the CRD system arising from disputes with [public] customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief.

(b) Members or associated persons petitioning a court for expungement relief or seeking judicial confirmation of an arbitration award containing expungement relief must name NASD as an additional party and serve NASD with all appropriate documents unless this requirement is waived pursuant to subparagraph (1) or (2) below.

(1) Upon request, NASD may waive the obligation to name NASD as a party if NASD determines that the expungement relief is based on *affirmative* judicial or arbitral findings that:

(A) the claim, allegation, or information is [without factual basis] *factually impossible or clearly erroneous*;

(B) the [complaint fails to state a claim upon which relief can be granted or is frivolous] *registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds*; or

(C) the [information contained in the CRD system is defamatory in nature] *claim, allegation, or information is false*.

(2) If the expungement relief is based on judicial or arbitral findings other than those described above, NASD, in its sole discretion and under extraordinary circumstances, also may waive the obligation to name NASD as a party if it determines that:

(A) the expungement relief and accompanying findings on which it is based are meritorious; and

(B) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.

(c) *For purposes of this rule, the terms "sales practice violation," "investment-related," and "involved" shall have the meanings set forth in the Uniform Application for Securities Industry Registration of Transfer ("Form U4") in effect at the time of issuance of the subject expungement order.*

\* \* \* \* \*

## II. Summary of Comments and Response to Comments

### A. Comments Received

As stated above, the Commission received 28 comments from a variety of sources.<sup>6</sup> The majority of comments received were in favor of the NASD putting a rule in place on this topic, but had a variety of suggestions as to how to make the proposed rule text more

<sup>6</sup> See Letter to Margaret H. McFarland, Deputy Secretary, Commission, from Charles W. Austin, Jr., Executive Vice-President, Public Investors Arbitration Bar Association (March 28, 2003) ("PIABA Comment"); letter to Secretary, Commission, from Joel A. Goodman and Stephen Krosschell, Goodman & Nekvasil, P.A. (March 29, 2003) ("G&N Comment"); electronic mail ("e-mail") to Secretary, Commission, from Barry D. Estell (March 28, 2003) ("Estell Comment"); letter to Secretary, Commission, from C. Thomas Mason III (March 31, 2003) ("Mason Comment"); letter to Jonathan G. Katz, Secretary, Commission, from Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association (March 31, 2003) ("SIA Comment"); e-mail to Commission Rule Comments from Steven M. Sherman (March 31, 2003) ("Sherman Comment"); e-mail to Commission Rule Comments from Alan L. Sachs (March 28, 2003) ("Sachs Comment"); e-mail to Commission Rule Comments from Helen Mangano (March 28, 2003) ("Mangano Comment"); e-mail to Commission Rule Comments from John J. Miller (March 30, 2003) ("Miller Comment"); letter to Jonathan G. Katz, Secretary, Commission, from Gerald S. Siegmyer, Siegmyer, Oshman & Geddie, L.L.P. (April 7, 2003) ("SO&G Comment"); letter to Commission from Donald G. McGrath, McGrath & Polvino, PLLC (March 27, 2003) ("M&P Comment"); letter to Commission from A. Daniel Woska, Woska & Hasbrook (March 31, 2003) ("W&H Comment"); letter to Jonathan G. Katz, Secretary, Commission, from Dan Jamieson (April 25, 2003) ("Jamieson Comment"); letter to Commission from Kenneth R. Hyman, President, Partnervest Securities, Inc. (May 19, 2003) ("Partnervest Comment"); e-mail to Commission from Steven K. McGinnis (May 19, 2003) ("McGinnis Comment"); letter to Commission from Robert L. Hicks, President, Finance 500 (May 19, 2003) ("Finance 500 Comment"); e-mail to Commission Rule Comments from Robert Eastmann (June 3, 2003) ("Eastmann Comment"); letter to Margaret H. McFarland, Deputy Secretary, Commission, from Deborah Bortner, North American Securities Administrators Association CRD Steering Committee Co-Chair and Washington State Director of Securities (June 4, 2003) ("NASAA Comment"); e-mail to Commission Rule Comments from Tammy McQuade (June 7, 2003) ("McQuade Comment"); e-mail to Commission Rule Comments from Fired Broker (June 9, 2003) ("Fired Broker Comment"); e-mail to Commission Rule Comments from Mike Marchetta (June 10, 2003) ("Marchetta Comment"); e-mail to Commission Rule Comments from David Macias (June 10, 2003) ("Macias Comment"); e-mail to Commission Rule Comments from djs (June 10, 2003) ("djs Comment"); 23 substantially identical form letters to Commission from John Schooler, President, WFP Securities (May 21, 2003) ("Form Letter Comment"); e-mail to Commission Rule Comments from Richard Lavoice (July 29, 2003) ("Lavoice Comment"); e-mail to Commission Rule Comments from Steve Kus (July 2, 2003) ("Kus Comment"); e-mail to Commission Rule Comments from David Haburjak (July 8, 2003) ("Haburjak Comment"); and e-mail to Commission Rule Comments from Jim Aldendifer (October 12, 2003) ("Aldendifer Comment").

effective. The arguments put forth in the comments are summarized as follows.

*Argument #1*—The criteria adopted with respect to when the NASD will waive its involvement at the court confirmation level should be the criteria used by arbitrators for granting expungement. In short, rather than simply the criteria for NASD joining the court confirmation proceeding, the standards should be applied directly to arbitrators through the NASD's Code of Arbitration Procedures.<sup>7</sup>

*Argument #2*—Member firms and associated persons will be in a position to "buy clean records" through an arbitration award containing unwarranted expungement criteria that includes one of the three standards proposed.<sup>8</sup>

*Argument #3*—The standard for proving a defamation claim varies by jurisdiction and, in conjunction with the proposed standard language invoking defamation principles, the result will be confusion as to which law should be applied.<sup>9</sup>

*Argument #4*—An absolute or partial privilege exists for defamation claims that arise out of quasi-judicial proceedings (e.g., arbitration) in most jurisdictions, but not all. Thus, confusion could result from the lack of uniformity in this regard.<sup>10</sup>

*Argument #5*—Extensive collateral litigation will be required to resolve which jurisdiction's defamation standard should apply.<sup>11</sup>

*Argument #6*—The proposal will cause a "chilling effect." Investors will be disinclined to bring any arbitration claims because of the near certainty that members and associated persons will raise defamation as a defense and counterclaim.<sup>12</sup>

*Argument #7*—The proposal will result in a "dispositive motions practice." The formal pleading requirements established by the proposal will give rise to an expensive and legally complex motions practice (thus defeating the main goal of arbitration—informal and inexpensive conflict resolution).<sup>13</sup>

<sup>7</sup> See PIABA Comment and Mason Comment.

<sup>8</sup> See PIABA Comment; G&N Comment; Estell Comment; Mason Comment; SO&G Comment; W&H Comment; and Jamieson Comment.

<sup>9</sup> See PIABA Comment.

<sup>10</sup> See PIABA Comment; G&N Comment; Mason Comment; Mangano Comment; and SO&G Comment.

<sup>11</sup> See PIABA Comment.

<sup>12</sup> See PIABA Comment; G&N Comment; Estell Comment; Mason Comment; Sachs Comment; Mangano Comment; Miller Comment; SO&G Comment; M&P Comment; and W&H Comment.

<sup>13</sup> See PIABA Comment; G&N Comment; Estell Comment; Mason Comment; Sachs Comment; Mangano Comment; Miller Comment; SO&G Comment; M&P Comment; and W&H Comment.

*Argument #8*—NASD Rule 2110 (“just and equitable principles of trade”) should be strengthened to prevent the use of unwarranted criteria for expungement or a new rule should be adopted that states that a member may not seek expungement unless one of the standards is met.<sup>14</sup>

*Argument #9*—Expungements generally will increase because of the additional criteria and such an increase is clearly detrimental to investors.<sup>15</sup>

*Argument #10*—A conflict will be created in cases when it is in the investor’s interest to settle (through an arbitration award containing expungement criteria), but the investor’s counsel will be averse to admitting to have filed a claim warranting expungement (e.g., a defamatory claim).<sup>16</sup>

*Argument #11*—Pro se investors will be unable to meet the heightened formal pleading requirements established by the proposed standards.<sup>17</sup>

*Argument #12*—The status quo is not unfair and altering the status quo would place member and associated records in a privileged class relative to other classes of public records (i.e., civil actions are not expungeable from the public record).<sup>18</sup>

*Argument #13*—The court confirmation process will be an insufficient safeguard relative to the added expungement criteria, because the NASD does not have the resources to put forth serious opposition to expungements at the court confirmation level.<sup>19</sup>

*Argument #14*—CRD information is considered to be part of the states’ books and records. NASAA and the states currently insist that only “factually impossible” claims are expungeable and, thus, an expansion of the expungement criteria would conflict with the states’ books and records laws.<sup>20</sup>

*Argument #15*—Investors already view the NASD arbitration process with suspicion and adding criteria for expungement will serve to exacerbate this perception.<sup>21</sup>

<sup>14</sup> See PIABA Comment; G&N Comment; and NASAA Comment.

<sup>15</sup> See G&N Comment and SO&G Comment.

<sup>16</sup> See G&N Comment.

<sup>17</sup> See G&N Comment.

<sup>18</sup> See Estell Comment; Sherman Comment; Mangano Comment; Miller Comment; and M&P Comment.

<sup>19</sup> See G&N Comment; Estell Comment; Mason Comment; Jamieson Comment.

<sup>20</sup> See Estell Comment; Mason Comment; and Sherman Comment.

<sup>21</sup> See Estell Comment; Sherman Comment; and Mangano Comment.

*Argument #16*—The integrity of the CRD will be negatively affected by the proposal.<sup>22</sup>

*Argument #17*—The court confirmation process is still too burdensome on members and associated persons and this burden should be eased, rather than increased.<sup>23</sup>

*Argument #18*—The proposal evidences a general lack of respect for arbitrators. Moreover, it will undermine the integrity of arbitrators by limiting their decision-making ability.<sup>24</sup>

*Argument #19*—The proposal should not be acted upon in isolation, instead it should be combined with NASD NtM 02-74 regarding expanding the amount of information that brokers must report, generally.<sup>25</sup>

*Argument #20*—The proposal would automatically convert the NASD into an adversary of members at the court confirmation level. Furthermore, the proposal will create a systemic prejudice on the part of NASDR against members.<sup>26</sup>

*Argument #21*—The court confirmation process will require a rehearing of the issues and recalling of witnesses. Such rehearing and recalling will not only be inefficient, but could result in the confirming court making different findings from those made in the underlying arbitration proceeding. This could create confusion as to the status of the underlying arbitration decision.<sup>27</sup>

*Argument #22*—The current system of disclosing unproven allegations is inequitable and making it more difficult for members and associated persons to remove such allegations from their CRD records is “doubly unfair.”<sup>28</sup>

#### B. Amendment No. 2

In Amendment No. 2, the NASD addressed a number of the comments received by the Commission in response to the publication of the notice in the **Federal Register**. As noted above, some commenters expressed concern that the mere existence of an NASD rule governing expungement could

<sup>22</sup> See Mason Comment; Sachs Comment; SO&G Comment; M&P Comment; and W&H Comment.

<sup>23</sup> See SIA Comment.

<sup>24</sup> See SIA Comment; Jamieson Comment; Partnervest Comment; McGinnis Comment; Finance 500 Comment; and Form Letter Comment.

<sup>25</sup> See SIA Comment and Jamieson Comment.

<sup>26</sup> See Partnervest Comment; McGinnis Comment; Finance 500 Comment; and Form Letter Comment.

<sup>27</sup> See SIA Comment; Partnervest Comment; McGinnis Comment; Finance 500 Comment; and Form Letter Comment.

<sup>28</sup> See Eastmann Comment; McQuade Comment; Fired Broker Comment; Marchetta Comment; Macias Comment; djs Comment; LaVoice Comment; Kus Comment; Haburjak Comment; and Aldendifer Comment.

encourage registered persons to seek expungements and make expungement easier to obtain. NASD noted its belief that this is not a legitimate concern. NASD stated that these commenters may not have considered the fact that NASD currently expunges information from the CRD system when ordered to do so by a court of competent jurisdiction, and that court-ordered expungements currently are not subject to any NASD limitations or standards.<sup>29</sup> Under the 1999 moratorium, registered persons seeking expungement relief need only obtain a court order to expunge or court confirmation of an arbitration award granting expungement relief. Under the proposed rule, NASD stressed that it will have the opportunity to review the basis for expungement and to oppose an expungement in court unless there is a specific finding that the expungement meets one of the prescribed standards.

In Amendment No. 2, NASD discussed a concern raised by commenters that arbitrators should have sole authority and complete discretion to order expungement. They suggested that NASD’s and the States’ proposed role in the court confirmation process would undermine arbitrators’ credibility. In response, NASD argued that, to the contrary, the critical element in the proposal is NASD’s reliance on fact finders, especially arbitrators, to find that the expungement relief is based on one of the standards in the proposed rule. Also of note, NASD stated in Amendment No. 2 that NASD Dispute Resolution will provide training to arbitrators regarding the standards for expungement that will trigger the NASD waiver of opposition. Under proposed Rule 2130, NASD asserted that it will rely on arbitrators’ findings and waive participation in the court confirmation process if arbitrators have appropriately awarded expungement.

Other commenters contended that the proposed procedures will be economically prohibitive. In response, NASD recognized that the additional step of naming NASD as a party may involve additional costs. In an effort to minimize costs to the parties, NASD may waive participation in the court confirmation process before filing with the court if the parties give NASD a copy of the award to review and the

<sup>29</sup> NASD has, since the inception of the CRD system, executed expungements involving customer dispute information based on a court order or (since the imposition of the moratorium in 1999 on expungements based solely on arbitration awards) court confirmation of an arbitration award directing expungement. These court orders included expungement relief granted in cases involving both settlements and hearings on the merits.

arbitrators have ordered expungement based on one of the standards in the rule. NASD noted the belief that the availability of this waiver process should limit any additional costs to the parties.

The NASD also spoke to whether the proposed rule will discourage settlements, since the parties will no longer have total control over whether information about the arbitration will be expunged. NASD admitted that it is unable to predict the ultimate effect of the proposed rule on settlements. Further, NASD noted that compliance with the proposed rule may have the effect of decreasing the number of settlements that are reached. Currently, it is possible that respondents may agree to pay damages as a *quid pro quo* for expungement and obtain court confirmation of the expungement. NASD believes that the proposed rule will reduce, if not eliminate, the risk of expunging information that is critical to investor protection and regulatory interests as a condition in settlement negotiations. NASD asserted that the potential dampening effect on settlements must be weighed against the integrity of the information in the CRD system, and the ability of public investors and regulators to examine the entirety of a registered person's record, with the limited exceptions as proposed.

A number of comments received expressed the concern that members and associated persons will be able to "buy clean records" by inserting terms into arbitration settlements that match the standards established under the proposed rule. NASD 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. NASD 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*, NASD would have no basis under this standard to waive its obligation to be named as a party in the court confirmation process.

Commenters expressed concern that the "complaint fails to state a claim upon which relief can be granted" standard, which parallels a motion to dismiss made in federal court, could be

interpreted to authorize arbitrators to grant such motions in arbitration. In response, NASD modified in Amendment No. 2 the language describing the standards under which NASD may waive participation in the court confirmation process. Currently, there is no provision in the Code of Arbitration Procedure that either permits or prohibits motions. NASD did not intend for the proposed rule to have any effect on the authority of arbitrators to grant or deny motions to dismiss a claim before a hearing on the merits. Therefore, through Amendment No. 2, NASD eliminated the "complaint fails to state a claim upon which relief can be granted" standard and replaced it with a more objective standard based on CRD reporting requirements. Specifically, Amendment No. 2 proposed a standard that would require an affirmative arbitral or judicial finding that the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. Such a finding, NASD argued, would be consistent with the registered representative reporting "No" answers to current Question 14I(1) of the Uniform Application for Securities Industry Registration or Transfer ("Form U-4"). Should arbitrators make the required finding, NASD argued, no logical basis would exist for reporting the underlying complaint and other information on an individual's CRD record. NASD stated its belief that this revised standard eliminates any unintended implications for the arbitration process, while preserving the intended substantive effect of the standard.

Commenters were also concerned that the "defamatory in nature" standard would encourage respondents to counterclaim for defamation and require claimants to defend such claims, thereby creating undue burdens on public investors in the arbitration process. Some commenters correctly noted that claims in arbitration are privileged and therefore immune from suit. In response, NASD stated that it believes the proposed rule should not substantially affect either the substance or procedure of an arbitration proceeding and should not place any undue burden on claimants in the arbitration process. Thus, to avoid the possibility that the proposed standard might result in additional counterclaims for defamation, NASD replaced it in Amendment No. 2 with a requirement that the arbitrator or adjudicator make a finding that the claim, allegation, or information is "false."

Some commenters expressed the concern that the "without factual basis" standard is overly vague. In response, NASD replaced the "without factual basis" standard with a "factual impossibility or clearly erroneous" standard. NASD asserted that this standard has a clear meaning to regulators and public investors and was favored by a number of commenters. This standard, NASD believes, would enable an individual who has been erroneously named in an arbitration, because he or she was not even employed by the member firm during the relevant time, to obtain expungement of a dismissed complaint.

Some commenters suggested that the burden of complying with the three proposed standards should be placed squarely upon the NASD's members. Such a rule would require that NASD members only seek expungement of data from the CRD system, if such data fits within one of the three standards. NASD noted that it does not believe such an approach is necessary to achieve the objectives of the proposed rule. Federal and state courts, that are fully informed about the investor protection and regulatory implications of a proposed expungement order, NASD argued, should be trusted to make the proper decision.

Other commenters put forth the argument that the burden of complying with the three proposed standards should be applied to arbitrators directly through the NASD's Code of Arbitration Procedure. NASD argued that imposing substantive requirements on arbitrators via the Code of Arbitration Procedure would be inappropriate. NASD stated that in no other instance does the Code of Arbitration Procedure impose limitations on arbitrators' ability to decide a legal issue. NASD asserted that arbitrators will know the standards for expungement relief under proposed Rule 2130, because they will have received appropriate training, and members and associated persons will know that arbitrators will only grant expungement relief based on those standards. Therefore, NASD stressed that, although the proposed rule does not place any specific obligations on arbitrators or respondents, all parties and arbitrators will be aware of the standards under which expungement relief should be granted.

As discussed above, under proposed Rule 2130, NASD will participate in the court confirmation proceeding and oppose confirmation of the expungement portion of the arbitration award if the expungement order does not meet one of the specified criteria. Some commenters asserted that NASD

will be unable to present sufficient opposition to expungement attempts at the court confirmation level. NASD responded in Amendment No. 2 by stating that these comments were without merit or supporting evidence. NASD noted that it is committed to enforcing the proposed rule, as amended, and that it has an obligation as a self-regulatory organization to fulfill all of its regulatory obligations. Furthermore, NASD stressed that it will be subject to Commission oversight in its administration of the proposed rule. As a further means to ensure that the court is made aware of the investor protection and regulatory implications of an expungement, NASD noted that states will be able to intervene if they have concerns regarding whether investor protection or regulatory issues have been fairly considered by the NASD.<sup>30</sup>

The NASD also discussed on the effective date of the proposed rule in Amendment No. 2. NASD stated that, following Commission approval of proposed Rule 2130, it will announce the approval of the Rule in a NtM, which also will announce the effective date of Rule 2130. According to NASD, the NtM will announce that the requirements of Rule 2130 will apply to all arbitrations or civil lawsuits filed on or after the effective date. NASD noted that all requests to expunge customer dispute information from the CRD system arising from arbitrations or civil lawsuits filed before the effective date of the rule, including any settlements arising therefrom, will continue to be subject to the terms of the moratorium in effect as of January 19, 1999.

### III. Discussion and Commission's Findings

The Commission has carefully reviewed the proposed rule change, as amended, the comments, and the NASD's response thereto, and finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations promulgated thereunder applicable to a national securities association,<sup>31</sup> and, in particular, with

<sup>30</sup> NASD represented to the Commission that it is in the process of establishing a notice procedure, whereby the state(s) in which a member or associated person is registered would be notified when that member or associated person seeks a waiver of NASD involvement in the court confirmation level. To the extent that the state(s) wishes to intervene, it could so petition the court. Telephone conference between Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD, and Christopher B. Stone, Special Counsel, Division of Market Regulation, Commission (October 17, 2003).

<sup>31</sup> 15 U.S.C. 78f(b). In approving this proposal, the Commission has considered the proposed rule's

the requirements of section 15A<sup>32</sup> of the Act. Specifically, the Commission finds that approval of the proposed rule change is consistent with section 15A(b)(6)<sup>33</sup> of the Act because it is designed to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission finds that the proposed rule change, as amended, is reasonably designed to accomplish these ends by allowing fact finders and the NASD to consider all competing interests before directing or granting expungement of customer dispute information from the CRD.

Moreover, the Commission, pursuant to section 19(b)(2)<sup>34</sup> of the Act, finds good cause for approving Amendment No. 2 prior to the 30th day after the date of publication of notice thereof in the **Federal Register**. As discussed below, the Commission believes that the NASD has responded to the concerns raised by the commenters and has struck a fair and reasonable balance between the burden that the proposed rule change will impose upon member firms and associated persons and the benefit that the proposed rule change will bestow upon investors, generally. To the extent that the NASD's Amendment No. 2 has not specifically addressed any arguments raised, the Commission is not persuaded by these arguments. The Commission believes that the proposal is a clear improvement over the current system for the expungement of information from the CRD system and believes that it should be put into place as soon as practicable to ensure that investors and regulators have access to more accurate information through the CRD system.

With respect to Argument Nos. 1–9, 11, 13, and 18 discussed above, the Commission believes that the NASD has sufficiently responded in Amendment No. 2. Specifically, with respect to Argument Nos. 1 and 8, the Commission believes that the NASD has sufficiently justified its application of the standards in question to the NASD's waiver or non-waiver of involvement at the court confirmation level. Argument Nos. 1 and 8 assert that the standards should be applied to arbitrators through the Code of Arbitration Procedure and to NASD members seeking expungement, respectively. The Commission agrees with the NASD that standards will be most effectively applied at the waiver juncture. In no other instance in the

impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>32</sup> 15 U.S.C. 78o–3.

<sup>33</sup> 15 U.S.C. 78o–3(b)(6).

<sup>34</sup> 15 U.S.C. 78s(b)(2).

NASD's Code of Arbitration Procedure are arbitrators bound by substantive restrictions on how they decide an arbitration case. Moreover, as the NASD notes in Amendment No. 2, arbitrators will be aware of the standards that will be utilized with respect to the NASD's waiver of involvement, and, thus, arbitrators will indirectly consider them. NASD notes in Amendment No. 2 that the standards should not be applied to members directly, because federal and state courts are more than able to make the proper decisions with respect to arbitration award confirmation. The Commission agrees with this analysis, and also believes that the potential involvement of the NASD at the court confirmation level will provide greater safeguards than simple application of the rule to members.

With respect to Argument No. 2, concerning the "buying of clean records," the Commission is satisfied that the NASD's requirement that an "affirmative" determination be made by an arbitrator will provide sufficient regulatory protection. In the initial proposed rule filing, the NASD's proposal simply required that a finding be made by an arbitrator that matched one of the proposed standards. In response to this, commenters expressed the concern that members and associated persons would be able to negotiate for the inclusion of a finding in the arbitration settlement that matched one of the requisite standards. By requiring an "affirmative determination" on the part of the arbitrator that one of the standards was met, the NASD asserted that this concern and the ability of members and associated persons to "buy clean records" will be greatly reduced. The Commission agrees with the NASD's analysis in this regard.

Argument Nos. 3–6 and 10 all relate to the potential problems that could be caused by the NASD's use of the word "defamation" in one of the three standards for waiver. In response to these arguments, the NASD proposed replacing the phrase "information contained in the CRD system is defamatory in nature" with "claim, allegation, or information is false." The Commission believes that this change sufficiently addresses Argument Nos. 3–6 and is satisfied that the new proposed language should achieve the NASD's goal in this respect (*i.e.*, ensuring that the CRD system contains accurate information).

Argument Nos. 7 and 11 are concerned with the proposed rule leading to a formal dispositive motions practice at the arbitration level. The Commission believes that the NASD has

sufficiently responded to this argument through Amendment No. 2. As discussed at length above, the initial proposed rule text included language that tracked Federal practice pleading requirements. Such language, the commenters argued, could lead to a complex, lengthy, and expensive dispositive motions practice. By removing this potentially problematic language in Amendment No. 2, the Commission believes that the NASD has responded sufficiently to these concerns.

With respect to Argument No. 9, concerning the NASD's proposed rule text itself leading to an increase in expungements, the NASD disagreed. The Commission agrees with the NASD in that the proposed rule is clearly an improvement over the current expungement system in which there are no parameters placed on expungements being incorporated into arbitration awards.

With respect to Argument No. 13, concerning the NASD's inability to present serious opposition to expungement requests at the court confirmation level, the NASD provided some comfort. In Amendment No. 2, the NASD stressed that it is a federally registered self-regulatory organization that is required by the federal securities laws to enforce its rules.<sup>35</sup> Moreover, to the extent it fails in that regard, it must answer to the Commission. The Commission acknowledges that the extent to which the proposed rule will ultimately require the NASD to contest expungements at the court confirmation level cannot be divined. The Commission believes, however, that the proposal is an improvement over the current system for expungement. To the extent that the NASD's responsibilities at the court confirmation level ever became untenable, the Commission would expect the NASD to approach the Commission with a proposed rule change or in some way seek to alter the process to ensure that the NASD fulfills its self-regulatory obligations.

With respect to Argument No. 18, concerning the proposal's lack of respect for the arbitration process, the NASD responded in Amendment No. 2. The NASD noted that, rather than indicating a lack of respect for arbitration, the proposal demonstrates that the NASD is prepared to rely heavily on the fact-finding ability of arbitrators. Once an arbitrator makes an "affirmative determination" that one of the standards has been met, the NASD will waive its involvement at the court confirmation level. The Commission

believes that the proposal strikes the appropriate balance between providing arbitrators with sufficient flexibility in addressing issues, while at the same time placing appropriate parameters on the type of information that is potentially expungeable from the CRD system.

While Amendment No. 2 does not directly address Argument Nos. 12, 14–17, and 19–22, the Commission is not otherwise persuaded by these arguments. The Commission believes that the proposal strikes the appropriate balance between permitting members and associated persons to remove information from the CRD system that holds no regulatory value, while at the same time preserving information on the CRD system that is valuable to investors and regulators.

With respect to Argument No. 12, concerning the proposal's establishment of a privileged class of public records, the Commission is unconvinced. The Commission believes that, notwithstanding the state "public record" status of data in the CRD system, such data is expungeable under certain circumstances. Indeed, a process for the expungement of data from the CRD system has been in place since the establishment of the CRD system. The Commission also is not persuaded by this "states" rights' argument and notes that NASAA itself did not make this argument to the Commission.

With respect to Argument No. 14, concerning the rule's potential conflict with the states' books and records rules, the Commission is not persuaded. NASAA works closely with the NASD in the operation and enhancement of the CRD system. To the extent this is a valid concern of the states, the Commission would have expected NASAA to have raised this point. In fact, NASAA submitted a detailed comment letter on the proposal and did not raise this concern.

With respect to Argument Nos. 15 and 16, concerning a worsening of the already poor perception that investors have of the NASD arbitration process and of the integrity of CRD data, the Commission is not persuaded. These arguments appear to rely on the assumption that adopting explicit criteria for expungement will make expungement easier, compromise the process for expungement, and, ultimately, degrade the CRD system. As discussed at length above, the Commission believes that the proposal will have the opposite effect. Specifically, the Commission believes it will strengthen the expungement process, by ensuring that only information that is not valuable to

regulators and investors is expunged from the CRD system.

Argument Nos. 17 and 20–22 ostensibly relate to maintaining the accuracy of data that appears in the CRD system. Specifically, by making it more difficult to expunge information, the arguments aver, members and associated persons will be less likely and less able to expunge inaccurate information from the system—ultimately, degrading the system. The Commission appreciates these arguments and agrees that expungement of inaccurate information from the CRD system is crucial to the system's value. Further to that point, the Commission would clearly be opposed to any proposed rule that would place an unfair burden upon members and associated persons seeking to expunge inaccurate information from the system. The Commission, however, does not believe that the proposal will make expungement of *appropriate* information from the system overly or unfairly difficult. To the extent a member or associated person seeks to expunge *appropriate* information, the NASD should waive involvement at the court confirmation level. In such a circumstance, the process should function not unlike how it currently functions and should not require a significant rehearing of the issues and/or recalling of witnesses. The Commission believes that the proposal has been structured in such a way that the potential for divergent findings at the court confirmation level and the arbitration level has been minimized. In sum, the Commission believes that the proposal addresses the serious Commission concern that valuable information is being expunged from the CRD system through arbitration settlements that include negotiated expungement instructions.

Finally, with respect to Argument No. 19, asserting that the proposal should be acted upon in conjunction with NASD NtM 02–74, the Commission does not agree. The NASD is a registered national securities association and is owed a certain degree of latitude with respect to how it carries out its self-regulatory responsibilities. The Commission believes that the decision to file this proposal separately from the proposal that will follow from NtM 02–74 is the type of self-regulatory decision that the NASD has discretion to make. Moreover, NtM 02–74 has not yet been filed by the NASD and the Commission does not believe it would be in the interests of investors to delay the Commission's action on the instant proposal.

<sup>35</sup> See Section 19(g) of the Act, 15 U.S.C. 78s(g).

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 2, including whether the amendment is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-NASD-2002-168. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2002-168 and should be submitted by January 14, 2004.

#### V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>36</sup> that the proposed rule change (SR-NASD-2002-168), as modified by Amendment No. 1, be, and it hereby is, approved, and that Amendment No. 2 be, and hereby is, approved on an accelerated basis. As discussed above, the NASD will announce the effective date of this proposed rule change through a NtM to be circulated as soon as possible after the publication of this approval order in the **Federal Register**.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>37</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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<sup>36</sup> 15 U.S.C. 78s(b)(2).

<sup>37</sup> 17 CFR 200.30-2(a)(12).

#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48930; File No. SR-NASD-2003-177]

#### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Technical Amendments to Interpretive Material 3130

December 16, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 2, 2003, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by NASD. NASD has designated the proposed rule change as "non-controversial" under section 19(b)(3)(A) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder,<sup>4</sup> which renders the proposed rule change effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to amend NASD IM-3130. The text of the proposed rule change is set forth below. Proposed new language is in *italics*; proposed deletions are in [brackets].

\* \* \* \* \*

#### IM-3130. Restrictions on a Member's Activity

(a) This explanation outlines and discusses some of the financial and operational deficiencies which could initiate action under Rule 3130. Paragraphs [(b)](c)(2) and [(c)](d)(2) of Rules 3130 and 3131 recognize that there are various unstated financial and operational reasons for which [the Association] NASD may impose restrictions on a member so as to prohibit its expansion or to require a reduction in overall level of business. These provisions are deemed necessary in order to provide for the variety of situations and practices which do arise and which, if allowed to persist, could

result in increased exposure to customers and to broker/dealers.

(b) In the opinion of the Board of Governors, it would be impractical and unwise to attempt to identify and list all of the situations and practices [which] that might lead to the imposition of restrictions or the types of remedial actions [the Association] NASD may direct be taken because they are numerous and cannot be totally identified or specified with any degree of precision. The Board believes, however, that it would be helpful to members' understanding to list some of the other bases upon which [the Association] NASD may conclude that a member is in or approaching financial difficulty.

(c) For purposes of paragraphs [(b)](c)(2) and [(c)](d)(2) of Rule 3130, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by [the Association] NASD that any of the parameters specified therein are exceeded or one or more of the following conditions exist:

(1) through (8) No change

(d) For purposes of paragraphs [(b)](c)(2) and [(c)](d)(2) of Rule 3131, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by [the Association] NASD that any of the parameters specified therein are exceeded or one or more of the following conditions exist:

(1) No change

(2) The member has experienced a substantial change in the manner in which it processes its business which, in [the] NASD's view, [of the Association,] increases the potential risk of loss to customers and members.

(3) through (8) No change

(e) If [the Association] NASD determines that any of the conditions specified in paragraphs (c) or (d) of this explanation exist, it may require that the member take appropriate action by effecting one or more of the following actions until such time as [the Association] NASD determines they are no longer required:

(1) through (12) No change

(13) Be subject to such other restrictions or take such other action as [the Association] NASD deems appropriate under the circumstances in the public interest and for the protection of members.

\* \* \* \* \*

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).