MONTH YEAR

FINRA Arbitration of Customer/Broker-Dealer Disputes: An Overview for the Uninitiated

Stephen L. Brodsky, Partner | Mazzola Lindstrom LLP

Arbitration is the primary method by which disputes between securities customers and their broker-dealer firms are resolved. The Financial Industry Regulatory Authority (FINRA) is the principal forum for these arbitrations. FINRA arbitration is comparatively quick and cost-effective. In addition, regulatory oversight and other mechanisms provide checks to ensure that the process is fair. This article provides an overview of the FINRA arbitration process.

Background

FINRA is an independent, self-regulatory organization (SRO) for securities broker-dealer firms and their representatives. Created in July 2007 through the consolidation of two prior SRO's, the National Association of Securities Dealers, and the member regulatory and enforcement operations of the New York Stock Exchange, FINRA is a membership -based SRO that creates and enforces rules for its members.

Today, FINRA is the primary SRO for broker-dealer firms. It oversees more than 3600 brokerage firms and more than 600,000 registered securities representatives nationwide. In addition, operating the largest securities arbitration program in the United States, FINRA oversees disputes between customers and their broker-dealer firms and those between broker-dealers and their employees and supervises a mediation program.

While it is a nongovernmental organization, FINRA still has a statutory mandate to provide a fair dispute resolution forum for securities disputes. The Securities and Exchange Commission (SEC) exercises broad oversight powers over FINRA to ensure its arbitration procedures are fair. The Securities Exchange Act of 1934, as amended empowers the SEC to ensure fair arbitration procedures. See: 15 U.s.C; see also *Shearson/AM. Express Inc. v. McMahon*, 482 U.S. 220, 233-34 (1987). By virtue of that authority, the SEC must approve FINRA's new rules and rule ammendments. The SEC may also conduct "reasonable periodic, special or other examinations" of FINRA's operations as it "deems necessary or appropriate in the public interest." *Pub. Inv'rs Arbitration Bar Ass'n v. SEC*, 771 F.3d 1, 2 (D.C. Cir. 2014). See also U.S. Gov't Accountability Off., GAO-12-625, *Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority (May 2012).*

The National Arbitration and Mediation Committee (NAMC), a committee composed of public and securities industry representatives, provides additional oversight of FINRA. The NAMC recommends rules, regulations and procedures, for FINRA's arbitration, mediation, and other dispute resolution processes. See FINRA Rule 14102.

Benefits of FINRA Arbitration

Like arbitration generally, FINRA arbitration is viewed as less costly and faster than litigation. See Sec. Indus. & Fin. Mkts. Ass'n (SIFMA), White Paper on Arbitration in the Securities industry (Oct.2007). See also *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 346 (2011) (discussing arbitration generally). FINRA arbitration has advantages. Claims that would be too small to litigate cost-effectively may still be resolved through this process, and the expense of determining higher dollar claims is less than what litigation would entail. The streamlined process also results in speedier resolution of disputes. For example, FINRA reports that arbitrations heard on written submissions are decided in about 7.1 months, while arbitrations with merits hearings are decided in about 16.6 months. Finally, because there is limited ground for appeal, the process yields finality more quickly than litigation. However, as discussed below, there is a fundamental trade-off: Parties essentially relinquish their right to appeal the award.

Some have contended that FINRA arbitration produces "pro-industry" outcomes. See, e.g., *Habliston v. FINRA Regulation, Inc.,* No. 1:2015-cv-02225 (D.D.C. 2017) n v. FINRA Regulation, Inc. Yet, studies have concluded that SRO securities arbitration is indeed fair and beneficial for retail investors. See, e.g., Barbara Black, "*Is Securities Arbitration Fair to Investors?*," 25 Pace L. Rev. 1, 5–6 (2004); Jill Gross, "*McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*," 76 U. Cin. L. Rev. 493, 517–18 (2018).

The FINRA Arbitration Process

A brokerage firm's account opening documents typically include an arbitration agreement by which the customer agrees to arbitrate through FINRA any disputes with the firm and its representatives. FINRA's procedures for customer/broker-dealer arbitrations are set forth in its **Code of Arbitration Procedure for Customer Disputes**, FINRA Rules 12000 et seq. However, even absent an arbitration agreement, if a customer requests arbitration, the broker's consent is deemed given by virtue of its membership in FINRA. (FINRA Rule 12200).

The arbitration is commenced by filing a statement of claim and submission agreement. FINRA Rule 12302. The statement of claim includes the relevant facts and sets forth the relief requested. It may also attach as exhibits certain important documents. By the submission agreement, the claimant acknowledges its agreement to abide by FINRA's procedures and be bound by the arbitration award. The responding party must submit its answer and defenses to the statement of claim, along with any counterclaims, cross-claims, or third-party claims it may have, as well as its own submission agreement. FINRA Rule 12303.

Claims for $50,000 or less in damages are decided by one arbitrator, and no hearing is held. Unless it is requested. FINRA Rules 12401, 12800. Claims from $50,001 to $100,000 are also decided by one arbitrator but require an in-person hearing. FINRA Rules 12401, 12600, 12602. Claims asserting more than $100,000 in damages or an unspecified amount of damages are heard by a panel of three arbitrators and require an in-person hearing. FINRA Rules 12401, 12600, 12602.

FINRA's Neutral List Selection System transmits to the parties a computer-generated, random list of potential arbitrators pulled from

FINRA's roster of neutrals. The parties submit their "strikes" and rank of the arbitrators in accordance with their preferences. FINRA Rule 12400. After the arbitrator or panel is appointed, an initial prehearing conference is held. FINRA Rule 12500. At this initial conference, the arbitrator or panel and the parties set discovery, briefing, and motion deadlines, schedule other hearings, and discuss any other preliminary matters. The arbitrator or panel may also address other issues to expedite the process or that a party raises. Best practice, therefore, is for counsel to reach an agreement on all anticipated matters before this conference. Subsequent conferences may still be held, either at a party's request or at the discretion of the panel, to address other matters before the merits hearing. These conferences may address essentially anything that is appropriate, such as discovery disputes, motions, subpoenas, stipulations of fact, contested issues that require briefing, and unresolved scheduling issues. FINRA Rule 12501.

Discovery in a FINRA arbitration is much narrower than that in litigation. Party document production is allowed. FINRA Rules 12506 and 12507. Party depositions, however, require panel permission requested by written motion. The panel may allow a deposition only in very limited circumstances, such as to preserve the testimony of an ill or dying witness or to accommodate an essential witness who is unable to travel long distances for the hearing. FINRA Rule 12510.

Subpoenas for nonparties likewise require permission from the panel, which may be requested only by written motion. FINRA Rule 12512. Prehearing dispositive motions are expressly discouraged. FINRA Rule 12504. Arbitrators are likely to defer nearly all matters for resolution at the merits hearing. A merits hearing also differs from a trial. For example, arbitrators are not bound by state or federal rules of evidence; they themselves determine what evidence may be admitted at the hearing. FINRA Rule 12604. The hearing is recorded, and the recording is preserved by FINRA for review if needed. FINRA Rule 12606. The award will be issued within 30 business days after the record is closed. FINRA Rule 12904. Parties may request that the award be issued via a simple determination or with an "explained decision," which discusses the reasons for the award. All parties must jointly request an explained decision.

Limited "Appellate" Rights

Counsel and parties must remember that a FINRA arbitration award is essentially final. FINRA itself provides no procedure to challenge, review, or appeal the award. As is the case for arbitration generally, federal and state law empowers a court to overturn the award only in limited circumstances.

The Federal Arbitration Act (FAA), which embodies the public policy strongly favoring arbitration see *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 443 (2006), enumerates specific grounds to vacate or modify an award. These include that the award was procured through corruption, fraud, or undue means or that the arbitrators exceeded their powers. See 9 U.S.C. § 10. Federal common law also recognizes "manifest disregard of the law" as another basis to vacate an award. See, e.g., *Telenor Mobile Commc'ns AS v. Storm LLC*, 584 F.3d 396, 407 (2d Cir. 2009). But see, e.g., *Beumer Corp. v. Pro Energy Servs.*, LLC, 899 F.3d 564, 566 (8th Cir. 2018).

State statutes may also list grounds to challenge an arbitration award. See, e.g., Fla. Stat. § 682.13 (1); N.Y. C.P.L.R. 7511 (b)(1). Certain state courts have drawn on federal common law to recognize manifest disregard of the law as a basis to overturn an award, but only in very limited circumstances and for arbitrations governed by the FAA. See, e.g., McLaughlin, Piven, Vogel Sec. Inc. v. Ferrucci, 67 A.D.3d 405, 406, 889 N.Y.S.2d 134 (N.Y. App. Div. 1st Dept. 2009).

An award will be upheld "if there is [even] a barely colorable justification for the outcome reached." Wallace v. Buttar, 378. 3d 182, 190 (2d Cir. 2004) (emphasis and quotation marks omitted). See also Hall St. Assocs., L.L.C. v. Mattel, Inc., 552 U.S. 576 (2008); Century Indem. Co. v. Certain Underwriters at Lloyd's London, 584, F. 3d 513, 557 (3d Cir. 2009).

Understanding the FINRA arbitration process is essential to those who represent participants in the securities industry. FINRA arbitration provides a cost-effective, streamlined, and quick process to resolve customer/broker-dealer disputes. However, like arbitration generally, it allows for very limited appellate rights.

Article originally published in *American Bar Association, Section of Litigation, Commercial & Business Litigation Committee*