

Mid-case Referrals in Arbitration

SEC Approves Amendments to the Arbitration Codes to Expand Arbitrators' Authority to Make Referrals During an Arbitration Proceeding

Effective Date: October 27, 2014

Executive Summary

The Customer and Industry Codes (Codes) permit arbitrators to refer to FINRA for disciplinary investigation any matter that has come to the arbitrator's attention during and in connection with the arbitration at the conclusion of the proceedings. The SEC approved amendments to the Codes to permit arbitrators to make a referral, during an arbitration, of any matter or conduct that 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.¹

The amendments are effective on October 27, 2014, for any arbitration case which has scheduled hearings remaining.

The text of the amendments is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

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Notice Type

- ▶ Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Arbitration
- ▶ Arbitrators
- ▶ Referrals

Referenced Rules & Notices

- ▶ FINRA Rule 12104
- ▶ FINRA Rule 13104

Discussion

FINRA has amended Rules 12104 and 13104 to permit arbitrators to make a referral, during an arbitration, of any matter or conduct that has come to the arbitrator's attention during a hearing,² 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. Prior to these amendments, the rules limited the arbitrators' ability to make referrals until the conclusion of an arbitration case.

Making a Mid-case Referral

Under Rules 12104(b) and 13104(b), an arbitrator may make a mid-case referral if the arbitrator learns of a matter or conduct from evidence presented by the parties during a hearing. The rules further provide that arbitrators should not make referrals during the pendency of an arbitration based solely on allegations in the statement of claim, counterclaim, cross claim or third party claim. The matter or conduct must pose a serious threat that is imminent or ongoing, and is likely to harm investors unless immediate action is taken. Examples of such a threat would include evidence of a Ponzi scheme or money-laundering.³

Finally, if the arbitrator believes that such a threat exists but the case is about to conclude, then the rule instructs the arbitrator to wait until the case concludes and make a post-case referral, under Rules 12104(e) or 13104(e), if the arbitrator believes that the delay will not materially compromise investor protection. An arbitrator may have the opportunity to exercise such judgment if, for example, during the third of four consecutively scheduled hearing days, the arbitrator learns of a serious threat that meets the criteria of the rule. If the arbitrator anticipates that the remaining tasks will be completed shortly after the last hearing session is conducted on the fourth day, the arbitrator could defer making the mid-case referral until the case concludes, so that there would not be a significant delay to the conclusion of the case. In deciding whether to delay making a mid-case referral, however, the arbitrator should weigh the potential harm a mid-case referral could have on the individual claimant against the possible harm to other investors that a brief delay could cause.⁴

Disclosure of Mid-case Referral to Parties and Time Limit to Request Recusal

If any arbitrator refers a matter or conduct for investigation as discussed above, Rules 12104(c) and 13104(c) provide that the director will disclose the referral to the parties. Under these rules, any party asking that the referring arbitrator(s) recuse themselves must make the request no later than three days after the director notifies the parties of the referral. Further, if a party does not make the recusal request within the prescribed timeframe, the party forfeits the right to request recusal of the referring arbitrator(s).

FINRA notes that the rule does not create a right to make a recusal request; this right exists in any arbitration case. Rules 12406 and 13409 of the Codes state that an arbitrator who is the subject of a recusal request has the discretion to decide whether to withdraw from the case. FINRA rules do not currently dictate the grounds for granting recusal requests and do not require specific decisions by arbitrators in response to such requests. Therefore, an arbitrator would not be required to grant a party's recusal request that results from the arbitrator's mid-case referral. Consistent with any other recusal request, an arbitrator challenged because of a mid-case referral would be required to make that decision in accordance with the Codes,⁵ and Code of Ethics for Arbitrators in Commercial Disputes.⁶

Further, if an arbitrator denies a party's recusal request, FINRA does not believe that the denial would provide the subject of the referral with valid grounds to challenge an award. The Federal Arbitration Act establishes four grounds for vacating an arbitration award.⁷ Some individuals who commented on the proposed rule change have predicted that a possible challenge that might be triggered by a mid-case referral would be evident partiality. However, arbitrator evident partiality encompasses both an arbitrator's explicit bias toward one party and an arbitrator's inferred bias when an arbitrator fails to disclose relevant information to the parties.⁸ "The party alleging evident partiality must establish specific facts which indicate improper motives" on the part of the arbitrators.⁹ Further, courts have stated that neither the appearance of impropriety, standing alone,¹⁰ nor the arbitrators' decision are sufficient to constitute a showing of evident partiality.¹¹

In addition, courts have found that a situation in which an arbitrator forms an opinion using evidence presented during a hearing and then acts on that evidence does not rise to the level of evident partiality.¹² Courts expect that after an arbitrator has heard considerable testimony, the arbitrator will have some view of the case.¹³ As long as that view is one that arises from the evidence and the conduct of the parties, it cannot be fairly claimed that some expression of that view amounts to bias.¹⁴ Based on case law, FINRA believes that, as arbitrators are expected to form opinions based on evidence presented to them after they are appointed, a prevailing investor's award would not likely be vacated because arbitrators acted on their views, in the form of a mid-case referral, prior to the conclusion of the proceedings.¹⁵

Moreover, filing a motion to vacate an award on the basis of an arbitrator making a mid-case referral could expose the attorney and the moving party to fees and sanctions. Courts have imposed sanctions to discourage parties from "defeating the purpose of arbitration by bringing such [motions] based on nothing more than dissatisfaction with the tribunal's conclusions."¹⁶ "Where parties agree to arbitration as an efficient and lower-cost alternative to litigation, both the parties and the system itself have a strong interest in the finality of those arbitration awards."¹⁷ Thus, courts have found that sanctions were appropriate when the motion "serves only to cause the parties to incur unnecessary expense and delay the implementation of the award."¹⁸

President or Director Evaluates Mid-case Referral

Under the amendments, Rules 12104(d) and 13104(d) provide that the president of FINRA Dispute Resolution or the director will evaluate the arbitrator referral to determine whether to transmit it to other FINRA divisions. Further, only the president or the director will have the authority to forward the referral under these rules.

Making a Post-case Referral

Rules 12104(e) and 13104(e) continue to permit an arbitrator to make referrals at the conclusion of an arbitration case. Specifically, the rules state that at the conclusion of an arbitration, any arbitrator may refer to FINRA for investigation any matter or conduct 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 the rules of FINRA, the federal securities laws, or other applicable rules or laws.

Effective Date

The amendments are effective on October 27, 2014, for any arbitration case which has scheduled hearings remaining.

Endnotes

1. See Securities Exchange Act Release No. 73319 (October 8, 2014), 79 FR 61915 (October 15, 2014) (Order Approving File No. SR-FINRA-2014-005).
2. The term "hearing" means a hearing on the merits of an arbitration under Rule 12600. See Rules 12100(m) and 13100(m).
3. FINRA notes that these examples are illustrative, not exhaustive.
4. FINRA contemplates that the mid-case referral rule would typically be used in those circumstances where hearings are scheduled for many days, or even weeks, and, in particular, when the hearing days are not scheduled consecutively.
5. Any 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. Rules 12406 and 13409.
6. See [The Code of Ethics for Arbitrators in Commercial Disputes, Canon I\(E\)](#) (stating, in relevant part, that "[w]hen an arbitrator's authority is derived from the agreement of the parties, an arbitrator should neither exceed that authority nor do less than is required to exercise that authority completely. Where the agreement of the parties sets forth procedures to be followed in conducting the arbitration or refers to rules to be followed, it is the obligation of the arbitrator to comply with such procedures or rules.").

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7. An award may be vacated upon the application of any party to the arbitration —
 - (1) where the award was procured by corruption, fraud, or undue means;
 - (2) where there was evident partiality or corruption in the arbitrators, or either of them;
 - (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy, or of any other misbehavior by which the rights of any party have been prejudiced; or
 - (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

See 9 U.S.C. §10(a).
8. Windsor, Kathryn A. (2012) "[Defining Arbitrator Evident Partiality: The Catch-22 Of Commercial Litigation Disputes](#)," *Seton Hall Circuit Review*: Vol. 6: Iss. 1, Article 7, p. 192.
9. *Sheet Metal Workers International Association Local Union 420 v. Kinney Air Conditioning Co.*, 756 F.2d 742, 746 (9th Cir. 1985).
10. *Kinney*, 756 F.2d at 746 (citing *International Produce, Inc. v. Rosshavet*, 638 F.2d 548, 551 (2d Cir.), *cert. denied*, 451 U.S. 1017 (1981)).
11. *Stanley J. Mical, et al. v. Phillip J. Glick, et al.*, No. 13 C 6508 (N.D. Ill. filed Jan 28, 2014).
12. *Ballantine Books Inc.*, 302 F.2d at 21. *See also Bell Aerospace Co. v. Local 516, UAW*, 500 F.2d 921, 923 (2nd Cir. 1974).
13. *Ballantine*, 302 F.2d at 21.
14. *Id.* *See also Health Services Management Corp. v. Hughes*, 975 F.2d 1253, 1267 (7th Cir. 1992).
15. *Health Services Management Corp.*, 975 F.2d at 1267.
16. *DigiTelCom, Ltd. v. Tele2 Sverige AB*, 2012 U.S. Dist. LEXIS 105896, 18-19 (S.D.N.Y. July 25, 2012).
17. *Id.* at 18.
18. *Id.* at 19-20. *See also B.L. Harbert Int'l v. Hercules Steel Co.*, 441 F.3d 905, 913 (11th Cir. Ala. 2006) (suggesting that courts cannot prevent parties from trying to convert arbitration losses into court victories, but it may be that we can and should insist that if a party on the short end of an arbitration award attacks that award in court without any real legal basis for doing so, that party should pay sanctions).

Attachment A

New language is underlined; deletions in brackets.

Customer Code

12104. Effect of Arbitration on FINRA Regulatory Activities; Arbitrator Referral During or at Conclusion of Case

(a) No change.

(b) During the pendency of an arbitration, any arbitrator may refer to the Director any matter or conduct that 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. Arbitrators should not make referrals during the pendency of an arbitration based solely on allegations in the statement of claim, counterclaim, cross claim, or third party claim. If a case is nearing completion, the arbitrator should wait until the case concludes to make the referral if, in the arbitrator's judgment, investor protection will not be materially compromised by this delay.

(c) 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, no later than three days after the Director notifies the parties of the referral. If a party does not make the recusal request within the prescribed timeframe, the party forfeits the right to request recusal of the referring arbitrator(s).

(d) The President of FINRA Dispute Resolution or the Director will evaluate the arbitrator referral to determine whether to transmit it to other divisions of FINRA. Only the President or the Director shall have the authority to act under this paragraph (d).

(e) [Only a] At the conclusion of an arbitration, any arbitrator may refer to FINRA for [disciplinary] investigation any matter or conduct 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] the rules of FINRA [rules], the federal securities laws, or other applicable rules or laws.

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Industry Code

13104. Effect of Arbitration on FINRA Regulatory Activities; Arbitrator Referral During or at Conclusion of Case

(a) No change.

(b) During the pendency of an arbitration, any arbitrator may refer to the Director any matter or conduct that 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. Arbitrators should not make referrals during the pendency of an arbitration based solely on allegations in the statement of claim, counterclaim, cross claim, or third party claim. If a case is nearing completion, the arbitrator should wait until the case concludes to make the referral if, in the arbitrator's judgment, investor protection will not be materially compromised by this delay.

(c) 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, no later than three days after the Director notifies the parties of the referral. If a party does not make the recusal request within the prescribed timeframe, the party forfeits the right to request recusal of the referring arbitrator(s).

(d) The President of FINRA Dispute Resolution or the Director will evaluate the arbitrator referral to determine whether to transmit it to other divisions of FINRA. Only the President or the Director shall have the authority to act under this paragraph (d).

(e) [Only a] At the conclusion of an arbitration, any arbitrator may refer to FINRA for [disciplinary] investigation any matter or conduct 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] the rules of FINRA [rules], the federal securities laws, or other applicable rules or laws.