

Recent Developments in FINRA Arbitration

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The Financial Industry Regulatory Authority (FINRA) appears poised for some major changes in the near term. This article will explore some of the potential consequences of these changes and examine some of the underlying causes.

In February 2014, Investment News reported that the FINRA board had recently approved two new proposals and was considering a third proposal that, if approved by the Securities and Exchange Commission (SEC), would have significant implications for the securities industry.¹

The first proposal, discussed in Regulatory Notice 14-19, would require brokerage firms to include on their publicly available websites a hyperlink to the FINRA BrokerCheck website, <http://brokercheck.finra.org/Search/Search.aspx>.² This proposal, which has been advocated for years by the Public Investors Arbitration Bar Association (PIABA), would make prior broker claims more readily accessible to the investing public. Additionally, the rule would require firms to include a hyperlink to BrokerCheck in online communications with the public, excluding e-mail and text messages, that include professional or contact information for an associated person. The rule also would not apply to messages posted on online interactive forums, such as message boards, chat rooms, or Twitter.³ However, Regulatory Notice 14-19 seems to suggest that a BrokerCheck hyperlink would be required on an associated person's profile on Facebook, LinkedIn, YouTube, or Pinterest.⁴

The rule is intended to educate the investing public about the existence of FINRA BrokerCheck, as well as to provide up-to-date information about prior complaints against financial advisors. By encouraging investors to investigate the background of their financial advisors, FINRA presumably hopes to reward advisors with clean

records and motivate the industry to weed out advisors with checkered histories. In addition, this proposal, if approved by the SEC, would encourage expungement proceedings.

This first proposal was open for comment until June 16, 2014, and, at the time of this writing, has not been formally adopted by the FINRA board of directors or approved by the SEC. While it is difficult to predict the long term effect of this yet-unapproved rule, it is likely that, in the long term, it would tend to steer business away from troubled financial advisors and towards advisors with cleaner records. In the long term, then, this would tend to have a mitigating effect and reduce the number of arbitration claims in the securities industry. Of course, while not every investor will investigate the background of her financial advisor, the rule could encourage scrutiny of registered representatives by making background information more readily accessible.

The second proposal considered by the FINRA board would narrow the definition of "Public Arbitrator" under FINRA rules, thereby making the FINRA arbitration forum more friendly to investor claimants. FINRA rules historically required most customer claims to be decided by panels comprised of three arbitrators, of whom one was an industry (or non-public) arbitrator with special expertise in the securities industry. The other two arbitrators have been "public arbitrators," who do not have significant ties to the securities industry. Since they were drawn from the securities industry, industry arbitrators tended to side with the industry respondent in many cases, prompting complaints from the claimants' bar. For example, between February 1, 2011, and March 31, 2013, FINRA tracked the results of awards decided by all-public panels and majority-public panels. During that time, customers who opted for an all-public panel prevailed in 49 percent of

all cases, whereas majority-public panels (in which there was an industry arbitrator) resulted in a claimant's award only 34 percent of the time.⁵ In 2013, FINRA changed its arbitrator selection rule (Rule 12403) to give parties to an arbitration the option to select an all-public panel.⁶

There are several factors to explain the 15 point difference between all-public and majority-public panels, including the obvious fact that the former was more likely to be selected by an experienced claimant's counsel. Nonetheless, it does appear that public arbitrators have tended to be more generous to investors.

The February 13, 2014 FINRA proposal seeks to narrow the definition of public arbitrator to exclude an arbitrator with any ties or background whatsoever with the securities industry, on behalf of other investors or the industry. Under current rules, an attorney, accountant, or other professional can represent himself as a public arbitrator as long as the firm with which he is associated has not received \$50,000 or 10 percent or more of its aggregate annual revenue from the securities industry over the past two years.⁷ Non-public arbitrators also include persons who were affiliated with a broker-dealer during the preceding five years.

The new proposal, which at the time of this writing has not yet been approved by the SEC, would exclude from the definition of public arbitrator any individuals who worked in the financial industry for any duration during their careers, no matter how long ago. Professionals who represented investors or the financial industry as a significant part of their business would also be classified as non-public. However, these professionals, such as attorneys and accountants, could become public arbitrators after an unspecified "cooling off" period from the time the individual ceased

his or her representation. This proposal is part of a trend to make arbitration more friendly and accessible to investors, and would tend to exclude arbitrators with exposure to or experience in the securities industry, however minimal. It would also remove from consideration as public arbitrators anyone who represented investors in customer-related arbitration or litigation.

A third proposal approved by the FINRA board on February 13, 2014, and heading for SEC approval, would also be part of the trend making FINRA arbitration more conducive to investors and their attorneys. This third rule would prohibit firms or registered representatives from extracting, as a condition of settlement, an investor's agreement not to oppose expungement from the firm's or registered representative's public record maintained in the Central Registration Depository (CRD) and accessible through FINRA BrokerCheck.⁸ Under existing practices, such an agreement is commonplace. This revision is sought by the investors' bar, and PIABA in particular, to avoid quid pro quo deals by which the firm (or registered representative) pays a settlement amount in exchange for the customer's agreement not to contest the broker's request for expungement of his CRD record.

This proposal would tend to make brokers' records more transparent and increase accountability. And while customers do not routinely oppose requests for expungement, as there is no money to be made in contesting such requests, it is likely that investor opposition to such requests would increase in the future. Accordingly, this proposal is part of the same trend towards transparency, described above, by which the broker's CRD record in BrokerCheck must be hyperlinked to his website.

The three new rules, if approved by the SEC, would tend to increase the visibility of customer complaints, and

reduce the availability of expungement. As a result, registered representatives may be more reluctant than before to agree to settlement of arbitrated claims, and the result may be increased costs for broker-dealers and their insurers.

The adoption of new rules making expungement more difficult to obtain could potentially result in fewer settlements, even at the risk of personal exposure, thereby potentially increasing insurance costs. It is important to consider that this increase in fully-arbitrated cases could cut both ways. Claimants' counsel will likely now be confronted with a larger number of arbitrations that actually go forward as opposed to settling, thereby increasing the costs and burdens on the claimants' bar.

In addition, these three proposals are all intended to make FINRA arbitration more accessible to investors, and can be seen, at least in the authors' view, as a response to congressional pressure, through the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and other legislation, to reduce and discourage mandatory pre-dispute arbitration agreements and give investors the option to either sue in court or bring an arbitration. Several pieces of legislation have been introduced to Congress, including the Investor Choice Act of 2013 and the Arbitration Fairness Act of 2013, that would eliminate mandatory pre-dispute arbitration clauses and give investors the option of either filing an arbitration or suing in court.⁹ Moreover, the Dodd-Frank Act authorized the SEC to promulgate rules to limit or prohibit mandatory pre-dispute arbitration clauses. A group of senators, led by Democrat Al Franken of Minnesota, had asked the SEC to take action to prohibit mandatory pre-dispute arbitration clauses. Numerous attempts at introducing such legislation have failed. In addition, FINRA has recently announced a crackdown on recidivist advisors with multiple complaints. According to the Wall Street Journal, FINRA is forming a special enforcement

strike force to investigate and prosecute brokers with records of many customer complaints and arbitrations.¹⁰

Viewed in this historical context, FINRA can be seen as attempting to preserve its historical turf by making arbitration more fair to claimants, thereby removing the impetus to have more significant reform imposed upon it by Congress and the SEC. ❖

Endnotes

- 1 Caitlin Mollison, "Finra Moves Ahead with BrokerCheck, Arbitration and Expungement Efforts," *Investment News*, Feb. 13, 2014, <http://www.investmentnews.com/article/20140213/FREE/140219938>.
- 2 FINRA Regulatory Notice 14-19, <http://www.finra.org/Industry/Regulation/Notices/2014/P496877>.
- 3 See Mark Schoeff Jr., "Finra Floats Revised BrokerCheck Link Proposal," *Investment News*, May 1, 2014, <http://www.investmentnews.com/article/20140501/FREE/140509995>.
- 4 FINRA Regulatory Notice 14-19, at 4.
- 5 Notice of Filing of Proposed Rule Change to Amendments to the Code of Arbitration Procedure for Customer Disputes, Exchange Act Release No. 34-69762, at 5 (June 13, 2013), <http://www.sec.gov/rules/sro/finra/2013/34-69762.pdf>; see also *All-Public/Majority Panel "Win-Rate" Survey*, *Sec. Arb. Commentator*, Dec. 2013, at 5.
- 6 FINRA Rule 12403, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_%20id=4141.
- 7 See FINRA Rule 12400, 12100(u), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4138.
- 8 News Release, FINRA, Finra Board Approves Rule Prohibiting Conditioning Settlements of Customer Disputes on a Customer's Agreement Not to Oppose Expungement (Feb. 13, 2014), <http://www.finra.org/Newsroom/NewsReleases/2014/P445251>.
- 9 See *Investor Choice Act Introduced*, *Sec. Arb. Commentator*, Dec. 2013, at 5.
- 10 See Scott Patterson and Matthias Riecke, "FINRA to Crack Down on Brokers with High Number of Complaints," *Wall St. J.*, Jan. 2, 2014.