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NASAA

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FINRA Dispute Resolution Task Force
Via DRTaskForce@finra.org

Dear Task Force Members:

I hereby submit the following comments on the FINRA dispute resolution process on behalf of the North American Securities Administrators Association ("NASAA").[1] NASAA has long maintained that investors should have a choice when it comes to how and in what forum they resolve disputes with their financial advisors. We were pleased to see that the Investor Choice Act of 2015[2] was recently reintroduced and, as in the prior Congress, we will support the legislation. Investors should have access to the court system through the prohibition of mandatory pre-dispute arbitration agreements ("PDAAs"). Until such time as investors have a choice in selecting the forum for resolving these disputes we encourage the Task Force to recommend changes to the process to improve transparency and predictability by, among other things, requiring reasoned, written decisions in conjunction with an arbitration award and requiring that applicable state and/or federal law be applied to claims in the arbitration forum.[3]

As a preliminary matter, NASAA and its members have advocated for the ability of investors to select an all public panel, and we were encouraged when FINRA made that change to its arbitration forum to improve equitability.[4] However, despite such improvements, the FINRA arbitration process continues to be flawed in many ways, including but not limited to the following: (1) inadequate disclosure of arbitrator conflicts;[5] (2) insufficient diversity and training

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation

[2] The text of H.R. 1098, the Investor Choice Act of 2015, is available at https://www.congress.gov/114/bills/hr1098/BILLS-114hr1098ih.pdf.

[3] NASAA will be submitting a separate comment letter regarding our concerns with the expungement process.

[4] On January 31, 2011, the U.S. Securities and Exchange Commission (SEC) approved a rule change to provide customers in cases that proceed with three arbitrators the option to choose whether their case would be decided by three public arbitrators. *See* SECURITIES AND EXCHANGE COMMISSION (Release No. 34-63799; File No. SR-FINRA-2010-053).

[5] *See, e.g.*, Jason R. Doss, *The Importance of Arbitrator Disclosure*, Oct. 2014, *available at* https://piaba.org/system/files/pdfs/The%20Importance%20of%20Arbitrator%20Disclosure%20%28October%207,%202014%29.pdf.

of the arbitrator pool;[6] (3) repeat user bias;[7] (4) mandatory use of PDAAs that preclude investors from enforcing their claims in court;[8] (5) failure of arbitrators to apply state and/or federal law to claims; (6) failure to require a reasoned, written decision for an award;[9] (7) inability of the investor to obtain a meaningful review of the arbitration award;[10] (8) lack of transparency of claims filed and other aspects of the process (e.g., only bare-bones awards are published online);[11] (9) issues involved in the expungement process;[12] (10) investor challenges with the discovery process;[13] and (11) the method by which costs are allocated among the parties.[14]

This letter, however, will focus on three areas that we believe are most critical and urgent to creating a fairer forum: (1) Prohibiting the Use of PDAAs, (2) Requiring Reasoned, Written Decisions, and (3) Mandatory Application of State and Federal Laws.

Prohibiting the Use of PDAAs.

NASAA has long been opposed to the use of mandatory pre-dispute arbitration agreements ("PDAAs") in account opening documents used by broker-dealers, and most recently, investment advisers.[15] We believe that investors must have a choice of forum when it comes to resolving disputes with their investment professionals and for that reason we were pleased to see the reintroduction of the Investor Choice Act of 2015.

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[6] *Id.*

[7] *Id.*; *see also* See Choi, Stephen; Fisch, Jill; and Pritchard, Adam C., "Attorneys as Arbitrators" (2009). Law & Economics Working Papers Archive: 2003-2009. Paper 94, *available at* http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1095&context=law_econ_archive.

[8] *See* NASAA letter to Rep. Keith Ellison (D-MN) regarding H.R. 1098, the Investor Choice Act of 2015, 26 Feb. 2015, *available at* http://www.nasaa.org/wp-content/uploads/2015/02/NASAA-Letter-in-Support-of-Investor-Choice-Act-of-2015-FINAL-2-26-2015.pdf; *see also* Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Jan. 2011, at 80, *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[9] FINRA Rule 12904 (g)(1) states in pertinent part that "[Explained Decisions] applies only when all parties jointly request an explained decision." FINRA Decision and Awards, FINRA Customer Code Rule 12904, Awards, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4192.

[10] *See* FINRA Dispute Resolution Basic Arbitrator Training Guide, Sept. 2014, at 138, *available at* http://www.finra.org/sites/default/files/FINRA%20Basic%20Arbitrator%20Training%20%28September%202014%29.pdf.

[11] *See, e.g.*, Jason R. Doss, *The Importance of Arbitrator Disclosure*, Oct. 2014, at 31-42.

[12] *See* supra note 2; *see also* James T. Farris, Note, *What You Do Not Know Can Hurt You: How the FINRA Expungement Process Is Endangering Future Investors Through a Lack of Information*, 42 Hofstra L. Rev. 4, (Summer 2014), *available at* http://www.hofstralawreview.org/wp-content/uploads/2014/08/DD1.Farris.final2_.pdf.

[13] *See* Jenice L. Malecki, Adam M. Nicolazzo, and Robert M. Van De Veire, *Ethics in Discovery: Court, A Backdrop for Arbitration*, Practicing Law Institute, (August 2012), *available at* http://www.aboutsecuritieslaw.com/files/ethics_in_discovery.court.a_backdrop_for_arbitration.2012.pdf.

[14] *See generally* "Securities dispute resolution: Deciding whether to file an arbitration claim," Cornell University Law School, Legal Information Institute, *available at* https://www.law.cornell.edu/wex/securities_dispute_resolution_whether_to_file_a_claim. Arbitration fees include not only the initial filing fee, but also fees assessed for each motion or hearing before one or more of the arbitration panelists.

[15] Since the U.S. Supreme Court decision in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), virtually all broker-dealer firms require that investors opening an account sign a mandatory PDAA as part of the New Account Form. Many investors do not understand that courts will enforce this provision even though the investor had to accept the provision or forgo opening an investment account.

Investor confidence in fair and equitable recourse is a critical element of the securities markets and promoting long-term investments by retail investors. We have argued that participation by "mom and pop" investors in our capital markets, and, by extension, job growth, is directly tied to their level of trust in having a reasonable avenue to seek recovery if they are victimized by securities fraud or other unethical conduct.

The inclusion of PDAAs in investor contracts has had a harmful impact on retail investors. Specifically, it deprives them of their right to a jury trial despite the absence of an informed and knowing waiver, and deprives them of the application of federal and state laws, including securities laws specifically designed to protect those investors. Further, it has effectively removed investors' ability to obtain any meaningful judicial review of arbitration awards. Finally, PDAAs have undermined the proper development of legal precedent by taking the courts out of the process absent class actions[16] or criminal cases. The result of this practice has stunted the development of any remedial legislation designed to specifically protect investors.

Absent a prohibition of PDAAs by FINRA, the odds of investors obtaining adequate remedies for violations of the securities laws are grim.[17] The U.S. Supreme Court has enforced PDAAs despite the absence of a knowing, intelligent waiver of the investor's right to jury trial, where the PDAA included a class action waiver, and under circumstances where doing so left the plaintiff with no effective means of vindicating their legal rights.[18] The Court has ignored well-established legal principles it typically upholds with regard to other constitutional rights.[19] Even when investors are successful in arbitration, the measure of damages is often a small percentage of the actual losses. We believe that investors are best served when they have a choice in the forum they will use for pursuing recourse. Given the deference afforded arbitration by the Supreme Court and the reluctance of the U.S. Securities and Exchange Commission ("SEC") to address or even analyze this issue as provided by Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, we believe that it is imperative that these issues be addressed by this Task Force.

Our recommendation to this Task Force is straightforward – investors should be given a choice and not forced into a process and forum. As the party with the least power and the most to lose in a relationship with a brokerage firm, the investor must have the unilateral right to

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[16] We applauded FINRA's Board of Governors April 24, 2014 decision finding that Charles Schwab & Co., Inc. violated FINRA rules when the firm attempted to prevent its customers from participating in class-action lawsuits. *See* FINRA v. Charles Schwab & Company, Inc., *available at* https://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p493598.pdf. If Schwab had been successful, class action waivers would likely be standard practice in the industry as well. We continue to assert that investors should retain the right to file class actions in court. The high cost of attorneys' fees alone makes adequate representation in a FINRA arbitration, particularly against a large and sophisticated brokerage firm, insurmountable in light of the potential dollar award for a small investor.

[17] *See* Cox, Trey, and Alan Dabdoub, "Which costs less: Arbitration or litigation?" InsideCounsel 6 Dec. 2012, *available at* http://www.insidecounsel.com/2012/12/06/which-costs-less-arbitration-or-litigation.

[18] See *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011) and *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013).

[19] See, Belton, Sarah E. and Bland, Jr., F. Paul, *How the Arbitration-at-all-Costs Regime Ignores and Distorts Settled Law*, 35 Berkeley J. of Emp. & Lab. L. 135, 141-152 (2014), *available at* http://bjell.weebly.com/uploads/2/5/0/3/25032320/preemption_symposium_cle_materials_february_2014.pdf.

choose the system and forum for the redress of conflicts at the time those issues arise and not before. The investor's choices should include mediation, arbitration and/or the civil courts. The investor's choice must apply to each conflict that arises, and should not be limited by previous choices in prior disputes. It also should not be limited by a waiver of the right to choose a forum before the facts and circumstances of the investor's dispute is known.[20] Many investors who bring claims against firms are trying to recover the loss of their hard-earned life savings, while for the firms and their registered representatives, the dispute is generally a cost of doing business. Loss of the right to sue in court, individually or as a class, would not only deprive the investors of their constitutional rights, but would effectively insulate the firms and their agents from the consequences of any wrongdoing. This impacts both individual investors and the broader markets, including investor confidence in those markets. As with investor choice of an all public panel, NASAA believes that investors should be given a choice of forum and not forced into mandatory pre-dispute arbitration.

FINRA Rule 12200 provides that the parties must arbitrate a dispute if it is either (1) required by a written agreement, or (2) requested by a customer (i.e., investor). Firms rely on (1) to justify including mandatory "pre-dispute" arbitration agreements in their customer agreements. If "pre-dispute" arbitration agreements were prohibited, however, investors could still require arbitration pursuant to (2) of the Rule. It is disingenuous for firms to seek a repeal of FINRA Rule 12200, or to argue that they would decline to participate in arbitration if it became voluntary. The broker-dealer industry has fervently supported the arbitration process and touted its benefits for both the industry and investors since mandatory pre-dispute arbitration clauses became commonplace in 1987. Some have even suggested that investors would not use a voluntary arbitration system, to their detriment, due to lawyering tactics. This line of reasoning blatantly disregards the ethical and fiduciary duties that lawyers owe to their clients to act in their best interest, which may involve the pursuit of litigation or arbitration. Finally, we note that FINRA itself has stated that preserving an investors' right to require arbitration pursuant to FINRA Rule 12200 is *essential* for investor protection.[21] Even the SEC has advised brokerage firms that "form" contracts requiring mandatory pre-dispute arbitration are against public policy.[22]

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[20] Recent research on the validity of these agreement provisions indicates many factors interfere with the consumers' intent and ability to make a knowing and intelligent waiver of their constitutional rights when presented with a mandatory PDAA, including the false assumption that the court will not enforce the PDAA. See, Consumer Financial Protection Bureau, *Arbitration Study Preliminary Results* (December 12, 2013); Sovern, *et al*., *"Whimsy Little Contracts" with Unexpected Consequences: An Empirical Analysis of Consumer Understanding of Arbitration Agreements*, St. John's School of Law Legal Studies Research Paper Series (October 29, 2014). *Available at* http://scholarship.law.stjohns.edu/cgi/viewcontent.cgi?article=1000&context=working_papers.

[21] "[I]t is essential for investor protection that FINRA maintain Code Rule 12200 if Congress or the SEC decides to limit or prohibit mandatory arbitration." Linda Fienberg, President, FINRA Dispute Resolution, SEC Investor Advisory Committee: Open Meeting (May 17, 2010), *available at* https://www.sec.gov/news/otherwebcasts/2010/iacmeeting051710.shtml.

[22] "Requiring the signing of an arbitration agreement without adequate disclosure as to its meaning and effect violates standards of fair dealing with customers and constitutes conduct that is inconsistent with just and equitable principles of trade." Notice to Broker-Dealers Concerning Clauses in Customer Agreements which Provide for Arbitration of Future Disputes," 1979 WL 174165 (S.E.C. Release No. 34-15984), p. 4.

Require Reasoned, Written Decisions.

NASAA advocates for the inclusion of reasoned, written decisions for all arbitration awards, unless specifically declined by both parties after the dispute has arisen.[23] Reasoned, written awards will result in more transparency and a more equitable system with accountability and less fee splitting regardless of the outcome. They will also make the potential for review by an appellate arbitration panel or a court more realistic and meaningful, since in order to appeal an award you need a record based on both the transcript and a reasoned decision. Therefore, we believe that reasoned decisions should include:

A. Liability Rationale. Written decisions explaining why the arbitrators have decided the grounds upon which the claims should be awarded or denied, permitting a reviewing court to determine whether the award should be vacated or confirmed on appeal. This should lead to greater user satisfaction with the forum as the parties will have some understanding of the resulting decision, and may feel they have had their "day in court."

B. Explanation of monetary award. NASAA believes a transparent explanation of the methodology for the award calculation is important for increased investor satisfaction with the forum as well as assisting a reviewing court on appeal.

C. Explanation of fee allocation. In most cases, forum fees are split between the parties regardless of the outcome. Even when a panel makes an award to an investor based upon the respondent's wrongdoing, the investor is often assessed a significant percentage of that award as its forum fees. A successful investor would not typically be subject to such fees as a prevailing party in a civil court proceeding. Those fees are considered customary business expenses to broker-dealer firms. For investors dealing with the substantial losses, these fees pose a significant obstacle. It is our belief that every award must include a reasoned explanation of the assessment and allocation of forum fees.

Mandatory Application of State and Federal Laws.

Arbitration awards must be based on the application of state and/or federal laws applicable to the investor's claims. Arbitrators must be trained in securities laws and in other state consumer law provisions applicable to investor claims, and must apply those laws where appropriate. Federal and state securities laws were intended to be broad, remedial statutes. By requiring that all disputes go to arbitration, firms have undermined the very purpose of these

[23] Both the AAA Construction Industry arbitration rules and certain types of arbitration in the UK use reasoned awards as the default; *see* AAA Construction: Arbitration Rules & Mediation Procedures, *available at* https://www.adr.org/aaa/ShowProperty?nodeId=/UCM/ADRSTG_004219; *see* Daniel L. FitzMaurice and Maureen O'Connor, "Preparing a Reasoned Award," *The Quarterly* 14, no. 4 (2007), *available at* http://www.daypitney.com/news/docs/dp_1987.pdf. *See* Morgenson, Gretchen. "When Winning Feels a Lot Like Losing." New York Times (Dec. 10, 2006), *available at* http://www.nytimes.com/2006/12/10/business/yourmoney/10gret.html?pagewanted=all. The case is believed to have settled as there is no subsequent award available online.

laws and inflicted a great disservice on investors. To the extent state consumer laws are applied in arbitration, the results are arbitrary and inconsistent. A preliminary review of cases brought to our attention indicates that arbitrators are more likely to apply state law to dismiss a claim based on the state statute of limitations, but are reluctant to apply state laws providing for remedies such as punitive damages, a damage multiplier, or costs and attorneys' fees to successful plaintiffs. The financial industry should not be permitted to insulate itself from liability by contractually forcing investors into a forum where they must surrender significant legal protections. Finally, as noted above, mandatory PDAAs have affected the continued development of legal precedent in civil securities actions.

For too many years, investors and consumers have suffered the consequences of an inadequate and unfair system to address their complaints. The Task Force has an unprecedented opportunity to address the issues we have noted above. Should you wish to discuss this letter further please contact Joseph Brady, NASAA General Counsel and Acting Executive Director, at jb@nasaa.org.

Sincerely,

William Beatty
NASAA President and Washington Securities Director