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Fiduciary Responsibility

Some Hope DOL Ambivalence on Arbitration In Fiduciary Rule a Sign It Will Be Banned

The Department of Labor has signaled a level of ambivalence about barring financial advisers from including mandatory arbitration clauses in customer agreements in its final fiduciary rule, provisions that would likely boost investors, attorneys told Bloomberg BNA.

In the proposed rule (RIN 1210-AB32), the DOL said it had grappled with the issue of banning such clauses. During multiple panels at an August hearing on the proposal, a high-ranking official with the DOL's Employee Benefits Security Administration repeatedly queried witnesses about mandatory arbitration, the attorneys said.

''I get the sense that mandatory arbitration will be'' allowed in the final rule, Joseph Peiffer, president of the Public Investors Arbitration Bar Association (PIABA) in Norman, Okla., who testified during the hearing, told Bloomberg BNA on Sept. 2.

Even if the DOL doesn't ban mandatory arbitration, if it makes only procedural changes that would make compliance easier for broker-dealers, the proposal is ''a huge step forward for investors,'' said Peiffer, who also is managing shareholder at Peiffer Rosca Wolf Abdullah Carr & Kane in New Orleans.

The DOL said in the preamble to the proposed rule that it adopted the position taken by the Financial Industry Regulatory Authority, which states that an adviser can require in its contract that individual claims be handled by arbitration. However, the contract can't prohibit a plan, participant, beneficiary or individual retirement account owner from bringing or participating in a class action against the adviser or financial institution.

According to the DOL's regulatory impact analysis of the proposed rule, the department considered banning mandatory arbitration when it was drafting the proposal, but ultimately abandoned the notion. The agency said that it was ''uncertain as to the potential cost and burden—to advisers, investors, and courts—that might attach to a prohibition against mandatory binding arbitration agreements.'' It also said the proposed rule would by itself limit the harms from such agreements.

Claims involving breach of various sorts of fiduciary duty have far exceeded any other type of arbitration complaint since at least 2011, according to FINRA.

DOL Seeks Input, Gets It. The DOL said in the regulatory impact analysis that it invited comments on the issue. At least six witnesses at the hearings said they opposed such arbitration clauses.

One was James D. Keeney, a retired attorney and former member and trustee of PIABA, who testified that allowing mandatory arbitration clauses is a ''fundamental flaw'' in the proposal that would undermine the rule's purpose.

''The best-interest contract exemption is self-defeating because it will allow brokerage firms to continue mandating arbitration clauses in these customer agreements,'' Keeney said Aug. 10 during the first day of the four-day DOL hearing. Investors would have to waive their Sixth Amendment right to a jury trial, and by doing so would waive the fiduciary protections that would be required under the DOL's proposal, he said.

Keeney said in an interview Sept. 1 that he's ''hopeful that my testimony and that of many others during the subsequent panels will persuade the DOL to prevent brokerage firms from demanding mandatory arbitration, especially mandatory FINRA arbitration.''

Keeney said it was a ''good sign'' when one of the co-panelists at the hearings asked whether he would favor voluntary arbitration.

Allowing voluntary arbitration would work, because both parties could negotiate the terms for arbitration, Keeney said on his panel(154 PBD, 8/11/15).

Keeney noted that Timothy D. Hauser, the deputy assistant secretary for program operations for the EBSA, repeatedly brought up FINRA arbitration, and asked the other panelists their opinion on the matter. ''The response was almost uniformly negative,'' Keeney said.

Arbitration Problems. Mercer E. Bullard, founder and president of Fund Democracy, and a professor of law at the University of Mississippi School of Law, said in a Sept. 3 interview that investors are at a disadvantage during arbitration because of several factors, including:

- it may be difficult for the investor to show that there was a breach of contract,
- the appropriate calculation of damages may be challenging,
- arbitrators may favor broker-dealers over investors in light of FINRA's take on the fiduciary rule in general and

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■ in-house attorneys have far more experience in arbitration than plaintiffs' lawyers.

On the first point, the question of whether the broker-dealer breached a contract is neither a fairness nor intuitive issue, but one that depends on how each side in the case reads and interprets the contract, Bullard said.

''The essence of most arbitrations on securities-type issues can be decided in the course of the hearing. So in that sense, it's just not as hospitable as an easily digested legal argument. So this is inherently less easy than showing that someone churned the account by doing 10 trades a day,'' he said.

On the second point, even if the investor does show that there was a breach of contract, for example, for losses incurred from having been invested in a high-cost versus low-cost product, the plaintiff might recoup the fee differential but not be made whole for the losses, Bullard said.

On the third point, investors may have an uphill battle in arbitration because, while the DOL says it supports FINRA's take on arbitration, FINRA has been less than supportive of the DOL's entire fiduciary rule initiative. FINRA has not only expressed opposition to the rule, but has ''publicly trashed'' it as one that broker-dealers can't reasonably be expected to comply with, Bullard said. ''Arbitrators will take heed of what FINRA has said about this rule, and their comments alone will undermine its enforcement of arbitration.''

On the last point, Bullard said, ''There are a lot of lawyers who do arbitration, but they can't hold a candle to the experience that in-house arbitration lawyers have.'' However, the rule would give investors in arbitration a leg up, because they will be able to prove that the broker-dealer agreed to take on fiduciary status, he said.

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