Author: Michael A. Nagy, Esq.
Date: October 1, 2010

Getting Industry Insiders Out of the Way:
FINRA Proposes a New Rule to Give Investors All-Public Arbitration Panels

FINRA[1] recently announced that in October it will file a rule proposal that would allow all investors who file arbitration claims the option to chose a panel comprised entirely of public arbitrators. This announcement is, potentially, a major step in the right direction for consumer protection and the achievement of fairness in FINRA arbitration proceedings. However, it remains to be seen whether the Securities and Exchange Commission ("SEC") will approve the proposal. And if the SEC does approve the proposal, it is uncertain whether the all-public arbitration panels will be of actual benefit to investors who file arbitration claims. However, the early statistics look promising.

The Current System

Currently, all-public panels are limited to a special pilot-program by FINRA. Most arbitration cases are currently heard by a three-person panel, with one panel member being affiliated with the securities industry (the "non-public" panel member). The arbitrators are supposed to serve as impartial judges to hear all sides of the issue, study the evidence, and decide how the matter should be resolved. The panel's decision is final, and as a general rule it cannot be appealed.

Problems with the Current System

Although the panel of arbitrators is supposed to be "neutral," the panels are composed of corporate executives, attorneys, and industry insiders, and these affiliations can influence their decisions. Investor advocates have argued that industry participants on the arbitration panel are often biased and sympathetic toward the broker. The concern is that the non-public panel member will not take the investor's interests to heart, and will typically find in favor of the broker. For many investors it can be a major burden to have to overcome the industry biases of the non-public arbitrator.

Moreover, FINRA is a securities-industry-funded organization. The result is that arbitration awards to consumers tend to be substantially lower than court awards. So although the consumer may win the battle by getting a favorable decision in his case (i.e., the arbitrators find the broker liable), the consumer may lose the war when he receives a minimal or reduced financial award compared to what he could have received in court. Again, this result may have much to do with the fact that the industry arbitrator still has a way to take care of his own by limiting the amount of financial awards given to investors, even if he finds the broker liable.

---

[1] FINRA is the "Financial Industry Regulatory Authority". FINRA is the largest independent regulator for all securities firms doing business in the United States. FINRA oversees nearly 4,700 brokerage firms, 167,000 branch offices, and approximately 635,000 registered securities representatives.

The Proposed System

If approved by the SEC, FINRA's proposed rule would give all investors the option of choosing an all-public panel. Investors would be empowered to make a choice between presenting their case to a panel that has two public arbitrators and one non-public arbitrator (the current system), or they could present their case to an all-public panel instead.

Essentially, the proposed rule would allow any investor to have his case heard by a panel with no investment industry insiders whatsoever. Richard Ketchum, FINRA Chairman and Chief Executive Office, said that the all-public option "will enhance confidence in and increase the perception of fairness in the FINRA arbitration process."

Pros and Cons of the Proposed System

Of course, there are pros and cons to the proposed system. Not surprisingly, brokers and industry insiders have voiced strong opinions against the proposed rule. They point out that the average person (i.e., the public arbitrator) doesn't know all that much about the investment world, and that it's unfair to have arbitrators with little or no knowledge of the investment world making important decisions that could have a substantial negative impact on a broker's business or career.

Interestingly, some observers even argue that it benefits the investor to have an industry insider on the panel. They argue that the industry insiders tend to be tougher on brokers than the non-industry arbitrators, because they take broker misconduct very seriously and they perceive a broker's misconduct as giving a good industry a bad reputation. However, in the majority of cases, it appears that this argument simply does not ring true, and most investors would probably rather not test this theory if given the opportunity to select the makeup of the arbitration panel.

On the positive side of things, FINRA recently released some statistics which appear to be promising for investors. The statistics show that investors whose cases were heard by all-public panels fared better than those whose cases were heard by panels that included an industry arbitrator. Investors won in 71% of the cases that were heard by an all-public panel. This is much better in comparison to cases that were heard by a panel that included an industry arbitrator, of which investors only won 50% of the time. These statistics also appear to disprove the argument set forth above that having industry insiders on the panel is actually a benefit to investors. By eliminating the industry insiders in the pilot-program cases, investors won 21% more often. Clearly, these statistics demonstrate that investors have a much better chance at winning if the arbitration panel does not have an industry insider on it.

Conclusion: Focus on Actual Fairness and Real Consumer Protection

Based upon the long history of arguments made by investor advocates about bias and conflict of interest in the current system, which arguments have been bolstered by the recent statistics of the pilot-program, the approval of FINRA's proposed rule would certainly be a monumental step in the right direction of achieving fairness for investors. The current system appears tilted in favor of brokers, and now the proposed rule aims to tilt things more appropriately in favor of the investor.

Investors and investor advocates have great reason to be cautiously optimistic. Optimism is warranted because the evidence certainly suggests that this is a much-needed reform to a flawed system. FINRA's proposed rule certainly gives the appearance that FINRA is cognizant of the problems with the current system and is willing to make necessary changes for the benefit of investors. However, investors should maintain a healthy level of skepticism and continue to approach arbitration with a cautious attitude because there is a serious difference between the *perception* of fairness and *actual* fairness.

As it stands, it is simply too early to tell whether the proposed rule will result merely in perceived fairness, or rather in actual fairness. But one thing is certain: investors need meaningful reforms to the investment arbitration process that result in actual fairness. Only through continued monitoring and evaluation will we be able to determine if all-public arbitration panels result in a true enhancement to the actual fairness of the investment arbitration process. So far, the early statistics look promising. But before we can make that ultimate determination, we need to see the SEC do the right thing and approve FINRA's proposed rule. Then we simply have to wait and see how investors fare under the new system.

Contact the Author

Michael A. Nagy, Esq.
412-391-2515 (Phone)
412-391-2762 (Fax)
michael.nagy.esq@gmail.com