

Defense of Investment Professionals: Securities Litigation in the FINRA Arbitration Setting

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Investment Professionals Exposed to Claims

They Have Many Titles

- ▶ Financial Planners
- ▶ Financial Advisors
- ▶ Wealth Managers
- ▶ Stock Brokers
- ▶ Variable Life Insurance Agents
- ▶ Investment Advisors
- ▶ Chartered Financial Analysts
- ▶ Money Managers

But Generally

- ▶ They are Registered Representatives of Broker-Dealers, or
- ▶ They are Registered Representatives of Investment Advisors
- ▶ They Often Are Called “Associated Persons” (Associated With a BD or IA)



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What is FINRA?

- ▶ Financial Industry Regulatory Authority
- ▶ FINRA is a Self Regulatory Organization Authorized by the 1934 Exchange Act
- ▶ Successor to the National Association of Securities Dealers (“NASD”)
- ▶ Established to Enforce Standards of Conduct of Broker-Dealers and Their Registered Representatives
- ▶ It Promulgates Rules for Broker Conduct, Discipline, and Reporting
- ▶ It Requires Representatives to Agree to Arbitration of Disputes
 - Customer Disputes
 - Employment Disputes
 - Disputes Between Industry Entities
- ▶ It Enforces Arbitration Clauses in Broker-Dealer/Customer Agreements



CODE OF ARBITRATION
PROCEDURE FOR
CUSTOMER DISPUTES

www.finra.org

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FINRA Arbitration: Initial Steps

- ▶ Arbitration of Securities Customer Disputes is Required:
 - By Written Agreement
 - If Requested By Customer
 - Rule 12200
- ▶ What Claims are Not Arbitrable?
 - Class Action Claims (Rule 12204)
 - Shareholder Derivative Actions (Rule 12205)
- ▶ Claimant Filing Fees Range from \$50 to \$1,800 (Rule 12900)
- ▶ FINRA Members Must Pay Filing Fees Ranging from \$150 to \$3,750 (Rule 12901)
- ▶ Commenced by Claimant Filing with FINRA of a Submission Agreement and a Statement of Claim (Rule 12302)
- ▶ Respondents Must Serve Within 45 Days a Submission Agreement and an Answer (Rule 12303)
 - Answer
- ▶ Ignore Notice Pleading (Court) Rules
- ▶ Never Use a General Denial
 - ▶ Panel May Bar Defenses
 - ▶ Rule 12308
- ▶ Explain Your Liability Defense in Detail
- ▶ Explain Your Damages Defense in Detail
- ▶ Attach Key Exhibits that are Vital
- ▶ Try to Influence the Panel Early On
- ▶ May be Narrative in Nature
- ▶ Not the Time for String Cites
- ▶ A Balance of Detail and Brevity

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What Laws/Rules Might the Claims Involve?

Statutes/Common Law

- ▶ Securities Act of 1933
- ▶ Securities Exchange Act of 1934
- ▶ Investment Company Act of 1940
- ▶ Investment Advisors Act
- ▶ Sarbanes-Oxley Act of 2002
- ▶ ERISA
- ▶ S.E.C. Rule 10b-5
- ▶ RICO
- ▶ State “Blue Sky” Laws
- ▶ State Insurance Agent Laws
- ▶ Common Law Fraud/Negligent Misrepresentation
- ▶ Deceptive Trade Practices Acts
- ▶ Breach of Fiduciary Duty
- ▶ Breach of Contract
- ▶ Professional Negligence

FINRA Rules

- ▶ The “Standards of Commercial Honor and Principles of Trade Rule”
 - ▶ Rule 2010
- ▶ The “Fair Dealing With Customers” Rule
 - ▶ Rule 2111
- ▶ The “Know Your Customer” Rule
 - ▶ Rule 2090
- ▶ The Investment “Suitability” Rule
 - ▶ Rule 2111

Focus of the Law/Rules

- ▶ To Prevent Fraud
- ▶ To Prevent Other Unfairness to Customers
- ▶ To Maintain Market Integrity

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What Claims Contexts Are Seen?

- ▶ Portfolio Churning or Overtrading
- ▶ Overexposure to Thin Market Investments
- ▶ High Commission Product Focus
- ▶ Investments Unsuitable for the Customer (*Most Frequent*)
- ▶ Margin Call Account Stress/Liquidation
- ▶ Unauthorized Trading
- ▶ Failure of BD or IA to Supervise
- ▶ Misrepresentation/Omission of Risk in Product Advocacy
- ▶ Inattentiveness to Customer Requests
- ▶ Self Dealing
- ▶ Securities Price Manipulation
- ▶ “Frontrunning” (Trade Execution for Broker Ahead of Customer Order)
- ▶ Order Failure
- ▶ Broker Ignorance/Negligence
- ▶ Forgery
- ▶ Sales by Unregistered Broker
- ▶ Sales of Unregistered Securities
- ▶ ERISA Claims
- ▶ “Selling Away” Claims (Sales of Products Not Marketed by the BD)
- ▶ Market Manipulation or “Chop Shop” Sales (Excessive Spread Markups)
- ▶ Internet Trading Cases
- ▶ Misappropriation of Portfolio Assets by the Representative
- ▶ Breakpoint Sales

1 David E. Robbins, *Securities Arbitration Procedure Manual*, ch. 5 (5th ed. 2013)

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Defenses

- ▶ Customer Sophistication
- ▶ Ratification – Receipt of Statements
- ▶ Market Crash
- ▶ *In Pari Delicto*
- ▶ Similar Trading in Other Accounts
- ▶ Failure to Mitigate
- ▶ Customer Made the Decisions
- ▶ Out of Pocket Loss Rule
- ▶ Lack of Scierter (S.E.C. Rule 10(b)-5)
- ▶ Customer Contributory Negligence
- ▶ Impropriety of Hindsight Bias
- ▶ Prospectus Defense
- ▶ Rules: No Private Action Right
- ▶ Customer Directed Trades
- ▶ No Customer Objections When Account Rose in Value
- ▶ No Causation
- ▶ Broker Acted in Good Faith
- ▶ BD Supervised Adequately
- ▶ Customer Knew Losses Were Possible
- ▶ Customer Observed Volatility
- ▶ “Eligible” Claims: Those Within 6 Years of Occurrence or Event (Rule 12206)
 - ▶ Court Action Not Foreclosed
 - ▶ Motion Loss may Mean Fees, Costs and Sanctions

1 David E. Robbins, *Securities Arbitration Procedures Manual*, §5-7 to §5-17 (5th ed. 2009)

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Arbitrator Number and Selection

Number of Arbitrators

- ▶ Claims of \$50,000 or Less: 1
- ▶ Claims of More than \$50,000 Up to \$100,000: 1 Unless All Agree to 3
- ▶ Claims of More than \$100,000: 3 Unless All Agree to 1
- ▶ Rule 12401

Types of Arbitrators

- ▶ Chair-Qualified Public Arbitrator
- ▶ Public Arbitrator
- ▶ Non-Public Arbitrator

Selection

- ▶ FINRA Maintains a Neutral List Selection Roster
- ▶ Selected Arbitrator May be Challenged for Partiality/Bias
 - ▶ Rules 12406, 12407

Candidate Disclosures/Strikes

- ▶ 1 Arbitrator Cases:
 - ▶ Parties are Given a List of 10 Candidates from the Chairperson Roster
 - ▶ Candidates Make Disclosures
 - ▶ Strikes/Rankings Occur
- ▶ 3 Arbitrator Cases:
 - ▶ Parties are Given Lists of 10 Candidates from Each of the Chairperson, Public and Non-Public Arbitrator Rosters
 - ▶ Candidates Make Disclosures
 - ▶ Strikes/Rankings Occur
- ▶ Rules 12400 to 12405

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Arbitrator (Panel) Jurisdiction

- ▶ Arbitrator/Panel May Interpret and Determine Applicability of All Provisions of the Code
 - Rule 12409
- ▶ Majority Vote Wins in 3-Arbitrator Panels
 - Rule 12410

Helpful Resources

- ▶ The FINRA Arbitrator's Manual, and:

SECURITIES ARBITRATION PROCEDURE MANUAL

Fifth Edition

VOLUME 1

DAVID E. ROBBINS

Filed Through:

RELEASE NO. 17 DECEMBER 2013



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What Happens Next Procedurally?

Prehearing Conferences

- ▶ Initial Conference Typically Held By Telephone (Rule 12500)
- ▶ Arbitrator/Panel Will Set Discovery, Briefing, and Motion Deadlines, and Will Address Other Preliminary Matters
- ▶ Other Conferences May Be Scheduled at Party's Request (Rule 12501)
 - Discovery Disputes, Motions, Unresolved Scheduling Matters, Other Matters
 - Typically Held by Telephone

Dispositive Motion Practice

- ▶ Use Sparingly!
- ▶ Motions to Dismiss Before Conclusion of Party's Case are *Discouraged*
 - ▶ Due 60 Days Before Hearing
 - ▶ Response Due 45 Days Before Hearing
 - ▶ Replies Due 5 Days Before Hearing
- ▶ Loser Must Pay Costs; If Frivolous, Fees Too
- ▶ Risk of Other Sanctions if Bad Faith Found
- ▶ Other Motion Rules Have Different Procedures
- ▶ Rule 12504

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FINRA Discovery: Documents Must Be Produced

- ▶ FINRA “Discovery Guide” (www.finra.org)
 - ▶ Documents Described in the Document Production Lists are Presumptively Discoverable (Rule 12506 (a))
 - ▶ List 1 (Respondent Documents)
 - ▶ List 2 (Claimant Documents)
 - ▶ Lists Need Not be Served
 - ▶ Responses Due: 60 Days After Answer
 - ▶ Arbitrators Can Order Production of Other Documents (Rule 12507)
 - ▶ Must Be Controversy-Specific
 - ▶ Non-Parties May Be Ordered to Produce Documents via Subpoena (Rule 12512)
 - ▶ Or Without a Subpoena (Rule 12513)
 - ▶ Confidentiality Orders Available
 - ▶ Objections
 - ▶ Cost/Burden Disproportionality
 - ▶ Any Objection Not Made is Waived
 - ▶ Rule 12508
- ### Motion to Compel
- ▶ Meet and Confer Required Before Motion
 - ▶ Motions Require No Particular Form
 - ▶ Served 20 Days Before Hearing
 - ▶ Responses Due 10 Days From Receipt of Motion
 - ▶ Replies Due 5 Days From Receipt of Response
 - ▶ Discovery Motions Decided by 1 Arbitrator, Usually Chair (if Panel)
 - ▶ Rules 12503, 12509

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Documents Respondents Must Produce

- ▶ Account Record Information
- ▶ Customer's Risk Tolerance Documents
- ▶ Parties' Agreements
- ▶ Correspondence/Notes
- ▶ Trading Strategy Documents
- ▶ Trading Authorization Documents
- ▶ Prospectuses, Research Reports, etc.
- ▶ BD Supervisory Notes
- ▶ Telephone Logs, Notes, Recordings
- ▶ Compliance Department Communications
- ▶ Representative's U-4, U-5 and Other Disclosure Reports
- ▶ BD's Manuals/Bulletins
- ▶ Account Analyses/Reconciliations
- ▶ Exception Reports/Activity Reviews
- ▶ Internal Audit Reports re Representative or Account
- ▶ Disciplinary Action Reports re Representative
- ▶ Regulator Investigation Reports
- ▶ Documents Received By Subpoena
- ▶ Representative's Compensation Earned on the Account
- ▶ Agreements Between Representative and BD
- ▶ Customer's Insurance Holdings (When Claim Involves an Insurance Product)

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Documents Claimants Must Produce

- ▶ Federal Tax Returns
- ▶ Financial Statements
- ▶ Documents Received from Respondent
- ▶ Account Statements from Non-Party Securities Firms
- ▶ Documents Relating to Accounts at Respondent
- ▶ Account Analyses/Reconciliations Prepared by Claimant
- ▶ Correspondence/Notes re Account
- ▶ Telephone Notes, Logs, Recordings and Records
- ▶ Account Evaluations Prepared by Accountants, Tax Advisors, Others
- ▶ Customer Ownership/Control Over Allied Entities Proof
- ▶ Documents Customer Received re Subject Investments
- ▶ Proof of Unauthorized Trading Documents
- ▶ Other Investment Opportunities Documents
- ▶ Claimant's Resume including Educational/Employment Documents
- ▶ Documents Received By Subpoena
- ▶ Insurance Documents if Insurance Product is Involved
- ▶ Customer Prior Claim Documents

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Otherwise FINRA Discovery Is Constrained

- ▶ Standard Interrogatories Generally Are Not Permitted (Rule 12507)
- ▶ But “Requests for Information” May Be Served
 - ▶ Generally Limited to Person/Entity Identification and Time Period Data
 - ▶ Must Not Require Fact Finding or Narrative Answers
- ▶ Parties May Request Additional Documents 45 Days or More After Service of the Statement of Claim
 - ▶ Response Due 60 Days Later
 - ▶ Dispute-Triggering Requests
 - ▶ Unrelated Customer Complaints
 - ▶ Arbitration Awards Against BD or Representative
 - ▶ Self-Critical Analysis Documents
 - ▶ Scope of Computer Database Requests
- ▶ Depositions Are “Strongly Discouraged” (Rule 12510)
- ▶ Panel May Only Allow Depositions:
 - ▶ To Preserve Testimony
 - ▶ To Accommodate Essential Witnesses
 - ▶ To Expedite Complex Cases
 - ▶ If Extraordinary Circumstances Exist
- ▶ Stonewalling and Scorched Earth Approaches Will Taint Your Credibility With the Arbitrator
- ▶ Objections May be Made to List Documents or Other Requests
 - ▶ Must Be Request-Specific
 - ▶ Objection Not Made is Waived
 - ▶ Rule 12508
- ▶ Don’t Forget Outside Investigation
 - ▶ Internet Searches
 - ▶ Google, Social Media
 - ▶ Court Record Searches
 - ▶ Governmental Data re BD

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Expert Witness Practice

Types of Experts Sought/Encountered

- ▶ Securities Attorneys
- ▶ Industry Alumni
- ▶ Accountants
- ▶ Former Governmental Agency Leaders
- ▶ Registered Representatives
- ▶ Finance, Business, Insurance, Law Professors

Challenging Adverse Experts

- ▶ Impeachment Material Through Discovery
- ▶ Impeachment Material Through Other Sources
- ▶ Preclusion Order (No Foundation)
- ▶ Admissions Through Effective Cross (Expert Depositions are Unlikely)

Purpose for Expert Retention

- ▶ Challenge Loss Causation
- ▶ Degrade Customer's Expert's Methods
- ▶ Explain Trading Patterns
- ▶ Describe Industry Practices
- ▶ Explain Product Complexity
- ▶ Support Suitability of Investments
- ▶ Track Account Profits/Losses
- ▶ Perform Mitigation of Damages Computations
- ▶ Support Standard of Care Arguments
- ▶ Describe Broker Obligations
- ▶ Prove Supervision by BD or IA
- ▶ Explain Margin Facts and Fairness

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FINRA Pre-Hearing Process

“Twenty Day” Actions (Rule 12514)

- ▶ At Least 20 Days Before the Hearing the Parties:
 - ▶ Must Produce Documents/Hearing Exhibits Not Previously Produced
 - ▶ Must Serve/File Witness List
 - ▶ Must Submit Joint Request for an Explained Decision
- ▶ Documents/Witnesses Not Disclosed are Excluded Absent Good Cause

Postponement Requests (Rule 12601)

- ▶ Requires a Motion, Plus Good Cause if Within 10 Days of Hearing
- ▶ Postponement Fees Will be Charged



Mediation (Rule 14104)

- ▶ Voluntary – All Must Agree
- ▶ See Code of Mediation Procedure



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FINRA Hearing Process

Subpoenas

- ▶ Panel May Issue Subpoenas
 - ▶ For Document Production
 - ▶ For Witness Appearance
 - ▶ Requires a Motion
- ▶ But Panel Should Not Issue Subpoena to Non-Party FINRA Members
 - ▶ Panel May Simply Order Them to Comply
 - ▶ Requesting Party Must Pay Non-Party's Expenses
 - ▶ Non-Party May Object to Order
 - ▶ Panel Will Decide Dispute
- ▶ Rules 12512, 12513

Place/Order

- ▶ Typically Held at Location Closest to Claimant
- ▶ Claimant Goes First, Respondent Follows
 - ▶ Rule 12607

Evidence

- ▶ Panel Not Required to Follow Evidence Rules
 - ▶ Rule 12604
- ▶ Document Production Does Not Create Presumption of Admissibility

Record

- ▶ Tape, Digital or Other Recording
 - ▶ Rule 12606
 - ▶ Party May Pay For Stenographic Record

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FINRA Hearing Process

Claims Involving \$50,000 or Less

- ▶ Simplified Arbitration Procedure
 - ▶ No Hearing Absent Claimant Request
 - ▶ Discovery is Limited
 - ▶ Rule 12800

Hearing Session Fees

- ▶ Range from \$50 to \$1,200 (Rule 12902)
- ▶ Panel Will Decide the Amount Each Party Will Pay
- ▶ Panel Also Will Determine Costs and Disbursements and Who Pays
- ▶ FINRA Members Also Must Pay Hearing Process Fees (Rule 12903)

Awards are Public

- ▶ Majority Decides/30 Day Rule
- ▶ Explained Decision Option
 - ▶ Rule 12904



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Measures of Damages

- ▶ Out of Pocket Loss Measure
 - ▶ What is the Total Decline in Account Value?
- ▶ Benefit of Bargain Measure
 - ▶ What is Expected Future Value Based on Customer's Understanding?
- ▶ Market-Adjusted Damages Measure
 - ▶ Comparable Index Approach
 - ▶ What Would the Account Show if it Had Been Handled Legitimately?
 - ▶ What is the Excess Portfolio Decline?
- ▶ Disgorgement Measure
 - ▶ Awards Wrongdoer's Enrichment to Customer
- ▶ Rescission Measure
 - ▶ Returns Customer to *Status Quo Ante*



1 David E. Robbins, *Securities Arbitration Procedures Manual*, §§6-7, 6-8 (5th ed. 2009)

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Damages Calculations/Other Issues

Account Value Calculations

- ▶ Cash/Securities Deposited
- ▶ Dividends/Interest Received
- ▶ Margin Interest Paid
- ▶ Cash/Securities Withdrawn
- ▶ Determine Start Date
- ▶ Determine End Date
- ▶ May Need Expert Support



Other Damages Issues

- ▶ Is Prejudgment Interest Recoverable?
- ▶ Is Disgorgement of Commissions Recoverable?
- ▶ Is Margin Interest Recoverable?
- ▶ Should Capital Gain Tax Timing be Considered?
- ▶ Is Failure to Mitigate a Defense?
- ▶ Is the Customer's Tax Benefit (Loss Write-off) a Damages Defense?

1 David E. Robbins, *Securities Arbitration Procedures Manual*, §§6-7, 6-8 (5th ed. 2009)

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Damages Defenses

Damages Defenses

- ▶ Out of Pocket Loss Measure
 - ▶ Must be the *Net Loss*
 - ▶ Argue Over the Calculations
- ▶ Benefit of Bargain Measure
 - ▶ Some Courts Require Reasonable Certainty BOP
 - ▶ Deny Any Specific Promise
 - ▶ No Broker Can Guarantee Profits
 - ▶ Show No Out-of-Pocket Loss
- ▶ Market-Adjusted Damages Measure
 - ▶ It is Inherently Speculative
 - ▶ Challenge the Comparative Indexes Used
- ▶ Disgorgement Measure
 - ▶ Raise the Level of “Excessive” Trading Up
 - ▶ Speculative to Say Customer Would Have Sold Securities at a Profit
- ▶ Rescission Measure
 - ▶ Mitigation, if Customer Retains Shares in an Active Market
 - ▶ Check State Law Defenses



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Judicial Review

- ▶ Awards are Final “Unless the Applicable Law Directs Otherwise”
 - ▶ Rule 12904
- ▶ Constrained by Federal Arbitration Act Limits
- ▶ Grounds to Vacate
 - ▶ Evident Arbitrator Partiality
 - ▶ Manifest Disregard for the Law
 - ▶ Panel Exceeded Powers
 - ▶ Fraud, Corruption, Undue Means
 - ▶ Party Prejudice
 - ▶ Refusal to Postpone
 - ▶ Refusal to Hear Evidence
- ▶ Presumption: Award Made on Permissible Grounds
- ▶ Make Sure Transcript is Available
- ▶ A Slim Chance of Success
- ▶ Rule 11 is Lurking About



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Expungement of Adverse Outcomes

- ▶ Very Important to a Regulated Person if a \$15,000+ Settlement is Paid
- ▶ Clients or Potential Clients Can Access Claim History
 - ▶ Data Accessible on FINRA Website, “BrokerCheck”
- ▶ Expungement Relief Difficult
 - ▶ Panel Must Hold a Hearing
 - ▶ Panel Must Conclude a Rule 2080 Ground is Met
 - ▶ Movant Must Pay Forum Fees
 - ▶ Rule 12805
- ▶ Take Away: Very Difficult to Achieve



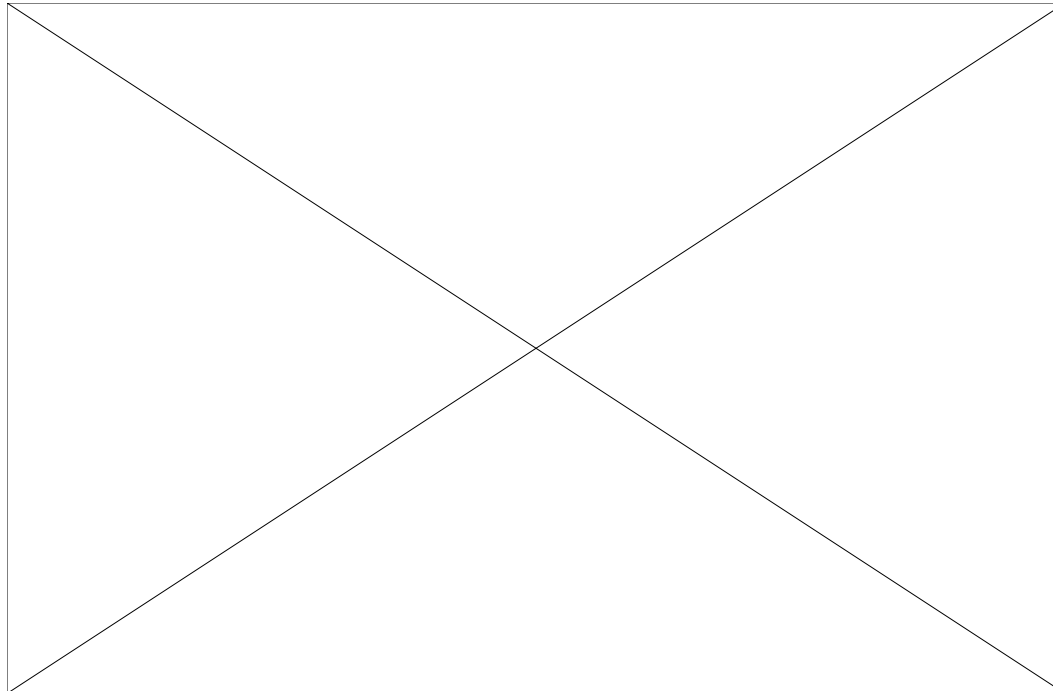
BrokerCheck®

- ▶ Expungement Grounds
 - ▶ Court Order Required
 - ▶ Generally FINRA Must be Joined
 - ▶ Requires Proof: (a) Claim is Impossible or Clearly Erroneous, (b) Respondent was Not Involved, or (c) Claim is False
 - ▶ Rule 2080



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Conclusion



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