Understanding Securities ARBITRATION

FINRA arbitration adheres to its own set of rules and customs. Learn how to guide your client's claim through the process.

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The 1987 U.S. Supreme Court case *Shearson/American Express, Inc. v. McMahon* solidified arbitration as the most widely used conflict resolution mechanism in the securities industry.[1] The Financial Industry Regulatory Authority (FINRA), a self-regulatory organization, operates the largest dispute resolution forum in the industry. It requires all brokerage firms to submit customer disputes to arbitration if the customer requests it or if the customer agreement contractually binds the customer to arbitrate, which it nearly always does.[2] Since *McMahon*, arbitration has become more complex, with its own set of rules and jargon. In the past several years, 3,500 to 7,000 cases have been filed annually.[3]

After each financial crisis, the typical securities cases shift to reflect the latest carnage Wall Street has left behind. For example, in the post-"tech wreck" era of 2000–2001, many cases focused on brokers' recommendations of high-flying Internet stocks. After the credit crisis in 2007–2008, a record number of claims were related to mortgage-backed securities, Ponzi schemes, and new types of investments. Wall Street is now selling alternative investments and structured products in record numbers.[4] Combine this with record low interest rates, a rallying stock market, and margin interest loans setting new records, and some believe there will be a bull market for FINRA arbitration cases after the next inevitable market crash.[5]

Many arbitrators are not lawyers, and they come from a variety of backgrounds. Arbitrators are not bound by the strict rules of law, and many bring their personal beliefs about investing into the hearing rooms. FINRA promotes arbitration as fair and efficient, but the process is increasingly complex, and the opposition is often well financed and familiar with the forum. Because arbitration is binding and there are few grounds for vacatur, an understanding of the rules and procedure is critical.

Submitting a Claim

The FINRA Code of Arbitration Procedure governs FINRA arbitration.[6] You initiate arbitration by filing a statement of claim (SOC), submission agreement, and filing fee.[7] A submission agreement is a statement that the party agrees to be bound by FINRA's rules. You do not need to worry about service—FINRA will serve the SOC on the other parties and assign them a date to respond (45 days later).[8]

The SOC should "specify the relevant facts and remedies requested."[9] Although there are no requirements about how the SOC should look—it could be drafted as a letter—it should include

the relevant facts and circumstances surrounding the dispute, including the relevant dates, transaction details, and damages sought. Most SOCs are written as a narrative meant to sway the arbitrator in the customer's favor. You should highlight why certain records should be produced in discovery. Ultimately, you get one chance to make a first impression on the arbitrators, and that impression should be made in the SOC. Only the final hearing is in person. All other hearings, procedural or substantive, are done by telephone.

The panel is allowed to award the same damages that an investor would be entitled to in court. The Supreme Court's 1995 ruling in *Mastrobuono v. Shearson Lehman Hutton, Inc.* generally allows securities arbitrators to award punitive damages.[10]

Class action claims and shareholder derivative actions may not be arbitrated.[11] The code allows claims involving multiple claimants (as plaintiffs are called in arbitration, or "customers," as the code frequently calls them) if "the claims assert any right to relief jointly or severally; or the claims arise out of the same transaction or occurrence, or series of transactions or occurrences."[12] Multiple claimant cases are becoming common as investors bring more claims tied to the same product or financial adviser. For example, we recently represented more than 100 victims of a Ponzi scheme orchestrated by a New York broker-dealer. We divided the clients into regions and filed multiple separate arbitration cases.

The most common types of FINRA arbitration claims include

- unsuitability, in which a customer alleges that the broker-recommended investments were not appropriate, considering the customer's investment objectives, time horizon, risk tolerance, tax and financial status, age, and other factors.
- unauthorized trading, in which a customer alleges that the broker made trades without the customer's knowledge or approval.
- material misrepresentations or omissions, in which a customer alleges that the broker failed to disclose a material fact about the investment or intentionally provided misleading information.
- breach of fiduciary duty, in which a customer alleges that the broker did not maintain the highest level of loyalty and fidelity.
- negligence, in which a customer alleges that the broker failed to use diligence and act prudently.
- failure to supervise, in which a customer alleges that the broker was

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not properly managed.
- churning, in which a customer alleges that the sole purpose of the broker's trades was to generate commissions.
- breach of contract, in which a customer alleges that the broker breached the customer agreement or other contract between the customer and the brokerage firm.[13]

These causes of action generally stem from a brokerage firm's failure to know its customer or the product it is selling. Every brokerage firm has a duty to know its customer.[14] For many years, arbitration claims focused primarily on a brokerage firm's failure to properly recommend suitable investments to a single customer. However, because Wall Street has invented a host of new and increasingly complex investments, FINRA has seen a flood of cases in recent years tied to the same product or brokerage firm. Many cases focus on the brokerage firm's failure to conduct due diligence on the products it is selling, including structured products, private placements, hedge funds, and illiquid real estate investment trusts.

For example, after customers bought Medical Capital notes from a brokerage firm and smaller broker-dealers in what turned out to be a Ponzi scheme, the cases focused on the firms' lack of due diligence and failure to know the product they were selling.[15]

Arbitrator Selection Process

The parties choose from a computer-generated list of neutral arbitrators.[16] FINRA classifies arbitrators as either "industry" or "public." In the past, FINRA required at least one industry arbitrator to serve on a panel. But many customers complained about industry arbitrators' potential bias in favor of the industry. Customers now may strike the industry arbitrator in favor of having three public arbitrators decide the claim. Concerns remain, though, that many arbitrators hesitate to rule against large brokerage firms for fear of being blacklisted by them.

You get one chance to make a first impression on the arbitrators, and that impression should be made in the statement of claim.

As part of the selection process, you will have access to potential arbitrators' CVs. It is important to review their employment history and past awards. Consider contacting active practitioners in the local community who may be familiar with the potential arbitrators and can share insights about them.

Answers, Counterclaims, and Third-Party Claims

The respondent's answer does not have to be in any particular form. It must specify all available defenses and related facts; general denials are not sufficient answers.[17] Respondents can assert claims against customers by filing a counterclaim.[18] A typical counterclaim is for outstanding debits for liquidated margin accounts. Third-party claims are also permissible.[19] However, the third party must be a FINRA member or someone otherwise required to arbitrate the dispute. Filing fees are required for each of these claims.

The code restricts motions to dismiss to very limited circumstances.[20] FINRA requires a hearing on the merits and only allows a motion to dismiss to be filed at the close of the customer's case, absent very unique circumstances.[21] Your client should not fear these overused motions. If the panel allows the motion, use it as an opportunity to demonstrate the strength of your client's case.

Prehearing Discovery

Discovery is limited to what is generally referred to as paper discovery. Interrogatories, requests for admissions, and depositions usually are prohibited.[22] FINRA's Discovery Guide offers additional guidance meant to supplement the code's discovery rules.[23] The guide lists 22 documents that brokerage firms must produce in all customer cases, including
- the customer's account record information
- all documents of investment or trading strategies used or recommended in the customer's accounts
- all exception reports, supervisory activity reviews, concentration reports, active account runs, and similar documents produced to review activity in the customer's accounts related to the case.

The guide also lists 19 documents that a customer must produce, including:
- portions of the customer's and customer-owned business federal tax returns
- financial statements
- all account statements for each nonparty securities firm with which the customer maintains an account.

You can request additional documents beyond these guidelines. Recently, FINRA issued an Amendment to the Discovery Guide recognizing the need for expanded discovery in product cases, which typically center around the mismarketing or defective development of a product or alternative investment.[24] Arbitrators may subpoena witnesses or documents from third parties[25] and may order FINRA members to appear or produce documents without a subpoena.[26] For example, the arbitrator may compel

the customer's former financial adviser to testify or require a nonparty broker-dealer to produce records.

Motions to compel discovery are common. Arbitrators frequently are willing to hear discovery disputes and try to find a resolution that satisfies everyone. In a pre-hearing discovery dispute, arguing your most important requests first may help you come across as the reasonable party, and arbitrators tend to be more giving while the issues still hold their attention.

At least 20 days before the first scheduled hearing, the parties must exchange documents and other materials they intend to use at the final hearing and identify all witnesses.[27]

While FINRA strongly encourages mediation, it is completely voluntary.[28] FINRA will automatically stay an arbitration or cancel the final hearing if the parties enter mediation.

MORE ON SECURITIES ARBITRATION

Visit the Web pages below for additional information.

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Business Torts
www.justice.org/sections

AAJ LITIGATION GROUP
Securities and Financial Fraud
www.justice.org/litgroups

LITIGATION PACKET
Mandatory Arbitration
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AAJ EDUCATION PROGRAM
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2014 Annual Convention: Securities Litigation Group CLE Program
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AAJ PRESS
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The Hearing

Generally, hearings are held at a designated location closest to the customer's residence at the time of the events giving rise to the dispute.[29] FINRA has 71 hearing venues.[30] If you have any doubt about the hearing location, determine where the customer's statements were mailed.

Hearing procedures. The code dictates very little about how the hearing should be conducted. It simply states, "Generally, the claimant shall present its case, 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."[31]

Because traditional discovery is limited, be prepared for unexpected answers on cross-examination. Brokerage firm witnesses frequently change their testimony—even during the course of giving their testimony—and often produce documents on the eve of a hearing. Arbitrators rarely take issue with these late document productions. Hearings generally follow the same order of events as a court trial. Many practitioners call the financial adviser as their first witness, especially if the case involves a complicated product. Sometimes, by simply asking the financial adviser to explain the product at issue, for the panel's benefit, your first question can put your case on the right track. The financial adviser is likely to admit that he or she just sells the investment and doesn't understand it.

The Federal Rules of Evidence do not apply.[32] But you may want to follow them anyway, depending on your panel: An arbitration panel chairperson who routinely practices in federal court will probably be more of a stickler for the rules of evidence than a nonlawyer chairperson. Cross-examination in arbitrations is more lenient than in court proceedings—lawyers are given broad discretion to question witnesses as long as their questions pertain to the facts of

the case or the witness's credibility. Arbitrators also may ask witnesses questions throughout the examination or after it. In response to most objections, arbitrators tend to be lenient and say they will take the evidence or testimony for what it is worth.

You should consider hiring a court reporter.[33] Arbitrations frequently do not finish in the time allotted and may be adjourned for several days or months. Having a transcript of where the hearing left off or prior testimony of a witness can be helpful.

Expert witnesses are not required, but both sides frequently use them. Arbitrators are loath to exclude any expert. But choose your expert carefully: An expert who takes extreme positions may end up making the case for the other side.

Stipulations. Stipulations are widely used in arbitrations, and arbitrators appreciate them, especially when the parties can reach an agreement on joint exhibit books. As a matter of practicality, prior to the final hearing, you should agree with the opposing party to jointly submit to evidence account statements and other voluminous records. This avoids the panel having to spend time asking if there is any objection to the exhibits and avoids duplicative exhibits.

Awards. FINRA generally asks arbitrators to render their decisions within 30 days of closing arguments.[34] An explanation is rarely given for the award amount. The brokerage firm must pay the award within 30 days or FINRA will suspend the firm's license, unless the award is the subject of a motion to vacate.[35] Arbitration is final, and awards are not subject to review or appeal unless the applicable law directs otherwise.[36] Courts are increasingly critical of baseless motions to vacate and have threatened sanctions for filing frivolous motions to vacate.[37]

Successful arbitration hearings require careful preparation, patience, and diligence. Arbitration panel decisions are important—although awards do not technically have precedential value, active practitioners monitor awards from similar cases to see how arbitrators have ruled. Learning the ins and outs of the arbitration process will help you guide your clients to victory.

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