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Securities Arbitration: Background and Questions of Fairness

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Securities Arbitration: Background and Questions of Fairness

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Summary

When an investor has a dispute with a broker-dealer in which damages of a certain size or more are alleged, it may be mediated by a panel of securities industry and non-securities industry arbitrators under the auspices of the NASD. Although the process has been criticized for having a pro-industry bias, research on the issue has not substantiated the bias claims. A smoothly functioning discovery process is integral to the fairness of arbitration hearings. In recent years, in the wake of the market collapse of 2000, there has been a surge in reported abuse of the discovery process largely concerning brokerage firms. Incidents of abuse have attracted the attention of the NASD and others. But due to the persistence of potentially perverse incentives, the efforts of the NASD to remedy the problems may prove to be unsuccessful. This report provides background on the NASD's securities arbitration process, examines concerns over its fairness, and reports on the upcoming merger of the NASD and NYSE Reg, which handles a small fraction of arbitration cases. It will be updated as developments warrant.

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Before 1987, a securities investor's claim against his or her broker for alleged wrongdoing would generally be pursued as a lawsuit against the broker's brokerage firm. But that year, in *Shearson/American Express Inc. v. McMahon* (482 U.S. 220), the Supreme Court upheld the enforceability of agreements to arbitrate investors' claims arising under the Securities Exchange Act of 1934. Since then, arbitration clauses have become an integral part of the contract between investors and brokerage firms. And securities arbitration has become the standard means by which investor complaints are mediated.[1] The arbitration process is primarily overseen by two self regulatory organizations (SROs), the New York Stock Exchange Regulation (NYSE Reg), the regulatory subsidiary of the Euronext New York Stock Exchange Group (which owns the

[1] In May 2007, Chairman Patrick Leahy and Senator Russ Feingold of the Senate Judiciary Committee wrote to SEC Chairman Cox, saying that because of the prevalence of mandatory arbitration clauses in brokerage contracts, the SEC should issue rules that better enabled investors to freely choose between arbitration and the courts to address their grievances.

New York Stock Exchange) and the NASD,[2] which also regulates broker-dealers. The Securities and Exchange Commission has substantial oversight over SROs through the Securities and Exchange Act of 1934.

Although the securities arbitration process has been described as relatively fast, efficient, flexible, and inexpensive, there are some concerns over its fairness. These concerns were aired during a hearing held by the House Financial Services Capital Markets Subcommittee in March 2005.[3]

This report begins with an introductory background look at securities arbitration overseen by the NASD, which received 6,000 case submissions in 2005, and handles more than 90% of such cases nationwide. (NYSE Reg presides over most of the remaining cases.) The report then provides an examination of criticism of its fairness and

The Basics of the Securities Arbitration Process

Securities arbitrations can take a number of forms. These forms are dependent on a number of factors, including the size of an investor's claim, and whether the investor opts for voluntary mediation over going before arbitrators. The variety of factors that shape the process is discussed below.

In securities arbitration, investors with cases involving less than $25,000 in claims go through "simplified" arbitration, in which an investor submits his allegations to a single arbitrator who then makes a written decision without resort to a hearing. For grievances of up to $50,000, a single arbitrator conducts the hearing, unless the investor requests a three-member panel. If the claim exceeds $50,000, the case automatically goes to a three-member panel.

Three-member panels are composed of one non-public arbitrator who is currently employed by the securities industry, and two public arbitrators with no current affiliation with the securities industry. Historically, the rationale for having a non-public arbitrator was that such a person would provide valuable insight into the inner workings of brokerage firms. The rationale for the public arbitrators was that they would inject a greater measure of independence into the process.

Some investors who submit to securities arbitration engage an attorney who generally operates on a contingency basis, while others opt to represent themselves. By contrast, brokerage firms always use attorneys to defend themselves.

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[2] The NASD was formerly known as the National Association of Securities Dealers, Inc.

[3] The hearing was held at the request of Rep. Barney Frank, then ranking member of the House Financial Services Committee (and now its Chairman), who said that the arbitration system was not in crisis but that there were some issues worth exploring. Rep. Richard Baker, chairman of the Financial Services Subcommittee on Capital Markets, which held the hearing, remarked that the system appeared to be sound. *House Committee on Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises Holds a Hearing on the Securities Arbitration Process*, March 17, 2005.

Investors who submit to securities arbitration can opt for voluntary mediation, an informal non-binding process in which a mediator facilitates negotiations between disputants. The mediation can be initiated at any stage of the arbitration process, and according to the NASD results in settlements more than 80% of the time.

If there is no settlement, the dispute proceeds to an arbitrator deliberated process. An investor prevails if a majority of the arbitrators on a three- member panel, or the single member of a one-member panel, decide to direct the brokerage firm to award the claimant some or all of the claims against it. Decisions made in arbitrations are generally final.

The people who populate arbitration panels are drawn from a nationwide pool of some 7,000 potential arbitrators. The much smaller potential pool for each three-member panel is initially selected by the NASD's arbitrator selection system, which provides the two parties to a dispute with the names of 15 potential arbitrators — 10 public and five non-public — to choose from. The two disputants can then make an unlimited number of "peremptory challenges" to "strike" any arbitrators for any reasons. After the peremptories, the remaining arbitrators are eligible for appointment to the panel. If more than the necessary number of arbitrators remain on the list, the panelists are selected on the basis of earlier rankings by the disputants. If any vacancies still remain, they are filled by arbitrators who are selected on a rotational basis by the selection process's computer system.

Non-public arbitrators are currently employed by a brokerage or securities firm. While many public arbitrators have never had any affiliation with the brokerage business, a person can qualify as a public arbitrator if he or she has held a job in the brokerage industry for fewer than 20 years and has been out of the business for at least five years. The NASD also permits accountants and lawyers to be public arbitrators if they receive less than 10% of their income from brokerage clients.

Key Criticisms

A number of observers, including William Galvin, secretary of the Commonwealth of Massachusetts, New York State Attorney General Eliot Spitzer, and representatives from the Public Investors Arbitration Bar Association, the trade group for lawyers who represent investors, have criticized aspects of the arbitration process for injecting a pro-industry bias into the hearings' outcomes. Key criticisms include

- the presence of the mandatory non-public (industry) arbitrator, which some say introduces a pro-industry bias into the process; and
- the existence of an overly expansive definition of who qualifies as a "public" arbitrator. Retired individuals who formerly worked for a brokerage firm for a number of years can serve as public arbitrators. And in an era that has seen significant consolidation of various parts of the financial services industry, some non-securities financial service workers may be employed by a firm (like an insurance or banking firm) that is under the same financial conglomerate ownership as a brokerage firm. NASD rules allow such workers to serve as public arbitrators, which

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raises some potentially credible questions over the possibility of pro-industry bias.

Some commentary and research on evidence of a pro-brokerage industry bias in NASD securities arbitrations are discussed below. Generally, there appears to be *little concrete evidence of a pro-industry bias*. But the evidence that the arbitration process is *devoid of a pro-industry bias* does not appear to be definitive.

Arbitration panels rule a majority of the time in favor of investors. Attempting to rebut criticism that the arbitration process has a pro-industry bias, NASD officials observe that in 2004, the SRO's arbitration panels ruled for investors in 55% of arbitrations, a percentage roughly comparable to those in previous years. But the fact that the arbitrators tend to rule somewhat more than half of the time for investors may not reveal much. It is not known whether 60% or 70% (or 40% for that matter) of the arbitrated cases may have actually merited rulings favorable to investors. In addition, when an investor wins a securities arbitration case, there is a monetary award that the brokerage firm is directed to pay. According to a number of investor attorneys, there is a de facto "common law" at the NASD that says that even in the most compelling cases, awards generally shall not exceed half of an investor's claim, which NASD officials refute.[4] Others, however, say that monetary awards that tend to "split the difference" are commonplace in the world of arbitration.[5] This suggests that the NASD awards are not inconsistent with awards in the realm of arbitration but it has nothing to say about whether there is pro-industry bias. Indeed, to the extent that the securities arbitration award process tends to conform to such a model, various NASD arbitrated cases in which investors deserved more than they got one could probably be found, and various cases in which investors probably got less than they actually deserved.

Public and non-public arbitrators tend to reach unanimous decisions. In another rebuttal to the pro-industry charge, NASD officials cite the fact that 98% of NASD securities arbitrations result in unanimous verdicts, which is said to be an indication that public and non-public arbitrators are almost always "on the same page" in their decision making. The statistic appears to provide at least some support for the view that the outcomes in the arbitration process do not reflect the presence of a pro-industry bias.[6]

The vast majority of those involved in NASD arbitration view the process as fair. Defenders of the arbitration process's fairness also cite a NASD survey and a follow-up study involving participants in 2,037 arbitration cases between December 1997 and April 1999. The participants were roughly divided between investors and their representatives and the representatives of securities firms. After analyzing the NASD

[4] Gary Weiss, "Walled Off From Justice?," *Business Week*, March 22, 2004, p. 90.

[5] For example, see Henry Farber, "Splitting-the-Difference in Interest Arbitration," *Industrial and Labor Relations Review*, vol. 35, no. 1, 1981. Orley Ashenfelter and David E. Bloom, "Models of Arbitrator Behavior: Theory and Evidence," *American Economic Review*, March 1984, pp. 111-124. The NASD does not supply data on the size of awards relative to the amounts sought.

[6] However, NASD officials have acknowledged that the mandatory training that all arbitrators are required to have focuses on procedural, not substantive issues related to the mechanics of investor trades. In addition, some investors' attorneys have spoken of encountering many public arbitrators who appear to be essentially clueless about investment basics.

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study, the U.S. Military Academy at West Point reported that 93% of the respondents concluded that the process was fair.[7] This would appear to indicate that there was a significant amount of satisfaction with the process on the part of a large proportion of winning and losing investors, which also provides some support for those who deny the presence of an industry bias.

Securities arbitrations on the NASD and arbitrations outside of the securities industry provided roughly similar outcomes. A 1992 study by the Government Accountability Office (GAO)[8] analyzed securities arbitrations between January 1989 and June 1990. The cases were divided between those arbitrated by an SRO like the NASD and those that were brought before the American Arbitration Association (AAA), an independent mediating organization that has no connection with a SRO or any securities industry group. The study found that investors prevailed in the SRO-based arbitrations 59% of the time and prevailed an almost identical 60% of the time in arbitrations before the AAA. It also found that when investors prevailed in SRO arbitrations, they recovered approximately 61% of their claimed damages compared to 57% in the AAA arbitrations. These results lend some support for the absence of a pro-industry bias in the process.

The GAO study was, however, conducted a decade and a half ago and since then, there have been a number of changes to the arbitration process. Some of the changes have involved reforms that have removed some potentially pro-industry facets of the arbitration protocol. For example, since the GAO study was conducted (1) a public arbitrator must be retired from the securities industry for at least five years compared with the earlier requirement of at least three years; and (2) investors or their representatives were given the opportunity to take part in the selection of the arbitrators who are to preside over their hearing. But by various accounts, one part of the process that can have a corrosive effect on its fairness, abuse in the discovery process, has been growing. This is discussed below.

Abuse in the Discovery Process and Some Response

The securities arbitration process is dependent on the free exchange of documents pivotal to the case being arbitrated, a process known as discovery. In the wake of the stock market collapse of 2000, there has been an explosion in the numbers of securities arbitration cases (and apparently the number of frivolous cases). Accompanying this explosion, and the doubling of the number of annual arbitrations, since the collapse, has been a surge in the incidence of reported discovery abuse.[9] The abuse often takes the

[7] David Robbins, ed., *Securities Arbitration 2000, Today's Trends, Predictions for Tomorrow* (Practicing Law Institute, 2000), p. 153.

[8] U.S. General Accounting Office, *Securities Arbitration: How Investors Fare*, GAO/GGD-92-74, May 11, 1992, p. 6. At the time of the study, the agency was known as the General Accounting Office.

[9] For example, see William S. Shepherd, "Ending Discovery Abuse in Securities Arbitration," *Texas Lawyer*, September 20, 2004, p. 27. "NASD Sparks Controversy as it Seeks to Address Discovery Abuse During Arbitrations," *Securities Week*, November 17, 2003, p. 1. Emily Thornton, "The Brokers Strike Back; They're Dragging Their Feet in Investor Cases and Suing Ex-Customers for Damages," *Business Week*, August 16, 2004, p. 70. Discovery abuse from the investor side is, however, not uncommon but most key documents tends to be held by securities firms.

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form of a securities firm's lawyer prolonging the release of or withholding documents deemed necessary for evidentiary purposes. As a result, cases can be dragged out and complainants can be worn down. The resulting evidentiary shortfalls, which may also have other causes, and should reduce an investor's odd of winning.[10]

NASD officials have acknowledged that discovery abuse is an issue at the NASD. But they also indicate that they are getting a grip on the problem. For example, they noted that in 2003, the NASD formally reminded brokerage firms of their obligation to comply with NASD discovery rules and procedures for production of documents and materials in arbitration claims. The reminders emphasized the NASD's intent to monitor the firms' ongoing compliance with the discovery rules as well as its willingness to refer perceived cases of discovery abuses to its enforcement side for investigation. NASD officials have also noted that in 2004, the NASD censured and fined three registered brokerage firms a total of $750,000 for failing to comply with their discovery obligations in 20 arbitration cases between 2002 and 2004.

In April 2006, the NASD provided the SEC with proposed revisions to its arbitration codes, which are designed to improve the arbitration process and reduce discovery abuses. Approved by the agency in early 2007, the revisions include provisions that (1) require NASD arbitrators to meet specific training or experience standards in order to serve as panel chairpersons; (2) codify discovery guidelines to clarify the fact that complying with the discovery rules is mandatory — and authorizes arbitrators to impose sanctions for noncompliance; and (3) give the contending parties greater control over the selection process by increasing the number of arbitrators they may choose from, while limiting the number of arbitrator strikes that each may exercise.

The NYSE Reg-NASD Merger

Approximately 200 broker-dealers are both members of the NASD and the NYSE (which exclusively regulates their financial and operational affairs) and have their sales practices regulated by both NYSE Reg and the NASD. In the fall of 2006, to eliminate the dual regulation's unnecessary costs on broker-dealers, the NASD and NYSE Reg agreed to merge their broker-dealer member regulatory operations. The merger, which must be approved by the SEC, would also involve the creation of a single securities arbitration venue. And it appears that the unified arbitration mechanism will be under current NASD arbitration rules and leadership. SEC officials have generally lent their support to the union, which regulatory officials project will be physically completed by the end of the second quarter of 2007.

[10] For example, see William S. Shepherd, "Ending Discovery Abuse in Securities Arbitration," *Texas Lawyer*, September 20, 2004, p. 27. "NASD Sparks Controversy as it Seeks to Address Discovery Abuse During Arbitrations," *Securities Week*, November 17, 2003, p. 1. Emily Thornton, "The Brokers Strike Back; They're Dragging Their Feet in Investor Cases and Suing Ex-Customers for Damages," *Business Week*, August 16, 2004, p. 70. Discovery abuse from the investor side is, however, not uncommon but most key documents tend to be held by securities firms.

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