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## Securities ADR

# FINRA Dispute Resolution Task Force Releases Its Final Report, with Support for Mediation and Live Hearings

BY JILL I. GROSS

**L**ate in 2015, the FINRA Dispute Resolution Task Force, a group formed solely for the purpose of systematically assessing and critiquing securities arbitration, released its Final Report and Recommendations (available at [bit.ly/1NTh18N](http://bit.ly/1NTh18N)).

The report contains 51 individual recommendations designed to improve FINRA's heavily-regulated dispute resolution program. Some recommendations offer specific details on implementation; others urge conceptual reform of a particular aspect of the arbitration process but leave FINRA to take care of fleshing out the details.

This article briefly describes the task force's formation; highlights its key recommendations (such as requiring mediation before arbitration of all claims—subject to party opt-out, and introducing a more affordable, live hearing option for small claims); analyzes in more detail a few more controversial suggestions (such as expressly banning class action waivers in customer agreements and increasing the use of explained awards), and critiques the task force's inability to reach consensus on other hot-button issues, such as mandatory arbitration.

Ultimately, the report does not create any binding obligations. But FINRA is likely to—and should—undertake implementation of many of these recommendations in the years to come.

In the securities brokerage industry, most customer-broker disputes must be arbitrated through FINRA Dispute Resolution, a sub-

siary of the Financial Industry Regulatory Authority, the largest securities self-regulatory organization in the United States.

These arbitrations are required either because the broker-dealer firm included a pre-dispute arbitration clause in its form customer agreement, or the customer invoked its unconditional right to demand arbitration of firms and their associated persons under FINRA arbitration rules.

Because FINRA—formerly known as the National Association of Securities Dealers—is subject to substantial oversight by the U.S. Securities and Exchange Commission, and the process is virtually “mandatory” for investors, FINRA periodically reviews its arbitration program to ensure it meets its statutory mandate to protect investors.

In 1994, the NASD Board of Governors appointed an Arbitration Policy Task Force, chaired by Prof. David Ruder of the Northwestern University School of Law, to study NASD-administered securities arbitration and suggest reforms.

The resulting 1996 Ruder Report concluded that, while NASD arbitration is “relatively efficient, fair, and less costly” when compared to litigation, improvements were needed. The report recommended dozens of changes to the process, most of which focused on countering and reducing the increasing litigiousness of securities arbitration.

Over the subsequent decade, FINRA adopted virtually all of the Ruder Report's recommendations. Yet fairness concerns lingered. See Jill I. Gross & Barbara Black, “When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration,” 2008 *J. Disp. Resol.* 349 (2008) (available at [bit.ly/1OQY6he](http://bit.ly/1OQY6he)) (reporting results of survey demonstrating investors' significant

negative perceptions of the fairness of securities arbitration).

Twenty years after the formation of the Ruder Task Force, in July 2014, FINRA announced the formation of a new Dispute Resolution Task Force “to consider possible enhancements to its arbitration forum to improve the transparency, impartiality and efficiency of FINRA's securities arbitration forum for all participants.”

The 13-member task force was chaired by retired University of Cincinnati College of Law Prof. Barbara Black, and included forum arbitrators, representatives from the securities industry, investor advocates and attorneys, industry attorneys, and a regulator.

A little more than one year later, on Dec. 16, 2015, the task force issued its Final Report and Recommendations (available at [bit.ly/1NTh18N](http://bit.ly/1NTh18N)) to FINRA's National Arbitration and Mediation Committee.

According to the Black Report—70 pages including appendices—“[t]he 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).”

Most recommendations appear fairly non-controversial, as they should improve the quality of the arbitrators and the process. Key recommendations include:

- Increase compensation to FINRA arbitrators (current compensation rates are well-known to be far below market rates for arbitrators' time and expertise) because of the task force's “strongly held opinion . . . that the most important investment in the future of the FINRA forum is in the arbitrators”;

(continued on next page)



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## Securities ADR

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- Increase the depth and diversity of the arbitrator and mediator pool through additional recruitment efforts;
- Increase training of FINRA arbitrators;
- Slightly adjust the arbitrator selection process in cases by providing a fresh list of 10 names where one party wants an all-public panel and strikes all non-public arbitrators so as to increase party choice;
- Adopt measures to encourage the writing of explained decisions to improve forum transparency, including mandatory explained decisions unless one party opts out;
- Improve arbitrator disclosure reports and checklists;
- Change the rules to require automatic mediation of claims in arbitration unless one party opts out, as well as offer financial incentives for early successful mediation;
- Create a special arbitration panel to handle individual brokers' expungement requests, and
- Consider funding law school securities clinics through FINRA fines and penalties.

### DEFAULT MOVE

A few of these recommendations are particularly notable for the ADR field.

First, the task force's focus on the quality of the arbitrators is critical. In theory, many dispute resolution processes appear well-designed, but misfire in the hands of the untrained, inexperienced or—dare I say—biased neutrals. Disputants should welcome any and all measures that facilitate the appointment of highly trained and sophisticated arbitrators to FINRA panels.

The move to the default of mediation before arbitration, patterned after the American Arbitration Association's 2013 change in its commercial arbitration rules, is a wise attempt to encourage earlier, more inexpensive resolution of disputes.

As in most forums, arbitration at FINRA has come to look more and more like litigation, particularly with expansive document discovery. Designating mediation as the automatic first dispute resolution mechanism should go a long way toward avoiding protracted arbitration proceedings.

Likewise, adjusting the rules to increase the likelihood of an explained decision will enhance transparency and arbitrator accountability, thus enhancing users' perceptions of

## Pushing for Better ADR

**The forum:** The Financial Industry Regulatory Authority, AKA the subsidiary known as FINRA Dispute Resolution.

**What's happened?** The SRO has had arbitration in agreements for years, where ADR has evolved as practices have developed. A second ADR-oriented task force has just completed a lengthy report with 51 modernizing recommendations.

**What's in? What's out?** The report requires mediation in broker disputes, with an opt out, and emphasizes arbitrator quality. Gone is the hard push to paper decisions and away from hearings.

the fairness of the process. More on explained decisions below.

### HEARINGS INSTEAD OF PAPER

Another substantial process change is the recommendation for the forum to offer an affordable, truncated in-person hearing as an alternative to a paper arbitration for low-dollar value claims.

Currently, claims with a dollar value of less than \$50,000 enter FINRA's "Simplified Arbitration" process: unless the claimant requests or the arbitrator orders otherwise, one arbitrator will decide the claim based solely on the parties' paper submissions—similar to a summary judgment motion. Disputants can submit memoranda, factual and expert affidavits, and documents produced in discovery to support their claims, but the arbitrator does not hear

any oral testimony from any disputant or third-party witness.

Research demonstrates, however, that disputants perceive a dispute resolution process as unfair if they have not been given a "voice"—an ample opportunity to be heard. In turn, stronger perceptions of procedural fairness affect disputant's perception of substantive fairness of the outcome. See Jill I. Gross, "AT&T Mobility and the Future of Small Claims Arbitration," 42 SW. L. Rev. 47 (2012)(available at [bit.ly/1UBiQrM](http://bit.ly/1UBiQrM))(arguing that FINRA arbitration should offer an alternative to paper arbitration for small claims due to lack of procedural justice).

Though the task force leaves to FINRA the tedious task of designing the mechanism, adopting its recommendation to provide claimants with low-dollar value disputes an affordable opportunity to be heard by an arbitrator will enhance the procedural justice of the process.

### POTENTIAL CONTROVERSY

The task force also made several recommendations with a greater potential to stir controversy, though ones this author enthusiastically supports.

First, the task force recommended that FINRA expressly bar class action waivers in customer agreements. This recommendation would codify a 2014 decision of the FINRA Board of Governors in FINRA's disciplinary action against brokerage firm Charles Schwab & Co., finding that the insertion of a class action waiver in its arbitration clause with retail customers violates FINRA rules. Complaint No. 2011029760201 (April 24, 2014)(available at [bit.ly/1S7EDcJ](http://bit.ly/1S7EDcJ)).

Given the Supreme Court's recent jurisprudence enforcing class action waivers in arbitration clauses (see, e.g., *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011)(available at [bit.ly/1MWMHVN](http://bit.ly/1MWMHVN)); *CompuCredit Corp. v. Greenwood*, 132 S.Ct. 665 (2012)(available at [bit.ly/1RnB1DB](http://bit.ly/1RnB1DB)); *American Express Co., et al. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013)(available at <http://bit.ly/1ISQ8wb>)); *DirectTV Inc. v. Imburgia*, No. 14-462 (Dec. 14, 2015)(available at [1.usa.gov/1Qhzb6R](http://1.usa.gov/1Qhzb6R))[for more on *DirectTV*, see the ADR Briefs feature on the case on Page 29 of this issue], this rule change is particularly

important to protect investors from being forced to waive their right to proceed as a class in court—a right that the SEC has confirmed should be preserved for investors.

While some industry players argue that such a rule is preempted by the Federal Arbitration Act, investor advocates cite to a recent Congressional grant of authority to the SEC to regulate broker-dealers' arbitration clauses with customers.

Under Supreme Court opinions, this “contrary congressional command” is sufficient to overcome the FAA. See Barbara Black and Jill I. Gross, “Investor Protection Meets the Federal Arbitration Act,” 1 *Stan. J. Complex Litig.* 1 (2012)(available at [bit.ly/1TIXGHQ](http://bit.ly/1TIXGHQ))(arguing that FINRA can ban class action waivers in customer agreements due to the contrary congressional command in the federal securities laws). Any express FINRA rule would make it painfully clear that brokerage firms cannot impose class action waivers on retail investors.

## TRANSPARENCY V. COSTS

Second, as mentioned above, the task force recommended amending FINRA rules to require explained decisions in awards unless any party requests otherwise. This would reverse the current default in FINRA Rule 12904(g): no explained decision unless all parties jointly request one.

Frequent forum users are divided on the desirability of explained decisions: While they increase transparency and arbitrator accountability, and possibly could lead to greater consistency and enhance the quality of arbitrator decision-making, they cost more, decrease the likelihood that equity will play a role in the award, impose legalistic-type analysis on arbitrators who are not necessarily lawyers,

‘[T]he task force recommended that FINRA expressly bar class action waivers in customer agreements. . . . [T]his rule change is particularly important to protect investors from being forced to waive their right to proceed as a class in court—a right that the SEC has confirmed should be preserved for investors.’

and risk leading to more appeals. See Barbara Black & Jill Gross, “The Explained Award of Damocles: Protection or Peril in Securities Arbitration,” 34 *Sec. Reg. L. J.* 17 (2006)(available at [bit.ly/1Rd5RP1](http://bit.ly/1Rd5RP1))(analyzing pros and cons of explained awards).

For these reasons, parties jointly requested only a small handful of explained decisions since FINRA first enacted its rule in 2009—37 out of about 5,000 eligible cases. Changing the rule surely will increase the number of explained awards—an outcome that many might oppose as anti-arbitration as it adds yet another time-consuming, costly, legalistic layer to an already overly litigious process.

In addition, while not a recommendation, the task force did take a policy position on an issue that is beginning to bubble up in the lower courts: whether a forum selection clause in a customer agreement can supersede FINRA's Rule 12200 providing customers with the unilateral right to demand arbitration of dispute with their brokers.

Brokerage firms are increasingly arguing that clauses designating a particular venue for resolution of disputes actually act as waivers of the customers' right to arbitrate. Because the federal circuits are split on this issue, the task force took a position and declared 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.”

Although a task force “policy position” certainly cannot make law, surely FINRA should be energized to enforce Rule 12200 more aggressively by bringing disciplinary actions against firms that deny customers their right to arbitrate disputes.

\* \* \*

Finally, while I applaud the Black Task Force's achievement in reaching consensus on 51 important recommendations, I am disappointed that it was not able to reach consensus on a few other important issues, including mandatory arbitration (i.e., whether the SEC should bar broker-dealers from inserting mandatory arbitration clauses in customer agreements), expressly requiring arbitrators to follow the law (this would contradict arbitration's roots as facilitating equitable outcomes), and reforming a broken arbitrator classification system (the overly broad definition of a nonpublic arbitrator excludes too many panelists with subject matter expertise). These difficult issues will continue to plague the industry until FINRA tackles them.

Hopefully FINRA's National Arbitration and Mediation Committee, which sets forum policy, will take up the task force's recommendations in the near future to continuously improve the forum and to protect investors. ■