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EXPUNGEMENT AWARDS

Awards that are subject to the new and more stringent requirements of NASD Rule 2130 have only recently begun to enter the Public Award stream. SAC gathered some 675 such Awards, isolated those where expungement was granted, and examined how the new regime is affecting the dynamics of arbitration practice -- and the broker in the middle..... 1

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Seeking Expungement Relief Under NASD Rule 2130

An Examination of post-2130 Arbitration Awards

Introduction

As with transactions on the stock market, individual arbitration Awards taken individually reveal little, but taken collectively they signal trends and patterns that can be useful in determining risk and likely outcomes. We review the Awards with this in mind when questions arise about the impact of rule changes or other material factors affecting the arbitration "market." In this article, we use SAC's Award Database to examine the initial signs of change in securities arbitration's dynamics under the tightened regulatory regime for qualifying expungement orders.

In his lead article for SAC's June 2005 edition, "Expungement of Customer Claims" (2005 SAC, No. 5), Roger D. Mellem reviewed the history of the Central Registration Depository (CRD) since its launch in 1981. He did a superb job of describing the NASD Moratorium on arbitral-ordered expungement relief, which was imposed in January 1999, the various Notices to Members that have issued on the subject (e.g., NTMs 99-09 & 99-90), and the recent promulgation of NASD Rule 2130. Mr. Mellem examined the probable ramifications of new Rule 2130 with its requirements of affirmative findings by arbitrators and NASD participation in post-Award confirmation proceedings.

Expungement orders have not always been around. In the 1990s CRD increasingly expanded the nature of the information it stores about securities brokers – from untested letters of complaint and employer allegations to dis-

ciplinary investigations and actions. The increased ease of public access to this information has also elevated brokers' concerns about the breadth and accuracy of CRD information. Awaiting approval at the SEC is a proposal that would expand disclosure of a broker's record through Broker-Check and make it immediately available to the public customer with a couple of online clicks. (See SR-NASD-2005-168).

Expungement & Arbitration in the 90s

The first reference we can find to an expungement order in an arbitration Award goes back to 1994, *Sadler v. Nesson*, NASD ID #93-00154 (Los Angeles, 3/1/94), a case dealing with a money market account, where the claim was dismissed for failure to obey a discovery order. The attorney who obtained the expungement order from the Panel was John P. Cione, who today maintains a practice in Southern California and who was a long-time Compliance Chief for Blyth Eastman Dillon. In total, there have been about 3,000 Awards containing expungement orders issued from 1994 to date. About 1,600 occurred in connection with a settlement and a stipulation between customers and broker-dealers to expunge a broker's record.

Just three of those expungement orders issued in 1994, another ten issued in 1995, and only about 250 issued before the NASD imposed its Moratorium in January 1999. The first expungement order we can find that

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issued in connection with a settlement of a customer claim was contained in a Stipulated Award that issued in 1997, *Fusco v. William Blair & Co.*, NASD ID #96-05251 (Tampa, FL, 11/18/97). The attorney representing William Blair and its broker in that case was Lisa Aidlin, Sonnenschein Nath, Chicago. The next Stipulated Settlement Award was issued in 1998, where, again, John P. Cione is listed as counsel, but this time Mr. Cione represented the Claimants (*Franklin v. Merrill Lynch*, NASD ID #96-04474 (NYC, 2/11/98)). By the time of the NASD Moratorium and the issuance of NASD NTM 99-09, about a score of such Stipulated Awards had been rendered.

Expungement & Arbitration
Post-2000

Expungement by stipulation is a relatively recent phenomenon, in terms of its impact on the process and regulatory recordkeeping. Things really started to gain momentum in 2003 and, by 2004, the 550-plus Stipulated Awards issued by NASD and NYSE arbitrators constituted more than 15% of the approximately 3,600 NASD-NYSE Awards issued during that year. For the first eight months of 2005, the pace has continued to quicken, so that more stipulated expungements have been recorded in that timeframe than in all of 2004. Expungement, because of the major impact customer-complaint data can have on a broker's career – and the accessibility of that data to public view – has become a familiar element in mediation discussions and settle-

ment negotiations relating to securities arbitration.

Requests for expungement relief also continue commonly to appear in counterclaims and answers submitted by Respondents, particularly when the broker is named as a Respondent. Expungement relief was requested in some 1,300 decided cases in 2004 and that same pace has been maintained thus far when one views the NASD Awards issued through August 2005. Arbitrators are granting expungement, pursuant to NASD NTM 99-09 and 99-90, not only pursuant to stipulations by the parties, but after merits hearings as well. We recorded about 300 such "merits" expungement orders in 2004 (i.e., 8-9%) and another 200-plus through August 2005.

Clearly, the impact of CRD disclosures has assumed an integral and important role in the dynamics of settling or trying arbitration disputes with securities customers. Clearly, too, hundreds of brokers each year are currently able to seek and can realistically obtain effective relief when, as happens, their CRD records are besmirched by the exaggerated or false allegations of disgruntled customers. There are abuses that have arisen, however, leading to charges that brokers were "purchasing" clean CRDs with settlement payments. NASD Rule 2130 and other recent drum-beating pronouncements by NASD Regulation (e.g., NTM 04-43) have targeted those perceived abuses.

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EXPUNGEMENT AWARDS *cont'd from page 2***Practice Under Rule 2130**

The question now is whether expungement through arbitration has become such a critical tool for brokers and supportive employers that the new hurdles erected by NASD Rule 2130 will be absorbed into the practice and overcome or whether they will become a barrier to deserving registered representatives pursuing a practical route to significant relief. As the Mellem article points out, to persist and prevail in the post-2130 regime, brokers will have to persuade arbitrators of the need for justifiable relief, through post-settlement, expungement mini-hearings and, many times, they will have to forego settlement and proceed on their own to merits hearings, when their brokerage firm employer opts for the certainty of settlement. With the need to make affirmative findings, arbitrators will seldom be in a comfortable position to endorse a Stipulated Award submitted by the parties.

The combination of greater commitments of time and money, of an increased incidence of separate representation and defense-team conflicts, matched against the heightened risks of failing the more stringent tests for expungement, suggest that, when fully activated, NASD Rule 2130 could sound the death knell for practical expungement relief. Looking today at the active commerce in obtaining expungement orders, whether by hearing or by settlement stipulation, one would discount that likelihood. After all, these first eight months of 2005 have seen the most active issuance of expungement orders of any year past. Remember, though, that the requirements for affirmative findings by arbitrators under NASD Rule 2130 and for notification to NASD Regulation of confirmation proceedings involving expungement requests only apply to cases filed on or after April 12, 2004.

Thus, the impact of Rule 2130 has only just begun to be felt. When we last checked at the start of 2005 (see SAA 2005-01), only 44 Awards had issued that were filed on or after April 12, 2004. Only one Award in that small lot

was a Stipulated Award granting expungement relief, but the sample was not large enough at that point to support generalized comment. It takes on average 17 months for a case to come to Award at NASD, so it is only now, 17 months after Rule 2130 took effect, that the answers have begun to be reflected in the latest-issuing Awards.

Surveying Post-2130 SRO Awards
Gathering Representative Awards

As we go to print, 675 NASD and NYSE Awards with filing dates of April 12, 2004 or later have been recorded on SAC's Award Database (post-2130 Awards). Only 45 of those 675 Awards – about 7% — are Settlement Awards containing expungement orders. Judging from this sample, we could state that the number of Settlement Awards will slow as NASD Rule 2130 takes effect, since this result in our post-2130 sample differs substantially from the 15% incidence of Stipulated Settlement Awards among 2004 Awards. While we do believe that will prove to be the case, two factors warrant caution in accepting this calculation as a final observation.

The first factor relates to the higher incidence of Small Claims Awards in our post-2130 sample. Small Claims cases have a much shorter turnaround time than do customer-initiated claims exceeding \$25,000 (Customer-Member cases) and Stipulated Awards among the Small Claims Awards are relatively rare. Thus, our sample of 675 post-2130 Awards, which all derive from cases that are no more than 17 months old, will naturally have a smaller incidence of Stipulated Awards.

The second factor affects our sample in the opposite way. The momentum of expungement practice in the old regime will, we think, carry old practices into the early months of the new regime, as a period of adjustment takes place. That will lead initially to more expungement requests being made and honored than may be the case once post-2130 norms crystallize. For instance, 21 of the 45 Awards granting

expungement relief, pursuant to a settlement of the main dispute, reflect the old practice of ordering expungement relief in an “embedded” Stipulated Award that concluded the main proceeding. Expungement orders in the other 24 Settlement Awards arose from separate proceedings that followed the main arbitration.

Traditional Stipulated Awards

Besides the ordered relief, though, and despite the absence of any merits hearings prior to settlement, the majority Panel in 16 of 20 Stipulated Awards made affirmative findings and provided the “magic words” for expungement in their decisions. In four of the Stipulated Awards, the Panel granted expungement relief, referred to NASD NTMs 99-09 and 99-90, as in earlier practice, but failed to supply the affirmative findings. In the 21st Stipulated Award, the Panel had conducted five hearing sessions in the case before it settled. In addition to the knowledge gained from this view of the dispute, the arbitrators also relied upon party submissions in making a finding that the allegations were “clearly erroneous.”

We think a change in approach is likely, at least where settlements occur before any hearing sessions have taken place. The shape of that change can be seen in the other 24 of the 45 settlements. In these cases, a different practice was followed, where the main case was closed as settled and a second arbitration, a “2130 collateral proceeding,” was begun in order to deal with expungement. In other words, a new arbitration was initiated, under a different case or docket number, by the requesting broker (sometimes joined by his/her broker-dealer employer) who names the customer with whom s/he has joined in settlement and asks in this separate matter for the affirmative findings that will, with judicial confirmation, secure the expungement relief.

Rule 2130 Collateral Awards

The developing practice at the NYSE forum finds the same Panel that

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was appointed to sit in the main dispute gathered to decide the expungement question in the 2130 collateral proceeding. This conserves resources, avoids the delay caused by new Panel appointment procedures, and utilizes the knowledge the original Panel gained about the case during the main dispute. In addition, in most of the 2130 collateral proceedings, the NYSE Director waives the fees, taking the implicit view that the new case is simply an administrative device to consider an issue left over from, but integral to, the original proceeding.

Under the model generally followed at the NASD forum, the main dispute is closed as settled and the 2130 collateral proceeding is treated as a new dispute to be arbitrated. The case not only gets a new docket number, but apparently a new "Panel." We cannot tell if the single Arbitrator appointed to a new case is a member of the original Panel, because the original case settled and no Public Award issued. Using a single arbitrator saves money, because forum fees are lower, but there does not appear to be a fee waiver policy for these collateral proceedings.

Of course, there is added expense for the broker-dealer in this formula, since NASD charges member surcharges and process fees, whether the brokerage firm is actually named in the 2130 collateral proceeding or not. The NYSE has recently adopted these member-only fee charges for imposition in NYSE arbitrations, so we must wait to see if the NYSE Director will continue to waive all of the collateral proceeding fees, including the lucrative surcharge and process fees. If fees continue to be waived, the broker and member firm will enjoy some small relative cost savings when settling cases under NYSE Arbitration's auspices.

Expungement – Merits Awards

Are any expungement requests being denied among the post-2130 Awards? The answer is "yes," but most commonly expungement denials are occurring at the end of merits hearings, i.e., in the decided Awards. How

often then are expungement requests being granted in the post-2130 "merits" Awards? We did not expect to see much change when we reviewed Awards for this factor, because arbitrators who hear an entire case can quite naturally make affirmative findings in connection with a request for expungement relief. We did think that the incidence of expungement requests and orders might decline, if Claimants, seeking to avoid expungement distractions, refrained more frequently from naming the broker as a Respondent.

So far, that does not appear to be a developing dynamic. If one views Customer-Member Awards for the past five years, the customer names an individual Respondent (presumably the broker) about 57% of the time. When we viewed the 255 Customer-Member Awards in our group of 675 post-2130 Awards, we found that the broker was named in 142 instances or about 56% of the time. Thus, we find no evidence as yet that Claimants' counsel (we say counsel, because customers are generally represented in Customer-Member cases) are increasingly reluctant to name the broker, despite the many arguments that favor that tactical choice.

In our sample of 675 Awards, we found 37 instances in which expungement was granted in a decided case — about 5% of the time. That differs from the 8-9% of "merits" Awards containing expungement relief among the 2004 Awards (see above), but the difference is due to the greater incidence of Small Claims Awards in the post-2130 sample. Allow for that and the percentages are comparable; they even indicate that "merits" expungements could be growing more common. For this survey of Expungement Awards, we reviewed those 37 "merits" Awards individually and found some interesting details.

Merits Awards - Observations

For instance, there are several "merits" expungements, where the broker-dealer is tagged with liability, but the broker is exonerated nevertheless. In five cases, the Arbitrators granted

pre-hearing motions to dismiss and included expungement relief as part of the defense victory. In those cases, the Arbitrators appear to have made the affirmative findings, based upon the same legal determinations that caused them to find no claim for relief, i.e., a "legal merits" test.

Just two of these cases were Small Claims matters. One Small Claims matter seemed particularly hard-fought, as it had counsel on both sides and lasted four hearing sessions. The broker-dealer was ordered to pay \$9,000 to Claimant, but the claims against the broker were found to be "false." Finally, we tried to test the likelihood that Respondent brokers, intent upon obtaining expungement relief from the arbitration Panel, would refuse to settle, would part company with the Respondent broker-dealer, and proceed to hearing alone. Our review did not disclose an instance where multiple Respondents were named, the brokerage firm settled (usually disclosed in the "Other Issues" section of the Award), and the broker or brokers continued to a "merits" hearing to establish entitlement to expungement. We make that observation with the appropriate caveats, but, for whatever reason, the fact pattern is not a stand-out phenomenon.

All Expungement Awards – Affirmative Findings

One last aspect of these post-2130 Awards caught our attention and bears examination: the choices made by Panels that provide affirmative findings. The terms that comprise the Rule 2130 affirmative findings emerged from a galvanizing process that would temper steel. Can it be that arbitrators can use their own words and not those supplied by Rule 2130 and expect that expungement will follow? To us, it seems that the correct terms will be essential for trouble-free expungement in both cases that settle and cases that are tried to conclusion. One may hope that NASD Regulation will not make the 2130 procedure more arduous by second-guessing arbitrators who include the 2130 language in their affir-

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mative findings, but when Panels do not, the road will grow considerably rougher for the broker seeking expungement from the CRD of a post-2130 proceeding.

What we found when we reviewed the post-2130 expungement Awards was a wide variety of experiences, indicating, on the plus side, many arbitrators coping intelligently with unfamiliar territory and, on the negative side, unprepared neutrals operating without adequate staff guidance. Briefly, any one of these three affirmative findings should accompany an expungement recommendation under NASD Rule 2130: (1) "factually impossible" and/or "clearly erroneous" allegations, (2) broker "not involved," or (3) "false" claims.

It was our guess in reviewing the Awards that most Panels would choose the "false" designation; instead, the choices were assorted. Arbitrators selected "factually impossible" and/or "clearly erroneous" in 19 of the post-2130 Awards, cited "not involved" in 16 of the Awards, and declared the allegations "false" in 16 of the Awards. Combinations of the three alternative findings were used in a few of the Awards. Most surprising, though, was the finding that, in a score of instances, Panels chose to employ either the pre-2130 text (and make no affirmative findings) or some unique phrasing.

Relying upon the pre-2130 text may have done no harm in certain of the 2130 collateral proceedings, because it is likely that the expungement order, while issued in an arbitration that commenced on or after April 12, 2004, actually related to an arbitration that was filed well before Rule 2130 took effect. In that sector, we found some interesting verbiage, such as the allegations contained "defamatory matter"(useful in industry disputes) or were "without factual basis or legal merit,"(a standard that NASD considered and discarded). In one instance, the broker had "no connection with the account" (close to "not involved"?)

and, in another, "he was not responsible, nor did he engage in unethical practices..." Soothing, perhaps, to the broker, but these are not certain to be helpful before the NASD 2130 staff.

In the "merits" Awards, where half of the "old text" and "other" findings occur, the failure of arbitrators to adhere to the requirements of Rule 2130 when they decided to grant expungement relief is truly unfortunate. These cases are clearly covered by Rule 2130. In one ironic instance, the arbitrators used the pre-2130 text in their Award to recommend expungement. While offering no affirmative findings, the Panel was scrupulous in advising the broker on the 2130 requirement that he had to notify the NASD before pursuing confirmation.

Conclusion

It seems as though the new 2130 regime is taking hold in the securities arbitration process, albeit it is off to a rough start. Arbitrators are utilizing an almost equal balance of the affirmative findings under Rule 2130, most commonly selecting the fairly declaratory "clearly erroneous." That care in selection indicates that Panels are tailoring the affirmative finding to the case at hand, as opposed to opting for the most amorphous of the terms to justify expungement. That Panels are awarding the expungement relief in decided cases as actively as they do in the pre-2130 cases indicates that the affirmative findings requirement is not a barrier to appropriate relief.

On the other hand, we saw no signs that brokers are refusing to join their firms in settling with a Claimant, in order to press for an adjudication and expungement relief. They may not have to, if arbitrators continue to grant Stipulated Awards following party settlements, but our surmise is that that practice will be replaced by the 2130 collateral proceedings. NYSE and NASD are both utilizing this mechanism, in order to assure that the Panel weighing expungement has the opportunity to gain foundation for the necessary affirmative findings.

From our review, it seems that presiding Panels in these collateral proceedings are generally amenable to providing the requested relief. Unlike the assorted outcomes in merits Awards, we found no collateral proceeding Awards where expungement relief was denied. We also saw a real reduction in the percentage of cases in which Settlement Awards containing expungement relief were requested of arbitrators. Taken together, these two findings may indicate that arbitrators are not just being facilitative, but that parties are scrutinizing more carefully whether expungement relief may justifiably be sought.

To the extent such salutary factors are at work, deserving brokers retain an effective path to relief. On the other hand, the reduced percentage of settled cases seeking expungement under Rule 2130 may be due to negative factors that are intimidating brokers or discouraging them from pursuing expungement when they should. If the reduced percentage is due to the application of higher standards and heightened reality checks, it may be just, but, if not, an important remedy -- the ability to set the record straight -- will have been lost to the exigencies of dispute resolution.

One thing that clearly needs to improve right away is the state of awareness of counsel, arbitrators and staff of the need to conform with the requirements of NASD Rule 2130 when dealing with expungement matters. If counsel does not insist upon the correct language and affirmative findings in the expungement Award, it will compel NASD to delay and perhaps contest confirmation efforts. If counsel also fails to notify NASD Regulation of a non-conforming Award and proceeds to confirmation, what then will be the regulatory reaction -- a violation of NASD Rule 2130? Pity the broker who incurs disciplinary sanctions because counsel failed to process properly the broker's expungement relief!