Regulatory Notice 17-34

Non-Attorney Representatives in Arbitration

FINRA Requests Comment on the Efficacy of Allowing Compensated Non-Attorneys to Represent Parties in Arbitration

Comment Period Expires: December 18, 2017

Summary

The FINRA Codes of Arbitration and Mediation Procedure permit compensated non-attorneys to represent clients in securities arbitration and mediation subject to certain exceptions. FINRA is conducting a review of the efficacy of continuing to allow such representation. The *Notice* outlines FINRA's review of compensated non-attorney representatives' (NAR firms) activities at the forum and seeks responses to questions related to forum users' experiences with NAR firms.

Questions concerning this *Notice* should be directed to:

- Kenneth L. Andrichik, Senior Vice President and Chief Counsel, Office of Dispute Resolution, at (212) 858-3915; or
- Kristine Vo, Assistant Chief Counsel, Office of Dispute Resolution, at (212) 858-4106.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by December 18, 2017.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or

October 18, 2017

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics

- Arbitration
- Associated Person
- Code of Arbitration Procedure
- Code of Mediation Procedure
- Dispute Resolution
- Mediation

Referenced Rules & Notices

- FINRA Rule 12208
- FINRA Rule 13208
- FINRA Rule 14106

- Mailing comments in hard copy to:

  Marcia E. Asquith
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.[1]

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).[2]

Background & Discussion

The FINRA Codes of Arbitration and Mediation Procedure (Codes) permit non-attorneys to represent clients in securities arbitration and mediation subject to certain exceptions.[3] Some parties are represented by relatives or friends who assist with case preparation or presentation. Typically, NAR firms provide public investors an alternative to representation by attorneys in disputes between investors and broker-dealers.

The Dispute Resolution Task Force in its Final Report and Recommendations[4] recommended that FINRA conduct a study to determine, among other matters, whether NAR firms are performing competently. FINRA's review revealed that there are a small number of NAR firms regularly practicing in the forum. Forum users have reported that the following NAR firm activities have taken place at the forum:

- using the forum as a vehicle to employ inappropriate business practices;
- requiring retainer agreements that reflect a non-refundable fee of $25,000;
- representing parties in hearing locations where state law prohibits such representation or, in the alternative, handling only small claims (decided on written submissions) to avoid hearing locations in which the unauthorized practice of law would become an issue;

- signing required arbitration submission agreements with the name of the NAR firm to avoid naming an individual representative who could be engaging in the unauthorized practice of law;
- pursuing frivolous or stale claims to attempt to elicit settlements; or
- breaching confidentiality provisions in settlement agreements by posting a picture of the settlement check to market the NAR firm's services.

FINRA permits parties to represent themselves in the forum. Investors with small claims (claims of $100,000 or less) who want to be represented in the forum have limited access to attorneys because some attorneys may not be willing to offer services given the small dollar value of a dispute. In recent filings, approximately one-fifth of customer claims with specified damages have relief amounts of less than $100,000.[5] Some of these investors are served by law school arbitration clinics,[6] and others are served by NAR firms.

While NAR firms provide service to public investors with small claims, among others, the allegations reported to FINRA raise serious concerns. There are no rules of professional conduct applicable to NAR firms' activities. Moreover, NAR firms are not subject to malpractice insurance requirements. Any recovery against a NAR firm for negligence is generally limited to the assets of the corporation. Therefore, investors have little recourse if a NAR firm negligently represents or defrauds them. In addition, NAR firms are not subject to licensing boards and there is no supervisory body with authority to police their activities. Therefore, FINRA is considering whether it would be prudent to further restrict representation of parties by NAR firms.

Economic Impact Assessment

In considering whether to further restrict representation of parties by NAR firms, FINRA will evaluate the economic effects of further restrictions with respect to the current rules under the Codes that permit non-attorneys to represent clients in securities arbitration and mediation.[7] Further restrictions on NAR firms are likely to affect investors, broker-dealers, NAR firms and other entities that offer services to investors in arbitration including attorneys.

As described previously, investors typically retain representation by attorneys, NAR firms, relatives and friends, and law school arbitration clinics. Investors can benefit from their representative's experience and expertise to prepare and present a case, and to decide when to settle or arbitrate a claim. The benefits of representation are likely to increase with the competency and experience of the representation and the difficulty for investors to make informed decisions, such as when the legal issues are more complex. Investors can also incur costs from retaining representation in arbitration. For example, investors incur fees to retain attorneys and NAR firms. Other types of representation, including law school arbitration clinics, typically charge no fee.

Economically rational investors will likely retain the representation that provides the most benefits relative to its costs, including retaining no representation if that is the most beneficial option. However, not all options may be available to all investors. Attorneys with the relevant competency are often not willing to offer services to smaller claims, and law school arbitration clinics may not be locally available. Law school arbitration clinics may also impose other restrictions, such as not handling claims above a set amount or offering services to high income investors.

Although NAR firms are an alternative to representation by attorneys, NAR firms are not subject to the same professional rules or guidelines, nor are they subject to malpractice insurance requirements. As a result, relative to representation by attorneys, investors who retain representation by NAR firms may be more likely to experience harm at the hand of their representative and have less legal recourse to receive compensation for that harm. Investors may also not be aware of the absence of these protections, and therefore may not properly evaluate the benefits and costs of representation by NAR firms.

Further restricting the representation of parties by NAR firms could benefit investors by reducing their exposure to firms that provide fewer client protections or redress options for malpractice. The absence of similar rules and requirements could result in a higher incidence of harmful practices, and thereby impose additional costs on investors when retaining representation. To the extent that harmful activities hinder the dispute resolution process, then broker-dealers would also incur additional legal expense and time to resolve disputes. Further restrictions on NAR firms would thereby also benefit broker-dealers through the reduction of these potential costs.

Alternatively, further restricting the representation of parties by NAR firms could also impose additional costs. A primary cost could be a decrease in the ability of some investors, including investors with smaller claims, to find other beneficial sources of representation. The available alternatives to NAR firms may not be as beneficial as representation by NAR firms, even if there is a higher risk of negligent representation or fraud, and therefore impose costs on investors. The loss of representation could result in worse arbitration outcomes. Also, to the extent that NAR firms market their services to investors, and in particular investors with smaller claims, then further restrictions could also reduce the number of investors who are aware of the potential need to seek recourse in arbitration.

Further restricting representation of parties by NAR firms would also have other economic effects. An inability by some investors to find other beneficial sources of representation in arbitration could impact the outcome of an arbitration hearing by affecting the quality and completeness of the information presented. Attorneys could also experience an increase in business from investors who would otherwise retain representation by NAR firms, which would then experience a loss of business. Holding the likely outcome of the arbitration constant, these impacts represent an economic transfer and not a new cost or benefit imposed.

The magnitude of the benefits and costs depends on the restriction on NAR firms that may be imposed. The magnitude of the benefits and costs would also depend on the exposure of these investors to harmful activities and their ability to retain other representation. For example, investors with higher exposure to harmful activities by NAR firms or better access to beneficial sources of alternative representation would likely experience greater benefits, while those with lower exposure or less access to other beneficial sources of alternative representation could experience higher costs. The magnitude of the benefits and costs to investors and other affected parties would depend on the nature and severity of the potential changes to the Codes. The magnitude of the benefits and costs does not depend on the investors that would not otherwise retain representation by NAR firms.

Request for Comment

FINRA seeks answers to the following questions with respect to the efficacy of allowing NAR firms to continue to represent clients in the forum.

1. What experiences have you had with a NAR firm in the forum? Do you believe the party received competent representation by the NAR firm? What was the economic impact to you or your firm of the experience?
2. What other types of representation or assistance do investors retain in arbitration? What experiences have you had with other types of representation or assistance in the forum? Do you believe the party received competent representation or assistance? What was the economic impact to you or your firm of the experience?
3. How does the expense to retain representation or assistance differ between NAR firms, law firms and other entities that offer services?
4. Have you been unsuccessful at obtaining attorney representation in arbitration, and if so, what factors drove this? If a small claim size was a factor, how much was the claim that you were seeking? What factors limit investors' access to attorney representation in arbitration other than the size of the claim?
5. Do you believe that FINRA should amend the Codes to restrict NAR firm activities in some way, or to prohibit entirely NAR firms from representing clients at the forum? If so, what are the appropriate restrictions?
6. If you believe that FINRA should continue to allow NAR firms to represent clients at the forum, do you believe it would be helpful to forum users if FINRA published a checklist of questions on the FINRA website that investors could review before hiring a NAR firm? What questions would you suggest that FINRA include? What other alternatives should FINRA consider to reduce the incidence of harmful activities by NAR firms but ensure investors are able to retain representation?
7. Are there other relevant benefits and costs associated with the further restriction on NAR firms that were not discussed in the economic impact analysis? What are the effects of these benefits and costs, and what are the magnitudes of the effects?

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.

2. *See* Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the Federal Register. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

3. Under Rule 12208 of the Code of Arbitration Procedure for Customer Disputes, Rule 13208 of the Code of Arbitration Procedure for Industry Disputes, and Rule 14106 of the Code of Mediation Procedure, parties may be represented in an arbitration or mediation by a person who is not an attorney, unless: (1) state law prohibits such representation; (2) the person is currently suspended or barred from the securities industry in any capacity; or (3) the person is currently suspended from the practice of law or disbarred.

4. In October 2014, FINRA formed the Dispute Resolution Task Force (Task Force) to consider possible enhancements to its arbitration and mediation forum. On December 16, 2015, the Task Force issued its Final Report, available at *http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf*.

5. FINRA staff is able to identify over 6,300 customer claims filed from 2014 to 2016 with specified compensatory, punitive or other damages.

6. *See* How to Find an Attorney on FINRA's website.

7. We request comment below for information that would improve FINRA's ability to evaluate the benefits and costs of further restricting the representation of parties by NAR firms. The benefits and costs of representation are dependent on the competency of the representation, the fees, as well as the incidence and degree of harmful activities. Whether these factors systematically differ across representatives would impact the economic effects of further restricting representation by NAR firms.