THE ANATOMY OF A FINRA SECURITIES ARBITRATION

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For most injuries to investors caused by the misconduct of stockbrokers, brokerage firms, and financial advisors, the injured investor must bring a claim in an arbitration through the Financial Industry Regulatory Authority, or "FINRA". Section 15A of the Securities Exchange Act of 1934 gives FINRA the authority to discipline its member firms and certain individuals for violations of the securities laws and rules administered by FINRA. FINRA also provides a forum for investors to bring claims in arbitration against member firms and associated persons with those member firms, often referred to as registered representatives, financial advisors, and/or brokers. For more than 30 years, arbitration agreements have been routine in new account forms for persons opening investment accounts, with virtually all the major and smaller investment firms. The enforceability of such arbitration agreements was confirmed by the U.S. Supreme Court in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987). FINRA regulations require member firms to permit investors to bring actions before FINRA Dispute Resolution procedures, even in the absence of an arbitration agreement. https://www.finra.org/arbitration-mediation/arbitration-overview. For disputes with other types of investment professionals not subject to FINRA, such as fee-based investment advisor firms, mutual fund companies, or trust companies regulated by the SEC or state regulators, the investor needs to determine whether there are arbitration agreements in their account documentation. Otherwise, the investors must initiate the dispute in the court system.

Arbitration is significantly different from traditional litigation, and it is important for investors considering a legal claim against their investment professional to consider a variety of factors before and during the case. This article provides a general background of FINRA arbitrations and identifies a few nuances that can arise in these cases.

I. FINRA Arbitration.

FINRA is a government-authorized, non-profit organization intended to protect investors and ensure fair securities markets. https://www.finra.org/about. Among other

things, it serves as the self-regulatory body for member brokerage firms and financial advisors. FINRA also provides a forum for investors to bring investment disputes against firms and advisors known as FINRA Dispute Resolution. https://www.finra.org/arbitration-mediation.

To initiate an arbitration before FINRA, an individual must submit a written claim generally referred to as the statement of claim and pay the appropriate filing fee that ranges depending on the relief sought. A typical filing fee can be between $1,500 to $2,000. The arbitration process is governed by a set of rules known as the FINRA Code of Arbitration Procedure. For investor cases, it may be found at: https://www.finra.org/arbitration-mediation/printable-code-arbitration-procedure-12000. Once filed, FINRA will review the filing and related documents, ensure all is in order, and serve the statement of claim on the named respondents. The initial statement of claim may be submitted online. After service of the papers on the respondents, the respondents have forty-five days to submit a formal written response to the statement of claim.

After the respondents file and serve their responses, or at the time they are originally due if an extension is provided to the respondents, the parties participate in FINRA's arbitrator selection process. FINRA arbitrators are neutral third parties with diverse backgrounds and can include bankers, regulators, lawyers, retirees, investment professionals, former investment advisors, and others. The number of arbitrators in each case depends on its size—one arbitrator will hear a smaller case and three arbitrators will hear larger cases. As part of the selection process, FINRA provides each side with a randomly generated list of 20 or more arbitrators along with a disclosure report that includes the arbitrators' resumes, background, and prior award information. Each side is permitted to rank the list of arbitrators by preference and to strike a select number of names on the list. For the names remaining on each side's list, FINRA will then review the parties' rankings and select the arbitrator or three-member panel.

After an initial pre-hearing conference at which the parties discuss various procedural and scheduling issues with the panel, the parties engage in a designated period of discovery consisting largely of exchanging of copies of relevant documents. In customer disputes, the parties need to comply with FINRA's Discovery Guide, which sets forth a list of documents that each party must produce. https://www.finra.org/arbitration-mediation/discovery-guide. Parties may request additional documents from each other. FINRA Arbitration Rule 12507. Depositions as are conducted in court proceedings are rarely allowed in FINRA arbitrations. FINRA Code of Arbitration Procedure Rule 12510.

After the discovery period, the parties prepare for the hearing. FINRA usually schedules hearings in a neutral location in the city where the underlying conduct took place. At the hearing, each side presents their case through witness testimony and documentary evidence much like parties do in litigation in courts. A typical arbitration

hearing can take between two days to two weeks. However, we find most cases are between three to five days in length.

Upon completion of the arbitration hearing, the parties can generally expect to receive a written award from the panel within thirty days. The award is binding on the parties, and if the panel found for the claimant, the respondent must pay the award or contest it in court within thirty days. While arbitration awards can be appealed to a court, judicial reversals of FINRA awards are rare and granted in very limited situations.

The timeline of a FINRA arbitration varies, but it is often much quicker and less expensive than standard litigation. Hearings are typically scheduled within sixteen months after the statement of claim is filed.

II. Who to Name as a Respondent?

An important decision that an investor claimant must make prior to filing a FINRA arbitration is who to name as a respondent. In the FINRA context, a claimant's injury is often caused by a financial advisor failing to choose suitable investments, a financial advisor negligently selecting or describing a particular investment, and/or the firm's failure to properly supervise the financial advisor. Thus, the question of who to name as a respondent often comes down to whether to name the advisor, the advisor's firm, or both.

There are two lines of thinking on this issue. The first is the commonly held view that a plaintiff should name all potentially culpable parties to increase the chances of recovery and not waive any claims. Under this theory, the injured customer should name the financial advisor in addition to the financial advisor's firm.

The second strategy is fashioned to the nuances of FINRA. Under this alternative view, a claimant would name the financial advisor's firm but not the financial advisor. Why? Because if the claimant includes the financial advisor as a respondent, the advisor must then report the claim on his/her Form U5. As a result, the financial advisor could be more inclined to dispute the claims. In contrast, brokerage firms are routinely named as respondents in FINRA arbitrations, and while a firm will give a good faith effort to dispute the charges, its resolve may be less than a financial advisor whose reputation is on the line. An individual financial advisor, especially where the defense costs are being paid by his firm, may be motivated out of a desire to clean his name through the arbitration hearing outcome. On the other hand, his employing investment firm may be more inclined to make a business decision weighing the risks of an adverse outcome along with the cost of defending the case. Where a broker has a history of customer complaints, it may make sense to name the broker personally. Where there have been no prior complaints, then it may make sense to omit naming the individual broker.

In short, although naming a financial advisor may be advantageous in some cases, whether to name the advisor as a respondent is a strategic decision that experienced legal counsel can help walk you through.

III. What Claims to Assert?

An investor must show more than simply losses in their investments to succeed in a FINRA arbitration against his or her investment professionals. It is well understood that most investments involve some degree of risk of loss. The key issues in these cases become one of whether the material facts were adequately disclosed, whether the investment was suitable based upon the investor's stated investment objections, or whether the investment was otherwise fraudulent, such as a Ponzi scheme.

Investor claimants will often assert a claim based on one of a handful theories of liability: unsuitability, churning, fraud, statutory securities violations, negligence, and/or failure to supervise. It is important to consider what types of claims will trigger insurance coverage. In general, claims sounding in negligence will trigger insurance coverage, while intentional-conduct claims, such as fraud, will not be due to exclusion clauses in insurance contracts.

Unsuitability is a commonly asserted claim. To prevail, the claimant must establish that the broker or advisor knew or should have known that the type of security conflicted with the claimant's objectives. Documentation in the firm's files reflecting the investor's risk tolerance, time horizon, and investment objectives can be very helpful for these claims. Generally, a claim of unsuitability is tied to some traditional legal claim such as negligence.

Depending on the facts, churning, i.e., "excessive trading," can be one of the easier claims to prove in FINRA arbitration. As the name suggests, the claimant must show that its account was traded in excess and that the broker had a certain level of control over the funds. Thus, if the broker excessively traded in a discretionary account, this could be a viable claim. Due to automated systems in place at major brokerage firms, churning claims are less frequent than they were several decades ago.

Today, investor claims often involve an alternative or non-traditional type investment where the claim is a lack of adequate due diligence into the subject company prior to recommending investment by the advisor's clients.

Negligence and failure to supervise claims are frequently asserted together. If a financial advisor acted negligently in executing a trade or selecting investments for a portfolio, there is often a manager who failed to supervise that advisor.

IV. Selecting Arbitrators.

The arbitrator selection process is governed by FINRA Code of Arbitration Procedure Rules 12400 – 12410. As noted above, one area that FINRA arbitration

differs from judicial litigation is that the parties have a say in who will hear their case. Although not guaranteed that a party's top choices for arbitrators will be chosen, it can be of enormous benefit to carefully rank the best arbitrators for a given case and remove certain arbitrators from the pool. Engaging seasoned counsel with knowledge of the arbitrators is therefore essential for an injured investor.

The decision on which arbitrators to rank highly or lowly, and which arbitrators to strike is a critically important part of the arbitration process. This is an area where having an experienced attorney who can draw information from a variety of sources about the arbitrators is crucial. Generally, FINRA arbitrators have served on cases previously. Sometimes the arbitrators may have served in many prior cases. An experienced securities arbitration lawyer may have personal experience to draw upon with respect to the arbitrators on the initial pool of arbitrators list from FINRA to the parties. In addition, an experienced securities lawyer can draw upon information from his peers in the practice. Finally, there are other third-party sources where information can be obtained about the prospective arbitrator. A seasoned securities arbitration lawyer will want to closely look at prior awards issued by arbitrators to see if they reflect a pattern that suggests open mindedness to the plight of investors, or whether their industry ties make them more skeptical of investor claims. The importance of the arbitrator selection process cannot be overemphasized.

V. Strategies for Approaching Discovery.

Various approaches exist for approaching discovery, and there is no one-size-fits-all approach. In customer disputes before FINRA, parties can obtain discovery via two main avenues of discovery: (1) responses to the items listed in FINRA's Discovery Guide and (2) case-specific discovery requests. Regardless of what method a party uses for discovery, it should plan its discovery with sufficient time for discovery motions.

In that respect, unless critical to protect your position, it may be advisable to leave formal motions to exclude evidence or preclude plausible areas of discovery at the door. Arbitrators are keenly aware that no appellate body exists to reverse an improperly granted or denied motion, but that one possible reason for judicial reversal is refusal to hear pertinent evidence. Thus, the key to FINRA arbitration is preparing for the hearing itself. If unfavorable evidence exists, the party should focus on its weight and addressing its context, not its admissibility.

VI. Strategies for Expert Witnesses.

Another important consideration in FINRA arbitration is whether to engage professional expert witnesses, and what type. In some cases, expert testimony is necessary to prove the case. In other cases, it is just beneficial. The two most common types of experts are standard of care experts and damages experts.

A standard of care expert will testify to the degree of prudence required of the broker or firm who is under a duty of care. In general, the standard of care is phrased in

terms of what a reasonable person would have (or should have) done under the circumstances. The specific requirements of the standard depend on the circumstances, and can rise or fall depending on the case. The arbitrators will ultimately determine whether the conduct at issue fell short of the applicable standard of care. Such experts are often former investment professionals who have recently retired.

Meanwhile, a damages expert can also be important—and sometimes imperative—to quantify the claimed damages. We often encourage clients to engage damages experts at an early stage in the litigation so the expert can consult with the attorney during discovery and identify important issues related to damages. Damages experts will eventually analyze the data to determine the extent of damages and explain the numbers (and process) to the arbitrators.

Investors have a natural disadvantage when it comes to experts. First, the advisor involved has licenses and training in the industry and will offer his or her professional justification for the subject investment recommendations. Sometimes the firms will bring on branch management or compliance persons who will likewise tout the wisdom of the investment decision at the time it was made. Then, there is a large pool of professional experts, often retired investment professionals, who offer their services as expert witnesses for such cases to voice support for the broker's actions. On the investor side, the investor should never be the one to explain why the investment was a poor recommendation. The reason is obvious. If the investor is knowledgeable enough to explain why the investment was not appropriate, it will inevitably lead to the question of why the investor agreed to the recommendation in the first instance. So, having a qualified capable expert on behalf of the investor is often crucial for the success of the investor's case.

VII. Ordering of Witnesses at the Hearing.

Another important consideration is the order of presenting witnesses at the hearing. Effective presentation can make or break a case, and delivering the client's story in a logical format is critical to arbitration success. In this respect, it can make sense for a claimant to call the financial advisor as its first witness. Assuming the financial advisor is not a respondent, the panel will immediately learn vital information about the case from a non-party.

VIII. Use of Technology.

The use of technology in dispute resolution has increased exponentially during the past decade. Technology—when used appropriately—can greatly enhance the effectiveness of a case. Products such as iPads and tablets, presentation resources like Prezi and PowerPoint, and videoconferencing tools such as Zoom and Skype can all be used to a claimant's advantage. We find that making the case easy to understand is critical to persuading the arbitration panel of the credibility and merits of the investor claims.

IX. Conclusion.

The foregoing discussion is merely a limited introduction to the many considerations and issues that arise during an investor case brought in FINRA arbitration. There are many other issues that arise in different cases depending upon the unique facts or investments involved in the case. If you have questions regarding a possible securities law matter, or to arrange for a consultation concerning your legal matter, please contact Robert Mitchell at rdm@tblaw.com or at (602) 452-2730.