

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-82693; File No. SR-FINRA-2018-003)

February 12, 2018

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change Relating to Simplified Arbitration

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on January 29, 2018, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rules 12600 and 12800 of the Code of Arbitration Procedure for Customer Disputes (“Customer Code” ) and 13600 and 13800 of the Code of Arbitration Procedure for Industry Disputes (“Industry Code,” and together with the Customer Code, the “Codes”), to amend the hearing provisions to provide an additional hearing option for parties in arbitration with claims of \$50,000 or less, excluding interest and expenses.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Codes provide two methods for administering arbitration cases with claims involving \$50,000 or less, excluding interest and expenses. The default method is a decision by a single arbitrator based on the parties' pleadings and other materials submitted by the parties. The alternative method involves a full hearing with a single arbitrator. Under the Customer Code, a customer may request a hearing (regardless of whether the customer is a claimant or respondent),<sup>3</sup> and under the Industry Code, the claimant may request a hearing.<sup>4</sup> If a hearing is requested, it is generally held in-person, and there are no limits on the number of hearing sessions that can take place.

FINRA believes that forum users with claims involving \$50,000 or less would benefit by having an additional, intermediate form of adjudication that would provide them with an opportunity to argue their cases before an arbitrator in a shorter, limited telephonic hearing format. Therefore, FINRA is proposing to amend the Codes to

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<sup>3</sup> See FINRA Rule 12800(c).

<sup>4</sup> See FINRA Rule 13800(c).

include a Special Proceeding for Simplified Arbitration (“Special Proceeding”). The Special Proceeding would be limited to two hearing sessions, exclusive of prehearing conferences,<sup>5</sup> with parties being given time limits for their presentations. As discussed above, parties with claims involving \$50,000 or less are currently limited to a decision based on the pleadings and other materials submitted by the parties, or a full hearing that typically takes place in-person and is not limited in duration. While a party might wish for an opportunity to present his or her case to an arbitrator, the travel and expenses associated with a full hearing might prevent that party from requesting one. In addition, the prospect of cross-examination by an opposing party might act as a deterrent for parties seeking to avoid a direct confrontation with their opponents. These concerns particularly impact *pro se*, senior, and seriously ill parties.

The suggestion to propose an intermediate form of adjudication originated from the FINRA Dispute Resolution Task Force (“Task Force”).<sup>6</sup> The Task Force observed that customers whose cases were decided on the papers were the least satisfied of any group of forum users. They also noted that, from the arbitrator’s perspective, it is more difficult to assess crucial issues of credibility when deciding cases on the papers. The Task Force recommended that the goal of the intermediate process should be to give the claimant personal contact with the arbitrator deciding the case and to give each party the

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<sup>5</sup> See FINRA Rules 12100 and 13100 (Definitions). Under these rules, “hearing” means the hearing on the merits of an arbitration and a “hearing session” is defined as any meeting between the parties and arbitrator(s) of four hours or less, including a hearing or a prehearing conference.

<sup>6</sup> The Task Force was formed in 2014 to suggest strategies to enhance the transparency, impartiality, and efficiency of FINRA’s securities dispute resolution forum. On December 16, 2015, the Task Force issued its Final Report and Recommendations, available at <http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf>.

opportunity to argue its case, to ask questions, and to respond to contentions from the other side. The Task Force also recommended that the intermediate process should allow the arbitrator to probe contentions in the papers in an interactive format.<sup>7</sup>

FINRA considered the Task Force's recommendations and questions in developing the format for an intermediate form of adjudication.<sup>8</sup> Accordingly, FINRA is proposing to amend Rules 12800(c) and 13800(c) to provide that parties that opt for a hearing must select between two hearing options. Option One would be the current hearing option that provides for the regular provisions of the Codes relating to prehearings and hearings, including all fee provisions. If the parties choose Option One, they would continue to have in-person hearings without time limits, and they would continue to be permitted to question opposing parties' witnesses.

Option Two would be the new Special Proceeding subject to the regular provisions of the Code relating to prehearings and hearings, including all fee provisions, with several limiting conditions. The conditions are intended to ensure that the parties have an opportunity to present their case to an arbitrator in a convenient and cost effective manner without being subject to cross-examination by an opposing party.

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<sup>7</sup> *Id.* at 29.

<sup>8</sup> The Task Force provided the following questions for FINRA to consider in developing an intermediate form of adjudication: (1) whether parties appearing should be able to amplify positions taken in their papers and to answer questions posed by the arbitrator; (2) whether fact witnesses should be permitted to tell their stories to the arbitrator; (3) whether there should be a clear boundary between the informal, expedited adjudication and a full-blown hearing; (4) whether witnesses should be subject to cross-examination by adverse counsel; (5) whether parties should be able to compel the attendance of particular witnesses, and if so, should there be a limit; (6) what arrangements should be made for parties who are not appearing in person; and (7) whether arbitrators should use the session as an opportunity to press the parties to settle.

Specifically:

- a Special Proceeding would be held by telephone unless the parties agree to another method of appearance<sup>9</sup>;
- the claimants, collectively, would be limited to two hours to present their case and ½ hour for any rebuttal and closing statement, exclusive of questions from the arbitrator and responses to such questions;
- the respondents, collectively, would be limited to two hours to present their case and ½ hour for any rebuttal and closing statement, exclusive of questions from the arbitrator and responses to such questions;
- notwithstanding the abovementioned conditions, the arbitrator would have the discretion to cede his or her allotted time to the parties;
- in no event could a Special Proceeding exceed two hearing sessions, exclusive of prehearing conferences, to be completed in one day;
- the parties would not be permitted to question the opposing parties' witnesses;
- the Customer Code would provide that a customer could not call an opposing party, a current or former associated person of a member party, or a current or former employee of a member party as a witness, and members and associated persons could not call a customer of a member party as a witness; and

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<sup>9</sup> The Task Force recommended allowing parties with claims involving \$50,000 or less to be able to appear in whatever manner they prefer: in person, by phone or by videoconference. FINRA determined that it is in the best interest of the parties to hold hearings by telephone because this method is the most expeditious and inexpensive format for hearings. As stated above, FINRA is proposing that parties can agree to other methods of appearance, including appearing in person or by videoconference.

- the Industry Code would provide that members and associated persons could not call an opposing party as a witness.

Except for the two hearing session time limit for a Special Proceeding, FINRA would not impose any restrictions on the arbitrator's ability to ask the parties questions and has incorporated a substantial amount of time for arbitrator questions. Specifically, since FINRA would limit the parties' combined presentations to five hours, the arbitrator would have up to three hours to ask questions. In addition, under the proposed rule change FINRA would not prohibit the arbitrator from allowing parties additional time for their presentations or witness testimonies, so long as the hearing on the merits is completed within the two hearing session limit.<sup>10</sup>

FINRA is further proposing to amend Rule 12800(a) to add clarity to the rule by explaining the customer's options earlier in the rule text. FINRA is proposing to amend the sentence in Rule 12800(c) that states that "[I]f no hearing is held, no initial prehearing conference or other prehearing conference will be held, and the arbitrator will render an award based on the pleadings and other materials submitted by the parties." FINRA would replace the first "held" in the sentence with the term "requested" to better reflect that a hearing would only occur if the customer requested it. FINRA believes the amendment would add clarity to the rule text. FINRA is further proposing to amend Rule 12600(a) that discusses exceptions to when required hearings will be held to specify Rule 12800(c) as one of the exceptions.

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<sup>10</sup> The Task Force recommended a shorter time limit on each case to enable an arbitrator to hear several cases in a hearing day and to limit the time commitment of the parties. FINRA was concerned that a period shorter than the proposed two hearing session time limit would restrict the parties' presentations and their ability to answer questions posed by the arbitrator.

To add clarity on how arbitrators are paid in cases where the customer requests a hearing, FINRA is proposing to amend Rule 12800(f) to clarify that the regular provisions of the Code relating to arbitrator honoraria would apply in such cases. Since the Special Proceeding would be a new form of adjudication at the forum, FINRA intends to provide substantial training to arbitrators including, but not limited to, updating FINRA's written training materials for arbitrators, posting a Neutral Workshop video on the FINRA website for arbitrators to view on-demand, and including discussions about the Special Proceeding in FINRA's publication for arbitrators and mediators, *The Neutral Corner*. FINRA would instruct arbitrators that the arbitrator's role in a Special Proceeding might be different than it is in a full hearing because parties would not be permitted to question opposing parties' witnesses. FINRA would emphasize that in a Special Proceeding the arbitrator might need to ask more questions than he or she would ask in a regular hearing to gain clarity on issues and to assess witness credibility.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>11</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. As discussed above, the Task Force recommended that FINRA provide the claimant with an additional cost effective option for personal contact with the arbitrator deciding the case and give each party the opportunity to argue its case, to ask questions, and to respond to contentions from the other side. FINRA believes that the proposed rule

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<sup>11</sup> 15 U.S.C. 78q-3(b)(6).

change aligns with the Task Force's recommendations.

In addition, FINRA believes that the proposed rule change is consistent with the provisions of the Act because it would provide parties with claims of \$50,000 or less with an additional, cost effective, hearing option for resolving disputes. FINRA believes that the proposed rule change would limit the potential costs of a hearing and provide parties with the opportunity to present their case without cross-examination from their opponents. The ability to present their case without cross-examination may benefit those who believe that a direct confrontation could intimidate their testimony. FINRA believes that the broader role of arbitrators for a Special Proceeding in asking questions of the parties would serve a similar function to cross-examination, such as gaining clarity on issues and assessing witness credibility, but within a potentially less intimidating environment.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

**Economic Impact Assessment**

(a) Need for the Rule

As noted above, the Code currently provides two methods for administering arbitration cases with claims involving \$50,000 or less, excluding interest and expenses. The default method is based exclusively on the parties' pleadings and other materials submitted by the parties, and the alternative method involves a full hearing. Although a full hearing provides the parties a more complete opportunity to present their cases to an

arbitrator, for the reasons discussed above, the parties sometimes forego a full hearing. The proposal provides an additional method for administering these arbitration cases that would allow for oral testimony while limiting the costs of the proceedings.

(b) Economic Baseline

The economic baseline for the proposal is the two current methods for administering arbitration cases with claims involving \$50,000 or less. The proposal is expected to affect customers, either as claimant or respondent, with a claim involving \$50,000 or less; industry parties, as claimant, with a claim involving \$50,000 or less; and industry parties as respondents to these claims. The proposal is also expected to affect FINRA arbitrators.

The parties today that opt for a decision on the pleadings or for a full hearing face trade-offs between the two choices. A decision on the pleadings is dependent solely on the parties' pleadings and other submitted materials, and the cost to parties is generally limited to filing fees and the legal fees and expenses to submit the materials. On the other hand, a full hearing is dependent on the pleadings and submitted materials as well as oral testimony and arguments. In addition to filing fees and legal fees to submit the materials, parties can also incur arbitration hearing session fees, travel and lodging expenses, lost income, and other costs associated with the time spent at the hearings such as accommodations for dependent care. These costs increase with the number of hearings and are also dependent on the characteristics of the parties. For example, parties that live further away from the hearing site or that are less able to travel will incur higher travel

costs than parties that live closer to the hearing site or that are more able to travel.<sup>12</sup> In addition, the costs associated with the time spent at hearings may be greater for some parties than for other parties.

The costs of a full hearing are greater and more uncertain at the outset than the costs of a decision on the pleadings. Among other factors, parties selecting the arbitration format will weigh the potential benefits of providing testimony and arguments at a full hearing relative to its higher and more uncertain costs. The greater and more uncertain costs of a full hearing may cause parties to forego providing oral testimony and arguments and instead opt for a decision on the pleadings. Parties also may forego providing oral testimony and arguments to avoid cross-examination.

The parties not selecting the arbitration format may instead prefer a decision on the pleadings. A decision on the pleadings is likely to minimize their costs and prevents the potential influence of oral testimony on the award decision. Alternatively, in a full hearing, these parties are likely to incur greater costs and have exposure to the potential persuasive influence of oral testimony and arguments on the award decision. In either instance, the parties not selecting the arbitration format would have incentive to settle a dispute and forego arbitration if the settlement amount and the costs of settling a dispute are less than the expected arbitration award and the costs of arbitrating the dispute.

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<sup>12</sup> In customer cases, the hearing location will generally be the location (of FINRA's designated hearing locations) closest to the investor's residence at the time of the events giving rise to the dispute. Investors may also seek to change the hearing location by obtaining the other party's consent or by requesting a change from FINRA. In industry cases, the hearing location will generally be the location closest to where the associated person was employed at the time of the events giving rise to the dispute. FINRA's hearing locations can be found at: [Dispute Resolution Regional Offices and Hearing Locations](#).

For arbitration cases with close dates from January 2016 to December 2016, FINRA staff is able to identify 194 arbitration cases that had an amount of compensatory relief requested of less than or equal to \$50,000 and were closed through a decision on the pleadings (154) or by hearing (40).<sup>13</sup> Of the 40 arbitrations that FINRA staff identifies as closed by a full hearing, 29 had one or two hearing sessions, and 11 had three or more hearing sessions. The maximum number of hearing sessions was eight.

(c) Economic Impact

The Special Proceeding would provide a new third option for administering arbitration cases with claims involving \$50,000 or less, and would not remove the ability of parties to choose either a decision on the pleadings or a full hearing. A primary benefit of this new third option is the increase in the ability of customers and intra-industry claimants to provide oral testimony but with fewer costs, including the provision of oral testimony without cross-examination, and with greater certainty of its length than in a full hearing. In general, a Special Proceeding would increase the number of options available to customers and intra-industry claimants in choosing the method which would provide the most benefits relative to its costs, and would therefore increase the overall net benefits of the forum to these parties.

A Special Proceeding would provide customers and intra-industry claimants the

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<sup>13</sup> The 194 arbitration cases were out of a total of 625 that FINRA staff identified as being closed through a decision on the pleadings or closed by hearings from January 2016 to December 2016. Approximately two-thirds of the 194 claims involved a customer as either a claimant or respondent, but typically as a claimant, and the remaining one-third of these claims involved a dispute among industry parties. Among the 40 cases that were closed by a hearing, approximately one-third involved a customer.

benefit of providing oral testimony to an arbitrator but subject to several conditions.<sup>14</sup>

These conditions not only limit the potential costs of the forum (see below), but also provide parties the opportunity to present their case without cross-examination from their opponents. The ability to present their case without cross-examination may benefit those who believe that a direct confrontation could intimidate their testimony. As a result, arbitrators may play a broader role in a Special Proceeding in asking questions of the parties that would serve a similar function to cross-examination, such as gaining clarity on issues and assessing witness credibility, but within a potentially less intimidating environment. Arbitrators would need to spend time and incur any associated costs related to reviewing the additional training materials for a Special Proceeding.

Parties to the Special Proceeding are expected to incur lower costs to participate in the forum than parties to a full hearing, particularly if the parties proceed by telephonic conference.<sup>15</sup> The magnitude of the cost reduction to the parties would be dependent on their ability to attend hearing sessions in person; parties that reside further away from a hearing site or that have difficulty traveling would incur greater costs of an in-person hearing than parties that reside closer to a hearing site or that have less difficulty traveling.

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<sup>14</sup> A limit to the number of hearings would not only affect the arbitration fees that parties could incur but also the travel and lodging expenses, lost income, and other costs associated with the time spent at the hearings.

<sup>15</sup> FINRA believes that most hearings would proceed by telephonic conference, thereby saving time and expenses.

A Special Proceeding would also limit the number of hearings, and the arbitration fees, including hearing session fees, would be based on the current fee schedule.<sup>16</sup> The limit on the number of hearing sessions requires the claimants and respondents to present their case within the span of one day. As discussed above, 11 of the 40 arbitrations with compensatory damages of less than \$50,000 that FINRA staff identified as closed by a full hearing had three or more hearing sessions. These arbitrations therefore would have required one or more days of hearings. Parties to the Special Proceeding would not be subject to additional days of hearings and its related costs (i.e., legal fees and expenses, arbitration fees, lost income, and other costs associated with the time spent at the hearings), and parties to the arbitration would also not be subject to the potential delays related to the scheduling of additional hearings. Relative to a decision on the pleadings, however, parties would incur additional costs to participate in a Special Proceeding including legal fees and expenses, arbitration and hearing session fees, and time.

The extent to which the benefits and costs associated with the forum increase or decrease for claims of \$50,000 or less is dependent on what the parties would have chosen absent this new option. Customers and intra-industry claimants would have a greater ability to choose the method based on the trade-off between the potential value of providing oral testimony and arguments with a corresponding increase in forum costs.

The costs incurred by the parties not selecting the arbitration format could increase or decrease depending on the method that would have been chosen absent the

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<sup>16</sup> The filing fees for claims are the same regardless of the method chosen to resolve the dispute and are dependent on claim size. Hearing session fees currently range from \$50, for claims up to \$2,500, to \$450, for claims greater than \$10,000. Parties that opt for a Special Proceeding or full hearing, in lieu of a decision on the pleadings, would also incur the other types of arbitration fees including pre-hearing session fees.

new option. If the customer or intra-industry claimant would have chosen a decision on the pleadings, then the costs to these parties such as arbitration and hearing session fees would likely increase under a Special Proceeding. They would also have exposure to the potential influence of oral testimony and arguments on the award decision. A decision to conduct a Special Proceeding in lieu of a full hearing would potentially decrease the costs incurred by these parties through lower hearing session fees and lower costs to participate in the hearings. To the extent that the Special Proceeding increases the expected costs of parties not selecting the arbitration format to participate in the forum and their exposure to the potential influence of oral testimony, these parties could have additional impetus to consider settlement.

(d) Alternatives Considered

FINRA considered a range of alternatives during this process. The alternatives to the proposal include more or less restrictive limiting conditions for a Special Proceeding, and providing the new option to a broader range of claims such as those with higher dollar amounts. As discussed above, the Task Force recommended allowing parties with claims involving \$50,000 or less to be able to appear in whatever manner they prefer: in person, by phone or by videoconference. FINRA determined that it is in the best interest of the parties to hold hearings by telephone because this method is the most expeditious and inexpensive format for hearings. As stated above, FINRA is proposing that parties can agree to other methods of appearance, including appearing in person or by videoconference. The Task Force also recommended a shorter time limit on each case to enable an arbitrator to hear several cases in a hearing day and to limit the time commitment of the parties. FINRA was concerned that a period shorter than the

proposed two hearing session time limit would restrict the parties' presentations and their ability to answer questions posed by the arbitrator. The proposal reflects the changes that FINRA believes were the most appropriate to propose for the reasons discussed herein.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2018-003 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2018-003. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to

File Number SR-FINRA-2018-003 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>17</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>17</sup> 17 CFR 200.30-3(a)(12).