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High Arbitration Costs and Confidentiality Burden Claims Against Bad Investment Advisers

By Aaron Cohn

The Wall Street Journal recently ran an article on the high arbitration costs associated with recovering losses from investment advisers. The crux of Jason Zweig's article was captured in its subheading—"Battling with a financial adviser who has wronged you is wildly expensive—and the fight will almost certainly happen in secret. That needs to change."

It certainly does.

The article highlights that confidential arbitrations against investment advisers are projected to exceed $60,000 in many instances, half of which is typically covered by the claimant. That is a large and cost-prohibitive number for most retail investors.

This is our experience as well. My firm, Weinberg Wheeler Hudgins Gunn & Dial, represents dozens of victims of investment fraud in various arbitrations, and the costs and fees in some claims will far surpass $60,000. There is no doubt that many cases require extensive work by the arbitrators, and their fees are reasonable given their efforts, but our clients are retail investors who, in many cases, have very limited means—especially after a significant investment loss. Without the financial resources to meet the high cost of arbitration, these retail investors – who effectively are "consumers" under any normal definition—must forgo bringing a claim or find a firm that can assume the financial risk. Alternatively, investors could outsource the burden to litigation funders, but that then reduces available recovery. It is a no-win situation for the retail investor that benefits bad financial advisers.

To make matters worse, these arbitrations are considered "confidential" by the arbitration services and are subject only to limited disclosures in order to comply with applicable law in a few states. This confidentiality—seemingly innocuous—makes arbitration attractive for advisers who are subject to frequent disputes over their practices. Since the claims and results of arbitrations are not disclosed, it is more difficult for would-be claimants to uncover prior bad acts and actors and the best means of seeking recovery. Confidentiality also allows the bad advisers to continue their schemes long after they have faced other claims.

Courtesy photo

Aaron M. Cohn, partner with Weinberg Wheeler Hudgins Gunn & Dial.

The confidentiality feature of arbitration is strictly enforced by the prominent arbitration services. In some of our recent cases, the issue of confidentiality was raised by the American Arbitration Association (AAA)—the world's largest provider of arbitration and other alternative dispute resolution services. Specifically, we disclosed an expert who intended to testify across eight different arbitrations that involved similar issues and, accordingly, one disclosure was made regarding all eight matters. In response, the AAA demanded eight separate disclosures because its database keeps each arbitration confidential; if one disclosure identified related arbitrations, it would violate the AAA's confidentiality policy.

Another feature of arbitration is that often the award is unappealable. That can be advantageous because it creates finality. On the other hand, it provides no accountability or remedy in the event of a completely unjustified decision. According to the Economic Policy Institute, statistics are alarming for consumers: A very small percentage of consumers who bring an arbitration to a final hearing are successful in obtaining an award or relief. At one point, the number was cited at only 9% for certain types of financial disputes. On its face, that number suggests an institutional bias in favor of businesses, which are the parties selecting the arbitration services that will resolve the disputes.

As for fees, the WSJ article reported that Judicial Arbitration and Mediation Services (JAMS) arbitrators charge up to $1,950 an hour to handle an investment dispute. While perhaps an extreme example, it highlights how costly it can become to bring an investment dispute before this organization. That service, however, may be preferred by advisers looking for confidential arbitration of investment disputes because JAMS' rules state that investment disputes are not subject to the consumer rules, even if it the claimant otherwise would qualify as a consumer. This means that the consumer or retail customer has to split the arbitration fees for an investment dispute unless a waiver applies.

Not all arbitration services impose the same costs. Scott Silver, managing partner of Silver Law Group and a top securities arbitration lawyer, states that Financial Industry Regulatory Authority (FINRA) arbitration can be a cost-effective forum for resolving investment disputes because the forum is subsidized by the brokerage industry. However, Silver notes that these reduced fees must be balanced against investors' fear that the forum is biased because it is beholden to the very industry it is supposed to regulate. He commented that "as investment advisor claims are growing, we are starting to see more contracts which call for arbitration before the AAA or JAMS, which can be cost prohibitive for the average retail investor where costs can easily exceed over $100,000."

Between the confidentiality and the cost associated with pursuing an investment adviser or investment fraud in arbitration, it has become extraordinarily difficult for the ordinary retail investor to initiate dispute resolution and recover from the impacts of bad financial advice and fraud. For most claims to make economic sense, the retail customer or consumer must find a firm that can assume the risk of incurring the costs or seek funding to sue parties that may be hard to collect against.

There are legislative fixes to these problems, including requiring transparency in connection with arbitration and imposing costs and fees on the businesses that require arbitration vis-à-vis retail investors and consumers who file investment disputes. Whether these fixes will ever be adopted remains to be seen.

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