FINRA Responds to Comments on Proposal To Merge FINRA-DR into FINRA Regulation

This proposal (SR-FINRA-2015-034), first filed on September 15 (see SAA 2015-35), has taken an interesting procedural path – one that now appears to be moving to a close.

After its filing by FINRA, the SEC quickly (SAA 2015-38) published the proposal (SEC Rel. 34-76082, dtd. 10/6/15) in the *Federal Register*, seeking public comment with a deadline of November 3. PIABA objected (SAA 2015-41) that the process was moving too quickly for such a serious undertaking and asked the SEC to permit more time for its members and others to comment. PIABA did comment within the allotted time – as did several of its members (SAA 2015-42) – and, then, the SEC seemingly responded by setting a new deadline for action in January 2016 (SAA 2015-43). Technically, though, the extension was not of the comment period, but of the time in which the SEC has to act on the proposal. That time was extended from November 27, 2015 to January 11, 2016 by SEC Rel. 34-76444.

FINRA has now filed a response to the comments that were filed within the initial comment period, in a letter from FINRA Assistant General Counsel Meredith Cordisco to SEC Secretary, Brent J. Fields, dated December 1, 2015. That letter may be viewed as closing off further comment from the public. Indeed, FINRA states, as concluding remarks, that "interested parties" have had "sufficient time to consider the proposed merger" and objects to PIABA's extension request. On the other hand, since FINRA itself has commented after the close of the initial comment period, the SEC extension may effectively mean that the Commission will consider further comment letters, if filed between now and the January deadline for action.

FINRA's Response to Comments

No further public comment letters have been filed since the initial five. Ms. Cordisco's letter characterizes four of the five (PIABA, Rhoades, Gross, Jacobson) as opposing the merger and views the American Association for Justice (*ed: formerly ATLA*) as neither opposing nor

supporting the proposal *(ed: just as a point of disclosure, we understood the letter as voicing opposition – SAA 2015-42).* FINRA disagrees with the perception voiced by commenters that the merger will "in any way impact the continued operation of its dispute resolution forum as a fair, efficient, and economical alternative to costly and complex litigation…." Nor will there be any "practical impact on the current governance or oversight that ensures the forum's fairness and effectiveness." The proposed merger's purpose is designed to "reduce the considerable administrative duplication," with a view to "achieving organizational operational efficiencies…. The merger would allow FINRA to lower its operating expenses and more efficiently use staff resources."

Addressing PIABA's Concerns

The letter answers PIABA's essential question, "What's changed?" since the turn of the Millennium, when FINRA established a separate dispute resolution subsidiary in the belief that it would "further strengthen the independence and credibility" of the facility. FINRA simply answers that it "does not need to maintain separate corporate entities" to achieve those purposes. It insists, as it did in the rule filing, that "FINRA Dispute Resolution remains financially dependent on" its parent "at current cost levels," without speaking to prior years' returns, when arbitration volume was much higher.

Finally, FINRA points out that the FINRA subsidiaries already interact and operate as a single entity. FINRA-DR cooperates with FINRA Regulation to detect misconduct and disciplinary proceedings promote member compliance with the payment of FINRA-DR Awards. Governance would continue to be shared after a merger, regulatory oversight of the forum would continue as before, and "[a]s an operational matter, FINRA's dispute resolution program would continue to function as a separate department within FINRA Regulation." No impact on the "public perception of fairness of the forum" will result from the merger and no "cost-benefit analysis," as suggested by PIABA, is necessary to prove that which is apparent from the efficiencies of consolidation.

(ed: This merger is going to happen, just as the spin-off back in 1999 sailed through the Commission. Our reservations with the plan relate to: (1) an old gripe – that FINRA-DR

made big changes to its fee structure on the premise that it needed to be self-sustaining, and has never reported publicly anything since, except it top-line annual revenues – so that we could know its true profitability; and, (2) a conceptual rejection of the regulatory need to "deputize" arbitrators and make arbitration part of the regulatory machinery, in order to protect investors. Arbitration promotes "investor protection" differently, i.e., by providing an affordable and efficient avenue of civil redress that ensures swift justice for investors and, with that, their continued participation in the nation's markets.) (SAC Ref. No. 2015-45-01)

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FINRA Reacts To PIABA Criticism of Efforts To Corral Expungement Grants by Arbitrators

We learned this week that FINRA had a lot to say about the most recent statistical study on expungement performed by the Public Investor Arbitration Bar Association.

We led last week's Arb Alert (SAA 2015-39) with an article about PIABA's "followup to its influential 2013 study of expungement" and the press conference that introduced the results. Through a spokeswoman, FINRA issued a Statement (as opposed to a News or Press Release, which would be posted on FINRA's WebSite) in response to PIABA's conclusion that expungement is still broken in FINRA arbitration and that a new regime is required to fix it.

FINRA's Statement began by reviewing the many steps the Authority has taken to assure that arbitrators give balanced consideration to expungement requests. The Statement starts: "FINRA has taken numerous steps to make clear that expungement is an extraordinary remedy and has trained arbitrators on the application of Rule 2080, 'Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System.' FINRA has supplemented that training with guidance, beginning in late 2013. On September 17, 2015, the FINRA Board approved proposed amendments to Rules 12805 and 13805 (Expungement of Customer Dispute Information under Rule 2080) to codify that guidance and adopt additional arbitration procedural modifications."

More to Come, FINRA Promises

That opening may have sounded like FINRA would dismiss the PIABA findings, but the Statement then offers more to indicate the forum's openness to further change. "In addition," it continues, "the Arbitration Task Force convened in 2014 to independently recommend enhancements to the fairness and efficiency *(ed: we recall the three mission objectives of the DRTF as transparency, impartiality and efficiency – we don't want that "transparency" thing getting lost in the debates)* of the arbitration forum and, comprised of several PIABA members, formed an expungement subcommittee to discuss possible enhancements to the expungement process. Among the possibilities under consideration is the creation of a Special Arbitration Panel comprised of specially trained arbitrators that would make decisions on requests for expungement *(ed: That line virtually quotes the DRTF's June 2015 Interim Report).* The Task Force is expected to issue its final report by the end of 2015 and we look forward to its recommendations."

FINRA Analyzes PIABA's Analysis

Turning back to the new Study itself and addressing the methodology PIABA undertook in its analysis, FINRA concludes: "PIABA's Study reflects no qualitative analysis of the awards recommending expungement and therefore no assessment of whether the information that was the subject of the recommendation had any investor protection or regulatory value.

Moreover, only 11 percent of the total number of cases cited in PIABA's study resulted in a recommendation for expungement as of 9/30/15."

(ed: This last sentence mystified us a bit, as it seemed to contradict PIABA's 87.8% figure. So, we did a little Award analysis ourselves. We think FINRA may be referring to the number of cases filed in 2012, 2013 and 2014, as cited on page 5 of PIABA's report. Those figures add up to 7,621. According to SAC's Award Database (which PIABA used in its data-gathering), there were 844 expungements issued as of 9/30/15 in Awards filed in 2012-14 (include several that were too late to be included in PIABA's study), which amounts to 11% of 7,621. In other words, FINRA seems to be saying that, as measured against the whole, expungement grants are not commonplace.)

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PIABA's Updated Expungement Study

The Public Investor Arbitration Bar Association (PIABA) rolled out a follow-up to its influential 2013 study of expungements in stipulated Awards in a press teleconference on Monday, October 19, 2015. PIABA's conclusion: the reforms FINRA adopted in response to the earlier report have failed and it must now adopt an entirely new set of procedures.

The earlier report, which analyzed expungement requests after settlement in cases filed between January 1, 2007 and December 31, 2011, found that expungement requests made in cases resolved by settlement or stipulated Award were granted more than 90% of the

time (see SAA 2013-38). At the time, PIABA blamed this phenomenon at least partly on settlement provisions that required customer claimants either to endorse or remain neutral with respect to expungement. In response, FINRA promptly adopted two of PIABA's recommendations: (1) it educated its arbitrators on the "extraordinary" nature of the expungement remedy and the "critical importance of accurate customer claims information with respect to investor protection,: laying out these teachings in "Expanded Expungement Guidance;" and (2) instructing arbitrators, as part of that education, to beware of settlement provisions that curtailed customers' rights to oppose expungement relief, eventually adopting Rule 2081 (eff. 7/30/14) to outlaw the practice. *(ed: We covered FINRA's initial responses in, e,g., SAAs 2013-38 and -40 and 2014-01 and Rule 2081 in, e.g., SAAs 2014-19, -21, -22 and -27.)*

Latest Survey: PIABA's Methodology and Findings

To test the effect of these efforts on expungement requests in stipulated Awards (i.e., Awards issued after settlement), PIABA analyzed Awards requesting expungement relief in cases filed between January 1, 2012 and December 31, 2014, inclusive, reporting the results separately for each calendar year, as well as the full period. For each year, PIABA separately reported the results for "Stipulated Awards/Settlements" and "Cases Tried on the Merits," finding an 87.8% expungement success rate (404/460) in the former set of cases, a 59.7% rate (142/238) when the respondent prevailed on the merits and a 13.6% rate (17/125) when the claimant prevails on the merits. The success rate for stipulated Awards was 86.5% (250/289) in 2012 cases, 89.8% (132/147) in 2013 cases and 91.7% (22/24) in 2014 cases.

PIABA's Disappointment

The teleconference featured remarks by Joseph C. Peiffer, of Peiffer Rosca Wolf Abdullah Carr & Kane, New Orleans, LA, outgoing president of PIABA; Scott C. Ilgenfritz, of Johnson Pope, Tampa, FL, Peiffer's predecessor as PIABA president and author of both reports; and Hugh D. Berkson, of Hermann Cahn & Schneider, Cleveland, OH, the incoming president. All expressed disappointment at the continuing high rates of expungement success. Peiffer

opined: “The bottom line from our new data is clear: FINRA’s efforts have failed to assure that expungement relief is an extraordinary remedy granted only in cases in which the customer dispute information requested to be expunged has no meaningful investor protection or regulatory value.” Ilgenfritz, who reported the findings, reiterated Peiffer’s point. Berkson called for “[a] wholesale change [that] needs to occur with respect to the handling of broker requests for expungement relief in settled customer cases” and offered the Report’s recommendations to achieve that goal.

PIABA’s Recommendations

And what are those changes? PIABA proposes that FINRA hearing officers, not arbitrators, decide expungements in all settled cases and have enforcement attorneys investigate and, where appropriate, oppose the requests. Customers should be allowed to present evidence in opposition to the request, if they so desire. FINRA should give notice of the request to state regulators and allow them to oppose it. Brokers should bear the cost of the proceeding and must bring their request no more than one year from the resolution of the customer’s claim. In addition, FINRA should either establish a rebuttable presumption that the facts alleged in the customer’s statement of claim are true or require brokers to meet a “clear and convincing evidence” standard of proof.

PIABA proposes that arbitrators continue to have the authority to award expungement relief in cases decided on the merits, but proposes a single standard for deciding whether to grant relief, applicable to all expungement proceedings: “that the information sought to be expunged has no meaningful investor protection or regulatory value,” in place of the current three standards set by Rule 2080. Finally, PIABA recommends that FINRA should continue its efforts to provide expungement education and guidance to arbitrators.

*(ed: *SAC provided the data used in both the 2013 and 2015 reports, but did not participate in the analysis of that data or in the preparation of the report. **As PIABA explained in the teleconference, the reason for the small size of the 2014 sample is that it takes time for arbitration cases to proceed to resolution and relatively few cases filed in 2014 had time to settle and result in an Award (especially since the sample included no Awards issued after*

*May 2015). ***Although we express no opinion about the merits of PIABA's specific recommendations (at least at this time), we have found that, whether or not customers are free to object to expungements, they almost never do; therefore, expungement proceedings in settled cases are, in effect, almost invariably* ex parte *proceedings under the current rules.)* (SAC Ref. No. 2015-39-02)

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SAC Awards Mini-Survey – 2014 Customer-Member Expungements

Starting in the fall of 2013, concerned that arbitrators were "rubber stamping" stipulated expungements, FINRA encouraged its arbitrators to examine expungement requests in general, and stipulated expungement requests in particular, with more care (see SAA 2013-38 and 2014-01). In this survey, we examine the current state of play to determine the "new normal" and to try to discern what factors affect the success rate of requests for expungement relief.

FINRA's concern was raised by the Public Investor Arbitration Bar Association (PIABA), which reported that stipulated expungements reached a success rate of 96.9%, warned that this easy erasure of customer complaints could jeopardize investor protection, and demanded that FINRA ban the practice of requiring investors to agree to join in or not to oppose expungement requests as a condition of settlement (see SAA 2013-38). Among other things, FINRA instructed its arbitrators that expungement is "an extraordinary remedy" and

that they should make sure that claimants did not waive their right to object to expungement as a condition of settlement, eventually adopting Rule 2081 (approved July 22, 2014) to make the latter point mandatory.

Sample and Methodology

Like PIABA's 2013 Study, our survey focuses exclusively on expungements in Customer –Member cases (Although brokers may also file separate arbitrations for the exclusive purpose of obtaining expungement relief, those Awards do not always explain the circumstances of the underlying case, such as whether it was settled or whether the expungee was named as a respondent, and therefore do not provide a clear basis for studying the relevant factors). We included only 2014 Awards, because those issued in the last two months of 2013 – directly after the FINRA guidance — were atypical: as we reported in mini-surveys back then, the success rate for stipulated expungements sank to 57% in the first two weeks (see SAA 2013-44) and then it popped back to 83% six months out (as of 4/30/14, see SAA 2014-19).

Stipulated Awards (those issues as a result of the settlement of the entire case) accounted for 224 of the 341 Customer-Member Awards featuring requests for expungement relief. For purposes of clarity and contrast, we did not survey all non-stipulated Awards, but only (a) cases decided on the merits, (b) in which there were at least two hearings, and (c) the claimant recovered nothing — there were 60 Awards in that group.

Award Results

The success rate for all 2014 Customer-Member Awards reflecting expungement requests was 73% (248/341). The rate for stipulated expungements was 85% (191/224), while those in cases decided on the merits, where the customer recovered nothing, was only 63% (38/60). However, it made a significant difference whether the broker was named as a respondent in the case or not. In Stipulated Awards, when a non-party broker sought expungement, the rate rose to 90% (118/131), as opposed to those in which all of the brokers requesting expungement were named — there the rate was 78% (73/93). In the

second group, where the cases were decided on the merits, the rate for non-party brokers was 77% (17/22) – a hefty rate, though still not as high as stipulated expungements – as opposed to only 55% (21/38) when the brokers were named respondents.

An even more important factor surfaced in the 60 merit cases — whether the claimants were assessed more than two-thirds of the hearing fees. In those 17 cases – where the claimant not only lost, but was hit with the bulk of the fees — the rate of expungement grants jumped to 88%; that contrasted with the remaining cases, in which grants occurred in only 53% of the cases.

*(ed: *What accounts for the 57% success rate for stipulated Awards in early November 2013? FINRA's new teachings on stipulated expungements followed quickly on PIABA's criticisms. If FINRA was right, then, perhaps, a number of respondents' attorneys were caught by surprise, leaving them with previously-obtained expungement stipulations in settlement agreements with the broker-dealer that suddenly proved to be white elephants. Another possible factor – more likely, we think — is an initially strong reaction (over-reaction?) from arbitrators, who relaxed once they became more comfortable with their new duties. **Our take on the lessons from this survey: (1) customers rarely object to stipulated expungement requests, even now that they have the "right" to do so; the absence of any contrary evidence or voiced objections makes it much easier to defend the broker and win relief. (2) Not surprisingly, it is even easier to convince the panel of one's entitlement to expungement, when the customer fails to name him/her, even if one's employer notes the customer's complaint in one's CRD record (note, however, that claimants' counsel may not name a broker for tactical reasons). (3) It seems, though, that the presentation of evidence in support of customers' complaints, even when it is not convincing enough to prove liability, still frequently creates enough doubt to dampen the case for expungement (whether the broker is named or not). (4) When panels assess the hearing fees primarily to claimants, we believe, they generally either believed that the claimants failed miserably to make their case or created unnecessary difficulties in the course of the arbitration. Therefore, it does not surprise us that panels are more likely to be sympathetic to expungement requests in those cases.)*

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FINRA Rule Changes Approved in 2013

So many changes were being made to the Arbitration (and Mediation) Codes by FINRA Dispute Resolution, at one time it was hard to keep up. The pace slowed in 2012 — four new changes were proposed and approved and one proposal from 2011 was approved in 2012 (SAA 2013-01) – and in 2013, it slowed even further. Even the number of new pilots has slowed. Remember the Public Arbitrator Pilot, the Short List Option Pilot, the Large Case Pilot – all initiatives of recent year, but the only new Pilot we recall being launched in 2013 was the Small Claims Mediation Pilot – and that was in January 2013 (SAA 2013-03)! Among the Rule proposals approved by the SEC in 2013 was a tweak to the Public Arbitrator classifications, targeted additions to the Discovery Guide for customer arbitrations (Rule 12000 series), and the "simplification" of the Optional All-Public Panel Program (OAPP). In SR-FINRA-2013-003, FINRA added to the list of disqualified persons those associated with hedge funds or mutual funds and established a "cooling-off" period for these individuals and a broad class of others, such as professionals, investment advisers, spouses, and immediate family. The Approval Release was published in the Federal Register on April 10, 2013, 78 Fed. Reg. 21449. (SAC Ref. No. 2013-13). We might expect an additional tweak of the classifications in 2014, since, during the rulemaking process, FINRA undertook to "conduct a comprehensive review" of its arbitrator classifications "with a view towards further clarifying the definitions…." In SR-FINRA-2013-024 (dtd. 6/3/13), which was approved by the Commission, the forum took the recommendations of its bi-partisan Discovery Task Force and amended the Discovery Guide. This was a fairly popular and collegial effort.

There were 18 comment letters on the proposal and FINRA offered some amendments to the original proposal in response (SAA 2013-33). The amended rule proposal was approved by the SEC in September. An executive summary on FINRA's website describes the changes as follows: "The amended guide provides arbitrators with guidance on resolving electronic discovery (e-discovery) disputes relating to the form for producing electronic documents. It explains how product cases are different from other customer cases and describes the types of documents that parties typically request in product cases. Finally, it clarifies the circumstances under which a party may request an affirmation when an opposing party does not produce documents specified in the guide." The new guidance applies to cases filed on and after December 2nd. While SR-FINRA-2013-023 was dubbed the "OAPP Simplification" proposal, the primary effect of the changes will be to "push" more customers towards choosing an All-Public Panel by removing a default "gate" that previously "nudged" those customer parties who either did not pay attention, did not care, or affirmatively wanted a Majority Public Panel toward that choice. The amendments to Rule 12403 of the Customer Arbitration Code assure that parties in the eligible cases will all follow the same panel composition method, that is, an unlimited number of strikes for the 10 non-public candidates and four strikes each for the other two seats. Striking all of the non-public arbitrators will assure an all-public panel, while ranking one or more non-public arbitrators may or may not assure a mixed or majority public panel. Regulatory Notice 13-30 made the new procedures effective as to all customer cases filed on or after September 30, 2013 and in some pending cases (SAA 2013-37). *(ed: A couple of proposals have been on the pending list for some time. One, SR-FINRA-2010-036, was actually filed by FINRA with the Commission in 2010 and, either due to a stalemate between the two regulators or a stasis born of indifference, it continues unattended and unapproved into 2014. That proposal, ill-advised in our view, would permit FINRA arbitrators to make disciplinary referrals during an arbitration proceeding, rather than after it concludes. The other proposal, stymied, perhaps, by the swirl surrounding the PIABA Expungement Study (see feature articles in the print newsletter, SAC 2013-02 & -03) is the long-promised "In Re Expungement Proceeding" (SAA 2013-38).*