

Client Alert

A report
for clients
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of the Firm **January 2009**

FINRA's New Rules "Discourage" Pre-Hearing Motions to Dismiss In Arbitrations

On December 31, 2008, the Securities and Exchange Commission ("SEC") approved rule changes to the Financial Industry Regulatory Authority ("FINRA") Code of Arbitration Procedure which severely curtail a party's right to file a pre-hearing motion to dismiss. These rules could have a major impact on the arbitration strategies employed by firms in the financial services sector and could often result in lengthier — and costlier — arbitrations.

On November 2, 2007, FINRA proposed NASD Rule 12504 of the Code of Arbitration Procedure for Customer Disputes ("Customer Code") and Rule 13504 of the Code of Arbitration Procedure for Industry Disputes ("Industry Code"), which set forth FINRA's position that "Motions to Dismiss a claim prior to the conclusion of a party's case in chief are discouraged in arbitration." *See* NASD Rules 12504(a)(1) and 13504(a)(1). The SEC spent over thirteen months reviewing the proposed rules, and FINRA amended the proposed rules once. During this time, the SEC received approximately one hundred comment letters from industry members, attorneys and other interested parties and extended the period of time to ratify the proposed rules on six occasions.

Ultimately, the SEC adopted Rules 12504 and 13504 as proposed by FINRA. The rules specify only limited circumstances under which an arbitration panel will be permitted to grant a pre-hearing motion to dismiss. Specifically, apart from motions to dismiss based on eligibility, failure to comply with the code or panel order, or discovery abuse (which are expressly codified as grounds for dismissal elsewhere in the FINRA Code of Arbitration Procedure and are referred to in the new

rules), these new rules **preclude** a pre-hearing dismissal, unless the arbitration panel determines that: (i) the opposing party previously signed a release with respect to the claims at issue; or (ii) the moving party was not "associated with the account(s), security(ies), or conduct at issue." NASD Rules 12504(a)(6) and 13504(a)(6).

In addition to restricting the grounds on which a panel can dismiss an action prior to the commencement of a hearing, these rules implement certain new procedures with respect to the filing of pre-hearing motions to dismiss. In particular, parties will be required to file pre-hearing motions to dismiss in writing and after the filing of — and in a separate document from — the answer. *See* NASD Rules 12504(a)(2) and 13504(a)(2). FINRA has also sought to avoid having pre-hearing motions interfere with a hearing schedule, as the new rules require that parties make these motions at least 60 days before a scheduled hearing, and also now require that opposing parties be afforded ample opportunity to respond (at least 45 days). *See* NASD Rules 12504(a)(3) and 13504(a)(3). Moreover, even though a panel can deny a pre-hearing motion to dismiss without first holding a conference, an in-person or telephonic pre-hearing conference will be mandatory before a panel grants a pre-hearing motion to dismiss. *See* NASD Rules 12504(a)(5) and 13504(a)(5).

As a final impediment, these rules impose **penalties** upon a party that, according to the arbitration panel, has taken advantage of motion practice. Although parties routinely reserve the right to re-file a motion to dismiss, pursuant to the rules, a party will not be permitted to re-file a previously denied pre-hearing motion to dismiss without an explicit order from the panel. *See* NASD Rules 12504(a)(8) and 13504(a)(8). Furthermore, in accordance with the rules, a panel will have the power to assess monetary sanctions against a party upon denying its pre-hearing motion to dismiss. Not only do the rules require a party bringing an unsuccessful pre-hearing motion to pay the costs associated with the motion, but the new rules also state that if an arbitration panel determines that a party's

pre-hearing motion to dismiss was frivolous, the panel **must** award costs and attorneys' fees to the opposing party. In addition to these automatic sanctions, the new rules also authorize a panel to sanction a party in other ways that it considers appropriate. See NASD Rules 12504(a)(9) - (11) and 13504(a)(9) - (11).

FINRA's rationale for proposing these rule changes was to ensure that claimants are afforded their right to a hearing in arbitration. FINRA has noted that the rules are necessary to combat an alleged abusive tactic of which some claimants complained: the filing of motions to dismiss in order to delay hearings, intimidate opponents or increase an opposing party's litigation costs. On the other hand, as a result of these new rules, arbitration panels will be powerless from dismissing even the most frivolous of claims that should be thrown out immediately because they are legally defective. This is particularly problematic for employment law claims, which face significant legal hurdles in court. For example, because of these new rules, a respondent will be unable to seek dismissal prior to a hearing of an action that is time-barred, is barred by the doctrine of *res judicata* or, in New York, because the claimant seeks damages for alleged defamatory

language on a Form U-5. In such instances, a party that previously would have moved to dismiss the claims prior to the commencement of the hearing will now have to prepare and participate in an unnecessary and costly hearing, at least until the conclusion of the claimant's case in chief. Frivolous legal claims that would have cost far less (in attorneys' fees and costs) to dispense in court will cost considerably more to address in this (theoretically more efficient and less costly) arbitral forum.

Although there is no timeline for these rules to officially become part of the Customer and Industry Codes, rules typically go into effect anywhere from 30 to 90 days following the SEC's approval. The complete text of these rules can be found on FINRA's website at: <http://www.finra.org/RulesRegulation/RuleFilings/2007RuleFilings/P037392>.

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