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Anticipating a FINRA Arbitration – What's Next?

By Amy E. Slusser, Esq.

When a dispute occurs between a customer and a securities broker, financial advisor, or other professional, it is highly likely that the parties will go to arbitration or mediation through the largest regulator of securities firms, FINRA— the Financial Industry Regulatory Authority. Many financial agreements include a clause that requires the parties bring any disputes to arbitration and forego the right to a jury trial. Both investors and industry professionals can learn to mitigate risks and plan for optimal resolutions by understanding key factors of the FINRA arbitration process.

Arbitration is fundamentally different from a trial by jury. An arbitral award is final. There may be very limited avenues for a party to appeal an award to a court, but these are very uncommon. In most cases, the parties will have a final resolution a few weeks after a hearing. But more often than not, the parties settle before a hearing takes place.

For all of the procedures below, see the FINRA Rules set out in the Code of Arbitration Procedure for Customer Disputes, available at www.finra.org.

Statements of Claim and Answer

The FINRA arbitration process begins when a claimant brings a Statement of Claim. Like a complaint in traditional litigation, the Statement of Claim lists the investor's allegations and contains a statement of the legal basis for these claims. The Claimant must file a Submission Agreement with the Statement of Claim.

The Respondent—usually the industry professional—responds with an Answer within 45 days after receipt of the Statement of Claim. The Respondent must also file a Submission Agreement. Motions to dismiss a claim before the hearing are discouraged and may be made only in limited circumstances: (1) if the non-moving party previously released the claims in dispute by a signed settlement agreement and/or written release; or (2) if the moving party was not associated with accounts, securities, or conduct at issue. Unlike litigation, a Respondent may not file a motion to dismiss before the answer is filed. (FINRA Rule 12504.)

Often, the Statement of Claim and Answer may be the only written documents a Panel reviews before the hearing. The parties may submit pre-hearing briefs, but these are not required. For this reason, the parties should make every effort to have the themes of their case presented effectively in their Statement of Claim or Answer.

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Selection of Arbitration Panel

After all parties have filed their appearances in the case, the FINRA Case Administrator will send the parties a neutral list of potential arbitrators. The parties will be able to "strike" potential arbitrators from the list and rate the remaining arbitrators. Parties do not have to disclose their choices to opposing counsel. The FINRA Case Administrator will then appoint the panel from these lists. Cases with potential damages of $50,000 or less will have one arbitrator; cases with a claim of more than $50,000 - $100,000 will also have one arbitrator, unless the parties agree to having panel of three arbitrators; cases of more than $100,000 or unspecified or non-monetary claims will have a panel of three arbitrators. (FINRA Rule 12401.)

Initial Prehearing Conference

The parties and the panel will then conduct an initial pretrial conference, usually by telephone, in which the arbitration schedule will be set. This process follows a script—there is very little that can vary in terms of the type of discovery allowed or the general timeline for particular deadlines. The hearing will be set for a time agreeable to all parties and the Panel. Most arbitrations take a little over a year to complete from the time a claim is filed, but some more complex cases might have a longer timeframe. At the pretrial hearing, parties should be prepared to describe their schedule for the foreseeable future. (FINRA Rule 12500.)

Discovery

The parties must exchange documents and respond to a required Document Production List within 60 days after the date that the answer is due. Parties may ask for additional information and documents as well, but these are generally limited to identifications of individuals, entities, and time periods related to the dispute. Standard interrogatories are generally not permitted. (FINRA Rules 12506-12507.)

Third-party discovery is also difficult to take in a FINRA arbitration. A party seeking third-party discovery must make a motion to the Panel for a subpoena. The Panel also has the authority, upon a motion of a party, to order without a subpoena the appearance of any employee or associated member of FINRA, or the production of documents in the possession or control of such persons. (FINRA Rules 12512-12513.)

Unlike litigation, depositions in a FINRA arbitration are strongly discouraged and very rare. Depositions may only occur to preserve the testimony of an ill or dying witness; to accommodate an essential witness who is unable to travel a long distance for a hearing; to expedite large or complex cases; or if the panel determines that extraordinary circumstances exist. This means that the parties must rely on documents to prepare their cases for hearing. Most often, the first testimony in a FINRA arbitration occurs at the hearing. (FINRA Rule 12510.)

Prehearing Exchange of Documents and Witness Lists: The "Twenty-day Exchange"

At least 20 days before the scheduled hearing date, all parties must serve copies of all documents that they intend to use at the hearing that have not already been produced. Included in this exchange are any expert analyses or documents that a party intends to use at the hearing. Parties must also exchange witness lists at this time. (FINRA Rule 12514.)

Hearing

Generally, the Claimant presents its case first, followed by the Respondent's defense. Each party may call witnesses and some witness may appear telephonically, if agreed to by the parties or ordered by the Panel.

One major difference between litigation and a FINRA arbitration is that the Panel is not required to follow state or federal rules of evidence. The Panel decides what evidence to admit. (FINRA Rule 12604.)

Award

The Panel will typically issue an award in writing a few weeks after the hearing, but is encouraged to do so within 30 days of the hearing. The award must contain an underlying rationale, but the Panel need not explain their decision unless the parties jointly make such a request at the 20-day exchange. All awards are public and must be paid within 30 days of receipt. Upon receipt of the award, the parties must also pay any fees and assessments for the arbitration. (FINRA Rules 12900-12905.)

Settlement

Industry professionals have a strong incentive to settle—up to a limit. FINRA requires industry professionals to report *any* award—even for a small amount. But if a case is settled, FINRA does not require disclosure of a settlement below $15,000 paid by broker or financial advisor, or below $25,000 paid by a securities firm. For this reason, many cases settle just below these thresholds. FINRA does not require industry professionals to report the reimbursement of forum fees, so an investor may seek to recover these costs above the threshold amounts of $15,000 and $25,000. (FINRA Rule 4530.)

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Total Return Swaps: From the Obscure to the Legal Spotlight

By Stacey P. Slaughter, Esq. and Justin Krieg, Ph.D.

Historically, Total Return Swaps ("TRS"), which share characteristics with both interest rate swaps and credit default swaps, have operated as obscure financial derivative products. Recently, however, TRS have gained heightened attention due to various investigations and regulatory scrutiny. Questions about LIBOR (London Interbank Offered Rate) manipulation and ISDA fix rate manipulation may have an impact on interest rate derivatives. Allegations of manipulation of credit default swaps, including that banks conspired with other parties to control the credit default swaps market, resulting in trading of CDS at artificially large bid-ask spreads have arisen.

Perhaps because of the unique structure of total return swaps and the resulting flow of risk, in recent years, these vehicles have received increased regulatory attention. The Dodd-Frank regulations expressly address total return swaps, which will be regulated by either the Commodity Futures Trading Commission ("CFTC") or the Securities and Exchange Commission ("SEC") depending on the type of TRS. Even the IRS has started to crack down on TRS as a means to avoid taxes on dividends paid to foreign investors.

This article begins with a description and diagram of the structure and risk relationships inherent in total return swaps. Next, this article considers scenarios in which investing in a TRS could bring advantages, which is followed by an analysis of the vehicle's vulnerability to manipulations. Finally, this article examines some of the unique regulatory aspects of this complex investment vehicle.

What is a Total Return Swap?

A total return swap transfers or swaps the total economic performance of a reference asset between two parties. The *total return payer* transfers the total return on a reference obligation, such as a bond, loan pool, or commodity index, to the *total return receiver*. The *total return receiver* is paid the cash flows from the underlying obligation as well as any appreciation in the value of the obligation. But, the *total return receiver* must pay the *total return payer* any depreciation in the value and compensate the payer for any default losses. The *total return receiver* is also obligated to pay periodic interest equal to a money market rate, usually LIBOR, plus a negotiated spread.

TRS have common features with other derivatives such as interest rate swaps and credit default swaps. As stated above, in a TRS the *total return payer* transfers the total return, including losses due to default, to the *total return receiver*. This transaction transfers the credit risk from the *total return payer* to the *total return receiver* for the duration of the swap. The transfer of credit risk puts the *total return payer* in a similar position to that of a protection buyer in a cash settled credit default swap.[1] The TRS also exposes the *total return payer* to interest rate risk as they are accepting LIBOR in exchange for the reference obligation's total return. This gives the *total return payer* a position that is similar to the payer position in an interest rate swap.

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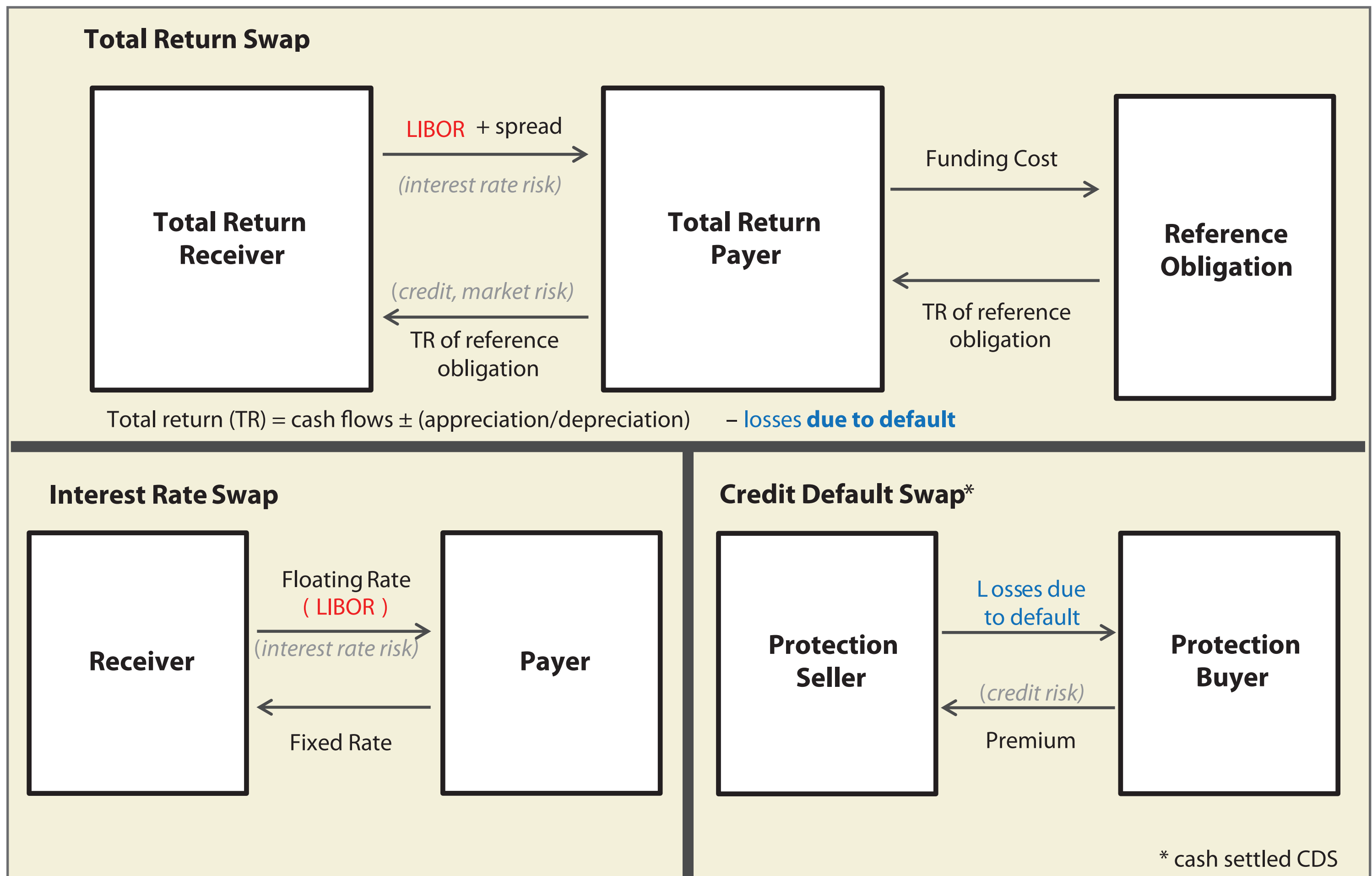
The chart below illustrates the common characteristics of an interest rate swap and credit default swap embedded in the TRS.



Who Might Invest in a TRS and Why?

TRS originated as a way for commercial banks to change the risk profile of their loan portfolios, which were traditionally concentrated in specific industries and/or geographical regions. By acting as a *total return* payer, a TRS allowed a bank to reduce its risk exposure to a specific industry or geographic location without having to sell its customers' loans. On the flip side, if a bank wanted to diversify the risk in its loan portfolio, it could enter into a TRS as a *total return receiver* and obtain exposure to other industries or geographic regions that were outside its traditional area of expertise.

Diversification is also the reason why non-traditional investors, such as hedge funds, are drawn to TRS. By entering into a TRS as a *total return receiver* these investors can obtain exposure to illiquid or untraded asset classes. For example, these investors have obtained exposure to the returns of commercial loans and other illiquid asset classes such as lightly traded stocks, bonds and commodities, or an untraded commodity index using TRS.[2] As long as the returns of the illiquid assets are not correlated with the returns on the investor's existing holdings the diversification reduces the risk level of the non-traditional investor.

There are financial motivations for entering a TRS. The *total return payer* may be able to lock in profits by entering to a TRS. This occurs whenever *the total return payer* has a funding cost that is less than the payment they receive in the TRS (LIBOR plus a spread).[3]

On the other hand, the *total return receiver* is able to obtain

financing at favorable rates since they finance their exposure to the reference obligation at a spread to LIBOR. Generally, this spread is smaller than what the *total return receiver* could obtain if they financed an outright purchase of the reference obligation. This lower rate is because the *total return receiver* does not have to borrow the capital necessary to purchase the reference obligation. Since the *total return receiver* does not have to make an initial outlay to purchase the reference obligation and place the reference entity and financing on its balance sheet, this effectively gives the *total return receiver* a leveraged position in the reference obligation.[4]

Manipulations of Similar Products Affects the TRS

The common features between TRS and other derivative products means that manipulation and alleged manipulations that impact interest rate swaps or credit default swaps will also impact total return swaps. This is clear in the case of LIBOR manipulation. The banks that set LIBOR have been accused of pushing LIBOR down, resulting in lower payments to *the total return payer* just as in interest rate swaps. Several banks have entered into settlement agreements with the U.S. regulators regarding manipulation of LIBOR.

Various investigations and recent litigation have alleged that banks used their position in the over-the-counter ("OTC") market to maintain high bid-ask spreads and sell credit default swaps at non-competitive prices. Since both credit default swaps and total return swaps are credit derivatives sold in OTC markets, total return swaps may have been similarly impacted as credit default swaps.

The manipulations of the LIBOR and potential manipulations of ISDAfix Rate and even credit default swaps has affected the pricing, payments, and possible termination amounts within the TRS.

The Evolving Regulatory Landscape Relating to TRS

The proposed Dodd-Frank regulations of TRS gives authority to two different regulatory agencies depending on the type of TRS. Pursuant to the Dodd-Frank Act, the CFTC has authority to regulate "swaps," while the SEC is charged with regulating "security-based swaps." The Securities and Exchange Commission and the United States Commodity Futures Trading Commission published regulations in 2012 outlining their authority to govern TRS. The scope of the term "swap" and "security-based swap" determines which TRS transactions, and which parties to a TRS transaction, will be subject to many of the derivatives regulatory provisions of the Dodd-Frank Act, *i.e.*, requirements for recordkeeping and reporting, mandatory clearing and trade execution, collateral segregation and margin levels, and registration as a regulated entity such as a swap dealer or major swap participant.

Regarding "security-based swaps," the Dodd-Frank Act explains that they are based on "(I) an index that is a narrow-based security index...; (II) a single security or loan...; or (III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer."[5] While this statutory definition provides that a swap based on a single loan is classified as a "security-based swap," it does not expressly include other types of loan-based transactions, including TRS based on multiple loans or borrowers. The Final Rules published by the SEC and CFTC confirm that TRS based on a single loan will be treated as a "security-based swap" and clarify that a TRS "based on two or more non-security loans are swaps, and not security-based swaps."[6] Therefore, the CFTC regulates TRSs based on two or more loans and the SEC regulates TRS based on a single loan.

Parties engaging in a TRS transaction should carefully understand what agency will regulate their transactions. For example, when counterparties seek TRS exposure to several loans, they might document their trades under multiple individual confirmations subject to a single "Master Confirmation" agreement. The SEC and CFTC have now made clear that each transaction for which a separate confirmation is sent constitutes an individual instrument that must be analyzed independently to determine whether it is a security-based swap. Multiple individual transactions under a single master agreement or master confirmation "would not constitute a Title VII instrument based on one 'index or group' under the security-based swap definition but instead would constitute multiple Title VII instruments."[7] Therefore, multiple single-name TRS transactions documented using separate "supplemental confirmations" under a single "Master Confirmation" will be classified as security-based swaps.

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Increased IRS scrutiny to TRS

Another concern with TRS is that they allegedly may be used to avoid tax on dividends on U.S. securities paid to foreign persons. The Internal Revenue Code imposes a "withholding tax" on certain types of U.S. source income, including dividends, paid to foreign persons. The "withholding tax" is generally withheld from the dividend payment by a payor ("withholding agent").[8] Pursuant to a 20 year old Treasury regulation, payments to a foreign person on a notional principal contract are treated as foreign source income.[9] Thus, it has been generally accepted that there is no "withholding tax" imposed on TRS payments, including dividend equivalent payments with respect to U.S. securities. In 2009, legislative proposals were introduced in Congress that, under certain circumstances, would subject dividend equivalent payments under TRS referencing U.S. securities to withholding tax as if they were actual dividends on the referenced shares. Along those lines, the IRS has designated the issue as a "Tier I" issue, meaning one of high strategic importance to the IRS. As such, in 2010 the IRS issued an "Industry Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax" (the "Directive").[10]

The Directive states that its intent is to provide guidance on developing facts for determining when a transaction that is in form a TRS will be respected in substance as a notional principal contract, and when such a swap will be recharacterized in accordance with its substance as an agency agreement, repurchase agreement, lending transaction, or some other form of economic benefit by the foreign person."[11] Thus, the IRS indicates that an agency agreement, repurchase agreement, and lending transaction are examples of transactions that will incur the "withholding tax." Additionally, the Directive identifies four factual situations that may constitute improper tax avoidance: (1) cross-in/cross-out, (2) cross-in/inter-dealer broker out, (3) cross-in/foreign affiliate out, and (4) fully synthetic.[12] The four factual situations are representative examples of common variations of TRS transactions.[13] The Directive notes that particular transactions under examination may not fit exactly within any one of the four situations.[14] The Directive instructs revenue agents to develop facts showing that the form of the TRS should be disregarded for U.S. federal income tax purposes.[15] In those situations, revenue agents are directed to develop facts supporting a legal conclusion that the foreign person retained ownership of the reference securities for U.S. federal income tax purposes even though the foreign person may have transferred the legal title to such securities.[16]

Conclusion

TRS transactions are complicated and widely used, although they formerly operated in a rather obscure part of the financial markets. However, with changes to the regulatory environment and allegations of various manipulations schemes, total return swaps will be the subject of increased scrutiny. This may increase the legal spotlight on these formerly obscure financial derivatives.

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1. When default occurs in a traditional credit default swap, the protection buyer sends the reference bond to the protection seller and the protection seller sends the buyer the principal value of the bonds. In a cash-settled credit default swap the protection seller only sends the difference between the principal of the bonds and the market value of the bonds following default. Cash settlement removes the requirement that the protection buyer must hold the bonds to receive payment following a default.
2. In some instance the total return payer does not actually own the reference obligation. For example, when the reference obligation is a commodity index the total return payer doesn't purchase the commodities underlying the index, instead the payer simply pays the return on that index to the receiver.
3. If the *total return payer* is a bank then its funding cost is approximated by LIBOR. In this instance the two LIBOR streams offset and the bank earns a fixed profit, equal to the spread, over the duration of the swap.
4. This is sometimes referred to as renting the balance sheet of the total return payer.
5. Dodd Frank Wall Street Reform and Consumer Protection Act § 761 (hereinafter Dodd Frank).
6. Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,266 (Aug. 13, 2012) (codified at 17 C.F.R. pts. 1, 230, 240, 241).
7. *Id.* at 48,267.
8. *See* Internal Revenue Code §§ 1441-42.
9. 26 C.F.R. § 1.863-7.
10. Internal Revenue Service, Industry Directive on Total Return Swaps ("TRSs") Used to Avoid Dividend Withholding Tax (2010) (available at *http://www.irs.gov/Businesses/Corporations/Industry-Directive-on-Total-Return-Swaps-%28%E2%80%9CTRSs%E2%80%9D%29-Used-to-Avoid-Dividend-Withholding-Tax*)
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*

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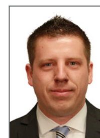

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Spotlight on Justin Krieg, Ph.D. Economist and In-House Economic Consultant

Our 15-person, in-house Financial and Economic Consultants Group is comprised of C.P.A.s, M.B.A.s, and Ph.D. economists who assist our attorneys with the many financial, accounting, and economic issues that arise in complex litigation. This at-the-ready pool of talent and expertise enables us to more effectively and efficiently serve our clients. The newest member of our group is Justin Krieg, a Ph.D. Economist, who specializes in derivative securities.

Congratulations on becoming a newlywed. How do you describe your new job to your wife?

Thank you. I help our attorneys understand the different aspects of the financial markets to better represent their clients. I proactively sift through financial news and academic literature to ferret out real economic evidence. One of the things we do is corral and organize the information from varied and vast resources to make it more useful and understandable so our attorneys can put it to strategic use representing our clients. It's not only knowing where to find the information, it's understanding what to do with it. We know how to distill and extract what is useful to our attorneys and their clients, providing a different perspective that often yields additional evidence and creative solutions in a case.

Members of the Financial and Economic Consultants Group each have areas of expertise in complex financial instruments. Yours is in derivative securities. What is a derivative security and how did you become interested in them?

Derivative securities are securities that derive their value from other assets such as financial derivatives, interest rate derivatives, or financial future contracts. I have always been fascinated by understanding how things work. In particular, I am interested in the strategic use of derivative securities by the various parties in the financial markets.

For example, say a commercial bank specializes in servicing a particular industry and as a result their loan portfolio is concentrated in that industry. This would expose the bank to risk that is industry specific. In order to manage and diversity that concentrated risk, the bank has several choices. It could stop originating loans in the industry it specializes in. It could sell some loans to other investors, but would have to explain to their customers why they were not comfortable taking on the risk of that customer's loan. Alternatively, it could enter into a total return swap (which is discussed in the article I have co-authored for this issue). A total return swap is a strategy to address the bank's risk levels and allow the bank to continue to originate loans in the industry in which it has specialized knowledge.

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As a numbers guy, given the choice between word games or number games in your spare time, which would you choose?

We played a lot of Scrabble, Monopoly, and poker. My grandfathers were nuclear engineers at the Hanford Nuclear Reservation in eastern Washington so there was always an expectation that no matter what you did, you did it intelligently. My interest in strategy has manifested itself throughout my life by playing board games and poker, as well as studying game theory in graduate school. Game theory is the study of strategic decision making. I also participate in sports. When I watch a professional basketball game I get as excited about how an offense creates the open space that allows for a Lebron James dunk as I am about the dunk itself.

And, when you're not playing games and sports?

In addition to my interest in finance in graduate school, I studied behavioral economics which is the psychology behind our economic decision making processes. Writing academic papers about behavioral economics has become a hobby of mine and I have recently resumed work on several projects in this area. The most advanced project I have, looks at how different types of incentives change people's perceptions of charitable giving.

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