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A Trial Lawyer's Perspective on FINRA Arbitrations and Expungement Proceedings

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A Trial Lawyer's Perspective on FINRA Arbitration and Expungement Proceedings

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FINRA is the Financial Industry Regulatory Authority

- FINRA operates the largest securities dispute resolution forum in the United States
- FINRA has created an efficient dispute resolution process
  - Quicker to a final determination on the merits than litigation
    - May be able to go from filing the Statement of Claim to a final Award in less than 18 months
  - Less discovery available than in a litigation
  - Less motion practice

FINRA is the Financial Industry Regulatory Authority

- As a trial lawyer, you have to take advantage of the FINRA arbitration process
  - Your focus should be the hearing and not discovery
  - The hearing is your opportunity to present evidence and be persuasive
  - It may be your only opportunity

FINRA Arbitrations – Disputes Must Be Arbitrated

- Every broker-dealer and broker that sells securities in the United States must be licensed by FINRA
- FINRA requires that all of its member firms and their brokers submit securities disputes to arbitration
  - Shearson/Am. Express, Inc. v. McMahon, 402 U.S. 220 (1987) – affirmed the validity of mandatory arbitration clauses in disputes involving customers and broker-dealers and registered representatives

FINRA Arbitrations – Disputes Must Be Arbitrated

FINRA members must arbitrate:

- Disputes with customers
  - Governed by the Code of Arbitration Procedure for Customer Disputes
  - The 12000 series of the FINRA Rules
- Disputes between broker-dealers and their registered representatives
  - Governed by the Code of Arbitration Procedure for Industry Disputes
  - The 13000 series of the FINRA Rules

Benefits

- Faster and less expensive than litigation
- Less formality than litigation and arbitrators generally let the parties plot the course of the case
- Cases are decided on the merits because of limited dispositive motion practice
- Arbitrators can apply equitable principles and try to be fair – "split the baby"
- Easy process to confirm an arbitration award

Arbitrations – The Benefits and Disadvantages

Disadvantages

- No appeal and limited grounds to vacate an award under 9 U.S.C. § 10
  - Grounds to vacate an award include
    - An award procured by fraud, corruption, or undue means
    - Evident partiality or corruption in the arbitrators
    - The arbitrators exceeded their powers
    - Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced
- Limited discovery of your adversary's case
- Generally, limited discovery obtainable from third-parties

Arbitrations – The Benefits and Disadvantages

FINRA Arbitrations – Pleadings and Early Motion Practice

The Claimant commences the arbitration by filing a Statement of Claim that, like a complaint, contains allegations and causes of action

- FINRA Rule 12303 – the Statement of Claim should allege "the relevant facts and remedies," and can attach relevant documents
- Some commonly asserted causes of action include:
  - Breach of Fiduciary Duty
  - Negligence
  - Suitability
  - Selling away
  - Churning

FINRA Arbitrations – Pleadings and Early Motion Practice

- FINRA serves the Statement of Claim on the Respondents who have 60 days to file an Answer
- Answer should include a request for expungement of claim from the broker's Form U-4 and CRD

FINRA Arbitrations – Pleadings and Early Motion Practice

Motions to Dismiss – rare and based on limited grounds

- FINRA Rule 12504(a)(1) – "Motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged in arbitration."
- Best basis to succeed on a motion to dismiss is the statute of limitations
  - FINRA Rule 12206(a) – "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."

FINRA Arbitrations – The Panel

- All matters are decided by a panel of 1 or 3 arbitrators
  - The judge and jury for your case
- FINRA arbitrators are typically industry professionals
  - Arbitrators do not work for FINRA
  - Three categories of arbitrators
    - Chair Qualified – public arbitrators with training to serve as chairperson at the hearing
    - Non-Public – individuals who have some association with the securities industry
    - Public – have no affiliation with the securities industry

FINRA Arbitrations – The Panel

- Selected from a list that FINRA randomly picks from its roster of arbitrators
  - Candidates must have at least five years of full-time business or professional experience
- FINRA allows a limited number of "strikes" to remove an arbitrator from serving on the panel
  - The remaining arbitrators are ranked by the parties in order of preference
  - Each party sends their strikes and rankings to FINRA, but not the other side

FINRA Arbitrations – The Panel

- Important to do due diligence on the arbitrators picked by FINRA
  - Review their prior Awards
  - Contact colleagues for information
  - Check for articles authored by the arbitrators
    - May get insight into how the arbitrators view their authority
  - Identify who you want to strike and then rank the remaining options
- After both sides submit their strikes and rankings, the panel is selected

FINRA Arbitrations – The Panel

- Initial Pre-Hearing Conference – your first contact with the panel
  - Create a discovery schedule
  - Set a final hearing date
    - Depending on the complexity of the case, a final hearing can be as short as one day or last weeks or months
  - Raise any other issues related to the arbitration

FINRA Arbitrations – Discovery and Hearing by Ambush?

- Discovery is more limited than litigation – that is why the final hearing is critical
  - Inability to wear down your adversary through burdensome discovery
- Discovery is generally limited to an exchange of documents
  - No interrogatories or requests for admission
    - FINRA Rule 12507(a) – allows limited "requests for information," such as the identification of individuals, entities, or time periods related to the dispute
  - FINRA Rule 12506 – the parties must produce the documents set forth on the FINRA Discovery Guide, which are presumed to be discoverable

FINRA Arbitrations – Discovery and Hearing by Ambush?

- Documents that Customers Must Produce Include:
  - Three years of prior federal income tax returns
  - Documents received from the broker-dealer and its associated persons
  - Account statements for non-party securities firms
  - Notes relating to the accounts or transaction at issue

FINRA Arbitrations – Discovery and Hearing by Ambush?

- Documents that Broker-Dealers and Registered Representatives Must Produce Include:
  - Account record information for the customer
  - Correspondence sent to the customer relating to the claim, account, transaction or product at issue
  - All recordings, notes, and logs relating to the transactions at issue
  - Records of disciplinary action taken against the registered representative for conduct that is similar to that alleged in the Statement of Claim

FINRA Arbitrations – Discovery and Hearing by Ambush?

- Depositions are not typical and are discouraged
  - Limited circumstances – to preserve the testimony of a dying witness or a witness who cannot testify at the final hearing
- Your first chance to cross-examine an opposing witness is likely to be the final hearing

FINRA Arbitrations – The 20-Day Exchange

- The parties exchange their witness and exhibit lists 20 days before the final hearing
- The only new information you may learn about your adversary's case is the identity of their experts and get of copy of the reports
- After the 20-day exchange you will have a full view into the other side's case
  - A good opportunity to consider settlement before proceeding to the final hearing

FINRA Arbitrations – The Final Hearing and Deciding the Case

It is critical to understand what arbitrators consider when conducting a hearing and deciding which party prevails

- Arbitrators do not have to strictly apply the law and are permitted to make awards based on principles of equity and fairness
- What your client says on social media is likely to be given substantial weight by the arbitrators
- Arbitrators may not be lawyers
- The standard of care in the industry
  - FINRA and New York Stock Exchange rules are given substantial weight

FINRA Arbitrations – The Final Hearing and Deciding the Case

There are some similarities to a trial

- Opening and closing statements
- Fact and expert witnesses testify, with the opportunity for cross-examination
  - Fact witnesses – claimant, the registered representative
  - Expert witnesses – expert on industry practices, accountant or other damages expert
- Documents are admitted into evidence
- Arbitrators (like a judge) can and often will question witnesses
  - Indicates what the arbitrator thinks of your case or finds important

FINRA Arbitrations – The Final Hearing and Deciding the Case

But an arbitration is unlike a trial in that

- No formal rules of evidence – FINRA Rule 12604
  - Arbitrators often admit objectionable evidence, especially hearsay and unauthenticated documents
    - Failing to hear material and pertinent evidence is a basis to vacate an award
    - Arbitrators are likely to be annoyed by repeated objections
- The hearing is your opportunity to present your client's entire case
  - Unlike litigation, issues in an arbitration are rarely decided before the hearing on a dispositive motion

Presenter to read NY Code

This code is required for all attorneys wishing to receive CLE credit in the state of NY and taking the program 'on-demand' at Celesq AttorneysEd Center either online or via CD

Please notate it carefully

The presenter will only be able to read the code twice and will not be able to repeat it or email it to you.

Thank you!

Persuading the Panel

Three types of people:

- **Rational People**: Use data and reason to arrive at truth. (This group is mostly imaginary.)
- **Word-Thinkers**: Use labels, word definitions, and analogies to create the illusion of rational thinking. This group is 99% of the world.
- **Persuaders:** Use simplicity, repetition, emotion, habit, aspirations, visual communication, and other tools of persuasion to program other people and themselves. This group is about 1% of the population and effectively control the word-thinkers of the world.

--Scott Adams, Dilbert

How are Myths and Fables created?

- Based on preconceived notions, ideas, generalizations, biases and stereotypes
  - Evidence is viewed through these belief systems
  - Evidence is tested against the bias-based belief system
  - Belief system fills in the gaps left by missing evidence
- Fact finders need to be provided new beliefs to transform belief system

Attribution Theory

- Reactive Attribution
  - Fact finder believes the party's behavior was unconscious and unintended
- Purposive Attribution
  - Fact finder believes the party's behavior was purposeful and intended

- If we as lawyers fail to address the "why," then the fact finder will fill-in the cause and effect based on his/her own belief system.

Battling the Myths and Fables

- Research the Finder of Fact
- Know the Myths and Fables for Your Client and Adversary
- Use the Realty Shifting Tool Box
  - Primacy
  - Own the Myth and Create the White Hat
  - Rule of Three

Primacy

- People tend to believe the facts they first believe
  - Need to shape fact finders belief from the beginning and then frequently

- Acknowledge the Myths and Fables
- Distinguish from your case
- Rebuild client outside of Myths and Fables

Own the Myth and Create the White Hat

Statistics

- 2014-2016: 2232 Arbitration Cases involved Expungement
- Arbitrators made expungement determination in 808 of those cases
- Expungement recommended in 75% of the 808 cases

The Central Registration Depository

- The CRD is akin to a permanent record for a financial services professional. The CRD contains, among others, disclosures relating to:
  - customer complaints
  - arbitration claims
  - court filings

U-4 Disclosure Requirements

- The U-4 has disclosure questions
- Question 14I(1)-(3):
- Have you ever been named as a respondent/ defendant in an investment-related, consumer-initiated arbitration or civil litigation which alleged that you were involved in one or more sales practice violations and which was settled, on or after May 18, 2009, for an amount of $15,000 or more?

U-4 Disclosure Requirements

- The arbitration or civil litigation is reportable if all of the following six criteria are met:
  - Consumer – initiated
  - Investment – related
  - Individual named as respondent/defendant (or alleged to have engaged in sales practice violation)
  - Alleged individual involvement in any sales practice violation
  - Settled on or after May 18, 2009
  - Settled for $15,000 or more

FINRA'S Expungement Framework

- FINRA Rule 2080 (formerly NASD Rule 2130)
- FINRA has long described expungement as an "extraordinary remedy"
- FINRA Rule 2080: (a) Members of associated persons seeking to expunge information from the CRD system arising from disputes with customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief.

FINRA Pushes Back

- In 2008, FINRA adopted FINRA Rule 12805 to require arbitrators to perform additional fact finding before recommending expungement of customer dispute information from the CRD system.

The Adoption of FINRA Rule 12805

To expunge, arbitrators must:

- Review settlement documents
- Review the amount of payments made to any party, and any other terms and conditions of the settlement
- Indicate in the award which of the grounds in FINRA Rule 2080 serves as the basis for their expungement recommendation
- Provide a brief written explanation of the reasons for recommending expungement

FINRA Comments Suggesting Expanded Expungement Requirements

- FINRA has also made various comments in proposals and notices stating that expungement relief can only be granted when the information being expunged "has no meaningful investor protection or regulatory value."

FINRA Rule 2081

- In 2013, FINRA sent to arbitrators and published on its website guidance stating that, in determining whether to recommend expungement relief in settled arbitration claims, arbitrators should inquire whether a party conditioned settlement on an agreement not to oppose a request for expungement relief.
- FINRA Rule 2081 precludes a firm or associated person from conditioning the settlement of a customer's claim on the customer's agreement to consent to, or not to oppose, the firm's or associated person' s request for expungement;
- Precludes a firm or associated person, following a settlement of the dispute at issue, from compensating the customer in return for the customer not opposing the firm's or associated person's expungement request.

Notice to Members 17-42

- December 6, 2017
- Contains new rule proposals which will radically impact the current expungement framework

Rationale for the New Proposal Regarding Expungement

- The new proposals are designed to "improve the quality and timeliness of the information available to panels determining requests for expungement." – NTM at 14
- The new proposals "would benefit investors, member firms, and regulators by helping to ensure that the customer dispute information on CRD, and therefore, BrokerCheck more accurately reflects those customer disputes that have investor protection or regulatory value." NTM at 15
- The new proposals would "impose costs on associated persons, primarily by restricting how and when they could file an expungement request and, in some cases, by increasing the cost of filing an expungement request." – NTM at 15

Proposed Changes Regarding Expungement

What are the big new changes that might be coming?

Unanimous Arbitration Panel Decision

- Before, majority agreement was needed to expunge
- Now need unanimous agreement

Panel Decision

- Before panel had to find 1 of 3 grounds in Rule 2080
- Now, panel has to find that AND that the "customer dispute information has no investor protection or regulatory value."

Time Limit

- Before, no time limit
- Now, request must be filed 1 year of the closing of the underlying arbitration, if expungement is not decided during the underlying arbitration
- If the issue of expungement was decided, there are no further opportunities to expunge

The Panel

- Before, full roster of arbitrators
- Now, limited roster with "additional qualifications"
- Completed enhanced expungement training
- Admitted to practice law in one jurisdiction
- 5 years of experience in litigation, securities regulation, administrative law, served as a securities regulator, or a judge
- Could be good, could be bad

Attendance

- Before, telephonic
- Now, the associated person has to APPEAR at the hearing
- In person, or videoconference
- No telephone conferences permitted
- More expensive and burdensome

Filing Fee

- Before, $50
- Now, a minimum filing fee of $1425 for expungement requests

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Mr. Kohel's practice is concentrated in the areas of commercial, intellectual property, and product liability litigation. He represents clients in a wide variety of matters, including for breach of contract, fraud, franchise disputes, employment discrimination, and in securities cases and FINRA arbitrations, as well as in disputes for trademark infringement, the sale of counterfeit goods, misappropriation of trade secrets, and in patent infringement matters. Mr. Kohel has litigated in federal courts across the country and in domestic and international arbitrations. He regularly handles technical, scientific, and regulatory issues.

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