Should Non-Member Registered Investment Advisors Voluntarily Agree to FINRA Arbitration or Litigate

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Rolling the dice: should non-member registered investment advisors (RIAs) voluntarily agree to FINRA arbitration or litigate in court? Recent FINRA guidance allows nonmember RIAs to voluntarily participate in FINRA arbitrations, however, the decision of whether to proceed with FINRA carries benefits and well as risks. This presentation discusses the pros and cons of RIAs voluntarily participating in FINRA arbitrations.[1]

Introduction

For many years, the vast majority of disputes between retail investors and securities brokers have been resolved in arbitrations administered by the Financial Industry Regulatory Authority (FINRA). FINRA-administered arbitrations, however, were not available in those cases that involved Registered Investment Advisor (RIAs) that were not affiliated with a securities broker/dealer firm principally because FINRA does not have authority over RIA firms.[2]

FINRA's New Approach To Arbitrating With Non-Regulated RIAs

Recently, FINRA has promulgated a new policy that permits RIA firms and their clients to engage in FINRA-administered arbitrations even though the RIA is not affiliated with a FINRA Member Firm. As detailed in FINRA's "Guidance On Disputes Between Investors And Investment Advisers Who Are Not FINRA-Regulated Firms," FINRA will accept jurisdiction over disputes between customers and non-member RIAs on "a voluntary, case-by-case basis" if the parties meet certain conditions, including the following:

- The RIA must agree to pay all FINRA arbitration fees and surcharges;
- The RIA, the investment advisor representatives involved, and the investor must each sign a special form of FINRA's standard Submission Agreement that was executed after the dispute arises (pre-dispute arbitration clauses are not valid);
- The parties must all affirmatively acknowledge and agree on the RIA dispute Submission Agreement form that: (1) FINRA cannot enforce awards entered against non-member RIA firms and/or their employees that are not associated with a FINRA Broker/Dealer member firm; and (2) investors who prevail at arbitration may only enforce awards entered against non-member RIAs and their personnel through a court action in the event of non-payment of the Award;
- FINRA may bar the RIA from using FINRA Dispute Resolution in future cases if the firm fails to pay any award, settlement agreement, or FINRA fees;
- FINRA and its arbitrators will be held harmless from liability arising in connection with the resolution of the parties' dispute;
- Disputes involving RIA firms will be administered in accordance with the FINRA Codes of Arbitration Procedure.

The parties must also affirmatively acknowledge that the final arbitration Award will be made publicly available.

FINRA Arbitration v. Court Litigation: The Pros & Cons

Before considering whether to engage in FINRA-administered arbitration, it is important to be mindful of the pros and cons of FINRA arbitration versus litigation. Some of the advantages of arbitration include the following:

- FINRA-sponsored arbitration can generally be resolved much faster, often in 11 to 12 months versus years in court;
- Discovery is significantly limited in FINA-sponsored arbitration;
- The chance for delays is often much less when dealing with FINRA;
- The costs associated with FINRA-sponsored

arbitration can be significantly less than court-related litigation. In particular, the costs associated with deposition discovery will be significantly less since FINRA rarely allows the taking of depositions and rarely permits the filing of extensive motions, including

- dispositive motions;
- All FINRA-sponsored arbitrations will be decided by individuals with securities industry experience, as opposed to a judge who may not have any experience at all (though, of course, there are those who would welcome a fact-finder who is unfamiliar with the securities industry).

However, RIA firms are not without risk if they opt to have their dispute decided through a FINRA-sponsored arbitration. In particular, if the facts of the case are very problematic for the firm, it may not want to have seasoned securities professionals deciding their case, and applying the higher "fiduciary" standard of care applicable to RIAs and Investment Adviser Representatives. Indeed, while brokers need only recommend securities that are "suitable" for their clients, RIAs are bound to a fiduciary standard of care that obliges them to act in their clients' best interests.

Additionally, if RIA firms choose to arbitrate through FINRA, the decisions will be publically available on the FINRA website. By contrast, an arbitration conducted by AAA, for instance, would be private because the decisions in such cases are not posted publicly (though the cost of AAA arbitration is greater than arbitrating with FINRA).[3] Further, if the RIA and firm believe they have a viable dispositive motion (a motion to dismiss or motion for summary judgment), it is unlikely that it would be granted at a FINRA-sponsored arbitration. The same goes for deposition discovery. If the RIA and firm believe they will be able to elicit favorable deposition testimony, it will be exceptionally difficult, if not impossible, to depose the targeted person in a FINRA-sponsored arbitration. Lastly, to the extent that expert witnesses will be at issue, it is exceptionally difficult to take issue with experts and their methodology via so-called Daubert challenges in FINRA-sponsored arbitration.

Conclusion

FINRA's decision to make its arbitration arm available to RIA firms for resolving disputes with their customers (as well as their departing personnel) offers an intriguing new option for these firms and their professionals. But RIA firms should retain qualified legal counsel as soon as any customer dispute arises – and before any litigation actually ensues – in order to assess whether it makes sense to propose using FINRA's arbitration forum given the facts and circumstances of the particular dispute. Ultimately, the decision of whether to arbitrate versus litigate will largely center on the expected expenditure of money and time in court-related litigation versus arbitrating before FINRA in a forum that has historically been viewed (at least in the securities industry) as claimant friendly.

1 By Jeffrey J. Hines and George S. Mahaffey Jr., attorneys at Goodell, Devries.
2 There are approximately 28,000 RIAs overseen by the U.S. Securities and Exchange Commission (SEC).
3 For instance, AAA arbitrators charge per hour (often $200 to $500 per hour), while FINRA arbitrators often charge $400 for an 8 hour arbitration session.

About Jeff Hines

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Mr. Hines joined the firm as a partner in 2003. He was formerly the managing principal of a regional law firm's District of Columbia and Virginia offices. Mr. Hines is licensed in Maryland, the District of Columbia and Virginia, and has represented clients in trials and appeals in all three jurisdictions. His areas of practice include professional malpractice, toxic tort and environmental litigation, pharmaceutical litigation, product liability, and commercial, securities and employee litigation.

Professional Liability. Mr. Hines defends attorneys, health care providers, realtors, clergy, social workers and other professionals in malpractice claims brought in Maryland, Virginia and the District of Columbia. In 2011, Mr. Hines successfully tried a legal malpractice claim before a jury in the Circuit Court for Montgomery County. That same year, Mr. Hines also tried a will caveat case in the Orphans' Court for Prince George's County, Maryland. In 2008, Mr. Hines successfully tried a will construction case in the Circuit Court for Montgomery County. In 2005, he convinced a federal judge in the United States District Court for the Eastern District of Virginia to apply Virginia law regarding the non-assignability of legal malpractice claims, substantially reducing an insurance company's claims against its panel counsel. In 2004, Mr. Hines obtained a defense verdict in Maryland for an accountant who allegedly provided improper tax advice. In December 2003, Mr. Hines successfully tried a wrongful adoption matter involving allegations of child trafficking and brain damage in the Circuit Court for Montgomery County. Mr. Hines was able to strike plaintiff's expert neuropsychologist for basing his opinion on unreliable data. At his prior firm, Mr. Hines obtained a defense verdict after a three-week jury trial in a sexual abuse case brought against a psychologist in the Circuit Court for Fairfax County. In addition, Mr. Hines obtained a defense verdict in a multi-million dollar case against an attorney brought in the Superior Court of the District of Columbia. Mr. Hines has also defended attorneys and health care providers in matters before disciplinary boards. As a service to his clients, Mr. Hines provides in-house educational seminars to professionals to assist them in avoiding claims.

FINRA. Mr. Hines is currently defending broker-dealers in cases filed with the FINRA. In that capacity, Mr. Hines prepares responses to the FINRA's Enforcement Department and defends broker-dealers and registered representatives in Rule 8210 examinations and in customer-initiated arbitrations. Mr. Hines frequently lectures on FINRA issues including the potential impact of FINRA's New Suitability Rule.

Commercial and Business Tort Litigation. In 2010, Mr. Hines tried a multi-million dollar case in the United States Bankruptcy Court for the District of Delaware. In 2009, Mr. Hines tried a three-week case in the United States Bankruptcy Court for the Eastern District of Virginia arising out of the sale of an Alabama radio station. For over 10 years, Mr. Hines was national counsel for Parents Without Partners, Inc., the largest single-parent organization in the world whose members at one time exceeded 250,000. In his capacity as national counsel, Mr. Hines attended all Board of Director meetings and served on the executive committee. Mr. Hines handled employment claims, prepared all corporate filings, dealt directly with the Internal Revenue Service on 501(c)(3) issues, advised the Board as to its duties and responsibilities, and prepared or reviewed all contracts. Mr. Hines also lectured throughout the United States at local chapters regarding their legal and ethical obligations, and assisted local counsel in the defense of claims filed against the corporation. Mr. Hines also represents corporations regarding compliance with ethical obligations.

Education

- University of Maryland (B.S. 1981)
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