

# Forced Investment Advisory Arbitration and the Effect on the Investing Public and on the Industry

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# SEC Office of the Investor Advocate's Report on Mandatory Arbitration Among SEC-Registered Investment Advisors

TABLE: FREQUENCY OF SPECIFIC PROVISIONS IN MANDATORY ARBITRATION CLAUSES

Agreement designates a specific dispute resolution forum:	92%
When designating a forum, advisers designated the following fora:	
American Arbitration Association ("AAA")	83%
Financial Industry Regulatory Authority (FINRA) Dispute Resolution Services ("FINRA DRS")	10%
JAMS	6%
Other	1%
Agreement designates specific forum rules:	37%
When designating forum rules, advisers selected the following rules:	
AAA Commercial Rules	83%
JAMS Streamlined Rules and Procedures	3%
JAMS Comprehensive Rules and Procedures	2%
AAA Securities Arbitration Supplementary Procedures	1%
Agreement designates the arbitration venue:	60%
When designating arbitration venue, percent of agreements that did not consider client's location or place of business:	97%
Agreement precludes participation in class action	6%
Agreement limits claims the client may assert	5%
Agreement limits damages that may be awarded	11%
Agreement includes fee-shifting provision	18%

# PIABA Conducted a Similar Study

- ◆ Reviewed RIA contracts for 189 RIAs, including 28 SEC-registered RIAs and 161 state-registered RIAs. 58% of those contracts included an arbitration clause:

<b>Agreement designates a specific dispute resolution forum</b>	
<b>When designating a forum, advisers designated the following fora:</b>	
AAA	69.09%
FINRA	8.18%
JAMS	5.45%
Other	14.55%
<b>Agreement designates specific forum rules</b>	
<b>When designating forum rules, advisers selected the following rules:</b>	
AAA Commercial Rules	32.73%
AAA Consumer Rules	0%
FINRA	6.36%
JAMS Streamlined Rules and Procedures	1.82%
JAMS Comprehensive Rules and Procedures	1.82%
None	51.82%
Other Rules	5.45%
Agreement designates the arbitration venue	30.69%
Agreement precludes participation in class actions	8.47%
Agreement includes Hedge Clause	59.79%



# The Studies' Results Highlight Similar Issues With RIA Cases

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## PIABA Findings

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# Issues That Can Harm Investors and in some cases RIAs

1. “Hedge Clauses”
2. Group Claims and Class Waivers
3. Venue Clauses
4. Choice of Law Provisions
5. One way fee shifting provision
6. Inconsistent Rule Application
7. Costs
8. Awards are Non-Public → No analogous system like the CRD

# Hedge Clauses

- ◇ Hedge clauses limit liability of the firm at the time the client signs the RIA agreement.
- ◇ The investor is waiving their rights, claims and, often the ability to seek damages over a certain amount, just by deciding to work with a particular RIA.
- ◇ All RIAs are *fiduciaries*, yet they can limit liability at the time of contract.

18. Arbitration. Unless otherwise prohibited by law, I hereby waive my right to seek remedies in any court or before any governmental agency, including any right to a jury trial. In the event of any dispute between us arising out of, relating to or in connection with this Agreement, such dispute shall be resolved exclusively by arbitration in Chicago, Illinois, under the auspices of JAMS. No punitive damages shall be awarded. Any award rendered by the arbitrator shall be final and binding, and judgment may be entered upon it in any court of competent jurisdiction in Cook County in the State of Illinois or as otherwise provided by law.



## 8.0 Limitation of Liability

# Hedge Clauses

- 8.4** Except as may otherwise be provided by law, neither Adviser nor [REDACTED] shall be liable to Client for (i) any loss that Client may suffer by reason of any investment recommendation made or other action taken or omitted by Adviser or [REDACTED], except where such loss directly results from gross negligence or willful misconduct by Adviser or [REDACTED] or as is otherwise required by federal or state law; or (ii) any loss arising from Adviser's or [REDACTED]'s adherence to Client's instructions.
- 8.5** No Party shall be liable for any act or omission of another Party or its agents or employees, or any act or admission of an independent third-party including but not limited to the Qualified Custodian or its agents or employees.
- 8.6** Neither Adviser nor [REDACTED], nor their respective directors, officers, employees, affiliates, agents or assigns shall be liable for any loss incurred with respect to Client's Account, except where such loss directly results from gross negligence or willful misconduct by Adviser or [REDACTED] or as otherwise provided by federal or state law.
- 8.7** The federal securities laws impose liabilities under certain circumstances on persons who act in good faith, and therefore nothing herein shall in any way constitute a waiver or limitation of any rights which Client may have under any federal or state securities laws.
- 8.8** Client understands and agrees that in the event the Adviser or [REDACTED] is liable for a Client's loss, neither Adviser nor [REDACTED] shall be liable for any special or consequential damages related to such loss.

# Venue Clauses and Choice of Law Clauses

- ◇ Force Claimants to bring arbitration in a specific location.
- ◇ Claimants must incur expenses travelling to and from the hearing location.

11. **Applicable Law/Venue.** This Agreement supersedes and replaces, in its entirety, all previous financial advisory agreement(s) between the parties. To the extent not inconsistent with applicable law, this Agreement shall be governed by and construed in accordance with the laws of the State of California. In addition, to the extent not inconsistent with applicable law, the venue (i.e. location) for the resolution of any dispute or controversy between PLANNER and CLIENT shall be the County of Contra Costa, State of California.

15. **Governing Law:** This Agreement shall be governed by and construed in accordance with the laws of the State of Alabama, except to the extent that the federal securities laws shall otherwise be controlling.
16. **Venue:** In the event that any dispute shall arise by and between the parties, it is hereby agreed that any litigation, cause, suit, arbitration, mediation or any other proceeding shall take place in the State of Alabama.



# One-Way Fee Shifting Arrangements

- ◆ One-way fee shifting clauses state that the investor could be responsible for the RIA's attorneys' fees and costs in the event they are unsuccessful in arbitration
- ◆ Potential Claimants are discouraged from pursuing their claims where they might be responsible for thousands of dollars in costs and fees on top the losses they have incurred

# Inconsistent Rule Application Leads To Procedural Obstacles and Disparate Costs

## AAA Consumer Rules

- ◇ RIA pays all but the filing fee
- ◇ AAA chooses the arbitrator

### R-1. Applicability (When the AAA Applies These Rules)

- (a) The parties shall have made these *Consumer Arbitration Rules* ("Rules") a part of their arbitration agreement whenever they have provided for arbitration by the American Arbitration Association ("AAA"), and
- 1) have specified that these *Consumer Arbitration Rules* shall apply;
  - 2) have specified that the *Supplementary Procedures for Consumer-Related Disputes* shall apply, which have been amended and renamed the *Consumer Arbitration Rules*;
  - 3) the arbitration agreement is contained within a consumer agreement, as defined below, that does not specify a particular set of rules; or
  - 4) the arbitration agreement is contained within a consumer agreement, as defined below, that specifies a particular set of rules other than the *Consumer Arbitration Rules*.

## AAA Commercial Rules

- ◇ Fees are split
- ◇ Parties choose the arbitrator

### R-1. Agreement of Parties\*

- (a) The parties shall be deemed to have made these rules a part of their arbitration agreement whenever they have provided for arbitration by the American Arbitration Association (hereinafter AAA) under its Commercial Arbitration Rules or for arbitration by the AAA of a domestic commercial dispute without specifying particular rules. These rules and any amendment of them shall apply in the form in effect at the time the administrative requirements are met for a Demand for Arbitration or Submission Agreement received by the AAA. Any disputes regarding which AAA rules shall apply shall be decided by the AAA. The parties, by written agreement, may vary the procedures set forth in these rules. After appointment of the arbitrator, such modifications may be made only with the consent of the arbitrator.

# Inconsistent Rule Application Leads To Procedural Obstacles and Disparate Costs

**9.3 If the Parties cannot resolve the dispute, controversy or claim for any reason after mediation, any Party may commence binding arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association then applying. Judgment on the award rendered by the arbitrator(s) shall be final and binding, and may be entered in any court having jurisdiction thereof. The Parties understand that they are waiving their respective rights to seek remedies in court, including the right to a jury trial. This paragraph does not constitute a waiver of any right provided by the Investment Advisers Act of 1940 or other applicable federal securities laws. Client understands and acknowledges that he or she has had a reasonable opportunity to review and consider this arbitration provision prior to signing this Agreement.**



# *Example 1: Fight Over AAA Consumer Rules vs. AAA Commercial Rules Costs Parties Time and Money*

- Claimants filed an arbitration with AAA against their RIA on December 10, 2019. The RIA refused to pay the filing fees and objected to arbitrating under the AAA Consumer Rules because the contract called for the AAA Commercial Rules to apply. Because the RIA would not pay, AAA declined to administer the arbitration unless the Claimant paid all the costs.
- Claimants' counsel filed a Complaint with the U.S. District Court for the Northern District of California, seeking to compel arbitration. Nearly a year after the original arbitration claim, the Court granted Claimants' motion to compel arbitration and ordered that the RIA pay reasonable attorneys' fees and costs for the entire arbitration under Cal. Civ. Proc. Code § 1281.97.
- At arbitration, the arbitrator ultimately applied the AAA Commercial Rules and ruled that Claimants would not be entitled to interim attorneys' fees.
- **What Was the Ultimate Cost to the Investor and the Investment Advisory Firm?**

## *Example 2: Elderly Customer's Arbitration Claim Drags For Over a Year Because of Procedure*

- ◇ 85-year-old Claimant was forced to file her claim against her RIA in AAA arbitration
- ◇ Claimant's counsel followed the AAA Consumer Rules in filing. The RIA refused to pay AAA fees, and the matter was dismissed
- ◇ Claimant's counsel filed a court case against Respondent. The RIA filed a motion to compel arbitration, blaming Claimant for the failed AAA arbitration and claiming that AAA misinterpreted its own rules
- ◇ The Court denied the RIA's motion. The RIA appealed and the case is *still* pending over a year later

# *Example 3: No Recourse for Claimant Where Forum Fees are Nearly Half of Recovery Sought*

- ◇ Client lost over \$60,000 because of RIA mismanagement.
- ◇ The RIA firm had a clause requiring that arbitration be pursued through JAMS, a forum that has fees of upwards \$25,000.
- ◇ Claimant's counsel explained to client that given how high the fees were in comparison to the amount lost, it was nearly impossible to pursue the arbitration against the RIA



## **Arbitration Schedule of Fees and Costs**

### **U.S. Domestic**

#### **PROFESSIONAL FEES:**

Hourly rate is set by the individual arbitrator(s). Please [contact a JAMS case manager](#) for more information.

#### **ADMINISTRATIVE FEES:**

For two-party matters, the Filing Fee is \$2,000. For matters involving three or more parties, the filing fee is \$3,500. The entire Filing Fee must be paid in full to expedite the commencement of the proceedings. Thereafter, a Case Management Fee of 13% will be assessed against all Professional Fees, including time spent for hearings, pre- and post-hearing reading and research and award preparation. JAMS also charges a \$2,000 filing fee for counterclaims.

For matters involving consumers, the consumer is only required to pay \$250. See [JAMS Policy on Consumer Arbitrations Pursuant to Pre-Dispute Clauses](#). For matters based on a clause or agreement that is required as a condition of employment, the employee is only required to pay \$400. See [JAMS Policy on Employment Arbitrations, Minimum Standards of Fairness](#).

A refund of \$1000 will be issued if the matter is withdrawn within five days of filing. After five days, the filing fee is non-refundable.



- ◆ Always take the position Investors should have choice to arbitrate or litigate their claims and to be able to chose the forum. That said if investors are required to arbitrate the system has to be affordable and fair. Currently RIA arbitration is a disaster for investors and the industry as large because it is too expensive and inconsistent.
- ◆ What can the SEC do?
- ◆ A Commission Interpretation of the standard of conduct for IA's that prohibit the use of arbitration clauses that contain offending provisions
- ◆ Or through rule making in its power under section 921 of the Dodd-Frank act.
- ◆ As for the publication of awards RIA awards are not generally made public like awards through the brokercheck system at FINRA. So while the SEC and PIABA have done the leg work to look at issues in the language of RIA arbitrations, there is still work to be done regarding issues with the underlying arbitral forum if the SEC mandates that disclosure of that information in IA Advs.