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ALTERNATIVE DISPUTE RESOLUTION

A Look at the FINRA'S Rules Limiting Motions To Dismiss in Arbitration Proceedings

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The Financial Industry Regulatory Authority ("FINRA") operates the largest dispute resolution forum in the securities industry. It oversees the arbitration and mediation of disputes between investors, securities firms and individual registered representatives. It has been one year since FINRA implemented new rules significantly limiting the use of motions to dismiss in arbitration. This article summarizes the new FINRA rules, examines the effect the rules have had on the arbitration process and concludes that these new restrictions — however well intentioned — do not justify either: (i) the increased costs to respondents in defending frivolous claims; or (ii) more importantly, the severe prejudice to respondents' prehearing rights.

New FINRA Rules

Effective since February 23, 2009, the new FINRA rules limiting motions to dismiss were primarily implemented in response to complaints by claimants that the filing of motions to dismiss resulted in increased costs, undue delay and even intimidation of "less sophisticated" claimants. Ostensibly, the new rules were intended to bolster claimants' "right to have their claims heard in arbitration" by limiting the respondent's ability to move for early dismissal of a claim. However, the lack of data collected by FINRA on whether the new rules have served their intended purpose, coupled with increased arbitration filings due to current market conditions, has lead many industry commentators to conclude that the new rules may have done nothing more than increase the time and expense of defending arbitrations for securities firms.

Rules 12504 and 12206, governing customer-related disputes, and 13504 and 13206, governing industry-related disputes (the latter rules are not cited herein unless substantively different from the former) of the FINRA Code of Arbitration Procedure, effectively bar respondents from filing motions to dismiss prior to the conclusion of the claimant's case in chief. This general prohibition is subject only to three limited exceptions. A prehearing motion to dismiss may be made if: (i) the nonmoving party previously released the claims by a signed settlement agreement or written release; (ii) the moving party was not associated with the accounts, securities or conduct at issue; or (iii) the claims are ineligible for submission to arbitration (pursuant to Rules 12206, a claim is ineligible for submission to FINRA arbitration where six years have elapsed from the event giving rise to the claim; motion to dismiss based on eligibility grounds must be made pursuant to Rules 12206 and 13206).

In addition to these, limits on grounds for filing a motion also are subject to a number of procedural requirements. For example, a respondent wishing to file a motion to dismiss must do so in writing and only after the answer is filed. FINRA Rule 12206(b)(1), 12504(a)(2). Motions pursuant to Rule 12504 (a) must be made no later than 60 days before a scheduled hearing. Rule 12206 (b). Before ruling on a motion to dismiss, the panel is required to conduct an in-person or telephonic prehearing conference. And a decision granting a motion to dismiss must be unanimous and must be accompanied by a written explanation of the decision. FINRA Rules 12206(b) (3)-(5), 12504(a) (4)-(5), (7).

Additionally, forum costs to a respondent resulting from an unsuccessful motion to dismiss can be substantial and have a chilling effect. If the panel denies a motion under 12206 or12504, the panel is required to assess the forum fees associated with any hearing on the motion against the moving party. FINRA Rule 12206(b)(8); 12504(a)(9). Further, if the panel deems a motion to dismiss frivolous, the panel is required to award reasonable costs and attorneys' fees to any party that opposed

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the motion. FINRA Rules 12206(b)(9); 12504(a)(10). The panel, in its discretion, also may issue other sanctions pursuant to Rules 12212 and Rule 12504 if it determines that a party filed the motion in bad faith.

Reaction From the Claimants' Bar And the Securities Industry

The new rules were met with a mix of ambivalence and skepticism by securities industry professionals. The changes were intended to reinforce FINRA's position that prehearing motions are discouraged in arbitration because parties have the right to a hearing on the merits. While some saw the virtual bar on motions to dismiss as materially altering the playing field in arbitration, others believed it was merely the codification of a longstanding yet unwritten practice among panel members to deny motions to dismiss. That is not to say that motions to dismiss failed to serve an important purpose in the dispute resolution process. For example, many arbitrators are nonlawyers, and a motion to dismiss can have the effect of informing them early on of the possible legal infirmities of a case. In the same vein, a successful partial motion to dismiss could narrow the scope of issues at the arbitration hearing, keeping only the relevant matters on the table and streamlining the administration of the case through the hearing. Additionally, the ability to dismiss a meritless claim early on serves as a deterrent to claimants who might otherwise be inclined to file frivolous claims in an attempt to "try their luck" at a quick settlement.

Under the new rules, a broker-dealer facing a small yet untimely claim may be inclined to settle the case, rather than face the expensive, lengthy and potentially penal process of attempting to have the matter dismissed. To successfully argue an eligibility motion pursuant to Rule 12206 (b), respondent firms are required to incur the time and cost associated with the drafting and filing of an answer as well as a motion to dismiss, followed by oral argument on the motion. If successful, the respondent firm still faces the time and costs associated with a possible appeal of that decision to a court. If unsuccessful, respondents face stiff penalties, including payment of claimant's attorneys' fees and possibly sanctions, if the panel deems the motion frivolous.

Still, many in the claimants' bar argue that the securities industry — which pushed hard for arbitration (as opposed to traditional litigation) and lobbied mightily against the adoption of these rules — is trying to gain an unfair advantage. FINRA member firms already require both their registered representatives and customers to arbitrate their disputes. It also is no secret that one of the key benefits to arbitration is a streamlined discovery process which does not allow some of the more costly litigation tools, such as depositions, interrogatories and other expensive discovery tactics. Others argue that motions to dismiss were often used by financial companies to "bully" less sophisticated claimants.

One of the principal reasons offered by FIRNA for the new rules was to address complaints that parties were filing prehearing motions to delay scheduled hearings and ultimately increase costs for claimants. However, recent statistics provided by FINRA do not necessarily show that this problem has been resolved. According to FINRA, the number of arbitration claims filed has increased 43 percent in 2009, from 4,982 to 7,137 filings. In addition, the number of cases closed through arbitration in 2009 increased 22 percent, with a decrease of 12 percent in turnaround time (time between filing of the claim and the decision). The statistics for mediated claims are similar: a 22 percent increase in cases that end in agreement, with a negligible difference in those closed through December of 2009 (down 1 percent from 2008).

Supporters of the new rules might argue that FINRA's increased efficiency is a result, at least in part, of less frivolous motions clogging the system. Still, it is not hard to appreciate how the new rules invite an abuse of the arbitration process and effectively shift the burden of increased arbitration costs entirely to respondents. Severely limiting the ability to dismiss frivolous claims may force respondents into early settlement discussions or mediation of a claim they otherwise would seek to dismiss — a more cost-effective alternative to arbitration. Unwilling to set this sort of precedent with the claimants' bar, respondents may be forced to waste valuable time and limited resources defending a frivolous claim through the arbitration process to a hearing on the merits.

Looking back, it is difficult to conceptualize exactly why FINRA chose to act in such an extreme fashion instead of coming to a more practical solution regarding prehearing motions to dismiss. While a rule that protects the rights of the ordinarily less financially able and often less sophisticated claimant is desirable, maintaining the efficiency and cost-effectiveness of arbitration is no less important. Moreover, allowing claimants to maintain frivolous claims in arbitration even though such claims could be preliminarily dispensed of in court is not an equitable solution. Nearly one year after the rules have been refined, it appears that the virtual bar on prehearing motions to dismiss may very well have been a harsh overreaction to an otherwise vaguely defined problem. ■