Arbitration v. Litigation and Dodd-Frank Act and the Proposed Uniform Fiduciary Duty

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Arbitration vs. Litigation

• 2015 Arbitration Fairness Act of 2015- proposed legislation designed to prohibit pre-dispute agreements to arbitrate consumer disputes.

• Benefits of arbitration v. state/federal court litigation.
Mandatory Arbitration

• In FINRA, Rule 12200 requires that parties must arbitrate a dispute under the Code if:

  • Required by a written agreement or requested by the customer.

  • The dispute is between a customer and a member or associated person of a member; and

  • The dispute arises 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.
Elective Arbitration

• Under FINRA Rule 12201, the parties may arbitrate a dispute under the Code if:
  • The parties agree in writing to submit the dispute to arbitration under the Code after the dispute arises; and
  • The dispute is between a customer and a member, associated person of a member, or other related party; and
  • The dispute arises in connection with the business activities of a member or an associated person, except disputes involving the insurance business activities of a member that is also an insurance company.
Definition of a “Customer”

FINRA Rule 12100(i): “A customer shall not include a broker or dealer.”

- FINRA Rule 1250, Continuing Ed. Requirements, Firm Element, Persons Subject to the Firm Element: “any natural person and any organization, other than another broker or dealer, executing securities transactions with or through or receiving investment banking services from a member.”

- FINRA Rule 4530, Reporting Requirements: “any person, other than a broker or dealer, with whom the member has engaged, or has sought to engage, in securities activities.”

- FINRA Reg. Notice 12-55: “the term customer includes a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer received or will receive, directly or indirectly, compensation.”
Definition of a “Customer”

• Case Law Summary:

  • A customer is “one who, while not a broker-dealer, either (1) purchases a good or service from a FINRA member, or (2) has an account with a FINRA member. Sagepoint Financial, Inc. v. Small, No. 15-CV-0571, 2015 WL 2354330, *4 (E.D. Mich. May 15, 2015) (citing Citigroup Global Markets, Inc. v. Abbar, 943 F. Supp. 2d 404 (S.D.N.Y. 2013), aff’d, 761 F.3d 268 (2nd Cir. 2014)).

  • Whether the claimant is a “customer” must be determined as of the time of the events providing the basis for the claimant’s allegations. Id.
Hypotheticals re Arbitration v. Litigation

Ex. 1: Investor (OH) files a FINRA arbitration action against Broker-Dealer (DE) and Associated Person (OH) in 2015, arising out of a Tenant-In-Common investment made in 2007. The claims are negligence, violation of FINRA Rules (suitability, failure to supervise), fraud, and breach of fiduciary duty.

Ex. 2: The same investor files the same case in state court in Ohio.

Questions: Do you move to dismiss case #1 under FINRA’s eligibility rule? Do you move to compel case #1 into FINRA arbitration?
Considerations

1. **SEC Release No. 34-59189**: If a panel grants a motion to dismiss a party’s claim based on eligibility grounds, the party may re-file the claim in court to pursue its remedies.

2. **Statutes of Limitations**: Although there is authority to support the application of state-law statutes of limitations in FINRA proceedings, there is no mechanism to seek dismissal of claims prior to arbitration, and panels may or may not enforce them at hearing. Are the state law statutes of limitations favorable or not?

3. **Forum/Venue/Jurisdiction**: If you prevail on the motion, would the case be refiled in state or federal court? Will there be diversity jurisdiction if the case is re-filed in state court to remove to federal court? Will there be federal question jurisdiction?
Considerations Con’t

4. **Dispositive Motion:** Motions to dismiss prior to the conclusion of a case-in-chief are limited to three grounds: (1) the six year eligibility under Rule 12206; (2) the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release; or (3) the moving party was not associated with the account(s), security(ies), or conduct at issue. FINRA Rule 12504(a)(1); FINRA Rule 12504(a)(6). A fourth option—to move for dismissal where the dispute was previously adjudicated by an order, judgment, award or decision—may be added to these permissible options per the FINRA Task Force’s recommendation.

- Does your case have strong legal defenses such that a dispositive motion would be successful?
- How much is in dispute?
- Are you better off trying the case to the FINRA Panel or to a jury?
- Do you anticipate any issues to be taken up on appeal?

5. **Discovery:** No interrogatories. FINRA Rule 12507. No depositions, except (1) to preserve testimony of ill or dying witness, (2) to accommodate essential witnesses who are unable to travel long distances for a hearing and may not otherwise be required to participate in the hearing; (3) to expedite large or complex cases; and (4) if the panel determines that extraordinary circumstances exist. FINRA Rule 12510. Limited authority to subpoena non-FINRA members. Subpoenas to non-FINRA members are not enforceable. FINRA 12512.
Considerations Con’t

6. **Evidence**: Rules of evidence do not apply. FINRA Rule 12604. Motions to exclude are heard and decided by the fact-finders themselves—i.e., the Panel.


8. **Awards**: No jury instructions. No jury interrogatories. No right to an appeal. No written opinion or explained decision unless both parties agree and submit a joint request at least 20 days before the first scheduled hearing date. FINRA Rule 12514(d). This rule governing explained decisions is expected to change, however, due to the recommendation of the FINRA Joint Task Force. The new rule will be an opt out rule instead of an opt in. There will be an explained decision unless either party notifies FINRA, prior to the Initial Prehearing Conference, that it does not want an explained decision.

9. **Cost/Timeliness**:  
   - FINRA: The processing time from service of the claim to close of the case is 14.6 months, generally, and 17.8 months for cases going to hearing.  
   - Federal Court: The median time from service of a complaint to close of the case is 18.35 months, generally, and 32.4 months for cases going to trial, for civil cases in the U.S. District Courts in Ohio.
“The Dodd-Frank Wall Street Reform and Consumer Protection Act 2010”

General Overview

• Largest regulatory overhaul of Wall Street since Great Depression
• Introduced on Dec. 2, 2009 by Barney Frank
• Became law on July 21, 2010
• Contains 315 rulemaking requirements and 145 studies

Uniform Fiduciary Standard of Care

Section 913 of the Dodd-Frank Act directs the SEC to evaluate, among other things, the effectiveness of existing legal or regulatory standards of care for Broker-Dealers, Investment Advisers, and Associated Persons.
Why Study the Standards of Care for Broker-Dealers and Investment Advisers?

Current Standards

• Investment Advisers:
  • Fiduciary standard of care – must always act in the best interest of the client and avoid or disclose material conflicts.
  • Other recognized duties:
    • Carry out customer orders
    • Inform customers of risks related to purchasing/selling securities
    • Refrain from self-dealing
    • Do not misrepresent material information about a transaction

SEC Staff Recommends Uniform Fiduciary Standard

On January 22, 2011, the SEC Staff recommended, among other things, a uniform fiduciary duty for investment advisers and broker-dealers:

- The SEC should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.
Will the Recommended Uniform Standard be Adopted as Law?

“The need to harmonize the regulation of broker-dealers and investment advisers to enhance investor protection is clear. FINRA believes that in order to truly harmonize regulation of these providers, two steps are necessary. The first is establishing a consistent fiduciary standard for investment advisers and broker-dealers providing investment advice.”

• FINRA Chairman & CEO Rick Ketchum, October 6, 2009 testimony before the U.S. House of Representatives Committee on Financial Services

“I have long believed that retail investors deserve a fiduciary standard of conduct regardless of the title printed on their financial counselor’s business card.”

• SEC Chairman Mary Schapiro, February 8, 2011 Speech
When Would the Uniform Fiduciary Standard Apply?

- Applies to:
  - “Personalized Investment Advice” – no defined meaning.
  - There is, however, a definition of “impersonal investment advice”:
    - “Investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.” Adviser Act Rules 203A-3, 206(3)-1
  - It remains unclear when communication rises to the level of personalized investment advise or is considered “impersonal investment advice.”
- Retail investors
  - Defined as “someone who receives personalized investment advice about securities primarily for personal, family, or household purposes.” Section 913(g)(2) of the Dodd-Frank Act.
What Does a Uniform Fiduciary Duty Require?

Broker-dealers and investment advisers must act in the best interest of retail customers without regard to the financial or other interests of the broker, dealer, or investment adviser providing the advice.
Duty of Loyalty

• Current Standards:
  • Investment Advisers
    • Currently owe clients a duty of loyalty pursuant to Adviser Act Sections 206(1) and 206(2)
  • Broker-Dealers
    • Do not owe clients a duty of loyalty

• Standards under the Uniform Fiduciary Standard of Care:
  • Investment Advisers
    • Standard remains the same
  • Broker-Dealers
    • Would now owe clients a duty of loyalty as a result of the uniform standard incorporating Adviser Act Section 206(1) and 206(2)
Duty of Loyalty under the Uniform Fiduciary Standard

Continuing Duty?
• Investment Advisers – YES
• Broker-Dealers – NO
  • Section 913(k)(1) of the Dodd-Frank Act provides:
    • “Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.”

Proprietary Products?
• “The sale of proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of [the uniform fiduciary standard of care].” Section 913(k)(2) of the Dodd-Frank Act.
Current Status

• January, 2015: FINRA released its annual Regulatory and Examinations Priorities Letter: “Irrespective of whether a firm must meet a suitability or fiduciary standard, FINRA believes that firms best serve their customers—and reduce their regulatory risk—by putting customers’ interests first. This requires the firm to align its interests with those of its customers.”

• March, 2015 SIFMA Conference: Mary Joe White expressed her opinion that the SEC should implement the uniform fiduciary standards among brokers and advisers. On the 5-person SEC Commission, this aligns White with Commissioners Aguilar and Stein, making a majority in favor. Commissioner Pinwar is expected to oppose any vote on the uniform fiduciary duty. Commissioner Gallagher, an staunch critic, resigned effective October 2, 2015. His replacement has not yet been named.

• So five years after passing Dodd-Frank….Still waiting…. 
Hypotheticals

• Example 1:
  • Registered Rep. provides investment advice and/or recommends an investment to a portfolio manager. Would the uniform fiduciary standard govern this “investment advice” or “recommendation?”
Hypotheticals

• Answer to Example 1:
  • No. A retail customer is someone who receives personalized investment advice about securities primarily for “personal, family, or household purposes.” Section 913(g)(2) of the Dodd-Frank Act.

• Example 2:
  • What if a registered rep. provides personalized investment advice to an accredited investor? Would the uniform fiduciary standard apply?
• Answer to Example 2:
  • Yes. The definition of a “retail investor” does not differentiate between investors on the basis of wealth or investment experience. See Section 913(g)(2) of the Dodd-Frank Act defining “retail investor”; see also January 22, 2011 SEC Staff Report at fn. 582.

• Example 3:
  • What if a registered rep. discloses to the client that he receives a 5% commission for selling the recommended product, but still recommends the investment under the genuine belief that it is in the client’s best interest. Does the receipt of commission from this recommendation mean the registered rep. has violated his/her fiduciary duty?
• Answer to Example 3:
  No. The receipt of commission-based compensation, or other standard compensation, for the sale of securities does not, in and of itself, violate the uniform fiduciary standard. Section 913(k)(1) (The receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer.”).

• Example 4:
  • Registered rep. recommends that a retail investor purchase shares of ABC Company. Six months later, the rep. learns that the CEO and CFO are stepping down and the company is likely to decline in value. Under the uniform fiduciary standard, does the rep. have a duty to recommend that the client sell the shares of ABC Company?
• Answer to Example 4:

No. Broker-dealers do not have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice. See Section 913(k)(1) of the Dodd-Frank Act (“Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.”).

Note: An investment adviser, however, does have a continuing duty of loyalty and care and may be obligated to update the client on material changes in the investment portfolio.

Note: Under the new suitability rule, an express hold recommendation is covered by the suitability rule.