SEC must end mandatory FINRA arbitration, former agency officials say

By Ann Marsh

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Following revelations about falsified evidence used against a federal whistleblower, several former SEC officials and other critics want the commission to put an end to mandatory FINRA arbitration and, instead, allow financial advisors and investors to take their fights with financial firms directly to the courts.

Critics also are calling on the SEC to exercise its oversight over not only the bank involved, JPMorgan Chase, but also the self-regulator for apparently retaliating against the bank's former financial advisor, Johnny Burris. The calls for change come in response to revelations in a *Financial Planning* investigation into FINRA's handling of the Burris case.

"FINRA should not be permitted to run an arbitration program that permits this kind of misconduct," says Lisa Braganca, a former SEC branch chief in the agency's enforcement division in Chicago. "This is why arbitration doesn't work. ... When it's run with so little oversight by the SEC, things like this go wrong and they continue to get worse and worse."

Sen. Chuck Grassley (R-Iowa), speaking at a National Whistleblower Day event in Washington in July, says whistleblowers like financial advisor Johnny Burris should be "protected and rewarded" for exposing wrongdoing. *Clubhill Media*

A study by the Heritage Foundation, a conservative think tank, found that, "Some of the largest firms [regulated by FINRA] have committed multibillion dollar frauds with few consequences for the individuals who committed this fraud." The 2017 study recommended that either FINRA arbitration be farmed out to an independent organization, or all of its proceedings be open to the public, among other sweeping proposed reforms. It called FINRA a "monopoly" with "coercive authority over its members and investors."

Suing in court "should be an option for investors," says Teresa Verges, a former assistant regional director in the SEC's enforcement office in Miami. Verges served for four years on a FINRA committee designed to improve its arbitration process and is now on FINRA's Discovery Task Force, aimed at addressing issues with the production of evidence in arbitration. The director of the investor rights clinic at the University of Miami law school, Verges says advisors like Burris should be able to take their cases to court.

"In the industry cases, too, it's pretty worrisome. We tend to see [arbitrators] favoring the industry," Verges says. Because firms are allowed to strike some potential arbitrators from their cases, arbitrators who want to be chosen for future cases have a strong incentive to build a record of decisions that favor firms, she says.

Sean McKessy, the SEC's former whistleblower chief, joined Braganca and Verges in calling on the commission to end FINRA's forced arbitration. Of the Burris case, he said, "The rational reaction is that something seems to be off."

The SEC had no comment and would not make Peter Driscoll, who oversees FINRA through the commission's Office of Compliance Inspections and Examinations, available to discuss the issues raised. Despite its broad authority over the self-regulator, the commission has only once publicly taken action against FINRA for dereliction of duty, in 2011.

Critics say the transgressions that occurred during Burris' 2014 wrongful termination arbitration illustrate why the SEC needs to step in to reform FINRA. During the proceedings, officers from JPMorgan Chase provided false testimony against Burris, according to documents produced in the investigation. Despite having discovered the bank's false testimony in April 2016, FINRA proceeded with filing its own disciplinary case against Burris based on bank evidence five months later.


CHASE

Former JPMorgan financial advisor Johnny Burris. *Scott Wenger*

It did so even though Burris' complaints about bank practices already had been confirmed by a separate 2015 SEC case in which JPMorgan admitted to harming clients nationwide by not disclosing when it put them into its own managed accounts and high-cost, in-house products.

Despite its admission of guilt in the regulatory cases, JPMorgan has denied in court filings that it engaged in any of the behaviors Burris accused it of committing. In the filings, the bank says it had not mislead arbitrators, and had not been "pushing" or "steering" clients into its own higher-cost investments. It also maintains that it fired Burris for "legitimate [and] nonretaliatory business reasons."

'ABUSES OF POWER'

Sen. Tammy Baldwin (D-Wisconsin), a co-founder of the Senate Whistleblower Caucus, says, "I am concerned by reports that JPMorgan retaliated against a financial advisor who refused to put his elderly clients' savings into inappropriate higher-risk products that earned JPMorgan higher profits. Retirement savers should get investment advice that puts their interests first. That FINRA appears to be joining in the retaliation against the whistleblower raises serious questions about its priorities."

Baldwin has tried to advance legislation that would expand protections for financial whistleblowers, as well as a separate bill that aims to restrict job hopping between the financial world and regulatory agencies.

"Whistleblowers should be protected and rewarded for their courage and bravery in exposing waste, fraud or abuses of power," Sen. Charles Grassley (R-Iowa), another co-founder of the whistleblower caucus, said in response to questions about the Burris case. "Punishing whistleblowers is not only unfair, it also has a chilling effect on potential future whistleblowers who may be deterred from coming forward. These principles not only apply to government, but to every institution that holds the public trust, including major financial institutions." A spokesman says Grassley is considering potential action as a result of the *Financial Planning* investigation of the Burris case.

In response to its critics, FINRA provided the following statement, concluding with its view that the future of mandatory arbitration should be decided by Congress or the SEC: "FINRA's enforcement and arbitration programs are overseen closely by the SEC. FINRA's enforcement actions seek to address clear violations of investor protection rules based on independent investigations, and such actions are all reviewed by senior managers. FINRA's role in the arbitration process is administrative and separate from the enforcement program. As a neutral administrator, FINRA strives to provide a fair and efficient forum for investors, brokers and firms to resolve disputes, and FINRA does not have any input into the outcome of arbitrations. FINRA rules do not require investors or brokers to arbitrate disputes with a firm, but courts have interpreted federal law to protect the use of mandatory arbitration clauses in customer and employee agreements, and any restrictions on such clauses are best addressed by Congress and the SEC."

FINRA bills its arbitration forums as a more-efficient and affordable alternative to the courts for financial clients and advisors. Its private nature ensures confidentiality for clients who don't want their financial lives or losses exposed, while still allowing them to release transcripts of the proceedings if they choose to do so.

However, the process can severely hamper the ability of clients and advisors to receive fair treatment, Verges says. For example, under FINRA rules, firms can decline to produce evidence. Arbitrators, some of whom are predisposed to favor firms, vote to approve or deny a firm's decision, Verges says. That ruling is usually final. The lack of an appeal process — for all decisions, including discovery and final case decisions — locks decisions in place.

"For many [advisors and investors], this is the first time they will bring a case," she says. "But JPMorgans and Merrill Lynches are repeat players. Often, they know the arbitrators."

Despite JPMorgan's admission in a separate case following Burris' whistleblowing that it breached its fiduciary obligations by failing to disclose when it moved client assets into its own products, the only individual who has been punished in Burris' case is Burris himself, the whistleblower.

"When you see that the only person being held accountable in an enforcement action is the person who was trying not to screw over the investors and the person who fabricated the evidence is not being held accountable, I don't see how you don't say something is fundamentally wrong here and we need to fix it," says Barbara Roper, director of investor protection at the Consumer Federation of America.

The revelations in the Burris case are "hair-raising," says Stephen Hall, legal director of the investor advocacy group Better Markets.

They reveal "many of the flaws in the financial system that are hurting millions of investors every day, including the systematic exploitation of clients and gross deficiencies in FINRA's biased, pro-industry and anti-investor arbitration forum," Hall said. "Indeed, FINRA appears more interested in protecting its own by persisting with disciplinary action against a whistleblower while taking little or no action against those at JPMorgan who helped create the phony evidence aimed at destroying the whistleblower's career."

'PRIVATIZED SYSTEM OF JUSTICE'

Individuals forced into arbitration are often stunned by practices behind closed doors that are considered acceptable, says Remington Gregg, an attorney with the investor advocacy group Public Citizen.

"You cannot even appeal an arbitration ruling because the arbitrator got the law wrong, which shocks people," Gregg says. "That's why it's so pernicious. It's a privatized system of justice."

The Heritage Foundation study cites numerous problems with FINRA arbitration, including the lack of due process and that some arbitrators lack training in law or finance. In most cases, arbitrators are not obliged to explain their decisions.

"Given that, under current law, FINRA proceedings supplant a civil trial and there is no means of accessing the courts, FINRA arbitration hearings should be open to the public and reported," the Heritage Foundation study says. "This is analogous to the public trial requirement in the Sixth Amendment and the long-standing presumption that *all* court proceedings in the United States are open to the public." Exceptions to this include instances in which a judge might close a proceeding if, for example, media attention could influence a jury or matters of national security are being discussed.

James Sallah, a former SEC senior enforcement attorney in Miami and a longtime FINRA arbitrator who teaches a class on the SEC at the University of Miami law school, also believes court should be an option in addition to arbitration. "The idea is for the public to witness and judge the process," he says.

During the proceedings detailed in the *Financial Planning* investigation, two JPMorgan compliance officers denied under oath repeatedly that the bank had anything to do with writing up client complaints against Burris when, in fact, another manager had done so.

"At the time that one of our employees testified, she had no idea that another employee had typed up these orally given complaints," JPMorgan said in a statement, adding that the complaints were not solicited or manufactured. Nonetheless, documents included in the *Financial Planning* investigation show the bank was aware that the testimony of this manager, Umbreen Kazmi, was false days after the arbitration ended. When asked why JPMorgan did not correct the record before the arbitrators rendered their decision, the bank did not reply. During the arbitration proceedings, Kazmi was not serving as a witness

offering her own view on what transpired in the case; instead, she was identified in the arbitration as the corporate representative for the bank.

Asked if the Justice Department considered lying under oath in arbitration testimony a crime, a spokesman emailed a link to the U.S. criminal code that defines lying "in any matter within the jurisdiction of the executive, legislative or judicial branch" of the federal government as a felony. FINRA is granted its regulatory authority by Congress. "If anyone has an allegation that a federal crime has been committed, we recommend that they contact their local FBI office," the spokesman added.

WHO'S ACCOUNTABLE?

"The SEC doesn't have a structure for accountability, although they can issue civil sanctions for false statements, but the U.S. Attorney's office does under several criminal statutes," says Tom Devine, legal director of the Government Accountability Project, a group that supports whistleblowers and is representing Burris in a federal lawsuit against JPMorgan, which is set to go to trial in the spring.

Another federal law states that anyone convicted of retaliating against a whistleblower could face up to 10 years in prison. "We've had that law on the books since 1980," Devine says. However, "The Justice Department has never prosecuted an employer for retaliating. The bottom line is there's a vacuum of personal responsibility" among federal officials, FINRA and, in the Burris case, JPMorgan, he says.

Glenn McCormick, an assistant U.S. attorney in Phoenix, where Burris' eight-day wrongful termination arbitration was held, was unfamiliar with the case but said he would refer *Financial Planning's* report to other investigators in his office and to Mike Caputo, the FBI's assistant special agent in charge in Phoenix. "The FBI has broader jurisdiction than the SEC does," McCormick said.

Burris worked out of the bank's office in Sun City West, Arizona, before he was fired in 2012.

Sherron Watkins, the former Enron vice president who blew the whistle on her bosses' notorious accounting fraud that led to the company's 2001 collapse, says Burris' experience shows just how powerless most whistleblowers are when facing their large employers or governmental agencies.

"FINRA strips workers of rights that everyone else has," Watkins says, adding that FINRA "should just be gone."

Michael Ross, a CFP in Boca Raton, Florida, and a FINRA arbitrator for more than 25 years, believes many FINRA arbitrations work well, citing their efficiency, privacy for investors and limits to discovery, which keeps costs down.

But baked into the system are insurmountable failings, Ross argues. Although FINRA is the primary regulator of the brokers and brokerages it oversees, it leaves much front-line regulatory work to firms themselves. That allows banks like JPMorgan, at their own discretion, to place disciplinary marks against their own employees and former employees on their public FINRA BrokerCheck file, which is what JPMorgan did to Burris.

"Your regulator should not be your employer," Ross says. "There's a conflict of interest there."

Following Burris' initial whistleblowing to his superiors in 2012, and then to the media in 2013, he was, according to whistleblower terminology, subjected to "adverse" actions: termination and the placement of disavowed client complaints on his formerly clean FINRA BrokerCheck report.

"That's the root of the problem here," Ross says. "That's why the whole system doesn't work."

The Burris case is not unique, says Braganca, the former SEC official in Chicago who handled 10 cases brought by Puerto Rican investors who sued their advisors at UBS for putting them into inappropriate investments.

The bank's advisors infamously overweighted their clients in closed-end bond funds that were highly leveraged. In the end, thousands of investors cumulatively lost billions of dollars, Braganca says. The losses coincided with the collapse of Puerto Rico's economy.

FINRA's arbitration process compounded the already severe losses of many of those individuals, she says.

Because of the way FINRA arbitration is structured, UBS was able to resist discovery efforts brought by dozens of lawyers on behalf of the first wave of aggrieved Puerto Rican investors, Braganca says. Those cases resembled Burris' because of arbitration's limited provisions for discovery — and the tendency of arbitration panels to rubber stamp firms' refusal to hand over documents — allowed UBS to avoid turning over critical evidence in the earliest arbitration cases, she says.

Over time, continued effort by the investors' lawyers did produce that evidence, much in the same way that key documents revealing JPMorgan's treatment of the Burris case have only emerged over the course of years, she says.

However, when it came to UBS, that didn't help the first wave of investors – who numbered in the hundreds, and were unable to get access to the evidence that supported their cases, Braganca says.

While some investors fared better in court, she says, "the people who were really hurt were those who were stuck in arbitration."

UBS did not respond to questions about these arbitrations.

"There's very little to enforce discovery abuses," says Verges, who handled the UBS Puerto Rico bond case while she was at the SEC. FINRA arbitration, with its emphasis on fast, efficient decisions, was the wrong forum for grievances in a case as complex and sprawling as the UBS scandal, she says. Given that the case involved a systemic policy of product-pushing that emanated from high up in the bank, it made no sense to handle the cases one by one, she says. But that's what FINRA arbitration required, since it makes no provision for class-action cases.

Louis Straney, a securities litigation consultant, who says he served as an expert witness on more than 200 arbitration cases involving UBS investors from Puerto Rican, takes issue with this characterization. Had the UBS cases been handled through a class action suit, some clients with greater losses would have had their restitution diminished by virtue of a decision generalized to suit all aggrieved investors. In many class action cases, Straney says, investors only recover ten cents on the dollar.

For that reason, Straney says, he thinks FINRA's decision to forbid class actions isn't always a bad thing. Given his expertise in demanding discovery, he adds that clients in the cases in which he was involved received the evidence they needed. However, he added, that he could not speak for the rest of the investors involved in the total of approximately 1,500 UBS Puerto Rican cases

That said, Straney agrees with Braganca and others that FINRA arbitration should be ended.

"Arbitration should not be forced, but one of the options that clients could choose," he says, especially given that firms take advantage of arbitration to avoid the steeper challenge of prevailing in court and in class actions.

The problem is not confined to the UBS cases or the Burris case, Braganca says. "This is not just JPMorgan, it happens all the time," she says.

"If FINRA doesn't reopen the case or just reverse the judgment" in Burris' wrongful termination fight and disciplinary case, she argues, "then the SEC should take away arbitration from FINRA."

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Arbitration | Johnny Burris | JPMorgan Chase | Fraud detection | Regulatory actions and programs | FINRA | SEC | Whistleblower

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