**The Inconsistent Dispute Resolution Process for Investment Advisers**

By: Adam J. Gana and Christopher L. Lufrano[i]

Today, nearly five years after the worst financial crisis since the Great Depression, a gap remains between the manner in which investment advisers and broker-dealers resolve disputes with their clients. Broker-dealers are subject to mandatory Financial Industry Regulatory Authority ("FINRA") dispute resolution with investors, whereas, investment advisers can either choose to arbitration or litigate disputes. In this current environment, investment advisers can leverage this freedom to their advantage to prevent investors from meaningfully participating in dispute resolution. A small window of opportunity existed in the wake of the financial crisis, whereby Congress, through the SEC, could have rectified this dispute resolution gap; however, this opportunity seems to have passed.

In 2010, Congress enacted into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[ii] Dodd-Frank was promulgated in reaction to the economic crisis that plagued our financial system from 2007 to 2009 and in response to several high-profile examples of fraudulent conduct by various financial institutions (i.e. Goldman Sachs, Countrywide Financial, Madoff Securities). At the time it was enacted, Congress indicated that Dodd-Frank's purpose was to promote "financial stability" and "protect consumers from abusive financial services practices."[iii]

Dodd-Frank, of course, was not intended to cure all of the ills facing the financial system by itself or all at once. As a result, Section 913 of Dodd-Frank required the SEC to conduct a study of the then current investment adviser and broker-dealer regulatory framework and identify regulatory gaps.[iv] Thereafter, interested parties, including securities attorneys, the financial industry and investors waited for "sweeping" changes to the financial industry with respect to investment adviser and broker-dealer regulation, discipline and dispute resolution.

Currently, and as was the case for many years dating back to the pre-financial crisis years, federally registered investment advisers are regulated by the SEC and are subject to the Investment Advisers Act of 1940 ("Advisers Act") and the regulations and rules promulgated there under.[v] Typically, the agreements investment advisers enter into with their customers contain pre-dispute arbitration clauses that provides for private arbitration through the American Arbitration Association (AAA) or the Judicial Arbitration and Mediation Services, Inc. (JAMS), or resolved through litigation in court. The authors have observed that many of these investment advisers include pre-arbitration dispute clauses that require unfavorable terms of investors, including requiring pre-arbitration mediation, three-person arbitration panels, and/or unfavorable forum locations.

On the other hand, the overwhelming majority of broker-dealers are regulated by the FINRA, the SEC, the states, and are subject to the Securities Exchange Act of 1934, the regulations and rules promulgated there under. Typically, broker-dealers included a pre-dispute FINRA arbitration clause, which require broker-dealers to arbitrate their disputes through FINRA.

Nearly three years after President Obama signed Dodd-Frank into law the regulation of investment advisers and broker-dealers is largely unchanged. Congress' failure to consolidate regulation of investment advisers and broker-dealers under FINRA's umbrella, at least for purposes of dispute resolution, is problematic because the investment adviser dispute resolution model was flawed and presents a barrier to investor protection. FINRA is admittedly an imperfect forum, but FINRA still provides many benefits and advantages to both the financial industry and investors as compared to private arbitration, like AAA and JAMS, or through litigation in court.

First, FINRA is generally cheaper than AAA, JAMS or court. The costs associated with AAA and JAMS can begin as high as $600 per hour for arbitration services. In comparison, FINRA arbitration panels are paid a flat fee per hearing session and can make a maximum of only $475 per day. In total, FINRA forum fees typically cost approximately $20,000 even for a three arbitrator panel, whereas an AAA or JAMS arbitration could cost upwards of $100,000 for a three member panel.

Second, the FINRA rules provide procedural advantages that streamline the discovery process through the Discovery Guide; limit onerous and costly discovery practices like depositions and interrogatories; and substantially reduce motion practice (at least for motions to dismiss). These procedural limitations are not explicitly available in AAA and JAMs arbitrations, although the parties do retain flexibility to augment the process in AAA and JAMs arbitrations as the parties see fit. Of course, if investment advisers and their clients choose to litigate their dispute through court these limitations are not available and the litigation can drag on for years.

Lastly, the substantive law applied in FINRA versus AAA and JAMS arbitrations suffers from the same aforementioned regulatory gap. This is especially true with respect to the suitability rule applied in the broker-dealer context in FINRA arbitration as compared to the fiduciary duty standard utilized in the investment adviser context. A resolution to the investment adviser and broker-dealer regulatory gap from a dispute resolution perspective would certainly require a unified legal standard for investment advisers and broker-dealers.

FINRA's suitability rule is relatively more straightforward in terms of application and derived directly from federal and state securities laws, SEC rules and regulations, as well as the FINRA rules and notices to members. Undoubtedly, this stems from FINRA's role as broker-dealer regulatory and designated forum for broker-dealer and investor disputes. For example, FINRA has specific rules regarding a whole host of potential legal claims and misconduct, including the most commonly alleged sales practice violations, including but not limited to suitability (FINRA Rule 2111), communications with the public (FINRA Rule 2210) and supervision (NASD Rule 3010).

On the other hand, the fiduciary obligation applied in AAA, JAMS and court for investment adviser and investor disputes with respect to breach of fiduciary duty claims is less straightforward and derived from a myriad of sources of law, including the Advisers Act, judicial interpretation of the Advisers Act, as well as SEC rules and regulations. This fiduciary duty is not easily defined, and includes duties of loyalty and care, but unlike the FINRA rules-based approached, there is no detailed list of prescribed actions to be taken or avoided. As a result, arbitrators in AAA and JAMS are often confused as to the contours of the investment adviser fiduciary duty, or look towards the FINRA rules as guidance for breach of fiduciary duty claims sounding in suitability, communications with customers or supervision.

Nevertheless, it seems as if FINRA is attempting to bridge this gap on its own, despite Congress and the SEC's failure to bridge the regulatory and dispute resolution gap between investment advisers and broker-dealers. FINRA recently opened its arbitration and mediation forum to registered investment advisers on a voluntary basis. FINRA Dispute Resolution indicated on its website that the new program was in response to inquiries from attorneys representing both investors and investment advisers.[vi]

However, the parties must submit both a post dispute agreement to arbitrate as well as a submission agreement acknowledging that FINRA cannot enforce awards against investment advisers, in order for investment advisers and investors to participate in this voluntary FINRA program. As a result, FINRA's voluntary alternative dispute resolution program lacks enforceability, the necessary teeth that legitimize the process for broker-dealer and investor disputes. As well, advisers can still exercise control over their agreements with customers and fail to write in FINRA arbitration clauses in their agreements. FINRA's open forum, while ambitious, perpetuates the problem because it now provides ammunition to advisers who can now point to an informal, voluntary allowance as being sufficient to ensure access to alternative dispute resolution for investors.

Congress started and stopped short of fully utilizing Dodd-Frank to fill in this "regulatory gap" between investment advisers and broker-dealers. Instead, some customers of investment adviser are left with the unwelcome position of having to choose between accepting investment adviser misconduct or to seek dispute resolution under unfavorable conditions. Congress' time to act may have come and passed, but officially joining investment advisers and broker-dealers under FINRA's regulatory control, at least for purposes of dispute resolution, should remain a priority as it presents an attractive alternative to other adjudicative processes for ordinary investors.

***Adam J. Gana*** *heads the Securities and Commercial Litigation Department of Napoli Bern Ripka Shkolnik, LLP. His practice focuses on complex business litigation, securities cases in various forums, whistle blower complaints and employment litigation in the securities context. An experienced arbitration and trial lawyer, Mr. Gana's practice includes litigation in both State and Federal Courts as well as in various alternative dispute resolution venues.He has tried more than fifteen cases and arbitrations to verdict before the AAA, JAMS, NFA and FINRA. Mr. Gana's recent civil cases and arbitrations have involved RICO Fraud, securities class actions, allegations relating to unsuitable investment strategies, and breach of contract. His clients range from individuals to large institutional banks. While at the firm, Mr. Gana was named to the New York Super Lawyers, Rising Stars edition as one of the top attorneys in the state of New York.*

*Associate Attorney* **Christopher Lufrano** *is a member of Napoli Bern Rikpa Shkolnik, LLP's Securities and Commercial Litigation Department. Mr. Lufrano's practice focuses on complex business litigation, securities cases in various forums, whistle blower complaints and employment litigation in the securities context.Prior to becoming an attorney, Mr. Lufrano worked for one of the largest broker-dealers in the world, before and during the most recent financial crisis. He applies his unique experiences and perspective to each case. His practice is concentrated in litigation of claims arising from unsuitable investment strategies, breach of contract and federal and state securities fraud for individuals and institutional investors.*

---

[i] Special thanks to Lucy Boyadzhyan for her help with this article.

[ii] Pub. L. No. 111-203, 124 Stat. 1376 (2010)[hereinafter Dodd-Frank]

[iii] *Id.*, 124 Stat. at 1376 pmbl.

[iv] *Id.* § 913(b)-(d), 124 Stat. at 1824-27.

[v] Registration with the SEC generally is required if an adviser (1) manages more than $100 million in client assets, (2) advises certain funds or business development companies, or (3) works in a state that

does not register advisers. Advisers Act § 203, 15 U.S.C. § 80b-3 (2006 & Supp. IV 2010); Advisers Act § 203A, 15 U.S.C. § 80b-3a (2006 & Supp. IV 2010). All other advisers are subject to state registration systems that have requirements similar to the Advisers Act. Advisers are regulated by either the SEC or the states, but not both.

[vi] FINRA Arbitration and Mediation: Guidance on Disputes between Investors and Investment Advisers who are not FINRA-regulated firms (Available at: www.finra.org/ArbitrationAndMediation/Arbitration/SpecialProcedures).