Broker-Dealer Update: FINRA Arbitration Rule Changes Favor Single Arbitrator Hearings and Limit the Availability of Motions to Dismiss

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The Securities and Exchange Commission (SEC) has recently approved several amendments to the Financial Industry Regulatory Authority (FINRA) Code of Arbitration Procedure (the Code). The SEC has approved rule changes that will increase the number of cases to be heard by a single arbitrator and severely limit the number of pre-hearing motions to dismiss filed.

New Rule 12401/13401 raises the amount in controversy to be heard by a single arbitrator from $25,000 to $100,000.[1] Under the current rules, a single arbitrator is appointed to hear claims of $25,000 or less. A single arbitrator is also allowed to hear claims of up to $50,000 unless one of the parties request that the claim be heard by a three-arbitrator panel in its initial pleading. The new rules mandate that a single arbitrator be appointed to hear claims of $100,000 or less. These claims may be heard by a three-arbitrator panel only if both parties agree to the arrangement in writing. As a practical matter, this means that customer claims of $100,000 will be heard by a single public, chair-qualified arbitrator.

Other recently approved amendments to the Code, which go into effect February 23, 2009, significantly reduce the tools in a respondent's defense arsenal.[2] Simply stated, these amendments severely limit the available grounds for making pre-hearing dispositive motions to dismiss and impose significant penalties on any unsuccessful moving party. Because these rules take away most of the legal protections and defenses that are used at any early stage to weed out claims that are defective as a matter of law, the rules are likely to have a major impact on arbitration strategy and may lead to lengthier and more costly arbitrations.

While FINRA arbitration panels, which are often composed in-part of non-lawyers, were historically reluctant to tackle the legal issues presented by a motion to dismiss, many legitimate grounds existed and respondents found the device useful to narrow the scope of arbitrations and provide the arbitrators (and the Claimant) with an early indication of the legal infirmities of the case. When FINRA proposed NASD Rule 12504 of the Code of Arbitration Procedure for Customer Disputes and Rule 13504 of the Code of Arbitration Procedure for Industry Disputes in November 2007, it unambiguously expressed its policy position: "Motions to dismiss a claim prior to the conclusion of a party's case in chief are strongly discouraged in arbitration." While the amendments apply to both public customer cases and industry disputes, FINRA's driving motivation is to give claimants their proverbial "day in court" to present the details of the grievance to a neutral panel.

Once the new rules become effective, a motion to dismiss will only be granted in the following limited situations: (1) the parties have settled their dispute in writing; (2) there is a "factual impossibility," meaning the party could not have been associated with the conduct at issue; or (3) the claimant fails to satisfy the rule that all claims be brought within six years of the conduct at issue. A pre-hearing motion to dismiss cannot be granted for any other reason.

Under the new rules, there is little room for motions. The "case settled" and "six year" allowances are straight-forward and leave little, if any, room for flexibility. FINRA has also indicated that it intends for the "factual impossibility" exception to be interpreted narrowly. Under that prong, a pre-hearing motion to dismiss can be granted if: (a) a party filed a claim against the wrong person or entity; (b) the claimant named a person as a respondent who was not an employee of the firm at the time of the conduct at issue, or (c) the claim named as a respondent an individual or entity with no control over or connection to the account, security, or firm at issue. By defining the exception so narrowly, the panel will lack the authority to dismiss a claim on such grounds as (a) the claimant named a clearing broker or senior executive that had no supervisory role as a party; (b) defamation for statements made on required forms or (c) statute of limitations.

To enforce the new limitations, the amended rules impose new practices and procedures. Pre-hearing motions to dismiss can only be made in writing and only after an answer is filed. *See* NASD Rules 12504(a)(2) and 13504(a)(2). Motions to dismiss must be made at least 60 days before a scheduled hearing date and the opposing party must be allowed at least 45 days to respond. All pre-hearing motions to dismiss must be heard by a full panel. The panel can deny the motion without holding a conference, but cannot grant it without conducting an in-person or telephonic conference (unless waived by all parties). Any decision to grant a pre-hearing motion to dismiss must be unanimous and accompanied by a written explanation.

In addition to the new procedures, Rules 12504 and 13504 require the panel to impose mandatory penalties on a party that files an unsuccessful pre-hearing motion to dismiss. In particular, that party is precluded from re-filing the motion without an order by the panel, and the panel ***must*** assess forum fees against it. If the panel finds that the motion was frivolous, the panel is required to award reasonable costs and attorney’s fees to the opposing party, and it is authorized to impose other sanctions against the moving party if it determines that the motion was made in bad faith.

The new rules will have the effect of further reducing the impact of the legal defenses that could be asserted in court cases to eliminate or at least narrow the scope of a claim. While these defenses are still available at the later stages of a FINRA arbitration, and care should be taken to preserve them in the answer, more cases will necessarily have to proceed through an evidentiary hearing before they can be dismissed. As a result, some of the cost-savings normally associated with arbitration as an alternative dispute mechanism are lost and more cases will necessarily be decided on bases other than applicable law.

[1] The complete text of the approved rules can be found on FINRA's website at: http://www.finra.org/Industry/Regulation/RuleFilings/2008/P117044. The effective date of the amendments has yet to be announced; however, FINRA rules have historically gone into effect 60 to 90 days after SEC approval.

[2] On January 23, 2009, FINRA placed a moratorium on the filing of new motions to dismiss as of that date. The moratorium is in effect until the new Rules 12504/13054 and 12206/13206 become operative. Motions to dismiss filed before the moratorium date will proceed under the current procedures. The complete text of the approved rules can be found on FINRA’s website at:

http://www.finra.org/industry/rule-filings/sr-finra-2007-021.