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KD Alert: FINRA Authorizes Mid-Case Disciplinary Referrals in Arbitration

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FINRA arbitrators have long been permitted to make disciplinary referrals to FINRA's Member Regulation division at the conclusion of an arbitration hearing. However, FINRA has recently amended Rule 12104 and Rule 13104 of the Customer and Industry Arbitration Codes, respectively, to permit arbitrators to make such a disciplinary referral during the course of an arbitration hearing. An arbitrator may make such a "mid-case" referral when the arbitrator learns of a matter or of conduct from evidence that is presented by the parties during an arbitration hearing, which he or she believes poses a serious threat, either ongoing or imminent, that is likely to harm investors unless immediate action is taken. These amendments to the Codes of Arbitration Procedure go into effect on October 27, 2014 for any FINRA arbitration case that has scheduled hearings on or after that date.

Examples of threats that might warrant a mid-case disciplinary referral include evidence of a Ponzi scheme or money-laundering. Once such a referral is made, either the president of FINRA Dispute Resolution or the director will review the referral and decide whether or not to forward it to other FINRA divisions. If an arbitrator should decide that a serious threat to investors exists, but the case is about to conclude, then the arbitrator should wait until the conclusion of the case before making the referral so long as the delay does not materially compromise investor protection.

Should an arbitrator make a mid-case disciplinary referral, then the director will disclose the referral to the parties. The parties will then have three days in which to request that the referring arbitrator recuse herself. The arbitrator has the discretion to grant or deny any such recusal request. Should the arbitrator deny a recusal request in this context, FINRA does not believe that the denial would provide the person or entity that is the subject of the disciplinary referral with valid grounds to challenge an arbitration award that is issued in connection with the matter. However, the securities industry may legitimately have concerns regarding the impartiality of an arbitrator who decides to make a disciplinary referral before hearing the totality of the evidence at an arbitration.

In defending arbitrations that span more than one week and whose subject matter may be an issue of ongoing concern for regulators, securities industry members and their counsel should bear in mind the potential for a concurrent disciplinary referral that exists under these new amendments to FINRA's Customer and Industry Arbitration Codes. The practical impact of such referrals on private arbitrations may be to encourage settlement during the course of a hearing, since once an arbitrator makes such a referral, it becomes clear to the parties "which way the wind is blowing," at least with respect to that arbitrator.

A concern regarding these rule amendments, which was voiced while the SEC was considering FINRA's rule proposal, is that they may increase the cost and delay involved in conducting a private arbitration. This is so because if an arbitrator grants a request for recusal after making a mid-case disciplinary referral, then it will take some time to appoint a replacement arbitrator and have that person familiarize himself with the testimony thus far and/or to recall witnesses for the benefit of the replacement arbitrator. Moreover, if the arbitrator who makes the referral is the chairperson, who is doing so on behalf of the three member arbitration panel, then the entire panel may be asked to recuse itself. This may only further increase the delay and expense associated with the arbitration, as an entirely new panel may have to be appointed. FINRA's response to this concern is that its interest in early detection of what may be a large-scale threat to numerous investors outweighs the potential increased cost to the parties to a single arbitration.

Regardless of the possible regulatory benefits of such a rule, it will likely be a "game-changer" for parties to an arbitration that is scheduled to take place on non-consecutive days or for a period of weeks, as the parties may now learn, before the conclusion of the hearing, how one arbitrator views the evidence presented thus far. This may result either in resolution of the matter by the parties or in a longer, more expensive arbitration that involves the appointment of replacement arbitrator(s) in order ensure that the evidence is considered by an unbiased arbitration panel.

The impact of a mid-case disciplinary referral may be tempered somewhat if, as in many cases, FINRA already has commenced a parallel "cause" examination based on the U4 or U5 disclosure of the complaint and/or the arbitration. However, even where such an examination is ongoing, a mid-case disciplinary referral would be detrimental to Respondents and would likely diminish their prospects for having that examination closed without action. Securities industry members who have concerns that conduct may be viewed by an arbitration panel in such a way as to possibly lead to a mid-case disciplinary referral should give serious consideration to resolving the

matter before it reaches an arbitration panel.