Securities Arbitration & Mediation Hot Topics 2017

Nuts and Bolts: Securities Arbitration

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I. Introduction

If you are involved in a dispute regarding securities, then you are likely involved in a FINRA arbitration. While securities arbitration can be held in other forums, such as the American Arbitration Association ("AAA") or JAMS, "[t]he Financial Industry Regulatory Authority (FINRA) 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."[2] In fact, FINRA's Dispute Resolution division manages more than 99 percent of U.S. securities-related arbitrations and mediations, and "maintains a roster of more than 6,400 arbitrators and nearly 250 mediators."[3]

The fact that most broker-dealers are members of FINRA, and that their employees are accordingly associated persons of member firms, plays a large part in FINRA's predominance in securities dispute resolution. FINRA members are governed, in part, by the FINRA Bylaws, Rules and Regulations and its Code of Arbitration Procedures. Under these governing documents, FINRA members and their associated persons must submit to arbitration, not only when there is a dispute between members or between members and associated persons, but also when there is a dispute between a customer and a member or associated person (if the customer requests arbitration). In fact, a member's failure to submit a request for arbitration "may be deemed conduct inconsistent with just and equitable principles of trade."[4] Importantly, since 1987, broker-dealers have been able to enforce pre-dispute arbitration agreements between them and their securities customers.[5] As a result, brokerage firms and brokers may compel a client to arbitrate when a dispute arises between them. Consequently, in most instances, customer disputes are resolved before the FINRA Dispute Resolution Department.

Accordingly, this article will address the nuts and bolts of securities arbitration specifically in the FINRA forum.

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[2] FINRA Dispute Resolution Task Force, "Final Report and Recommendations of the FINRA Dispute Resolution Task Force." The full text can be found at: http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf.

[3] *Id.*

[4] FINRA Rule 2010. The text of the rule may be found at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.

[5] Shearson/American Express Inc. v. McMahon, 482 U.S. 220 (1987).

II. Getting Started: Witness Interviews and Document Reviews – The Essentials

Whether you are commencing a FINRA Arbitration or defending one, your initial task will be to get your story straight and determine what the other side's story is or may be.

If you are claimant's counsel, your story starts with your client and the documents that your client has within his or her possession, custody or control. Assessing the viability of a claim requires more than just listening to the client's story. You must assess whether the story is supported by the client's documents. Are the claims viable or are they stale? Is the client credible or is there a less than sympathetic backstory to the dispute propelling the action? What support will the client be able to muster? Do you need to get additional account statements, trade confirmations or other fundamental documents from the client's brokerage firm?

If you are defending a customer claim, your story begins with a review of the Statement of Claim (the "Claim") filed by the aggrieved customer. Are there exhibits attached to the Claim which will direct you to the right witnesses to interview? What additional documents will you need in order to assess the allegations asserted in the Claim? Importantly, you will need to put your detective's hat on and investigate the customer. What are the customer's employment status, profession, education, income, net worth, risk tolerance, investment horizon, investment goals, and trading experience? You will want to take a look at the trading within the customer's accounts, the commissions associated with that trading, and any communication between the brokerage firm and/or the broker and the customer. Ultimately, you will likely need to review the new account documents that identify what the broker knew about his customer. You will also want the broker's story. Talk to the broker. Seek out his or her supervising manager(s), compliance manager, sales assistant, and any other employees at the branch who had contact with the customer. You also will want explore the broker's complaint history. For instance, have other customers complained about the very same trading style in this very stock, all of which was marked unsolicited. Is there an issue with the security in dispute? Is the complaint about a point-of-sales issue or the product itself? Sometimes, you can determine out of the gate if you have an issue with the case, the product and/or with representing the broker.

1. Joint Representation and Conflict Issues – Keep Them Front of Mind

Beware that you know who you represent during these interviews. For example, if you are representing both the brokerage firm and the broker, then you must ensure there is no present conflict between the two. Make it clear to all parties that there exists a possibility of a conflict, and also explain what happens in the event of an actual conflict. Reducing this to writing is in everyone's best interest. A conflict waiver letter will serve you well as the relationship develops. It is unlikely you will be aware of all the essential facts at the beginning of the relationship, and you want to ensure that everyone understands the limits of your representation in the event of a conflict. You will eventually need to reassess your ability to continue joint representation as you become more entrenched in the facts of your case.

Joint representation will also be an issue if you represent more than one Claimant. The same analysis and disclosures should be made when you represent several Claimants, even if their interests initially appear to be aligned.

2. Corporate Miranda and Upjohn Warnings – To Be Forewarned

If the individuals you need to interview are not named as parties in the arbitration (this may also be the case for the broker), then joint representation is not necessary. Disclosures, nonetheless, are necessary. When your interview begins, everyone in the room must be clear as to who is and who is not your client. Everyone must know who can assert the attorney-client privilege, who may be covered by the privilege but cannot necessarily assert it, and who is not covered by the privilege. If you are counsel for the brokerage firm, it must also be clear that you are not counsel for the individual you are interviewing, and that YOU CANNOT GIVE THEM LEGAL ADVICE. These "Upjohn Warnings,"[6] sometime called mini- or corporate-Miranda Warnings, should be given before you begin your questioning. Failure to do so can be a dangerous misstep. So be forewarned, always forewarn.

You should also be aware that, in the event you are interviewing a former employee, your communication may only be privileged if they meet the Upjohn factors. In determining the scope of the attorney-client privilege in the corporate setting, a Court will evaluate "whether the communications at issue (1) were made at the direction of corporate superiors, (2) were made by corporate employees, (3) were made to corporate counsel acting as such, (4) concerned matters within the scope of the employee's duties, (5) revealed factual information not available from upper echelon management, and (6) revealed factual information necessary to supply a basis for legal advice, and whether the communicating employee was sufficiently aware that (7) he or she was being interviewed for legal purposes and (8) the information would be kept confidential."[7] It is possible that knowledge acquired by the former employee after that individual's employment ended may not be covered by the privileged.[8] Moreover, at least in Washington State, even if the Upjohn standards are met, the communication may not be considered privilege.[9] In fact, your interview notes may not be deemed attorney work product.[10]

Now you have interviewed your witnesses and reviewed the initial documents. Hopefully, your witness accounts are in accord with your documents, and between the two you have what you need to answer the Claim.

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[6] See Upjohn Co. v. United States, 499 US 383 (1981).

[7] Newman v. Highland Sch. Dist. No. 203, 186 Wash. 2d 769, 778 (2016); see also Upjohn, 449 U.S. at 394-95 and Upjohn, 449 U.S. at 403 (Burger, C.J., concurring).

[8] Peralta v. Cendant Corp., 190 F.R.D. 38, 40, 41 (D. Conn. 1999).

[9] Newman, 186 Wash. 2d at 779; see also Carl A. Aveni, *Attorney-Client Privilege Does Not Apply to Former Employees*, ABA LITIGATION NEWS, Contributing Editor (Jan. 31, 2017). The full text can be found at: https://apps.americanbar.org/litigation/litigationnews/top_stories/013117-privilege-former-employees.html.

[10] See, e.g., Bowne of New York City, Inc. v. AmBase Corp., 150 F.R.D. 465, 471 (S.D.N.Y.1993); see also Rick Conner and Bradley R. Kutrow, *The Applicability of Privilege and Work Product Protection to Communications with Former Corporate Employees*, THE LITIGATOR, North Carolina Bar Association, Vol. 36, No. 1 (Aug. 2015). The full text can be found at: http://media.mcguirewoods.com/publications/2015/Litigator-August-2015.pdf.

3. The Pleadings - Your Opening Volley

The initial pleading will be your opening volley. MAKE IT GOOD.

If you are filing the Claim, remember this will be Arbitrator Exhibit 1. It will be your first impression with the arbitrators. The arbitration forum provides you with an opportunity to tell a story—something lacking in court litigation. Take advantage of that freedom. Show why your client is sympathetic, what the relationship was between your client and his or her broker, and how that relationship was abused. Explain the damage your client has suffered and what is required to make him or her whole. Remember to attach the exhibits you need to make this point.

If you are filing an Answer, use this opportunity to describe the virtues of your broker and brokerage firm, the experience and sophistication of the client and his or her trading history, and why the Claim lacks merit. While you may choose to Answer the Claim in whatever fashion you believe appropriate, sticking to "Admit," "Deny," and "Deny Knowledge and Information" may be a lost opportunity to make a strong first impression. Indeed, the Code of Arbitration Procedure anticipates that a full factual response will be given in the Answer.[11] Like the Claimant, you should choose the exhibits to your Answer carefully. They will be in evidence.

As a caution for both claimants and respondents, be careful not to overstate your case. Like an Opening Statement, if you plead a case you cannot support your adversary will likely point out your folly to the arbitration panel. For example, if you have a strong unauthorized trading case, make your case and avoid trying to plead a market manipulation case that you cannot prosecute. Similarly, if the brokerage firm has a strong market adjustment case, defend that case rather than trying to turn a 90-year-old claimant with a high school education into a sophisticated investor. When you Open (pleading or oral), know what you can prove at your Close.

Remember the Claim is Arbitrators' Exhibit 1 and entered into evidence without a fight. Therefore, you should strongly consider attaching the documents which make the strongest statements on your client's behalf. Be conscious, however, that these documents often contain personal information about the client, e.g., social security numbers, account numbers (brokerage and bank), etc. Similar to filing papers in court, when you file documents with FINRA, you are required to ensure that personal and private information is redacted to secure the privacy of the parties. This information will not only be on the client's documents, but may also be on the broker's documents if you are including information from the broker's personnel file.

[11] FINRA Code of Arbitration Procedure Rules 12303 and 13303, stating an answer must "specify[] the relevant facts and available defenses to the statement of claim."

4. Arbitrator Selection – Think Jury Selection

Approximately 30 days after the last answer is due[12], FINRA will begin the task of assigning arbitrators to hear your dispute. FINRA Arbitrator selection is a List Selection Process.[13] Under this process, the parties are presented with a list of 30 potential arbitrators divided into to three categories (Chair, Public and Non-Public) or two categories (Chair and Public). Since 2013, in customer cases that proceed with three arbitrators, all parties have the option to select an all-public panel. They can do so by striking all of the arbitrators from the non-public arbitrator list.[14]

Arbitrators are both the "finders of fact" and the "determiners of the law." Their experience and expertise will vary immensely, and their selection (as discussed above) is based on the parties' preferences. There was a time when the arbitration panel contained one individual who had experience in the securities industry—the "Industry Arbitrator"—but that role has been largely abandoned. Therefore, the arbitrators sit less for their expertise in the subject matter, and more upon who the parties believe will be more sympathetic to their story. In this way, arbitrators are much more akin to juries than to judges. The selection of your arbitrator may, therefore, be one of the most constructive dedications of time in the prosecution or defense of your case.

As part of this process, FINRA provides the parties with Disclosure Reports—biographies—of the 30 potential arbitrators and access to the potential arbitrator's former awards. The parties may conduct their own investigation of the potential arbitrators, and may also ask the arbitrators questions through FINRA.[15] The parties may strike an enumerated number of arbitrators from each category, and then must rank the remaining arbitrators—"1" being their first choice.[16] After combining the lists and producing a combined ranking, the lowest ranked arbitrators are appointed to the panel. Therefore, while it is unlikely both parties will get their first choice arbitrator, it is also unlikely they will get their least favorite arbitrator.

5. Experts – Do They Have Something to Add?

Your view of an expert's value may turn on whether you are the claimant or the respondent. As a general note, claimants are more likely to want to show that the trading in their account or the handling of their relationship was complicated – too complicated and therefore, beyond the understanding of mere mortals. Surely, if the arbitrators could not understand the trading how could the claimant. The appearance of an expert to explain that complicated trading, therefore, makes sense and may, in and of itself, drive home that point. Conversely, in gross general terms, the respondent would like to show that not only was the trading/handling of the client's account straight forward, it was absolutely within the client wheel house to understand it

[12] FINRA Arbitration Code of Arbitration Procedure Rules 12402(c)(1) and 12403(b)(1) .

[13] FINRA Arbitration Code of Arbitration Procedure Rule 12400.

[14] FINRA Arbitration Code of Arbitration Procedure Rule 12403(c)(1)(A).

[15] FINRA Arbitration Code of Arbitration Procedure Rule 12402(c)(2)

[16] FINRA Arbitration Code of Arbitration Procedure Rule 12402(d).

and, in fact, the client controlled it. Therefore, an expert may be less helpful to the respondent. However, not all experts need to be testifying experts. The respondent may retain an expert to conduct profit and loss calculations or assess alternative investment comparisons; or, the respondent may retain an expert to attend the hearing to listen to the claimant's expert testify for purposes of testifying to a contrary or alternative interpretation. Ultimately, the respondent may decide that cross-examining the claimant's expert is sufficient to achieve respondent's purpose.

If your case involves a product an expert may be the best way of explaining the product. Once again, it is unlikely a respondent would want the product to appear too complicated for the customer to have understood. However, the respondent may find the expert a valuable asset in disabusing the panel of negative media coverage of a particular type of investment.

Suffice it to say, experts may be used for more than merely explaining a trade to an arbitration panel, or establishing the standard for supervision. The use of an expert is a strategic decision, and one very different from the decision to retain an expert to consult with counsel. This is a fact-specific exercise that should be part of the overall strategy of your case.

6. Cross-Examination – The Crux of The Matter

You have presented your best foot forward in your pleading and opening statement and your client has had his or her say. Have you swayed the arbitrators? Maybe. But a client's ability to put on their direct case is expected. Can your client withstand cross-examination? More importantly, can you expose the truth of the matter in the cross-examination of your adversary's client? Cross-examination will be the defining moment in your arbitration, just as it would be in court before a jury.

How do you prepare yourself and your client for the big moment? Know your documents and know what testimony will be derived from other witnesses. There will always be documents that you will not introduce because they do not advance your case, or worse, they affirmatively hurt your case. You must prepare your client to address these documents and why they are not as damaging as they might appear at first glance. You must also prepare your client for what it feels like to be cross-examined and why it is ill-advised to try to outsmart opposing counsel.

As to the cross-examination of your adversary's client, know everything the documents can tell you and then some. What did you find from public records about this witness? What has this witness been saying on the internet that might be contrary to the position the witness has taken in the hearing.

Know the specifics both your own witnesses and your adversary's witnesses, regardless of whether they have come to light in the pleadings. In addition, know the facts surrounding your case. What was the market doing at the time of the trades at issue? What was the news about the market, the stock, your client, and your adversary? What must you get into the record to give the arbitrators a full picture of the events as they unfolded? How can you take the panel back to that period in time when hindsight was not available to judge what was and was not the best next move?

While these are all very specific events, they fit into your big picture approach to your prosecution/defense of the matter. What are you trying to show and how can these particularities assist you in getting there?

7. Explained Award – A Rose by Any Other Name

Usually FINRA Awards are not explanatory. They explain who the parties are, the claims, the defenses to that claims, and any cross-claims. The number of hearing sessions is also detailed, as well as any collateral matters heard by the arbitration panel. But the actual award is simply put: Denied or Awarded (with a damage number), accompanied by an allocation of FINRA Fees.

If the parties want a more descriptive discussion of why the arbitrators came to their conclusion, they must affirmatively ask for that description in advance—called an "explained decision."[17] Note that legal authorities and damage calculations are not required; the explained decision merely states the general reasons for the arbitrator's decision. Parties must make a joint request for an explained decision 20 days before the date of the first scheduled hearing. Beginning January 3, 2017, as part of a new FINRA initiative, if the parties jointly request an explained decision, FINRA will waive the $400 fee.

There has been much debate about whether a more descriptive basis for an arbitration award would make the process seem more fair.[18] In fact, a 13-member FINRA Task Force recently addressed the wisdom of explained decisions.[19] The task force believes "the availability of explained decisions would improve the transparency of the forum." However, the question of whether you want a reasoned decision should not be taken lightly. As a general rule, FINRA Arbitration Awards have no precedential value in other cases. However, parties may nonetheless attempt to treat them as if they do. Explained decisions may lead to an increase in this practice. More importantly, the arbitration process is meant to be final. An explained award will likely lead to more motions to vacate the arbitration award, especially given the fact that courts are often unwilling to infer grounds for vacatur absent an explanation for the arbitrators' decision.[20] Indeed, the Task Force recognized that "[a]mong 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."[21]

Also to be considered is whether the losing party will be appeased or appalled by a description of why they failed to carry the day. If the decision was based upon lack of credibility, will the explained award engender more animosity toward the arbitration forum or less?

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[17] FINRA Code of Arbitration Procedure Rules 12904(g) and 13904(g).

[18] See Jill I. Gross & Barbara Black, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (Feb. 6, 2008). The full text can be found at: http://ssrn.com/abstract=1090969.

[19] Final Report and Recommendations of the FINRA Dispute Resolution Task Force (December 16, 2015). The full text can be found at: *available at* http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf.

[20] *See, e.g.*, *Robbins v. Day*, 954 F.2d 679, 684 (11th Cri. 1984) ("It is well settled that arbitrators are not required to explain an arbitration award and that their silence cannot be used to infer a grounds for vacating the award.").

[21] Final Report, *supra* n. 19, at 21.

Conclusion

Each case is an individual mosaic of facts and legal theories. Know what you envision your big picture to be so you can set your road. God is in the details, and you may win and lose based upon whether your particular facts rule the day. However, understanding where your case and facts fit into the big picture of market movement and bad/good news will provide you a method of explaining the actions of the parties to the arbitrators in a way they can understand the facts and the dynamics of the parties. Once you figure this out yourself, the strategic decisions, like whether to retain an expert or not, will be easier to resolve.

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