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Med-Arb Adoption in Securities Law Disputes: Advantages and Costs

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MED-ARB ADOPTION IN SECURITIES LAW DISPUTES:
ADVANTAGES AND COSTS

*Hyung Kyun Kwon**

This Article considers the adoption of a hybrid method of Alternative Dispute Resolution (ADR)—Med-Arb—in securities law disputes. Because securities law ADR is currently monopolized by claims that proceed through arbitration, this Article argues that the benefits of settling a claim through mediation are being lost. Med-Arb allows parties to access the benefits of both mediation and arbitration with potentially lower economic costs and the assurance of finality of the dispute. This Article therefore presents how best to use Med-Arb to successfully resolve securities law disputes.

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INTRODUCTION

In 1925, congestion in the court system and increasing litigation costs led the United States Congress to pass the Federal Arbitration Act (FAA).¹ Since then, the legal industry has frequently used arbitration, a form of Alternative Dispute Resolution (ADR), to resolve legal disputes in the United States.²

With its simple and cost-efficient features, arbitration soon became the norm for ADR in many legal disputes, such as labor and employment conflicts.³ Securities traders innately crave cost savings and are naturally drawn to arbitration because of its efficiency. In an effort to steer dispute resolution toward arbitration, securities traders increasingly used mandatory arbitration clauses in investment contracts, and the Supreme Court of the United States approved the use of these clauses in 1987.⁴ Since then, mandatory arbitration has been the primary ADR device used to resolve securities law disputes.⁵

However, arbitration is not the only ADR method available for securities disputes. In addition to arbitration, the Securities and Exchange Commission (SEC) also allows the use of mediation in securities disputes.⁶ Despite the presence of this alternative option—mediation—the vast majority of cases are resolved through arbitration.⁷ In 2015, roughly 99% of securities

¹ See Zachary E. Davison, *Minding the Gap: A Call for Standardizing Pre-dispute Arbitration Clauses in OTC Derivative Transactions*, 59 N.Y.L. SCH. L. REV. 707, 714 (2015).

² *Id.* at 716.

³ See Carmen Comsti, *A Metamorphosis: How Forced Arbitration Arrived in the Workplace*, 35 BERKELEY J. EMP. & LAB. L. 5, 20 n.94 (2014).

⁴ In *Wilko v. Swan*, the Supreme Court initially outlawed use of mandatory arbitration provisions in securities contracts as a result of the non-waiver provisions of the Securities Act of 1933, viewing arbitration as inadequate to protect investors' rights. 346 U.S. 427, 438 (1953). However, in *Shearson/Am. Express, Inc. v. McMahon*, the Court upheld the use of mandatory provisions, holding that *Wilko* did not apply to claims under the Securities Exchange Act of 1934 and noting that the Securities and Exchange Commission's oversight authority protects the parties' substantive rights. 482 U.S. 220, 242 (1987); Davison, *supra* note 1, at 715–16.

⁵ Davison, *supra* note 1, at 715–16.

⁶ See *Overview*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/arbitration-and-mediation/overview> (last visited Mar. 4, 2017) (referring to the Overview of Arbitration & Mediation portion of the site).

⁷ See *Dispute Resolution Statistics*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics#mediationstats> (last visited Mar. 4, 2017).

cases were filed with arbitration clauses, and only 9% of the cases were resolved in mediation.⁸ Despite arbitration's efficiency and credibility, the overwhelming preference for arbitration is undesirable because in some cases mediation can be more effective than arbitration.

This Article suggests the adoption of an alternative, hybrid method of the two existing systems, called Med-Arb, as a prospective solution that can help improve the efficiency of ADR in the securities context. As the title directly reflects, Med-Arb combines features of mediation and arbitration⁹ and is composed of two separate phases that mimic mediation and arbitration respectively. In Med-Arb, mediation and arbitration happen in the same place and time—this reduces costs and promotes an efficient resolution of the dispute.¹⁰ Med-Arb reduces overall ADR costs because it appropriately encourages the increased use of mediation (instead of arbitration) in the resolution of disputes.

To analyze and evaluate Med-Arb's applicability to resolving securities law disputes, this Article will present a three-part analysis. First, this Article examines the current ADR structure of securities law disputes and assesses the problems of the current system. It then introduces and analyzes the elements and characteristics of the Med-Arb approach and evaluates its strengths and weaknesses. Next, this Article presents a framework for how Med-Arb can be used effectively to resolve securities law disputes, arguing that the benefits of the supervised use of the Med-Arb approach ultimately outweigh its costs.

I. OVERVIEW OF ADR IN SECURITIES LAW DISPUTES IN THE UNITED STATES

Since the Supreme Court approved the use of mandatory arbitration clauses in investor contracts for securities in the *Shearson/American Express v. McMahon*¹¹ decision in 1987, ADR has become the most common practice for resolving securities disputes.¹² Most modern investment contracts include arbitration provisions, mediation provisions, or both.¹³ Accordingly, most

⁸ *See id.*

⁹ John T. Blankenship, *Developing Your ADR Attitude Med-Arb: A Template for Adaptive ADR*, 42 TENN. B.J. 28, 28 (2006).

¹⁰ *Id.*

¹¹ 482 U.S. 220, 242 (1987).

¹² Davison, *supra* note 1, at 716; *see also* Byron Crowe II, *Financial Services ADR: What the United States Could Learn from South Africa*, 47 CORNELL INT'L L.J. 145, 152 (2014).

¹³ *See* Crowe II, *supra* note 12, at 146.

securities disputes are settled using these ADR methods,¹⁴ with most proceeding through arbitration.¹⁵ This section will introduce a brief historical background of Financial Industry Regulatory Authority (FINRA) dispute resolution; explain the structural features of FINRA arbitration and mediation; and examine the inherent problems of the existing system.

A. *Historical and Institutional Background of Governance*

The seemingly straightforward structure of ADR in securities law disputes began in 1933 when Congress increased efforts to regulate financial markets.¹⁶ After the disastrous experience of the Great Depression, Congress realized that the securities market needed an authoritative and resourceful monitoring institution to govern securities matters and prevent another financial disaster.¹⁷ As a result, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 in an effort to restore confidence in U.S. capital markets.¹⁸ Notably, with the Securities Exchange Act of 1934, Congress delegated power to regulate securities to a new agency—the SEC.¹⁹

Entrusted with this newly granted authority, the SEC became the sole regulatory body responsible for governing and monitoring participants in the securities markets.²⁰ The Securities Exchange Act of 1934 requires all traders to register with the SEC.²¹ Once registered with the SEC, traders are bound to comply with SEC rules and regulations.²²

After several years, however, Congress realized that the SEC might need help regulating securities markets.²³ Thus, Congress passed an additional law—the Maloney Act—that formed a group of non-governmental institutions, called self-regulatory organizations (SROs), to assist with SEC operations.²⁴ The SROs alleviate some of the SEC's administrative burden

¹⁴ See *id.* at 160; see also *Dispute Resolution Statistics*, *supra* note 7.

¹⁵ See *id.*

¹⁶ See *What We Do*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 4, 2017).

¹⁷ See *id.*

¹⁸ See *id.*

¹⁹ See *id.*

²⁰ Crowe II, *supra* note 12, at 150.

²¹ *Id.* at 150–51.

²² See *id.* at 151.

²³ See *id.*

²⁴ *Id.*

by helping regulate broker-dealers and their representatives.²⁵ While technically the SEC delegates this authority to the SROs,²⁶ the SEC still retains control over broker-dealers because the Maloney Act mandates that SROs register with, and be authorized by, the SEC.²⁷ Thus, broker-dealers remain under incidental control of the SEC, as the SEC directly controls the SROs, which hold regulatory authority over the broker-dealers and their representatives.²⁸ Originally, there were several SROs governing different types of broker-dealers,²⁹ but in 2003 all of the functions were unified under a single flagship, FINRA.³⁰ Currently, FINRA is the only SRO that supports SEC governance for broker-dealers and their representatives.³¹

B. *FINRA Dispute Resolutions*

In addition to handling administrative duties that assist the SEC's securities governance, FINRA also performs another critical function: providing an official tribunal for securities law dispute resolution.³² As the SEC's only SRO, FINRA is the primary direct supervisor of securities law dispute resolution.³³

Even though ADR has been available since 1817 when the New York Stock Exchange (NYSE) held its first internal arbitration,³⁴ ADR did not become the primary method for securities dispute resolution until the Supreme Court affirmed the validity of securities law arbitration in 1987.³⁵ Before this time, customer disputes normally went through litigation proceedings because the Court had been reluctant to approve pre-dispute ADR agreements for securities disputes due to the informal nature of ADR.³⁶

²⁵ *See id.*

²⁶ *See id.* (regarding SROs making rules subject to the approval of the SEC).

²⁷ *See id.*

²⁸ *See id.*

²⁹ *See* Jill I. Gross, *Securities Mediation: Dispute Resolution for the Individual Investor*, 21 OHIO ST. J. ON DISP. RESOL. 329, 336–38 (2006).

³⁰ *See generally* *What We Do*, *supra* note 16.

³¹ *See id.*

³² *See id.*

³³ *See id.*

³⁴ Gross, *supra* note 29, at 336–37.

³⁵ There is no clear reason why ADR was not commonly used even though traders and investors could have chosen ADR after the dispute arose. The participants may have been reluctant to choose ADR to resolve their conflicts because they thought it might not be appropriate based on the *Wilko* ruling. *See id.*

³⁶ *See id.*

Over time, the Court's thinking on the subject evolved, culminating in its opinion in *Shearson/American Express* in 1987.³⁷ In that case, the Court held that claims under the Securities Exchange Act could be resolved using arbitration if an arbitration agreement had been executed prior to the beginning of the dispute.³⁸ In return, any such ADR process had to be conducted or monitored by an SRO under SEC control.³⁹ After *Shearson/American Express*, then-existing SROs, like the National Association of Securities Dealers (NASD) and the NYSE, started to build dispute resolution departments. All of these SROs were unified under FINRA's ADR department in 2007,⁴⁰ and FINRA presently conducts 99% of securities law disputes using ADR.⁴¹

Securities law disputes filed with FINRA generally arise in two forms: customer or industry claims.⁴² Customer claims fall into six different categories: (1) misrepresentation and omission, (2) market manipulation, (3) price predictions and guarantees, (4) churning, (5) breach of fiduciary duties, and (6) failure of service claims.⁴³ Industry claims fall into four different categories: (1) collection claims, (2) Central Registration Depository issues, (3) clearing disputes, and (4) employment claims.⁴⁴ Regardless of the type of claim, most disputes will be between a customer and a broker-dealer firm or between an employed broker and a hiring broker-dealer firm.⁴⁵ Structured governance is key to fair and reasonable ADR proceedings because parties to a dispute often bring disparate legal and financial resources to the negotiation. Essentially, FINRA tries to level the playing field between broker-dealer firms and individual parties that have relatively limited resources.⁴⁶

³⁷ See generally *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (demonstrating the Court's endorsement of the use of pre-dispute arbitration agreements and that the Federal Arbitration Act of 1925 indicates a federal policy favoring the use of arbitration in general).

³⁸ *Id.* at 242.

³⁹ See Gross, *supra* note 29, at 336–37.

⁴⁰ Ernest Edward Badway & Matthew S. Adams, *The Alternative Dispute Resolution Process in the United States Securities Industry: A Primer*, 24 J. TAX'N & REG. FIN. INSTITUTIONS 31, 33 (2011).

⁴¹ Crowe II, *supra* note 12, at 146.

⁴² Badway & Adams, *supra* note 40, at 43.

⁴³ See *id.* at 43–47.

⁴⁴ See *id.* at 48–51.

⁴⁵ See *id.* at 43–51.

⁴⁶ See *id.*

C. *FINRA Arbitration*

FINRA manages securities law arbitration through the procedural rules set forth in the FINRA Manual.⁴⁷ FINRA's definition of arbitration does not differ much from most state and federal definitions of arbitration: namely, arbitration is a method of dispute resolution that results in a final determination that binds the parties.⁴⁸

FINRA arbitration generally follows the pattern set forth in *Shearson/American Express*.⁴⁹ Once parties sign an investment contract that includes an arbitration agreement, they are required to use arbitration when settling any conflicts arising out of the execution of that contract.⁵⁰ The parties are technically free to agree on where to conduct the arbitration, but most parties agree to arbitrate at FINRA, where all broker-dealers are registered.⁵¹ As a result, the FINRA Manual provides the governing standards used in securities arbitration.⁵²

In doing so, the FINRA Manual articulates separate guidelines for customer and industry arbitration.⁵³ The two standards contain procedural rules that are nearly identical except for the eligibility requirement provisions for arbitrating cases.⁵⁴ The rules governing customer arbitrations state that

⁴⁷ See 12000. *Code of Arbitration Procedure for Customer Disputes*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5174&element_id=4096&highlight=12000#r5174 (last visited Feb. Mar. 4 2017); see also 13000. *Code of Arbitration Procedure for Industry Disputes*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5272&element_id=4193&highlight=13000#r5272 (last visited Mar. 4, 2017).

⁴⁸ See Gross, *supra* note 29, at 350–51; see also 12000. *Code of Arbitration Procedure for Customer Disputes*, *supra* note 47.

⁴⁹ See generally *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (requiring arbitration to settle a conflict when parties have signed an investment contract with an arbitration agreement).

⁵⁰ See Davison, *supra* note 1, at 716.

⁵¹ See *Standards for Admission*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/industry/standards-admission> (last visited Mar. 4, 2017) (regarding registration requirements for broker-dealers with FINRA).

⁵² Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101, 105 (2014).

⁵³ 12000. *Code of Arbitration Procedure for Customer Disputes*, *supra* note 47; 13000. *Code of Arbitration Procedure for Industry Disputes*, *supra* note 47.

⁵⁴ See 12200. *Arbitration Under an Arbitration Agreement or the Rules of NASD*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11006&element_id=7944&highlight=12200#r11006 (last visited Mar. 4, 2017); 12201. *Elective Arbitration*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11007&element

the arbitration agreement must be included in the investment contract in order to bind the customer.⁵⁵ Since all broker-dealers must register with FINRA and all conflicts involving broker-dealers registered with FINRA must be held there, the rules essentially mandate that all customer arbitration be held at FINRA.⁵⁶ Likewise, the rules for industry arbitration require registered firms to resolve industry conflicts at FINRA.⁵⁷

To receive an enforceable arbitration award, parties must comply with the FINRA Manual's procedural rules.⁵⁸ Otherwise, the opposing party can file a motion to dismiss the suit—running the risk that the arbitrator might accept the motion and dismiss the claim.⁵⁹ FINRA regulates arbitrator selection,⁶⁰ procedural conduct requirements for the parties, and

_id=7945&highlight=12201#r11007 (last visited Mar. 4, 2017); *12202. Claims Against Inactive Members*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11008&element_id=7946&highlight=12202#r11008 (last visited Mar. 4, 2017); *12203. Denial of NASD Forum*, http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11009&element_id=7947&highlight=12203#r11009 (last visited Mar. 4, 2017); *see also 13200. Required Arbitration*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11105&element_id=8043&highlight=13200#r11105 (last visited Mar. 4, 2017); *13201. Statutory Employment Discrimination Claims*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11106&element_id=8044&highlight=13201#r11106 (last visited Mar. 4, 2017); *13202. Claims Involving Registered Clearing Agencies*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11107&element_id=8045&highlight=13202#r11107 (last visited Mar. 4, 2017); *13203. Denial of NASD Forum*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11108&element_id=8046&highlight=13203#r11108 (last visited Mar. 4, 2017).

⁵⁵ *12200. Arbitration Under an Arbitration Agreement or the Rules of NASD*, *supra* note 54.

⁵⁶ *12208. Representation of Parties*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11014&element_id=7952&highlight=12208#r11014 (last visited Mar. 4, 2017).

⁵⁷ *13208. Representation of Parties*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11113&element_id=8051&highlight=13208#r11113 (last visited Mar. 4, 2017).

⁵⁸ *See generally 12000. Code of Arbitration Procedure for Customer Disputes*, *supra* note 47; *see also 13000. Code of Arbitration Procedure for Industry Disputes*, *supra* note 47.

⁵⁹ *12503. Motions*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11057&element_id=7995&highlight=12503#r11057 (last visited Mar. 4, 2017); *13503. Motions*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11156&element_id=8094&highlight=13503#r11156 (last visited Mar. 4, 2017).

⁶⁰ *12401. Number of Arbitrators*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11039&element_id=7977&

qualifications for necessary statements.⁶¹ The rules cover these matters in a fairly exacting fashion; thus, satisfying the given standards may require the assistance of attorneys or other representatives with sophisticated legal knowledge.

Despite the level of complexity in this system, arbitration's competitive advantage lies in its economic and procedural efficiency. Securities trading parties are likely to turn to litigation in federal court if arbitration is impossible. Binding arbitration that complies with the Supreme Court's existing standard can be somewhat complex but nowhere near as complex as full-scale federal litigation.⁶² Federal litigation invariably takes far more time and resources than a FINRA-supervised arbitration. For example, in litigation, the parties must consider a wide gamut of procedural issues unrelated to the substance of the underlying dispute itself. Further, parties must comply with demanding court filing deadlines and any unique legal customs and rules applicable in the jurisdiction.

In contrast, when parties use FINRA's uniform standard for securities arbitration, there is no need to worry about additional procedural issues—instead, the parties can focus on resolving the substantive legal issue being disputed. Arbitration also has the advantages of finality and flexibility.⁶³ Moreover, FINRA arbitration is attractive to parties that want to protect private information because its confidentiality requirements are more extensive than those in litigation—usually the only thing disclosed at the end of arbitration is the outcome of the proceeding.⁶⁴

D. *FINRA Mediation*

FINRA also allows for the more informal ADR method of mediation, which differs from arbitration in many respects. While arbitration results in a binding decision based on an arbitrator's legal analysis, mediation does not

highlight=12401#r11039 (last visited Mar. 4, 2017); 13401. *Number of Arbitrators*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11138&element_id=8076&highlight=13401#r11138 (last visited Mar. 4, 2017).

⁶¹ See generally 12000. *Code of Arbitration Procedure for Customer Disputes*, *supra* note 47; see also 13000. *Code of Arbitration Procedure for Industry Disputes*, *supra* note 47.

⁶² See *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 232–33 (1987).

⁶³ See Gross, *supra* note 29, at 357–59.

⁶⁴ See *id.*

provide a legally binding result, because mediators do not have any authority to issue a binding legal judgment. Mediation, completed in an informal setting, is designed to provide a mutually beneficial solution for all parties to the dispute. Thus, unlike arbitrators acting as active decision makers, mediators facilitate voluntary settlements.⁶⁵ Moreover, while arbitration uses litigious hearings attended by both parties, mediation uses a series of private, ex parte meetings called caucuses.⁶⁶ In mediation, the mediator interacts separately with each party and hears the differing opinions in private settings.⁶⁷ The information obtained from these meetings allows the mediator to pinpoint the issues on which the parties may compromise—enabling the mediator to efficiently soothe the conflict.⁶⁸ Because information from these meetings could adversely impact the parties in the event of a lawsuit, all information uncovered during the course of mediation is confidential.⁶⁹ This level of confidentiality is higher than in arbitration,⁷⁰ and arbitration or litigation awards may be repealed when they are rendered based on information from mediation procedures.⁷¹

Mediation is a much simpler and cheaper alternative to arbitration.⁷² Parties in mediation are likely to encounter even fewer procedural rules than are found in arbitration hearings. As previously noted, arbitration employs procedural rules that are simpler than traditional court rules; mediation simplifies the procedural picture even further. While arbitration must use pleading-like procedures to maintain legitimacy, as a tribunal rendering a decision according to rule of law, mediation needs no such procedures because it is nothing more than a settlement assistance process. Mediation provides a catalyst for parties to negotiate a settlement without the help of a binding decision-maker, thus saving money. This is not to say that mediation

⁶⁵ See *Initiate an Arbitration or Mediation*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/arbitration-and-mediation/initiate> (last visited Mar. 4, 2017).

⁶⁶ See Kristen M. Blankley, *Keeping a Secret from Yourself? Confidentiality When the Same Neutral Serves Both as Mediator and as Arbitrator in the Same Case*, 63 BAYLOR L. REV. 317, 334 (2011).

⁶⁷ *Id.*

⁶⁸ *See id.*

⁶⁹ *Id.*

⁷⁰ *See id.* at 336.

⁷¹ *See id.* at 346.

⁷² *Comparison Between Arbitration & Mediation*, FIN. INDUS. REGULATORY AUTH., <https://www.finra.org/arbitration-and-mediation/comparison-between-arbitration-mediation> (last visited Mar. 4, 2017).

is not governed by procedural rules; the Supreme Court mandates some procedural protection for parties involved in mediation.⁷³ FINRA mediation rules govern, among other issues, mediator selection, caucus formats, and confidentiality protection.⁷⁴ None of the rules for FINRA mediation resemble the procedural requirements for arbitration.⁷⁵ Some people may question mediation's procedural sufficiency because, in general, lighter regulatory schemes regularly lead to a lack of oversight.⁷⁶ However, for FINRA mediation, such concerns are largely unfounded because FINRA ADR procedures are monitored and administered by two controlling departments: the FINRA Office of Dispute Resolution, and the FINRA National Arbitration and Mediation Committee.⁷⁷ These committees oversee FINRA arbitration and mediation and also have the power to intervene in individual cases should the need to protect one or both parties arise.⁷⁸ FINRA oversight

⁷³ Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 245 n.2 (1987).

⁷⁴ See 14000. *Code of Mediation Procedure*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5373&element_id=4293&highlight=14000#r5373 (last visited Mar. 4, 2017).

⁷⁵ See 12000. *Code of Arbitration Procedure for Customer Disputes*, supra note 47; 13000. *Code of Arbitration Procedure for Industry Disputes*, supra note 47; 14000. *Code of Mediation Procedure*, supra note 74.

⁷⁶ Shahla F. Ali & Antonio Da Roza, *Alternative Dispute Resolution Design in Financial Markets—Some More Equal Than Others: Hong Kong's Proposed Financial Dispute Resolution Center in the Context of the Experience in the United Kingdom, United States, Australia, and Singapore*, 21 PACIFIC RIM L. & POL'Y J. 485, 515–16 (2012) (exploring the differences between strong statutory regimes and the issues that arise with less stringent statutory schemes).

⁷⁷ 14000. *Code of Mediation Procedure*, supra note 74.

⁷⁸ 12102. *National Arbitration and Mediation Committee*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=16704&element_id=4101&highlight=12102#r16704 (last visited Mar. 4, 2017); 12103. *Director of the Office of Dispute Resolution*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=16705&element_id=4102&highlight=12103#r16705 (last visited Mar. 4, 2017); 13102. *National Arbitration and Mediation Committee*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=16709&element_id=4198&highlight=13102#r16709 (last visited Mar. 4, 2017); 13103. *Director of the Office of Dispute Resolution*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=16710&element_id=4199&highlight=13103#r16710 (last visited Mar. 4, 2017); 14102. *National Arbitration and Mediation Committee*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=16716&element_id=4296&highlight=14102#r16716 (last visited Mar. 4, 2017); 14103. *Director of the Office of Dispute Resolution*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=11201&element_id=8139&highlight=14103#r11201 (last visited Mar. 4, 2017).

helps to ensure that the informal nature and systematic efficiency of mediation do not harm its credibility.

E. *Problems with ADR in Securities Law Disputes*

At first glance, the options for ADR in resolving security law disputes do not pose any apparent problems. The FINRA mediation and arbitration processes work commendably. These methods have passed the test of time and are protected by concrete procedural rules that organize and monitor the conduct of the parties. But sometimes neither mediation nor arbitration is a perfect solution for resolving a dispute. Accordingly, the FINRA ADR regime currently suffers from several problems.

First, FINRA mediation is underutilized: it is often overlooked as an option in situations where an efficient compromise between the parties might be possible. In 2015, among the 3,489 cases resolved under FINRA's ADR regime, only 306 cases were settled through mediation.⁷⁹ That number is not an outlier, as the percentage of mediated cases has remained around eight to ten percent since 2012.⁸⁰ This low rate of mediation is clearly abnormal compared to other industries where mediation is on the rise.⁸¹ This discrepancy can partially be explained because pre-dispute arbitration agreements are allowed in the securities industry—making arbitration less complex than it is in other industries. However, the reduction in complexity does not fully explain the securities industry's overwhelming preference for arbitration over mediation.⁸² This indicates that the securities industry may be wasting resources on unnecessary litigation and arbitration when many disputes could be settled more efficiently through mediation.

Additionally, the disparity of use between arbitration and mediation may be straining the credibility of FINRA's ADR regime. While eight to ten percent of cases are settled through mediation, 50% of cases are resolved

⁷⁹ *Dispute Resolution Statistics*, *supra* note 7.

⁸⁰ *See id.*

⁸¹ Cornell University's Scheinman Institute on Conflict Resolution surveyed executives of Fortune 1000 companies in 1997 and 2011 and conducted a research analysis comparing the results. *See* Thomas J. Stipanowich & J. Ryan Lamare, *Living with ADR: Evolving Perceptions and Use of Mediation, Arbitration, and Conflict Management in Fortune 1000 Corporations*, 19 HARV. NEGOT. L. REV. 1, 45–48 (2014). The analysis indicated that use of mediation had increased over the period time while use of arbitration had decreased. *Id.* Moreover, 45.8% of the sample stated that they used mediation very often. *Id.*

⁸² *Dispute Resolution Statistics*, *supra* note 7.

through direct settlement by the parties every year.⁸³ Some people may see this phenomenon as desirable, because it seems to indicate that the system is adequately encouraging parties to settle. However, as discussed above, most FINRA securities cases are a David and Goliath-like struggle between a lay individual and a gigantic broker-dealer firm backed by multi-billion dollar budgets for litigation and dispute resolution. Therefore, without the supervision of a third-party, honest broker, the settlement process risks unfairness. Mediation could help alleviate this problem, but FINRA mediation has proved too unpopular to offer much help so far. Consequently, in order to better protect smaller, weaker parties, FINRA must come up with a way to either encourage more mediation or, better yet, create a new system comparable with arbitration.

II. MED-ARB: A POSSIBLE SOLUTION

The Scheinman Institute on Conflict Resolution of Cornell University added an interesting question to its survey measuring the ADR experiences of executives of Fortune 1000 Corporations.⁸⁴ The question asked whether the executives had experienced a hybrid ADR method called mediation-arbitration (Med-Arb).⁸⁵ Of the executives sampled, 51% answered the question in the affirmative, thus confirming the growing influence of Med-Arb.⁸⁶ Increasing use of Med-Arb is not limited to the United States; internationally, Med-Arb has been studied extensively.⁸⁷ Because of the many problems associated with ADR discussed above, the time has come for FINRA to consider Med-Arb. To understand the value of Med-Arb in the ADR context, it is first necessary to provide some basic background information on the history and structure of this new tool for resolving disputes.

⁸³ *Id.* The percentage of cases resolved through direct settlement for 2012, 2013, 2014, and 2015 is 50%, 51%, 52%, and 50% respectively. *Id.*

⁸⁴ Stipanowich & Lamare, *supra* note 81, at 5.

⁸⁵ *Id.* at 41.

⁸⁶ *Id.*

⁸⁷ See generally Carlos De Vera, *Arbitrating Harmony: 'Med-Arb' and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China*, 18 COLUM. J. ASIAN L. 149 (2004); Emilia Onyema, *The Use of Med-Arb in International Commercial Dispute Resolution*, 12 AM. REV. INT'L ARB. 411 (2001); and James T. Peter, *Med-Arb in International Arbitration*, 8 AM. REV. INT'L ARB. 83 (1997).

A. *What is Med-Arb?*

Med-Arb is a form of ADR that combines features of mediation and arbitration.⁸⁸ The method is a two-stage process: in the first stage, the parties try to settle the case using standard mediation procedures.⁸⁹ If issues remain unresolved after mediation, parties immediately move on to the second stage: arbitration, in which the remaining unresolved issues are finalized with binding decisions.⁹⁰ This combination provides unprecedented procedural efficiency by providing the flexibility of mediation and the finality of arbitration in a single package.⁹¹

The use of Med-Arb in the U.S. was first seen in labor law disputes.⁹² Sam and John Kagel coined the term “Med-Arb” and first used it to settle a San Francisco nurses’ strike in 1970.⁹³ Since then, Med-Arb has been used to resolve various types of industrial and commercial disputes, including employment disputes, international disputes, and corporate disputes.⁹⁴ However, due to Med-Arb’s distinctive design (which some scholars view as potentially problematic),⁹⁵ its use has normally been limited to specific types of disputes that can be carefully overseen by regulatory institutions.⁹⁶

There are several variations of Med-Arb, which fall into two broad types.⁹⁷ First, there is the most general type, called Med-Arb-Same or Same-Neutral Med-Arb.⁹⁸ In Med-Arb-Same, the same neutral decision-maker serves as both mediator and arbitrator, so the phases continue without a change in decision-maker.⁹⁹ Due to differences in the confidentiality standard between mediation and arbitration, some alternative types of Med-Arb

⁸⁸ See Blankenship, *supra* note 9, at 28.

⁸⁹ *Id.* at 29.

⁹⁰ *Id.* at 30.

⁹¹ Brian A. Pappas, *Med-Arb and the Legalization of Alternative Dispute Resolution*, 20 HARV. NEGOT. L. REV. 157, 166–67 (2015).

⁹² Blankenship, *supra* note 9, at 32.

⁹³ *Id.*

⁹⁴ *Id.* at 32–33.

⁹⁵ See, e.g., *id.* at 38; De Vera, *supra* note 87, at 159–60.

⁹⁶ For example, Med-Arb became customary in settling labor disputes involving a quid pro quo dynamic when management agrees to a procedure that ends with binding arbitration in exchange for employees giving up their right to strike or lockout. Because, without the right to strike employees would not have as much leverage as management. Med-Arb helps to level the playing field. Blankenship, *supra* note 9, at 32.

⁹⁷ *Id.* at 30.

⁹⁸ *Id.*

⁹⁹ *Id.*

attempt to regulate the power of the mediator-arbitrator.¹⁰⁰ For example, sometimes the parties might opt-out of the second phase and pursue a separate arbitrator.¹⁰¹ The parties might also limit the range of possible outcomes available to the arbitrator.¹⁰²

The second type is Med-Arb-Diff, in which the two phases are conducted with different neutral decision-makers.¹⁰³ This obligatory restriction attempts to insulate the two stages more effectively than Med-Arb-Same and prevent any legal issues of confidentiality between the stages.¹⁰⁴ However, requiring this rigid segregation may harm the general advantage of choosing the hybrid system since the process becomes less efficient. Like Med-Arb-Same, Med-Arb-Diff can vary in its procedural details. For example, parties might allow the mediator to write a recommendation to the arbitrator of the second stage—allowing the mediator to deliver his impressions and interpretations of the case.¹⁰⁵ Parties might also expand the mediator's power by allowing him to attend the hearing stage of the arbitration.¹⁰⁶ These variations, however, do not change the fundamental principle that the mediator has no direct say on the binding decision in arbitration.

While separating mediation and arbitration by using two different neutral decision-makers may alleviate some of the innate disadvantages of the Med-Arb-Same process (such as confidentiality and due process issues), Med-Arb-Diff erodes the efficiency gains that Med-Arb is designed to maximize. Med-Arb-Diff merely provides an additional ADR option that is more expensive than either mediation or arbitration with a single neutral decision-maker. Because the additional expense is not balanced against a clear increase in efficiency, there is no point in spending time and money focusing on such an alternative. Thus, Med-Arb-Same is the best solution to the problems discussed above, as it requires only one neutral decision-maker for the procedure and may finish at the mediation stage, costing no more than a standard mediation. Therefore, the analysis that follows will only consider the more efficient system, Med-Arb-Same.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 30–31.

¹⁰² *Id.*

¹⁰³ *Id.* at 31.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

B. *Advantages of Med-Arb*

Med-Arb has many advantages. In order to assess how compatible Med-Arb is with ADR in the securities law context, its costs and benefits must be carefully weighed. The use of Med-Arb has three general benefits over traditional mediation and arbitration processes. First, Med-Arb's hybrid format allows the parties to the dispute and the governing neutral decision-maker to apply the beneficial elements of both mediation and arbitration flexibly.¹⁰⁷ Arbitration alone does not allow the participants to assess personal and external evidentiary impressions and intentions. When evidence adequately resembles the factual circumstances of the dispute, such personal mindsets and invisible intentions may not be relevant to the resolution of the dispute. However, evidentiary circumstances are not always a true reflection of reality. Giving arbitration an informal touch through sharing *ex parte* conversations during mediation caucuses may provide the neutral decision-maker with a better view of the real events.¹⁰⁸ Even though the neutral decision-maker must delicately filter out confidential information that should not be applied during arbitration, he will possess a better understanding of the evidence brought to the arbitration stage.¹⁰⁹ This allows the neutral decision-maker some flexibility in grappling with the factual circumstances of the case.¹¹⁰ Parties will also benefit from flexibly incorporating the two different stages, allowing them to better design their case presentations.¹¹¹

Second, Med-Arb's consolidated dispute resolution process should be less expensive than holding arbitration and mediation separately. Under Med-Arb, the dispute might be resolved in either the mediation phase or the arbitration phase. If all the issues are settled at the first stage, the procedural costs of the suit will roughly equal the costs of resolving the case through mediation because the parties only have to pay one decision-maker. Even if the process moves to the second stage, the increase in procedural costs will not be as great as if the parties had held a separate arbitration after the mediation.¹¹² Through Med-Arb, parties will be able to proceed to the arbitration process without incurring the additional expenses of hiring a new

¹⁰⁷ See Pappas, *supra* note 91, at 168.

¹⁰⁸ See *id.*

¹⁰⁹ See Blankenship, *supra* note 9, at 33.

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² See *id.* at 34.

arbitrator and selecting a new date, time, and location for a separate arbitration. This saves significant time because the neutral decision-maker does not have to relearn the relevant factual and legal circumstances of the case.¹¹³ Moreover, FINRA will be able to reduce a sizable amount of administrative expenses relating to arbitration.¹¹⁴ When mediation use increases at the expense of arbitration use, FINRA saves money because there is no arbitration award to post and less meeting space is needed.¹¹⁵ The cost reduction continues into the second phase as well because the arbitrator takes less time, as the arbitrator is already familiar with the case.¹¹⁶

Finally, from the outset of Med-Arb, parties know that the process will resolve the dispute.¹¹⁷ Thus, the mediation phase of Med-Arb functions partially as a negotiation, guaranteeing either a settlement or a mandatory arbitration. Such finality strengthens the mediation stage by incentivizing the parties to settle at the earliest opportunity.¹¹⁸ Before moving on to arbitration, the parties are aware that the dispute will be finalized one way or the other.¹¹⁹ Thus, settling disputes through mediation is more economical because mediated settlements are often cheaper for the parties. This encourages the participants to favor a faster, more economical conclusion to the dispute through settlement at the mediation stage.

C. *Disadvantages of Med-Arb*

The benefits of Med-Arb however are only one side of the story. Scholars have expressed concerns that Med-Arb risks breaches of the confidentiality of information shared in the mediation stage.¹²⁰ Because parties engage with mediators during private caucus sessions, if the dispute makes it to Med-Arb arbitration, the neutral decision-maker may have already been exposed to more confidential information than the arbitrator otherwise would have in a non-Med-Arb arbitration.¹²¹ Some of the information discussed in mediation may not be usable in the later rendering

¹¹³ *See id.*

¹¹⁴ *See id.*

¹¹⁵ *See id.*

¹¹⁶ *See id.*

¹¹⁷ *See id.* at 35.

¹¹⁸ *See id.*

¹¹⁹ *See id.*

¹²⁰ *See id.*; *see also* Blankley, *supra* note 66, at 333.

¹²¹ *Id.* at 334.

of an arbitration decision.¹²² And although the neutral decision-maker might declare that she or he did not use the confidential information in rendering her or his decision, it is not unreasonable to presume that such information may have had an improper influence. Decisions rendered under the cloud of such suspicion may harm the transparency of the mediation process in future disputes because parties might not fully disclose certain information during mediation.¹²³ If information is withheld, there is a risk that the parties' interests in a fair resolution of the dispute will be fundamentally damaged.¹²⁴

A second problem of Med-Arb is that it jeopardizes a party's right to due process in the arbitration phase.¹²⁵ The confidential information obtained in the mediation phase may harm the procedural structure of the arbitration phase by damaging the discovery process and the impartiality of the neutral decision-maker. The information revealed during the mediation caucuses may prevent the neutral decision-maker from performing adequate analysis: the prior information may cause the neutral decision-maker to interpret evidence from a biased viewpoint.¹²⁶ This bias could threaten the impartiality of the final decision, potentially undermining a party's right to due process.¹²⁷ This may make parties less likely to proceed to the arbitration stage of Med-Arb, causing them to prematurely settle in mediation under a perceived state of duress.¹²⁸

Despite these minor flaws, Med-Arb remains a flexible and inexpensive alternative to traditional arbitration: it offers the possibility of finality, but may often result in a mediated settlement. These structural features make Med-Arb an attractive ADR alternative that lies between arbitration and mediation. In addition to the benefit of its efficiency gains, Med-Arb also improves the structural operation of FINRA ADR.

III. IS MED-ARB THE ANSWER?

Because it is relatively untested in the context of securities dispute resolution, this Article presents a careful analysis of Med-Arb's policy and

¹²² *See id.*

¹²³ *See Pappas, supra note 91, at 172.*

¹²⁴ *See id.* at 173–74; *see also Blankley, supra note 66, at 334.*

¹²⁵ *See Pappas, supra note 91, at 184.*

¹²⁶ *See Blankenship, supra note 9, at 35.*

¹²⁷ *See Pappas, supra note 91, at 178.*

¹²⁸ *See Blankenship, supra note 9, at 36.*

structure. In particular, this section will demonstrate that Med-Arb is a good fit with FINRA. This section will also suggest additional safeguards that can help alleviate the concerns some have with Med-Arb's use in resolving securities law disputes.

A. *How Med-Arb Use Meets FINRA's Needs and Standards*

Med-Arb is a good fit for resolving securities disputes under FINRA. First, Med-Arb promotes the increased use of mediation. Parties who fail to settle the case at the mediation stage move on to arbitration, where they are subject to a final binding decision. Parties therefore have a greater incentive to settle in mediation than they would under the traditional mediation-only framework.¹²⁹ The looming shadow of arbitration puts both psychological and economic pressure on the parties, incentivizing them to reach a mediated settlement on their own terms.¹³⁰ This emphasis on the mediation stage will therefore help promote the use of the FINRA mediation system. Were FINRA to succeed in convincing parties to use Med-Arb, its structural features will push a significant number of those cases to resolution through mediation. Also, as more cases are settled in the mediation phase of Med-Arb, parties will become familiar with the regular mediation process and might consider using it more often in the future. Because of this familiarity, coupled with FINRA's mediation system (which is governed by detailed procedural rules),¹³¹ users will likely begin to use FINRA mediation in certain circumstances instead of arbitration or Med-Arb.

Second, as a less expensive alternative to traditional arbitration, Med-Arb would compete with other forms of ADR within the FINRA ADR market. The current dominance of FINRA arbitration is worrisome at best.¹³² A monopoly of one form of dispute resolution may cause overall structural decay in FINRA's ADR regime. For many lay investors and employees confronting large broker-dealer firms, FINRA ADR may be a once-in-a-lifetime event; however, for the broker-dealer firms, FINRA ADR is a routine part of doing business. These firms have a substantial advantage in arbitration because of their abundant resources and cumulative experience. If this is allowed to continue unchecked, it will be even more difficult for parties

¹²⁹ *See id.* at 34.

¹³⁰ *See id.*

¹³¹ *See generally* 14000. *Code of Mediation Procedure*, *supra* note 74.

¹³² *See Dispute Resolution Statistics*, *supra* note 7.

with fewer resources to be treated fairly in FINRA ADR. Therefore, the viability of other forms of FINRA ADR, like Med-Arb, is critical to improving the overall procedural fairness of the FINRA ADR regime—competition may create a more level playing field that larger broker–dealer firms are less likely to dominate so thoroughly.

Med-Arb is an excellent system for stimulating competition among the different FINRA ADR options. Med-Arb is a viable alternative to FINRA arbitration. Much of the preparatory work and documentation required for both mediation and arbitration substantially overlaps in Med-Arb. Incorporating arbitration into the second phase of Med-Arb does not drastically increase the amount of preparation beyond that which is required for mediation; hearing documents and evidentiary filings required by the FINRA Discovery Guide are all that should be needed.¹³³ Other than those preliminary materials, there is no practical difference between the procedural expenses of performing traditional mediation and the procedural expenses of settling a case in the first stage of Med-Arb.

The procedural expenses for Med-Arb do increase if a complete settlement is not reached in mediation. However, the increased cost is much less than the cost of preparing and organizing a totally new and separate arbitration. In Med-Arb, there is no additional cost required to hire new arbitrators and set new schedules: all the parties must do is proceed to

¹³³ See 12505. *Cooperation of Parties in Discovery*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5238&element_id=4159&highlight=12505#r5238 (last visited Mar. 4, 2017); 12506. *Document Production Lists*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13757&element_id=4160&highlight=12506#r13757 (last visited Mar. 4, 2017); 12507. *Other Discovery Requests*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5240&element_id=4161&highlight=12507#r5240 (last visited Mar. 4, 2017); 12508. *Objecting to Discovery; Waiver of Objection*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13756&element_id=4162&highlight=12508#r13756 (last visited Mar. 4, 2017); 12509. *Motions to Compel Discovery*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5242&element_id=4163&highlight=12509#r5242 (last visited Mar. 4, 2017); 12510. *Depositions*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5243&element_id=4164&highlight=12510#r5243 (last visited Mar. 4, 2017); 12511. *Discovery Sanctions*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5244&element_id=4165&highlight=12511#r5244 (last visited Mar. 4, 2017); see also *Discovery Guide*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/sites/default/files/ArbMed/p394527.pdf> (last visited Mar. 4, 2017).

arbitration. Med-Arb is an accessible, economical, and practical alternative to mediation and arbitration. Med-Arb can alleviate the current arbitration monopoly and level the playing field amongst parties.

Finally, case law and FINRA's administrative regulations can adequately protect the confidentiality of the mediation phase and prevent subsequent confidentiality and due process issues from arising in the arbitration phase. Currently, the confidentiality of information exchanged within the FINRA mediation process is highly protected under FINRA Conduct Rules.¹³⁴ These provisions specifically prohibit parties and the neutral decision-maker mediating the dispute from disclosing, introducing, or using information disclosed during the mediation for any outside purpose unless the parties agree in writing to such use.¹³⁵ Some may argue that these protections are insufficient because the neutral decision-maker performing the mediation will invariably be exposed to confidential communications. Once the information is heard—the argument goes—the disclosure of confidential information (such as room for flexibility in the demands of the parties, previously contemplated settlements, and weaknesses of claims) will inevitably influence the thought process of the neutral decision-maker and thus compromise the enforceability of the arbitration award.¹³⁶ However, FINRA provisions allow these confidentiality protections to be waived with the written consent of the parties.¹³⁷ Thus, parties could prevent confidentiality conflicts by signing consent forms as a part of the Med-Arb process.

However, if parties to Med-Arb pre-dispute agreements could conduct Med-Arb under FINRA's regulatory umbrella—as parties to pre-dispute arbitration agreements can—then consent forms might not even be necessary.¹³⁸ FINRA interprets *Shearson/American Express* to hold that the only ADR method enforceable under pre-dispute contracts is arbitration per se.¹³⁹ However, *Shearson/American Express* leaves open the possibility that

¹³⁴ 14109. *Mediation Ground Rules*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5383&element_id=4303&highlight=14109#r5383 (last visited Mar. 4, 2017).

¹³⁵ *Id.*

¹³⁶ See Pappas, *supra* note 91, at 172–73.

¹³⁷ 14109. *Mediation Ground Rules*, *supra* note 134.

¹³⁸ See *Basic Arbitrator Training*, FIN. INDUS. REGULATORY AUTH. 1, 4 (2017), <http://www.finra.org/sites/default/files/FINRA-Basic-Arbitrator-Training.pdf>; *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

¹³⁹ See *Shearson/Am. Express, Inc.*, 482 U.S. 220, 242.

other dispute resolution procedures might be covered by its holding in the future.¹⁴⁰ In addition, a number of court cases dispute the degree to which the FAA encourages dispute resolution under the term “arbitration.” For example, in *Bakers Union Factory, #326 v. ITT Continental Baking Co.*,¹⁴¹ the Sixth Circuit Court of Appeals ruled that what the federal government purported to accomplish with the FAA was not requiring arbitration per se, but rather enforcing any ADR method that the parties agreed to in order to reach a conclusive resolution.¹⁴² In other words, some jurisdictions have held that FAA enforcement is not limited to arbitration per se, and that it is therefore reasonable to conclude that other forms of ADR, such as mediation or Med-Arb, also meet the *Shearson/American Express* standard.¹⁴³

However, FINRA is yet to acquiesce to this more open-minded interpretation, instead only allowing for arbitration per se; FINRA requires both parties to file voluntarily signed written agreements when they want to use FINRA mediation.¹⁴⁴ This may indicate that FINRA would likely require parties pursuing Med-Arb to provide similar voluntary consent forms. Therefore, requiring the parties to agree to consent forms permitting the partial release of information exchanged in mediation may require nothing more than adding a sentence or two to the existing voluntary participation agreement. Moreover, FINRA’s conservative tendencies suggest that FINRA is capable of implementing regulations to prevent subsequent confidentiality issues in Med-Arb.

Courts will likely be loath to enforce awards when confidentiality is violated in the mediation phase of Med-Arb. Because it is still relatively new and uncommon, judicial precedents regarding Med-Arb are rarely found. However, in *Bowden v. Weickert*,¹⁴⁵ the Ohio Court of Appeals vacated an arbitration award because the neutral decision-maker used information introduced in the first phase of Med-Arb to reach the decision in the second

¹⁴⁰ *See id.*

¹⁴¹ 749 F.2d 350 (6th Cir. 1984).

¹⁴² *Id.* at 353 (citing *United Mine Workers v. Barnes & Tucker Co.*, 561 F.2d 1093, 1096 (3d Cir. 1977)).

¹⁴³ *Johnston Boiler Co. v. Local Lodge No. 893, Int’l Bhd. of Boilermakers*, 753 F.2d 40, 43 (6th Cir. 1985); *Teamsters Local Union 480 v. UPS*, No. 3:12-cv-00178, 2012 U.S. Dist. LEXIS 130676, at *12–13 (M.D. Tenn. Sept. 13, 2012).

¹⁴⁴ 14104. *Mediation under the Code*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5378&element_id=4298&highlight=14104#r5378 (last visited Mar. 4, 2017).

¹⁴⁵ 2003 Ohio App. LEXIS 2871, 2003-Ohio-3223 (Ohio App. June 20, 2003).

phase.¹⁴⁶ In other words, for those situations in which confidentiality is not adequately protected by FINRA's conservative legal provisions, courts are likely to provide a second layer of confidentiality protection.¹⁴⁷ As it currently stands, FINRA allows parties to vacate arbitration awards through procedural rules.¹⁴⁸

B. *Suggested Design for FINRA Med-Arb: Hodges Test*

FINRA's governing rules should provide a proper framework for Med-Arb in securities dispute resolution. FINRA is ideally positioned to mitigate the negative effects of combining mediation and arbitration because it sets high ethical standards that limit the type of voluntary agreements available to the parties.

A recent Louisiana court decision provides one example of how best to frame such voluntary agreements. The Louisiana Supreme Court devised an innovative framework for deciding whether arbitration agreements can be used in attorney–client malpractice disputes.¹⁴⁹ The applicability of arbitration agreements to malpractice disputes is a subject of national-level legal debates primarily because arbitration creates a potential conflict with the American Bar Association's (ABA) Model Rules of Professional Conduct. ABA Model Rule 1.8(h) states:

A lawyer shall not:

- (1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement; or
- (2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.¹⁵⁰

¹⁴⁶ *Id.* at *36–40.

¹⁴⁷ Blankley, *supra* note 66, at 348.

¹⁴⁸ *12504. Motions to Dismiss*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=17287&element_id=7377&highlight=12504#r17287 (last visited Mar. 4, 2017); *13504. Motions to Dismiss*, FIN. INDUS. REGULATORY AUTH., http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=17288&element_id=7378&highlight=13504#r17288 (last visited Mar. 4, 2017).

¹⁴⁹ See *Hodges v. Reasonover*, 103 So. 3d 1069, 1078 (La. 2012).

¹⁵⁰ See MODEL CODE OF PROF'L RESPONSIBILITY r. 1.8(h) (AM. BAR ASS'N 2014).

Signing an arbitration agreement could be deemed a settlement of a future malpractice claim, which would require the client to receive advice in writing and proper notice to seek independent counsel. Thus, consent to arbitration might be viewed as a limitation on the client's right to the many procedural protections of a trial such as the right to appeal and the opportunity to discover evidence under state or federal rules.¹⁵¹

In order to determine whether an arbitration agreement is enforceable, the Louisiana Supreme Court created a seven-element test.¹⁵² The arbitration agreement must (1) provide that the client waives the right to a trial, (2) require the client to waive the right to an appeal, (3) state that the client waives the right to broad discovery under federal and state procedural rules, (4) inform the client that arbitration might involve substantial upfront costs compared to litigation, (5) explicitly mention that it covers malpractice claims, (6) not impinge upon the client's right to make a disciplinary complaint to the proper authorities, and (7) advise the client to seek independent counsel before signing the agreement.¹⁵³ The court held that when the agreement meets all seven requirements, it should be deemed enforceable because it complies with the ABA Model Rules.¹⁵⁴

The holding of the Louisiana Supreme Court provides an example of how FINRA might design a similar rule for Med-Arb that could help shield it from potential legal challenges. FINRA could draft specific qualifications applying conservative standards that require the client to make an informed decision about which rights they might be waiving by participating in Med-Arb. The FINRA requirements may be less burdensome than those of the *Hodges* standard, as securities disputes are already subject to arbitration. The test, therefore, might merely oblige the parties to acknowledge the confidentiality issues inherent in the first phase, while also encouraging the parties to seek independent counsel before signing. Med-Arb's cost-effective features will make it sufficiently attractive to prospective users, even after meeting these seemingly burdensome requirements. Because Med-Arb is different than arbitration per se, voluntary consent forms will likely be

¹⁵¹ Steven Quiring, Note, *Attorney-Client Arbitration: A Search for Appropriate Guidelines for Pre-Dispute Agreements*, 80 TEX. L. REV. 1213, 1217 (2002).

¹⁵² *Hodges*, 103 So. 3d at 1077.

¹⁵³ *See id.*

¹⁵⁴ *See id.*

mandatory—the requirement boils down to nothing more than adding additional language to the existing consent form.

IV. CONCLUSION

The FINRA application of Med-Arb suggested in this Article may need to be adapted over time. As discussed above, Med-Arb is a relatively new and uncommon form of ADR. For formalists who believe in the distinctive functions of mediation and arbitration, the idea of combining the two procedures may seem an outrageous suggestion—one that would damage the procedural integrity of both systems. However, for FINRA, the benefits of Med-Arb outweigh its potential costs. In fact, Med-Arb may provide the key to mitigating some of the negative effects resulting from arbitration's current dominance in securities dispute resolution. Because Med-Arb leads to increased use of mediation, it will make the FINRA ADR regime more efficient, thus strengthening it. Although Med-Arb runs the risk of compromising confidentiality during mediation, FINRA has ample tools at its disposal to minimize the negative effects of this problem without significantly eroding Med-Arb's many benefits. The adoption of Med-Arb in securities dispute resolution may not only effectively solve some of FINRA ADR's structural problems, but might also plant seeds that lead to the development of other ADR methods that will further improve securities dispute resolution in the future.