SHOULD MID-CASE REFERRALS BE PERMITTED IN FINRA ARBITRATIONS?

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Is the potential protection of multiple investors worth more than prejudice to one investor's interests? This is the tussle working itself out for the second time in four years, as the Financial Industry Regulatory Authority ("FINRA") has again proposed to adopt a mid-case referral process for arbitrators to inform FINRA enforcement of "ongoing or imminent … harm to investors" during the course of an arbitration hearing. *See* SR-FINRA-2014-005; SEC Release No. 34-71534. This amendment, while magnanimous in its effort to attempt to avoid potential harm to non-party investors, may substantially burden a claimant's arbitration hearing by delaying the arbitration as a result of recusal of the

arbitrator from the proceeding and by increasing the costs of prosecution.

FINRA seeks to adopt the mid-case referral procedure by amending current Rules 12104 and 13104, which currently only allow an arbitrator to refer a matter to FINRA enforcement at the conclusion of an arbitration hearing:

> Only at the conclusion of an arbitration, any arbitrator may refer to FINRA for disciplinary investigation any matter that has come to the arbitrator's attention during and in connection with the arbitration, either from the record of the proceeding or from material or communications related to the arbitration, which the arbitrator has reason to believe may constitute a violation of NASD or FINRA rules, the federal securities laws, or other applicable rules or laws.

Rule 12104(b). The arbitrator’s referral may be based on any information reviewed or realized during the arbitration proceeding, but would be limited to violations of securities laws and rules.

The first proposal was made in 2010 through SR-FINRA-2010-036. According to that rule change proposal, a mid-case referral would only be permitted when an arbitrator had reason to believe, based not solely on allegations in the pleadings, that "a serious ongoing or imminent threat was likely to harm investors." *See* SEC Release No. 34-64954 (July 25, 2011).

FINRA eventually withdrew rule proposal SR-FINRA-2010-036 and then in 2014 made the same proposal through SR-FINRA-2014-005. Proposed Rule 12104(b) and (c) would permit an arbitrator to refer a case to the FINRA Director for a disciplinary investigation if

> During the pendency of an arbitration, … any matter or conduct … has come to the arbitrator's attention during a hearing, which the arbitrator has reason to believe poses a serious threat, whether ongoing or imminent that is likely to harm investors unless immediate action is taken. …
>
> If any arbitrator refers a matter or conduct for investigation

> under subparagraph (b) of this rule, the Director will disclose the act of making the referral to the parties. A party may request that the referring arbitrator(s) recuse themselves, as provided in the Code.

The arbitrator's referral may not be based solely on the pleadings, and if the case is close to completion, the rule directs that the arbitrator should wait until the case's conclusion if "investor protection will not be materially compromised by this delay." *Id.* The amended rule would largely keep the post-hearing referral procedure.

FINRA proposed this Rule without reference to any study, other findings, or examples of conduct or activities revealed in an arbitration that if reported would have allowed FINRA to prevent investor losses. Moreover, FINRA did not provide the industry or public investors with any study or other findings that would suggest that the amendment of Rule 12104 would create a net benefit to public investors.

In the FINRA published "The Neutral Corner – Volume 1, 2014," FINRA stated that it "believes that mid-case

referrals would provide it with an important tool to protect investors by alerting FINRA to potentially serious wrongdoing earlier than is currently possible …[and that] stringent criteria for making mid-case referrals … should make them an extremely rare occurrence in its forum." The Neutral Corner – Volume 1, 2014, pg. 7.

There are two interesting observations to make from this rule: (1) the important role FINRA arbitrators can have in the regulatory and enforcement process; and (2) the conflict between the arbitrator's role in a pending arbitration and his or her role as a part of the regulatory and enforcement process. It is important to note that should FINRA and the SEC act quickly to stop a larger fraud based on information from one investor's case, that investor's efforts to collect on any resulting judgment may be sacrificed. The SEC has the power to go to court to stay proceedings and freeze a wrongdoer's assets. This ability to step in front of the individual investor for the equitable treatment of all investors effectively renders the arbitration a fruitless process. Moreover, while the

arbitration process is designed to be efficient, regulatory actions (particularly those aided by enforcement in the court system) could take many years to complete.

This potentially unjust result could be lessened or eliminated if FINRA would require all member firms and registered persons to carry appropriate insurance. As reported by the Wall Street Journal on October 4, 2013, FINRA is at least looking in to the idea of arbitration insurance, in response to the Journal's prior page-one article regarding "cockroaching" (the practice of registered persons jumping from one small defunct broker-dealer to another small, soon-to-be-defunct broker-dealer). *See also,* Bernstein, Scot, Broker Liability Insurance From the Claimants' Perspective (Practicing Law Institute, Securities Arbitration, 2003, Vol. 1) (calling for formation of an investor recovery fund or requiring certain brokerage firms to carry errors and omissions insurance policies).

A. Background to the Mid-Case Referral Debate

According to FINRA, it is dedicated to "investor protection and market integrity." *See* FINRA, "About FINRA," 2014 (http://www.finra.org/AboutFINRA/, last accessed May 3, 2014). Currently, FINRA already possesses substantial review, enforcement and regulatory power. FINRA Dispute Resolution provides all pleadings to the Central Review Group, part of the Office of Fraud Detection and Market Intelligence, which has the discretion to refer matters to FINRA Enforcement to commence investigations on that basis alone.

FINRA also possesses an Office of the Whistleblower. This office fields concerns from other FINRA offices as well as individuals with evidence or other material information concerning illegal or unethical activity. *See* FINRA, Office of the Whistleblower, 2014 (http://www.finra.org/Industry/Whistleblower/, last accessed May 3, 2014).

Fraudulent acts and schemes, such as the Madoff Ponzi scheme are an ever-present issue in the securities markets. Though this Ponzi scheme was not discovered through a FINRA arbitration referral, it is possible that mid-case referrals could inform regulators of imminent harm to investors. However, there are potential pitfalls to the mid-case referral as currently proposed. In comparison to other statutory schemes, FINRA's proposal could cause greater prejudice to the parties in the arbitration from which such tips would come.

B. Benefits of Mid-Case Referrals: Arbitrators' Important Role in Investor Protection

Arbitrators are an arm of FINRA, and it makes sense to further enable them to aid in the investor protection mandate. As it stands, arbitrators are an important part of enforcement of FINRA Rules, since virtually no case law has developed since the industry-wide use of arbitration as a means of resolving disputes with customers. As FINRA

Enforcement certainly cannot take up each and every customer complaint due to economic constraints, arbitrators' civil enforcement of the Rules is important.

FINRA provides few reasons other than investor protection for support of mid-case referrals in SR-FINRA-2014-005. Without citation to any study or other evidence, FINRA states that it "believes the proposed rule change would provide it with an important tool for detecting and addressing serious ongoing or imminent threats to investors that may only be known to the participants in the arbitration." *Id*. At pg. 18. FINRA may be correct. At the very least, FINRA's rule proposal actualizes and further evidences arbitrators' very important role served in the securities regulatory, disciplinary and enforcement system, and the market in general.

C. Potential Pitfalls of Mid-Case Referrals

Despite positive aspects to FINRA's "greater good" argument, mid-case referrals present a bevy of issues that do not exist under the current rule. First, while many arbitration

hearings are conducted in an efficient manner, mid-case referrals could cause additional delays due to the way FINRA has incorporated the idea of recusal into the proposed rule. FINRA stated in the rule proposal that it believed mid-case referrals would not substantially delay a hearing, and that the parties would have the "tools" to minimize such attendant delays and costs. Those who practice in this area know all too well how easy it is to knock an arbitration proceeding off track and into months of delay.

Second, recusal of the referring arbitrator would present at least one party with a Hobson's choice of starting the hearing over, continuing with only two arbitrators, or accepting an additional arbitrator, a prospect neither expected when they began the hearing.[1] *See* Rule 12403 of the Customer Code; Rule 13411 of the Industry Code. Selection

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[1] SR-FINRA-2014-005 proposes additional steps the arbitration panel could take to speed up the hearing, including rehearing a limited number of witnesses or stipulating to summaries of prior testimony. *See* SR-FINRA-2014-005, pg. 16. It is unlikely that the parties would have much to agree about after the recusal of an arbitrator in such a situation.

of arbitrators is partially chance and partially science. It is not hard to imagine that referrals may generally be made by arbitrators who could favor one side's position. If that arbitrator leaves the hearing after being accused of bias, a party's selection could be upset, perhaps tilting the favor in the proceeding. More troubling, it is conceivable the recusal process could be misused to simply delay the proceeding.

Third, FINRA's proposed rule change does not address which party would bear the cost of any effort to force an arbitrator to recuse him/herself. Such costs may include hourly fees by attorneys and additional hearing session[2] costs, not including disbursements resulting from copies and mailings, which could be applicable. It would be a perverse result indeed if an investor was forced to pay to respond to a motion to recuse an arbitrator for referring imminent investor harm. *See* 15 U.S.C. 78o-3(b)(6). This cost should be borne

[2] Unlike in court proceedings, parties to FINRA arbitration pay the arbitrators for their time, at the current rate of $1,250 per session, or half-day.

by the recusal movant, or "FINRA as an advancement of its mandate to detect fraud." *See* SR-FINRA-2014-005 Comment Letter of Public Investors Arbitration Bar Association, dated February 26, 2014, pgs. 1-2.

D. Federal Laws do not Expressly Provide for Recusal as a Result of Criminal Referrals

Federal laws, by their own terms, are less stringent than FINRA's proposal, and do not expressly provide for recusal as a result of a criminal referral. For instance, criminal referrals are required under the Bankruptcy Code when:

> Any judge, receiver, or trustee having reasonable grounds for believing that any violation under chapter 9 of this title [18 USCS §§ 151 et seq.] or other laws of the United States relating to insolvent debtors, receiverships or reorganization plans has been committed, or that an investigation should be had in connection therewith, shall report to the appropriate United States attorney all the facts and circumstances of the case, the names of the witnesses and the offense or offenses

> believed to have been committed.

18 U.S.C. § 3057(a). This code section does not provide for recusal, though motions have been made by affected parties in reported cases. *See, e.g., Washington 1993, Inc. v. Hudson (In re Hudson)*, 420 B.R. 73 (N.D.N.Y. 2009) (noting that § 3057 provides for no due process right to notice or to be heard before criminal referral is made, and that the motion for recusal was denied); *Seidel v. Durkin (In re Goodwin)*, 194 B.R. 214, 223 (9th Cir. 1996) ("it is clear that Goodwin has no right to notice and an opportunity to respond before a criminal referral is made. The statute itself does not create any such right. The result would be nonsensical"). Thus, the act of referral alone does not generally bestow a right for notice, and is generally insufficient to serve as a reason for recusal of the referring judge.

Motions for federal judge recusal are generally made pursuant to 28 U.S.C. § 455. Section 455(a) states that "[a]ny justice, judge, or magistrate [magistrate judge] of the United

States shall disqualify himself in any proceeding in which his impartiality might reasonably be questioned," while § 455(b) sets forth several grounds where recusal would be mandatory, including "personal bias or prejudice concerning a party" or where the judge served as a lawyer in the controversy while in private practice. 28 U.S.C. § 455(b)(1) and (2).

"Judges are presumed to be impartial." *Tripp v. Executive Office of the President,* 104 F. Supp. 2d 30, 34 (D.D.C. 2000) (citing *United States v. Fiat Motors*, 512 F. Supp. at 251 (D.D.C. 1981)). The U.S. Supreme Court has held that

> [J]udicial rulings alone almost never constitute a valid basis for a bias or partiality motion… [and] only in the rarest circumstances evidence the degree of favoritism or antagonism required … when no extrajudicial source is involved.

Liteky v. United States, 510 U.S. 540, 555 (U.S. 1994) (citing *United States v. Grinnell Corp*., 384 U.S. 563, 583 (U.S.

1966)). Even when considering facts learned through a proceeding, the *Liteky* Court noted that

> [O]pinions formed by the judge on the basis of facts introduced or events occurring in the course of the current proceedings, or of prior proceedings, do not constitute a basis for a bias or partiality motion unless they display a deep-seated favoritism or antagonism that would make fair judgment impossible.

Liteky, 510 U.S. at 555. The *Liteky* Court noted one 1921 U.S. Court decision in which such antagonism was displayed by a district judge in a World War I espionage case: "German Americans … hearts are reeking with disloyalty." *Id*. However, the *Liteky* Court noted that

> *Not* establishing bias or partiality, however, are expressions of impatience, dissatisfaction, annoyance, and even anger, that are within the bounds of what imperfect men and women, even after having been confirmed as federal judges, sometimes display. A judge's ordinary efforts at courtroom administration --

> even a stern and short-tempered judge's ordinary efforts at courtroom administration -- remain immune.

Id. at 555-556 (emphasis in original).

FINRA seeks to go further than Federal laws by duplicitously placing language within Rules 12104 and 13104 that specifically sets forth the availability of recusal motions, even though the Customer and Industry Codes already have those rules in place. *See* FINRA Rules 12406 (Arbitrator Recusal), 13409 (Arbitrator Recusal). Both rules provide that "[a]ny party may ask an arbitrator to recuse himself or herself from the panel for good cause. Requests for arbitrator recusal are decided by the arbitrator who is the subject of the request."

E. Conclusion

As of the date of this writing, public comments are still being collected regarding the mid-case referral issue until May 20, 2014. It remains to be seen whether FINRA will follow

through on the rule proposal this time, or if the SEC will intervene to block the effort.