# *Welcome to the Party?*

## FINRA Invites Investment Advisers to Utilize its Arbitration Procedures

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The Financial Industry Regulatory Authority (FINRA) recently issued guidance (Guidance) stating that it will now accept requests for arbitration on a voluntary, case-by-case basis from investors and investment advisers (IAs), provided the parties meet certain conditions, *available at* http://www.finra.org/ArbitrationAndMediation/Arbitration/SpecialProcedures/P196162. These conditions are explained in detail below. The Guidance also states that FINRA will offer mediation services for any IA disputes on a voluntary basis. The question that IAs must now grapple with is whether FINRA's proposal makes sense for them. This article provides background information that investment advisers should carefully consider before deciding whether to accept FINRA's invitation to adopt its arbitration procedures.

### *Background*

At this time, IAs are regulated by either the Securities and Exchange Commission (SEC) or the states. For some time, however, FINRA has positioned itself to take on oversight responsibility for IAs, a move that the IA industry has resisted, *See* IAA testimony at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/120606tstmny.pdf. Although one might question FINRA's intentions in issuing the Guidance, the President of FINRA Dispute Resolution has denied any link between the Guidance and FINRA's efforts to become the self-regulatory organization (SRO) for IAs, *see* http://www.investmentnews.com/article/20121028/REG/310289999. Instead, she insists that the Guidance is merely a response to substantial demand from attorneys for access to FINRA's arbitration and mediation forums.

Since the announcement, the response from the investment adviser community has been lukewarm. Before agreeing to submit a dispute to FINRA arbitration, an investment adviser should carefully weigh the pros and cons of FINRA jurisdiction. The chart set forth below summarizes certain relevant considerations.

**FINRA Arbitration vs. Court Litigation**

| Issue | FINRA | COURTS |
|---|---|---|
| **Expedited Resolution?** | Yes: Most cases resolved within 16 months | No: Cases can drag on for years |
| **Expensive Discovery?** | No: Depositions generally prohibited; parties allowed limited document production | Yes: Depositions almost always allowed, along with other discovery procedures |
| **Appeals?** | Limited: Motions to vacate curtailed by Federal Arbitration Act | Yes: Full appeal rights |
| **Subpoenas?** | Limited: Generally only FINRA members subject to subpoena | Yes: Court may issue subpoena to anyone within its jurisdiction |
| **Date Certain for Final Hearing?** | Yes: Parties and arbitrator agree on date | No: Absent a special setting, trial may be delayed |
| **Trial Expense?** | Limited: Parties pay for arbitrator hearings, usually $1,000 per day | Substantial costs associated with litigation |
| **Impartial Decision Maker?** | Maybe: Most FINRA panels now are all-public with no industry arbitrator | Yes: Judges are sworn to be fair and impartial |
| **Decision Maker Required to Follow Binding Precedent and Rules of Evidence?** | Not necessarily; depends upon the panel | Yes |
| **Hearings and Decisions Public?** | Hearings and pleadings are private, but the final ruling is posted on the FINRA website | Pleadings, trial and final judgment are public |
| **Decision Maker an Attorney?** | Maybe. Arbitrators are not required to have legal training | Yes |

### *The Conditions for Eligibility to Arbitrate with FINRA*

The Guidance provides that

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investors and IAs wishing to arbitrate at FINRA must submit a post-dispute agreement to arbitrate, as well as a special submission agreement. The special submission agreement is a form agreement prepared by FINRA and requires the parties to make a number of acknowledgments, the most notable of which include:

- FINRA cannot enforce awards entered against IAs that are not members of FINRA, because FINRA is not an SRO for IAs, although prevailing parties can enforce awards in state or federal courts of competent jurisdiction;
- FINRA may bar an IA and/or its employees from its arbitration forum in future cases if the IA or its employees fail to pay any award, settlement agreement or FINRA fees in connection with the arbitration;
- The final award will be made publicly available; and
- Disputes involving IAs will be administered in accordance with the FINRA Codes of Arbitration Procedure.

In addition, the special submission agreement requires the parties to explain how payment of FINRA's member and surcharge fees will be apportioned between the parties.

The Guidance also states that it will begin accepting industry disputes between IAs that are not members of FINRA and their employees on a voluntary, case-by-case basis, provided the parties to such disputes accept the conditions detailed above.

### Issues to Consider

With these realities in mind, an IA contemplating the use of FINRA arbitration has to consider both the general cost-benefit analysis of choosing arbitration as well as the application of these considerations to the IA context. For example, a dispute brought by a client against an IA often will include an allegation of a breach of fiduciary duty. An IA must consider whether a FINRA arbitration panel is going to be well-positioned to understand and adjudicate questions related to fiduciary duty. While FINRA arbitrators may be familiar with the broker-dealer business model, they may not understand how an IA operates. For example, while the FINRA conduct rules apply to broker-dealers and their employees, such rules will not apply to IAs.

It also is important to look at the Guidance FINRA has provided regarding the process by which cases involving IAs will be accepted by FINRA. In particular, FINRA has stated that the IA and the investor must submit a "post-dispute agreement to arbitrate." This is a key distinction from a situation in which the jurisdiction of an arbitration forum is established by a pre-dispute arbitration agreement. In the brokerage context, such language is typically contained in the new account forms signed by the customer when opening a new account, with specific reference to FINRA as the chosen arbitration forum. Should an IA wish to require arbitration of any dispute, a mandatory arbitration agreement signed at the time the client opens his or her account is a necessary first step. It does not appear, however, that an IA will be required to name FINRA as the sole chosen forum in this pre-dispute agreement. Instead, pending further guidance from FINRA, an IA seeking to craft an arbitration clause may be best served by including reference both to FINRA as a forum for dispute resolution, and an alternative forum such as the American Arbitration Association (AAA) or JAMS (formerly Judicial Arbitration & Mediation Services), if the customer refuses to select an appropriate forum within a set period of time.

### Conclusion

FINRA recently issued its Guidance concerning the ability of IAs to use FINRA as a forum to arbitrate disputes with clients. Therefore, IAs should carefully review the issues outlined above, as well as other issues that may arise. It is possible that at some point FINRA arbitration will be an attractive forum for IAs. At this time, however, the jury is still out on whether this adjudication model makes sense for IAs. Of course, the landscape could change if FINRA finally does become the SRO for IAs. If that occurs, it is possible that FINRA arbitrations will become mandatory for IAs. Until then, IAs should become familiar with FINRA's process and keep abreast of subsequent developments.

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