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FINRA arbitration

THE BASICS OF ARBITRATION OF DISPUTES WITH BROKER-DEALERS AND FINANCIAL ADVISORS, PLUS SOME PRO TIPS FROM AN INDUSTRY INSIDER

The stock market has been appreciating for an unprecedented 10 years, so investor claims have been relatively slow because claims are counter-cyclical to the market trends. However, as the recent COVID-19 market volatility has shown, that may be about to change. As Warren Buffet said, "Only when the tide goes out do you discover who's been swimming naked." I expect that we are going to see an exponential rise in investor claims in the next few years. If you want to help those investors in need, I suggest you get better acquainted with Financial Industry Regulatory Authority, Inc. ("FINRA") arbitration.

FINRA

FINRA is the self-regulating organization, authorized by Congress to supervise broker-dealers and FINRA-licensed financial advisors, under the purview of the Securities and Exchange Commission ("SEC"). FINRA Dispute Resolution Services ("FINRA DR") is the division that administers securities arbitrations involving FINRA-licensed broker-dealers, intra-industry disputes and customer disputes.

All FINRA members and their registered representatives, as part of their membership, are required to submit intra-industry and customer disputes to FINRA DR, except for discrimination, harassment and retaliation statutory claims. (See FINRA Rule 13201.)

On the other hand, all customer disputes are subject to mandatory arbitration before FINRA DR. Just about every member firm incorporates the binding arbitration agreement in their New Account Applications, which consumers are required to sign before opening securities accounts. FINRA DR arbitration claims are controlled by the Code of Arbitration Procedure For Customer Disputes ("the Code") (https://www.finra.org/arbitration-mediation/printable-code-arbitration-procedure-12000).

The most common types of claims in these consumer disputes with financial advisors and the brokerage firms are based on breach of fiduciary duty, professional negligence, unsuitable investment recommendations, conflicts of interest, misrepresentations, omissions of material facts, fraud and financial elder abuse.

Registered Investment Advisors ("RIAs") are a separate group of financial advisors that are involved in many of these securities claims. Some RIAs operate under a dual registration with FINRA and the SEC, but most are exclusively registered with the SEC. Some RIAs, if their assets under management are under a specific threshold, register with the states in which they are incorporated. Most RIAs have binding arbitrations agreements in their investment contracts which require all customer disputes to be submitted to binding arbitration administered by the American Arbitration Association ("AAA") or JAMS.

In recent years, the competition provided by AAA and JAMS and the pressure exerted by public investor advocacy groups, like the Public Investors Advocate Bar Association ("PIABA"), of which I am a member, has motivated FINRA to enact more consumer-friendly rule changes and increase their efforts to recruit a more diverse arbitrator pool. The FINRA DR arbitrator pool is slowly moving away from a group of predominantly elderly white men and towards a more racially, gender and socio-economically diverse group that better reflects the investing public.

Pre-filing considerations

In order to initiate a new FINRA DR arbitration claim, claimants must submit a claim form online through FINRA's Portal along with a Statement of Claim describing the nature of the dispute and the relief being requested. It is similar to a Complaint in state or federal court, but without strict pleading requirements. I have found it most effective to draft a factually detailed Statement of Claim that focuses on the most persuasive presentation of the Claimant's narrative and theme of the case.

The Statement of Claim is your first opportunity to begin persuading the arbitrators and they will often refer back to this foundational pleading throughout the proceedings. Some attorneys prefer to file a generic, say-nothing Statement of Claim as a way to ambush the adversary at arbitration. I believe this is a tactical error because preconditioning the arbitration panel to your narrative and themes is a valuable opportunity.

Number of arbitrators (Rule 12401 of the Code)

(a) Claims of $50,000 or Less

If the amount of a claim is $50,000 or less, exclusive of interest and expenses, the panel will consist of one arbitrator and the claim is subject to the simplified arbitration procedures under Rule 12800.

(b) Claims of More Than $50,000 Up To $100,000

If the amount of a claim is more than $50,000 but not more than $100,000, exclusive of interest and expenses, the panel will consist of one arbitrator unless the parties agree in writing to three arbitrators.

(c) Claims of More Than $100,000; Unspecified or Non-Monetary Claims

If the amount of a claim is more than $100,000, exclusive of interest and expenses, or is unspecified, or if the claim does not request money damages, the panel will consist of three arbitrators, unless the parties agree in writing to one arbitrator.

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Filing fees

Claimant is also required to submit a filing fee, which is determined by a sliding scale based on the amount of the claim. If the claim is from $50,000 to $100,000, the fee is $975 to begin the process. If the claim is for an unspecified amount, claimant is required to pay $1,575. Filing fees can be paid via credit card via the DR Portal at the time of filing or by check sent directly to FINRA DR. (See Rule 12900(a)(1) for a complete breakdown of the filing fees.) All forum fees are allocated to the parties at the discretion of the Panel at the conclusion of the case.

If the filing fees pose a financial hardship, the claimant can request a fee waiver, provided an explanation of the financial hardship and supporting financial documents are furnished. FINRA DR is fairly generous with granting fee waiver requests when any reasonable financial hardship exists.

Once FINRA DR receives the online claim form, they will confirm receipt and send a notice of any deficiencies, if present. Once any deficiencies are cured, FINRA will serve the Statement of Claim on the Respondent(s) and notice to respond within 45 days' time. Respondents usually request an extension to file their Answer and reasonable requests are routinely granted, as a matter of professional courtesy. However, one "pro tip" is to insist that the extension does not delay discovery deadlines or the appointment process to select the arbitration panel ("Panel").

Six-year eligibility rule

Rule 12206 of the Code contains an eligibility provision, which states, "No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim." There is often a dispute regarding whether this means six years from the original purchase date of the security or six years based on principles of delayed discovery.

If your case has a possible six-year eligibility issue, you might want to consider first filing in state court because California law does not expressly recognize tolling if an action is not filed in court. Although, FINRA Rule 12206(c) states that FINRA recognizes tolling while a claim is pending in FINRA RD. Also, if the adversary files a motion or petition to compel arbitration, and if the claim is ordered to FINRA DR, the adversary waives the right to then seek dismissal under the six-year eligibility rule. See Rule 12206(c).

Scheduling preference

FINRA is intended to be a quicker and more cost-effective forum of dispute resolution. The speed factor will be significantly more attractive than ever before due to the shut-down of California jury trials due to COVID-19.

FINRA offers a special "Expedited Administration" procedure for all cases involving senior (over 65) or seriously ill claimants. In order to apply for the procedure, simply check the box during online claim submission and provide enough details in your Statement of Claim to demonstrate claimant's qualification. FINRA is relatively liberal in granting Expedited Administration for all eligible cases.

Arbitrator ranking

Arbitrator selection, in my opinion, is the most important phase of any case. It is arguably more important than jury selection, since your panel will serve as both the trier of fact and law. Because the arbitrator pool is stocked with many long-time arbitrators with ties to the financial services industry, you must be extremely thorough in your due diligence on each potential arbitrator's background. This includes reviewing all past awards, the disclosure reports and all other publicly available background information. There are many arbitrators in the prospect pool that have never given a favorable award to an investor. If you get appointed these arbitrators on your panel, it will be an impairment to your case that your adversary may exploit.

In addition to reviewing past award history and professional backgrounds, the Code allows a party to request additional information from an arbitrator:

> If a party requests additional information about an arbitrator, the Director will request the additional information from the arbitrator, and will send any response to all of the parties at the same time. When a party requests additional information, the Director may, but is not required to, toll the time for parties to return the ranked lists under Rule 12402(d)(3).

(See Rule 12403(b)(2).)

It is therefore critical to make any requests for clarification or additional information promptly, as the Arbitrator Ranking forms are due within 20 days of receipt of the list from the Director of Arbitration. Beware that some arbitrators will elect to recuse themselves rather than provide further clarification or additional information requested by the parties during the ranking process. And some attorneys use this as another method to remove unfavorable arbitrator candidates. The benefit of this situation is that you need not utilize the limited amount of strikes for an arbitrator prospect.

For cases with three arbitrators, FINRA DR will send the parties a list of 30 potential arbitrators to rank, including 10 chair qualified candidates, 15 public arbitrator candidates and another 10 non-public or "industry-related" candidates. Each separately represented party is allowed to strike four of the 10 chair qualified candidates, six of the 15 public candidates and all 10 of 10 of the non-public candidates. FINRA DR will combine the rankings to appoint the arbitrators with the highest combined rankings. Consideration should be given to exercise strikes for all non-public candidates due to apparent bias or industry ties. The rare exception is when the non-public candidates are either claimants' attorneys, industry-adverse or present as reasonably impartial prospects.

Because each separately represented party gets to confidentially submit their own ranking form with their own set of strikes, you should also give careful consideration to whether you separately name the individual financial advisor,

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in addition to the supervising brokerage firm. In most cases, we find it a tactical advantage to only name the brokerage firm to eliminate a second strike opportunity if the financial advisor is separately represented.

We don't find not naming the financial advisor an obstacle to liability because brokerage firms are generally responsible for the misconduct of their financial advisors. A couple possible exceptions are when you have collectability concerns because the firm is insolvent or on the verge of insolvency or if you suspect that certain professional liability policies may exist.

No "cram-down" arbitrators

Before submitting the ranking form, another "pro tip" is to stipulate with opposing counsel to avoid any potential "cram-down" arbitrators being assigned to the case without the parties having the opportunity to review, strike or rank those candidates. Without such a stipulation, FINRA will simply appoint the next candidate in the cue, if the original list was not sufficient to seat a full panel based upon the separate party ranking forms. This is one of the very rare examples in which claimants and respondents generally agree; neither side wants to get stuck with an arbitrator they have never had a chance to vet.

IPHTC

Once the Panel is assigned, FINRA DR will schedule an Initial Pre-hearing Scheduling Telephone Conference ("IPHTC") for the parties and the Panel to discuss setting hearing dates and all other relevant deadlines (motions, discovery, pre-hearing briefs, etc.). Another "pro tip" is to never waive the IPHTC by stipulating to an arbitration schedule. It is important to evaluate the Chairperson's mannerisms on the initial call and to evaluate the co-panelists' interactions during the scheduling conference. While the IPHTC is conducted by telephone conference call, I plan to consider asking for the IPHTC to be held by videoconference on a case-by-case basis.

Page 21 of the FINRA Arbitrator's Guide recommends the Panel set hearing dates within six months of the IPHTC for expedited cases and within 12 months for normal cases. However, respondents routinely suggest hearing dates 12-18 months out. If you are not prepared to push back, the Panel will often accommodate reasonable requests and often look to the parties to reach a consensus on the IPHTC.

Due to recent COVID-19 delays and case postponements, we have been scheduling one or two alternative back-up hearing dates, so that we can get these cases heard as soon as possible. If you don't schedule back-up dates early on, it can be difficult to coordinate the schedules of all the arbitrators, counsel and key witnesses on short notice down the line.

It is critical to be diligent with all scheduling matters, as I firmly believe in the old adage, "justice delayed, is justice denied."

Discovery

The FINRA Discovery Guide lists which documents are "Presumptively Discoverable" and are automatically to be produced in every case within 60 days of the date the Answer is due. (See Rule 12506(b).) The Discovery Guide is a great guide on the documents you should request the clients gather before the Statement of Claim is filed.

Rule 12507(a) permits a party to request additional documents and information from any party: "Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute; such requests should be reasonable in number and not require narrative answers or fact finding. Standard interrogatories are generally not permitted in arbitration."

Depositions are also generally not allowed. However, they are sometimes permitted in order to preserve the testimony of a seriously ill, dying or otherwise unavailable witness. (See Rule 12510.)

Arbitrators also have the authority to issue orders to produce for FINRA licensees and subpoenas to non-licensees for the production of documents or the appearance of witnesses. (See Rules 12512 and 12513.) Be aware that FINRA has no power to enforce subpoenas, so if a non-licensee's discovery is material, a "pro tip" is to obtain a party's written consent for the records, voluntary cooperation or potentially to file a civil action. The consent form is a reliable way to gain cooperation if the third party is affiliated with a party in the action such as custodians, tax preparers and vendors.

Twenty-day exchange

At least 20 days before the first scheduled hearing date, all parties must disclose all documents and witnesses that they may offer into evidence. A "pro tip" is to not disclose impeachment or rebuttal evidence. Another "pro tip" is to categorize the documents instead of transmitting an exhibit list or re-producing all the discovery in the action.

Parties may not present any documents or other materials not produced and or any witnesses not identified in accordance with this rule at the hearing, unless the panel determines that good cause exists for the failure to produce the document or identify the witness. Good cause includes the need to use documents or call witnesses for rebuttal or impeachment purposes based on developments during the hearing. It is important to categorize rebuttal and impeachment narrowly because arbitrators can, in violation of the rule, exclude evidence that is not found to qualify only as impeachment or rebuttal. (See Rule 12514.)

Arbitration briefs

During the IPHTC, the panel will determine whether they prefer to have the parties file pre-hearing briefs. If the panel indicates a preference for pre-hearing briefs, we usually request the panel allow "optional" pre-hearing briefs at least two weeks before the hearing with an optional reply brief due at least one week before the hearing. This is another "pro tip" because the routine brief exchange at the 20-Day Exchange

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means that the brief will likely not rebut expert reports and expert witnesses typically disclosed at the 20-Day Exchange. We routinely insist on the reply brief because we want to avoid having to spend significant time at the beginning of the evidentiary hearing correcting misleading, false and erroneous case law cited in the adversaries' briefs.

Evidentiary hearing

Location

The evidentiary hearing is generally scheduled by FINRA DR at the hearing location closest to the Claimant's residence at the time of the events giving rise to the dispute. (See Rule 12213.) The parties are also permitted to stipulate to a more convenient hearing location. As with most issues that arise in the course of the arbitration, the FINRA DR case administrators will usually defer to the joint stipulation of the parties to amend any of the normal procedural rules contained in the Code. Over the last few months, FINRA DR has initiated remote arbitration. The feedback from counsel who have partaken in remote arbitration has generally been positive, especially with all the advances to the remote environment and participants' reluctance to commute and congregate for a live arbitration hearing.

Evidence

FINRA DR follows relaxation of strict rules of evidence. It is typical that objections to hearsay, speculation and leading questions of witnesses are overruled. It is typical that evidence is received without foundation or chain of custody requirements. It is hardly ever the case that certified originals are necessary to authenticate evidence.

Panels generally err on the side of allowing everything in and under the "giving it the weight it deserves" philosophy. But, they are guided by a few of the following rules:

Rule 12604

(a) The panel will decide what evidence to admit. The panel is not required to follow state or federal rules of evidence.

Order of presentation of evidence and arguments

Generally, the claimant shall present its case-in-chief, followed by the respondent's defense. The panel has the discretion to vary the order in which the hearing is conducted, provided that each party is given a fair opportunity to present its case. (See Rule 12607.)

Panels usually allow cross-examination to go beyond direct in order to expedite the process and so that witnesses do not have to return for additional testimony later in the hearing.

Attendance at hearings

(a) The parties and their representatives are entitled to attend all hearings. Absent persuasive reasons to the contrary, expert witnesses should be permitted to attend all hearings. (See Rule 12602.)

Experts

Expert witnesses are not required to prove industry standards or breaches, unlike in court actions. Every attorney has their own perspective on the use of experts, but my preference is that I can always count on the respondents to call expert witnesses, so I take advantage of getting admissions to prove the case. There are cases in which expert witnesses are necessary to discuss the standard of care or supervisory requirements in the industry. They can also be very helpful in explaining complicated financial product failures. You can rest assured that respondents are almost always going to call at least one expert witness, so plan accordingly.

Because there are no depositions before arbitration, it is critical that you are fully prepared to cross-examine the expert based on independent research and your own expertise of the securities industry. This unique situation is probably the most important reason that FINRA arbitration is reserved for the attorneys who make their living in the forum.

Forum fees

Each hearing day consists of two sessions, one in the morning and one in the afternoon. This amounts to a maximum of $3,000 per day for a three-person panel, depending on the amount of the claim. You can see a full forum fee breakdown at Rule 12902(a). Rule 12214(1) provides: $300 to each arbitrator for each hearing session in which he or she participates; (2) an additional $125 per day to the chairperson for each hearing on the merits. Therefore, a standard five-day hearing will result in approximately $15,000 in forum fees to be allocated to the parties at the discretion of the Panel at the conclusion of the case. In egregious cases, the Panel will assess all forum fees against the respondent. However, the Panel can choose to split the fees 50/50 or any other way they decide is fair.

Zoom hearings

Due to the recent COVID-19 situation, FINRA DR has been administratively postponing all in-person evidentiary hearings each month since March 2020. As of the date of this article, cases are postponed through October 30, 2020. As a result, FINRA has recently been encouraging parties to proceed with evidentiary hearings via Zoom. In some cases, Panels have ordered Zoom hearings over the objections of respondents. As with depositions in state court, this appears to be the new normal for the foreseeable future.

Post-hearing

After the conclusion of the evidentiary hearing, the Panel has up to 30 business days to publish their award. Unless the parties jointly request an Explained Decision, the award will only include some basic information regarding the nature of the claim, some procedural details, the amount of the final award and forum fee allocation. (See Rule 12904(b).)

An Explained Decision will include a more detailed summary of the evidence and the application of the relevant law to the facts of the particular case. The chairperson will receive an additional honorarium of $400 for writing the Explained Decision requested by the parties. The Panel may also issue an

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Explained Decision on their own initiative, but would not be entitled to the $400 honorarium.

Once the award is served, the Respondent has 30 days to pay the award unless a petition to vacate has been filed with a court of competent jurisdiction. (See Rule 12904(j).) If the firm does not pay the award promptly, they run a very real risk of FINRA suspending their securities license. Most firms take this threat very seriously and do not risk inviting any enforcement actions by FINRA.

Vacate award

Section 12 of the Federal Arbitration Act ("FAA") requires that a petition to vacate be served upon the adverse party "within three months after the award is filed or delivered." Two of the most common challenges these days have been for arbitrators failing to disclose material information to the parties in their Arbitrator Disclosure Reports and for failure to admit relevant evidence. However, awards are rarely vacated, due to extremely limited bases available to challenge such awards.

If you wish to confirm a favorable award, you have one year from the date of the award, pursuant to section 9 of the FAA.

If you wish to correct some minor errors in the award, Rule 12905(a)(2) gives you 10 days after the award to request the Panel correct any typographical or computational errors, or mistakes in the description of any person or property referred to in the award.

Conclusion

FINRA arbitration can be a relatively cheap and efficient way for your clients to resolve their investment-related claims. However, it is a bit like the Wild West and attorneys not immersed in the securities industry will find themselves at a significant disadvantage to prosecuting claims in the FINRA DR forum. So, the better you know the lay of the land, the better result you will be able to achieve for your clients. Good luck.

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