

FINRA Dispute Resolution Task Force

Final Report and Recommendations of the FINRA Dispute Resolution Task Force

INTRODUCTION

The Financial Industry Regulatory Authority (FINRA)¹ operates the largest securities dispute resolution forum in the United States, with hearing locations in all 50 states, as well as Puerto Rico and London. FINRA's Dispute Resolution division (DR) handles more than 99 percent of the securities-related arbitrations and mediations in the U.S. and maintains a roster of more than 6,400 arbitrators and nearly 250 mediators.²

FINRA formed a task force in June 2014, to consider possible enhancements to its arbitration and mediation forum, in order to ensure that the forum meets the evolving needs of participants. The task force is comprised of individuals, from the public and industry sectors, who represent a broad range of interests in securities dispute resolution.³ FINRA charged this group to work together to suggest strategies to enhance the transparency, impartiality, and efficiency of FINRA's securities dispute resolution forum for all participants. This document is the Final Report of the task force, including its recommendations to FINRA's National Arbitration and Mediation Committee (NAMC).

BACKGROUND

FINRA is, for all practical purposes, the sole arbitration forum in the United States for resolving disputes between broker-dealers, associated persons, and customers. FINRA requires arbitration of disputes between customers and broker-dealers and associated persons at the request of the customer.⁴ The dispute must arise in connection with the business activities of the member or the associated person (except disputes involving the insurance business activities of a member that is also an insurance company). In addition, a written agreement can require arbitration of customers' disputes.⁵ Although some securities firms included predispute arbitration agreements (PDAAs) in customers' brokerage agreements at least since the 1950s,⁶

¹Until mid-2007, the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) ran separate arbitration forums that handled a combined 99% of all securities arbitrations in the country. On July 30, 2007, NASD and NYSE Regulation, including their respective arbitration forums, consolidated and formed FINRA. See Press Release, (July 30, 2007), available at <http://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority>. This report will, in most instances, refer to the regulator by its name at the time of the event being discussed. When referring to the regulator generally or over an extended period of time, it will be referred to as FINRA.

² <http://www.finra.org/>.

³ The members of the task force are set forth in Appendix I.

⁴ FINRA Rule 12200. FINRA's Code of Arbitration Procedure is available at FINRA's website, at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4096.

⁵ *Id.*

⁶ *Wilko v. Swan*, 346 U.S. 427 (1953) (holding that a PDA was not enforceable with respect to claims under Securities Act of 1933), *overruled*, *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989).

vast majority are consistent with this approach and that the quality of the explanation was generally good.

The task force recommends maintaining the basic brief, fact-based format contemplated by Rule 12904(g). The task force does not intend that explained decisions should carry any precedential value in subsequent arbitration cases. It also thought that some explanation of reasons for the amount of damages would be useful, but without requiring complex calculations. In addition, if the rule is revised to make explained decisions more common, but retaining an element of choice, changes will need to be made with regard to the timing of the request. Specifically, the request should come earlier in the process so that the panel chairperson could complete the required training (see below.)

Operational Issues that Would Need to be Addressed. A significant increase in requests for explained decisions could strain an arbitration system that uses individuals who serve as arbitrators on an occasional basis and who lack formal training or experience in writing decisions. The risk that decisions will be overturned on appeal likely increases if arbitrators are not well equipped to write such decisions. Thus, if FINRA chooses to move forward with changes designed to increase the use of explained decisions, it is essential that FINRA develops a program to train panel chairpersons in how to write appropriate decisions.

In summary, the task force recommends:

1. The FINRA rule should be amended to require explained decisions unless any party notifies FINRA, prior to the IPHC, that it does not want an explained decision.
2. The current brief, fact-based format of the explanation should be retained, but with the addition of some summary explanation of the reasons behind any damage calculation.
3. Before any plan to expand the use of explained decisions is implemented, FINRA must develop and administer a training program on how to write explained decisions. Chairpersons must complete the training promptly after they are notified that an explained decision is expected in an assigned case.

EXPUNGEMENT

Background. The Central Registration Depository (CRD[®]) is the securities industry's online registration and licensing database.⁷⁵ FINRA operates the CRD system pursuant to policies developed jointly with NASAA. Information in the CRD is obtained through forms that brokerage firms, associated persons and regulators complete as part of the securities industry registration and licensing process. The CRD includes information about criminal matters, regulatory disciplinary actions, civil judicial actions, and information relating to customer disputes, such as customer complaints, arbitration claims, and arbitration awards. Through BrokerCheck[®] investors can research the professional backgrounds of brokerage firms and

⁷⁵ <http://www.finra.org/industry/compliance/registration/crd/>.

associated persons.⁷⁶ FINRA recently began an advertising campaign to educate investors about the availability of BrokerCheck.⁷⁷

The existence of a customer's complaint—regardless of its merits—is an accurate reflection of the historical record. Yet there has long been a tension between the importance of accurate historical information and the harm that can result to an associated person if a customer's complaint is unfounded. Since the inception of the CRD system in 1981, NASD generally honored court-ordered expungements, and until January 1999, it honored arbitrator-ordered expungements contained in final awards. NASAA and states, however, took the position that information in the CRD system was a government record of any state that used the information in making licensing decisions and that state laws did not permit expungement without an explicit court order. In January 1999, NASD announced a moratorium on arbitrator-ordered expungements unless the award was confirmed by a court of competent jurisdiction. It also undertook to establish clear standards for expungement.

In 2002 NASD filed a proposed rule change with the SEC to establish procedures for expunging customer dispute information from the CRD system.⁷⁸ NASD acknowledged: the need to balance three competing interests: (1) the interests of NASD, the states, and other regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations; (2) the interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate; and (3) the interests of investors in having access to accurate and meaningful information about brokers with whom they conduct, or may conduct, business.⁷⁹

While there was general agreement about the need for a rule establishing procedures and criteria for expungement, there was considerable debate over both the procedures and the criteria. NASAA took the position that only “factually impossible” claims should be expunged, while representatives of the brokerage community urged that it was unfair to require associated persons to institute a cumbersome procedure to remove from their record unfounded allegations by disgruntled customers. The final product was necessarily a product of compromise.

FINRA Rule 2080 requires all directives to expunge customer dispute information from the CRD system to be confirmed by or ordered by a court of competent jurisdiction and requires the brokerage firm or associated person to name FINRA as a party in any judicial proceeding seeking confirmation of an arbitration award containing expungement relief. FINRA may, however, waive the requirement to name it as a party if it determines that the requested expungement relief is based on affirmative judicial or arbitral findings that (1) the claim, allegation or information is factually impossible or clearly erroneous, (2) the associated person was not involved in the alleged investment-related sales practice violation, forgery, theft,

⁷⁶ <http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/>.

⁷⁷ <http://www.finra.org/investors/brokercheck-ads>.

⁷⁸ Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System, Exch. Act Rel. 34-47435, 68 Fed. Reg. 11435 (Mar. 10, 2003).

⁷⁹ *Id.* at 11437.

misappropriation or conversion of funds, or (3) the claim, allegation, or information is false.⁸⁰ In addition, FINRA has sole discretion “under extraordinary circumstances” to waive the requirement if the expungement request is meritorious and expungement would not have a material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.⁸¹ In approving the rule, the SEC stated that it was “clearly an improvement over the current expungement system in which there are no parameters placed on expungements being incorporated into arbitration awards.”⁸²

By 2008, FINRA became aware that some arbitrators were approving expungement requests that were part of negotiated settlements without inquiring into the terms of the settlement.⁸³ Accordingly, FINRA proposed, and the SEC approved, procedures that arbitrators must follow in granting expungement requests. Under FINRA Rules 12805 and 13805 the panel must (i) hold a recorded hearing session by telephone or in person regarding the appropriateness of expungement, even if a claimant did not request a hearing on the merits; (ii) for cases involving settlements, review the settlement documents to examine the amount paid to any party and any other terms and conditions of the settlement that might raise concerns about the associated person’s involvement in the alleged misconduct before awarding expungement; (iii) indicate in the arbitration award which of the Rule 2080 grounds for expungement serves as the basis for the expungement order and provide a brief written explanation of the reason(s) for its finding that one or more grounds for expungement exists; and (iv) assess forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement.

In the public comment period, some commenters questioned whether it was appropriate to give the responsibility of expungement to arbitrators rather than regulators, given the importance of the CRD system in providing information to investors. FINRA asserted that these comments were beyond the scope of the rulemaking process. In approving the final rule, the SEC stated its expectation that expungement would be an “extraordinary remedy.”⁸⁴ Moreover, “[b]ecause of the central role that arbitrators have in the expungement process, the Commission believes that it is critical for arbitrators to be well-informed regarding FINRA’s rules governing expungement.”⁸⁵ The SEC also urged FINRA that “[g]iven the importance of CRD for regulators and to customers ... to monitor how this rule is applied by arbitrators to assure that it is achieving its goals, and to propose additional changes, if needed.”⁸⁶

⁸⁰ *Id.*(b)(1).

⁸¹ *Id.*(b)(2).

⁸² Self-Regulatory Organizations; National Association of Securities Dealers, Inc; Order Granting Approval of Proposed Rule Change and Amendment No. 1, Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2, Thereto, Relating to Proposed NASD Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System, Exch. Act Rel. 34-48933, 68 Fed. Reg. 74667, 74672 (Dec. 24, 2003).

⁸³ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change Amending the Codes of Arbitration Procedure To Establish Procedures for Arbitrators To Follow When Considering Requests for Expungement Relief, Exch. Act Rel. 34-48933, 73 Fed. Reg. 66086, 66087 (Nov. 6, 2008).

⁸⁴ 73 Fed. Reg. at 66089.

⁸⁵ 73 Fed. Reg. at 66090. FINRA requires all arbitrators to take an online expungement training course.

<http://www.finra.org/ArbitrationAndMediation/Arbitrators/Training/RequiredBasicArbitratorTraining/P124905>.

⁸⁶ 73 Fed. Reg. at 66090.

A closely related issue is the practice of conditioning settlements on the customer's agreement not to oppose a request for expungement relief. FINRA frequently expressed its concern about this practice and took steps to discourage it. In 2004, FINRA cautioned firms and associated persons that negotiating settlements with customers in return for exculpatory affidavits that the firm or associated person knows or should know are false or misleading is a violation of FINRA Rules.⁸⁷ In 2013, FINRA sent to arbitrators and published on its website guidance stating that, in determining whether to recommend expungement relief in settled claims, arbitrators should inquire whether a party conditioned settlement on an agreement not to oppose a request for expungement relief.⁸⁸ Finally, in April 2014, FINRA filed with the SEC a new rule that would expressly prohibit firms and associated persons from seeking to condition a settlement of a customer's dispute on the customer's agreement to consent to, or not to oppose, the firm's or associated person's request to expunge information about the customer's dispute from the CRD.⁸⁹ FINRA Rule 2081 went into effect July 30, 2014.

Despite these rule changes, reports from PIABA and state regulators suggest that flaws still exist in the process. Concerns have been expressed that customers' complaints are frequently expunged on the sole basis of a merits decision in favor of the broker-dealer or associated person, without due consideration of the limited grounds set forth in Rule 2080.⁹⁰ In approving the most recent rule changes, the SEC encouraged FINRA to conduct a comprehensive review of its expungement rules and procedures to determine whether additional rulemaking is necessary and appropriate to assure that expungement in fact is treated as an extraordinary remedy that is permitted only where the information to be expunged has no meaningful investor protection or regulatory value.⁹¹

At its September 2015 meeting, FINRA's Board of Governors authorized the filing with the SEC of proposed amendments to FINRA Rules 12805 and 13805 that would codify the best practices from the Expanded Expungement Guidance document issued as a notice to parties and arbitrators in 2013. The expanded guidance emphasizes that arbitrators "have a unique, distinct role in ensuring that customer dispute information is expunged from the CRD system only when it has no meaningful investor protection or regulatory value."⁹² Because of their significant role,

⁸⁷ Notice to Members 04-43, Members' Use of Affidavits in Connection with Stipulated Awards and Settlements to Obtain Expungement of Customer Dispute Information under Rule 2130, available at <http://www.finra.org/industry/notices/04-43>.

⁸⁸ The December 2013 issue of The Neutral Corner was devoted to expungement and addresses this issue, among others. <http://www.finra.org/arbitration-and-mediation/neutral-corner-volume-4-2013>.

⁸⁹ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Adopt FINRA Rule 2081 (Prohibited Conditions Relating to Expungement of Customer Dispute Information), Exch. Act Rel. 34-70442, 79 Fed. Reg. 22734 (Apr. 23, 2014).

⁹⁰ Although FINRA Rule 2080 provides specific grounds by which FINRA may waive its participation as a required party in a court expungement confirmation hearing and does not speak to those grounds as the only basis for an expungement, FINRA Rules 12805(c) and 13805(c) require that one of the Rule 2080 grounds be articulated by the arbitration panel "in order to grant expungement of customer dispute information under Rule 2080" (Rule 12805), in effect converting the Rule 2080 grounds into the only grounds for which expungement may be granted.

⁹¹ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change to Adopt FINRA Rule 2081, Prohibited Conditions Relating to Expungement of Customer Dispute Information, Rel. 34-72649, 79 Fed. Reg. 43809 (July 28, 2014).

⁹² <http://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance>.

arbitrators should make sure that they have all the necessary information to make an informed decision. The expanded guidance also emphasizes the importance of allowing customers and their counsel an opportunity to participate in the expungement hearing.

FINRA/NASAA Discussions. The task force has been advised that FINRA and NASAA are in the process of discussions with regard to the expungement process. Preliminary indications are that FINRA and NASAA are considering converting the process into a regulatory procedure. The task force encourages FINRA and NASAA to move forward expeditiously with their deliberations because of the importance of resolving this issue. The task force was also informed that FINRA and NASAA would not complete their discussions on the feasibility of a new regulatory approach and process before the completion of the task force's work. The task force takes no position on whether a regulatory approach should eventually replace the current expungement process. Because of uncertainty about the ultimate outcome of the NASAA/FINRA discussions, the task force gave serious consideration to the creation of a special arbitration panel consisting of specially trained arbitrators to decide requests for expungement. It makes the recommendations described below.

Creation of a Special Arbitration Panel. This group of arbitrators would conduct hearings on expungement requests and make determinations as to whether to grant expungement requests. All members of special arbitration panels should be experienced individuals from the chairperson roster who have received enhanced training on expungement (described below).

The task force noted that the majority of issues that arise in the expungement process are those involving settled cases that do not go to final resolution. In such cases, the panel selected by the parties has not heard the full merits of the case and therefore may not bring to bear any special insights in determining whether to grant an expungement request. In addition, claimants or their counsel have little incentive to participate in an expungement hearing once their case has been settled. Creation of a special arbitration panel would make up for these deficiencies. This corps of specially trained arbitrators would follow the procedure set forth in FINRA Rule 12805/13805 and the expanded guidance and make a decision about whether FINRA Rule 2080 grounds exist to grant the expungement request, keeping in mind the importance of maintaining the integrity of information in the CRD system.

Similarly, a special arbitration panel should handle expungement requests when claimants did not name the associated person as a respondent in the underlying arbitration claim. In these cases, the arbitration panel should ensure that the customer has notice of the associated person's expungement request and an opportunity to participate in the proceeding.

With regard to arbitration cases that go to hearing and full resolution on the merits, a stronger argument can be made that the panel who heard the case on the merits is the proper panel to make an expungement determination. The task force recommends allowing the panel that heard the merits to conduct the expungement hearing so long as the chairperson has completed the enhanced expungement training (described below).

The task force discussed whether there should be a FINRA representative participating in expungement hearings (or at least in those involving settled cases) in order to represent the public interest, but reached no consensus.

In all cases discussed above, the task force agrees that enhanced arbitrator training with regard to the expungement process is of great importance. While it is acknowledged that training on the expungement process is a requirement for all arbitrators, FINRA should review with a consultant ways to improve this training. In addition, to qualify for the special arbitration panel, arbitrators should receive additional training that will include input from state regulators and highlight the extraordinary nature of the expungement remedy. The training should impress upon arbitrators that they are involved in a regulatory process intended to protect investors and that the grounds for expungement must be one articulated in FINRA Rule 2080. In this regard, the task force heard concerns that arbitration panels and courts are interpreting the second ground in Rule 2080 (“the associated person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds”) too broadly and recommends that FINRA develop clearer guidance to emphasize the narrowness of the grounds.

While the arbitration panel conducts its hearing, the states, through a NASAA coordinated process, review the expungement request to make their own assessment whether the request meets the grounds for expungement. Accordingly, the task force recommends that the NAMC review procedures for notifying state regulators.

SMALL CLAIMS

Background. FINRA Rule 12800 provides a simplified arbitration procedure for small claims, currently defined as arbitrations involving \$50,000 or less, excluding interest and expenses. The purpose of the simplified arbitration procedure is to make the process less expensive and faster. The principal differences between simplified and standard arbitration is that one arbitrator from the chairperson roster decides the case and there is no hearing unless requested by the customer. In the absence of a hearing the arbitrator decides the dispute based on the pleadings and other documents submitted by the parties. In recent years, approximately 5 percent of cases were closed after review of the papers, compared with approximately 18 percent closed after a hearing.⁹³

Task Force Deliberations

Dissatisfaction with Paper Submissions. The task force formed a consensus around the following:

- Claimants whose cases are adjudicated as part of FINRA’s small case program are the least satisfied of any group of users of the FINRA forum. There are a variety of possible explanations for this finding.
 - Small case “win” rates for papers cases (approximately 37%) and small case hearings (approximately 34%) are lower than the win rates for claimants in cases decided by all public panels.

⁹³ How Arbitration Cases Close, <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>.