

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