

Summary of Special Arbitration Procedures for Consequential Damages Claims Against Firms Entering into Auction Rate Securities Settlements with State Regulators

Background

Several brokerage firms have entered, or are expected to enter into, settlements with state securities regulators in cases arising from the sale by those firms of auction rate securities. Those settlements provide, among other things, that many customers of those firms are entitled to receive a refund of the purchase price of those securities from the firm. Despite receiving those refunds, some customers may believe they have incurred consequential damages as a result of their purchase and ownership of the auction rate securities. The settlements also provide for a “special arbitration procedure” which may be used by customers attempting to recover those consequential damages. This summary describes those special procedures.

Arbitration Generally

Most account agreements between brokerage customers and firms allow either party to insist that disputes arising between them be resolved through an arbitration process, rather than by a lawsuit filed in a court of law. Most of these arbitrations are governed by procedures promulgated by the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization which regulates most of the brokerage firms in the country, including all of the firms which have settled auction rate securities cases with regulators. FINRA maintains and administers a Code of Arbitration Procedure [link] which governs the manner in which arbitrations are initiated and conducted.

An Option for Investors: The Special Arbitration Process

Investors who have disputes with their brokerage firms regarding auction rate securities may pursue those claims against the firms through the standard arbitration process governed by the FINRA Code. However, in conjunction with their settlements of the auction rate cases with some firms, State regulators have devised a special arbitration process that is available to investors who are seeking consequential damages arising from the sale of auction rate securities by the settling firms. This State special arbitration process (“State SAP”) is identical to the standard arbitration process administered by FINRA, with certain specific procedural differences set forth below. In addition to these procedural differences, the State SAP also limits certain claims and defenses which might be otherwise available to parties.¹

¹ FINRA has also adopted and published a separate special arbitration procedure for claims made against firms which have entered into settlement agreements with FINRA and the SEC. The provisions of that document do not apply to the State SAP.

Procedural Differences

Parties subject to the State SAP should note these procedural differences from the standard FINRA arbitration process:

- **Single arbitrator.** Most FINRA customer arbitrations provide for a panel of 3 arbitrators—one non-public arbitrator and two public arbitrators.² State SAP arbitrations will use a single, public arbitrator.
- **Firms pay certain fees.** Also, in the standard arbitration process, a customer filing a claim must pay a filing fee, and the costs of the arbitration forum are allocated among the parties by the arbitrators. In the State SAP, all settling firms have agreed to pay forum costs, and most have agreed to pay filing fees as well.

Limitations on Claims, Parties, and Defenses

Parties to a State SAP should also note these limitations:

- **Relief available.** The State SAP may be used only for consequential damages claims arising from auction rate securities investments, as well as claims for attorneys fees. Customers may not seek punitive damages or other forms of relief in the State SAP process.
- **Firms subject to the State SAP.** The State SAP is available for use against any firm that has settled ARS-related claims with State regulators, and only those firms.
- **The State SAP is optional.** An investor with eligible claims may, but is not required to, use the State SAP. The standard FINRA arbitration procedures, as well as any other remedy and forum which may be available to the investor, may be used instead of the State SAP. However, if an investor files a consequential damages claim through the State SAP process, he or she may not also use the standard process for the same damages claim.
- **Liability not to be contested.** In their settlement agreements, the brokerage firms have agreed that, while they may defend themselves against the consequential damages claim, the firms will not contest liability related to the sale of the auction rate security.
- **Failure to borrow money not a defense.** Most firms will not be able to use as part of their defense any decision by a customer not to borrow money from the firm.

² In addition to standard selection and screening applying to all FINRA arbitrations, non-public arbitrators in standard FINRA arbitration procedures in auction rate securities cases are additionally screened to eliminate persons with recent ARS firm or sales affiliations.

Additional Information

In all respects other than the differences summarized here, and set forth with specificity in the State Consent Orders, the special arbitration process is identical to the FINRA standard arbitration process.

Although arbitrations are not conducted in a court of law, they are nevertheless legal proceedings, they can involve complicated legal and factual issues, and the arbitration decisions are usually not appealable except in limited circumstances. For these reasons, customers contemplating bringing a claim against a brokerage firm, either in a State SAP or a standard arbitration, may wish to seek legal counsel. Investors may seek recovery for their attorneys fees under the State SAP to the same extent that they may under the standard arbitration procedures.

This document is a summary of the differences between the State special arbitration process and standard FINRA arbitrations. Prior to bringing an action, customers and their counsel should consult the FINRA Code of Arbitration as well as the specific Consent Order entered into by the applicable firm.