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Insights

FINRA WARNS OF POTENTIAL REGULATORY EXPOSURE STEMMING FROM OVERREACHING PRE-DISPUTE ARBITRATION AGREEMENTS

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SUMMARY

Key Takeaways:

- With pre-dispute arbitration agreements constantly under attack by PIABA and various federal legislators, FINRA recently issued Regulatory Notice 21-16 to address member firm agreements that extend too far and violate FINRA rules.
- FINRA urges member firms to review their standard agreements to ensure compliance with FINRA rules and to avoid disciplinary actions.
- Below is a quick reference chart designed to assist member firms in reviewing their respective pre-dispute arbitration agreements for proper compliance with FINRA rules.

Introduction

Member firms, have you reviewed your pre-dispute arbitration agreements lately? While arbitration agreements are certainly not required, member firms have almost universally adopted them since arbitration became a preferred method of dispute resolution in the 1980s. In April of this year, FINRA issued Regulatory Notice 21-16 to highlight some key areas where firms could be subject to disciplinary action for failing to preserve customer rights under FINRA rules. Below are the topics FINRA identified as areas of concern in customer agreements. While not an exhaustive list of possible violations, this quick reference chart should assist firms in identifying the types of issues that are currently on FINRA's regulatory radar.

- **Hearing Locations**
  - **Applicable FINRA Rule**: Rule 12213 provides that the Director of Dispute Resolution Services will decide which of FINRA's hearing locations will be the hearing location for the arbitration,

and typically the location closest to the customer's residence is selected.

- **Potential Violations**: Member firms may be tempted to choose a location which is most convenient or favorable to the firm and/or its key witnesses. However, such contractual requirements infringe upon Rule 12213 and may subject a firm to disciplinary action. Firms designating a location with favorable laws may also be found to have violated Rule 12213, as noted below.

- **Time Limitations**

  - **Applicable FINRA Rule**: Rule 12206 allows arbitration claims to be submitted unless six years have elapsed from the occurrence or event giving rise to the claim.

  - **Potential Violations**: Member firms may wish to shorten or lengthen the time frame allowed for claims to be asserted or require that applicable time bars must be determined in a judicial hearing as opposed to being decided by the arbitrators. These sorts of requirements undermine Rule 12206 and are considered a regulatory violation by FINRA.

- **Claims and Awards**

  - **Applicable FINRA Rule**: Rule 2268(d) prohibits a pre-dispute arbitration agreement from including any condition that: (1) limits or contradicts the rules of any self-regulatory organization; (2) limits the ability of a party to file any claim in arbitration; (3) limits the ability of a party to file any claim in court permitted to be filed in court; or (4) limits the ability of arbitrators to make an award.

  - **Potential Violations**: Member firms may attempt to limit their liability for consequential or punitive damages or damages that do not arise from the member firm's gross negligence or intentional misconduct. Similarly, firms may incorporate a choice of law or governing law clause which accomplishes this goal indirectly. These clauses contradict the customers' rights outlined in Rule 2268(d) and are potentially subject to FINRA disciplinary action.

- **Indemnity and Hold Harmless Provisions**

  - **Applicable FINRA Rule**: Rule 2268 prohibits indemnity and hold harmless provisions which, if given effect, would limit the customer from bringing a claim or receiving an award from the member firm or associated person that they would otherwise be entitled to receive.

  - **Other applicable considerations**: A well-developed line of case law has held that it is contrary to public policy for a person to seek indemnity from a third party for that person's own

violation of the federal securities laws.

- **Potential Violations**: Member firms may be tempted to insert variations of clauses which attempt indemnification from the customer. Some include broad provisions that require that the customer indemnify and hold harmless the member firm from all claims and losses arising out of the agreement or customer relationship. In addition, firms may assert that a customer could not bring a certain claim in arbitration, for instance a claim for failure to supervise. Such provisions are not in conformance with Rule 2268 and are prohibited.

- **Class Action Claims**

  - **Applicable FINRA Rules**: FINRA Rule 12204(a) provides that class action claims may not be arbitrated under the Customer Code. Rule 12204(d) prohibits member firms and associated persons from enforcing arbitration agreements against members of a certified or putative class action until certain events occur, such as the denial of class certification, or a customer is excluded from the class. Rule 2268(f) requires specific language in all customer agreements to reflect Rule 12204(d).

  - **Potential Violations**: Member firms may attempt to limit a customer's ability to initiate a class action via express waiver, or by agreement to bring any claims in an individual capacity. Others may attempt to waive the right of a customer to bring a claim in a judicial forum without excluding the right to bring a class action suit. These clauses are not compliant with the specific rules FINRA has outlined to protect the customer's ability to bring a class action.

Conclusion

While arbitration is generally still the preferred method of dispute resolution (well – perhaps depending on who you talk to!), and member firms are free to utilize pre-dispute agreements that require arbitration, member firms must be careful in drafting these agreements so as not to overreach and run afoul of FINRA rules. It is advisable and a best practice, based on FINRA's recent guidance, for firms to review their agreements to ensure proper compliance. If you have questions on this topic or need assistance with securities regulatory or litigation matters, please reach out to us as we would be delighted to help with your needs.

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