TEACHING ABOUT MANDATORY INVESTOR ARBITRATION IN A COMMERCIAL LAW CLASS

by
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I. Broadening Securities Law Coverage by Including Mandatory Investor Arbitration

This paper, based in part on the author's classroom experience, proposes including a one class-long session on the mandatory investor arbitration process in a Commercial Law class. Although a shortened version of this class session could be used in teaching about ADR in a legal environment course, the author employed this session in a "second" business law course covering commercial law and securities laws. Legal environment instructors might consider employing just the material in Section III discussing mandatory arbitration in the classroom, which focuses on how the wide-spread use of mandatory arbitration provisions in many contracts has made a radical change in the legal system.

Business law textbooks typically cover various state law and federal law issues involving securities. Typical state law securities topics include: corporate financing, types of securities, legality of dividends, and shareholder rights, duties and liabilities. Typical federal law topics include the Securities Act of 1933,[1] the Securities Exchange Act of 1934,[2] the Foreign Corrupt Practices Act,[3] the Racketeer Influenced and Corrupt Organizations Act,[4] and the Sarbanes Oxley Act,[5] and a brief mention of state "blue sky" securities laws. The later five topics are often taught in detail because they are topics tested on the Uniform CPA Exam. Securities issues are also touched upon in Business Law textbooks include the professional liability of accountants. What's seldom covered in the typical Business Law or Finance course is investor disputes with broker-dealers and investment advisors, and the contractually-mandated remedy of investor arbitration in the securities industry forum which prohibits investors from using the court system. Although they portray ADR as a positive development, textbooks do not discuss how mandatory arbitration provisions prohibiting certain legal claims from reaching a courtroom is a radical change in the legal system. This exercise is designed to provide a more balanced view of ADR and to trigger a class discussion.

Because of the increasing complex legal landscape of business, textbook and classroom coverage of any topic's utility needs to be evaluated. Although resolving investor disputes with stockbrokers may seem a minor part of corporate finance, the students are far more likely to eventually have a personal brush with this issue than they will issuing stocks and bonds. Viewed through a different lens, mandatory investor arbitration actually integrates a number of discrete business law topics including: negligence in tort, consumer protection, contracts, and ADR, as well as business ethics. Because textbooks necessarily are organized by topic, students often fail to see how the various areas of law integrate with one another because of the inevitable "silo effect." Because an investor dispute often consists of a relatively simple fact pattern, an investor dispute

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[1] 15 U.S.C. § 77a et seq.

[2] 15 U.S.C. § 78j(b).

[3] (Foreign Corrupt Practices Act of 1977), 15 U.S.C. §§ 78a, 78m, 78dd-l, 78dd-2, 78ff amending The Securities Exchange Act of 134.

[4] (RICO), 18 U.S.C. § 1961 et seq. (1970).

[5] (SOX) 15 U.S.C. § 7201 et seq., PL 107-204 (2002).

can illustrate in a single class--or even a shorter period--the integration of several legal issues in a conceptually simple fact pattern.

Most investor complaints against broker-dealers are filed because the investor has lost money or experienced disappointing returns.[6] If the disappointing return is a result solely of a general market downturn, or a modest return from a safe investment, there may be no legal or moral reason to provide the claimant damages or restitution. On the other hand, if the shareholder can allege and prove the broker-dealer's lack of professional care in some respect, misrepresentation, recklessness or even fraud, the investor will be able to recover damages which are sometimes significant.[7] However, because sellers of securities uniformly include mandatory arbitration provisions in their customer contracts, resolution of such disputes will be entrusted to industry appointed arbitrators in a industry forum. Resolving the matter in court is not an option for either side. Besides the securities, torts, contracts, and consumer protections issues, learning about shareholder dispute resolution in arbitration will expose students to the real-life pros and cons of employing ADR in place of traditional litigation.

This paper will examine the operation of the mandatory arbitration provisions in investor disputes that were developed after the controversial 30-year old Supreme Court decisions that had barred mandatory arbitration of investor's claims.[8] The paper examines the background and mechanics of FINRA securities arbitration, including a brief description of FINRA and FINRA Dispute Resolution Services. Investor arbitrations are administered by FINRA Dispute Resolution Services, a separate entity from FINRA. However, for ease of reading, this paper will generally refer to that forum as "FINRA arbitration." The paper concludes with a description of how to frame a one-class discussion about mandatory investor arbitration, and suggestions on how to facilitate a class discussion about the widespread adoption mandatory arbitration, and how that development has the potential to produce perverse results in any number of situations. The Appendix: Possible Claims Against Broker-Dealers, contains the author's list of prohibited conduct for broker-dealers and investment advisors in the securities industry, which teachers may find useful in teaching about investor arbitration.

II. FINRA Dispute Services Arbitration Procedures

The National Association of Securities Dealers (NASD) was the predecessor to the Financial Regulatory Industry Regulatory Authority (FINRA). Prior to the merger of two separate securities arbitration panels, approximately 90% of investor arbitrations were handled by an arbitration panel administered by the NASD; the remainder were arbitrated through the New York Stock Exchange arbitration program. The two arbitration systems were merged after the creation of FINRA on July 30, 2007, when NASD and the member regulation, enforcement and arbitration operations of the

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[6] Other common disputes with brokers will be listed later in this paper.

[7] Although most shareholder arbitration claims and awards are relatively modest in amount, multi-million dollar awards including large punitive damage awards are not out of the question.

[8] *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), overruling *Wilco v. Swam,* 346 U.S. 427 (1953) which held that mandatory agreements barring investor from asserting their legal rights in court under the 1933 and 1934 securities acts were invalid.

New York Stock Exchange were consolidated. This merger eliminated even the option of two different arbitration forums for investors.

FINRA Dispute Resolution Services also offers claimants a separate "mediation track" that runs concurrently with the arbitration. FINRA Dispute Resolution Service statistics reveal that roughly the same number of cases are "closed" after arbitration and mediation. Almost 90 percent of mediated cases are settled, the reminder are returned to arbitration where they may be decided, settled or dropped by the claimant without a resolution. This paper, however, focuses on the mandatory arbitration system rather than FINRA's voluntary mediation services.

FINRA Dispute Resolution Service's arbitration panel has slightly over eight thousand arbitrators, located nation-wide with a few arbitrators located in London. Slightly less than half are classified as "public arbitrators" with no connection to the securities industry, while slightly over half are "non-public arbitrators." Non-public arbitrators either worked in the industry, or have a family member who currently works or worked in the industry, who provides or provided services to financial industry clients or to parties engaged in securities arbitration and litigation.

Arbitrators are not required to have extensive experience in the securities industry or experience with investments. They must have at least five years of paid business and or professional experience and at least two years of college-level credits. All arbitrators, including those with experience in the securities industry, are required to complete FINRA Dispute Resolution Services training including passing an exam, prior to serving on a panel. FINRA also offers advanced arbitrator training in specific areas such as employment discrimination and expungement of broker disciplinary records.[9]

FINRA panels are normally comprised of three arbitrators, although in some case a sole arbitrator may hear a dispute. Panels hearing investment claims generally must contain two public arbitrators but a claimant can select a full panel of public arbitrators. According to FINRA's website, arbitrator selection seems straight-forward: "The arbitrator's name will begin to appear on lists (generated on a random basis by our list selection system) and be sent to the parties during the list selection process." [10] The actual process is somewhat more complex.

One leading expert on investor arbitrations opined that arbitrations are not necessarily won on the merits of the case, but in the selection of arbitrators by the parties.[11] FINRA publishes a limited amount of information about each arbitrator on its website. Arbitrators must provide very detailed vitas, and FINRA regularly "googles" its 8000 arbitrators to see if they have omitted anything. Experienced counsel typically access past arbitration awards to determine how the arbitrator voted. An attorney representing a claimant would ordinarily strike an arbitrator who voted to deny ten claimants in a row. Commercially available software can now streamline this previously time-consuming process.[12] Litigants should recall however, that past history is no guarantee of future performance. If the parties strike all the non-public arbitrators from the list FINRA provides the panel will be composed of all pubic arbitrators. Some attorneys representing claimants evidently

[9] FINRA maintains a database called BrokerCheck that provides information about complaints made by customers. Few brokers have a complaint recorded, a small number have two, and a tiny percentage have three or more. Expungement of a broker's complaints requires a hearing before a one-person arbitration panel. Although FINRA cautions arbitrators that expungement should only be granted in rare occasions (brokers and broker-dealers can post their own explanations on BrokerCheck) arbitrators approve the vast majority of such requests.

[10] https://www.finra.org/arbitration-mediation/what-expect-training-case-service-and-honorarium

[11] David Robins at https://www.securitieslosses.com/blog/2016/03/selecting-arbitrators-part-1/

[12] https://www.batesgroup.com/news/bates-group-introduces-arbitrator-evaluator-the-essential-information-source

believe that public arbitrators are more likely to award damages, while in fact data suggests the opposite may be correct. [13]

Claimants typically, but not always, hire attorneys to pursue their claims against broker dealers.[14] *Pro se* appearances are permitted and not actively discouraged, even if they are not appreciated by opposing counsel and veteran arbitrators. In some areas of the country state court systems have seen an increase in *pro se* appearances and FINRA may expect the same. Claimants' attorneys may make their own fee arrangements and many accept these arbitrations on a contingent-free basis. Some law firms prospect for clients in a variety of states. In practical terms state bars usually do not enforce the requirement to associate with local counsel when an out-of-state attorney participates in an arbitration hearing. Although arbitrations may be held anywhere, they are typically held in the city where the claimant resides. It is not unusual for both counsels to fly into the city for the first time to appear at the arbitration hearing.

Although prehearings, motions and one arbitrator hearings can be heard telephonically to save travel expense and FINRA's cost of hiring a hearing room, regular arbitration hearings are typically live events, although distant witnesses may testify telephonically. During the COVID 19 shutdown FINRA experimented with Zoom meetings for regular hearings. [15]

FINRA arbitrations are conducted according to FINRA's Code of Arbitration Procedure. [16] FINRA actually has two codes of procedure, one for customer cases, and one for industry member cases. The FINRA code provides a limited number of documents that are automatically available for discovery; and ,discovery of other documents is open to negotiation between the parties. The panel chair typically hears motions concerning discovery issues. The panel may impose a variety of sanctions for a party's failure to provide requested documents, including financial penalties. Rule 12212(c) of the code also gives the panel the power to dismiss a claim, defense or proceeding with prejudice for intentional and material failure to comply with a discovery order of the panel if the panel's prior warnings or sanctions have proven ineffective.

Although many investor disputes are settled informally or through concurrent FINRA mediation, those disputes that go to a hearing resemble a trial although the matter is "in equity" so arbitrators are not strictly bound by legal statutes including statutes of limitation that would bar the claims in court. Motions to dismiss are routinely deflected. Panels hear the evidence, deliberate

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[13] See FINRA statistic which reveal a small but significant difference in awards. https://www.finra.org/arbitration-mediation/dispute-resolution-statistics/2019#top15controversycustomers The author believes this results because non-public arbitrators are more aware of back office and sales practice rules and more apt to punish brokers and broker-dealers for sloppy work.

[14] Interestingly, a non-lawyer can represent a client at a FINRA arbitration and there is no particular qualification to do so. This differs from FINRAs own qualifications to serve as an arbitrator, and an IRS audit in which the IRS bars individuals from advocating on behalf of a client unless they are a licensed attorney, a licensed CPA or an" EA,"--an "Enrolled Agent" who has passed a rigorous IRS exam on federal tax law.

[15] The experiment was not uneventful. One recent big-ticket arbitration required about 12 days of hearings with the last session on March 12 after the shut-down so it was conducted using Zoom. The panel awarded claimant $11 million. In a motion filed to vacate the arbitration award in the US District Court for the Southern District of New York, respondant's new council argued that the panel had shown clear bias throughout the sessions, improperly excluding evidence and testimony and the panel failed to provide the required rationale for the decision. Additionally the filing argued that one arbitrator during the remote Zoom session looked at other screens, typed and ate, another "blocked her screen…preventing the parties from confirming that she was even participating," and the panel's chairman walked away from his screen at one point during closing arguments." Wunderlich Securities, Inc. and Gary Wunderlich, Petitioners, v. Dominick & Dickerman, LLC and Michael J. Campbell, Respondents (Petition to Vacate Arbitration Award, United States District Court for the Southern District of New York, 20-CV-03507)

[16] https://www.finra.org/arbitration-mediation/printable-code-arbitration-procedure-12000#12409-0.

and reach a decision. A unanimous decision is not required. Unless both parties request one, the panel does not have to provide an "explained decision," a written rationale for its reasoning.

Panel awards are generally final. Although parties have the option of motioning a state or federal court to vacate a panel's award, the grounds are limited to: 1) the award was procured by corruption, fraud, or undue means; 2) there was evident partiality or corruption in the arbitrators; 3) the arbitrators were guilty of misconduct in refusing to postpone the hearing, even in light of sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy, or of any other misbehavior by which the rights of any party have been prejudiced; 4. the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made; 5. the arbitrators disregarded a clearly defined law or legal principle applicable to the case before them (Manifest Disregard of the Law); or 6. there is no factual or reasonable basis for the award (Complete Irrationality).[17]

III. Discussing Mandatory Arbitration in the Classroom

The suggested class session should briefly refresh the students' understanding of arbitration as an alternative to litigation before explaining the operation of the FINRA arbitration system in more detail. That review of arbitration should carefully cover the distinctions between "voluntary" arbitration"--situations in which the parties voluntarily agree to use arbitration rather than litigation to resolve a legal dispute, court-annexed arbitration which is common in certain urban areas, and mandatory private arbitration, which has just recently become widespread. FINRA arbitration is, of course, in the third category. Either before or after coverage of the FINRA arbitration procedures, the students might profit from the opportunity to dicuss the pros and cons of mandatory arbitration in general. Students need to understand that in many areas of contract law mandatory arbitration causes are becoming the norm, not the exception. Because of time constraints this opportunity may have to be considered to homework.

Students who study contracts may come out of class believing that all contractual terms are negotiable. In reality, when they enroll in college, sign up for a credit card, cell phone or cable TV, buy a car and insure it, get a job, rent an apartment, and even arrange for grandpa to enter an assisted living facility, other than perhaps price, none of the terms of these contracts are negotiable and each of the contractual arrangements will typically contain a mandatory arbitration clause (in many cases mandatory on the consumer, not the drafter) barring them from using the court system to get redress for any wrongdoing.

Naturally students will have a better understanding of how the law will work if they have first-hand experience with the underlying transactions. Most college students have drivers' licenses and can quickly see the how comparative negligence apportions damages after a traffic accident. Students typically have little or no experience with contracts. Younger college students are not only unlikely to own a stock brokerage account, but many will not have their own cell phone contracts, or car insurance policies either. Accordingly, discussing the operation of a mandatory arbitration clause in a hypothetical employment or consumer contract may be more comprehensible to them than discussing a business case. Students need to understand that they themselves may be victims of a breached contract without a realistic route to redress.

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[17] Federal Arbitration Act, 9 U.S.C. §10.

Although most Business Law textbooks discuss both arbitration versus litigation, and consumer protection, they generally provide a generalized overview of both areas without a detailed description of the most commonly-employed business and consumer arbitration forums. While the textbook descriptions are accurate, they are not evaluative and do not provide the level of detail to allow the reader to make a critical evaluation of the effectiveness of arbitration as a consumer protection remedy. At the other end of the continuum the textbooks do not present a bird's eye view of the consequences of wide-spread mandatory arbitration on the US legal system. The softening of both federal and state consumer protections and employment law protections necessarily throws potential claimants back into the court system for remedies when consumer or employee rights are violated. However, the wide-spread use of mandatory arbitration in a variety of contracts has left many individuals without an effective remedy for redress in a variety of contexts. The widespread adoption of mandatory arbitration has been propelled by the appellate courts, not by the legislative branch, and represents a major change in the US legal system.

Although perhaps well-intentioned, in practice consumer arbitration has failed to protect individuals from corporate wrong-doing. Although some consumer class actions have provided both victim compensation and withdrawal of dangerous products from the marketplace, the tort system is not always suited to efficiently protect and compensate consumers either. In many cases settlements in class action consumer product lawsuits have resulted in large payoffs to plaintiff's' attorneys with small or even no financial return to the consumers themselves.[18] Although proponents of mandatory arbitration use this example to promote mandatory arbitration, the argument is self-serving since mandatory arbitration provides little more than a cynical mirage of a remedy. The real problem of course is toothless government regulation. This may be a fertile area for class discussions or homework assignments.

IV. Conclusion

This paper has proposed devoting one class-long session of your Business Law class to examining mandatory investor arbitration. Because sellers of securities uniformly include mandatory arbitration provisions in their customer contracts, resolution of investor disputes only takes place in FINRA's arbitration forum before a FINRA panel of arbitrators. This system, approved by the US Supreme Court about thirty years ago, and which required the Court to overturn one of its own decisions, made a radical change in the legal system: resolving an investor's complaint in court is now no longer an option for either the investor, the broker, or the broker-dealer, the broker's employer. Since the Supreme Court gave its stamp of approval and even encouraged the practice, mandatory arbitration clauses have become commonplace. Mandatory arbitration clauses are included in an estimated 800 million contracts in the U.S., and the parties to all of those contracts are barred from getting a day in court to seek redress. The paper proposes that by learning about FINRA's arbitration program, students will not only learn more about how investor disputes are resolved, but will also appreciate the theoretical advantages of arbitration in this and other contexts such as consumer and employment law, but will also appreciate the

[18] The December 2019 $700 million Equifax data breach settlement awarded $77 million in attorney fees (their request was for $80 million) and $380 million to a consumer fund. Anticipating 248,000 Equifax subscribers would request a $125 cash refund, $31 million of the $700 million was set aside. Because about 4.5 million subscribers actually applied for a cash refund they will each receive about $6.80 not $125. The FTC did warn consumers they might get far less than the maximum $125. https://www.ftc.gov/news-events/press-releases/2019/07/ftc-encourages-consumers-opt-free-credit-monitoring-part-equifax

sometimes perverse results of mandatory arbitration in practice. The intent of the one-class session is also to overcome the "silo effect" of studying individual legal topics in isolation. Examining a hypothetical investor dispute will illustrate to students how tort, contract, consumer protection and Alternative Dispute Resolution law operate in concert.

V. Appendix: Possible Claims Against Broker-Dealers and Registered Investment Advisors

Certain conduct and sales practices in the securities industry are prohibited, and may be the basis of investor claims against brokers, broker-dealers and registered investment advisors (RIAs)[19] that will be subject to FINRA arbitrations, including the following (the list is NOT complete or all-inclusive:)

1. Unsuitability. Recommending to a customer the purchase or sale of a security that is unsuitable given the customer's age, financial situation, investment objective and investment experience. Investment in a particular type of security may be unsuitable, or the amount or frequency of transactions may be excessive and therefore unsuitable for a given customer. [20]
2. Failure to disclose risks. Selling unvetted investment products or sales of unapproved investments.
3. Excessive trading or account “churning” (also termed "quantifiable unsuitability").
4. Switching a customer from one mutual fund to another when there is no legitimate investment purpose for the switch.
5. Lack of diversification or over-concentration.
6. Recommendations that lack a reasonable basis.
7. Unauthorized trading. Purchasing or selling securities in a customer's account without first contacting the customer and receiving the customer's authorization to make the sale or purchase, unless the broker has received from the customer written discretionary authority to effect transactions in the account or the broker was given discretion as to price and time.
8. Removing funds or securities from a customer's account without the customer's prior authorization.
9. Charging a customer excessive markups, markdowns or commissions on the purchase or sale of securities.
10. Misrepresenting or failing to disclose material facts concerning an investment. Examples of information that may be considered material and that should be accurately presented to customers include: the risks of investing in a particular security; the charges or fees involved; company financial information; and technical or analytical information, such as bond ratings.
11. Guaranteeing customers that they will not lose money on a particular securities transaction, making specific price predictions or agreeing to share in any losses in the customer's account.
12. Misrepresentations or false promises
13. Interpositioning. Running transaction through a second broker-dealer to generate fees.

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[19] Although customers may not understand the distinction, broker-dealers have a different level of duty than investment advisors who owe a true fiduciary duty to their clients. Under SEC rules effective June 1, 2020 broker-dealers are subject to the SEC's Reg BI (best interest of the customer standard), 17 C.F.R. §§ 240.15l1, 240.17a-3, and 240.17a-4 rather than full fiduciary duty imposed on RIAs by the Advisors Act.

[20] Reg BI (*supra.* note 19) modified and limited application of the suitability standard for broker-dealers but not investment advisors.

14. "Trading ahead of the Customer." Accepting and holding an order in an equity security from its own customer or a customer of another broker-dealer without immediately executing the . is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.
15. "Front Running." No FINRA member broker-dealer may cause an order to buy or sell a security or a “related financial instrument” to be executed when that member has material, non-public market information concerning an imminent block transaction in that security, a related financial instrument or a security underlying the related financial instrument prior to the time information concerning the block transaction has been made publicly available, or has otherwise become stale or obsolete.
16. Failure by a market maker to display a customer limit order in its published quotes, without a valid exception.
17. Failing to execute. Failing to use reasonable diligence to see that a customer's order is executed at the best possible price, given prevailing market conditions.
18. Failure to monitor customer account.
19. Failure to communicate with a customer.
20. Failure to supervise staff.
21. Using information gleaned from a seller to solicit sales from other clients unless the seller explicitly approves such an action.
22. Sales of fraudulent investments.
23. Purchasing or selling a security while in possession of material, non-public information about an issuer.
24. Using information gleaned from a seller to solicit sales from other clients unless the seller explicitly approves such an action.
25. Using manipulative, deceptive or other fraudulent methods to effect a transaction in, or induce the purchase or sale of, a security.
26. Theft of customer funds (this is covered by required insurance)
27. Sales of Ponzi scheme investments
28. Violation Rule 506 Private Placements
29. Private securities transactions between a broker and a customer that may violate FINRA rules, particularly where the transactions are done
30. Elder abuse.