Avoiding Arbitration

How to Prevent a FINRA Claim and Handle the Unthinkable If It Happens

By Amy E. Buttell March/April 2010

It's your worst nightmare: receiving a letter from an attorney or the Financial Industry Regulatory Authority (FINRA) notifying you that a client or former client is filing a claim against you. Could you be headed toward a potentially expensive and painful securities arbitration hearing?

In the wake of the financial crisis, more aggrieved consumers than ever are filing securities arbitration claims. During the first 10 months of 2009, consumers filed 6,601 securities arbitration claims, a 50 percent increase from the same period in 2008, according to FINRA statistics. Defending yourself against arbitration has two aspects, experts say-practicing defensive financial planning by keeping good records and communicating regularly with clients before a claim is even filed, and hiring knowledgeable representation and adequately preparing once a claim is filed.

It's something you never think is going to happen to you, says Jodee Brubaker-Rager, chief compliance and operations officer at Genos Wealth Management in Centennial, Colo.

"Advisers never think their clients are going to file a claim against them," she says. "In their minds, they have a great relationship with the client and it's not even a possibility. They don't operate under the assumption that one day they may be sitting across the table from that client at an arbitration hearing defending themselves against the recommendations they've made, the comments they've made and the letters they've sent."

Being cross-examined by a plaintiff's attorney in an arbitration hearing can be an unpleasant process, especially if your case isn't well documented, says **Richard Roth** of **The Roth Law Firm** in New York.

"One thing I have always said is that if you really want to prevent these kinds of things, to keep from being sued, show up at an arbitration hearing and watch another broker being cross examined," he says. "Because if you see how a plaintiff's lawyer can

essentially totally tangle up another broker you will make sure all of the I's are dotted and T's are crossed; that everything is documented."

Record Keeping and Communication

A major key to either avoiding consumer arbitration hearings altogether or defending yourself against one once a complaint has been filed is establishing strong processes and procedures for both recordkeeping and client communication.

"Most of the problems I see in arbitration hearings result from the adviser not having enough information in writing," says Larry P. Ginsburg, CFP®, of Ginsburg Financial Services in Oakland, Calif. "You would be amazed at the amount of 'she said/she said' that occurs, and in my opinion, if the client and the adviser both say they communicated something, the adviser is the professional and should make certain it is in writing."

Particularly important are client documents filled out when a relationship is initiated, such as the risk profile, says Sara Soto, a partner with Fowler White Burnett, a law firm in Miami.

"The arbitrators give a tremendous amount of importance to that documentation because when it was prepared, neither side had a motive to make up stories," she says. "That documentation is going to be viewed as more reliable than all the testimony in a hearing after the fact about how this, that or the other happened."

You also need to ensure that all disclosures your clients receive about particular investment products be understandable and in plain English, says Nancy Lininger, founder of The Consortium, a securities marketing and compliance consulting firm in Camarillo, Calif.

Document all contacts you have with clients either via notes that can't later be altered in your contact relationship management software or elsewhere. Include information such as where the conversation took place, what decisions were made, the date and time of the conversation and the client's name, phone number and address, she adds.

In terms of communication, proactively communicating with clients can head off many problems. If there is a specific complaint, make sure your staff knows how to deal with it. Consider holding annual trainings on this topic to keep new and current staff up to date on your practice's procedures for handling complaints.

Avoiding initiating relationships with potential problem clients is one way to avoid problems in the future.

"It's easier to turn away a client who you know will be a problem, rather than try to get rid of that client once they are a client," says Lininger.

Problem clients include those who want you to handle everything, those who are unwilling to disclose all their financial dealings to you and those who are unwilling to take the time to learn to be financially responsible, she continues.

Handling a Formal Complaint

Once a complaint has been filed against you, the arbitration process is pretty predictable. Consumers can file complaints online or in writing through FINRA, which has detailed materials about the process for both parties at

www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/index.htm.

As the table below shows, complaints fall into a number of categories, with the most common being breach of fiduciary duty, misrepresentation, negligence and breach of contract.

Consumers currently must arbitrate securities disputes, although a bill is pending in Congress that would change that, according to David Lipton, J.D., a professor and director of the Securities Law Program at Catholic University in Washington, D.C. Should that bill pass and be signed into law, arbitration would only apply to disputes between brokers, and consumers would be able to litigate their claims in court.

If you receive a complaint, you're required to respond in writing within a certain number of days. In most cases, your broker-dealer will need to be informed about the process and will be involved as the case progresses. The period from when the complaint is filed to the actual hearing can take anywhere from six to nine months. Except for the most simple and uncomplicated matters, hearings typically last a couple of days and are held in a locale near the client.

There are usually three arbitrators per hearing, two of those being public arbitrators not affiliated with the securities industry, and one who is affiliated with the industry. As for the hearing itself, "It's a full-blown hearing down at the FINRA office or in a conference room at a hotel and there's an opening statement, cross examination, direct examination, experts, the whole thing," says **Roth**.

Because the hearings are involved and the law and rules complex, you need to retain a lawyer experienced in securities arbitration, which will not be cheap. It is not uncommon for a law firm to spend at least 150 hours preparing and presenting an arbitration case, according to the legal information Web site www.Avvo.com.

But because the stakes are potentially so high-you could lose your license if it goes badly awry-it's worth the expense.

"In some states, if you have a couple of customer complaints, they will not allow registration unless your firm agrees to put you on heightened supervision," says Brubaker-Rager. "Some states will flat out deny your licensing application and ask you to withdraw. If you don't withdraw they'll deny you, and that is a reportable event to other states, which could result in a domino effect of other states giving you problems."

At the Hearing

Before and during a hearing, your record will be examined with a fine-tooth comb, says Keith Loveland, J.D., A.I.F.A., C.I.D.A., of Loveland Consulting in Minneapolis.

"Complete information about the registered representative's background and experience in the securities industry as well as licensing and disciplinary information will be available," he says. "If the dispute centers on a particular product, the plaintiff's lawyer will try to exhaust the registered representative's understanding of that product and what representations were made to the client."

Lipton's advice: When you testify, avoid arrogance in all forms.

You are also entitled to information about your client's background in investing and

their other investment accounts, and your attorney will cross-examine your client about their investment experience. The bottom line is that all the evidence presented relates to whatever is helpful to the arbitration panel, very broadly defined as things that might be relevant, helpful or useful to them in determining where the truth lies.

Once the hearing is over, a ruling is generally issued in 30 days, according to Soto. While there are very limited rights to appeal, such appeals very rarely happen. If they do happen, they are very rarely successful, so the decision of the arbitrators is pretty much final. If you lose and have to pay the client, you may be able to negotiate to pay the funds over a period of time with interest, but otherwise they are due to the client within 30 days, and you're subject to severe FINRA sanctions if you don't pay.

While this all may sound daunting-and perhaps downright scary-ensuring your processes for recordkeeping and client communication are thorough will go a long way if you ever find yourself faced with FINRA arbitration.

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Arbitration Filing Statistics*

FINRA keeps detailed statistics about arbitration filings and hearings. Below is a summary of the most common type of charges and securities involved in arbitration hearings during 2007, 2008 and through November 2009.

Type of Charge	2007	2008	2009
Breach of Fiduciary Duty	1,616	2,836	3,917
Misrepresentation	739	2,005	3,160
Negligence	891	1,602	3,152
Breach of Contract	953	1,658	2,496
Failure to Supervise	830	1029	2,456
Unsuitability	695	1,181	2,294
Omission of Facts	275	1,201	2,261

Type of Security	2007	2008	2009
Mutual Funds	375	930	1,479
Common Stock	790	672	1,275
Preferred Stock	26	115	457
Corporate Bonds	71	143	345
Annuities	243	200	285

*Each case can have up to four types of charges and four types of securities cited, so the column totals will not be equal to the number of cases served in a particular year. Visit www.finra.org for more information.

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What About Mediation?

FINRA encourages consumers to mediate their claims before filing for arbitration. The mediation process is voluntary, informal and less expensive than arbitration. Both parties decide who the mediator will be, and both parties split the cost, including the mediator's fees and travel expenses and FINRA's mediation filing fees- which vary depending on the dollar amount being disputed.

FINRA uses more than 900 mediators around the country. However, the mediator does not impose decisions. Instead, the mediator works with both sides to try to

come to a mutual agreement. According to FINRA, since the mediation program was established in 1995, more than 6,000 cases have been mediated, with four out of every five disputes resolved.

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