

# FINRA Dispute Resolution Task Force

## Final Report and Recommendations of the FINRA Dispute Resolution Task Force

### INTRODUCTION

The Financial Industry Regulatory Authority (FINRA)<sup>1</sup> operates the largest securities dispute resolution forum in the United States, with hearing locations in all 50 states, as well as Puerto Rico and London. FINRA's Dispute Resolution division (DR) handles more than 99 percent of the securities-related arbitrations and mediations in the U.S. and maintains a roster of more than 6,400 arbitrators and nearly 250 mediators.<sup>2</sup>

FINRA formed a task force in June 2014, to consider possible enhancements to its arbitration and mediation forum, in order to ensure that the forum meets the evolving needs of participants. The task force is comprised of individuals, from the public and industry sectors, who represent a broad range of interests in securities dispute resolution.<sup>3</sup> FINRA charged this group to work together to suggest strategies to enhance the transparency, impartiality, and efficiency of FINRA's securities dispute resolution forum for all participants. This document is the Final Report of the task force, including its recommendations to FINRA's National Arbitration and Mediation Committee (NAMC).

### BACKGROUND

FINRA is, for all practical purposes, the sole arbitration forum in the United States for resolving disputes between broker-dealers, associated persons, and customers. FINRA requires arbitration of disputes between customers and broker-dealers and associated persons at the request of the customer.<sup>4</sup> The dispute must arise in connection with the business activities of the member or the associated person (except disputes involving the insurance business activities of a member that is also an insurance company). In addition, a written agreement can require arbitration of customers' disputes.<sup>5</sup> Although some securities firms included predispute arbitration agreements (PDAAs) in customers' brokerage agreements at least since the 1950s,<sup>6</sup>

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<sup>1</sup>Until mid-2007, the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) ran separate arbitration forums that handled a combined 99% of all securities arbitrations in the country. On July 30, 2007, NASD and NYSE Regulation, including their respective arbitration forums, consolidated and formed FINRA. See Press Release, (July 30, 2007), available at <http://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority>. This report will, in most instances, refer to the regulator by its name at the time of the event being discussed. When referring to the regulator generally or over an extended period of time, it will be referred to as FINRA.

<sup>2</sup> <http://www.finra.org/>.

<sup>3</sup> The members of the task force are set forth in Appendix I.

<sup>4</sup> FINRA Rule 12200. FINRA's Code of Arbitration Procedure is available at FINRA's website, at [http://finra.complanet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4096](http://finra.complanet.com/en/display/display_main.html?rbid=2403&element_id=4096).

<sup>5</sup> *Id.*

<sup>6</sup> *Wilko v. Swan*, 346 U.S. 427 (1953) (holding that a PDA was not enforceable with respect to claims under Securities Act of 1933), *overruled*, *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989).

modern securities arbitration began with the 1987 U. S. Supreme Court opinion, *Shearson/American Express Inc. v. McMahon*,<sup>7</sup> which held that brokerage firms could enforce PDAs and require customers to arbitrate their claims arising under the Securities Exchange Act of 1934 (the Exchange Act).<sup>8</sup> Since that pivotal decision, virtually all broker-dealers require their customers to execute PDAs that require arbitration of all customers' disputes with broker-dealers or associated persons before a Self-Regulatory Organization (SRO) forum.

Over the years FINRA has amended frequently its arbitration rules to improve its procedures and to reduce the influence of the securities industry. The Securities and Exchange Commission (SEC) must approve FINRA's arbitration rules upon a finding that they are consistent with the requirements of the Exchange Act and its rules.<sup>9</sup>

At the time of *McMahon*, arbitration procedures were informal,<sup>10</sup> and the arbitration staff selected the panel of arbitrators from a pool of qualified arbitrators. In the aftermath of *McMahon*, the SROs, including NASD, filed with the SEC proposed changes to their arbitration rules, as it became increasingly important that the SRO forums provide a process which investors perceived as fair and in which they could have confidence. Procedures became more formalized and provided for (among other things) discovery, prehearing conferences, publication of awards, and the requirement of a hearing record. Standards for classifying arbitrators as either public or non-public (industry) were tightened. Rules requiring highlighted disclosures about the inclusion of a PDA in customers' agreements and the characteristics of arbitration were adopted. In 1989 the SEC approved the changes,<sup>11</sup> while making it clear that it continued to have concerns about the process. The agency implied that its views on the fairness of arbitration might change if SRO arbitration became, *de facto*, the exclusive forum for investors.<sup>12</sup>

The next significant impetus for review and reform was the NASD Board of Governors' appointment of an Arbitration Policy Task Force in 1994 to study its arbitration forum and make recommendations for reform. The Task Force's 1996 report, known as the Ruder Report after its Chairman, former SEC Chairman David S. Ruder, greatly influenced the future direction of securities arbitration.<sup>13</sup> The Ruder Report noted the "phenomenal growth in securities arbitration"<sup>14</sup> since *McMahon* and identified what it saw as the most significant issues facing securities arbitration: its increased litigiousness, PDAs, the eligibility rule, punitive damages,

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<sup>7</sup> 482 U.S. 220 (1987).

<sup>8</sup> Two years later, in *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989), the Court extended *McMahon*'s holding to claims under the Securities Act of 1933.

<sup>9</sup> SEA § 19(b)(2)(C), 15 U.S.C. § 78s(b)(2)(C).

<sup>10</sup> See Deborah Masucci & Edward W. Morris, Jr., *Securities Arbitration at Self-Regulatory Organizations: Administration and Procedure*, in *Securities Arbitration 1988*, at 309, 399 (PLI Corp. Law & Practice Course, Handbook Series No. 601, 1988). The NASD's Code of Arbitration Procedure in effect in July 1987 is set forth as Exhibit 24; Part III governs customers' disputes with broker-dealers.

<sup>11</sup> Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exch. Act Rel. 34-26805, 54 Fed. Reg. 21144 (May 10, 1989).

<sup>12</sup> *Id.*

<sup>13</sup> *Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc.* (1996).

<sup>14</sup> *Id.* at 6.

and matters relating to arbitrators.<sup>15</sup> It concluded that the securities industry should be permitted to continue to use PDAs because, in its view, “even with its flaws, securities arbitration is clearly preferable to civil litigation.”<sup>16</sup> It also expressed concern that “the increasingly litigious nature of securities arbitration has gradually eroded the advantages of SRO arbitration.”<sup>17</sup> Consistent with these views, it proposed changes designed to retain the traditional advantages of speed, informality, and reduced costs and yet meet the demand for increased professionalism.<sup>18</sup> The Ruder Report set forth more than 70 recommendations. From 1997 to 2007, NASD filed more than 65 proposed rule changes with the SEC dealing with various aspects of its securities arbitration process.<sup>19</sup> In a 2007 Report Card assessing the post-Ruder Report reforms, NASD stated that it had implemented “nearly every key recommendation” contained in the Ruder Report,<sup>20</sup> in addition to a number of initiatives that were not generated by the Ruder Report, with the objective of “preserv[ing] and respect[ing] the basic elements of a fair and efficient dispute resolution system, while embracing the adjustments needed to enhance the system and effectively serve an evolving customer base.”<sup>21</sup> David Ruder concluded that the 2007 FINRA arbitration system was “greatly improved” over the 1996 system.<sup>22</sup>

Since 2008 FINRA has continued its efforts to improve the forum, filing over 40 proposed rule changes with the SEC, the most significant of which are discussed throughout this report. Notwithstanding these changes, the fairness of requiring investors to arbitrate their disputes in a SRO forum remains a contentious issue.

## REASONS FOR THE TASK FORCE

FINRA established this task force because it recognized the need to reflect on what its dispute resolution forum will look like in the next 20 years and determined to look to a broad range of independent viewpoints to offer recommendations outside the rulemaking process.

In the aftermath of the 2008 financial crisis, both Congress and the Executive Branch called for further study of securities arbitration, particularly as it affects retail investors.<sup>23</sup> Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) gives the SEC the authority to prohibit, or to impose conditions or limitations on the use of, agreements that require customers or clients . . . to arbitrate *any future dispute between them arising under the Federal securities laws, the rules and regulations*

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<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 17-18.

<sup>17</sup> *Id.* at 7.

<sup>18</sup> *See, e.g., id.* at 88 (discussing the need for a more professional corps of arbitrators).

<sup>19</sup> FINRA’s website posts its rule filings at <http://www.finra.org/industry/rule-filings>.

<sup>20</sup> The Arbitration Policy Task Force Report—A Report Card at 5 (2007) (noting that in several instances the path to implementation or the outcome was different than the Ruder Report’s recommendation).

<sup>21</sup> *Id.* at 27.

<sup>22</sup> *Id.* at 1.

<sup>23</sup> In 2009, Congress considered, but did not pass, legislation to invalidate PDAs in employment and consumer arbitration and expressly included securities arbitration within the definition. In 2009, the U.S. Dept. of Treasury issued a white paper on financial regulatory reform that recommended an SEC study of the issue as well as an amendment of the federal securities laws to give the SEC authority to prohibit PDAs in brokerage and investment advisory contracts with retail investors. Financial Regulatory Reform: A New Foundation 72 (2009).

*thereunder, or the rule of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.*<sup>24</sup>

While to date the SEC has taken no action, Dodd-Frank has revived the debate over the fairness of PDAAs.

The fairness of PDAAs is not the only important issue affecting the future of securities arbitration. Increased demands placed on arbitrators have raised questions about the qualifications, training, and incentives of arbitrators. The confidential nature of arbitration and the paucity of explained awards result in a lack of transparency that can lead to misunderstandings about the FINRA forum. There is increased recognition of the need to tailor procedures for different groups of investors; for example, small cases involving unsophisticated investors present different challenges than large cases involving institutional investors. The expungement process continues to raise questions about the appropriate balance between useful investor information and brokers' protection from false accusations. The separate mediation code,<sup>25</sup> which was adopted nearly 10 years ago, is ready for review and assessment. The use of technology has the potential for greater efficiencies that have not yet been fully realized.

Accordingly, FINRA formed this task force in June 2014 to consider possible enhancements to its arbitration and mediation forum so that the forum would meet the evolving needs of its users.

## **WORK OF THE TASK FORCE**

At the outset, the task force agreed that it would be open to examine all issues that may affect securities arbitration and mediation over the next 20 years and that no issue was off the table for discussion. Because of the broad scope of its charge, the task force focused its attention on securities disputes involving customers of brokerage firms, and its recommendations primarily address these disputes. The comments and suggestions submitted to the task force also focused on customers' disputes.

The task force met as a group in four in-person meetings and five telephonic meetings. At its first in-person meeting it identified the initial topics for review<sup>26</sup> and established ten subcommittees to gather information and viewpoints on those topics and to report back to the full task force. The subcommittees met regularly via telephonic conference calls. At the second and third in-person meetings, the task force reviewed the reports and recommendations of the subcommittees. At its fourth in-person meeting the task force reviewed a draft of this final report. The task force approved the final report during its December 7, 2015, telephonic meeting.

To inform its work, the task force solicited information and viewpoints from forum participants and members of the general public in a variety of ways. It established a mailbox, [DRTaskForce@finra.org](mailto:DRTaskForce@finra.org), that was available for the duration of the task force's existence. The task force received 188 comments via the mailbox, almost all of which came from individuals

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<sup>24</sup> Dodd-Frank Act, Pub. L. No. 111-203, § 921(a), 124 Stat. 1376, 1841 (2010) (emphasis added).

<sup>25</sup> The Code of Mediation Procedure became effective January 30, 2006.

<sup>26</sup> These are set forth in Appendix II.

identifying themselves as arbitrators. In addition, the task force solicited written comments from 33 interested organizations and individuals and received 9 written submissions (including one joint submission by nine organizations).<sup>27</sup> It also conducted telephonic interviews with representatives of four organizations that filed written submissions and requested interviews.<sup>28</sup> The task force released an interim summary in June 2015 to alert users of the forum, arbitrators, mediators, and the general public to its current thinking on the key issues before it, with the hope that it would generate additional input on these, and any other, issues related to the FINRA arbitration forum.<sup>29</sup> Many of the subcommittees, in turn, solicited information and viewpoints on their own.<sup>30</sup>

Throughout this process FINRA staff assisted the task force by providing data, reviewing drafts of the report for factual accuracy, and facilitating logistical arrangements.

## **SUMMARY OF KEY ISSUES**

The task force looked at every aspect of FINRA's dispute resolution forum as it relates to customers' disputes and makes 51 recommendations to improve the system. Some of them would make significant changes to the forum; others would be small improvements. Some would require FINRA to invest substantial resources (both money and staff time).

In arriving at these recommendations, the task force generally followed this approach: (a) identify issues that it perceived as of concern or worthy of note; (b) offer suggestions on the issue (to the extent it has a consensus) or advise what the various perspectives on the issue are (in the event it does not have a consensus); and (c) identify impediments or possible negative consequences to addressing the issue. On some issues the task force makes a specific recommendation, while on other issues it leaves the details and implementation issues to the NAMC and, ultimately, FINRA's Board of Governors.

It is the unanimous, strongly held opinion of the task force that the most important investment in the future of the FINRA forum is in the arbitrators. The task force has concerns that the below-market-rate arbitrators' compensation acts as a disincentive in the recruitment of arbitrators and in the commitment of substantial time by arbitrators in executing their responsibilities. Accordingly, it recommends an increase in the compensation paid to arbitrators for hearings conducted pursuant to FINRA Rules 12600, 12805, 13600, and 13805, as well as biennial increases tied to the Consumer Price Index (CPI). The task force also makes a number of recommendations relating to the recruitment and training of arbitrators and the disclosures required from arbitrators that it believes are of the highest importance for achieving the goals of enhancing the transparency, impartiality, and efficiency of the forum.

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<sup>27</sup> Appendix III lists the individuals and organization that were solicited to submit written comments, as well the list of organizations that submitted comments.

<sup>28</sup> North American Securities Administrators Association (NASAA), the Dispute Resolution Section of the American Bar Association (ABA), the Financial Services Institute (FSI), and the American Association for Justice (AAJ).

<sup>29</sup> The Interim Report is attached as Appendix IV.

<sup>30</sup> Information about the work of the subcommittees is set forth in Appendix V.

The task force believes that encouraging the writing of explained decisions is the second most important category of recommendations that it is making, because the availability of explained decisions would improve the transparency of the forum. If FINRA adopts any changes that would result in more explained decisions, it must develop further training to assure that arbitrators can perform this additional responsibility competently.

The task force felt that it was important to take up the issue of mandatory arbitration. The mandatory nature of SRO securities arbitration is a defining characteristic of the process that engenders controversy about its fairness. Despite considerable discussion, however, the task force was not able to reach consensus. It concludes that the debate over mandatory securities arbitration is to a large extent a philosophical or policy question about which thoughtful, informed individuals disagree and which the task force cannot settle. The task force therefore decided that it was a better use of its limited time and resources to focus on the current system of FINRA arbitration and propose recommendations to improve it.

The task force does not have the ability to cost out its various recommendations. It is obvious, however, that implementation of many of these reforms, including those relating to arbitrators and explained decisions, will entail significant costs that will be passed on to the users of the forum. Currently, member firms and associated persons are assessed 84 percent of total fees, while customers are assessed 15 percent.<sup>31</sup> Fees received from parties who use the arbitration and mediation programs are not sufficient to fund the forum's arbitration and mediation activities.<sup>32</sup> The task force believes it is important that the FINRA forum is accessible to retail investors, consistent with the investor protection mandate of the Exchange Act. It suggests strongly that the cost structure remain the same, since any increase in costs could impede access to the only forum that is generally available to customers who have disputes with broker-dealers or associated persons.

## **DISCUSSION**

### **ARBITRATORS**

The quality of dispute resolution at the FINRA forum depends greatly on the abilities and commitment of the individuals who serve as arbitrators. The Ruder Report addressed the issues of arbitrator selection, quality, and training, and its recommendations influenced subsequent reforms in this area. Nevertheless, the task force heard many concerns about these issues. For example, a number of the comments received via the DR Mailbox related to arbitrator training, competence, or professionalism. In addition, almost all of the comments submitted via the DR Mailbox came from individuals who self-identified as arbitrators, suggesting that this group does not feel that its concerns have been adequately voiced. The size of the subcommittee addressing

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<sup>31</sup> FINRA provided these percentages, based on 2015 data and isolating customer cases from intra-industry cases. Fees charged to non-members account for the remaining 1 percent.

<sup>32</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Merge FINRA Dispute Resolution, Inc. into and with FINRA Regulation, Inc., Exch. Act Rel. 34-76082, 80 Fed. Reg. 61545 (Oct. 13, 2015).

these issues—consisting of 9 of the 13 task force members—reflects the importance the task force assigns to the role of arbitrators in the arbitration process. The task force discussed the following topics related to arbitrators.

### *Arbitrator Compensation*

*Background.* Effective for cases filed on or after December 15, 2014, the arbitrator's honorarium was increased from \$200 to \$300 per hearing session (typically, a hearing day comprises two sessions), with the chairperson receiving an additional honorarium of \$125 per day (up from \$75). This was the first increase in 15 years.<sup>33</sup> FINRA funded the recent increase in honoraria by increasing the member surcharges and process fees for claims larger than \$250,000, as well as filing fees for investors, associated persons, or firms bringing claims of more than \$500,000 and hearing session fees for claims of more than \$500,000.<sup>34</sup> In addition, the SEC recently approved a rule change that if one or more parties request a postponement or cancellation within ten days before a scheduled hearing session and the arbitrators grant the request, the party or parties making the request will pay a late cancellation fee of \$600 per arbitrator. (Previously the fee was \$100 per arbitrator, and the cancellation period was three days.)<sup>35</sup>

FINRA is aware that the current honorarium rate is not "market rate," but believes that increasing the honorarium to market rates would impose a significant financial burden on the users of the forum.<sup>36</sup>

*Task Force Deliberations.* The task force received many complaints from arbitrators about the relatively low level of compensation, particularly because the level of case complexity has increased, the requirements for arbitrator disclosure continue to rise, and the responsibilities and time requirements expected from arbitrators are increasing. As a result, FINRA may not be able to attract individuals (particularly, working professionals at the height of their careers) to serve as arbitrators at the current rate.

The task force engaged in an extended discussion about what level of arbitrator compensation is necessary to attract qualified individuals to serve as arbitrators and to take their responsibilities seriously. The task force does not believe it is feasible to raise arbitrator

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<sup>33</sup> SEC Approves Amendments to the Codes of Arbitration Procedure to Increase Arbitrator Honoraria by Increasing Arbitration Filing Fees, Member Surcharges and Process Fees and Hearing Session Fees, Regulatory Notice 14-49 (Effective Date: December 15, 2014), available at <http://www.finra.org/industry/notices/14-49>. The Ruder Report (at 103) also identified the relatively low level of arbitrator compensation as a factor; at that time arbitrators were paid a honorarium of \$225 per day, with the panel chair receiving an additional \$50.

<sup>34</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change To Amend the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes To Increase Arbitrator Honoraria and Increase Certain Arbitration Fees and Surcharges, Exch. Act Rel. 34-73245, 79 Fed. Reg. 59876 (Sept. 29, 2014).

<sup>35</sup> SEC Approves Amendments to the Codes of Arbitration Procedure to Increase the Fees Assessed for Late Cancellation or Postponement of a Hearing, Regulatory Notice 15-21 (Effective Date: July 6, 2015), available at <http://www.finra.org/industry/notices/15-21>.

<sup>36</sup> Exch. Act Rel. 34-73245.

compensation to levels customary at non-SRO arbitration forums, such as the American Arbitration Association (AAA).<sup>37</sup> It does believe that arbitrator compensation must be increased in order to professionalize the FINRA arbitrator pool, which the task force identifies in this report as the highest priority.

The task force recommends that the session fee for all hearings conducted pursuant to FINRA Rules 12600, 12805, 13600, and 13805 be increased from \$300 per session to \$500 per session, *i.e.*, \$1000 for a typical hearing day consisting of two sessions. In addition, the task force recommends automatic biennial increases in the honorarium pegged to the CPI, without which arbitrators are paid less each successive year, which is not appropriate.

The task force reviewed a rough estimate of the additional honorarium expenses resulting from these increases and felt that FINRA and the industry could manage the additional expenses. The task force also expects that the additional costs would be assessed consistent with the current allocation of fees between industry parties and customers.

### *Expanding the Depth and Diversity of the Arbitrator Pool*

*Background.* Expanding the pool of qualified arbitrators is a perennial issue for the FINRA forum; the Ruder Report noted that the NASD faced “a serious challenge in recruiting qualified arbitrators.”<sup>38</sup> The revision of the definition of public arbitrator, combined with the recent Optional All Public Panel procedure, has made the need for additional public arbitrators more acute. In addition, the task force heard criticisms about the lack of diversity in the FINRA arbitrator pool<sup>39</sup> and agrees that diversity must be increased. The task force discussed at length the need to expand the arbitrator pool and the importance of active efforts to reach out to appropriate target audiences for applicants. It also heard concerns that the current application process may discourage qualified applicants from applying.

The task force met with FINRA staff to discuss current outreach efforts. As described to the task force, FINRA’s Department of Neutral Management (DNM) is strongly focused on recruiting individuals from diverse backgrounds from across different industries to serve as arbitrators. Its goal for 2015 is to recruit at least 650 qualified arbitrator candidates, with a focus on attracting more women and minority candidates; its goal for 2016 is 750 applicants. From January 2015 to October 2015, DNM received 491 applications.

Ongoing recruitment initiatives have included more than 100 women and minority organizations nationwide to recruit individuals through onsite events, targeted recruiting advertisement (print and digital), and direct marketing campaigns. DNM has partnered with FINRA Human Resources and Investor Education on business conferences and minority events as well as collaborating with FINRA’s Corporate Communications department to develop recruitment marketing materials and enhance visibility on FINRA’s website.

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<sup>37</sup> AAA Commercial Arbitration and Mediation Rules provide that neutral arbitrators “shall be compensated at a rate consistent with the arbitrator’s stated rate of compensation.” R-55(a), available at <https://www.adr.org>.

<sup>38</sup> Ruder Report at 102.

<sup>39</sup> *See, e.g.*, Comments of ABA Section of Dispute Resolution for FINRA Dispute Resolution Task Force at 1 (May 1, 2015).



In addition, in 2015, DNM participated in recruitment events with nine diversity-based organizations. In 2016, DNM plans to participate in recruitment events with at least 15 diversity-based organizations.

In 2014, DNM hired a consultant to conduct a demographic survey of its roster. In fall 2015, DNM worked with the consultant to conduct another demographic survey in order to measure the progress of diversity recruitment efforts. DNM is also working with outside consultants to develop a long-term strategy to recruit qualified arbitrators, including minority and female arbitrators, and continues to explore ways to expand its reach more broadly through the use of social media.

The task force also discussed with FINRA staff the application process. DNM acknowledged that, in the past, it often took too long to process applications and stated that it is working hard to reduce the time it takes to approve applications. Its current expectation is that the application process will be completed in 120 days. As evidence of this expedited process, from April 2015 to October 2015, the average time for application completion was 65 days. In addition, the DNM is reviewing other ways to streamline the application process. The expectation is that once an application is processed the individual will complete the required arbitrator training within 120 days. From April 2015 to October 2015, the average time to complete the training was 70 days.

*Task Force Deliberations.* While the task force agreed that a deep and diverse pool of arbitrators is important to the operation of the forum, members expressed different views about the most important characteristics in an arbitrator. This difference of opinion was also reflected in commentary received by the task force. The Public Investors Arbitration Bar Association (PIABA), for example, questions the requirement of two years of college credits or five years of business or professional experience,<sup>40</sup> while the American Bar Association's (ABA) Section on Dispute Resolution urges steps to increase the number of arbitrators with substantial process and subject matter expertise.<sup>41</sup> Simply put, the question is whether the arbitrator should more closely resemble a juror or a judge. Since the task force was not able to reach consensus on this question, it decided that the best solution was for FINRA to develop an arbitrator pool with sufficient variety to reflect the parties' preferences.

The task force commends FINRA's recent recruitment efforts. It recommends that FINRA continue efforts to develop effective strategies to recruit aggressively applicants for the arbitrator pool, with a view to increasing both the depth and the diversity of the pool, and to monitor the results. It should also continue to review and monitor the arbitrator qualification process to ensure that its goals of processing an application within 120 days and training arbitrators within 120 days of approval are achieved. In addition, FINRA's website, as well as its recruitment materials, should be reviewed to ensure that they convey a message of inclusiveness

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<sup>40</sup> PIABA, Study: Industry-Run FINRA Arbitrator Pool Lacks Diversity and Fails to Detect, Communicate Potential Biases, (Oct. 7, 2014), available at <http://piaba.org/piaba-newsroom/study-industry-run-finra-arbitrator-pool-lacks-diversity-and-fails-detect-communicate>.

<sup>41</sup> Comments of ABA Section of Dispute Resolution for FINRA Dispute Resolution Task Force at 3 (May 1, 2015).

and do not discourage from applying qualified and diverse individuals with a variety of educational backgrounds and work experiences.

### *Arbitrator Selection*

#### *(a) The Neutral List Selection System (NLSS) and the All Public Panel*

*Background.* At the time of the Ruder Report, the NASD arbitration staff selected the panel members and attempted to appoint arbitrators who were suited for a particular case. This selection process raised concerns about bias, and parties had limited input on the choice of arbitrators. In 1998, NASD responded to these concerns and adopted new procedures for the selection of arbitrators.<sup>42</sup> The NLSS allowed the parties to rank arbitrators from lists generated through an automated process.<sup>43</sup> In cases heard by a three-person arbitration panel,<sup>44</sup> parties received two lists of arbitrators, one for public arbitrators, one for non-public (industry) arbitrators, along with background information on each arbitrator and a list of arbitration awards signed by the arbitrator. Parties could strike any and all names from the lists and rank the remaining ones. NASD then appointed the two highest ranking public arbitrators and the highest ranking non-public arbitrator. If the panel could not be filled from the consolidated lists, NASD filled the panel with arbitrators from a computer-generated selection, whom the parties could challenge for cause. As originally adopted, unless the parties agreed on a choice, the public arbitrator who received the highest ranking was appointed chairperson. In 2007, as part of the extensive Code revision, the selection process was changed to provide for a separate list of chairperson-qualified arbitrators.<sup>45</sup>

Despite adoption of the NLSS, FINRA acknowledged “the perception that FINRA’s mandatory inclusion of a non-public arbitrator (often referred to as the ‘industry’ arbitrator) in the Majority Public Panel is not fair to customers.”<sup>46</sup> Industry representatives denied there was any evidence of a pro-industry bias and argued that the presence of an industry arbitrator

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<sup>42</sup> Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3 and 4 to Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exch. Act No. 34-40555, 63 Fed.Reg. 56670 (Oct. 22, 1998).

<sup>43</sup> Effective 2005, the method of generating the arbitrator lists was changed from rotational to random. Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 Thereto by National Association of Securities Dealers, Inc. Relating to the Random Selection of Arbitrators by the Neutral List Selection System, Exch. Act No. 34-51339, 70 Fed. Reg. 12763 (Mar. 15, 2005).

<sup>44</sup> Under the current rule, a three-person panel hears claims of more than \$100,000, as well as claims that do not specify an amount and do not request money damages. Claims that are \$50,000 or less are heard by one arbitrator. Claims that are more than \$50,000 but not more than \$100,000 are heard by one arbitrator, unless the parties agree to three. FINRA Rule 12401. In arbitrations heard by one person, the arbitrator is a public arbitrator, unless the parties otherwise agree. FINRA Rule 12402.

<sup>45</sup> Notice to Members 07-07, SEC Approves Revision of Customer and Industry Portions of NASD Code of Arbitration Procedure; Effective Date: April 16, 2007, available at [http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=3059](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3059).

<sup>46</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes, Rel. 34-63799, 100 S.E.C. Docket 1148 (Jan. 31, 2011).

provided expertise that benefits both parties.<sup>47</sup> In 2008, FINRA commenced a 27-month pilot program with 14 firms that offered investors the option of an all public panel. In that pilot program, investors presented with this option chose the new method of arbitrator selection nearly 60 percent of the time. In 2011, the SEC approved a rule change to FINRA Rule 12403 that allowed customers to choose between two panel selection options: the Majority Public Panel, which retained the existing panel composition method, or the Optional All Public Panel, which allowed any party to select an all public panel.<sup>48</sup> Customers were required affirmatively to elect the Optional All Public Panel procedure early in the process; otherwise, FINRA would apply the procedures for the Majority Public Panel option. Under the Majority Public Panel option, the parties would select their panel by striking names from three lists (public arbitrator, chairperson, and non-public arbitrator), each containing ten arbitrators, and then ranking the remaining arbitrators. Each party was permitted to strike up to four names from each list, and FINRA would appoint the panel from among the remaining names. The process for striking non-public arbitrators, however, was different under the Optional All Public Panel approach. Instead of limiting strikes to four non-public arbitrators, any party could strike all ten names and thus guarantee that no non-public arbitrator would be appointed to the panel. Instead, FINRA would appoint the next highest ranked public arbitrator to complete the panel.

In 2013, FINRA adopted a rule change to FINRA Rule 12403 that no longer required customers to elect a panel selection method. Instead, parties in all customer cases with three arbitrators receive three lists of arbitrators (chairperson, public and non-public). Parties may strike four arbitrators on the chairperson list and four arbitrators on the public arbitrator list.<sup>49</sup> Any party may select an all public panel simply by striking all non-public arbitrators from that list. Between September 30, 2013 (the effective date for the rule change) and January 16, 2015, there were 1,705 customer cases filed where customers submitted their ranking forms. Of these, claimants struck all non-public arbitrators in 69% of the cases and ranked one or more non-public arbitrators in 31% of the cases. As of January 16, 2015, 515 of these cases have been paneled, resulting in 300 (58%) cases where a non-public arbitrator was appointed.<sup>50</sup>

The following table shows a comparison of awards from all public panels and majority-public panels from 2011 through October 2015<sup>51</sup>:

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<sup>47</sup> Sec. Indus. & Fin. Mkts. Ass'n, White Paper on Arbitration in the Securities Industry 35 (Oct. 2007), available at <http://www.sifma.org/issues/item.aspx?id=21334>.

<sup>48</sup> Notice to Members 11-05, Customer Option to Choose an All Public Arbitration Panel in All Cases; Effective Date: February 1, 2011, available at [http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=9973](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=9973).

<sup>49</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change Relating to Amendments to the Code of Arbitration Procedure for Customer Disputes Concerning Panel Composition, Exch. Act Rel. 34-70442, 78 Fed. Reg. 58580 (Sept. 24, 2013).

<sup>50</sup> Data supplied by FINRA Dispute Resolution.

<sup>51</sup> The information is posted on FINRA's website and is regularly updated.

Year Decided	Cases Decided All Public Panel	Number and Percentage of Cases Where Claimant Awarded Damages	Cases Decided Majority Public Panel	Percentage and Number of Cases Where Claimant Awarded Damages
2011 <sup>52</sup>	13	54% (7)	17	18% (3)
2012	99	49% (49)	111	33% (37)
2013	128	43% (55)	107	44% (47)
2014	135	44% (59)	104	38% (39)
2015	138	51% (70)	67	48% (32)

*Task Force Deliberations.* Some members of the task force expressed concern that the all public panel option disserves forum users because the industry arbitrator may provide expertise to panel deliberations. Others noted that parties may still opt for a non-public arbitrator (if no party strikes all non-public arbitrators) and that expertise may be provided by expert witnesses if the parties deem it necessary. The task force determined that it would not reconsider the existing right of parties to select an all public panel. This issue has been extensively debated, and the task force received no new information that would warrant reopening the discussion.

The task force does propose one modification to the current selection process in light of the all public panel option. Under the current system, in those instances where all names on the non-public arbitrator list are struck, the parties must fill three seats from two ten-person lists of public arbitrators, thus increasing the likelihood of a party getting a low-ranked arbitrator. The task force recommends that in those instances where all non-public arbitrators are struck, a new list of ten public arbitrators should be generated for that seat. In that way, selection of the all public panel will be made from lists containing 30 potential arbitrators.

The task force also considered circumstances where challenging arbitrators for cause is appropriate. FINRA Rule 12407 governs the removal of an arbitrator by the Director for conflict of interest or bias; FINRA Rule 12408 gives the Director discretionary authority to facilitate the appointment of arbitrators and the resolution of arbitrations. FINRA does not currently allow challenges for cause on the ground that an arbitrator has been appointed to serve on multiple related cases, i.e. involving the same broker-dealer or the same product. The task force recommends that FINRA should allow challenges for cause in these circumstances so long as the challenge is made promptly upon the party learning about the multiple appointments. In addition, the task force recommends that the arbitrators' training materials address the possible conflicts that can arise from serving on multiple related cases and emphasize the importance of prompt disclosure and that the initial appointment letter reiterate these concerns.

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<sup>52</sup> The rule became effective on February 1, 2011, for all cases in which the parties had not yet received a list of arbitrators. The numbers for 2011 include only cases that were eligible for the option and closed before the end of that year.

(b) *Arbitrator Disclosure; Voir Dire*

The task force discussed whether the current disclosure requirements for arbitrators elicit all the relevant information appropriate to take into account in selecting arbitrators without becoming too burdensome and acting as a disincentive on arbitrators' willingness to serve. There was complete concurrence that full disclosure is necessary to provide a fair, equitable, and unbiased forum for the parties and to assure public confidence in the system. The task force does recommend some changes to the current disclosure system, as follows.

*Arbitrator Disclosure Report and Checklist.* Currently, after arbitrators are selected for a case, they are expected to review their arbitrator disclosure report on file with FINRA (which is provided to the parties at the time of ranking potential arbitrators) for accuracy and to update it if necessary. In addition, they must complete an arbitrator disclosure checklist that requires disclosure of additional information. Some of the additional disclosures relate specifically to the arbitration to which they have been appointed (*e.g.*, relationships and connections with parties, counsel for parties, and the other arbitrators; experiences with the subject matter of the case), while other items ask for information of a more general nature (*e.g.*, arbitrator classification disclosures). FINRA then circulates arbitrators' additional disclosures to the parties or their counsel, who then may follow up with questions to the arbitrators at the initial prehearing conference (IPHC).

The task force was in agreement that the IPHC is not the ideal time to examine an arbitrator's suitability for a particular arbitration. The arbitrators have already been appointed and may be caught off guard if questioned about their impartiality at this stage. Counsel feel they should not have to seek removal for cause of an arbitrator who should have been excluded from the pool of 30 arbitrators generated for this case because of relationships or connections that could have been ascertained earlier.

The task force recommends the following about, first, the arbitrator disclosure report and, second, the arbitrator disclosure checklist:

First, with respect to the arbitrator disclosure report:

1. Arbitrators should be required to update their arbitrator disclosure report promptly to report material new information or a material change in their status. In addition, all arbitrators should be required to review, at least annually, their arbitrator disclosure report and either confirm its accuracy or update it to take account of new information. These requirements will help to prevent the circulation of an outdated report if a potential arbitrator has not been recently appointed to a case. FINRA recently instituted the practice of sending quarterly reminders to arbitrators to update their reports, which is a good first step.

2. The arbitrator disclosure report should add to the existing list of current cases assigned to the arbitrator the name of counsel and city of counsel's office to allow the parties to contact them if they wish.

Second, with respect to the arbitrator disclosure checklist (sent to arbitrators after they are appointed to a case):

1. The Subject Matter (case-specific) Disclosures should be deleted from the arbitrator disclosure checklist. Instead, upon filing of a statement of claim, answer, and other applicable pleadings, each party will be required to complete a short, case-specific, disclosure form identifying the parties, the general nature of the claim (a paragraph or two summary of facts and causes of action), a list of products and strategies at issue, and other specific case-related matters in summary format. FINRA will then send the forms to the 30 potential arbitrators who are on the computer-generated selection lists. The potential arbitrators will be required to provide the Subject Matter (case-specific) Disclosures at this time. FINRA will then send the completed forms to the parties' counsel at the same time as the list of 30 arbitrators. If the potential arbitrators fail to respond within five days, they will be removed from the selection lists for that case. FINRA staff will need to monitor this process in order to minimize delays. Arbitrators who repeatedly do not respond should be removed from the arbitrator pool. The task force expects that use of the DR Portal should allow this process to be accomplished efficiently.

Since this procedure precedes the final selection and ranking of the arbitrators for the case, it will enhance disclosure and allow for the selection of arbitrators on a more informed basis. The task force is of the view that the need for more detailed arbitrator disclosure earlier in the selection process justifies the additional time and effort associated with the new process. In addition, the arbitrators included in the pool will know that they are in fact being considered for service, even if they are not selected. (Many arbitrators commented to the task force that they were uncertain about whether they were even considered for appointment.)

2. Section IV of the arbitrator disclosure checklist asks:

1. Are you, or were you **ever**, associated with, including employed by, or registered through, under, or with (as applicable):

.....

e. an investment adviser?

The term "investment adviser" requires clarification because it is a term that is often used in a non-technical sense. The task force recommends revising the language to state "registered investment adviser."

*Voir Dire.* The task force examined whether to institute the use of written *voir dire* questions into the parties' process of selecting arbitrators. It decided, however, that a better way for parties to obtain relevant case-specific information about the arbitrators is the above-described approach. In addition, the parties' existing right to ask the panelists questions at the IPHC should be preserved. The task force recommends that the IPHC script emphasize that the parties have the right of further inquiry at that time and that the arbitrators expect questions and will not take exception to appropriate questions. The task force felt strongly that *voir dire* should not be used to request information of marginal relevance to the specific case and should not be used to solicit opinions. It is inappropriate, for example, to ask arbitrators about their views on remedies, substantive issues, and procedural issues.

### *Classification of Public and Non-Public Arbitrators*

*Background.* In general, FINRA classifies arbitrators as “non-public” or “public” based on their professional and personal affiliations. The Ruder Report thought that the distinction between public and non-public arbitrator was “somewhat arbitrary”<sup>53</sup> and that labels were less important when parties have greater control over the selection process. It also believed that greater flexibility in classifying arbitrators would aid in recruitment because NASD had a shortage of public arbitrators.<sup>54</sup> The recent rule changes, however, have been to tighten the definitions to exclude individuals with certain affiliations to the securities industry from serving as public arbitrators, in order to provide additional assurance to investors that the forum is fair and unbiased.<sup>55</sup>

The definitions of non-public and public arbitrators were most recently amended effective June 26, 2015. FINRA stated that it proposed the reclassification of arbitrator categories in response to concerns regarding the neutrality of the public arbitrator roster raised by both investor representatives and industry representatives. In its view, addressing both investor and industry perceptions of bias in the public arbitrator roster would better safeguard the integrity of its arbitration forum.<sup>56</sup>

Under the previous definition of non-public arbitrator, if a person was currently, or was within the past five years, affiliated with a financial industry entity specified in the rule, the person was classified as a non-public arbitrator. The rule permitted these individuals to be reclassified as public arbitrators five years after ending all financial industry affiliations unless (i) they retired from, or spent a substantial part of their career with, a specified financial industry entity or (ii) they were affiliated for 20 years or more with a specified financial industry entity. The individuals subject to these exceptions remained classified as non-public arbitrators. The recently amended rule eliminated the five-year cooling-off provision for persons who work in the financial industry by permanently classifying persons who are, or were, affiliated with a specified financial industry entity at any point in their careers, for any duration, as non-public arbitrators.

In addition, under the previous definition of non-public arbitrator, attorneys, accountants, and other professionals who devoted 20 percent or more of their professional work in the last two years to serving specified financial industry entities and/or employees, were classified as non-public arbitrators. These individuals were reclassified as public arbitrators two years after they

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<sup>53</sup> Ruder Report at 96.

<sup>54</sup> *Id.* at 97.

<sup>55</sup> *See, e.g.*, Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations, Exch. Act Rel. 34-49573, 71 Fed. Reg. 21871 (Apr. 22, 2004) (modifying definitions of public and non-public arbitrator, in order to provide additional assurance to investors that process is neutral and fair).

<sup>56</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change Relating to Revisions to the Definitions of Non-Public Arbitrator and Public Arbitrator, Rel. 34-74383, 80 Fed. Reg. 11695 (Mar. 4, 2015).

stopped providing services to specified financial industry entities, with one exception; a person who provided services for 20 calendar years or more over the course of his or her career was permanently disqualified from serving as a public arbitrator. The new definition (i) increases the look-back period from two years to five years, (ii) applies not only to services provided to specified financial industry entities, but also to services provided to any persons or entities associated with those specified financial industry entities, and (iii) permanently disqualifies from serving as public arbitrators persons who provided the specified services for 15 calendar years or more over the course of their careers (in contrast to the previous 20 year provision).

Finally, under the previous categories of non-public and public arbitrators, individuals who represented or provided professional services to investors in securities disputes were permitted to serve as public arbitrators. Under the new definitions, attorneys, accountants, and other professionals who devoted 20 percent or more of their professional time, within the past five years, to serving parties in investment or financial industry employment disputes are classified as non-public arbitrators. However, these individuals are permitted to serve as public arbitrators five years after they stopped devoting 20 percent or more of their professional time to serving parties in investment or financial industry employment disputes with one exception; a person who provided services for 15 calendar years or more over the course of his or her career is permanently disqualified from serving as a public arbitrator.

Many expressed concern that the new definitions would reduce the number of public arbitrators at a time when more public arbitrators are needed because of the Optional All Public Panel approach. FINRA acknowledged this possibility, but thought that addressing users' perceptions of the neutrality of its public arbitrators outweighed those concerns. In approving the rule changes, the SEC stated that it:

believes that the proposed rule change would help address forum users' perceptions of neutrality in, and maintain the integrity of, the arbitration forum. In addition, the Commission believes the potential negative effects (in particular, a temporary decline in the number of available public arbitrators) will be mitigated by FINRA's proposed recruitment and retention of public arbitrators.

The SEC also noted that its staff would monitor the consequences of the changes and that it was interested in FINRA's future cost-benefit analysis of the rule change.

After the SEC approved the new definitions, FINRA conducted a survey of its arbitrators in order to reclassify affected arbitrators. FINRA reports that, as of July 6, 2015:

- 13.8% (487 out of 3,512) of the public roster were reclassified as non-public.
- 2.6% (93 out of 3,512) of the public roster were made ineligible to serve as either public or non-public arbitrators. Of the 93 ineligible arbitrators, 49 were due to an immediate family member relationship. These arbitrators can become public arbitrators after a cooling-off period. (Note that this number reflects only the effect of the new rules on arbitrators who were available at the time of the survey. There are other arbitrators on the roster who were already ineligible based on the previous definitions; however, FINRA does not have an accurate way of counting those arbitrators.)



- 6.2% (221 out of 3,512) were removed from the roster because they did not take the survey.

FINRA currently has 2,871 public arbitrators and 3,528 non-public arbitrators for a total of 6,399 arbitrators. In contrast, on April 15, 2015, there were 3,509 public arbitrators and 2,844 non-public arbitrators, for a total of 6,353 arbitrators. This is a reduction of the public arbitrator pool by 638.

*Task Force Deliberations.* The task force discussed the changes to the definitions of public and non-public arbitrators that reduce the number of individuals who can serve as public arbitrators. The task force heard from some who expressed concern that the effect of the definitions is to remove from the pool of public arbitrators highly qualified individuals who would in all respects conduct themselves as neutrals. Others believed that the definitions should strengthen public confidence in the forum because they will avoid even the appearance of bias because of past affiliations.

The task force noted that the SEC stated that its staff would monitor the effect of the change and that FINRA stated it would perform a cost-benefit analysis of the rule's impact. The task force recommends that FINRA monitor the application of the recently adopted definitions of public and non-public arbitrators in light of concerns that individuals with substantial process and subject matter expertise are stricken from the list of public arbitrators. In particular, the task force has doubts that making otherwise qualified individuals ineligible for service because of a family member's industry affiliation is warranted.

### *Arbitrator Training*

*Background.* The Ruder Report found that "it is clear that the overall performance of NASD arbitrators is not as high as it could be"<sup>57</sup> and recommended expansion of the scope and frequency of mandatory arbitrator training.<sup>58</sup> Since 1996, FINRA has devoted significant resources to the training of panel members and chairpersons.<sup>59</sup> FINRA's website describes the training requirements for arbitrator applicants as follows:

After FINRA approves an arbitrator candidate's application, the individual must complete the comprehensive Basic Arbitrator Training Program to become eligible to serve on arbitration cases. The Basic Arbitrator Training Program covers each stage of the arbitration process and reviews the procedures that arbitrators must follow to successfully complete an arbitration case. The Program consists of three parts and must be completed within 120 days:

1. Basic Arbitrator Training (Part I)
2. Expungement Training (Part II)
3. Live Video (conducted via WebEx and teleconference) OR Onsite Classroom Training Session at one of our regional offices (Part III)<sup>60</sup>

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<sup>57</sup> Ruder Report at 108.

<sup>58</sup> *Id.* at 109.

<sup>59</sup> They are described in 2007 Report Card at 10-11.

<sup>60</sup> <http://www.finra.org/arbitration-and-mediation/required-basic-arbitrator-training>

FINRA staff reports that some arbitrator candidates whose applications are approved do not complete the training.

To qualify as a chairperson, an arbitrator must have served on at least three arbitrations through award in which hearings were held, or be a lawyer who served on at least two arbitrations through award in which hearings were held.<sup>61</sup> In addition, an arbitrator must complete the chairperson training course and pass an examination. Chairperson training focuses on managing the prehearing and hearing processes and modifying procedures for a particular arbitration.<sup>62</sup>

FINRA also has available on its website subject-specific online training modules, which are voluntary.<sup>63</sup> The written materials for arbitrator training are available at FINRA's website.<sup>64</sup>

*Task Force Deliberations.* The task force received many expressions of concern about the level of professionalism of the arbitrator pool and complaints that some arbitrators lack the necessary skills to conduct a fair and efficient dispute resolution process. These reports are necessarily anecdotal, but lack of professionalism is a persistent and longstanding concern. This issue is linked to the level of arbitrator compensation, although task force members had different views about the extent of the relationship between professionalism and compensation.

The task force heard from some commenters who urged the adoption of mandatory continuing education training.<sup>65</sup> The task force recommends, instead, that all arbitrators should be encouraged to complete continuing education programs on a periodic basis. In addition, compulsory training requirements should be considered for arbitrators with a record of poor evaluations, as well as inexperienced arbitrators and arbitrators who have not been recently selected for panels and who do not arbitrate regularly. Additional training for arbitrators in the latter two categories may make them more attractive to parties' counsel and could help to address their complaints that they are not selected for panels.

In addition, public arbitrators, who by definition have little experience with the securities industry, may benefit from enhanced training that incorporates subject-matter training as well as the procedural issues currently covered.<sup>66</sup> Listing completed training on an arbitrator's disclosure form could encourage arbitrators to take courses and could also be useful to parties in making informed decisions when selecting panels. The following are some topics that were suggested to the task force for additional training, although the task force did not discuss specific course content.

- Pre-hearing motions to dismiss

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<sup>61</sup> FINRA Rules 12400(c), 13400(c).

<sup>62</sup> <http://www.finra.org/arbitration-and-mediation/written-materials-arbitrator-training>

<sup>63</sup> Topics include Civility in Arbitration, Direct Communication Rule, Discovery, Abuses and Sanctions, Understanding the Prehearing Stage, and Your Duty to Disclose. <http://www.finra.org/arbitration-and-mediation/advanced-arbitrator-training>

<sup>64</sup> <http://www.finra.org/arbitration-and-mediation/written-materials-arbitrator-training>

<sup>65</sup> FINRA Customer Arbitration Task Force of the Financial Services Institute, Inc., *Improving Securities Arbitration for Main Street Investors & the Securities Industry* at 3.

<sup>66</sup> FINRA already provides good product related training, which could be relevant to arbitrators.

- Discovery rules and remedies for discovery violations
- Eligibility rule and statute of limitations differences
- Case law noting the situations in which certain types of documents are not discoverable
- Confidentiality protections for regulatory productions
- Privacy laws regarding client information
- Relevance, materiality, and admissibility issues
- Expert witness credentials and the substance of expert opinions
- Special products
- Legal issues related to the arbitration process

The task force also recommends increased training for chairpersons in light of concerns that some chairpersons do not have the requisite skills to run an efficient and fair arbitration process.

Because of the importance of arbitrator training, the task force recommends that NAMC engage an outside consultant to study and design the specific type of coursework to be offered.

The task force also identified additional opportunities for arbitrator training and education:

- FINRA should gather data to identify recurring or particularly bothersome issues that arise during proceedings and develop additional arbitrator training curricula to address these issues. This would be an ongoing process so that the most current issues are continually being identified and addressed. That process could include soliciting submissions from arbitrators and counsel to identify such issues.
- FINRA should provide a centralized resource, such as the Director of Arbitration or other staff, to provide assistance to arbitrators who encounter procedural questions during proceedings.

### *Arbitrator Evaluations*

*Background.* FINRA asks parties and their representatives and peer arbitrators to rate arbitrator performance at the conclusion of their case, and the evaluation forms are available online.<sup>67</sup> FINRA has been tracking the receipt of peer and party arbitrator evaluations since 2011. During that time, 3,661 cases closed after an in-person hearing. In that same time frame, FINRA received 2,000 peer evaluations and 565 party evaluations.<sup>68</sup> FINRA considers its evaluation system an important source of information about the performance of arbitrators, although it acknowledges the low level of participation.

*Task Force Deliberations.* The task force was in agreement that there should be a process for evaluating the performance of arbitrators so that corrective measures can be taken to address poorly performing arbitrators. Members of the task force, however, expressed doubt about the value of the current system of evaluations, particularly since completion of evaluations is low.

<sup>67</sup> <http://www.finra.org/arbitration-and-mediation/arbitration-evaluation-form> (party); <http://www.finra.org/sites/default/files/ArbMed/p014776.pdf> (peer).

<sup>68</sup> Information provided by FINRA Dispute Resolution.

The task force reviewed with FINRA staff its procedures for encouraging arbitrators and counsel to submit evaluations. It also reviewed how FINRA staff use the evaluations. FINRA may respond to a negative evaluation in a variety of ways, ranging from taking no action to instituting removal of the arbitrator from the roster.

The task force considered, but determined not to recommend, requiring the submission of the evaluation forms. In the task force's opinion, it is essential that the evaluation process not become complicated and burdensome, and it must remain voluntary. The task force reached no consensus on a proposal to give arbitrators a token honorarium (\$50) if they fill out the evaluations. Instead, it recommends providing more education about the usefulness of the evaluations and encouraging chairpersons to emphasize the importance of filling out the evaluations to the parties at the conclusion of the hearing and to the panel members during the subsequent deliberations.

*Encouraging arbitrators to provide input on rule changes that will affect them*

It is unrealistic to expect that arbitrators, except for those who are active in the securities industry, will stay abreast of proposed changes in the arbitration process that could affect them. Yet it is clear to the task force from the number of comments it received from arbitrators that they want to know what changes are afoot that affect their participation in the process. FINRA currently uses The Neutral Corner as a mechanism to advise arbitrators of pending and adopted changes, and it is a good source of information for arbitrators. The task force believes that it would be beneficial for FINRA to do more; the involvement and comments of arbitrators should be encouraged in a manner that is not complicated or difficult. The task force recommends that FINRA send a broadcast email to all arbitrators advising them about a proposed rule change and how they can comment on it, either formally to FINRA or the SEC or informally (as through a DR Portal). If the proposed rule change is adopted, there should be a follow-up email to the arbitrator pool to that effect, with a summary description of how it affects them. This process will allow the arbitrators to see in advance what revisions to the process may affect them, keep them in the know, and provide a real-time chance to comment.

## **EXPLAINED AWARDS**

*Background.* FINRA rules require that awards be in writing,<sup>69</sup> and final awards are publicly available at FINRA's website.<sup>70</sup> All final awards must contain certain bare-bones information, including the names of the parties, a summary of the issues, the damages and other relief requested and the damages and other relief granted.<sup>71</sup> Arbitrators have the discretion to provide a rationale in any case,<sup>72</sup> although this is not the usual practice.

FINRA Rule 12904(g), which took effect in April 2009, requires arbitrators to provide a brief, fact-based explanation of their award when requested by both parties to the dispute. In the comments filed on the proposed rule change, compelling arguments were made both for and

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<sup>69</sup> FINRA Rule 12904.

<sup>70</sup> <http://www.finra.org/arbitration-and-mediation/arbitration-awards-online>.

<sup>71</sup> FINRA Rule 12904(e).

<sup>72</sup> The award "may contain a rationale underlying the award," *id.*(f).

against expanded use of explained decisions. Among the most compelling arguments for expanding the use of explained decisions is its potential to bring greater transparency to a system that some view as opaque. Supporters also argued that the requirement to explain the decision would improve the quality of decision-making, would provide for better oversight of the system by FINRA, and would increase the consistency among awards. Among the most compelling arguments offered against explained decisions is the risk that it will lead to increased appeals of arbitration awards, driving up the cost of the system and the length of time needed to resolve disputes.<sup>73</sup>

NASD had originally proposed an approach that would have required explained decisions if requested by the investor (or the registered representative in a complaint against a firm). Much of the opposition to the original NASD proposal focused on the perceived unfairness of giving investors, but not firms, the right to demand an explained decision. Ultimately, FINRA developed a revised proposal that reflects the current approach of requiring agreement by both parties to the dispute. When the SEC approved the revised FINRA rule, it expressed doubt as to whether this approach would have a significant impact on the use of explained decisions. Those doubts have proved to be warranted. Since the rule was adopted, there have been only 37 requests for explained decisions and 27 explained decisions issued out of roughly 5,000 eligible cases, according to FINRA statistics.<sup>74</sup>

*Task Force Deliberations.* A common complaint among parties, particularly customers who are dissatisfied with the outcome of arbitration, is the absence of any explanation. More generally, the absence of explained awards makes it difficult for observers to ascertain whether the system is functioning fairly and effectively in resolving disputes. In the view of the task force, expanding the use of explained decisions is one of the most important things FINRA can do to increase transparency in the system. Furthermore, the task force believes that increased confidence in the fairness of the system would likely flow from that increased transparency. Nevertheless, it recognizes that there are barriers to expanding the use of explained decisions that would have to be addressed before a workable plan could be developed to achieve this goal. These relate to practical considerations of how best to expand the use of explained decisions and how to ensure that arbitrators are adequately trained to write explained decisions.

In arriving at its recommendation, the task force considered the arguments presented for and against explained decisions in comments submitted to FINRA and in law review and other articles that address the topic. The task force evaluated evidence with regard to appeals in other arbitration forums where explained decisions are more common. The evidence did not support the concern that expanding the use of explained decisions would increase significantly the number of appeals, but the evidence was limited and the experience was not fully relevant in light of the different qualifications of arbitrators. Several task force members also read the explained decisions that have been written under FINRA Rule 12904. The task force considered how (if at all) the system would benefit from expanded use of explained decisions, whether the

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<sup>73</sup> On the other hand, some commenters viewed the potential to correct bad decisions through legal challenge as a benefit of the proposal.

<sup>74</sup> The discrepancy between explained decisions requested and finalized can be attributed in part to cases that were settled before a decision was issued and in part to cases that were not yet finalized when FINRA pulled these statistics.

nature of the written decision itself should be changed in any way, and what operational issues would need to be addressed for the system to work effectively.

*Rationale for Changing the Current Approach.* The task force recommends that the approach to explained decisions be changed in order to expand their use and enhance transparency of the securities arbitration process.

*Options for Expanding the Use of Explained Decisions.* The task force decided a number of approaches that FINRA could take to increase the use of explained decisions, each with its pluses and minuses, including:

- FINRA could require explained decisions in all cases, with or without the option for a waiver where both parties agree that they do not want an explained decision. On the plus side, this approach would provide the greatest increase in transparency, and it would not be seen as favoring one party to the dispute over the other. It would also put the greatest strain on the system by demanding that all panel chairpersons be equipped and trained to provide explained decisions.
- FINRA could require explained decisions whenever either party to the dispute requests it. This approach would allow the preferences of the system's participants to dictate the matter. It would likely lead to at least a modest increase in transparency, though it is unclear how much. Information was not available regarding the number of cases under the current rule where one party would have liked an explained decision but the other side refused to join the request. The main objection raised with regard to this approach was that it could empower deep-pocket defendants to pressure claimants to settle quickly in order to avoid the risk of a lengthy appeal. The task force was unable to assess the validity of this concern.
- FINRA could revive its original proposal to require explained decisions whenever requested by the investor. This would ensure that investors, who do not control the choice of forum, would at least control this aspect of the process. However, this approach would be likely to prompt the same complaints with regard to fairness that proved fatal to the original proposal.

After full discussion of these options, the task force recommends changing the rule to require an explained decision unless any party notifies the panel before the IPHC that it does not want it. Creating a presumption of an explained decision is a modest change that may or may not result in any appreciable increase in explained decisions. If it is adopted and it subsequently becomes clear that one party frequently blocks an explained decision, a different approach may be warranted. Whatever approach it chooses, once FINRA has determined the best approach, it should move forward with a plan to prepare arbitrators to deal with the expanded use of explained decisions.

*The Nature of the Written Decision.* Currently parties are required to submit the request for an explained decision at least 20 days before the first scheduled hearing date. The panel chairperson writes the decision, for which he or she receives an additional \$400 honorarium. FINRA Rule 12904 calls for a brief, fact-based explanation of the general reasons for the arbitrators' decision. The explanation need not include either legal authorities or damage calculations. A review of the explained decisions written under the current rule suggests that the

vast majority are consistent with this approach and that the quality of the explanation was generally good.

The task force recommends maintaining the basic brief, fact-based format contemplated by Rule 12904(g). The task force does not intend that explained decisions should carry any precedential value in subsequent arbitration cases. It also thought that some explanation of reasons for the amount of damages would be useful, but without requiring complex calculations. In addition, if the rule is revised to make explained decisions more common, but retaining an element of choice, changes will need to be made with regard to the timing of the request. Specifically, the request should come earlier in the process so that the panel chairperson could complete the required training (see below.)

*Operational Issues that Would Need to be Addressed.* A significant increase in requests for explained decisions could strain an arbitration system that uses individuals who serve as arbitrators on an occasional basis and who lack formal training or experience in writing decisions. The risk that decisions will be overturned on appeal likely increases if arbitrators are not well equipped to write such decisions. Thus, if FINRA chooses to move forward with changes designed to increase the use of explained decisions, it is essential that FINRA develops a program to train panel chairpersons in how to write appropriate decisions.

In summary, the task force recommends:

1. The FINRA rule should be amended to require explained decisions unless any party notifies FINRA, prior to the IPHC, that it does not want an explained decision.
2. The current brief, fact-based format of the explanation should be retained, but with the addition of some summary explanation of the reasons behind any damage calculation.
3. Before any plan to expand the use of explained decisions is implemented, FINRA must develop and administer a training program on how to write explained decisions. Chairpersons must complete the training promptly after they are notified that an explained decision is expected in an assigned case.

## **EXPUNGEMENT**

*Background.* The Central Registration Depository (CRD<sup>®</sup>) is the securities industry's online registration and licensing database.<sup>75</sup> FINRA operates the CRD system pursuant to policies developed jointly with NASAA. Information in the CRD is obtained through forms that brokerage firms, associated persons and regulators complete as part of the securities industry registration and licensing process. The CRD includes information about criminal matters, regulatory disciplinary actions, civil judicial actions, and information relating to customer disputes, such as customer complaints, arbitration claims, and arbitration awards. Through BrokerCheck<sup>®</sup> investors can research the professional backgrounds of brokerage firms and

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<sup>75</sup> <http://www.finra.org/industry/compliance/registration/crd/>.

associated persons.<sup>76</sup> FINRA recently began an advertising campaign to educate investors about the availability of BrokerCheck.<sup>77</sup>

The existence of a customer's complaint—regardless of its merits—is an accurate reflection of the historical record. Yet there has long been a tension between the importance of accurate historical information and the harm that can result to an associated person if a customer's complaint is unfounded. Since the inception of the CRD system in 1981, NASD generally honored court-ordered expungements, and until January 1999, it honored arbitrator-ordered expungements contained in final awards. NASAA and states, however, took the position that information in the CRD system was a government record of any state that used the information in making licensing decisions and that state laws did not permit expungement without an explicit court order. In January 1999, NASD announced a moratorium on arbitrator-ordered expungements unless the award was confirmed by a court of competent jurisdiction. It also undertook to establish clear standards for expungement.

In 2002 NASD filed a proposed rule change with the SEC to establish procedures for expunging customer dispute information from the CRD system.<sup>78</sup> NASD acknowledged: the need to balance three competing interests: (1) the interests of NASD, the states, and other regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations; (2) the interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate; and (3) the interests of investors in having access to accurate and meaningful information about brokers with whom they conduct, or may conduct, business.<sup>79</sup>

While there was general agreement about the need for a rule establishing procedures and criteria for expungement, there was considerable debate over both the procedures and the criteria. NASAA took the position that only “factually impossible” claims should be expunged, while representatives of the brokerage community urged that it was unfair to require associated persons to institute a cumbersome procedure to remove from their record unfounded allegations by disgruntled customers. The final product was necessarily a product of compromise.

FINRA Rule 2080 requires all directives to expunge customer dispute information from the CRD system to be confirmed by or ordered by a court of competent jurisdiction and requires the brokerage firm or associated person to name FINRA as a party in any judicial proceeding seeking confirmation of an arbitration award containing expungement relief. FINRA may, however, waive the requirement to name it as a party if it determines that the requested expungement relief is based on affirmative judicial or arbitral findings that (1) the claim, allegation or information is factually impossible or clearly erroneous, (2) the associated person was not involved in the alleged investment-related sales practice violation, forgery, theft,

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<sup>76</sup> <http://www.BBB0ndr08rtooktoestab>



misappropriation or conversion of funds, or (3) the claim, allegation, or information is false.<sup>80</sup> In addition, FINRA has sole discretion “under extraordinary circumstances” to waive the requirement if the expungement request is meritorious and expungement would not have a material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.<sup>81</sup> In approving the rule, the SEC stated that it was “clearly an improvement over the current expungement system in which there are no parameters placed on expungements being incorporated into arbitration awards.”<sup>82</sup>

By 2008, FINRA became aware that some arbitrators were approving expungement requests that were part of negotiated settlements without inquiring into the terms of the settlement.<sup>83</sup> Accordingly, FINRA proposed, and the SEC approved, procedures that arbitrators must follow in granting expungement requests. Under FINRA Rules 12805 and 13805 the panel must (i) hold a recorded hearing session by telephone or in person regarding the appropriateness of expungement, even if a claimant did not request a hearing on the merits; (ii) for cases involving settlements, review the settlement documents to examine the amount paid to any party and any other terms and conditions of the settlement that might raise concerns about the associated person’s involvement in the alleged misconduct before awarding expungement; (iii) indicate in the arbitration award which of the Rule 2080 grounds for expungement serves as the basis for the expungement order and provide a brief written explanation of the reason(s) for its finding that one or more grounds for expungement exists; and (iv) assess forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement.

In the public comment period, some commenters questioned whether it was appropriate to give the responsibility of expungement to arbitrators rather than regulators, given the importance of the CRD system in providing information to investors. FINRA asserted that these comments were beyond the scope of the rulemaking process. In approving the final rule, the SEC stated its expectation that expungement would be an “extraordinary remedy.”<sup>84</sup> Moreover, “[b]ecause of the central role that arbitrators have in the expungement process, the Commission believes that it is critical for arbitrators to be well-informed regarding FINRA’s rules governing expungement.”<sup>85</sup> The SEC also urged FINRA that “[g]iven the importance of CRD for regulators and to customers . . . to monitor how this rule is applied by arbitrators to assure that it is achieving its goals, and to propose additional changes, if needed.”<sup>86</sup>

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<sup>80</sup> *Id.*(b)(1).

<sup>81</sup> *Id.*(b)(2).

<sup>82</sup> Self-Regulatory Organizations; National Association of Securities Dealers, Inc; Order Granting Approval of Proposed Rule Change and Amendment No. 1, Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2, Thereto, Relating to Proposed NASD Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System, Exch. Act Rel. 34-48933, 68 Fed. Reg. 74667, 74672 (Dec. 24, 2003).

<sup>83</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change Amending the Codes of Arbitration Procedure To Establish Procedures for Arbitrators To Follow When Considering Requests for Expungement Relief, Exch. Act Rel. 34-48933, 73 Fed. Reg. 66086, 66087 (Nov. 6, 2008).

<sup>84</sup> 73 Fed. Reg. at 66089.

<sup>85</sup> 73 Fed. Reg. at 66090. FINRA requires all arbitrators to take an online expungement training course. <http://www.finra.org/ArbitrationAndMediation/Arbitrators/Training/RequiredBasicArbitratorTraining/P124905>.

<sup>86</sup> 73 Fed. Reg. at 66090.

A closely related issue is the practice of conditioning settlements on the customer's agreement not to oppose a request for expungement relief. FINRA frequently expressed its concern about this practice and took steps to discourage it. In 2004, FINRA cautioned firms and associated persons that negotiating settlements with customers in return for exculpatory affidavits that the firm or associated person knows or should know are false or misleading is a violation of FINRA Rules.<sup>87</sup> In 2013, FINRA sent to arbitrators and published on its website guidance stating that, in determining whether to recommend expungement relief in settled claims, arbitrators should inquire whether a party conditioned settlement on an agreement not to oppose a request for expungement relief.<sup>88</sup> Finally, in April 2014, FINRA filed with the SEC a new rule that would expressly prohibit firms and associated persons from seeking to condition a settlement of a customer's dispute on the customer's agreement to consent to, or not to oppose, the firm's or associated person's request to expunge information about the customer's dispute from the CRD.<sup>89</sup> FINRA Rule 2081 went into effect July 30, 2014.

Despite these rule changes, reports from PIABA and state regulators suggest that flaws still exist in the process. Concerns have been expressed that customers' complaints are frequently expunged on the sole basis of a merits decision in favor of the broker-dealer or associated person, without due consideration of the limited grounds set forth in Rule 2080.<sup>90</sup> In approving the most recent rule changes, the SEC encouraged FINRA to conduct a comprehensive review of its expungement rules and procedures to determine whether additional rulemaking is necessary and appropriate to assure that expungement in fact is treated as an extraordinary remedy that is permitted only where the information to be expunged has no meaningful investor protection or regulatory value.<sup>91</sup>

At its September 2015 meeting, FINRA's Board of Governors authorized the filing with the SEC of proposed amendments to FINRA Rules 12805 and 13805 that would codify the best practices from the Expanded Expungement Guidance document issued as a notice to parties and arbitrators in 2013. The expanded guidance emphasizes that arbitrators "have a unique, distinct role in ensuring that customer dispute information is expunged from the CRD system only when it has no meaningful investor protection or regulatory value."<sup>92</sup> Because of their significant role,

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<sup>87</sup> Notice to Members 04-43, Members' Use of Affidavits in Connection with Stipulated Awards and Settlements to Obtain Expungement of Customer Dispute Information under Rule 2130, available at <http://www.finra.org/industry/notices/04-43>.

<sup>88</sup> The December 2013 issue of The Neutral Corner was devoted to expungement and addresses this issue, among others. <http://www.finra.org/arbitration-and-mediation/neutral-corner-volume-4-2013>.

<sup>89</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Adopt FINRA Rule 2081 (Prohibited Conditions Relating to Expungement of Customer Dispute Information), Exch. Act Rel. 34-70442, 79 Fed. Reg. 22734 (Apr. 23, 2014).

<sup>90</sup> Although FINRA Rule 2080 provides specific grounds by which FINRA may waive its participation as a required party in a court expungement confirmation hearing and does not speak to those grounds as the only basis for an expungement, FINRA Rules 12805(c) and 13805(c) require that one of the Rule 2080 grounds be articulated by the arbitration panel "in order to grant expungement of customer dispute information under Rule 2080" (Rule 12805), in effect converting the Rule 2080 grounds into the only grounds for which expungement may be granted.

<sup>91</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change to Adopt FINRA Rule 2081, Prohibited Conditions Relating to Expungement of Customer Dispute Information, Rel. 34-72649, 79 Fed. Reg. 43809 (July 28, 2014).

<sup>92</sup> <http://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance>.

arbitrators should make sure that they have all the necessary information to make an informed decision. The expanded guidance also emphasizes the importance of allowing customers and their counsel an opportunity to participate in the expungement hearing.

*FINRA/NASAA Discussions.* The task force has been advised that FINRA and NASAA are in the process of discussions with regard to the expungement process. Preliminary indications are that FINRA and NASAA are considering converting the process into a regulatory procedure. The task force encourages FINRA and NASAA to move forward expeditiously with their deliberations because of the importance of resolving this issue. The task force was also informed that FINRA and NASAA would not complete their discussions on the feasibility of a new regulatory approach and process before the completion of the task force's work. The task force takes no position on whether a regulatory approach should eventually replace the current expungement process. Because of uncertainty about the ultimate outcome of the NASAA/FINRA discussions, the task force gave serious consideration to the creation of a special arbitration panel consisting of specially trained arbitrators to decide requests for expungement. It makes the recommendations described below.

*Creation of a Special Arbitration Panel.* This group of arbitrators would conduct hearings on expungement requests and make determinations as to whether to grant expungement requests. All members of special arbitration panels should be experienced individuals from the chairperson roster who have received enhanced training on expungement (described below).

The task force noted that the majority of issues that arise in the expungement process are those involving settled cases that do not go to final resolution. In such cases, the panel selected by the parties has not heard the full merits of the case and therefore may not bring to bear any special insights in determining whether to grant an expungement request. In addition, claimants or their counsel have little incentive to participate in an expungement hearing once their case has been settled. Creation of a special arbitration panel would make up for these deficiencies. This corps of specially trained arbitrators would follow the procedure set forth in FINRA Rule 12805/13805 and the expanded guidance and make a decision about whether FINRA Rule 2080 grounds exist to grant the expungement request, keeping in mind the importance of maintaining the integrity of information in the CRD system.

Similarly, a special arbitration panel should handle expungement requests when claimants did not name the associated person as a respondent in the underlying arbitration claim. In these cases, the arbitration panel should ensure that the customer has notice of the associated person's expungement request and an opportunity to participate in the proceeding.

With regard to arbitration cases that go to hearing and full resolution on the merits, a stronger argument can be made that the panel who heard the case on the merits is the proper panel to make an expungement determination. The task force recommends allowing the panel that heard the merits to conduct the expungement hearing so long as the chairperson has completed the enhanced expungement training (described below).

The task force discussed whether there should be a FINRA representative participating in expungement hearings (or at least in those involving settled cases) in order to represent the public interest, but reached no consensus.

In all cases discussed above, the task force agrees that enhanced arbitrator training with regard to the expungement process is of great importance. While it is acknowledged that training on the expungement process is a requirement for all arbitrators, FINRA should review with a consultant ways to improve this training. In addition, to qualify for the special arbitration panel, arbitrators should receive additional training that will include input from state regulators and highlight the extraordinary nature of the expungement remedy. The training should impress upon arbitrators that they are involved in a regulatory process intended to protect investors and that the grounds for expungement must be one articulated in FINRA Rule 2080. In this regard, the task force heard concerns that arbitration panels and courts are interpreting the second ground in Rule 2080 (“the associated person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds”) too broadly and recommends that FINRA develop clearer guidance to emphasize the narrowness of the grounds.

While the arbitration panel conducts its hearing, the states, through a NASAA coordinated process, review the expungement request to make their own assessment whether the request meets the grounds for expungement. Accordingly, the task force recommends that the NAMC review procedures for notifying state regulators.

## SMALL CLAIMS

*Background.* FINRA Rule 12800 provides a simplified arbitration procedure for small claims, currently defined as arbitrations involving \$50,000 or less, excluding interest and expenses. The purpose of the simplified arbitration procedure is to make the process less expensive and faster. The principal differences between simplified and standard arbitration is that one arbitrator from the chairperson roster decides the case and there is no hearing unless requested by the customer. In the absence of a hearing the arbitrator decides the dispute based on the pleadings and other documents submitted by the parties. In recent years, approximately 5 percent of cases were closed after review of the papers, compared with approximately 18 percent closed after a hearing.<sup>93</sup>

### *Task Force Deliberations*

*Dissatisfaction with Paper Submissions.* The task force formed a consensus around the following:

- Claimants whose cases are adjudicated as part of FINRA’s small case program are the least satisfied of any group of users of the FINRA forum. There are a variety of possible explanations for this finding.
  - Small case “win” rates for papers cases (approximately 37%) and small case hearings (approximately 34%) are lower than the win rates for claimants in cases decided by all public panels.

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<sup>93</sup> How Arbitration Cases Close, <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>.

- Many small claim claimants are pro se, who may have an unrealistic view of the likely outcome of arbitration. They might not have consulted with an experienced claimants’ lawyer; if they did consult with one, they might not have accepted the lawyer’s assessment that their case lacked merit or might result in only a modest recovery.
- Prevailing small claim claimants may see a significant part of their recovery consumed by fees and other costs.
- 43% of small claim claimants do not opt for a hearing, a decision that reduces the time and expense associated with pursuing a claim. Such claimants, however, give up the ability to look the arbitrator in the eye and argue their case and lose the ability to have an arbitrator assess the relative credibility of the parties based on demeanor.
- A small claims award (like other awards) need not explain the rationale for the award or the amount granted, if any. While an explanation for why the claimant lost (or got less money than requested) is unlikely to make the claimant happy, the lack of an explanation in addition to the lack of personal contact with the arbitrator may lead to dissatisfaction.
- From the arbitrators’ perspective, deciding cases on the papers is a problematic method of resolving disputes where issues of credibility are often determinative.
- If the opportunity to be heard (literally) is an important element in a participant’s satisfaction with the forum, the solution might be reducing the FINRA fees associated with small claims hearings.<sup>94</sup> But hearing session fees are but part of the cost of choosing a live hearing instead of a decision on the papers. A hearing may require transportation to a hearing location, food, lodging, and missed time at work. These costs may consume a significant portion of a modest recovery. A pro se claimant may fear harsh and lengthy examination by the respondent, may not know how to examine adverse witnesses, and may be uncomfortable with the formality of a traditional hearing.

*An Intermediate Approach.* In light of the above, the task force recommends that the NAMC consider adopting an intermediate form of adjudication—more than the papers, but less than a full hearing—in which the claimant and respondent appear before an arbitrator and have the opportunity to explain their positions and respond to their adversary’s positions. The goal of this intermediate process is to give the claimant personal contact with the arbitrator deciding the case and to give each party the opportunity to argue its case, to ask questions, and to respond to contentions from the other side. It also allows the arbitrator to probe contentions in the papers in an interactive format. There would be a time limit on each case, allowing an arbitrator to hear several cases in a hearing day and to limit the time commitment of the parties. Arbitrators should be specially qualified and trained for this role. Parties should be able to appear in whatever manner they prefer: in person, by phone or by video conference.

Exactly what would go on at these sessions is a matter for further discussion. At the least, those who appear should be able to amplify positions taken in their papers and to answer questions posed by the arbitrator. In addition, fact witnesses should be permitted to tell their

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<sup>94</sup> FINRA waives hearing fees upon a demonstration of inability to pay.

stories to the arbitrator. Should those witnesses be subject to cross-examination by adverse counsel? Should parties be able to admit documents not already in their paper submissions? Should parties be able to compel the attendance of particular witnesses, and if so, should there be a limit? What arrangements should be made for parties who are not appearing in person? Should the arbitrator use the session as an opportunity to press the parties to settle? These are questions that need to be decided if the task force recommendation is accepted.

The task force understands that additional time and effort in adjudicating small claims will increase the cost to respondents as well. If, for instance, a claimant can demand the personal attendance of employees of the respondent and its counsel at a session, it might give settlement value to even the weakest of claims. For this reason, respondent firms may object to additional procedural options for the claimant; they might prefer that the claimant pick either a full hearing or nothing. In developing an intermediate approach, the NAMC may want to draw a clear boundary between the informal, expedited adjudication and a full-blown hearing.

In sum, while work needs to be done on the details, the task force recommends an intermediate form of arbitration for small claims that will give claimants the opportunity to appear before an arbitrator and plead their case in an abridged format best developed by the NAMC.

## LARGE CLAIMS

*Background.* FINRA's Code of Arbitration applies generally to all claims no matter the amount of damages sought, except for simplified procedures for claims of \$50,000 or less. The FINRA forum has seen an increasing number of arbitrations seeking substantial amounts; currently, there are approximately 200 cases where the actual damages sought exceed \$10 million. Indeed, several cases involve exposure in excess of hundreds of millions of dollars and, in certain cases, over \$1 billion. Sophisticated financial institutions are claimants in many of these cases. It is generally recognized that large and complex cases present "special and often unique problems ... which require greater procedural flexibility."<sup>95</sup> Two related concerns have been expressed about the increase in large claims: whether the forum is meeting the needs of the parties and whether these cases place a disproportionate burden on the forum.

Previous attempts to craft special procedures for large claims have not garnered much enthusiasm. On May 1, 1995, the NASD initiated a one-year pilot program for large and complex cases, at that time defined as claims of \$1 million or more. The rules for large and complex cases generally allowed the parties, the arbitration staff and the arbitrators to customize the procedures for their claim. While an administrative conference with a NASD staff person for the purpose of developing a hearing plan was required, other procedures were based on the parties' agreement, and parties proceeded under the rules for large and complex cases only by the consent of all parties. To defray increased administrative costs, NASD charged higher fees. In fact, very few parties elected to proceed under these rules,<sup>96</sup> even though NASD extended the pilot program through 2000. Parties elected to proceed under the pilot program in only 43 of the first 880

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<sup>95</sup> Ruder Report at 68.

<sup>96</sup> *Id.* at 68-69.

eligible cases. In qualifying cases, less than one percent opted to proceed to the administrative conference stage, and none elected to continue past it.<sup>97</sup> FINRA believes that the introduction of the NLLS in 1998 and the availability of the IPHC for standard cases beginning in 1997 gave parties in large and complex claims many of the benefits of the pilot program without incurring the additional costs.<sup>98</sup>

On July 2, 2012, FINRA launched a voluntary program for large cases targeted at cases involving damages claims of at least \$10 million.<sup>99</sup> The program allows the parties to have more control over the administration of their case. The parties may agree to different methods of arbitrator appointment, discovery, and hearing facilities, among other things. FINRA also assigns to these cases a specially trained and experienced case administrator, who assists the parties in developing a detailed plan for the administration of the case. Since the pilot program was launched, DR has had a total of nine cases opt into the program, four of which have been decided by award.

*Task Force Deliberations.* Because the voluntary pilot programs have been under-utilized, the task force gave consideration to recommending the adoption of mandatory procedures for large claims, with an opt-out for certain investors. These procedures would include an alternative method of selecting arbitrators that allows for the selection of arbitrators who are not in the FINRA pool, with additional costs shared by the parties. Some members of the task force believe that procedures tailor-made for large claims would benefit both the parties and the forum; others opposed the adoption of mandatory procedures because they could result in the elimination of the all public panel option and in the loss of control by the parties of the arbitrator selection process. The task force was not able to reach consensus on procedures for large claims, and it makes no recommendation on this topic.

The subcommittee that addressed large claims proposed the following framework for discussion. Although the task force is not recommending the subcommittee's proposal, it is included in the final report for the information of the NAMC.

*Definitions.* Large claims would be defined as matters where actual damages sought are \$20 million or more, exclusive of claims for consequential or punitive damages or attorneys' fees.

The procedures would be mandatory with respect to accredited investors as set forth below:

1. a bank, insurance company, registered investment company, business development company, or small business investment company;
2. other institutional investors;
3. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$20 million;

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<sup>97</sup> 2007 Report Card at 20.

<sup>98</sup> *Id.*

<sup>99</sup> <http://www.finra.org/arbitration-and-mediation/faq-large-case-pilot>.

4. a charitable organization, corporation, or partnership with assets exceeding \$20 million that is advised by an registered investment manager;
5. a director, executive officer, or general partner of a company selling securities or other investment products;
6. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$20 million, including trusts controlled by such persons.

*Arbitrators.* Arbitrator selection would involve a revised process in which each side selects one arbitrator and the selected arbitrators would choose a third arbitrator to serve as the chairperson. The parties are not limited to the FINRA pool in their selection; similarly, the designated arbitrators may select a chairperson from outside the FINRA pool. If arbitrators are selected from outside the FINRA pool, they must adhere to the FINRA conflicts disclosure process, including completion of the FINRA oath of arbitrators and the arbitrator disclosure checklist. If the arbitrators cannot agree on a chair, FINRA will provide a list of ten candidates from the chairperson roster, the parties will strike no more than four candidates and rank the remaining candidates in order of preference, and FINRA will select the chairperson based on the highest combined ranking. Parties are free to agree to an alternative method of selection. After the panel is selected, there shall be no ex parte communications by the parties or their representatives with any of the arbitrators, including each party's designee.

*Compensation.* Because of the added demands of a large case, it is expected that parties will compensate the arbitrators at a higher rate than the customary FINRA honorarium. The FINRA administrator can facilitate discussions between the parties and arbitrators to agree on arbitrator compensation specifics such as deliberation time, travel time and other expenses. Based on the agreement, the arbitrators will submit invoices to FINRA, who will then bill the parties for the amounts in excess of the FINRA rate. The fees for arbitrators will be split among the principal parties, unless the parties otherwise agree.

*Initial Prehearing Conference.* After selection of the panel, the case administrator will set up an initial administrative conference with the panel and the parties' representatives. The purpose of the conference is to obtain additional information about the case and to discuss timing of discovery, potential motions, expected length of the hearing, and potential hearing dates. Parties are encouraged to agree on scheduling issues, including potential hearing dates, prior to the conference. FINRA shall assign a specially trained and experienced person to be the administrator who will aid in the development of a detailed plan for scheduling and other procedures governing the matter.

*Depositions.* Each side will have the right to take one deposition which shall last no longer than six hours, including breaks. In multi-party cases, the chairperson shall permit additional depositions to ensure balanced access to information about all of the principal parties. The parties may also agree to additional depositions or other discovery devices.

*Discovery.* Document discovery will follow the FINRA rules, which may be modified by the parties.

*Prehearing Briefs.* Prehearing briefs will be required, unless the parties otherwise agree.



*Final Prehearing Conference.* There shall be a final prehearing conference with the panel and the parties' representatives to address the following issues:

1. Presentation of evidence at the hearing (*e.g.*, paper or electronic);
2. Availability of witnesses and method of testimony (*e.g.*, live, video, or telephonic);
3. Remaining scheduling issues;
4. Pending motions;
5. Confirmation of arbitrator availability.

*Hearing Location.* Parties can agree to the location of hearings, both as to city and actual facilities, including the use of law firm offices or conference room facilities. Additional costs of such facilities outside of FINRA will be shared by the parties.

*FINRA Cost.* FINRA will assess an administrative fee of \$1000 for each separately represented party.

## **MEDIATION**

*Background.* The Ruder Report discussed “a widespread concern that SRO arbitration has become too adversarial, too costly, and too time consuming” and noted that the use of mediation to resolve disputes had increased in recent years.<sup>100</sup> As described by FINRA, “[m]ediation is an informal, voluntary process in which a mediator facilitates negotiations between disputing parties. The mediator's role is to help the parties find a mutually acceptable solution to the dispute.”<sup>101</sup> At the time of the Ruder Report, NASD had just begun a mediation program and adopted rules that set out the basic framework for its mediation process. The Ruder Report recommended that NASD expand its efforts to offer voluntary mediation.<sup>102</sup>

In response to the Ruder Report, the NASD accelerated development of its mediation program, including increasing the size of its mediation staff and educating practitioners about the benefits of mediation.<sup>103</sup> Effective 2006, it included the mediation procedures in a separate mediation code. FINRA reports that since the establishment of the mediation program, it has handled over 19,000 mediations, with over 80 percent resulting in a settlement.

*Task Force Deliberations.* The task force felt that it was appropriate to review the mediation program and consider changes to encourage its further use and enhance its effectiveness. There has been only one substantive change to the Mediation Code since its adoption.<sup>104</sup> The task force received few comments about FINRA's mediation program via the DR Mailbox, but the mediation subcommittee reached out to experienced mediators for input.

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<sup>100</sup> Ruder Report at 47.

<sup>101</sup> <http://www.finra.org/arbitration-and-mediation/mediation-overview>.

<sup>102</sup> Ruder Report at 54.

<sup>103</sup> 2007 Report Card at 13.

<sup>104</sup> FINRA Rule 14107 (giving FINRA Director of Mediation to approve a mediator not from FINRA's list if the parties so request).

*Automatic Mediation with Opt-Out.* Mediation encourages parties to solve their own problems with a professional mediator and save the expense, delay, and stress of a full-blown arbitration hearing. Accordingly, the task force considered ways to encourage greater use of mediation. The task force discussed (1) an automatic mediation process for cases filed in arbitration, subject to an opt-out by any party, and (2) an automatic mediation track, without an opt-out, for pro se, employment and small claims. The task force was not in favor of requiring any claims to go to mediation without an opt-out. The task force recommends an automatic mediation process for all cases filed in arbitration, subject to an opt-out by any party.

The task force bases its recommendation for an automatic mediation track, subject to an opt-out, largely on the overall success of FINRA’s mediation program. Feedback from mediators, arbitrators and attorneys interviewed on the topic was uniformly positive. For example, the ABA’s Dispute Resolution Section supports this approach as “appropriate ... to encourage greater participation in the mediation process.”<sup>105</sup> Others have suggested that requiring parties to opt-out of mediation would make mediation available to parties without their having to request it, which some parties believe to be a sign of weakness. An automatic mediation track will ensure that parties are informed of mediation early in the process when mediation may be most beneficial and cost effective. The task force recognizes that, if this recommendation is adopted, the current 80 percent settlement rate may drop somewhat, but believes that is acceptable in light of the benefits of mediation.

*Financial Incentives for Early Successful Mediation.* The task force recommends a financial incentive for parties who have achieved a final and complete resolution of their dispute through mediation. The task force suggests that a schedule be developed to refund part of the mediation and arbitration fees to parties who are successful at early mediation. As a framework for discussion, the task force proposes the following:

<b>Timing of Settlement</b>	<b>% of Fees Refunded</b>
Pre-Answer	100% of all Parties’ FINRA Arbitration Fee (including nonrefundable fee and Member fees) and 100% of all Parties’ FINRA Mediation Fee if mediated through FINRA
Pre- List Selection	80% of all Parties’ FINRA Arbitration Fee (including nonrefundable fee and Member fees) and 80% of all Parties’ FINRA Mediation Fee if mediated through FINRA
Pre – IPHC	65% of all Parties’ FINRA Arbitration Fee (including nonrefundable fee and Member fees) and 65% of all Parties’ FINRA Mediation Fee if mediated through FINRA
Pre-Discovery Cut-off	50% of all Parties’ FINRA Arbitration Fee (including nonrefundable fee and Member fees) and 50% of all Parties’ FINRA Mediation Fee if mediated through FINRA

<sup>105</sup> Comments of ABA Section of Dispute Resolution for FINRA Dispute Resolution Task Force at 8 (May 1, 2015).

Pre-20 Day Exchange	Parties do not have to pay a postponement fee or pay arbitrators for reserving their time.
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*Training.* The task force heard concerns that the pool of experienced FINRA mediators is not deep and lacks diversity. Because of this, parties who might be interested in mediation may be deterred because of an inability to identify and obtain the services of appropriate mediators for their disputes. Accordingly, it recognized the need to train new mediators to handle securities mediations. In that regard, it makes three recommendations:

1. A formal, mandatory continuing education program for new mediators should be developed so they can gain knowledge about securities law and the practice of mediation. In addition, a continuing education program for all mediators on a voluntary basis would keep them abreast of developments in securities law and mediation practice. Experienced mediators should be recruited to serve as instructors on a pro bono basis. The task force suggests that annual mediator roundtables on various topics of interest be part of this program.
2. FINRA should sponsor more opportunities for inexperienced mediators to gain experience and training. These opportunities could include adding more Mediation Months in the schedule, perhaps quarterly, and promoting reduced fees to parties in that program.
3. A formal mentoring program should be established in which experienced mediators would permit new mediators to shadow them and perhaps co-mediate with them. This is currently being done informally by certain mediation case administrators.

*Diversity.* The task force is concerned about the lack of race and gender diversity among mediators in the FINRA forum. It recommends that FINRA undertake aggressive efforts to recruit, train, and encourage the use of more diverse mediators. As a first step, FINRA should compile data, on a voluntary basis, on the race and gender of its current mediators. This will yield statistical data on the composition of the pool and serve as a baseline for comparison to determine whether future programs make any meaningful difference.

The task force recommends that FINRA take actions to increase both the numbers of diverse mediators as well as greater use of their services. In addition to providing the previously described training, mentoring, and mediation opportunities, these activities could include actively recruiting mediators from affinity groups with diverse populations and featuring diverse mediators in FINRA’s telephonic or teleconference mediations.

*Special Mediator Rosters.* Mediators would be encouraged to volunteer for training in specialized areas and to list it on their disclosures. Subjects may include, among others, special products, intra-industry issues like raiding and promissory note cases, and elder financial abuse cases. Developing more mediators with expertise in specialized areas could help promote diversity by encouraging parties to use mediators who have not yet established a track record

instead of relying on a few experienced mediators. Counsel would not be required to use mediators from the specialized rosters.

*Alternatives to Mediation (e.g., med-arb, arb-med and ENE).* The task force supports alternatives to mediation in appropriate cases where the parties choose them. It recommends that mediator training include these alternatives and the requirements for handling them correctly.

*Mediator Self-Assessment Program.* The task force endorses FINRA's continuing participation in the mediator self-assessment programs being developed by the ABA, together with AAA, FINRA, CPR and the cooperation of JAMS, to provide mediators with confidential insights on their performance.

## MOTIONS TO DISMISS

*Background.* Motions to dismiss claims prior to a hearing on the merits were for many years a controversial issue. Customers and their representatives firmly believed that they had a right to present their claims before an arbitration panel since arbitration practice does not require claimants to state legal claims and arbitrators have considerable discretion about applying the law in deciding disputes. Therefore, they asserted, motions to dismiss for failure to state a claim were not appropriate in the arbitration forum before a hearing on the merits. Respondents and their representatives, in contrast, believed strongly that there needed to be an expeditious process for dismissing frivolous claims.

In 2007, FINRA filed with the SEC a proposed rule change to set forth procedures governing dispositive motions.<sup>106</sup> FINRA stated that the proposed rule was necessary because of "concerns raised by investors' counsel, SEC staff and other constituent groups about abusive and duplicative filing of dispositive motions."<sup>107</sup>

FINRA Rule 12504(a), approved by the SEC in 2009,<sup>108</sup> begins with a policy statement: motions to dismiss a claim prior to the conclusion of a party's case in chief are "discouraged in arbitration."<sup>109</sup> The panel can only grant motions to dismiss prior to the conclusion of a party's case in chief under Rule 12504 upon the following grounds: (1) the non-moving party previously released the claim in writing, or (2) the moving party was not associated with the accounts,

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<sup>106</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Relating to Amendments to the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes To Address Motions To Dismiss and To Amend the Eligibility Rule Related to Dismissals, Exch. Act Rel. 34-57497, 73 Fed. Reg. 15019 (Mar. 20, 2008).

<sup>107</sup> *Id.* at 15021.

<sup>108</sup> Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Amendments to the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes To Address Motions To Dismiss and To Amend the Eligibility Rule Related to Dismissals, Exch. Act Rel. 34-57497, 74 Fed. Reg. 731, 739 (Jan. 7, 2009).

<sup>109</sup> FINRA Rule 12504(a)(1).

securities or conduct at issue.<sup>110</sup> FINRA Rule 12206 authorizes motions to dismiss based on the eligibility rule.<sup>111</sup>

Rule 12504(a) sets forth the procedure for making motions to dismiss pursuant to that rule. They must be made in writing, separately from the answer and after the answer is filed.<sup>112</sup> The rule sets forth filing deadlines to prevent a moving party from filing a motion shortly before a hearing as a surprise and delaying tactic.<sup>113</sup> The full panel must decide a motion to dismiss,<sup>114</sup> and a panel cannot decide a motion to dismiss prior to the conclusion of a party's case in chief unless the panel holds a recorded in-person or telephonic conference.<sup>115</sup> A motion to dismiss can only be granted upon a unanimous, explained written decision.<sup>116</sup> A party is prohibited from refiling a denied motion to dismiss without specific permission from the panel.<sup>117</sup> The rule also requires arbitrators to award fees associated with denied motions to dismiss against the party filing the motion<sup>118</sup> and to award fees and costs associated with frivolously filed motions to the prevailing party.<sup>119</sup> If the panel determines that a party filed a motion in bad faith, it may also impose sanctions.<sup>120</sup>

### *Task Force Deliberations*

*Current Motion Practice.* The task force heard concerns that the current rule was not sufficiently deterring abusive motions to dismiss prior to the conclusion of a party's case in chief. Accordingly, it reviewed recent statistical data provided by FINRA staff on the number of prehearing motions to dismiss:

From 2013 to December 2014, DR had an average monthly caseload of around 5,000 cases. During that time, DR recorded 725 cases (both customer and industry disputes) in which a prehearing motion to dismiss was filed by respondents. Of those 725 cases, 249 are still pending, 310 have since settled or closed for other reasons (i.e., bankruptcy, etc.), and 166 have closed by award. FINRA staff reviewed the 166 cases closed by award to determine the arbitrators' decisions regarding the motion to dismiss:

The arbitrators granted a prehearing motion to dismiss (in whole or part) in 64 of the 166 cases closed by award.

- In 36 of the 64 cases, the arbitrators granted a prehearing motion to dismiss because the claim was ineligible for arbitration (the eligibility rule).

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<sup>110</sup> *Id.*(a)(6).

<sup>111</sup> FINRA Rule 12206 is discussed in the next section of this report.

<sup>112</sup> FINRA Rule 12504(a)(2).

<sup>113</sup> *Id.*(a)(3).

<sup>114</sup> *Id.*(a)(4).

<sup>115</sup> *Id.*(a)(5).

<sup>116</sup> *Id.*(a)(7).

<sup>117</sup> *Id.*(a)(8).

<sup>118</sup> *Id.*(a)(9).

<sup>119</sup> *Id.*(a)(10).

<sup>120</sup> *Id.*(a)(11).

- In 18 of the 64 cases, the arbitrators granted a prehearing motion to dismiss because the respondent was “not associated with the account, security or conduct at issue.”
- In 6 of the 64 cases, the arbitrators granted a prehearing motion to dismiss due to a prior settlement or written release.
- In 4 of the 64 cases, the arbitrators granted a prehearing motion to dismiss for “other reasons” (including discovery abuse, failure to state a cause of action in an employment dispute, as well as reasons unspecified in two awards). (Two cases cited multiple grounds for dismissal.)

In addition, arbitrators granted a respondent’s motion to dismiss *after* the conclusion of claimant’s case in chief in 12 of the 166 cases closed by award.

Based on the statistical evidence, the rule appears to be working as intended, and there is no evidence of abuse of the current rule. The task force does not recommend any action to respond to alleged abuse.

*Previously Adjudicated Cases.* The task force also addressed concerns that the current rule was too restrictive. It recommends that FINRA Rule 12504(a) be amended to include one additional category for which motions to dismiss may be made before the conclusion of the case in chief: situations where the dispute has been previously concluded through adjudication or arbitration and memorialized in an order, judgment, award or decision. The task force agreed that in instances where arbitrations involve claims previously adjudicated by a court or arbitrated by an arbitration panel, respondents should be able to obtain early dismissal. In instances where a prior arbitration award was not an explained decision, the arbitration panel will need to make inquiry to ascertain that the claims before it were in fact resolved in the prior arbitration.

*FINRA Rule 12504(a)(6)(B).* The task force reviewed the second category for which a motion to dismiss may be made before the conclusion of the case in chief in Rule 12504(a)(6): the moving party was not “associated with” the accounts, securities or conduct at issue. Some members felt that the rule should define the phrase “associated with” because it is unclear and potentially too expansive.

FINRA’s FAQ on motions to dismiss explains that “associated with” refers to matters of misidentification.<sup>121</sup> Specifically, the FAQ states:

*Not associated with the account, security or conduct at issue*

A panel cannot act on a motion to dismiss under Rules 12504(a)(6)(B) and 13504(a)(6)(B) unless the panel determines that the moving party was not associated with the accounts, securities or conduct at issue. FINRA intends this exception to apply in cases involving issues of misidentification. For example, the panel could grant a motion to dismiss under this exception if a party files a claim against the wrong person or entity, or a claim names an individual who was not employed by the firm during the time of the dispute.

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<sup>121</sup> <http://www.finra.org/industry/faq-motion-dismiss-and-eligibility-rules-faq>.

The task force decided that the rule and the FAQ are sufficient as written and does not recommend a change. This is an area where effective advocacy can explore the rule's parameters according to the facts of specific cases.

*Motions to Dismiss After Conclusion of Case in Chief (FINRA Rule 12504(b)).* FINRA Rule 12504(b) does not set out a briefing schedule for motions to dismiss made after the conclusion of the case in chief. Many motions made at the conclusion of the claimant's case do not require briefing; such motions are typically made orally and argue that claimants have not sustained their burden of proof on an essential element of the claim. But some dispositive motions require a briefing of the law, e.g., statutes of limitation, duties of clearing brokers or custodians. The current rule gives practitioners no guidance on when to file a brief in support of such a motion; nothing in the rule prohibits a brief from being filed before, during or after the hearing.

The task force discussed whether the benefit of providing guidance to practitioners by specifying a briefing schedule was outweighed by the risk that it would encourage the routine filing of boilerplate briefs. The task force does not recommend a change to Rule 12504(b).

#### **TIME LIMITS (MOTIONS TO DISMISS BASED ON ELIGIBILITY)**

*Background.* FINRA first adopted in 1968 an eligibility rule that barred stale claims from the forum. FINRA Rule 12206(a) provides that “[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.” The eligibility rule operates independently of any applicable statute of limitations. Dismissal of a claim under FINRA Rule 12206 does not prohibit a party from pursuing the claim in court, and by filing a motion to dismiss under the eligibility rule, the moving party agrees that if the panel dismisses a claim under Rule 12206, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all claims in court.<sup>122</sup>

The Ruder Report noted that the eligibility rule had deleterious unintended consequences. Brokerage firms went to court, seeking to enjoin arbitrations based on the eligibility rule, which led to extended collateral litigation. This created confusion about the rule's application and contributed to the erosion of investor confidence in the SRO arbitration forum.<sup>123</sup> In the view of the Ruder Report, a preferable approach to stale claims would be to direct arbitrators to decide statute of limitations issues based on applicable law.

The Supreme Court largely solved the problem of collateral litigation by holding, in *Howsam v. Dean Witter Reynolds, Inc.*,<sup>124</sup> that the applicability of the eligibility rule was a procedural question that did not present a “question of arbitrability”<sup>125</sup> and therefore was

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<sup>122</sup> FINRA Rule 12206(b).

<sup>123</sup> Ruder Report at 23.

<sup>124</sup> 537 U.S. 79 (2002).

<sup>125</sup> Questions of arbitrability are presented when there is a question whether the party is bound by an agreement to arbitrate, 537 U.S. at 84.

presumptively a matter for the arbitrator to decide, not a judge.<sup>126</sup> FINRA Rule 12206(a) reinforces the Supreme Court's holding by expressly providing that the panel will resolve any questions regarding the eligibility of claims.

*Current Debate.* The purpose and the application of the eligibility rule have continued to be the subject of debate. For example, questions have arisen over when the six-year time limit begins to run. FINRA's Arbitrator's Guide states that "[t]he arbitrators may find that there is a continuing occurrence or event giving rise to the dispute. For example, although a customer purchased stock 10 years ago, there are allegations of ongoing fraud starting with the purchase, but continuing to a date within six years of the date the claim was filed."<sup>127</sup>

*Task Force Deliberations.* Some members of the task force believed that the eligibility rule should be eliminated and the issue of stale claims addressed through applicable statutes of limitations. Others believed that the rule should be a rule of repose. The task force spent a considerable amount of time debating the issue, but reached no consensus. Accordingly, it makes no recommendation.

## CASE MANAGEMENT—PROCEDURAL ISSUES

*Scheduling Delays.* One of the frequently cited advantages of arbitration is that it is a faster process than litigation. FINRA's goal in non-expedited cases, set forth in the IPHC's arbitrator script,<sup>128</sup> is the commencement of evidentiary hearings within nine months or less after the IPHC. In cases involving senior or seriously ill parties, the hearing should be expedited. Yet the task force heard concerns that the scheduling of hearing dates frequently extends beyond these time frames.

Scheduling delays is an intractable problem, with no obvious solution. Experienced counsel, both claimants' and industry representatives, frequently have heavy caseloads that make scheduling hearing dates in the near future difficult at best. Arbitrators have their own professional and personal calendars that they must take into account in scheduling. The task force believes it is important to the efficiency and efficacy of the forum that chairpersons make diligent efforts to meet the nine-month goal and to schedule hearings even sooner for senior or seriously ill parties. The task force recommends that FINRA review all of its procedures to encourage expeditious scheduling, including frequent reminders to arbitrators that hearings should be scheduled within nine months, unless both parties agree otherwise or there are special circumstances. In particular, with respect to expedited hearings for senior and seriously ill parties, the task force was very concerned about reports that these hearings are seldom expedited. FINRA staff recently undertook a study to identify approaches to expediting these cases, which the task force reviewed. The study is a good first step. The task force recommends that FINRA implement procedures to insure that once the expedited process is selected, the goals of achieving an expedited process and hearing are achieved.

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<sup>126</sup> *Id.* at 85.

<sup>127</sup> Arbitrator's Guide 45, available at <http://www.finra.org/arbitration-and-mediation/arbitrators-guide>.

<sup>128</sup> <http://www.finra.org/sites/default/files/iphc-script.pdf>.



The task force also discussed whether there should be an expectation that IPHCs are scheduled within four months of the filing of the complaint and whether FINRA could send the arbitrator lists to the parties sooner than current practice. FINRA Rules 12402 and 12403 state that the Director will send the lists within approximately 30 days after the last answer is due. Changing the rule to use the first answer due date as opposed to the last answer due date would be a modest step to speed up the process, and the task force recommends this change.

*Last-Minute Recusals; Mandatory Adjournment.* There is a perceived problem with occasional last-minute recusals by arbitrators, creating scheduling difficulties for the parties and causing additional delays. A frequent complaint of arbitrators, on the other hand, is that after they have reserved dates for a scheduled hearing, the parties will settle the dispute on the eve of the hearing, leaving the arbitrators with unproductive reserved time. As a result, some arbitrators may resort to “double-booking.” The recently adopted changes to FINRA Rule 12601 expanding the cancellation deadline from three to ten days and increasing the cancellation fee from \$100 to \$600 per arbitrator may alleviate the problem of double-booking.

The task force discussed various proposals to address the problem of last-minute recusals and recommends the following for consideration:

- FINRA should emphasize to all arbitrators, in its training materials, in The Neutral Corner, and in other communications, the need to avoid late recusals and the perceived problem of double-booking;
- FINRA should include similar language in the appointment letters sent to arbitrators appointed to specific cases;
- FINRA should send a communication to the panel approximately 75 days before the first date of a scheduled hearing reminding them of the hearing and the need to avoid late recusals;
- FINRA should develop a formal disciplinary process to deal with arbitrators who engage in last-minute recusals without good cause.

*Mandatory Direct Communications.* FINRA Rule 12211 permits direct communications between arbitrators and parties, if all agree and if all parties are represented by counsel. The task force heard suggestions that direct communications should be required because it is more efficient. The task force also understands that many arbitrators and parties do not favor direct communications. After discussion, it agreed that direct communications should not be forced on unwilling parties and panel members, and it does not recommend any change in the current practice. The task force expects that the DR Portal will, in time, effectively accomplish direct communication.

*Discovery.* FINRA’s Discovery Guide outlines documents that the parties should exchange without arbitrator or staff intervention in customer cases. The guide contains two document production lists of presumptively discoverable documents: one for the firm/associated persons to produce and one for the customer to produce.<sup>129</sup> The task force recommends that the

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<sup>129</sup> <http://www.finra.org/sites/default/files/ArbMed/p394527.pdf>.

document production list of presumptively discoverable documents for the firm/associated persons to produce be revised to require production of all insurance policies that may be applicable to claimants' claims.

*Use of Technology in Cases.* The task force heard concerns from counsel that some arbitrators were reluctant to allow the use of technology at hearings despite the agreement of the parties. It recommends that the IPHC script be revised to make clear that the parties may agree to modify hearing procedures, including the use of any type of technology, in the interest of efficiency and cost-effectiveness, subject to the arbitrators' discretion for good cause.

*DR Portal.* FINRA developed the DR Portal to facilitate interactions among neutrals, parties, and DR staff. The DR Portal is a web-based system that allows invited participants to log into a secure section of FINRA's website for self-service access to submit documents and view their case information. The DR Portal has two parts: one for FINRA neutrals serving on the Dispute Resolution roster and another for arbitration and mediation case participants. All arbitrators and mediators may use the portal to view and update their current profile and disclosure information; view and print their entire disclosure report; access information about their assigned cases, including upcoming hearings and payment information; schedule hearing dates; view case documents; submit documents; and view information about all cases on which they have served. FINRA encourages arbitrators and mediators to take advantage of the portal's capabilities. In Party Portal cases, FINRA serves claims online, and firms file answers electronically through the Portal. FINRA also invites parties in these cases to view their case information online, select arbitrators online, schedule hearings using the Portal, and file all documents online. In addition, FINRA sends arbitrators and parties case-related documents through the Portal. Pro se parties, counsel, and arbitrators receive an automated email alert every time FINRA publishes documents through the Portal for their review.

The task force met with FINRA staff and obtained information about the operation of both the DR Party and DR Neutral Portals. Development of the portals is evolving to meet the needs of the parties and the arbitrators, and its use is likely to expand as individuals become more comfortable with its features. The task force supports efforts to improve the functionality of the DR Portal. It recommends that FINRA develop a feature on the party portal which allows a party to view all costs on an on-going basis. The task force did not receive any concerns or reports of problems that required its further attention.

*Phantom retention of experts.* The task force received a report about the practice of "phantom retentions," which occurs when one party lists an expert witness during the 20-day exchange without the knowledge or consent of the listed expert and without actually retaining the expert. The task force recommends an addition to the IPHC script to strongly discourage this practice. It also suggests to PIABA and the Securities Industry and Financial Markets Association (SIFMA) that both groups periodically remind their members that this practice is disfavored.

## PUBLIC AVAILABILITY OF INFORMATION

*Content of Awards.* As previously discussed, the task force is recommending a change in FINRA Rule 12904 to require explained decisions unless any party notifies FINRA that it does not want an explained decision. Before FINRA could implement this change, it would need to develop a program to train chairpersons for this responsibility. This change would go far toward enhancing the transparency of the arbitration process. Even if this recommendation is not adopted, the task force recommends that steps should be taken to improve the informational content of awards. These include:

- (a) Educating arbitrators during training on the importance of a detailed summary of the issues and products involved in each award; and
- (b) Providing a template or examples of the items an arbitrator should consider including in an award summary that would set a minimum standard which arbitrators should be encouraged to exceed. In particular, arbitrators should be trained to describe briefly the claims and defenses presented at the hearing, rather than to set forth the claims and defenses contained in the pleadings.

The task force also considered suggestions that awards should include additional information, such as identifying experts who testified at the hearing or identifying the branch office involved in the dispute. The task force concluded that such information would not meaningfully improve transparency.

The task force heard a concern that an arbitrator who dissents from an award may file a written dissent that expresses his/her views in strident language, thus possibly giving the minority view a disproportionate emphasis if a motion to vacate is filed. The task force did not see evidence that this was a prevalent problem and believes it could be addressed in arbitrator training.

*Substantive Decisions.* The task force recommends that certain substantive decisions, such as injunctive orders or final dismissals, be treated as awards and be available in FINRA's Arbitration Awards Online (AAO) database. Publication of these decisions would allow parties to obtain more information about arbitrators that may be relevant in selecting a panel. FINRA advised the task force that the outcomes of almost all dispositive motions are currently included in final awards. Injunctive motions are noted in the award as an issue considered and decided, but the substance of any resulting order is not generally discussed with specificity. It would be willing to attach these orders as an addendum to final awards (where applicable) and post them on a going forward basis.

The task force also discussed whether FINRA should make available to parties all interim and other written decisions, in addition to final arbitration awards, made by its arbitrators, but decided to take no action because of confidentiality issues.

*Including Awards from Other Forums.* The task force considered a suggestion that the AAO database include awards from other arbitration forums. The database already includes

awards from other SRO forums, including NYSE, Pacific Exchange/ARCA, AMEX, PHLX, MSRB and, beginning this year, all legacy CBOE awards. FINRA indicated it was willing to discuss posting AAA and JAMS awards if practical issues could be worked out. In the view of the task force, however, there is no compelling reason to require FINRA to use its resources for this purpose. Other forums may already have their own online databases available to practitioners. Collecting and posting other forums' awards did not strike the task force as an appropriate use of FINRA staff resources.

*Publication of Additional Information on FINRA's Website.* The task force considered a suggestion that additional statistical information be posted on FINRA's website, specifically:

- a. A roster breakdown of active arbitrators by hearing location,
- b. Pending cases by hearing location,
- c. Average Turnaround Time for closed cases by hearing location.

It was suggested that this information would be useful to parties to determine if there were particular bottlenecks or delays regarding arbitrations in particular locations and would also assist FINRA to determine where additional arbitrators may be needed for recruiting purposes.

The task force was advised by FINRA staff that monthly statistical reports posted on FINRA's website will soon include a chart on neutral roster availability and the number of cases in each location. In addition, staff collects relevant arbitrator staffing information for internal uses such as staffing and training. The task force did not see any data suggesting that certain districts were more delayed than others in their ability to facilitate arbitration cases; in any event, most arbitration hearing locations are determined by the residence of the claimant, unless otherwise agreed to by the parties. Therefore, the task force does not recommend release of any information beyond what FINRA has decided to release.

## **TRANSPARENCY**

Arbitration is traditionally a confidential process, in contrast to the judicial system. Yet, as this report has previously noted, a frequent criticism of the FINRA arbitration process is its lack of transparency, which makes it difficult to assess the fairness of the forum. The task force makes two recommendations in this regard:

- FINRA should adopt a policy of promoting, to the maximum extent possible, transparency about its dispute resolution forum. FINRA should use its good judgment in evaluating what data and information can be released to the public, even if it requires some expense to redact or remove personal or confidential information prior to release. For example, FINRA might consider the release of arbitrators' evaluations with redaction of identifying information because it could shed light on the performance of panels.
- The task force specifically recommends that FINRA reinstate its prior practice of disclosing on its website the names of NAMC members.

The task force also believes that its recommendation to increase explained awards, if implemented, will help increase transparency over time.

## CLASS ACTION WAIVERS IN CUSTOMERS' PDAAS

*Background.* In 2011, Charles Schwab & Co amended its customer agreement to provide that customers could not bring judicial class actions to vindicate any rights it may have against the brokerage firm.<sup>130</sup> Instead, the agreement provided that a Schwab customer's exclusive remedy was individual arbitration in the FINRA forum. The Schwab class action waiver was a clear violation of FINRA rules that bar their inclusion in customers' agreements.<sup>131</sup> Both FINRA and the SEC have consistently stated that customers that have claims against a brokerage firm suitable for class action treatment are permitted to institute a class action in court, and that a brokerage firm cannot enforce a PDAA against a member of the class so long as the class action appears viable.<sup>132</sup> In February 2013 a FINRA hearing panel held that the FINRA rule was unenforceable because it conflicted with the Federal Arbitration Act (FAA).<sup>133</sup> In April 2014, however, FINRA's Board of Governors reversed the Hearing Panel on this critical point, finding that the FAA did not preclude FINRA's enforcement of its rules.<sup>134</sup> The Board relied on Supreme Court precedent that the FAA's mandate is not absolute, but can be overridden by a "contrary Congressional command."<sup>135</sup> In the case of SRO securities arbitration, the Exchange Act contains Congress's command that the SEC approve FINRA's arbitration rules, upon a determination that they are consistent with the legislative purpose. Specifically, Exchange Act § 15A empowers FINRA to regulate broker-dealers, including their dispute resolution processes with customers, subject to SEC oversight. Indeed, in the past 20 years, the SEC has approved dozens of FINRA's arbitration rules after public notice and comment. "Therefore, the Exchange Act gives the SEC the authority to approve FINRA rules that govern arbitration in FINRA's forum and that regulate the content of predispute arbitration agreements."<sup>136</sup> Schwab's conduct, moreover, "demonstrates its attempted piecemeal erosion of FINRA's well-established arbitration rules."<sup>137</sup> Schwab settled with FINRA by paying a \$500,000 fine and agreeing to notify its customers that the class action waiver was no longer in effect.<sup>138</sup>

The *Schwab* decision was a significant victory for retail investors. If the hearing panel's decision had been upheld on appeal and the inclusion of class action waivers in brokerage firms' PDAAs became a standard practice, customers with small claims that could be aggregated in a judicial class action would be relegated to individual arbitrations in the FINRA forum, even if the amounts of the individual claims made arbitration economically infeasible. Although this result would be exactly the opposite of consistent FINRA and SEC policy, such an outcome

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<sup>130</sup> See Barbara Black & Jill I. Gross, *Investor Protection Meets the Federal Arbitration Act*, 1 Stanford J. Complex Litig. 1 (2012)

<sup>131</sup> FINRA Rules 12204, 2268(d), (f).

<sup>132</sup> Black & Gross, *supra* note 130, at 27-28.

<sup>133</sup> Dept. of Enforcement v. Charles Schwab & Co., Inc. (FINRA OHO Feb. 21, 2013).

<sup>134</sup> Dept. of Enforcement v. Charles Schwab & Co., Inc. (FINRA Bd. Of Governors Apr. 24, 2014).

<sup>135</sup> *Id.* at 18.

<sup>136</sup> *Id.* at 19.

<sup>137</sup> *Id.* at 3.

<sup>138</sup> <http://www.finra.org/Newsroom/NewsReleases/2014/P493587>.

would have exacerbated investors' concerns about mandatory securities arbitration. Because Schwab chose to settle with FINRA, however, there remains the lingering doubt about whether a federal appellate court, or ultimately the U.S. Supreme Court, would agree with FINRA's legal analysis.

*Task Force Deliberations.* The task force believes that class action waivers should not be permitted in broker-dealers' PDAs with customers and strongly endorses FINRA's policy on class action waivers, as expressed in *Schwab*. The task force notes that the Consumer Financial Protection Bureau recently released a proposal to bar class action waivers in contracts for consumer financial products.<sup>139</sup>

## **.MANDATORY NATURE OF ARBITRATION; FINRA RULE 12200**

*Background.* As described previously, after *McMahon* the inclusion of PDAs in customers' agreements became standard practice in the brokerage industry. The Ruder Report noted that "[o]ne of the most often expressed concerns about SRO arbitration is investors' perceptions that they do not have an alternative forum."<sup>140</sup> The Ruder Report, however, recommended that "the industry should be permitted to continue to utilize predispute arbitration agreements in customer agreements,"<sup>141</sup> because, in its view, securities arbitration was clearly preferable to civil litigation, the available evidence did not support the charge that SRO securities arbitration was unfair to investors, and the Ruder Report's recommendations would significantly address investors' concerns.<sup>142</sup> Yet, despite FINRA's adoption of rule changes designed to increase investor confidence (*e.g.*, neutral-list selection procedures for arbitrators, the all public panel option), criticisms of mandatory arbitration persist, and the lack of investor choice continues to generate at least some distrust of the FINRA forum. For example, in the view of NASAA, prohibiting the use of mandatory PDAs would promote investor confidence by allowing investors a choice of forums to pursue remedies and would improve transparency.<sup>143</sup>

As noted previously, Dodd-Frank gives the SEC the authority to prohibit PDAs with respect to disputes "arising under the Federal securities laws, the rules and regulations thereunder, or the rule of a self-regulatory organization."<sup>144</sup> FINRA's position is that whether PDAs should be prohibited is a policy question for Congress and the SEC to decide. FINRA also advised the task force that no issue was off the table for its deliberations and, specifically, that the task force was free to take up the issue of PDAs.

*Task force deliberations.* The task force felt that it was important to take up the issue of PDAs, regardless of any ultimate resolution by Congress or the SEC. The mandatory nature of securities arbitration is a defining characteristic of the process and is necessarily interrelated with other issues involving the FINRA forum. Many of the previously mentioned post-*McMahon*

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<sup>139</sup> <http://www.consumerfinance.gov/blog/new-proposal-to-ban-companies-from-using-arbitration-clauses-as-a-free-pass-to-avoid-accountability/>.

<sup>140</sup> Ruder Report at 12.

<sup>141</sup> *Id.* at 17.

<sup>142</sup> *Id.* at 18.

<sup>143</sup> NASAA Letter to the Task Force: Key Points at 2 (May 15, 2015).

<sup>144</sup> Pub. L. No. 111-203, § 921(a), 124 Stat. 1376, 1841 (2010).

reforms, for example, have been driven by the need to promote investor confidence in the system, and different choices may well have been made if securities arbitration were not perceived as mandatory.

The task force identified and considered four possible recommendations: allowing investors to choose, post-dispute, between arbitration and litigation; maintaining the status quo; requiring broker-dealers to offer at least some customers an agreement without a PDAA; and requiring broker-dealers to offer a non-SRO forum in their PDAA. Although the task force devoted considerable time to debating these alternatives, it was not able to reach a consensus. The task force acknowledges that the central debate is between investor choice and mandatory arbitration and that proponents of these positions hold convictions that are longstanding, strongly held and based on their experiences and perceptions. In contrast, the other two alternatives are compromise approaches that did not garner much enthusiasm.

The foundational argument for investor choice is that investors who feel aggrieved by their broker-dealers' conduct should be able to choose the forum to assert their remedies and that this right can be meaningfully exercised only after a dispute has arisen. Accordingly, proponents of investor choice feel strongly that PDAA's are an impermissible curtailment of investors' rights. In their view, it is unfair to require investors to use the FINRA arbitration forum, no matter how commercially reasonable its procedures may be.

In contrast, the foundational argument for the status quo is legal parity for the broker-dealer industry. FINRA Rule 12200 imposes mandatory arbitration on broker-dealers by requiring them to arbitrate disputes at the customer's option. Firms secure the same right for themselves by including arbitration clauses in customer agreements. Proponents of the status quo feel strongly that banning PDAA's would unfairly strip firms of the contractual freedom to name a commercially reasonable dispute resolution forum at the outset of the relationship between broker-dealer and customer.

The advantages of arbitration, as identified in the Ruder Report, are speed, reduced costs, and informality. Proponents of investor choice, on the one hand, and the status quo, on the other, disagree about whether arbitration is, in fact, less expensive and faster than litigation. With respect to informality, there were similarly conflicting views; proponents of investor choice assert, for example, that investors have greater difficulty obtaining necessary documents from broker-dealers in the discovery process in arbitration than in litigation. The task force did not have any empirical evidence to assess these conflicting assertions, and there may well be differences based on geography, the judicial forum, and the particulars of the investors' claim.

Proponents of the competing positions also dispute whether customers achieve fair outcomes in arbitration. FINRA posts on its website Results of Customer Claimant Arbitration Award Cases.<sup>145</sup> From 2010 through 2014, the percentage of cases where a customer was awarded damages ranged from 38% (2014) to 47% (2010). These statistics do not take into account the recoveries achieved through settlement of claims.<sup>146</sup> The numbers also do not provide any basis for assessing whether the amounts awarded to customers adequately

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<sup>145</sup> <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>.

<sup>146</sup> According to FINRA, in 2013 approximately 77% of filed cases resulted in monetary or non-monetary relief. *Id.*

compensated them for their losses. Again, the task force did not have any empirical evidence to assess the fairness of customers' recoveries. Because so few broker-dealer disputes go to litigation, it is also not possible to compare results in arbitration with any alternative forum.

Proponents of the two viewpoints did agree on some advantages and disadvantages of the current arbitration system. An acknowledged advantage of FINRA arbitration is the regulatory oversight provided by the SEC, the federal agency charged with the protection of investors. In addition, FINRA takes steps to require broker-dealers to pay awards promptly so that investors may not have to engage in lengthy collection efforts. Parties have the ability to select arbitrators with more disclosed information than would be available in selecting juries or judges (to the extent that the latter is even possible). An acknowledged disadvantage of arbitration is the lack of developing legal authority, so that legal precedent applicable to resolving disputes between customers and broker-dealers is limited and often outdated. The confidential nature of arbitration proceedings and the paucity of explained awards, moreover, make the system less transparent than judicial proceedings. Individual members of the task force had differing views about the importance of these features of the current arbitration system.

As noted above, there were two proposed compromise positions that did not gain much support. They are briefly described below:

Broker-dealers should be required to offer at least some investors a "plain-vanilla" customer agreement that does not include a PDAA. The customer should knowingly agree to arbitrate, and the customer should not be denied an account if he opts not to agree to arbitration. Limiting the option to investors with cash accounts recognizes that broker-dealers have a creditor relationship with investors holding margin accounts that provides additional support for resolution of disputes through arbitration.

Broker-dealers should be required to offer in their PDAAs the option of a non-SRO forum. Requiring firms to allow for choice in their PDAAs could enhance the perception of fairness in FINRA's dispute forum. The scope of choice can be left to the discretion of the firm, but might include AAA (which has recently adopted Consumer Arbitration Rules), JAMS or another professional forum.

The task force concludes that the debate between investor choice and the status quo is to a large extent a philosophical or policy question about which thoughtful, informed individuals disagree and which the task force cannot settle. Assessment of the fairness of the alternative systems, and which one better protects investors, requires empirical evidence that is not available. Accordingly, the task force determined that it was a better use of its limited time and resources to focus on the current system of FINRA arbitration and propose recommendations to improve it.

## **FORUM ACCESS**

*Definition of "Customer."* FINRA Rule 12100(i) defines a customer to exclude a broker or a dealer. Recent litigation has criticized this definition as unhelpful and has provided more



content to the definition.<sup>147</sup> The task force considered whether it should propose a definition that would provide more guidance, but decided that it was not necessary because the courts are adequately addressing this issue.

*Forum Selection Clauses.* Currently there is a split among the federal appeals courts on whether forum selection clauses that choose litigation in federal courts trump a customer's right to arbitration under FINRA Rule 12200.<sup>148</sup> Some members of the task force take the view that sophisticated investors should be free to negotiate around FINRA Rule 12200; others believe that a waiver of the customers' right to arbitrate violates § 29(a) of the Exchange Act. The task force was in agreement that interpreting a forum selection clause as a waiver of a retail customer's right to arbitrate pursuant to FINRA rules is against public policy.

*Inclusion of Investment Advisers/Firms in FINRA Forum.* Whether FINRA's authority should be extended to include investment advisers has engendered controversy in recent years.<sup>149</sup> In April 2014, FINRA Chairman and CEO Richard G. Ketchum stated that FINRA was not seeking to expand its regulatory authority over investment advisers.<sup>150</sup>

In late 2012, FINRA issued Guidance on Disputes between Investors and Investment Advisers that are Not FINRA Members, stating that it would accept such disputes for arbitration on a voluntary, case-by-case basis, provided that certain conditions were met, including submission of a post-dispute arbitration agreement between the adviser and the investor.<sup>151</sup> Since initiating the program in 2012, 13 Investment Adviser cases were filed on a post-dispute agreement basis. Of those cases, six are pending, four settled, two closed with awards, and one closed with an award relating only to expungement.

The task force decided not to make any recommendation about the inclusion of investment advisers/firms in the FINRA forum, for two reasons. First, as indicated above, it is related to a highly charged policy question. Second, many members of the task force were selected for their expertise and experience with broker-dealer regulation and the FINRA forum. For these reasons, the task force believes that it is unlikely that it could make any recommendation on this issue that would make a meaningful contribution to this debate.

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<sup>147</sup> See *Citigroup Global Markets Inc. v. Abbar*, No. 13-2172 (2d Cir. Aug. 1, 2014) (defining a customer as "one who, while not a broker or dealer, either (1) purchases a good or service from a FINRA member, or (2) has an account with a FINRA member"); *Raymond James Fin. Serv., Inc. v. Cary*, 709 F.3d 382 (4<sup>th</sup> Cir. 2013) (defining customer as "an entity that is 'not a broker or dealer, who purchases commodities or services from a FINRA member in the course of the member's business activities,' namely, 'the activities of investment banking and the securities business'"); *Wachovia Bank, Nat. Ass'n. v. VCG Special Opportunities Master Fund, LTD.*, 661 F.3d 164 (2d Cir. 2011) (holding that hedge fund was not a customer because it did not have a brokerage agreement with the firm and it acknowledged that it received no advice, recommendations or services from the firm).

<sup>148</sup> *Goldman Sachs v. City of Reno* (9<sup>th</sup> Cir. 2014) and *Goldman Sachs v. Golden Empire Schools* (2d Cir. 2014) (yes); *UBS Financial Services v. Carilion Clinic* (4<sup>th</sup> Cir. 2013) (no).

<sup>149</sup> See Richard G. Ketchum, Testimony Before the Committee on Financial Services, U.S. House of Representatives (June 6, 2012) (testifying on H.R. 4624, the Investment Adviser Oversight Act of 2012).

<sup>150</sup> Investment News, *Is Finra pulling its efforts to be the SRO for advisers?*, <http://www.investmentnews.com/article/20140413/REG/304139997/is-finra-pulling-its-effortsto-be-the-sro-for-advisers> (Apr. 13, 2014).

<sup>151</sup> <http://www.finra.org/arbitration-and-mediation/guidance-disputes-between-investors-and-investment-advisers-are-not-finra>.

## UNPAID AWARDS

Unpaid awards present a difficult problem. An aggrieved investor may feel doubly victimized if, after obtaining a monetary award against her broker-dealer, she is not able to collect the money. This is not an issue that is unique to the FINRA forum; investors who recover judgments in judicial proceedings face the same problem. Yet unpaid awards diminish investor confidence and reflect poorly on the securities industry and FINRA. Accordingly, the task force reviewed FINRA's actions against broker-dealers or associated persons who do not pay awards.

FINRA advised the task force that since 2000, firms have been required to notify FINRA in writing within 30 days of receipt of an award that they or their associated persons have paid, or otherwise complied with, the award. FINRA suspends the registration of any firm or associated person that fails to comply with a FINRA arbitration award. In each suspension action, FINRA records in the CRD that the firm or associated person failed to demonstrate payment of an arbitration award. The CRD reference prevents the firm and associated persons from reentering the securities industry until the award has been satisfied. FINRA will stay suspension proceedings only when there is a valid legal basis for nonpayment including circumstances when firms or associated persons timely file an action to vacate or modify any award, and such motion has not been denied, or file for bankruptcy protection, and the award has not been deemed nondischargeable by a bankruptcy court. According to FINRA, suspension, or the threat of suspension, directed at active firms and associated persons often forces payment of the award or settlement to the satisfaction of investors.

In 2013, FINRA issued arbitration awards in 539 investor cases, of which 75 were not paid. The amount of damages awarded and not paid in these cases total \$62.1 million. This dollar amount does not include 19 unpaid awards that were the subject of judicial motions to vacate (which suspends the obligation to pay until the court has ruled on the motion).<sup>152</sup>

FINRA also found that in 15 of the 75 investor awards listed as unpaid, the investor settled with one or more parties before pursuing an award against the remaining (often defaulting) parties. Overall, 51 of the unpaid investor awards were against firms or associated persons that were no longer registered in the industry.

FINRA advised the task force that it has implemented a number of changes to its arbitration program to address the problem of unpaid awards resulting from firms and associated persons that are no longer in business. When an investor files an arbitration claim, FINRA alerts the investor if the respondent firm or associated person is no longer in business. Thus, investors know before pursuing the claim in arbitration that collection of an award may be more difficult. FINRA also prohibits a terminated or suspended firm from enforcing PDAAs, thus permitting those investors to take their claims to court. In addition, FINRA provides streamlined default proceedings for investors where a terminated or suspended firm or associated person does not

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<sup>152</sup> If a broker or firm appeals the denial of a motion to vacate, they must still pay the award or face FINRA suspension unless they obtain a stay of the payment obligation under the rules of the jurisdiction where the appeal is pending.

answer or appear. These measures may help investors obtain more timely judgments against defunct firms and associated persons, but these actions do not always result in collection from defunct firms and associated persons.

In 2014, FINRA considered imposing an insurance requirement for payment of awards, but decided against it. A FINRA spokesperson stated that it had researched the issue and found that the cost would be “prohibitively high.”<sup>153</sup> The task force discussed whether to recommend reconsideration of an insurance requirement for payment of awards, but reached no consensus.

### **FRIVOLOUS MOTIONS TO VACATE**

The task force heard concerns that some broker-dealers may be filing frivolous motions to vacate awards. The task force, however, found no evidence of misconduct, based on the following statistics provided by FINRA:

#### **Motions to Vacate – Outcomes 2010-2013**

<b>Year</b>	<b>Total Motions</b>	<b>Motions Denied or Parties Settled or Motion Withdrawn Prior to Court Ruling</b>	<b>Motions Granted</b>	<b>Joint Motions to Vacate Granted or Motions Unopposed</b>	<b>Motion Pending or Outcome Unknown</b>
2010	24	20	1	0	3
2011	17	17	0	0	0
2012	19	14	3	2	0
2013	19	13	2	2	2

The task force recommends that FINRA continue to monitor this area and, in particular, be alert to motions to vacate explained decisions.

### **SHOULD ARBITRATORS BE REQUIRED TO APPLY THE LAW?**

In its written and oral presentations to the task force, the North American Securities Administrators Association (NASAA) asserted that arbitrators should be required to apply the law. It is NASAA’s position that “[a]rbitration awards must be based on the application of state and/or federal laws applicable to the investor’s claims.”<sup>154</sup>

The task force is in agreement with FINRA’s frequently stated position that the FINRA forum is an equitable forum:

<sup>153</sup> Reuters, Watchdog won’t force brokers to insure against U.S. legal action (Sept. 29, 2014).

<sup>154</sup> NASAA letter to task force (Mar. 30, 2015) at 5.

*Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail. — Domke on Aristotle<sup>155</sup>*

Task force members had differing views on whether FINRA arbitrators must strictly follow the law and reached no consensus on this issue.

## **PROFESSIONALISM**

The task force is aware of complaints about inappropriate conduct by attorneys, but it was presented with no evidence that this is a serious problem. The task force does not believe that FINRA should attempt to regulate the conduct of bad-behaving lawyers by denying them the privilege to practice before the forum. This is best handled by the strong hand of the chairperson of panels and appropriate state lawyer disciplinary authorities.

The task force also heard complaints about poor performance by compensated non-attorney representatives (NARs) and doubts about whether they provide a service to investors. NARs may represent parties in the FINRA forum unless prohibited by state law. FINRA, however, bars individuals from representing parties in the FINRA forum if they are suspended or barred from the securities industry in any capacity or are suspended from the practice of law or disbarred.<sup>156</sup> The task force recommends that a study be conducted to determine how many jurisdictions allow NARs to represent customers in the FINRA forum, whether NARs provide a service to investors with small claims who otherwise would not be able to obtain representation, and whether NARs are performing competently.

## **FUNDING TO LAW SCHOOL ARBITRATION CLINICS**

The FINRA Foundation has provided three-year grants to a few law schools as start-up funding to establish clinics to provide assistance to customers with small claims who are not able to obtain legal assistance. The Foundation's policy is that it expects law schools to provide funds to continue operation of the clinics and that it will not renew the grants beyond the initial three-year term. The task force received reports that, as a result of the Foundation's policy, some clinics will be forced to close.

While the task force supports law school clinics as providing a benefit to small investors and training law students, the task force is not inclined to second-guess the Foundation's policy that limits funding to new or expanded projects with reasonable prospects for post-grant sustainability. The task force believes that an appropriate use of FINRA fines and penalties would be funding of law school arbitration clinics and recommends FINRA consideration. FINRA could, of course, establish reasonable terms and conditions to such grants and may wish

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<sup>155</sup> Arbitrator's Guide at 9.

<sup>156</sup> FINRA Rule 12208(c).

to consider the number of investors who have benefited, or are likely to benefit, from the services of a clinic in a particular geographic area.

## **PROPOSED FINRA-DR MERGER**

On October 13, 2015, the Federal Register published a notice of filing of a proposed rule change to merge FINRA Dispute Resolution, Inc. into FINRA Regulation, Inc.<sup>157</sup> If approved by the SEC, the merger would reverse the 1999 decision to move the dispute resolution program into a separate subsidiary in order to strengthen its independence and credibility. According to FINRA, the proposed merger “would align the legal structure with the public’s perception of FINRA as well as its operational realities” and would “reduce administrative burdens.”<sup>158</sup> The dispute resolution program would continue to operate as a separate department. FINRA states that “while the proposed rule change would change FINRA Dispute Resolution’s corporate status, it would not affect the services and benefits provided by or costs to use the dispute resolution forum, its corporate governance or oversight.”<sup>159</sup> The task force discussed the proposed merger with FINRA staff, who confirmed that the restructuring would not affect any change to the securities and mediation forum except for the name change. Because this rule change filing was published as the task force was nearing completion of its work, it was not able to analyze independently this assertion or make an informed opinion on policy implications. The task force has heard concerns that the proposal, if implemented, would impact negatively investors’ perceptions of the neutrality of the forum.

## **RECOMMENDATIONS**

### **Arbitrators**

1. An increase in the compensation paid to arbitrators for hearings conducted pursuant to FINRA Rules 12600, 12805, 13600, and 13805 from \$300 to \$500 per session.
2. Biennial increases in arbitrator compensation tied to the Consumer Price Index (CPI).
3. Continued efforts to develop effective strategies to recruit aggressively applicants for the arbitrator pool, with a view to increasing both the depth and the diversity of the pool, and to monitor the results.
4. Continued review and monitoring of the arbitrator qualification process to ensure that the goals of processing an application within 120 days and training arbitrators within 120 days of approval are achieved.
5. Continued review of FINRA’s website, as well as its recruitment materials, to ensure that they convey a message of inclusiveness and do not discourage from applying qualified and diverse individuals with a variety of educational backgrounds and work experiences.

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<sup>157</sup> Exch. Act Rel. No. 34-76082, 80 Fed. Reg. 61545 (Oct. 13, 2015).

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

6. In those instances where all non-public arbitrators are struck from the arbitrator selection process, a new list of ten public arbitrators should be generated for that seat. In that way, selection of the all public panel will be made from lists containing 30 potential arbitrators.
7. Challenges for cause because of multiple appointments to related cases should be allowed so long as the challenge is made promptly upon the party learning about the multiple appointments.
8. Arbitrators' training materials and the initial appointment letter should address the possible conflicts that can arise from serving on multiple related cases and emphasize the importance of prompt disclosure.
9. Arbitrators should be required to update their arbitrator disclosure report promptly to report material new information or a material change in their status, and to review, at least annually, their arbitrator disclosure report and either confirm its accuracy or update it to take account of new information.
10. The arbitrator disclosure report should add to the existing list of current cases assigned to the arbitrator the name of counsel and city of counsel's office.
11. Require potential arbitrators to disclose Subject Matter (case-specific) Disclosures earlier in the arbitrator selection process.
12. Section IV of the arbitrator disclosure checklist should be revised to state "registered investment adviser."
13. The IPHC script should emphasize that the parties have the right to ask appropriate questions at that time and that the arbitrators expect questions and will not take exception to them in any manner.
14. Monitor the application of the recently adopted definitions of public and non-public arbitrators in light of concerns that individuals with substantial process and subject matter expertise are stricken from the list of public arbitrators.
15. All arbitrators should be encouraged to complete continuing education programs on a periodic basis.
16. Compulsory training requirements should be considered for arbitrators with a record of poor evaluations, as well as inexperienced arbitrators and arbitrators who have not been recently selected for panels and who do not arbitrate regularly.
17. Increased training for chairpersons.
18. NAMC should engage an outside consultant to study and design the specific type of coursework to be offered.
19. Increased education regarding the usefulness of arbitrator evaluations, as well as efforts to encourage chairpersons to emphasize the importance of filling out the evaluations to the parties at the conclusion of the hearing and to the panel members during the subsequent deliberations.
20. Develop a procedure for advising arbitrators about a proposed rule change and how they can comment on it and notifying them of adoption of proposed rule changes.

## **Explained Awards**

1. The FINRA rule should be amended to require explained decisions unless any party notifies FINRA, prior to the IPHC, that it does not want an explained decision.
2. The current brief, fact-based format of the explanation should be retained, but with the addition of some summary explanation of the reasons behind any damage calculation.
3. Before any plan to expand the use of explained decisions is implemented, FINRA must develop and administer a training program on how to write explained decisions. Chairpersons must complete the training promptly after they are notified that an explained decision is expected in an assigned case.

## **Expungement**

1. Creation of a pool of trained, experienced arbitrators to conduct expungement hearings in settled cases and in all cases where claimants did not name the associated person as a respondent.
2. Development of enhanced arbitrator training with regard to the expungement process, including clearer guidance on the Rule 2080 grounds for expungement, which will be required of chairpersons who conduct expungement hearings for cases that were decided after a hearing.
3. Review of procedures for notifying state regulators of expungement requests.

## **Small Claims**

1. Development of an intermediate form of adjudication for small claims – more than the papers, but less than a full hearing – in which the claimant and respondent appear before an arbitrator and have the opportunity to explain their positions and respond to their adversary's positions.

## **Mediation**

1. An automatic mediation process for cases filed in arbitration, subject to an opt-out by any party.
2. Financial incentive for parties who have achieved a final and complete resolution of their dispute through mediation, by refunding part of their mediation and arbitration fees.
3. A formal, mandatory continuing education program for new mediators and a continuing education program for all mediators.
4. More opportunities for inexperienced mediators to gain experience and training.
5. A formal mentoring program in which experienced mediators would permit new mediators to shadow them and perhaps co-mediate with them.
6. Aggressive efforts to recruit, train, and encourage the use of more diverse mediators.

7. Mediator training should include alternatives to mediation and the requirements for handling them correctly.

### **Motions to Dismiss**

1. Rule 12504(a) should be amended to include one additional category for which motions to dismiss may be made before the conclusion of the case in chief: situations where the dispute has been previously concluded through adjudication or arbitration and memorialized in an order, judgment, award or decision.

### **Case Management – Procedural Issues**

1. Review of procedures to encourage expeditious scheduling of hearings.
2. With respect to expedited hearings for senior and seriously ill parties, implementing procedures to insure that once the expedited process is selected, the goals of achieving an expedited process and hearing are achieved.
3. Amend FINRA Rules 12402 and 12403 to use the first answer due date as opposed to the last answer due date.
4. Take steps to emphasize to arbitrators the need to avoid late recusals and the perceived problem of double-booking.
5. Develop a formal disciplinary process to deal with arbitrators who engage in last-minute recusals without good cause.
6. Revise the document production list of presumptively discoverable documents for the firm/associated person to require production of all insurance policies that may be applicable to claimants' claims.
7. Revise the IPHC script to make clear that the parties may agree to modify hearing procedures, including the use of any type of technology, in the interest of efficiency and cost-effectiveness, subject to the arbitrators' discretion for good cause.
8. Develop a feature on the party portal which allows a party to view all costs on an on-going basis.
9. Adding language to the IPHC script to strongly discourage the practice of phantom retention of experts.

### **Public Availability of Information**

1. Take steps to improve the informational content of awards, including (a) educating arbitrators on the importance of a detailed summary of the issues and products involved in each award and (b) providing a template or examples of the items an arbitrator should consider including in an award summary. In particular, arbitrators should be trained to describe briefly the claims and defenses presented at the hearing, rather than to set forth the claims and defenses contained in the pleadings.



2. Certain substantive decisions, such as injunctive orders or final dismissals, should be treated as awards and be available in FINRA's Arbitration Awards Online (AAO) database.

### **Transparency**

1. FINRA should adopt a policy of promoting, to the maximum extent possible, transparency about its dispute resolution forum.
2. FINRA should reinstate its prior practice of disclosing on its website the names of NAMC members.

### **Frivolous Motions to Vacate**

1. Continue to monitor this area and, in particular, be alert to motions to vacate explained decisions.

### **Professionalism**

1. Conduct a study on NARs.

### **Funding to Law School Arbitration Clinics**

1. Consider funding of law school arbitration clinics through FINRA fines and penalties.

## **Appendix I**

### **FINRA DISPUTE RESOLUTION TASK FORCE MEMBERS**

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Morgan Stanley Wealth Management

## Appendix II

### FINRA Dispute Resolution Task Force Issues

December 2014

#### 1. Access to FINRA Forum

- Mandatory nature of arbitration; FINRA Rule 12200
- Definition of “customer”
- Inclusion of investment advisers/firms
- Class action waivers
- Cost/funding

#### 2. Arbitrators

- Disclosures; information on arbitrator disclosure reports
- All-public panel option
- Classification of arbitrators
- Depth and quality of arbitrator pool
- Evaluations
- Assignment of arbitrators to multiple cases
- DR Portal

#### 3. Case Management Issues—Substance

- Motions to dismiss
- Eligibility rule

#### 4. Case Management Issues—Procedure

- Last-minute recusals; mandatory adjournment
- Mandatory direct communication
- Discovery issues
- Use of technology to lower costs and improve efficiency
- Professionalism of practitioners
- FINRA accounting for costs

#### 5. Reasoned Awards

## **6. Expungement**

- When is it appropriate to expunge information from a broker's record?
- How should the expungement process work?

## **7. Large Claims**

- Can the forum be made more attractive to large claims?
- Issues of institutional investors (forum selection clauses)

## **8. Small Claims**

- Can a better process be devised to handle small claims, especially pro se claimants?
- Costs of arbitrating small claims
- Funding to law school clinics
- Pro bono initiatives
- Use of technology (e.g., telephonic hearings)

## **9. Mediation**

- Should greater use of mediation be encouraged?
- Opt out instead of opt in

## **10. Educating Participants and Public About the Arbitration Process and Transparency**

- Arbitration awards; FINRA Rule 12904
- Expansion of FINRA award database to include other awards (e.g., JAMS, AAA, etc.)
- More information on FINRA website
- How should FINRA solicit and use information from forum users on an ongoing basis?
- Indemnification agreements/brokers' countersuits against investors
- Unpaid awards

## **11. Motions to Vacate Arbitration Awards**

Are some attacks on arbitration awards frivolous?

## **Appendix III**

### **FINRA DISPUTE RESOLUTION TASK FORCE**

#### **INDIVIDUALS AND ORGANIZATIONS THAT WERE SOLICITED TO SUBMIT WRITTEN COMMENTS**

American Arbitration Association

American Association for Justice

American Association of Individual Investors

American Association of Retired Persons

American Bar Association

Americans for Financial Reform

Association of Mature American Citizens

Better Business Bureau

Better Markets

Commodity Futures Trading Commission

Conflict Prevention and Resolution

Consumer Financial Protection Bureau

Consumers Union

Council for Institutional Investors

Financial Services Institute

Fund Democracy

Gupta Beck PLLC

Investment Adviser Association

Judicial Arbitration and Mediation Services

National Association of Consumer Advocates

National Consumers League

National Futures Association

North American Securities Administrators Association

Professor James D. Cox, Brainerd Currie Professor of Law, Duke University School of Law

Public Citizen

Public Investors Arbitration Bar Association

Public Justice

Securities and Exchange Commission

Securities Arbitration Commentator

Securities Industry and Financial Markets Association

SICA

University of Miami School of Law Investor Rights Clinic

US Chamber of Commerce

## **ORGANIZATIONS THAT SUBMITTED COMMENTS**

American Association for Justice

American Bar Association

Financial Services Institute

North American Securities Administrators Association (two submissions)

Securities Arbitration Commentator

University of Miami School of Law Investor Rights Clinic

Securities Expert Roundtable (not solicited)

**The following organizations submitted one joint submission:**

Americans for Financial Reform

Consumers Union

National Association of Consumer Advocates

National Consumers League

Public Citizen

Public Investors Arbitration Bar Association

Alliance for Justice (not solicited)

Center for Justice and Democracy (not solicited)

US PIRG (not solicited)



## Appendix IV

# FINRA DISPUTE RESOLUTION TASK FORCE

## INTERIM SUMMARY OF KEY ISSUES

June 2015

The FINRA Arbitration Task Force met on May 14-15, 2015 and reviewed the reports and recommendations made to date by the ten subcommittees set up to study the issues identified in the Task Force Issues Outline posted on the FINRA website. The Task Force is issuing this Interim Summary of Key Issues at this time so that it can alert users of the forum, arbitrators, mediators, and the general public to its current thinking on the key issues before it. It hopes, in this way, to generate additional input on these, and any other, issues related to the FINRA arbitration forum.

The Task Force emphasizes that it took no formal votes on any issue. What is set forth below represents what appears to be the group's consensus at this time. The Task Force did not sign off on any topic and did not foreclose further discussion of any matter, including additional topics. Individual members of the Task Force may reconsider their views on any particular issue; accordingly, even the positions currently supported by consensus may change, and the recommendations contained in the Task Force's final report (scheduled for release at the end of 2015) may be different from those suggested here.

**The Task Force reached consensus that it would likely make recommendations on a number of issues.** Significant issues include:

- I. *Class action waivers.*
  - a. Class action waivers should not be allowed in broker-dealers' PDAAs, and the FINRA policy set forth in *Schwab* is strongly endorsed.
- II. *Arbitrators: selection and disclosure.*
  - a. Develop a rationale and procedure for *voir dire* of panel members and provide examples of appropriate questions.
  - b. Propose modifications to the list selection process in light of the all-public panel option.
  - c. Monitor the application of the recently adopted definitions of public and non-public arbitrators in light of concerns that individuals with substantial process and subject matter expertise are stricken from the lists.
  - d. Strengthen disclosure requirements to highlight potential conflicts when arbitrators are assigned to multiple cases with the same witnesses, experts, documents, etc.
- III. *Arbitrators: Training.*
  - a. All arbitrators should be encouraged to complete continuing education programs on a periodic basis. In addition, compulsory training requirements should be

considered for inexperienced arbitrators, arbitrators who have not been recently selected for panels, and arbitrators with a record of poor evaluations. The Task Force recommends that NAMC engage an outside consultant to study and potentially design the specific type of coursework to be offered.

- b. Arbitrators should receive additional training on drafting the summary description of the award, including the development of templates or examples of descriptions. See also 7.c below.

IV. *Arbitrators: Recruitment.*

- a. FINRA should aggressively recruit applicants for the arbitrator pool, with a view to increasing both the depth and the diversity of the pool. In addition, it should review the arbitrator registration process and consider modifications to streamline the process.

V. *Motions to Dismiss.*

- a. Expand the grounds for Motions to Dismiss Prior to Conclusion of Case in Chief to include situations where the dispute was previously adjudicated by an order, judgment, award or decision.

VI. *Discovery Guide.*

- a. Add insurance policies for firms and associated persons to respondents' list of discoverable documents.

VII. *Explained Decisions.*

- a. The FINRA rule should be amended to require explained decisions unless either party notifies FINRA, prior to the IPHC, that it does not want an explained decision.
- b. The current brief, fact-based format of the explanation should be retained, but with the addition of some summary explanation of the reasons behind any damage calculation.
- c. Before any plan to expand the use of explained decisions is implemented, FINRA must develop and administer a training program on how to write explained decisions; chairs must complete the training promptly after they are notified that an explained decision is expected in an assigned case.

VIII. *Large Cases.*

- a. FINRA should seriously consider the adoption of a mandatory set of procedures for large claims, i.e., matters where the actual damages sought are at least \$20 million, exclusive of consequential or punitive damages and attorneys' fees. The rules would, in general, give parties flexibility to set up alternative procedures to the FINRA rules, including an alternative method of selecting arbitrators. Limited use of depositions would be expressly authorized.

IX. *Small Cases.*

- a. Develop an intermediate form of adjudication for small claims in which the claimant and the respondent appear before an arbitrator and have the opportunity to explain their positions and respond to their adversary's positions. Parties would be able to appear in whatever manner they prefer: in person, by phone, or by video conference. Arbitrators would be specially qualified and

trained for this role. How these sessions would be conducted is a matter for further discussion.

X. *Mediation.*

- a. Automatic mediation process for all cases filed in arbitration, subject to an opt-out by either party.
- b. Development of a formal, mandatory continuing education and mentoring program for new mediators.
- c. Development of a continuing education program for all mediators.
- d. FINRA should develop opportunities for beginning mediators to gain experience and training.
- e. FINRA should compile data, on a voluntary basis, of the race and gender of mediators and should undertake aggressive efforts to recruit, train and encourage the use of more diverse mediators.

XI. *Transparency.*

- a. FINRA should adopt a policy of promoting, to the maximum extent possible, transparency about its dispute resolution forum. FINRA should use its good judgment in evaluating what data and information can be released to the public, even if it requires some expense to redact or remove personal or confidential information prior to release. For example, FINRA might consider the release of arbitrators' evaluations with redaction of identifying information because it could shed light on the performance of panels.
- b. We specifically recommend that FINRA reinstate its prior practice of disclosing on its website the names of NAMC members.

XII. *Expungement.*

- a. The Task Force has been made aware that FINRA and NASAA are in discussions with respect to the expungement process. It was the consensus that it should allow time for FINRA and NASAA to complete their discussions on the feasibility of a new regulatory approach and process. The Task Force will give further consideration to the creation of a Special Arbitration Panel consisting of specially trained arbitrators to decide requests for expungement.

XIII. *DR Portal.*

- a. The Task Force supports efforts to improve the functionality of the DR Portal.

**The Task Force reached consensus that, at least at this time, it did not expect that it would make any recommendations on some topics.** They include:

I. *The All-Public Panel Option.*

- a. The Task Force does not anticipate making a recommendation to change the existing right of claimants to select an all-public panel.

**The Task Force decided that, on certain issues, it was not ready to state even a tentative position and it would continue to review and discuss those topics.** They include:

- I. *Forum Access.*
  - a. Whether broker-dealers may continue to require customers to sign PDAA's under the current system; whether customers should have the choice, post-dispute, to choose between arbitration or litigation; whether broker-dealers should be required to offer at least some customers a brokerage contract that does not include a PDAA; whether broker-dealers should be required to include non-SRO forums as an option in PDAA's.
- II. *Arbitrator Disclosure Requirements.*
  - a. Comprehensive arbitrator disclosure requirements (both general and case-specific) are necessary for the users of the forum and the public to have confidence in the fairness and impartiality of the system, yet they should not be unduly burdensome and discourage qualified individuals from serving as FINRA arbitrators.
- III. *Arbitrator Recruitment.*
  - a. The Task Force agrees that a deep and diverse pool of arbitrators is important to the operation of the forum, yet expressed different views about the most important characteristics of the appropriate arbitrator. Simply put, should the arbitrator more closely resemble a juror or a judge? Is the solution to develop a pool with enough variety of arbitrators so that the parties can select the type of arbitrator they want for a particular case?
- IV. *Arbitrator Compensation.*
  - a. The Task Force received many comments from arbitrators expressing dissatisfaction with arbitrator compensation, but recognizes that the comments may not take account of FINRA's recent increases.
- V. *Unpaid Awards.*
  - a. The Task Force explored options to address the problem of unpaid awards, including the hiring of a consultant to review the feasibility of setting up and funding an insurance fund or insurance policy to assist customers with unpaid awards.

## **APPENDIX V**

From Oct. 10, 2014 (the date of the establishment of the subcommittees) until Dec. 7, 2015 (the date of the task force's approval of the report), the subcommittees met telephonically to discuss their assigned topics, as set forth below. In addition to telephonic meetings, the subcommittees exchanged frequent emails to continue their discussions.

Each subcommittee had a FINRA staff person assigned as its liaison, who provided requested data for the subcommittee's review. In addition, subcommittees reviewed comments received via the DR Mailbox, as well as relevant commentary and literature related to their topics. Additional outreach by subcommittees is set forth below.

### **Forum Access**

4 meetings

### **Arbitrators**

6 meetings of entire subcommittee

3 meetings of voir dire working group

### **Case Management – Substantive Issues**

5 meetings

### **Case Management – Procedural Issues**

5 meetings

### **Explained Awards**

3 meetings

### **Expungement**

5 meetings

Outreach to NASAA, FPA, PIABA, AAJ, SIFMA and individual practitioners

### **Large Cases**

3 meetings

### **Small Claims**

3 meetings

Outreach to directors of Securities Arbitration Clinics

**Mediation**

8 meetings

Outreach to individual FINRA mediators and practitioners

**Education and Transparency**

3 meetings

Outreach to members of FSI and SIFMA, broker-dealer counsel and other practitioners