FINRA
Financial Industry Regulatory Authority

Richard G. Ketchum
Chairman and
Chief Executive Officer

November 13, 2013

The Honorable Edward J. Markey
United States Senate
218 Russell Senate Office Building
Washington, DC 20510

Dear Senator Markey:

This letter is in response to your letter dated October 25, 2013, regarding several issues raised in recent *Wall Street Journal* articles about "rogue brokers." Specifically, you asked FINRA to respond to three issues: expungement of customer dispute information from FINRA's BrokerCheck database, arbitration awards in favor of investors that are not paid by brokers, and the movement of brokers from firms that are expelled by FINRA to other securities firms.

We at FINRA take our mission of investor protection seriously, and it motivates every aspect of our regulatory program. I appreciate your longstanding interest and engagement in these important issues and we are committed to working with you and your staff as we continue to monitor and evaluate our programs for improvement. Below, you will find descriptions of FINRA's initiatives in the areas of expungement, payment of arbitration awards, and monitoring the movement of securities brokers who worked at expelled firms.

BrokerCheck and Expungement

BrokerCheck is part of FINRA's ongoing efforts to help investors make informed choices about the FINRA-registered brokers and brokerage firms with which they may conduct business. BrokerCheck also provides the public with access to information about formerly registered brokers who, although no longer in the securities industry in a registered capacity, may work in other investment-related industries or may seek to attain other positions of trust with potential investors. Through BrokerCheck and the Investment Adviser Public Disclosure (IAPD) system, operated by FINRA under contract with the Securities and Exchange Commission (SEC), FINRA makes available to the public more comprehensive information on investment professionals than is available for doctors, lawyers, accountants, or any other group of professionals.

Over the past several years, FINRA has dramatically expanded the scope of information and investor education content available in BrokerCheck. In 2009, FINRA revised

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questions on the uniform securities industry registration forms—the data source from which BrokerCheck information is derived—to require reporting of arbitrations or civil litigation containing allegations of sales practice violations involving a broker, even if the broker was not named as a party to the action. Those allegations are now disclosed through BrokerCheck.

In 2010, FINRA extended the BrokerCheck disclosure period for former brokers from two years to ten years, and expanded the category of customer complaint information disclosed through BrokerCheck to include certain historic customer complaints. That same year, FINRA made information about former brokers permanently available if they were convicted of or pled guilty to certain crimes, if they were found in a civil court to have been involved in a violation of investment-related statutes or regulations, or if they were subject to a judgment or award as a respondent or defendant in an arbitration or civil litigation in which they were alleged to have committed a sales practice violation. Brokers who have been out of the industry for more than ten years also remain permanently in BrokerCheck if they have been the subject of a final regulatory action. In 2012, FINRA implemented additional enhancements to BrokerCheck, including the ability to search BrokerCheck by zip code and providing direct links to the IAPD system for individuals who are dually registered as brokers and investment advisers. Moreover, BrokerCheck now links directly to the FINRA Arbitration Awards Online Database, which provides arbitration awards rendered in FINRA's and other forums and to FINRA's Disciplinary Actions Online, which provides decisions and settlements from FINRA disciplinary actions that meet the publicity standards of FINRA Rule 8313. Both of these databases are available on FINRA's web site. When a broker's record includes an arbitration award or regulatory action available in those systems, the BrokerCheck record provides a hyperlink directly to the relevant document.

Less than two weeks ago, on October 26, 2013, FINRA made significant changes to BrokerCheck to improve the user experience for investors by highlighting critical information on the search results and summary pages and adding a "timeline" view of the broker's industry experience and the criminal, regulatory, civil judicial, customer complaint, termination and financial disclosure events reported on his or her uniform registration filings (e.g., Form U4, Section 14. Disclosure Questions and Form U5, Section 7. Disclosure Questions).

One of FINRA's goals is to increase public awareness of BrokerCheck. The number of searches over the past several years suggests that FINRA's efforts are succeeding. In 2012, BrokerCheck records were searched 14.6 million times; more than triple the number of searches in 2001. Recently, FINRA enhanced BrokerCheck's Internet presence to enable investors searching investment professionals and investment firms through Google and Bing to obtain results with direct links to records in BrokerCheck. This week, we are deploying a stand-alone and more visible BrokerCheck search box, first on the FINRA home page and then on other investor-related websites, that will enable investors to enter a broker or firm name and go directly to the search results page in BrokerCheck.

We agree that BrokerCheck needs to effectively convey to investors that disciplinary, customer complaint and other disclosure information is available through BrokerCheck and that it is important for them to review this information. We are considering ways to

better convey the types of information available in BrokerCheck and, to the extent possible, the relevance of that information to investors, on the FINRA home page and elsewhere. To that end, we will emphasize on the BrokerCheck home page that disciplinary and other disclosure information is available through BrokerCheck. The fact that certain information may be expunged from the Central Registration Depository (CRD®), and therefore unavailable in BrokerCheck, is explained in the "About BrokerCheck Reports" link on the right side of every BrokerCheck page. We will carefully review the existing information about expungement, as well as the placement of that information, to better inform investors and others of the possibility that matters have been expunged from a BrokerCheck record.

Since we created the CRD database in the early 1980s, FINRA has been attuned to the issues involving expungement. FINRA expunges customer dispute information only when ordered to do so by a court. FINRA receives expungement orders issued by courts confirming arbitration awards, but also in cases that were litigated or settled only in courts.

FINRA has consistently worked to ensure that expungement of customer dispute information occurs only after an adjudicator concludes that expungement is appropriate. In 2004, following SEC approval, FINRA implemented Rule 2080 (formerly Rule 2130), which establishes procedures for seeking expungement of customer dispute information from CRD. Rule 2080 was developed in consultation with representatives of the North American Securities Administrators Association (NASAA) and state regulators. The rule codified existing practice that all such expungement directives be ordered or confirmed by a court, and requires that members and associated persons seeking such a court order or confirmation name FINRA as a party. The rule allows FINRA to waive the obligation to name it if expungement is based on an affirmative arbitral or judicial finding that the claim is false, factually impossible or clearly erroneous, or that the broker was not involved in the alleged violation.

In litigated cases, arbitrators may consider the issue of expungement after hearing the merits of a dispute, in which case arbitrators have heard testimony, reviewed evidence, and considered arguments by parties on the expungement issue. However, as you observed, in some cases, arbitrators are asked to consider expungement relief after the underlying case is settled between the parties. Settled cases raise different issues about the process and the decisions reached. Instead of the parties contesting a dispute before the arbitrators, they are presenting a negotiated settlement agreement and asking arbitrators to approve the proposed resolution. In 2008, following SEC approval, FINRA changed its rules to require arbitrators to perform additional fact finding before granting expungement relief and to provide transparency into the process. FINRA Rule 12805 requires arbitrators to (1) hold a recorded hearing regarding the appropriateness of expungement; (2) review settlement documents, and consider the amount of payments made to any party, and any other terms and conditions in cases involving settlements; and (3) indicate in the award which of the grounds in Rule 2080 is the basis for their expungement recommendation and provide a brief written explanation of the reasons for recommending the expungement.

During the five-year period covered by the PIABA study referred to in your letter, customers initiated almost 18,000 arbitration cases against securities firms or brokers. A

large majority of these cases did not include any expungement request. In more than half of the cases in which an expungement request was made in the pleadings, the request was not pursued with the arbitrators. Over that same five-year period, FINRA received and executed fewer than 850 court orders for expungement that confirmed arbitrator recommendations, or less than five percent of the number of claims filed in the FINRA forum. This is due, in no small part, to FINRA Rules 2080 and 12805, the latter rule being in effect during the majority of the time period covered by the study.

However, despite the rule changes, we continue to see a high percentage of expungement requests granted where the underlying case was resolved by settlement. Investors may stipulate to the expungement request or declare that they are not opposed to such relief. The investor who brought the underlying claim rarely attends the required expungement hearing. This has been an ongoing concern for FINRA because arbitrators will only hear the position of the party requesting expungement. We understand from counsel who regularly represent investors that the terms of settlements often require an investor to consent to expungement relief or at least not oppose expungement. The standard of judicial review of arbitration awards is among the most stringent in the law, and courts are very reluctant to disturb an arbitrator's decision on the merits of a case, including expungement.

Since Rule 2080 was approved, FINRA has strengthened training of arbitrators on how to evaluate expungement requests. FINRA has required arbitrators to take a mandatory training course on expungement to be eligible for service as an arbitrator. Among other matters, the training materials remind arbitrators that "expungement of a CRD record under any circumstances is an extraordinary remedy and should be used only when the expunged information has no meaningful regulatory or investor protection value." The arbitrator training materials were updated in 2008 after the approval of Rule 12805 and all arbitrators were required to certify that they had familiarized themselves with the requirements of that rule. In addition to the mandatory training, FINRA staff periodically publishes informational pieces about expungement in the *Neutral Corner*, a FINRA publication distributed to arbitrators.

In response to renewed concerns that the terms of settlement agreements often require an investor to consent to or not oppose expungement relief, we sent arbitrators a notice and published on our website guidance for parties and arbitrators concerning expungement requests. The guidance emphasizes the extraordinary nature of expungement relief and advises arbitrators to consider the importance of CRD information to regulators, firms, and investors when considering requests for expungement. The guidance encourages arbitrators to request any documentary or other evidence they believe is relevant to the expungement request, particularly in cases that settle before an evidentiary hearing or in cases where only the requesting party participates in the expungement hearing. The guidance also suggests that arbitrators ask the broker requesting expungement to provide a current copy of his or her BrokerCheck report and, in addition, in settled matters, inquire whether the firm or broker conditioned settlement of the arbitration upon agreement by the investor not to oppose the broker's request for expungement. The guidance further recommends that arbitrators identify in the award the specific documentary or other evidence that they relied upon when recommending expungement.

In addition to arbitrator-ordered expungements, FINRA receives court orders for expungement in civil litigation, usually as the result of a settlement. In these cases, FINRA tries to have the court make a finding under Rule 2080, but cannot compel a court to apply FINRA's rules in this area. Sometimes FINRA does not receive notice of a case until after the court has ordered expungement as part of a settlement that concludes the case. FINRA has opposed requests for expungement where FINRA believes that expungement is inconsistent with Rule 2080, and could impair the integrity of the data in CRD. In one recent case, FINRA prevailed after two and a half years of litigation through state and federal courts, and an appeal. In other cases, courts have ordered expungement of such information, despite FINRA's opposition. FINRA will continue to be active in this area.

We are presently reviewing the overall expungement process. We are developing expanded training on expungement for arbitrators, including an emphasis on the importance of the integrity of the information in the CRD system. We are also considering additional rule changes to address the practice of conditioning settlements upon the investor's agreement not to oppose expungement.

Unpaid Arbitration Awards

In response to the recommendations in the 2000 United States Government Accountability Office Report entitled *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, FINRA took significant steps to track and address the non-payment of awards. Since 2000, firms have been required to notify FINRA in writing within 30 days of receipt of an award that they or their brokers have paid or otherwise complied with the award. FINRA proactively suspends the registration of any firm or broker that fails to comply with a FINRA arbitration award. In each suspension action, FINRA records in CRD that the firms or brokers failed to demonstrate payment of an arbitration award, and the CRD reference prevents both firms and brokers from re-entering the securities industry until the award has been satisfied.

FINRA will stay suspension proceedings only when there is a valid legal basis for non-payment including circumstances when firms or brokers: 1) timely file an action to vacate or modify any award and such motion has not been denied; or 2) file for bankruptcy protection and the award has not been deemed by a bankruptcy court to be non-dischargeable. Our data show that FINRA suspension or the threat of suspension directed to active firms and brokers often forces payment of the award or settlement to the satisfaction of investors.

Most awards are paid in full because FINRA has the power to suspend any firm or broker that fails to satisfy an arbitration award. In 2011, the most recent year for which full data are available, FINRA issued arbitration awards in 739 investor cases, of which 79 were not paid. Three quarters of the unpaid awards were against firms or brokers that were no longer registered in the industry. The firms with unpaid awards will not be able to re-register without satisfying the award. Individual brokers will not be able to register with any brokerage firm without paying the outstanding award.

Most of the remaining unpaid awards were the subject of motions to vacate in court, which suspends the obligation to pay until the court has ruled on the motion. Courts may

either vacate the award, leaving the parties to begin again, or confirm the award, reinstating the obligation. If a broker or firm appeals the denial of a motion to vacate, they must still pay the award—or face FINRA suspension—unless they obtain a stay of the payment obligation under the rules of the jurisdiction where the appeal is pending. While such a motion can delay the outcome, the grounds for vacating an arbitration award are extremely limited and such motions are rarely successful.

FINRA has implemented a number of changes to our arbitration program to address the problem of unpaid awards resulting from firms and brokers that are no longer in business. When an investor first files an arbitration claim, we alert the investor when the respondent firm or broker is no longer in business. This means that investors know before pursuing the claim in arbitration that collection of an award may be more difficult. We also prohibit a terminated or suspended firm from enforcing pre-dispute arbitration agreements with investors, therefore permitting those investors to take their claims to court. In addition, we provide streamlined default proceedings for investors where a terminated or suspended firm or broker does not answer or appear.

These measures may help investors obtain more timely judgments against defunct firms and brokers, but these actions do not always result in collection from defunct firms and brokers. Nevertheless, investors often decide to pursue arbitration claims even after notification that the firm or associated person is already out of business. In several of the 2011 matters, the investor claimant severed his or her claims against the defunct firm or broker and settled with the viable entities, while obtaining an award against the defunct firm or broker.

Ultimately, it is difficult for investors to collect from firms or brokers that are no longer in business whether the investor gets an arbitration award or a court judgment. However, we monitor closely every award obtained in our forum and follow up in each case to use FINRA's disciplinary tools to enforce awards. FINRA suspends firms or brokers that do not pay arbitration awards and prevents them from doing business without satisfying their obligations. While we are confident that our forum provides investors with support for enforcing awards, unpaid awards mean incomplete justice for investors. We will continue to evaluate steps to further incentivize firms and their control persons to meet their arbitration award obligations.

Movement of Brokers from Expelled Firms

FINRA strongly agrees that protecting the investing public from unscrupulous brokers is one of FINRA's most important priorities, and we are vigilant in our efforts to identify and remove them from the securities industry. From January 2011 through September 30, 2013, FINRA has barred 1342 individual brokers for a variety of violations of the federal securities laws or FINRA rules.[1]

FINRA is sensitive to the potential risks posed by brokers who formerly worked at one or more firms that have been expelled by FINRA. Mere association with an expelled firm,

[1] This figure excludes an additional 475 brokers and firms whose registrations were suspended during this period for failure to pay arbitration awards.

absent any indication of wrongdoing by an individual broker, is not grounds for disciplinary action. Nonetheless, FINRA keeps close tabs on this small but potentially high-risk group of registered persons—and the firms that hire them—using a combination of methods, including sophisticated data mining analytics and near real-time analysis of incoming tips, complaints and ongoing field examinations. Two of the primary analytic tools are FINRA's Broker Migration Model, which tracks the movement of certain brokers from firm to firm based on a variety of risk metrics, and the Problem Broker Model, which identifies and monitors brokers with significant regulatory disclosures. These electronic tools allow FINRA to leverage data to prioritize sales practice examinations and investigations.

FINRA's Broker Migration Model identifies and monitors both brokers who move from a firm that has been expelled or otherwise has a disciplinary history to another FINRA firm, and the firms that hire such individuals. The model, which FINRA developed with the School of Computer Science at the University of Massachusetts Amherst, uses a risk-based scoring system based on individual and firm regulatory disclosures, among other things, to alert FINRA to registered firms that have a high concentration of brokers who have significant regulatory histories or who were formerly associated with a firm that has a problematic regulatory history. This information is routinely used by FINRA staff to prioritize surveillance, examination and enforcement resources to conduct focused or accelerated examinations and enforcement actions. At any given time, FINRA is typically monitoring more than 40 firms that hired brokers who have a significant number of disclosures or who have worked at high-risk firms.

The Problem Broker Model is designed to identify and monitor associated persons who have been, or are, the subject of multiple disclosed or known regulatory matters. Specifically, the model generates a risk score for brokers who are currently registered, or who have been registered, with FINRA within the past two years, based on disciplinary actions, customer complaints, regulatory tips, arbitrations, litigation, internal reviews, terminations for cause, and other disclosure events within recent years. It also takes into consideration factors such as the broker's firm's disciplinary history and the frequency with which the broker has changed firms. FINRA staff uses this model to target brokers for a range of surveillance, examination and enforcement activity. In addition, FINRA sends firms that employ brokers identified by the Problem Broker Model a Heightened Supervision Questionnaire to ensure the current firm is on notice that appropriate supervision of these individuals is required given the broker's regulatory history. Nevertheless, we can never be satisfied when there are still instances of brokers committing additional sales practice violations that harm investors.

Recognizing the potential harm individual brokers can cause investors and the need to confront them more quickly, in early 2013, FINRA launched a High Risk Broker (HRB) initiative to identify individuals for targeted, expedited investigation. The HRB initiative is being led by FINRA's Office of Fraud Detection and Market Intelligence, which uses incoming regulatory intelligence such as broker terminations, complaints, tips, arbitrations, and field reports from ongoing examinations to identify candidates for expedited review. Since February 2013, 42 brokers have been designated as High Risk

Brokers, resulting in fast-tracked regulatory actions. Thus far, 16 enforcement actions have been brought to resolution, all resulting in bars. To date, the entire investigation and prosecution of designated High Risk Brokers has averaged 80 days, including one broker who was barred in just ten days. The High Risk Broker initiative demonstrates that a concentrated effort on single brokers using expedited tactical techniques can achieve material results. In 2014, we plan to expand the HRB program and create a dedicated Enforcement team to prosecute such cases.

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We hope this information is helpful to you and your staff. FINRA welcomes the interest you have taken in these topics, and we look forward to working with you as we continue to take steps to make improvements to the arbitration and expungement process and further enhance investor protections. Please feel free to contact me if you have any questions and I hope to meet with you soon to continue this important dialogue.

Sincerely,

Richard G. Ketchum
Chairman and CEO