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August 10, 2015

Testimony of James D. Keeney, Esq.

Re: DOL Fiduciary Conflict of Interest Regulation RIN 1210-AB32

I am a recently retired Florida Lawyer who represented individual retirement investors in arbitrations and litigation against securities broker-dealers and their associated persons for 20 years. I am still an active FINRA arbitrator. Finally, I am a former member and Trustee of the Public Investors Arbitration Bar Association (PIABA), a group of attorneys who specialize in representing securities investors. I'd like to share my knowledge and experience about securities arbitration.

In my legal practice, I saw almost every imaginable type of conflict of interest, self-dealing, and customer abuse committed by brokers and financial advisors. Typically, my clients had lost their retirement savings because of conflicted advice, fraud or other misconduct.

In my experience, retirement investors already think their financial advisor is required to act in their best interest. They don't know if he or she is a Registered Investment Advisor, regulated by the SEC, an insurance agent, regulated by their state insurance commissioner, or a registered representative, regulated mainly by the financial industry itself. Securities customers need the same unbiased advice they expect from their doctor, lawyer, or pharmacist. But their financial advisor more often acts like a used car salesman: he gives them a sales pitch motivated by higher commissions, sales goals, and meeting monthly quotas to keep his job.

I strongly support this DOL proposal to force financial advisors to act more like fiduciaries, but it has a fundamental flaw. It does not prohibit mandatory arbitration. Every investor has to sign a customer agreement in order to open a securities account. The “best interest contract” exemption is self-defeating because it will allow brokerage firms to continue including mandatory arbitration clauses in their customer agreements. Retirement investors will still be forced to waive their Sixth Amendment rights to a trial by jury in the event of any dispute with their broker. In doing so, they will effectively waive the very fiduciary protections being established by this regulation.

There are at least two major problems with mandatory arbitration of securities customer disputes.

First, the very essence of arbitration is that parties put their entire fate in the hands of arbitrators, with virtually no assurance that the result will bear any relation to well-established rules or protections of law.

Under Section 10 of the Federal Arbitration Act, arbitration awards must be enforced by the state and federal courts and cannot be overturned or modified except on a handful of extremely limited grounds. You may be surprised to learn that in the Eleventh Circuit and at least two other circuits, manifest disregard of the law is <u>not</u> one of those limited grounds. Both state and federal courts in many parts of our country, including Florida, routinely hold that even the most outrageous refusals of arbitrators to follow the law are not sufficient grounds to vacate or modify an arbitration award. Think about that. “The law,” of course, includes federal regulations such as the one proposed here. Unless this proposal is changed, there will be no enforceable right to have a fiduciary standard applied to a stockbroker’s recommendations.

The second problem is that securities industry customer arbitrations are all held at <u>a single private arbitration forum which the industry itself manipulates and controls</u>. FINRA, the Financial Industry Regulatory Authority, is actually an industry trade association, not an impartial government agency. Despite minimal oversight by the SEC, FINRA dances to the tune of its largest member firms.

Based upon my extensive experience with FINRA arbitration, I can certify that the FINRA customer arbitration system is fundamentally biased against retirement investors.

FINRA controls access to becoming an arbitrator. FINRA's eligible arbitrator lists include a lot of industry retirees and friends or relatives of industry participants, who have had no legal training, as well as active stockbrokers. FINRA arbitrator training consists of only a single day of classes. This minimal training is wholly inadequate to make certain that new arbitrators understand the legal rights of investors, or the legal obligations of financial advisors.

Lists of proposed arbitrators, from which each party can strike a certain number, are prepared by FINRA staff. The few arbitrators who have voted in favor of substantial awards to customers seem to get stricken much more often, especially by lawyers for the big firms.

FINRA arbitration rules favor the industry in subtle but important ways. For example, if an investor believes her broker sold the same risky investment to all of his clients, FINRA's limited discovery rules make it nearly impossible for the investor to obtain the firm's records that would show how many of the broker's customers were sold the same investment. Because of such subtle aspects of the FINRA rules, there is often no practical way for a customer to martial the evidence needed to prove her case.

Lots of strange things happen during FINRA arbitration hearings. Arbitrators sometimes fall sound asleep. They resign as late as the night before a hearing, forcing months of delay, due to their own personal activities. They sometimes continue hearings into the night in order to get paid for extra sessions, exhausting themselves and the elderly claimants. There is no court reporter, and the tape recorders used are old fashioned and unreliable, producing inaudible gaps in the record. If the arbitrators forget to turn on the tape recorder, or accidentally turn it off, there is no record at all.

FINRA arbitrators are not required to explain why they ruled as they did. An award arrives in the mail, saying nothing except, "Claimant's claims are all denied." That's it. If any amount is awarded to a claimant, it is usually only a fraction of her actual loss, and the awards rarely add interest, costs, or attorney fees, even where state law absolutely entitles the investor to receive them as the prevailing party.

In their secret and unrecorded deliberations, FINRA arbitrators can and probably will simply choose to ignore the new fiduciary standard. They may continue to apply the much lower “suitability” standard for stockbroker misconduct. They may even use a yet lower standard such as their own idea of “common sense.” Since there is no record of the panel’s secret deliberations, no written opinion, and no evidence of why the panel decided the way it did, the hapless investor will have no recourse. FINRA insists that panel deliberations are confidential and tells its arbitrators they must never discuss the case with any of the parties. State and federal courts are generally without power to review FINRA arbitration awards because they must follow their federal appellate courts’ interpretations of the Federal Arbitration Act.

In conclusion, I urge you to recognize that allowing the industry to include a mandatory arbitration provision in a securities customer agreement is actually allowing a self-defeating loophole in the proposed regulation, and a conflict of interest <u>per se.</u> I respectfully request that you change the proposed regulation to state that a “best interest contract” CANNOT (instead of “may”) require that individual disputes be submitted to arbitration.

Thank you. I will be happy to answer any questions or submit additional information if it would be of assistance.

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It is never in a customer's best interest to have a mandatory arbitration agreement in his brokerage account agmt. Historically, the insutry has been allowed to include man arb clauses.

Imagine an employee whose employer has missed several paydays and stolen from the company pension fund. What if the police would do nothing? Suppose that employee had an employment contract that prevented him from suing his employer in court, regardless of whether the employer has done something criminal? What if the employment contract forced the employee to bring all disputes with the employer to an informal kangaroo court owned by the employer and his buddies, where they controlled the rules and where they decided who could be selected to hear and decide the case? That is pretty much the situation faced by a securities investor whose broker has mismanaged his account.

Almost every week in Sarasota, where I live, retirees receive invitations to free lunch and free dinner seminars given by financial advisors. These events are usually funded by the purveyors of financial products such as mutual funds or annuities, or even hedge funds. Sometimes, the free lunches are even financed by promoters of Ponzi schemes or other outright fraudulent investments. During and after these seminars, the stockbrokers and insurance agents entice their retiree guests to roll over their 401(k)'s and other assets into new investments and accounts which are usually not in the investor's best interest, to say the least. I have seen the commissions on some of the investment products sold after these seminars run as high as 18 percent. Other investments have lost half their value or become worthless within a year after they were sold. Accounts have been churned, loaded with unsuitable investments, charged outrageous management fees and expenses, etc., etc. The effects on individual retirees are devastating. Retirement investors desperately need better protections from the vultures who are preying upon them.

Mandatory arbitration clauses are always, by their very nature, contrary to the best interest of the retirement investor. This is true regardless of the rules of the arbitration forum, the backgrounds of the arbitrators, or anything else. Arbitration clauses necessarily require all parties to give up their legal rights, substituting in their place the decision of a panel of arbitrators who are <u>not required to follow the law.</u> If a customer is deprived of the right to have disputes with her stockbroker decided according to law, she is <u>thereby denied the right to have DOL regulations and other protective provisions of state and federal law applied to her case</u>. In arbitration, no one can insure that a fiduciary standard will actually be applied to the broker's actions, regardless of what any statute or regulation may say. **<u>Arbitrators are not required to follow the law.</u>** They are generally not even required to give reasons for their decisions. Frequently, they choose to ignore the law in favor of "common sense" or rules of thumb they have learned or developed based upon nothing more than their own personal philosophy or experience. <u>Their decisions are not subject to any form of appeal</u> and often cannot be overturned by any court regardless of even the most obvious and outrageous failures to follow the law. A long line of cases has clearly established that short of proving that an arbitrator actually took a bribe, there is virtually no way for a disappointed party to vacate or even modify an arbitration award.

FINRA arbitrators are not required to follow the law in rendering their decisions. Therefore, they will be free to ignore the entire proposed fiduciary standard regulation, just as they already often effectively ignore the presently existing fiduciary standard requirements when deciding cases involving Registered Investment Advisors.

Since this proposed fiduciary standard conflict of interest regulation will therefore not materially improve net recoveries of losses caused by conflicts of interest and suffered by retirement investors this proposed regulation is almost worthless to individual retirement investors as presently proposed.

The United States Supreme Court has held[1] that mandatory pre-dispute arbitration clauses in securities industry contracts are not unlawful and will be

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[1] *American Express vs. McMahon (1987).*

enforced, but that does not *ipso facto* make inclusion of such arbitration clauses in the best interest of a securities firm's customer. On the contrary, it is never in the customer's best interest when a brokerage firm includes a mandatory FINRA arbitration clause in its standard customer agreement.

So what's so bad about requiring retirement investors to take all their disputes to FINRA arbitration? In a nutshell, the biggest problem

Now let me explain why the state and federal courts reluctantly allow such unfair arbitration proceedings to go on, and why there is almost no way for an investor to appeal, overturn or modify an unfair arbitration award.

In 2008, in *Hall Street Associates vs. Mattel, Inc.*,[2] the United States Supreme Court repeatedly stated that under the Federal Arbitration Act, there are only four grounds for vacating or modifying an arbitration award. These are set out in Chapter 1, Section 10(a) of the Arbitration Act. :

1. The award was procured by corruption or fraud;
2. The arbitrators were biased;
3. The arbitrators denied due process to one of the parties;
4. The arbitrators exceeded their powers or executed them imperfectly such that a final award was not rendered.

   Each of these four grounds is very limited, indeed. Short of showing that an arbitrator took a bribe, hid the fact that he was the broker's brother-in-law, refused to allow the investor to testify or present any arguments at all, or completely failed to decide the case for years, there is no way to attack a bad arbitration award on any of the four grounds allowed.

Note that Section 10 of the Federal Arbitration Act does not list "manifest disregard of the law" as one of the grounds for overturning or modifying an arbitration award. In at least some of the circuits, "manifest disregard of the law"

[2] 552 US 576 (2008)

used to be a fifth ground that courts would sometimes use to overrule particularly outrageous arbitration awards: This ground was very narrow, because the customer had to prove somehow that the arbitrators knew the law and intentionally refused to apply it. Since arbitrators make their decisions in secret, and are not required to give reasons for their awards, this is almost impossible to prove. But at least the ground existed.

Now, since the *Hall Street* decision, the circuits are split as to whether "manifest disregard of the law" is ever a valid basis for vacating an arbitrator's award. Several of the circuits, including the Eleventh, which includes Florida, where I live, have clearly held that an arbitration award must be enforced even when the arbitrators have rendered the award in manifest disregard of the law. Even in those other circuits where the manifest disregard of the law standard does at least theoretically still exist, courts almost never actually vacate awards on that basis. A recent July 2015 article in the Litigation Section News published by the American Bar Association noted that only two federal appellate courts, the 4th and the 9th circuits, have actually overturned an arbitration award based upon manifest disregard of the law since 2009. Recently, the Supreme Court had an opportunity to review a case that directly raised the question of whether manifest disregard of the law allows a court to vacate an arbitration award.[3] Unfortunately, the Court declined to hear the case.

For example, the law may say that a broker who defrauds his client is required to pay damages calculated in a certain way. FINRA arbitrators routinely ignore such legal requirements, and award whatever lesser amount they choose. They rarely award interest, regardless of settled law entitling a prevailing party to receive interest. Similarly, they routinely deny attorney fees despite legal precedent requiring them to be awarded. Often, FINRA arbitration awards are just a compromise among the panelists. Arbitrators generally do not provide any explanation at all, so there is usually no way to even guess at how they arrived at

[3] *Walia vs. Dewan,* cert. pet. No. 13-722 (US Dec. 13, 2013); cert. denied, April 7, 2014.

their award. If this Department requires financial advisors to act in the best interest of their retirement investor customers, I predict that FINRA arbitrators will just ignore that law, too, and continue to decide securities arbitration cases based upon their own idea of what a stockbroker's duty should be.

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If securities firms are allowed to continue forcing their customers into FINRA arbitration, there is no way the customers will be able to enforce the fiduciary protections contained in this regulation. Specifically, there is no way a retirement investor will be able to ensure that anyone applies a fiduciary standard or a best interest standard to the actions of her stockbroker

Under Section 10 of the federal Arbitration Act, arbitrators are free to disregard the law. Accordingly, they will be free to disregard any requirement to give unbiased advice as well.

FINRA allows securities brokerage firms to include mandatory FINRA arbitration provisions in their customer agreements. Nearly all securities firms now do so, routinely forcing retail customers to submit "all disputes" to mandatory FINRA arbitration. Investors cannot even choose to go to an independent arbitration forum such as the American Arbitration Association. Today, you can't open a securities account anywhere in the USA without accepting one of these mandatory FINRA agreements. The large firms of the securities industry control FINRA, and that control is reflected throughout the FINRA arbitration process, especially in the final results. This mandatory arbitration system serves the industry well, but it is certainly not in the best interest of the retirement investor.

The proposed regulation allows securities firms to continue forcing mandatory FINRA arbitration down the throats of their customers. It gives the fox the power to regulate the entire hen house. And most ironically, it does so in the name of retirement investor protection

Let me explain.

The second problem with this proposed regulation is that by allowing securities brokerage firms to continue including mandatory arbitration clauses in their customer agreements, it places the imprimatur of the federal government, the USDOL stamp of approval, upon a private system of dispute resolution that is controlled and manipulated by the very industry it purports to regulate. It entrenches a corrupt dispute resolution system that is opaque, unreviewable, and strongly biased against retirement investors.

Under the proposed regulation, the new account agreement that the investor must sign in order to open an account will be a safe harbor for the securities industry provided it meets the requirements to be called a “best interest contract.” This “best interest contract” will be the key document that regulates the entire relationship between the investor and his financial advisor. The “private right of action for breach of contract” contained in the “best interest contract exemption” is plainly intended to allow individual retirement investors to hold their fiduciary advisers accountable for failing to act in their customers’ best interest. The mandatory arbitration provisions in securities customer agreements, however, render this “private right of action” provision worthless and illusory. This is a huge loophole that must be shut.

This regulation as currently proposed, will allow retail securities investment firms to continue including mandatory arbitration clauses in all of their new account agreements. It will therefore undercut the vital retirement investor protections in this proposed regulation. In practice, allowing the firms to continue forcing their customers into FINRA arbitration will practically insure that a fiduciary standard or best interest standard will NOT actually be applied to resolve customers' disputes with their financial advisors. FINRA arbitrators already substitute their own ideas for other legal principles. This new legal standard of fiduciary duty will become just one more investor protection that FINRA arbitrators can and will disregard.