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**SECURITIES ARBITRATION:
WHAT TO DO AND WHEN**

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Needless to say, angry investors exist. According to figures recently released by FINRA, new arbitration cases filed between January and May 2009 jumped 110 percent, compared with the same period in 2008. Further, new rules have made it more difficult to have claims dismissed. The purpose of this presentation is to provide insight into the arbitration process to help protect the interests of your firm.

As demonstrated by the charts below, although the investor win rate during the past decade have fallen slightly, success before a FINRA arbitration panel is anything but a sure thing. As the materials that follow reveal, a complete understanding of the facts of a given case and a solid grasp of the arbitration process and rules will go far to ensure that the firm's interests are protected from the service of the Statement of Claim to the confirmation of the arbitration award.

FINRA 1997-2009 Investor Arbitration Win Rate¹			
<u>Year</u>	<u>Win Rate</u>	<u>Year</u>	<u>Win Rate</u>
1997	58%	2003	49%
1998	60%	2004	47%
1999	61%	2005	43%
2000	53%	2006	42%
2001	54%	2007	37%
2002	53%	2008	42%
		2009 (as of May)	47%

Solin/O'Neal: Award as a Percent of Amount Claimed²			
<u>Year</u>	<u>Percent</u>	<u>Year</u>	<u>Percent</u>
1995	59%	2000	61%
1996	61%	2001	58%
1997	63%	2002	49%
1998	68%	2003	49%
1999	62%	2004	50%

¹ FINRA statistics, [http:// www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/index.htm](http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/index.htm). A check of the FINRA Web site on April 30, 2008 revealed that the results for prior to 2002 had recently been deleted. The results set forth for FINRA reports in this table for those years were obtained prior to the deletion.

² Edward S. O'Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare* (2007) at 11. Solin and O'Neal point out that figures reflecting the amount recovered in relation to the amount claimed in an arbitration proceeding are subject to many variables, and, in particular, inflated damage claims, which may render these figures less meaningful in evaluating arbitration Awards. It must, however, be noted that in general these figures follow a similar pattern of decline for investors as noted in the declining investor win rate. Further, there is no empirical data to support the impact of possibly inflated claims on these statistics. FINRA has recently adopted a hearing script change designed to have claimants confirm their damage requests during the arbitration hearing, which may give greater assurance as to the accuracy of losses claimed for the purpose of calculating recovery rates.

I. DISPUTES LIKELY TO RESULT IN ARBITRATION CLAIMS

A. Reasons Customers File Claims

1. Customer Grievances That Are Ignored
 - a. Client's claims are not properly reviewed or addressed when raised
 - b. Management fails to fully review the allegations
 - c. Management denies the claim without completing a full investigation
2. Disputes With Clients Who Have "Nothing to Lose"
 - a. Wealthy clients who are dissatisfied with their broker will be willing to finance a claim
 - b. Middle income clients, who have lost enough of their net worth, will feel as if they have no alternative
3. Disputes Related to a Broker or Firm Sanctioned by Regulators
 - a. Sales Practices
 - (i) Firms offering both Investment Advisor and Broker Dealer services
 - b. Failure to Supervise
4. Disputes Related to "High Risk" Accounts

- a. Discretionary Accounts
- b. Retirement Accounts
- c. Elderly Customers

B. Types of Controversies Involved (See Appendix A)

- 1. Breach of Fiduciary Duty
- 2. Misrepresentation
- 3. Negligence
- 4. Breach of Contract
 - a. Incomplete or old account opening documents
- 5. Unsuitability
 - a. High commissions
 - b. High Turnover
 - c. High cost to equity or break even ratios
 - d. Over-concentration
 - (i) Over concentration in single equities or “high risk” sectors
- 6. Failure to Supervise
- 7. Unauthorized Trading

C. Types of Securities Involved (See Appendix A)

1. Mutual Funds
2. Common Stock
3. Derivatives
4. Auction Rate Securities
5. Annuities

II. BENEFITS OF ARBITRATION

A. Selection of Arbitrators

1. Many Arbitrators are experienced industry professionals
 - a. Not laypersons
2. Arbitrators are selected through an automated system that produces lists
 - a. One Private, One Public, and One Chairperson List, each including eight choices – See Section VI below
 - b. Parties may remove any listed arbitrator for any reason

B. Cost-Effective

1. Arbitration is faster, less expensive, and less formal than litigation

C. Convenience

1. FINRA conducts arbitrations in 47 cities nationwide
 - a. Note: Hearing location is usually that closest to the customer's residence

D. Arbitration is final and binding

1. Awards are subject to very limited judicial review

E. Expediency

1. Total turnaround time is about 15 months for hearing decisions
 - a. Less than 7 months for Simplified Decisions
2. Award decisions are generally made within 30 business days after the close of the proceeding

F. Statistics show that Arbitration may favor Industry Respondents

1. From 1999 to 2007, FINRA/NASD Win Rates for investor arbitrations have consistently declined
 - a. In 1999 investors won arbitration awards in 61% of cases compared to 37% in 2007.

2. This trend may have reversed in recent years due to the current economic crisis and changes instituted in the FINRA rules in response to lobbying by investor advocates.³
 - a. New Rule which effectively eliminates pre-hearing Motions to Dismiss. Rule 12504
 - b. New Rule which allow for a single, public (non-industry), arbitrator for disputes up to \$100,000 (previously \$50,000). Rules 12401, 12402
 - c. New Pilot Program which allows certain cases to be heard by an all-public, three person arbitrator panel.⁴

III. INTRODUCTION TO THE FINRA CUSTOMER ARBITRATION RULES

A. Rule 12100: Definitions

1. “Associated person” includes former brokers or representatives
2. Definition of “public arbitrator” has been narrowed significantly
 - a. To reduce the perception of bias, public arbitrators can no longer include anyone who is employed by, or a spouse or family member of, anybody engaged in the securities industry.

³ Pessin, Jaime Levy and McNamara, Kristen, New and Improved Arbitration?, The Wall Street Journal (July 6, 2009). The Win Rate for 2008 was 42% and is up to 47% for the first 5 months of 2009.

⁴ See id.

B. Rule 12105: Agreement of the Parties

1. Generally, the FINRA arbitration code allows for modification of certain provisions or procedures of the arbitration, if agreed to in writing between the parties.
 - a. This Rule allows parties the ability to streamline or limit the arbitration to suit the needs of the parties.
 - b. Industry professionals should be aware of the potential to modify arbitration proceedings as significant benefit can be gained in certain situations.

IV. JURISDICTION AND ELIGIBILITY FOR ARBITRATION

A. Rule 12200: Arbitration Under an Arbitration Agreement or the Rules of FINRA

1. Parties must arbitrate a dispute under the Code if:
 - a. Arbitration under the Code is either:
 - (i) Required by a written agreement, or
 - (ii) Requested by the customer;
 - b. The dispute is between a customer and a member or associated person of a member; and
 - c. The dispute arises 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.

2. Practice Pointers:

a. Customers have the choice to arbitrate unless it is required by a written agreement (such as a customer or sales agreement).

(i) For this reason, most customer agreements contain an arbitration clause.

b. Disputes can also be arbitrated under FINRA, even if the above are not met, if both parties agree to arbitration in writing. Rule 12201

3. Compelling of Arbitration

a. If there is a written agreement to arbitrate (ex.: Customer Agreement) then it will often be beneficial to make a Motion to Compel Arbitration in the event that the customer initiates their claim in Court.

(i) Cases and Authorities:

(a) The Federal Arbitration Act, 9 U.S.C. § 1, et seq.

(b) Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 103 S.Ct. 927 (1983)

(c) Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 107 S.Ct. 2332 (1987)

(d) Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 105 S.Ct. 1238 (1985)

- b. Even if no agreement to arbitrate exists, in certain situations, it may still be possible to Compel arbitration under theories of Contract, Agency or Estoppel⁵

B. Rule 12204: Class Action Claims

1. Class Action claims are generally not arbitrable under the Code

C. Rule 12205: Shareholder Derivative Claims

1. Shareholder Derivative Claims are also not arbitrable

D. Rule 12206: Time Limits/Statute of Limitations

1. 6 year limit from the occurrence or event giving rise to the claim
2. Dismissal under this rule does not prohibit a party from pursuing such claim in Court, but does not extend applicable statutes of limitations.
 - a. Motions to Dismiss under this Rule are governed by strict procedural requirements.
3. However, if a party files a claim in Court, the six year time limit for arbitration does not run while the Court retains jurisdiction.

⁵ See, e.g., Securities arbitration: construction and application of self-regulatory organization eligibility rules, 129 A.L.R. Fed. 489; The Arbitration Contract—Making It and Breaking It, 83 Am. Jur. Proof of Facts 3d 1; Thomson-CSF, S.A. v. American Arbitration Ass'n, 64 F.3d 771 (2d Cir. 1995).

E. Rule 12209: Legal Proceedings

1. During an arbitration, no party may bring any suit, legal action, or proceeding against any other party that concerns or that would resolve any of the matters raised in the arbitration.

V. GENERAL ARBITRATION RULES

A. Rule 12210: Ex Parte Communications

1. Except as provided in Rule 12211, no party, or anyone acting on behalf of a party, may communicate with any arbitrator outside of a scheduled hearing or conference regarding an arbitration unless all parties or their representatives are present.
2. Practice Pointer:
 - a. The exceptions and special procedures provided in Rule 12211 only apply if a party is represented by counsel, and are not available if *any* party is acting *pro se*.

B. Rule 12212: Sanctions

1. The panel may sanction a party for failure to comply with any provision in the Code, or any order of the panel or single arbitrator authorized to act on behalf of the panel.
2. Practice Pointer:
 - a. The rule is intended to provide guidance to parties and arbitrators regarding the scope of arbitrator authority to address

noncompliance with the Code or orders of the panel. The rule also provides that the panel may sanction a party in egregious situations.

VI. CLAIM INITIATION AND RESPONDING TO CLAIMS

A. Rule 12302: Statement of Claim

1. Attached documents no longer required
2. Requires only “relevant facts and remedies”
3. Practice Pointer:
 - a. No mention of pleading causes of action or any legal basis for claim

B. Rule 12303: Answers

1. Respondent(s) must directly serve each other party with the following documents within 45 days of receipt of the statement of claim:
 - a. Signed and dated Uniform Submission Agreement; and
 - b. An answer specifying the relevant facts and available defenses to the statement of claim.
 - c. The respondent may include any additional documents supporting the answer to the statement of claim Parties that fail to answer in the time provided may be subject to default proceedings under Rule 12801.

2. The answer to the statement of claim may include any counterclaims against the claimant, cross claims against other respondents, or third party claims, specifying all relevant facts and remedies requested, as well as any additional documents supporting such claim. When serving a third party claim, the respondent must provide each new respondent with copies of all documents previously served by any party, or sent to the parties by the Director.
3. At the same time that the answer to the statement of claim is served on the other parties, the respondent must file copies of the Uniform Submission Agreement, the answer to the statement of claim, and any additional documents, with the Director, with enough copies for the Director and each arbitrator.
4. Practice Pointers:
 - a. Pre-answer investigation needs to be even more thorough
 - b. Always Reserve the right to amend
 - c. Try to hold claimant's Statement of Claim to same standard of fact investigation as Answer
 - d. Missing uniform submission agreement could lead to a "deficient" answer
 - e. Be prepared to argue vacatur standard of "failure to hear evidence" at hearing

C. “General Denials”

1. Rule 12308: “Loss of Defenses Due to Untimely or Incomplete Answer.”

a. “If a party answers a claim that alleges specific facts and contentions with a general denial, or fails to include defenses or relevant facts in its answer that were known to it at the time the answer was filed, the panel may bar that party from presenting the omitted defenses or facts at the hearing.”

b. Practice Pointers:

(i) The new rule is broader than the old rule because defenses or “relevant facts” can now be barred if they were “known” to a party when the Answer was filed and not included in the Answer.

(ii) There is no procedural guidance in the rule concerning how/when the decision to bar a defense or fact should be made. The rule does not provide substantive guidance on determining whether a Respondent “knew” a fact or defense and should have recognized its relevance at the time the Answer was filed. To comply with the rule, pre-Answer investigations need to be thorough so that potentially helpful facts are learned and can be included in the Answer.

D. Amended Pleadings/Adding Parties

1. Rule 12309:

- a. Before an arbitration panel has been appointed, parties can liberally amend any pleadings. However, once a panel has been appointed, a party may only amend a pleading after the panel grants a motion to amend. The motion to amend is governed procedurally by the new rule concerning motion practice. Rule 12309(b).
- b. “Once the ranked arbitrator lists are due. . . no party may amend a pleading to add a new party . . . until a panel has been appointed and the panel grants a motion add the party....[T]he party to be added may respond to the motion . . . without waiving any rights or objections under the Code.” Rule 12309(c).
 - (i) Practice Pointers: This rule codifies the right of a party to be served with, and heard on, the motion to amend seeking to add that party.
- c. Rule 12407: a party added before arbitrator lists are due can participate in list selection, or, if added after a panel has been appointed, the added party can challenge an arbitrator for cause (but cannot strike any arbitrators).

VII. ARBITRATORS

A. Appointment/Selection of Arbitrators

1. Rules 12400 - 12404:
 - a. Parties will receive three lists: public, non-public, and chair. Each list will include eight names. Rule 12400(b); 12403(a)(2).

- b. Parties may strike up to four arbitrators from each list. Rule 12404.
 - c. The striking and ranking of individuals on a separate chairperson roster (all of whom will be public arbitrators) will replace the current procedures for selection of chair by agreement of the parties or by the NASD.
 - d. In single arbitrator cases, the parties will receive a list of eight arbitrators from the chairperson roster. Rule 12403(a)(1).
2. Practice Pointers:
- a. This rule should generally result in greater certainty and efficiency because there will be fewer cases in which the NASD needs to appoint arbitrators who were not on the original list.
 - b. Eligibility requirements for the chairperson roster include formal NASD training and experience with at least three arbitrations in which hearings were held (or, for lawyers, two arbitrations in which hearings were held.) Rule 12400(c). (The NASD has noted that this standard is not easy to meet, since approximately 22% of cases filed in the past four years have gone to hearing). Chair-qualified arbitrators do not appear on both the chair roster and the public arbitrator list in the same case, but are included on the public arbitrator list for that case if the chair roster is already filled, and are included on the public arbitrator list in other cases. Rule 12403(3). Therefore, a panel can include more than one chair-qualified arbitrator.

- c. The definition of “public arbitrator” now excludes individuals employed by, or a director or officer of, an affiliate of a securities firm, or whose spouse or other immediate family member holds such a position.

B. Disqualification of Arbitrators

1. Rule 12410:
 - a. Arbitrators may be removed at the request of a party if it is “reasonable” to infer a conflict of interest or bias.
 - b. Arbitrators were formerly subject to removal if they had an “interest in the outcome of the arbitration.” The rule now states that the interest may be “direct or indirect.”

VIII. PRE-HEARING CONFERENCE

A. “Once a panel is appointed, the director will schedule an Initial Prehearing Conference.” Rule 12500(a).

1. Practice pointers
 - a. contact the client before to determine potential hearing dates
 - b. contact claimant prior to the first call to establish discovery calendar and potential hearing dates

- B. Prehearing conferences are generally held by telephone. Rule 12500(b).**
1. At the conference, the arbitrators decide procedural matters, such as discovery between parties, and set hearing date(s).
- C. “The parties may forgo the Initial Prehearing Conference only if they jointly provide the director with the following information, in writing, with additional copies for each arbitrator:**
1. a statement that the parties accept the panel;
 2. whether any other prehearing conferences will be held, and if so, for each prehearing conference, a minimum of four mutually agreeable dates and whether the chairperson or the full panel will preside;
 3. a minimum of four sets of mutually agreeable hearing dates;
 4. a discovery schedule;
 5. a list of all anticipated motions, with filing and response due dates; and
 - a. usually a discovery hearing tentatively set
 6. a determination regarding whether briefs will be submitted, and if so, the due dates for the briefs and any reply briefs.” Rule 12500.

