FAIRNESS IS IN THE EYES OF THE BEHOLDER

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I. INTRODUCTION

This article discusses whether the 2007 *Reorganization and Revision of the NASD Rules Relating to Customer Disputes* ("the 2007 NASD Code Revision"[2]) and other recent developments in the area of securities arbitration provide support or undermine the underlying principal arguments for the enforcement of mandatory pre-dispute securities arbitration agreements as expressed by *Shearson/American Express, Inc. v. McMahon*.[3]

This article examines the Supreme Court decisions concerning the adequacy of the SRO arbitration forum and concludes whether, after two decades of SRO securities arbitration conducted post-*McMahon*, the statutory authority exercised by the U.S. Securities and Exchange

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[2] See Reorganization and Revision of NASD Rules Relating to Customer Disputes, File No. SR-NASD-2003-158 (October 15, 2003); Notice of Filing of Proposed Rule Change and Amendments 1-4 to Amend NASD Arbitration Rules for Customer Disputes, Exchange Act Release No. 51,856, 70 Fed. Reg. 36442 (June 15, 2005) (The NASD is an acronym for the National Association of Securities Dealers, Inc., a self-regulatory organization ("SRO"). The NASD initially filed the 2007 NASD Code Revision on October 15, 2003 and, after several amendments by the NASD, it was subsequently approved by the SEC on January 24, 2007); see Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573 (January 24, 2007); NASD Code of Arbitration Procedure for Customer Disputes, available at http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p018365.pdf.

[3] 482 U.S. 220 (1987).

Commission ("SEC") relating to the NASD's Code of Arbitration[4] has been adequate to "vindicate Exchange Act rights," or instead, has resulted in the current judicial enforcement of mandatory pre-dispute securities arbitration agreements which improperly waives compliance with the substantive

[4]The NASD described itself as the "world's pre-eminent private sector securities regulator" and the operator of "the largest dispute resolution forum in the world to assist in the resolution of monetary and business disputes involving investors, securities firms, and individual brokers." The Securities Arbitration System: Hearing Before the Subcomm. on Capital Mkt.s, Ins. and Gov't Sponsored Enter.s of the Comm. On Fin. Services, 109th Cong. 32 (2005) (Prepared Statement of Linda D. Fienberg, President of NASD Dispute Resolution). On July 26, 2007, the SEC approved the consolidation of the NASD and the New York Stock Exchange's member regulation, enforcement and arbitration operations, with the surviving entity now known as the Financial Industry Regulatory Authority ("FINRA") (Press Release, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority (July 30, 2007), available at http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P036329). FINRA states the following on its website concerning its operations and creation:

The Financial Industry Regulatory Authority (FINRA), (sic) is the largest non-governmental regulator for all securities firms doing business in the United States. All told, FINRA oversees nearly 5,100 brokerage firms, about 173,000 branch offices and more than 665,000 registered securities representatives.

Created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange, FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complimentary compliance and technology-based services.

FINRA touches virtually every aspect of the securities business – from registering and educating industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. It also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange.

FINRA has approximately 3,000 employees and operates from Washington, DC, and New York, NY, with 15 District Offices around the country.

Available at http://www.finra.org/AboutFINRA/CorporateInformation/index.htm (bold emphasis supplied). The SEC currently discloses that it has about 3,100 staff members operating out of Washington, DC and 11 regional offices throughout the United States. Available at http://sec.gov/about/whatwedo.shtml. Thus, the size and breadth of FINRA is arguably comparable with that of the SEC. FINRA, via its wholly owned subsidiary, FINRA Dispute Resolution, is the self-proclaimed operator of "the largest dispute resolution forum in the securities industry to assist in the resolution of monetary and business disputes between and among investors, securities firms, and individual registered representatives." Available at http://www.finra.org/ArbitrationMediation/index.htm.

provisions of the Securities Act of 1933[5] ("the 1933 Act") and the Securities Exchange Act of 1934[6] ("the 1934 Act") regarding investor protection.

This article examines the evolution of securities arbitration. Particular attention is paid to the NASD Code of Arbitration, its recent revisions and currently proposed rules concerning motions, sanctions, discovery, arbitrator classification, and the use of "explained decisions" concerning arbitration awards. The NASD's recent consideration of dispositive motions is reviewed along with the perception of industry arbitrator bias.

The creation of FINRA, via the 2007 merger of the NASD and the NYSE's member regulation, enforcement and arbitration operations, is examined along with the SICA's Public Members' stated opposition to this combination and the NASD's rebuttal argument thereto, as well as the SEC's order approving the consolidation.[7]

Archetypical arguments, pro and con, regarding the fairness of NASD securities arbitration are highlighted along with the declining trend of NASD arbitration decisions awarding investors their compensatory damages. The potential for, and effect of, future Congressional action regarding the NASD arbitration process is also discussed, with particular emphasis concerning the recently filed *Arbitration Fairness Act of 2007*[8] which, if enacted, would abolish pre-dispute mandatory securities arbitration agreements.

Finally, recommendations are made for future revisions of the Code in an effort to fulfill and justify *McMahon*'s belief that NASD securities arbitration really does provide the investor with the protections intended by Congress when it enacted the 1933 Act and the 1934 Act.

The creation of FINRA notwithstanding, for clarity's sake the Author

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[5] Securities Act of 1933, Pub. L. No. 73-72, 48 Stat. 74

[6] Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881.

[7] On July 26, 2007, the SEC approved the consolidation of the NASD and the member regulation, enforcement and arbitration operations of the New York Stock Exchange. The SEC's order was effective July 30, 2007, with the surviving entity to be known as the Financial Industry Regulatory Authority ("FINRA"). See Press Release, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority (July 30, 2007), available at http://www.finra.org/PressRoom/
NewsReleases/2007NewsReleases/P036329.

[8] Arbitration Fairness Act of 2007, H.R. 3010, 110th Cong., 1st Sess. (2007). The companion Senate Bill is S. 1782, 110th Cong., 1st Sess. (2007).

will continue to refer to NASD arbitration as "NASD" arbitration rather than "FINRA" arbitration, except as appropriate; typical exceptions include this article's examination of the NASD – NYSE regulatory merger as well as the Conclusion.

II. *MCMAHON* AND THE BASIC PREMISE REGARDING BINDING SECURITIES ARBITRATION AGREEMENTS

Prior to the 1987 *McMahon* decision, it was generally well-settled that agreements to arbitrate disputes between a broker-dealer and its customer were not binding regarding violations of the federal securities laws. Thirty-three years earlier, in *Wilko v. Swan*,[9] the Court decided the issue of:

whether an agreement to arbitrate a future controversy is a 'condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision' of the Securities Act which § 14 declares 'void.'[10]

The specific statutory framework affected by the *Wilko* decision concerned the relationship between the 1933 Act and the Federal Arbitration Act ("the FAA").[11]

The petitioner's primary argument in *Wilko* was that the compulsory arbitration clauses in the customer's agreements signed by the petitioner and the respondents were void under the non-waiver provisions of the 1933 Act and that the FAA was inapplicable because of the overriding provisions

[9] 346 U.S. 427 (1953). In Wilko, the petitioner was a brokerage customer of the respondents. Respondents, being stockbrokers and dealers in securities, were subject to the Securities Act of 1933. Petitioner brought suit for damages of $3,888.88 under Section 12(2) of the Securities Act of 1933 relating to an equity transaction. The complaint alleged that the sale "was made by means of communications by the defendants to the plaintiff which were [misleading] and, which included untrue statements of material facts and omitted to state material facts necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading." Brief of Respondents-Appellants at 4, Wilko v. Swan, 346 U.S. 427 (1953) (No. 53-39), 1953 WL 78484. The respondent moved to stay the trial of the action pursuant to § 3 of the FAA until an arbitration was held pursuant to customer account agreements executed between the parties which incorporated terms of mandatory arbitration of any controversy arising under the contracts. See Wilko, 346 U.S. 427, at 429.

[10] Wilko, 346 U.S. at 430.

[11] The Court in Wilko specifically stated that they granted certiorari "to review this important and novel federal question affecting both the Securities Act and the United States Arbitration Act." Wilko, 346 U.S. at 430.

of the 1933 Act.[12] In particular, § 14 of the 1933 Act provided that: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."[13]

The respondents countered by arguing that no conflict existed between the FAA and the 1933 Act.[14] While the respondents conceded that the provisions of § 14 of the 1933 Act voided any agreement which waived compliance with the substantive provisions of the 1933 Act, the respondents argued that § 14 did not void an agreement relating to a security buyer's *remedies* when there had been a failure of compliance on the part of the seller.[15] The respondents argued that arbitration was merely a *form* of trial to be used instead of a trial at law, and therefore no conflict existed between the 1933 Act and the FAA, either in their language or respective Congressional purposes.[16]

The SEC filed an *amicus* brief in *Wilko* in which it strongly argued that a pre-dispute arbitration agreement deprives a customer of the 1933 Act's special court remedies intended by Congress.[17] These remedies afforded by the 1933 Act included the following: § 12(2) placed the burden of proof with the defendant to prove a lack of *scienter*;[18] § 22(a) provided the investor the opportunity to bring suit in "any court of competent jurisdiction—-federal or state;" that an action filed in state court could not be removed to federal court;[19] and if the action is filed in federal court, then the investor is afforded "a broad choice of venue, with the privilege of nation-wide service of process, and need not comply with the $3,000.00

[12] Brief of Petitioners-Appellees at 5, Wilko v. Swan, 346 U.S. 427 (1953) (No. 53-39), 1953 WL 78483.

[13] Securities Act of 1933 § 14, 15 U.S.C. 77n.

[14] Brief of Respondents-Appellants at 7, Wilko v. Swan, 346 U.S. 427 (1953) (No. 53-39), 1953 WL 78484.

[15] See Brief of Respondents-Appellants at 7, Wilko, 346 U.S. 427 (1953) (No. 53-39), 1953 WL 78484.

[16] Wilko, 346 U.S. at 433.

[17] Brief for SEC as Amicus Curiae Supporting Petitioners-Appellees at 11, Wilko v. Swan, 346 U.S. 427 (1953) (No. 53-39) , 1953 WL 78482.

[18] SEC Amicus Brief at 16, Wilko, 346 U.S. 427 (1953) (No. 53-39) , 1953 WL 78482 (". . . the burden of proof is shifted to the defendant seller who must 'prove he did not know, and in the exercise of reasonable care could not have known of [the] untruth or omission.").

[19] Id. at 17.

requirement of diversity cases."[20] The SEC argued that § 14 of the 1933 Act precluded the waiver of these rights.[21]

The SEC also argued that public policy prohibited the enforcement of agreements limiting or preventing access to the courts "where the statutory rights involved, although conferred on a private party, are affected by the public interest," and that § 12(2) qualified under this principle given that a primary purpose of the 1933 Act was: "to curb the "wanton misdirection of the capital resources of the Nation" which had resulted in large measure from sales of securities to the public without adequate disclosures of the relevant facts and frequently by positive misrepresentations."[22]

The SEC's amicus brief attacked the very concept that an arbitration forum assured an investor that his or her statutory rights under the 1933 Act would be protected.[23] The SEC stated that the intent of the 1933 Act was to protect the less informed members of the public against securities professionals given the industry's past history of frequent misrepresentations and the extreme difficulty for the investor to obtain proper redress under pre-existing law.[24]

The SEC also recited a specific litany of advantages provided by the statute's special court remedies which are not available in arbitration, and which are still voiced by present day critics of the securities arbitration process.[25] These advantages, according to the SEC, included the rights to have:

> . . . judges decide questions of law subject to appellate review, to have issues of fact established by competent and relevant evidence, and to have such issues determined by a jury unless a jury is waived. In arbitration, however, as Judge Learned Hand has stated, the parties 'must content themselves with looser approximations to the enforcement of their rights than those that the law accords them, when they resort to its machinery.' . . . the arbitrators would ordinarily be laymen who would hear and decide the

[20] Id. at 17-18.
[21] Id. at 18-19.
[22] Id. at 25.
[23] Id. at 30.
[24] Id. at 33.
[25] Id. at 34-35.

> customer's claim without reference to technical rules of law of procedure, the principles of correct measure of damages. . . . Finally, as Judge Clark observed in his dissent, it is improbable that industry arbitrators would give "the customer that objective and sympathetic consideration of his claim envisaged by the Securities Act" . . .[26]

The Supreme Court's decision in *Wilko* adopted many of the arguments made by the petitioner and the SEC.[27] The Court stated that the policy of the 1933 Act was to protect investors by requiring full and fair disclosure of securities transactions and to prevent fraud in their sale.[28] The Court cited the enactment of a "special right" which included making the seller assume the burden of proving its lack of scienter; [29] that the "special right" was enforceable in any court of competent jurisdiction, federal or state; that removal from a state court was prohibited; and if suit were brought in federal court, the purchaser would have a wide choice of venue, the privilege of nation-wide service of process, and that the jurisdictional

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[26] Id. at 34-35.

[27] Wilko v. Swan, 346 U.S. 427, 431 (1953).

[28] Id. at 431.

[29] § 12(2) of the 1933 Act provides that any person who:

sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of section 77c of this title), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Securities Act of 1933 § 12(2), 15 U.S.C. § 77l. The Court in Wilko cited the Congressional Record regarding the seller's burden of proof concerning scienter:

'Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance. * * * To impose a lesser responsibility would nullify the purposes of this legislation.' H.R.Rep.No.85, 73d Cong., 1st Sess. 9-10.

Wilko, 346 U.S. at 431.

$3,000 requirement of diversity cases would be inapplicable. [30]

While generally looking upon arbitration with favor,[31] the Court's analysis in *Wilko* nonetheless cited to both §§ 14 and 22(a) of the 1933 Act in reaching its decision that the arbitration agreements at issue were void regarding claims under the 1933 Act.[32] In particular, the Court quoted the following language of § 22(a) of the 1933 Act:

> 'The district courts of the United States * * * shall have jurisdiction * * * concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections (1292-93) and (1254) of Title 28. No case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States. * * *'[33]

The Court in *Wilko* further stated that the language found in § 14 voids a stipulation waiving compliance with any provision of the 1933 Act, including the provision conferring the right to select the judicial forum.[34]

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[30] Wilko, 346 U.S. at 431.

[31] The Court in Wilko stated that the FAA's statutory scheme established the "desirability of arbitration as an alternative to the complications of litigation," and that Congress had stressed the need for avoiding the delay and expense of litigation. Wilko, 346 U.S. 427, 431. The Court also stated that arbitration under the FAA's terms raised the hope for its usefulness both in "controversies based on statutes or on standards otherwise created." Id. at 431-32.

[32] See Wilko, 346 U.S. at 434-35 ("This arrangement to arbitrate is a 'stipulation,' and we think the right to select the judicial forum [under § 22(a)] is the kind of 'provision' that cannot be waived under s 14 of the Securities Act.").

[33] Id. at 433.

[34] The Wilko Court also buttressed its decision by stating that Congress, via the 1933 Act, considered the buyers of securities to be different from the typical commercial buyer due to the "disadvantages under which the buyers labor" due to issuers and dealers of securities having greater opportunities to investigate and appraise "prospective earnings and business plans . . ." Id.

While the Court in *Wilko* conceded that the 1933 Act would still apply in the arbitration context, the *application* of the provisions of the 1933 Act in arbitration would not be equal to that of a judicial proceeding.[35] Of particular note, the Court discussed the following areas, *which are still* inherent in securities arbitration, as creating this inequality as compared to a judicial proceeding; an arbitrator has to make subjective findings on the purpose and knowledge of an alleged violator of the 1933 Act, and apply such findings without judicial instructions on the law; given that an arbitration award may be made without an explanation of the reasons behind it, and without a complete record of the proceedings, a review of the arbitrators' conception of the legal meanings of statutory requirements involving burden of proof, reasonable care, and material fact can not be properly examined; and, the power of the courts to vacate an award was limited.[36]

The Court in *Wilko* ultimately held that "the intention of Congress concerning the sale of securities is better carried out by holding invalid an agreement for arbitration of issues arising under the [1933] Act."[37]

A. The Application of Wilko to the 1934 Act

Between 1977 and 1986, eight Circuit Courts of Appeal followed *Wilko*'s analysis and held that pre-dispute securities arbitration agreements involving 1934 Act claims were unenforceable waivers of compliance with the Act's substantive provisions.[38] However, in 1986 the First and Eighth Circuits upheld the enforcement of mandatory pre-dispute securities arbitration agreements involving the 1934 Act.[39] During this time period,

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at 435.

[35] Id. at 435.

[36] Id. at 435-36.

[37] Id. at 438.

[38] Brief for Respondents-Appellants at 5, Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44), 1987 WL 880930. Id. at 8-9 (citing Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 797 F.2d 1197 (3d Cir. 1986); Mayaja, Inc. v. Bodkin, 803 F.2d 157 (5th Cir. 1986); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 558 F.2d 831 (7th Cir. 1977); Conover v. Dean Witter Reynolds, Inc., 794 F.2d 520 (9th Cir. 1986); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore, 590 F.2d 823 (10th Cir. 1978); Wolfe v. E.F. Hutton & Co., 800 F.2d 1032 (11th Cir. 1986) (en banc)).

[39] See Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc., 806 F.2d 291(1st Cir. 1986);

the validity of applying *Wilko* analysis to pre-dispute arbitration agreements regarding § 10(b) claims under the 1934 Act was also being thrown into question by the Supreme Court in its 1974 decision in *Scherk v. Alberto-Culver Co.*[40] and its 1985 decision in *Dean Witter Reynolds Inc. v. Byrd*.[41]

Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 795 F.2d 1393 (8th Cir. 1986).

[40] 417 U.S. 506 (1974). The Supreme Court held that a pre-dispute international arbitration agreement was of such international stature, given that the underlying agreement was entered into between two large corporations in which the respondent was an American corporation and the petitioner a German citizen, the negotiations took place in the United States, England, and Germany, the signing took place in Austria and the closing in Switzerland, and the underlying transaction concerned the sale of businesses organized under the laws of European countries, that it was enforceable regarding § 10(b) claims under the 1934 Act and was not subject to the Wilko carve-out exception to the FAA. However, the Court further stated in dicta that a "colorable argument" could be made that Wilko was not controlling for a § 10(b) claim given that there was no statutory counterpart to the special right of a private remedy for civil liability under § 12(2) of the Securities Act of 1933, nor was the jurisdictional provision under the 1934 Act as broad as the 1933 Act in that it did not include a preclusion of removal from state court.

[41] 470 U.S. 213 (1985). The matter involved an aggrieved investor filing suit in federal district court. The investor alleged both federal and state securities law violations against his broker-dealer. The Supreme Court held that the FAA mandated the arbitration of pendent arbitrable claims even though this could result in bifurcated proceedings involving the arbitration of the pendent claims and the litigation of the federal securities claims. Id. at 224. Justice Marshall, writing for the majority in Byrd, stated the following dicta in a footnote:

In Wilko v. Swan… this Court held that a pre-dispute agreement to arbitrate claims that arise under § 12(2) of the Securities Act of 1933 … was not enforceable. . . . Years later, in Scherk v. Alberto-Culver Co. … this Court questioned the applicability of Wilko to a claim arising under § 10(b) of the Securities Exchange Act of 1934, or under Rule 10b-5, because the provisions of the 1933 and 1934 Acts differ, and because, unlike § 12(2) of the 1933 Act, § 10(b) of the 1934 Act does not expressly give rise to a private cause of action. 417 U.S., at 512-513, 94 S.Ct., at 2453-2454. The Court did not, however, hold that Wilko would not apply in the context of a § 10(b) or Rule 10b-5 claim, and Wilko has retained considerable vitality in the lower federal courts . . .

Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 215 n.1 (1985). Justice White wrote the following in a concurring opinion:

The premise of the controversy before us is that respondent's claims under the Securities Exchange Act of 1934 are not arbitrable, notwithstanding the contrary agreement of the parties. The Court's opinion rightly concludes that the question whether that is so is not before us. . . . Nonetheless, I note that this is a matter of substantial doubt.. . .

Wilko's reasoning cannot be mechanically transplanted to the 1934 Act. While § 29 of that Act, 15 U.S.C. § 78cc(a), is equivalent to § 14 of the 1933 Act, counterparts of the other two provisions are imperfect or absent altogether. Jurisdiction under the 1934 Act is narrower, being restricted to the federal courts. 15 U.S.C. § 78aa. More important, the cause of action under § 10(b) and Rule 10b-5, involved here, . . . is implied rather than express. . . . The phrase "waive compliance with any provision of this chapter," . . . is thus literally inapplicable. Moreover, Wilko ' s solicitude for

Shortly thereafter, the Supreme Court issued the *McMahon* decision.

B. McMahon and the SEC

In *Shearson/American Express, Inc. v. McMahon*, the Court was presented a petition for certiorari from a Second Circuit decision[42] involving, among other issues, whether a pre-dispute arbitration claim could be enforced to arbitrate claims under § 10(b) of the 1934 Act. The resulting Supreme Court decision held that pre-dispute arbitration agreements involving § 10(b) claims under the 1934 Act were enforceable.[43]

In *McMahon*, the SEC once again filed an amicus brief.[44] However, in a substantial change of direction from its views expressed in *Wilko*, the SEC

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the federal cause of action-the "special right" established by Congress, . . . is not necessarily appropriate where the cause of action is judicially implied and not so different from the common-law action. . . .

The Court has expressed these reservations before. Scherk v. Alberto-Culver Co., 417 U.S. 506, 513-514, 94 S.Ct. 2449, 2454, 41 L.Ed.2d 270 (1974). I reiterate them to emphasize that the question remains open, and the contrary holdings of the lower courts must be viewed with some doubt.

Byrd, 470 U.S. at 224-25.

While the Court in Byrd chose not to address the issue of whether a § 10(b) claim was arbitrable under a pre-dispute arbitration agreement because the defendant broker-dealer did not seek to compel arbitration of the federal securities claims and therefore this issue was not properly before the Court. Id. at 216, the Court in Byrd left little doubt that a pre-dispute arbitration agreement involving a § 10(b) claim under the 1934 Exchange Act might well be enforceable.

[42] McMahon v. Shearson/American Express, Inc., 618 F.Supp. 384, 388 (S.D.N.Y. 1985), aff'd in part, rev'd in part, 788 F.2d 94 (2d Cir. 1986).

[43] Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987). The district court in McMahon previously ordered, in part, that a pre-dispute arbitration agreement could be enforced by a broker-dealer and its registered representative against their customers in order to arbitrate the customers' § 10(b) claims which had been filed in a federal district court lawsuit. The Second Circuit reversed, in part, relying upon the settled case law of that Circuit that claims under § 10(b) and Rule 10b-5 of the 1934 Act are not arbitrable, applying the following the analysis:

As our late colleague, Judge Friendly, noted in Colonial Realty v. Bache & Co., 358 F.2d 178, 183 n. 5 (2d Cir.), cert. denied, 385 U.S. 817 (1966), the non-waiver provision of § 14 of the 1933 Act has an almost identical counterpart in § 29(a) of the 1934 Act. In view of Wilko and the similarity of the non-waiver provisions of the 1933 and 1934 Acts, we consistently have held that § 10(b) and Rule 10b-5 claims are not arbitrable.

McMahon, 788 F.2d at 96-97.

[44] Brief for SEC as Amicus Curiae Supporting Petitioners-Appellees, Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

amicus brief in *McMahon* supported the broker-dealer's position on the arbitrability of a federal securities claim.[45]

Citing *Byrd* and *Scherk* for the proposition that the Supreme Court had previously questioned the applicability of *Wilko* to claims under the 1934 Act, the SEC's amicus brief in *McMahon* argued that *Wilko* was distinguishable due to the Supreme Court's subsequent rejection of *Wilko*'s "suspicion of arbitration," and the fact that the authority granted to the SEC under § 19 of the 1934 Act to regulate the arbitration procedures of the stock exchanges and other self-regulatory organizations could "ensure" the adequacy of these procedures so there would be no prohibited § 29(a) waiver[46] of a provision under the 1934 Act.[47]

[45] SEC Amicus Brief, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

[46] Section 29(a) of the 1934 Act voids "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Act]." Securities Exchange Act of 1934 § 29(a), 15 U.S.C. § 78cc.

[47] SEC Amicus Brief at 6-7, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882. The SEC made the following commentary regarding § 19 of the 1934 Act:

The view of arbitration on which Wilko rested is today inappropriate in cases involving disputes between registered broker-dealers and their customers. Under Section 19 of the Exchange Act, 15 U.S.C. 78s, the Commission has broad regulatory authority over securities exchanges and other self-regulatory organizations (SROs). Since 1975, when Congress amended Section 19 to expand that authority, the Commission has had the power to ensure that arbitration procedures prescribed by the SROs are adequate to enforce the rights of customers against brokerage firms that are members of SROs. In these circumstances, the suspicion of arbitration on which Wilko rested is inappropriate, and an agreement to arbitrate accordingly should not be deemed a waiver of rights under the Exchange Act.

SEC Amicus Brief at 12, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882:

Under current law, each SRO must file with the Commission any proposed change to its rules (Section 19(b)(1), 15 U.S.C. 78s(b)(1)), including the rules and procedures governing the conduct of arbitration programs administered by the SRO. Upon the filing of any proposed rule change, the Commission must publish notice of the change and provide interested parties an opportunity to comment (ibid.). Subject to certain exceptions, no proposed rule change may take effect unless approved by the Commission (ibid.). The Commission must grant such approval if it finds that the proposed rule is consistent with the requirements of the 1934 Act and with the rules and regulations thereunder applicable to SROs. Section 19(b)(2), 15 U.S.C. 78s(b)(2). Moreover, the Commission may, on its own initiative, "abrogate, add to, and delete from" any SRO rule if it finds such changes necessary or appropriate to further the purposes of the Act. Section 19(c), 15 U.S.C. 78s(c). In short, the Commission has sweeping authority over the rules adopted by SROs relating to arbitration of customer disputes, including the power to mandate the adoption of any additional rules it deems necessary to ensure the adequacy of an SRO's arbitration system.

SEC Amicus Brief at 11, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

The SEC cited the Supreme Court's 1985 decision in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth* for the position that the Federal Arbitration Act, standing alone, would require "the enforcement of an agreement to arbitrate statutory claims," along with creating a presumption for the enforceability of an arbitration agreement under the FAA unless Congressional intent was found to preclude a waiver of judicial remedies for the relevant statutory right.[48]

The SEC's amicus argument had merit. The 1975 amendments to the 1933 and 1934 Acts greatly increased the SEC's authority over the rules and procedures of the self-regulatory organizations.[49] Prior to the amendments, the SEC arguably had no authority to alter or supplement exchange or association rules.[50]

The SEC also argued that the *Wilko* Court considered the waiver of the investor's right to a judicial forum under § 22 of the 1933 Act as being unenforceable *only* because if such a waiver were enforced, substantive rights under § 12(2) of the 1933 Act would have been impermissibly "waived" due to the inadequacy of the arbitration process at that earlier point in time.[51] Ergo, so long as the arbitration process is adequate, an agreement which waives the remedies under § 22 of the 1933 Act may be enforced.[52]

In *McMahon*, the petitioners' primary analysis in arguing for the

[48] Id. at 8-9 (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985)).

[49] Brief for Petitioners-Appellees at 34, Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

[50] SEC Amicus Brief at 15-16, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882. The SEC further stated the following concerning its authority to regulate SRO securities arbitration procedures:

The Commission has exercised this new authority since 1975 in several ways specifically designed to promote fair and effective arbitral forums for the resolution of disputes between customers and SRO-member brokerage firms. Chief among them was the Commission's promotion, in 1977, of the formation of the Securities Industry Conference on Arbitration, a group consisting of representatives of various SROs, the Securities Industry Association, and the public, and created to develop a uniform arbitration code. The Conference drafted the Uniform Code of Arbitration, and the Code has since been adopted by all of its SRO members.

SEC Amicus Brief at 16-17, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

[51] SEC Amicus Brief at 10-11, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

[52] Id. at 10-11.

enforcement of agreements to arbitrate § 10(b) claims rested on the following basic points.[53] First, the FAA mandated the judicial enforcement of agreements to arbitrate statutory claims in the absence of Congressional intent to preclude such enforcement being implicitly manifested in the statute or legislative history.[54]

Second, the petitioners in *McMahon* contended that the Court's decision in *Wilko* should not be extended to void pre-dispute arbitration agreements regarding § 10(b) claims.[55] The petitioners asserted that § 10(b) held no "special right" status compared to that found by the *Wilko* Court in § 12(2) under the 1933 Act;[56] that § 10(b) was a judicially created implied right of action, thus Congress lacked the intent to include it within the scope of provisions protected by § 29(a) of the 1934 Act;[57] and that the Court, under *Scherk* and *Byrd*, expressly questioned the applicability of *Wilko*'s rationale to § 10(b) claims.[58]

Third, the petitioner in *McMahon* argued that Congress intended the anti-waiver provision found in § 29(a) of the 1934 Act to prohibit the waiver of substantial compliance with a statute, rather than to preclude the enforcement of statutory rights pursuant to an arbitration agreement.[59] The petitioners argued that the *Wilko* Court misinterpreted the anti-waiver provision in § 14 of the 1933 Act by citing to *Scherk*'s enforcement of an agreement to arbitrate § 10(b) claims relating to international transactions, lower courts' enforcement of post-dispute agreements to arbitrate § 12(2) claims, the judiciary's allowance of both the settlement of §§ 12(2) and 10(b) claims without judicial approval, and the voluntary submission of such claims to binding arbitration.[60]

Fourth, the *McMahon* petitioners argued that the *Wilko* Court's rationale in rendering void a contractual agreement to arbitrate a § 12(2) claim was substantially based on misplaced and outdated beliefs that arbitration was

[53] See Brief for Petitioners-Appellees, Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

[54] Brief for Petitioner-Appellees at 13-14, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

[55] Id. at 19.

[56] Id. at 21.

[57] Id. at 24-25.

[58] Id. at 26-27.

[59] Id. at 28.

[60] Id. at 32.

inadequate to resolve claims involving federal securities law disputes, and that arbitrators were not capable to adjudicate such controversies.[61] The petitioners cited the *Mitsubishi* Court's assertion that "we are well past the time when judicial suspicion of the desirability of arbitration and the competence of arbitral tribunals inhibited the development of arbitration as an alternative means of dispute resolution," and the post-*Wilko* increased sophistication of the procedures related to securities arbitration.[62] The petitioners in *McMahon* addressed the adequacy of judicial review of arbitration awards by citing to various vacatur provisions found in the FAA,[63] and further stated that:

[61] Id. at 33.

[62] Id. at 34. In particular, the petitioners in McMahon stated the following to support their opinion of the maturation of SRO sponsored securities arbitration:

Carefully developed procedures have been established by the securities industry under the auspices of the Securities and Exchange Commission. . . . See, e.g., Constitution of New York Stock Exchange, Inc., Art. XI, 2 N.Y.S.E. Guide (CCH) ¶¶ 1501-1503 (June 1985); Arbitration Rules 600-634 of the New York Stock Exchange, Inc., 2 N.Y.S.E. Guide (CCH) at ¶¶ 2600-2634 (Mar. 1985). See also Uniform Code of Arbitration, N.A.S.D. Manual (CCH) ¶¶ 3712-3743 (July 1986).

. . .

The Uniform Code of Arbitration was approved by the Securities and Exchange Commission which found it to be in the public interest and in furtherance of just and equitable principles of trade. See SEC Securities Exchange Act Release No. 16390 (Nov. 30, 1979), 18 S.E.C. Docket 1197 (1979). The Commission retains jurisdiction to correct any perceived abuses or unfairness in the arbitration rules, pursuant to § 19 of the Exchange Act, 15 U.S.C. § 78s. Section 19(b) of the Act requires the SROs to file copies of any proposed rule change with the Commission, which publishes notice of the proposed rule change and gives interested persons an opportunity to submit their views on the proposal. 15 U.S.C. § 78s(b). At the conclusion of this process, the Commission either approves or disapproves the change. This procedure applies to changes in the SRO arbitration rules, and it adds a further measure of public protection which did not exist when Wilko was decided.

. . .

. . . Arbitrators are generally selected by the various arbitration forums based upon their expertise in particular areas of the law. They are knowledgeable individuals who have experience working with these laws, such as attorneys specializing in securities law and retired judges, as well as businessmen and other individuals with extensive experience in arbitrating securities disputes. . . .

[63] Brief for Petitioners-Appellees at 37, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882 (citing § 10 of the FAA:

[e]xplicit grounds for vacating arbitration awards are found in the Arbitration Act which provides for vacatur when the decision of the arbitrator is tainted by: (1) corruption, fraud, or undue means; (2) evident partiality or corruption of the arbitrators; (3) misconduct on the part of the arbitrators; or (4) the arbitrator exceeding or improperly executing his powers. 9 U.S.C. § 10.).

while an arbitrator's award will not be set aside because of misinterpretation of the law, numerous lower courts have relied on dictum in *Wilko*, and held that an arbitrator's award will not be confirmed if it is demonstrated that the arbitrator acted in "manifest disregard of the law."[64]

The respondents in *McMahon* countered the petitioners' arguments by stating that an exception to the FAA was compelled due to the 1934 Act's underlying federal policies and the Congressional intent fundamental to the passage of the 1934 Act's remedies.[65] The respondents cited to the text and legislative history of the 1934 Act; the inadequacy of arbitration concerning the resolution of federal securities law disputes; the current Congressional concerns regarding the effectiveness of securities markets regulation; and argued that pre-dispute arbitration agreements impermissibly undermined the fundamental goals of the 1934 Act.[66]

Of particular note, the *McMahon* respondents argued the following as evidence of recent Congressional intent supporting their position:

In its 1975 examination and revision of the securities laws, Congress in effect ratified Wilko and left undisturbed the unbroken line of precedent in this Court and the Circuits upholding the judicial forum for 1934 Act claims. The Ninth Circuit Court of Appeals, in Conover v. Dean Witter Reynolds, Inc., supra, 794 F.2d 520, found the Conference Report of the Congress compelling evidence that the legislative branch would permit predispute arbitration agreements only between industry professionals, i.e., brokers and exchanges:

> . . . that in 1975, Congress expressly recognized the nonarbitrable nature of disputes between brokers and customers. In the conference report to the Securities Act Amendment of 1975, Congress emphasized that its amendment to section 28 of the Securities Exchange Act of

[64] Brief for Petitioners-Appellees at 37-38, McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882 (quoting Siegel v. Titan Indus. Corp.; 779 F.2d 891, 892 (2d Cir. 1985), also citing Wilko, 346 U.S. at 436-37; Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Broker, 636 F. Supp. 444, 445 (S.D.N.Y. 1986) (manifest disregard of law under Rule 10b-4 required arbitrators' award to be vacated); Swift Indus., Inc. v. Botany Indus., Inc., 466 F.2d 1125, 1130 (3d Cir. 1972); San Martine Campania de Navegacion v. Saguenay Terminals, Ltd., 293 F.2d 796, 801 (9th Cir. 1961)).

[65] Brief for Respondents-Appellants at iii, Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44), 1987 WL 880930.

[66] Id. at iii-iv.

> 1934, which permitted arbitration agreements between brokers and exchanges, did not extend to arbitration agreements between brokers and customers: 'It was the clear understanding of the conferees that this amendment did not change existing law, as articulated in Wilko v. Swan, 346 U.S. 427. . . (1953), concerning the effect of arbitration proceeding provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations.' H.R. Rep. No. 229, 94th Cong., 1st Sess. 111, reprinted in 1975 U.S. Code Cong. & Ad. News 321, 342." Conover v. Dean Witter Reynolds, Inc., supra, 794 F.2d at 524 (citations omitted, emphasis added), citing Hermann & McLean v. Huddleston, supra; Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 379 (1982) (finding, analogously, comprehensive amendments to Commodities Act evidence that Congress intended preservation of implied remedy under the Act).
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> . . .
>
> Notably, the Eleventh Circuit Court of Appeals' en banc panel in Wolfe v. E.F. Hutton & Co., supra, 800 F.2d 1032, while discerning no more or less than a simple endorsement of Wilko in the Conference Report, nonetheless found that Congress "declined to take further action," thereby acquiescing in the application of Wilko to Section 10(b) claims by the Courts. Id. at 1037-1038. See Section 28(b), 15 U.S.C. Section 78bb(b). That Congress found it necessary at all to amend the 1934 Act with respect to Section 28(b) is significant to this inquiry. Certainly, if the antiwaiver provision of Section 29(a) were arguendo to have been deemed not to prohibit a pre-dispute waiver of the right under Section 27 to bring Section 10(b) claims in a judicial forum, then Congress would not have carved out the unequivocal but limited exception to the antiwaiver provision under Section 28(b), permitting arbitration agreements between brokers and exchanges. This is precisely the evidence of congressional intent required under the Mitsubishi test in which the Court assumed "that

> if Congress intended the substantive protection afforded by a given statute to include protection against waiver of the right to a judicial forum, that intention would be deducible from text or legislative history." Mitsubishi, supra, 105 S.Ct. at 3355, citing Wilko.[67]

The *McMahon* respondents, asserting that the overriding policy concern before the Court was the protection of the public investor, argued that the SRO arbitration process denied the investor significant substantive and procedural rights, including full disclosure, fair dealing and judicial scrutiny.[68] Holding to the view that arbitration procedures had not changed sufficiently since *Wilko*,[69] the *McMahon* respondents recited the familiar litany of commonly perceived shortcomings inherent in the arbitration process, including:

> the loss of constitutional guarantees of due process, trial by jury, findings of fact and conclusion of law, federal pleading, discovery and evidentiary rules, and compulsory, orderly discovery; the risk that the law will be improperly applied to the facts at issue; the possible risk of collateral estoppel or inconsistent verdicts; and the unlikelihood, if not unavailability, under various rules of the industry's self-regulatory organizations . . ., of the right to appeal.[70]

3. The McMahon Court's Analysis

The Supreme Court in *McMahon* began its analysis by expressing the Court's long held view that the intent of the FAA was to:

> "revers[e] centuries of judicial hostility to arbitration agreements," Scherk v. Alberto-Culver Co., supra, 417 U.S., at 510, 94 S.Ct., at 2453, by "plac[ing] arbitration agreements 'upon the same footing as other contracts.' " 417 U.S., at 511, 94 S.Ct., at 2453, quoting H.R.Rep. No. 96, 68th Cong., 1st Sess., 1, 2 (1924). The Arbitration Act

[67] Id. at 18-20.

[68] Id. at 27.

[69] Id. at 24.

[70] Id. at 25.

> accomplishes this purpose by providing that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2.[71]

The Court in *McMahon* summarily discarded any concerns regarding the desirability or inadequacy of the arbitration forum to resolve statutory claims under the securities laws by stating that:

> [t]his duty to enforce arbitration agreements is not diminished when a party bound by an agreement raises a claim founded on statutory rights. As we observed in Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., "we are well past the time when judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals" should inhibit enforcement of the Act " 'in controversies based on statutes.' " 473 U.S., at 626-627, 105 S.Ct., at 3354, quoting Wilko v. Swan, supra, 346 U.S., at 432, 74 S.Ct., at 185.[72]

Citing *Mitsubishi*, the Supreme Court in *McMahon* then provided a simple standard by which a pre-dispute securities arbitration agreement may be found unenforceable:

> Absent a well-founded claim that an arbitration agreement resulted from the sort of fraud or excessive economic power that "would provide grounds 'for the revocation of any contract,' " 473 U.S., at 627, 105 S.Ct., at 3354, the Arbitration Act "provides no basis for disfavoring agreements to arbitrate statutory claims by skewing the otherwise hospitable inquiry into arbitrability." Ibid.[73]

The *McMahon* Court stated that the express language in 1934 Act was silent as to the question of arbitration regarding § 10(b) claims.[74] The Court also found that the express language of § 29(a) of the 1934 Act, which voids any condition, stipulation, or provision binding any person to waive

[71] Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 225-226 (1987).

[72] Id. at 226.

[73] Id. at 226.

[74] Id. at 227.

compliance with any provision of the 1934 Act, *as not reaching* § 27 of the 1934 Act, which provides the federal district courts with exclusive jurisdiction over violations of all suits in equity and law brought to enforce any liability, duty created by, or rules and regulations under, the 1934 Act.[75]

The Court equated "compliance" under § 29(a) of the 1934 Act with that of a "duty" owed under the 1933 Act.[76] Thus, the Court reasoned that § 29(a) of the 1934 Act forbids the enforcement of agreements to waive "compliance" with the provisions of the Act dealing with the "substantive obligations" owed under the statute, and that since § 27 of the 1934 Act does not impose a "duty" with which persons trading securities must comply, then § 29(a) of the 1934 Act does not preclude the waiver of provisions found under § 27 of the 1934 Act.[77]

The Court stated that *Wilko*'s application of § 14 to the 1933 Act's judicial jurisdictional provision, § 22(a), was based on its view that the arbitration process at that time was inadequate to protect the substantive rights found under the 1933 Act.[78] Thus, the judicial forum provided by § 22(a) of the 1933 Act could not be waived, according to the *Wilko* Court, because such a waiver would act as a *de facto* waiver of the 1933 Act's substantive provisions.[79]

The *McMahon* Court asserted that *Wilko*'s view - that arbitration was inadequate to enforce the substantive provisions of the 1933 Act - as being the "heart" of the *Wilko* Court's decision, and specifically stated the following as comprising the *Wilko* rationale:

> . . . arbitration proceedings were not suited to cases requiring "subjective findings on the purpose and knowledge of an alleged violator." . . . that arbitrators must make legal determinations "without judicial instruction on the law," and that an arbitration award "may be made without explanation of [the arbitrator's] reasons and without a complete record of their proceedings." . . . that the "[p]ower to vacate an award is limited," and that

[75] Id. at 227-28.

[76] Id. at 228. The Court stated ". . . § 27 itself does not impose any duty with which persons trading in securities must 'comply.'" Id.

[77] Id. at 228.

[78] Id. at 228-29.

[79] Id. at 228-29.

> "interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation." . . . that in view of these drawbacks to arbitration, § 12(2) claims "require[d] the exercise of judicial direction to fairly assure their effectiveness."[80]

The *McMahon* Court refused to share the *Wilko* Court's distrust of the arbitration process.[81] The *McMahon* Court reasoned that *Wilko*'s opinion regarding the insufficiency of the arbitration process regarding securities claims did not rest upon any evidence in the record or any fact of which *Wilko* could take judicial notice; that it merely reflected "a general suspicion of the desirability of arbitration and the competence of arbitral tribunals . . ."[82] The Court cited the subsequent decisions favorable to the FAA, and in particular *Mitsubishi* which recognized arbitration forums' ability to hear "the factual and legal complexities of antitrust claims"[83] and *Scherk*'s holding that arbitration was adequate to resolve § 10(b) claims in the international commercial context.[84] The Court in *McMahon* reasoned that judicial review, albeit limited, of arbitration awards was sufficient to ensure arbitrator compliance with statutory law;[85] that arbitration agreements between members of a securities exchange or the NASD were already routinely enforced by the courts; and that submission of existing disputes between parties has been uniformly allowed by the courts.[86]

Holding that a pre-dispute arbitration agreement does not waive the investor protections under the 1934 Act, including the right to a § 10(b) claim, the *McMahon* Court discussed the changed regulatory structure of the securities laws post-*Wilko*, including the 1975 Amendments providing the SEC with expanded and broad regulatory authority under § 19 of the

[80] Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 231 (1987).

[81] Id. at 231.

[82] Id. at 231.

[83] Id. at 231-32 (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985); Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213 (1985); Southland Corp. v. Keating, 465 U.S. 1 (1984); Moses H. Cone Memorial Hospital v. Mercury Construction Corp., 460 U.S. 1 (1983); Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974)).

[84] Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 232 (1987) (citing Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974)).

[85] McMahon, 482 U.S. at 232.

[86] Id. at 232-33.

1934 Act.[87] The Court stated that the issue of adhesion was irrelevant regarding the 1934 Act and was instead related to the potential revocation of the arbitration argument under contract principles and not under § 29(a) of the 1934 Act.[88]

Thus, the Court in *McMahon* concluded that:

> Congress did not intend for § 29(a) to bar enforcement of all predispute arbitration agreements. In this case, where the SEC has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights, enforcement does not effect a waiver of "compliance with any provision" of the Exchange Act under § 29(a). Accordingly, we hold the McMahons' agreements to arbitrate Exchange Act claims "enforce[able] . . . in accord with the explicit provisions of the Arbitration Act." Scherk v. Alberto-Culver Co., supra, at 520, 94 S.Ct., at 2457[89]

The *McMahon* Court also held that the investors' RICO claim against the petitioners was also arbitrable under the predispute arbitration agreement, finding:

> there is no inherent conflict between arbitration and the purposes underlying § 1964(c). Moreover, nothing in RICO's text or legislative history otherwise demonstrates congressional intent to make an exception to the Arbitration

[87] Id. at 233. The Court stated:

[S]ince the 1975 amendments to § 19 of the Exchange Act, however, the Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs. No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act, 15 U.S.C. § 78s(b)(2); and the Commission has the power, on its own initiative, to "abrogate, add to, and delete from" any SRO rule if it finds such changes necessary or appropriate to further the objectives of the Act, 15 U.S.C. § 78s(c). In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.

McMahon, 482 U.S. at 233-34. The Court also cited to the SEC's approval of arbitration procedures of the NYSE, ASE, and the NASD. Id. at 234.

[88] Id. at 230-31.

[89] Id. at 238.

Act for RICO claims.[90]

4. Subsequent Court Decisions Relating To Mandatory Securities Arbitration

The *McMahon* Court stated that:

> While stare decisis concerns may counsel against upsetting Wilko's contrary conclusion under the Securities Act, we refuse to extend Wilko's reasoning to the Exchange Act in light of these intervening regulatory developments [regarding securities arbitration].[91]

Accordingly, these and other comments in *McMahon* left substantial doubt as to the continued viability of *Wilko*'s precedential value regarding the unenforceability of mandatory pre-dispute arbitration agreements involving claims under the 1933 Act.

Less than two years after its decision in *McMahon*, the Supreme Court overruled *Wilko* in *Rodriguez v. Shearson/American Express, Inc*.[92] The Court in *Rodriguez*, citing *McMahon*'s rejection of the *Wilko* applicability to claims under the 1934 Act and the *Wilko* Court's unwarranted "aversion to arbitration as a forum for resolving disputes over securities transactions, especially in light of the relatively recent expansion of the Securities and Exchange Commission's authority to oversee and to regulate those arbitration procedures,"[93] concluded that:

> Wilko was incorrectly decided and is inconsistent with the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions. Although we are normally and properly reluctant to overturn our decisions construing statutes, we have done so to achieve a uniform interpretation of similar

[90] Id. at 242.

[91] Id. at 234.

[92] Rodriguez v. Shearson/American Express, Inc., 490 U.S. 477 (1989). The facts involved individual investors who, after their investments lost value with the respondent broker-dealer, filed suit in federal district court alleging unauthorized and fraudulent transactions which violated, among other things, the 1933 Act and the 1934 Act.

[93] Rodriguez, 490 U.S. at 483.

> statutory language . . . and to correct a seriously erroneous interpretation of statutory language that would undermine congressional policy as expressed in other legislation. . . . Both purposes would be served here by overruling the Wilko decision.[94]

Thus, the Court in *Rodriguez* held that "the arbitration agreement is enforceable because this Court's subsequent decisions have reduced *Wilko* to 'obsolescence.'"[95]

Subsequent to *McMahon* and *Rodriguez*, the Supreme Court has only rarely referenced the securities arbitration forum in its opinions, but has still done so with some consequence. In *Gilmer v. Interstate/Johnson Lane Corporation*, a matter involving the Age Discrimination in Employment Act (ADEA), the employer/broker-dealer sought to enforce a pre-dispute arbitration agreement against its employee.[96] The employee asserted that arbitration was inadequate to resolve his complaint, in part citing to arbitrator bias,[97] limited discovery,[98] and judicial review.[99] The Court

[94] Id. at 484.

[95] Id. at 477.

[96] Gilmer v. Interstate/Johnson Lane Corporation, 500 U.S. 20 (1991).

[97] Regarding arbitrator bias, the Court cited to the NYSE arbitration procedural rules requiring disclosure of the arbitrator's employment history, a preemptory challenge along with unlimited challenges for cause, disclosure by the arbitrator of any circumstances preventing him or her from rendering an objective and impartial determination, in addition to the FAA provision allowing a court to vacate an arbitration award upon a finding of arbitration partiality or corruption. Gilmer, 500 U.S. at 30 (citing 2 CCH New York Stock Exchange Guide ¶ 2608, p. 4314 (Rule 608) (1991); 2 CCH New York Stock Exchange Guide ¶ 2609, at 4315 (Rule 609); 2 CCH New York Stock Exchange Guide ¶ 2610, at 4315 (Rule 610).; 9 U.S.C. § 10(b)).

[98] Concerning the limited discovery afforded by the arbitration process, the Court referenced the NYSE discovery provisions as allowing for document production, information requests, depositions, and subpoenas, and the procedural safeguards under the NYSE rules as not binding the arbitrator with the rules of evidence. See Gilmer, 500 U.S. at 31 (citing 2 CCH New York Stock Exchange Guide ¶ 2619, pp. 4318-4320 (Rule 619); 2 CCH New York Stock Exchange Guide ¶ 2620, p. 4320 (Rule 620)).

[99] The employee argued that a lack of written opinion would result in his inability to obtain effective appellate review along with preventing public disclosure of an employer's discriminatory policies. Gilmer, 500 U.S. at 31. The Court responded that the NYSE rules actually required that all arbitration awards be written, containing the names of the parties, the issues in controversy, and a description of the award issued, along with stating that judicial decisions involving ADEA claims would continue to be issued because it would be unlikely that arbitration agreements governing such claims would affect all or even most future ADEA claimants. Gilmer, 500 U.S. at

Gilmer dispelled these concerns by citing to its past decisions in *Mitsubishi*, *McMahon*, and *Rodriguez*.[100]

The Court in *Gilmer* addressed the alleged unenforceability of arbitration agreements based upon inequality of bargaining power between the parties by citing to both *Rodriguez* and *McMahon* to support the proposition that mere inequality was not sufficient reason to invalidate,[101] but instead, that: ". . . courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds 'for the revocation of any contract.'"[102] and that such fact-specific analysis was best left resolved in specific cases. [103]

In *Mastrobuono v. Shearson Lehman Hutton, Inc*.,[104] the broker-dealer argued that the arbitration panel did not have the right under New York law to award punitive damages. The broker-dealer asserted that the choice of laws provision incorporated within the arbitration agreement precluded the panel from providing such remedy.[105] Finding that the choice of laws provision was ambiguous regarding the preclusion of punitive damages and that the NASD Code of Arbitration could be read broadly enough to allow for such a remedy, the Supreme Court in *Mastrobuono* held that the arbitrators had the authority under the agreement to award punitive damages.[106]

In *Green Tree Financial v. Randolph*,[107] a case involving the purchaser of a mobile home, the Truth in Lending Act (TILA) and the Equal Credit Opportunity Act (ECOA), the petitioner successfully filed a motion to compel arbitration. The Supreme Court framed a primary issue as being whether the arbitration agreement, which was silent regarding the

31-32. As to judicial review of arbitration decisions, the Court cited to McMahon that such review was sufficient to ensure compliance with statutory rights requirements. Gilmer, 500 U.S. at 32 (citing McMahon, 482 U.S. 220, supra).

[100] Gilmer, 500 U.S. at 26.

[101] Id. at 32-33.

[102] Id. at 33 (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627 (1985)).

[103] Gilmer, 500 U.S. at 33.

[104] Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995).

[105] Id. at 54-55.

[106] Id. at 64.

[107] Green Tree Financial v. Randolph, 531 U.S. 79 (2000)

arbitration costs and expenses, may be held unenforceable because such lack of disclosure acts as a failure to affirmatively protect a participant from substantial costs and expenses.[108] The Court stated in *Green Tree Financial* that:

> . . . we are mindful of the FAA's purpose "to reverse the longstanding judicial hostility to arbitration agreements . . . and to place arbitration agreements upon the same footing as other contracts." Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 24, 111 S.Ct. 1647, 114 L.Ed.2d 26 (1991).
>
> In light of that purpose, we have recognized that federal statutory claims can be appropriately resolved through arbitration, and we have enforced agreements to arbitrate that involve such claims. See, e.g., Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989) (Securities Act of 1933); Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987) (Securities Exchange Act of 1934 and Racketeer Influenced and Corrupt Organizations Act). . . . We have likewise rejected generalized attacks on arbitration that rest on "suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants." Rodriguez de Quijas, supra, at 481, 109 S.Ct. 1917. These cases demonstrate that even claims arising under a statute designed to further important social policies may be arbitrated because " 'so long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum,' " the statute serves its functions. See Gilmer, supra, at 28, 111 S.Ct. 1647 (quoting Mitsubishi, supra, at 637, 105 S.Ct. 3346).[109]

However, the Supreme Court in *Green Tree Financial* made a passing statement that may potentially provide grounds for future reconsideration of

[108] Id. at 82.

[109] Id. at 89-90.

its decisions in *McMahon* and *Rodriguez*:

> It may well be that the existence of large arbitration costs could preclude a litigant . . . from effectively vindicating her federal statutory rights in the arbitral forum. But the record does not show that [the litigant] will bear such costs if she goes to arbitration. Indeed, it contains hardly any information on the matter. . . . As the Court of Appeals recognized, "we lack . . . information about how claimants fare under Green Tree's arbitration clause." 178 F.3d, at 1158. The record reveals only the arbitration agreement's silence on the subject, and that fact alone is plainly insufficient to render it unenforceable. The "risk" that Randolph will be saddled with prohibitive costs is too speculative to justify the invalidation of an arbitration agreement.[110]

The Court in *Green Tree Financial* held that a party desiring to invalidate an arbitration agreement on the grounds of prohibitive costs of arbitration must bear the burden of proof, and given the lack of any showing on this issue arising from discovery, the respondent did not meet her burden.[111]

Lastly, in *Howsam v. Dean Witter Reynolds, Inc.*,[112] the Supreme Court decided the issue of whether the judiciary or an arbitration panel shall interpret the NASD Code of Arbitration § 10304 6-year eligibility rule which stated that no dispute "shall be eligible for submission to arbitration . . . where six (6) years have elapsed from the occurrence or event giving rise to the . . . dispute."[113] The Court considered the NASD 6-year eligibility rule to be an issue that the parties would have considered best left for the arbitrator's decision, one more akin to procedural questions which "'grow out of the dispute and bear on its final disposition' [and which] are presumptively *not* for the judge, but for an arbitrator, to decide."[114] The

[110] Green Tree Financial, 531 U.S. at 90-91.

[111] Id. at 91-92.

[112] Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79 (2002).

[113] Id. at 81; see NASD Code of Arbitration Procedure § 10304 (1984).

[114] Howsam, 537 U.S. at 83 (citing John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 557, 84 S.Ct. 909) (1964) (holding that an arbitrator should decide whether the first two steps of a grievance procedure were completed, where these steps are prerequisites to arbitration)).

Court held that the 6-year eligibility issue was to be decided by the arbitrator, stating that "the NASD's time limit rule falls within the class of gateway procedural disputes that do not present what our cases have called 'questions of arbitrability.'" [115]

III. THE POST-*MCMAHON* EVOLUTION OF NASD ARBITRATION

Subsequent to the McMahon and Rodriguez decisions, the number of SRO securities arbitrations substantially increased.[116] In 1980, there were a total of 830 SRO arbitration cases filed, increasing to 2464 cases in 1984, 4357 cases in 1987, 5332 cases in 1990, 6156 in 2000, increasing to an all-time post dot-com crash high of 10,212 in 2003.[117] Since McMahon, the execution of SRO mandatory pre-dispute arbitration agreements to resolve any dispute or controversy arising out of the customer/broker-dealer relationship are universally demanded by broker-dealers as a condition for an investor to open an account.[118] Thus, an SRO's arbitration code soon became the de facto set of rules of civil procedure for all investors who desired to file claims against their stockbrokers and broker-dealers for claims under the common law, state law, and the 1933 and 1934 Acts. As a result of the Congressional amendments to the 1934 Act in 1975, SRO arbitration procedural rules have been governed by SEC oversight.[119]

Prior to McMahon, NASD arbitration procedures were informal with minimal discovery, and with no rules governing the hearing process other than a provision stating that the arbitrators were not bound by formal rules of evidence governing the admissibility of evidence. Moreover, a record of the proceedings would not be made unless a party or arbitrator requested the

[115] Howsam, 537 U.S. at 85.

[116] See Sarah Rudolph Cole, Fairness In Securities Arbitration: A Constitutional Mandate?, 26 Pace L. Rev. 73 (2005) ("In 1986, before the McMahon decision, only 1,587 customer-broker and employment disputes were filed with NASD. In 2004, NASD reported the filing of 8,201 customer-broker and employment disputes." Id. at n.3).

[117] Constantine N. Katsoris, Roadmap To Securities ADR, 11 Fordham J. Corp. & Fin. L. 413, 525 (2006).

[118] Cole, supra 116

[119] Id. at 79 (Cole writes that in 1975:

. . . Congress amended the Exchange Act and "drastically shifted the balance of rulemaking power in favor of Commission oversight." According to a Senate Report, the 1975 amendments conferred upon the SEC "a much larger role than it had in the past . . ." over the SROs.).

creation of a record. [120]

The first securities code of arbitration had been developed in 1979-1980[121] by the Securities Industry Conference on Arbitration ("SICA"), an entity formed by SRO representatives, the public and the Securities Industry Association.[122] Subsequent to *McMahon*, SICA was called upon by the SEC to substantially reform the existing SRO arbitration process.[123] The SEC recommended that this reformation should include arbitrator training in both securities and relevant state law, that a record of proceedings be made to facilitate judicial review, and that arbitration awards be rendered in greater detail.[124]

In response to the SEC, the SROs made significant changes to arbitration procedure.[125] Overtime, discovery was expanded and procedures were adopted regarding arbitrator selection, qualification, training and disclosure, and methods for transcribing and preserving the record.[126] The SEC thereafter has maintained a self-described "comprehensive" oversight of the SROs, and both the SEC and the SROs have made substantial efforts, post-*McMahon*, to amend the SRO arbitration procedures.[127]

The NASD became the SRO arbitration forum of choice by the majority of claimants. In 1990, out of 5,332 total SRO arbitration claims filed, 3,617 (67.8%) were filed with the NASD.[128] In 1996, out of 6,510 total SRO arbitration claims filed, 5,631 (86.4%) were filed with the NASD. By 2004, out of 9,225 total SRO arbitration claims filed, 8,201 (88.9%) were filed with the NASD.[129]

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[120] Barbara Black & Jill I. Gross, Making It Up As They Go Along: The Role Of Law In Securities Arbitration, 23 Cardozo L. Rev. 991, 999 (2002)

[121] Id. at 998 (citing In re NASD, Order Approving Proposed Rule Change, Exchange Act Release No. 34-16860, 20 SEC Docket 233 (May 30, 1980)).

[122] Cole, supra note 116, at 79-80.

[123] Id. at 80.

[124] Id. at 80.

[125] Id. at 80.

[126] Katsoris, supra note 117, at 423.

[127] Cole, supra note 116, at 81.

[128] Katsoris, supra note 117, at 525 Appendix B.

[129] Id. 525 Appendix B.

A. The GAO Congressional Reports On Matters Related To Securities Arbitration

Despite the Supreme Court's finding in *McMahon* and *Rodriguez* that SRO securities arbitration provided an adequate forum to vindicate investor rights under the federal securities law, there still existed concerns regarding the overall fairness of the arbitration process.[130] Subsequent to the *McMahon* decision, Congress requested the United States General Accountability Office ("GAO") to evaluate SRO arbitration relating to concerns held by Congress, state regulators, and investor groups "about whether industry-sponsored arbitration is fair to investors," with a primary concern that "arbitration at an industry-sponsored forum may have a pro-industry bias."[131] The GAO issued a study in 1992 ("the 1992 GAO Report") finding that there existed no industry bias at industry sponsored forums versus independent forums, but made no finding regarding the overall "fairness" of the arbitration process due to the limited number of customer disputes being litigated and the inherent differences between the litigation and arbitration processes.[132] The 1992 GAO Report did find that the SROs lacked internal controls sufficient to reasonably assure that SRO arbitrators were either independent or competent.[133] In particular, the 1992 GAO Report found that the SROs had no formal standards to qualify arbitrators, performed no background verification regarding information provided by the arbitrators, and had no system to properly train arbitrators to function fairly and appropriately.[134] The 1992 GAO Report observed that arbitration fairness depended largely upon the individual arbitrator's impartiality and competence.[135] The GAO recommended that the SROs develop formal arbitration selection standards, verify the information submitted by arbitrators, and establish a system to adequately train the arbitrators.[136]

A subsequent GAO study in 2000 ("the 2000 GAO Report") addressed

[130] Black & Gross, supra note 120, at 994-95.

[131] Gen. Acct. Off., Rep. No. GGD-92-74, Securities Arbitration: How Investors Fare 4 (1992).

[132] Id. at 6.

[133] Id. at 6.

[134] Id. at 8.

[135] Id. at 8.

[136] Id. at 8.

issues concerning: whether the SROs had implemented recommendations made in the 1992 GAO Report, and their effectiveness; how investors fared in securities arbitration award decisions; and the extent to which awards were left unpaid by the securities industry.[137] Citing the continuing concerns held by Congress, state regulators, and investor groups regarding the overall fairness of arbitration, the 2000 GAO Report stated that it could not reach any conclusions about the fairness of the process from statistical analysis concerning case outcomes.[138]

The 2000 GAO Report did include positive findings regarding the SROs' implementation of the 1992 GAO Report's recommendations regarding allowing arbitration parties a greater role in arbitrator selection, periodically verifying arbitrator background information, and improving arbitrator training.[139]

IV. ARBITRATION AWARD STATISTICS AND INVESTOR RECOVERY

The 2000 GAO Report disclosed that the percentage of favorable investor arbitration awards from 1992 through 1998 (which annually ranged as low as 49% in 1995 to a high of 57% in 1998) was not as high as the favorable awards received during the January 1989 through June 1990 period (59%).[140] Moreover, the amounts awarded to investors as a percentage of the damage amounts claimed also declined during the 1992-1998 period (which annually ranged as low as 46% in 1994 to a high of 57% in 1997), compared with 61% for the earlier 1989-1990 period.[141] The GAO stated that these declines in both the percentage of favorable awards and amounts recovered may possibly have been due to an increase in the percentage of cases being settled, and that this increase was due to the industry apparently settling a greater percentage of their *weaker* cases.[142] However, a similar rationale could be applied to argue that investor representatives were settling a greater percentage of *their* weaker cases

[137] Gen. Acct. Off., Rep. No. GAO/GGD-00-115, Actions Needed to Address Problems of Unpaid Awards 1 (2000).

[138] Id. at 4.

[139] Id. at 4.

[140] Id. at 24.

[141] Id. at 4.

[142] Id. at 4-5. Additionally, the number of arbitrations resolved at the American Arbitration Association ("AAA") independent forum and at the courts were too few to make a meaningful comparison. Id. at 5.

because arbitration panels were issuing, on average, smaller and smaller awards.

The percentage decline of favorable investor arbitration awards, which began in 1990, has continued unabated. FINRA's currently published statistics on NASD customer claimant arbitration award cases discloses a steady percentage decline of customer claimant arbitration awards where the investors were awarded monetary damages:

A. Results of Customer ClaimantArbitration Award Cases

Year Decided	All Customer Claimant Cases Decided (Hearings & Paper)	All Customer Claimant Cases Where Customer Awarded Damages	*Percentage of Customer Award Cases
2000	1,196	635	53%
2001	1,172	637	54%
2002	1,330	702	53%
2003	1,513	742	49%
2004	1,894	888	47%
2005	1,610	687	43%
2006	1,011	425	42%

* Percentage of customer claimant award cases has been recalculated to reflect only instances in which investors as claimants recovered monetary damages or non-monetary relief. [143]

Thus, the percentage of NASD arbitration panels awarding investors

[143] Available at http://www.finra.org/ArbitrationMediation/ FINRADisputeResolution/ Statistics/index.htm.

damages appears to have dramatically fallen 28% over the past 9 years, from 57% in 1998, to 42% in 2006.[144]

The 2000 GAO Report further found that 49% of the awards favorable to investors were never paid by the industry respondent, and an additional 12% were only partially paid.[145] Moreover, the industry was still disputing 8% of the unpaid awards rendered in 1998 through tactics such as motions to vacate or to modify the award.[146]

B. The O'Neal-Solin Report

There is a long-held view by many practitioners that arbitrators, after finding the brokerage firm liable to the investor, are prone to "split the baby" when deciding the amount of compensatory damages to be paid by the securities industry in an effort to placate the industry arbitrator, and to increase the likelihood that industry respondents will not strike arbitrators ("public" or "industry") from serving on future arbitration panels. Moreover, there is the view that arbitration panels judge the securities industry's major broker-dealers with greater leniency than their smaller broker-dealer brethren.

These perceptions find a statistical foundation by a study recently released by Edward S. O'Neal, Ph.D, a former Assistant Finance Professor at Wake Forest University's Babcock Graduate School of Management, and investor representative Daniel R. Solin, Esq.[147] (hereinafter the "O'Neal-Solin Report"). The O'Neal-Solin Report opined that:

> . . . win rates and percent of amount claim that was awarded is an inaccurate and misleading basis for determining the fairness of the mandatory arbitration system. Our analysis considers the amount awarded and

[144] Id.

[145] Gen. Acct. Off., Rep. No. GAO/GGD-00-115, Actions Needed to Address Problems of Unpaid Awards 5 (2000).

[146] Id.

[147] Edward S. O'Neal, Ph.D. and Daniel R. Solin, Mandatory Arbitration of Securities Disputes – A Statistical Analysis of How Claimants Fair (June 13, 2007) available at http://www.slcg.com/pdf/news/ Mandatory%20Arbitration%20Study.pdf. Dr. O'Neal and Mr. Solin are principals with the Securities Litigation and Consulting Group, Inc. Dr. O'Neal was a faculty member with the Babcock Graduate School of Management during the compilation of the study.).

> the size of both the claim made and the firm against whom the claim is made. We believe this approach presents a far more accurate basis with which to assess the fairness of the process.[148]

Dr. O'Neal and Mr. Solin reviewed over 13,810 investor arbitrations that occurred before the NASD and NYSE panels between January of 1995 and December of 2005.[149] The O'Neal-Solin Report's findings included the following:

> The win rates increase generally from 48% in 1995 to 59% in 1999. The year 2000 began a multi-year decline in win rates which culminates in a low of 44% in 2004. The overall win rate in the entire sample period for claimants is 51%.[150]
>
> . . .
>
> Win rates are different depending on the size of the brokerage firm involved. . . . The win rate against the top 3 brokerage firms averaged 39% in our sample. Win rates against brokers in the 4-10 [brokerage size] category and in the 11-20 [brokerage size category] are 43%. For firms outside of the top 20 based on number of registered representatives, the win rate was 57%. Cases against smaller firms are more likely to result in an arbitration award to claimants.[151]

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[148] Id. at 5.

[149] Id. at 5-6. The authors state that they "attempted to obtain every arbitration decision that was handed down in either forum" during the 1/95 – 12/04 time period. NASD claims comprised 90% of the final sample of 13,810 arbitration awards with the remaining 10% being from the NYSE. O'Neal and Solin take particular note that neither forum would provide hard copies of the awards. This institutional intransigence allegedly caused the authors to have to obtain the NASD awards from the LexisNexis database while the NYSE required that the authors physically travel to its library and copy each award. O'Neal and Solin cite Rule 10330(f) of the NASD Code of Arbitration which mandates that "'[A]ll awards and their contents shall be made publicly available.'" Id. at 5 n.5.

[150] Id. at 9. Dr. O'Neal and Solin defined a "win" for a claimant if any monetary compensation was awarded to the claimant by the panel. Id.

[151] Id. at 9.

> . . . the percentages [of the compensatory amounts investors requested in their claims] won in cases in which investors were granted an award . . . reached a high in 1998 of 68% and have steadily declined in the later years of the sample to stabilize at approximately 50% in the 2003-2004 time period. Note that this decline in the award percentage roughly corresponds to the decline in win rates over the same period. Toward the end of the sample period, investors were winning less frequently and, when they did win, they were being awarded a smaller percentage of their claim.[152]

The authors state that given an average "win" rate over the sample period of approximately 50%, and with arbitration panels over the sample period awarding "winning" investors on average 50% of the compensation being requested, the investors actual *expected recovery percentage* was approximately 25% of the original amount claimed.[153] The authors further note that this *expected recovery percentage* itself has generally declined during the sample period from a high of 38% in 1998 to only 22% in 2004.[154]

The O'Neal-Solin Report also disclosed that the greater the compensatory dollar amount requested, and the *larger the size* of the brokerage firm named as the respondent, will each tend to result on average in a smaller *expected recovery percentage* for the investor.[155] In fact, the larger size of the broker-dealer and the compensatory amount claimed can dramatically reduce the likelihood for recovery and the percentage amount recovered. The O'Neal-Solin Report found that a compensatory claim for more than $250,000 against a top 3 brokerage firm resulted in a relatively meager expected recovery percentage of 12% compared to a 26% for a similar compensatory dollar claim against a brokerage firm smaller than the top 20 brokerage firms.[156] Conversely, if the claim was between $10,000 and $50,000 against a top 3 brokerage firm, then the expected recovery percentage more than doubled (from 12% to 27%) while a similar dollar

[152] Id. at 11.

[153] Id. at 12.

[154] Id. at 13.

[155] Id. at 14.

[156] Id. at 16.

claim against a brokerage firm smaller than the top 20 brokerage firms increased by only half (from 26% to 37%).[157] The O'Neal-Solin Report concludes, in part, by stating that claimants' ". . . win rates are lower against larger broker firms," "[a]wards as a percent of amount claimed in claimant victories have steadily declined since 1998," and "[t]he larger the case, the lower the award as a percent of the amount claimed."[158]

V. THE PRIMARY CHANGES ENACTED BY THE 2007 REORGANIZATION AND REVISION OF THE NASD CODE OF ARBITRATION

On October 15, 2004, the NASD filed with the SEC the 2007 NASD Code Revision.[159] The filing included a sweeping revision to the NASD Code of Arbitration applicable to customer disputes ("NASD Customer Code").[160] The filing was amended four times, on January 3, January 19, April 8, and June 10, 2005, respectively.[161] It was published for comment on June 23, 2005, which resulted in 53 comments being received by the SEC.[162] During this same time period, the NASD filed a concurrent rule change with the SEC to revise the NASD Code of Arbitration for *industry disputes*.[163]

On May 4, 2006, the NASD filed a fifth amendment to the NASD Customer Code which generated an additional 125 comments.[164] These 125 additional comments were substantially related to the NASD's request for

[157] Id. at 16.

[158] Id. at 17.

[159] See Reorganization and Revision of NASD Rules Relating to Customer Disputes, File No. SR-NASD-2003-158 (October 15, 2003); Notice of Filing of Proposed Rule Change and Amendments 1-4 to Amend NASD Arbitration Rules for Customer Disputes, Exchange Act Release No. 51,856, 70 Fed. Reg. 36442 (June 15, 2005)

[160] See Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, (January 24, 2007); NASD Code of Arbitration Procedure for Customer Disputes, available at http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p018365.pdf.

[161] Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4574 (January 24, 2007).

[162] Id. at 4574.

[163] Id. at 4574.

[164] Id. at 4574.

accelerated approval, discovery, and perhaps most contentious, the proposed Rule 12504 regarding dispositive motions.[165] The NASD responded to this commentary by filing Amendment 6, withdrawing proposed Rule 12504.[166] This sixth amendment was filed on July 21, 2006, and a seventh on August 15, 2006.[167] The SEC then issued an order approving the NASD Customer Code as amended on January 24, 2007.[168] The stated purpose of the revision to the NASD Code of Arbitration was to "to simplify the rule language into plain English, reorganize the rules, codify certain practices, and implement several substantive changes."[169]

A. Motions Practice

The prior NASD Code of Arbitration - essentially silent to motions practice - left the parties and the panel without procedural guidance regarding the filing of motions. Consequently, Rule 12503 establishes minimal procedures and deadlines for making, responding to, and deciding motions.[170]

Initially, the NASD also filed Proposed Rule 12504 which explicitly allowed for dispositive motions, although they were to be ''discouraged and may only be granted in extraordinary circumstances.''[171] However, this specific allowance of a rule for motions to decide claims prior to a *hearing*

[165] Id. at 4577.

[166] Id. On August 24, 2006, the NASD, recognizing the deep debate regarding the issue of dispositive motions, separately re-filed the original text of the proposed rules regarding dispositive motions (Rules 12504 and 13504) in order to provide the public with additional time to comment without delaying the SEC's approval of the remaining revisions to the Code. See Notice of Proposed Rule Change Related to Motions to Decide Claims Before a Hearing on the Merits, Exchange Act Release No. 54,360, 71 Fed. Reg. 51879 (August 24, 2006).

[167] Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4574 (January 24, 2007).

[168] Id. at 4574.

[169] Id. at 4575.

[170] NASD Code of Arbitration Procedure for Customer Disputes § 12503 (2007).

[171] Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4590-91 (January 24, 2007). At first, the proposed rule did not include the "extraordinary circumstances" language. Subsequently, the NASD amended the rule to instruct that such motions be granted only in "extraordinary circumstances," in a failed attempt to placate investor representatives. See SEC File No. SR-NASD-2003-158, Amendment No. 1 (2005).

generated substantial criticism from both investor representatives and industry commentators.[172]

Industry commentators complained that requiring "extraordinary circumstances" would have a chilling effect on the filing of dispositive motions for fear of being sanctioned.[173] Moreover, concerned investor representatives generally cited to claimants having a fundamental "right to a hearing," in addition to arguing that industry defense counsel would take improper advantage of such a rule by increasing the industry's perceived existing abusive use of dispositive motions, thereby causing claimants to incur additional pre-hearing expense in defending against such abusive tactics.[174] Unable to reach a consensus among the various constituencies, Proposed Rule 12504 was withdrawn and re-filed by the NASD as a separate proposed rule change and published for public comment.[175]

The "right to a hearing" argument has a foundation in statutory and case law.[176] The FAA specifically provides that the United States District Courts may vacate an arbitration award:

> Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.[177]

In *Prudential Securities, Inc. v. John B. Dalton,* a federal district court vacated an arbitration award which granted the respondent's pre-hearing motion to dismiss.[178] The court found the arbitration panel "guilty of misconduct in refusing to hear evidence pertinent and material to the controversy." The *Dalton* court went explained its decision as follows:

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[172] Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4590-91 (January 24, 2007).

[173] Id. at 4591.

[174] Id. at 4591.

[175] See Notice of Proposed Rule Change Related to Motions to Decide Claims Before a Hearing on the Merits, Exchange Act Release No. 54,360, 71 Fed. Reg. 51879 (August 24, 2006).

[176] See FAA, § 10(a)(3), 9 U.S.C. § 10; Prudential Securities, Inc. v. John B. Dalton, 929 F.Supp. 1411 (N.D. Okla. 1996).

[177] FAA, § 10(a)(3), 9 U.S.C. § 10 (bold emphasis supplied).

[178] Dalton, 929 F.Supp. 1411.

> The issue is whether or not claimant Dalton was granted a fair hearing under the Arbitration Code to offer evidence in support of his factual claims. . . . the Court concludes [that] by sustaining the motion to dismiss of Prudential the arbitration panel improperly denied claimant the right to a fundamentally fair hearing. Therefore, the Court hereby vacates the underlying arbitration award for the reasons stated above and directs the parties and the matter be remanded to a duly constituted NASD arbitration panel to proceed with an evidentiary hearing and ruling on the merits, within six months from this date.[179]

Additionally, investor representatives have cited to written testimony submitted to Congress by the President of NASD Dispute Resolution, Linda D. Fienberg, as affirming the NASD's commitment that public customers have a right to a hearing:

> In arbitration, an impartial person or panel hears all sides of the issues as presented by the parties, studies the evidence, and then decides how the matter should be resolved. Arbitration is final and binding, subject to review by a court only on a very limited basis as provided by the Federal Arbitration Act or applicable arbitration laws. Courts will vacate decisions by arbitrators only if, for example, a party can demonstrate that an arbitrator . . . failed to accept relevant evidence into the record.[180]

A substantial number of pre-hearing dispostive motions concern the potential application of a statute of limitation for the claim asserted. To defend against such a motion, in addition to the claimant's "right to a hearing" argument, experienced investor representatives assert that arbitrators are not required to apply the statutes of limitations because these *statutory* limitations apply to *statutory* "actions," rather than arbitrations.[181]

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[179] Id. at 1418. See also Neary v. The Prudential Insurance Company of America, 63 F.Supp.2d 208 (D.Conn. 1999).

[180] The Securities Arbitration System: Hearing Before the Subcomm. on Capital Mkt.s, Ins. and Gov't Sponsored Enter.s of the Comm. on Fin. Services, 109th Cong. 33 (2005) (Prepared Statement of Linda D. Fienberg, President of NASD Dispute Resolution).

[181] See Skidmore, Owings & Merrill v. Connecticut General, 197 A.2d 83 (Conn. 1963); Har-Mar v. Thorsen & Thorshov, Inc, 218 N.W.2d 751 (Minn. 1974); Lewiston Firefighters Assoc. v.

This argument comports with the general principle that arbitrators are not required to follow the law due to arbitration's special nature as an equitable, private dispute resolution mechanism designed to avoid litigation in the courts.[182]

However, the perception exists among many investor representatives that the securities industry's use of dispositive motions is rapidly expanding. On April 11, 2003, the GAO reported to Congress that out of 719 investor-initiated NASD monetary customer awards in 2001, dispositive motions were filed in only 54 (8.34%) of the cases.[183] However, this author's recent review of the 68 awards reported by the NASD as being rendered in January of 2007, in which the arbitration panel either denied the investors' claims or awarded the investors some compensation after the respondents appeared in defense at the evidentiary hearing, shows a marked increase in the use of dispositive motions. This recent NASD award data reveals that industry respondents filed motions to dismiss in 24 (35.2%) of the 68 cases.[184]

The GAO further reported to Congress that while nothing in the NASD Code of Arbitration expressly authorized the use of dispositive motions, nor did it specifically preclude them.[185] The GAO also cited relevant case law as evidence that the courts have consistently "recognized the authority of arbitrators to grant pre-hearing motions to dismiss."[186]

City of Lewiston, 354 A.2d 154 (Me. 1976); Son Shipping Co. v. DeFosse & Tangle, 199 F.2d 687 (2d Cir. 1952); NCR Corp. v. CBS Liquor Control, Inc., 1993 WL 767119 (S.D. Ohio); Carpenter v. Pomerantz, 634 N.E.2d 587 (Mass. App. 1994).

[182] See Raisler Corp. v. NYC Housing Authority, 32 N.Y.2d 274 (1973); SCM Corporation v. Fisher Park Lane Company, 358 N.E.2d 10248 (1973); Associated Teachers of Huntington v. Board of Education, 33 N.Y.2d 229 (1973); Town of Haverstraw v. Rockland County Patrolmen's Benevolent Assoc., 481 N.E.2d 248 (1985).

[183] Gen. Acct. Off., Rep. No. GAO-03-162R, Follow-up Report on Matters Relating to Securities Arbitration 6 (2003). This report primarily concerns arbitrator disclosure/removal, dispositive motions, and changes in the frequency of unpaid arbitration awards.

[184] Available at April 22, 2007, http:nasdawardsonline.nasd.com/search.aspx.

[185] Gen. Acct. Off., Rep. No. GAO-03-162R, Follow-up Report on Matters Relating to Securities Arbitration 6 (2003).

[186] Id. (citing Warren v. Tacher, 114 F.Supp. 2d 600 (W.D. Ken. 2000); Goldman, Sachs & Co. v. Patel (N.Y.L.J. Aug. 18, 1999, p. 23, co. 6) ("Contrary to respondent's assertion, the NASD panel has the power to decide a motion to dismiss a claim on legal grounds without holding an evidentiary hearing.")).

See also Sheldon v. Vermonty, 269 F.3d 1202 (10th Cir. 2001).

Thus, claimants are losing their right to proceed to a full arbitration hearing. Motions to dismiss have been considered and claims dismissed without the benefit of an evidentiary hearing, or pre-hearing discovery such as depositions or interrogatories. Furthermore, a dismissal under these circumstances would result in the arbitration record being insufficient for an appellate court to decide the issue of manifest disregard of the law. This would be especially true given that the NASD Customer Code currently does not require an explanatory award (or order) outlining the basis for dismissal on a dispositive basis.

In an apparent response to the increased use of dispositive motions by the securities industry, FINRA has recently once again attempted to delineate the proper contours of a motion to dismiss in securities arbitration. On September 26, 2007, FINRA announced that its Board of Governors approved rule amendments to the FINRA Code of Arbitration intended to significantly reduce both the number and abuse of dispositive motions.[187] The rule amendments would limit the applicability of any motion to dismiss filed before an investor finished his or her case to three scenarios: 1) the matter was settled in writing by the parties; 2) that it would be a "factual impossibility" for the party to have been associated with the conduct at issue; or 3) upon grounds based upon the existing requirement under Rule 12206 that an arbitration claim must be filed within 6-years from the occurrence or event giving rise to the claim.[188] Moreover, the filing of a dispositive motion under these rule amendments require that arbitrators hold a hearing regarding the motion, and that any decision granting the motion be unanimous and accompanied with a written explanation for the arbitrators' dismissal.[189]

In an October 2, 2007, Notice to Members regarding this latest rule proposal concerning dispositive motions, FINRA conceded that it was:

> aware that parties increasingly are filing motions to decide claims before a hearing . . . [and that it was] concerned that

[187] Press Release, FINRA Board Approves Rule to Limit Motions to Dismiss in Arbitrations (September 26, 2007), available at http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P037048.

[188] Id.

[189] NASD Notice to Parties on Motions to Dismiss Claims Prior to Award (Dispositive Motions) under the Code of Arbitration Procedure for Customer and Industry Disputes (October 2, 2007), available at http://www.finra.org/ArbitrationMediation/ResourcesforParties/NoticestoParties/p037078.

> parties are spending additional resources to defend against these motions, thus increasing the costs and processing times of the arbitration process.[190]

Moreover, FINRA stated that the rule amendments require that the arbitration panel assess all forum fees against the moving party if the panel denies a dispositive motion which had been filed before the end of the claimant's case, in addition to mandating sanctions against the moving party in the form of the opposing party's costs and attorney's fees for any such dispositive motion the panel deems frivolous.[191] These new amendments will replace that of Proposed Rule 12504 discussed *supra*.

Given the rise in the use of dispostive motions in securities arbitrations, the FINRA rule amendments would provide arbitration panels with rational guidance regarding the proper role of dispositive motions in the context of SRO securities arbitration. The primary cautionary note one takes away from FINRA's proposal is exactly what set of circumstances actually constitutes a "factual impossibility." FINRA states that it means that the "party could not have been associated with the conduct at issue."[192] Such a determination *on its face* requires a finding of fact by the arbitration panel. Moreover, given the limited discovery afforded by the arbitration process – typified by the fact that it is generally unheard of for a panel to order the taking of depositions - the SEC should take pause before approving the NASD's currently proposed rule amendments regarding dispositive motions without additional discovery safeguards, lest it create further argument for a repudiation of *McMahon*.

B. Sanctions

Rule 12212 of the NASD Customer Code now codifies the sanctions described in the NASD Discovery Guide,[193] including making an adverse inference against a party or assessing adjournment fees, forum fees, costs and expenses, and/or attorneys' fees for noncompliance with discovery orders, while extending sanctions to non-compliance with any provision of

[190] Id.

[191] Id.

[192] Id.

[193] See NASD Code of Arbitration Procedure for Customer Disputes § 12212 (2007); see NASD Notice to Members, 99-90 (1999) ("NASD Discovery Guide").

the NASD Customer Code, or arbitrator order.[194] This revision substantially expands the sanctioning power of a panel, in part to deter aggressive discovery tactics which the NASD has recognized as being common place in NASD arbitrations, and to clarify that the panel has the authority to sanction parties for noncompliance with the Customer Code.[195]The revised NASD Customer Code retains for the arbitrator the authority to dismiss a claim, defense, or arbitration, for non-compliance with an arbitrator's order.[196]

While the power to sanction has greatly increased under the new rules, the arbitration panel still lacks the judiciary's power to levy Rule 11 style sanctions against attorneys for improper practices.[197] Unfortunately, the behavior of counsel appearing before an NASD arbitration panel does not always rise to the level of expected decorum before a state or federal judge. While the lack of sanctioning power against attorneys individually is arguably for the better given the lack of adequate appellate review concerning arbitration awards, FINRA should consider a formal process to distinguish those broker-dealers which compile a history of repeated discovery sanctions from those who do not.

C. Discovery

The revised NASD Customer Code also essentially codifies the discovery and document production procedures set forth within the NASD Discovery Guide.[198] The SEC believes this codification, along with the

[194] Id. See also Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4602 (January 24, 2007).

[195] See NASD Code of Arbitration Procedure for Customer Disputes § 12212 (2007); see also Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4602-03 (January 24, 2007).

[196] See Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4602 (January 24, 2007).

[197] See Rule 11, Federal Rules of Civil Procedure.

[198] See Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD

Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4604 (January 24, 2007).

arbitration panel's clarified authority to sanction a party for non-compliance with the discovery and document production procedures, should reduce discovery disputes.[199]

Rule 12514 provides that the parties are only required to produce documents during the "20 Day Exchange"[200] which had yet to be produced during the discovery process, thereby reducing the overall expense of the arbitration process for all parties.[201] Rule 12514 codifies what has become customary between experienced arbitration counsel. The rule also creates a presumption that documents and witness lists not produced by the 20 Day Exchange will be excluded unless the panel determines that "good cause exists for the failure to produce the document or identify the witness.".[202] Rule 12514 states, in part, that:

Good cause includes the need to use documents or call witnesses for rebuttal or impeachment purposes based on developments during the hearing. Documents and lists of witnesses in defense of a claim are not considered rebuttal or impeachment information and, therefore, must be exchanged by the parties.[203]

Rule 12514 is somewhat more restrictive compared to the old rule. Under the old rule (R. 10321), a party was *expressly* not obligated to produce documents or witness lists to be used in rebuttal or cross-examination, nor did the rule attempt to define "rebuttal or impeachment information."[204] Furthermore, while under the old rule the arbitration panel

[199] Id.

[200] The phrase "20 Day Exchange" is the phrase customarily used by practitioners for the time period and procedure dictated by the NASD Code of Arbitration to exchange documents and witness lists before the hearing ("20 days before the first scheduled hearing date") by which a party provides notice to other parties of those documents and witnesses which he intends to introduce or call to testify in his case-in-chief. See NASD Code of Arbitration Procedure for Customer Disputes § 12514 (2007).

[201] See NASD Code of Arbitration Procedure for Customer Disputes § 12514 (2007); see also Order Approving Proposed Rule Changes and Amendments thereto regarding the NASD Customer and Industry Codes for Arbitration, Exchange Act Release No. 55,158, 72 Fed. Reg. 4573, 4606 (January 24, 2007); NASD NTM 99-90 (1999) (For the Discovery Guide to be used for NASD and FINRA arbitrations filed after April 16, 2007, available at http://www.finra.org/web/groups/rules_regs/documents/
rule_filing/p018365.pdf.).

[202] See NASD Code of Arbitration Procedure for Customer Disputes § 12514 (2007).

[203] NASD Code of Arbitration Procedure for Customer Disputes §12514(c) (2007).

[204] NASD Code of Arbitration, available at http://www.finra.org/web/groups/med_arb/

was *allowed* the power to exclude non-rebuttal and non-cross-examination documents and witnesses which were not identified by the 20 Day Exchange and which did not qualify under the rebuttal or cross-examination discovery exception, the old rule did not *expressly* exclude such documentation or witnesses from being introduced or testifying.[205]

D. Arbitrator Selection

Recognizing the need for an experienced arbitrator to occupy the position of Panel Chair, Rule 12400(c) requires that an arbitrator must be "chair-qualified" by completing specific NASD training (or possessing substantially the equivalent training or experience), in addition to being either an attorney having served on two SRO arbitrations in which hearings were held or a non-attorney having served on three SRO arbitrations in which hearings were held.[206]

Rule 12403 no longer allows an unlimited number of strikes which a party could exercise to remove potential arbitrators from serving on a panel.[207] For an NASD arbitration panel consisting of three arbitrators, three lists of arbitrators are now generated; chair-qualified, non chair-qualified public, and non-public, with each listing eight potential arbitrators.[208] Under Rule 12404, each separately represented party is limited to four strikes each per list. Additionally, no longer may a party request arbitrators with a particular expertise.[209] The cumulative effect of these rules is that individual parties have even less control over the arbitrator selection process.

In fact, the composition of the arbitrator pool takes on even greater significance since the system can easily be manipulated if either side – investor representatives or the securities industry – actively recruits individuals to become arbitrators which might favor a particular "point of view."

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documents/mediation_arbitration/p018653.pdf.

[205] Id.

[206] NASD Code of Arbitration Procedure for Customer Disputes § 12403(c) (2007).

[207] Id.

[208] Id.

[209] See NASD Code of Arbitration Procedure for Customer Disputes §§ 12400-14 (2007) ("Part IV

Appointment, Disqualification, and Authority of Arbitrators").

E. Revised Pleading And Discovery Deadlines

Rule 12304 of the NASD Customer Code extends the time a claimant has to answer a counterclaim to 20 days (from 10 under the old rule),[210] as measured from the receipt of the counterclaim, while Rule 12305 reduces the time that a respondent has to answer a cross claim to 20 days (from 45).[211]

Rule 12309 restricts a party's ability to amend a pleading to add a party between the time that ranked arbitrator lists are due and the time the panel is appointed, while also requiring that a party to be added by motion must be given an opportunity to be heard by the panel "without waiving any rights or objections under the Code."[212]

Rule 12310 requires, in most instances, a party to answer an amended pleading within 20 business days.[213] Additionally, the proposed discovery rules extend the time that parties have to respond to discovery requests from 30 to 60 days, a length of time which has become customary among practitioners.[214]

VI. THE NASD RULE PROPOSAL REGARDING "EXPLANATORY" DECISIONS AND THEIR POTENTIAL EFFECT UPON JUDICIAL REVIEW

In 1989, the SEC expressed a negative view toward requiring an arbitration panel to issue a written opinion.[215] The SEC deemed the data required to be included in an award under the rules at that time as being sufficient for the application of the *manifest disregard* standard for judicial review.[216] The SEC cited to the fact that an award may reflect an agreement on the damage amount without reaching consensus regarding "the reasons"

[210] NASD Code of Arbitration Procedure for Customer Disputes § 12304 (2007).

[211] NASD Code of Arbitration Procedure for Customer Disputes § 12305 (2007).

[212] NASD Code of Arbitration Procedure for Customer Disputes § 12309(b)-(c) (2007).

[213] NASD Code of Arbitration Procedure for Customer Disputes § 12310 (2007).

[214] NASD Code of Arbitration Procedure for Customer Disputes § 12506 (2007).

[215] Lynn Katzler, Should Mandatory Written Opinions be Required in All Securities Arbitrations?: The Practical and Legal Implications to the Securities Industry, 45 Am. U. L. Rev. 151, 173 (1995) (citing Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Pre-dispute Arbitration Clauses, Exchange Act Release No. 26,805, 54 Fed. Reg. 21,144, 21,151-52 (1989)).

[216] Katzler, supra note 215, at 173.

for such sum; that written awards would reduce the efficiency which arbitration affords while acting as a deterrent for arbitrator participation; and lastly, that arbitrators who were so inclined were already free to deliver written opinions.[217]

One commentator considered the SEC's stance as unrealistic regarding the strict application of the *manifest disregard* standard.[218] The commentator argued that written opinions would inform investors regarding the reasons why they prevailed or lost, and are consistent with the investor protection intended under the federal securities laws by providing a record for proper appellate review of arbitrator bias or error, in addition to generating arbitration award uniformity and predictability.[219]

On March 15, 2005, the NASD filed a proposed rule with the SEC to provide written explanations in arbitration awards upon the request of customers, or from a request by associated persons involved in industry controversies.[220] In particular, the proposed rule amendment defines an *explained decision* as being:

> a fact-based award stating the reason(s) each alleged cause of action was granted or denied. Inclusion of legal authorities and damage calculations is not required. . . [a]n explained decision will relate to all claims involved in the case, whether brought by the requesting party or another party.[221]

In its filing, the NASD stated that NASD Code of Arbitration did not require that the arbitrators include the rationale underlying their decision in

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[217] Id. at 173.

[218] Id. at n.158.

[219] Id. at 195-96.

[220] Proposed Rule Change to Provide Written Explanations in Arbitration Awards Upon the Request of Customers or Associated Persons, File No. SR-NASD-2005-032 (2005), available at http://www.finra.org/

web/groups/rules_regs/documents/rule_filing/p013541.pdf; see also Notice of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto, to Provide Written Explanations in Arbitration Awards Upon the Request of Customers or of Associated Persons in Industry Controversies, Exchange Act Release No. 52,0009, 70 Fed. Reg. 41065 (July 11, 2005).

[221] Proposed Rule Change to Provide Written Explanations in Arbitration Awards Upon the Request of Customers or Associated Persons, File No. SR-NASD-2005-032, 5 (2005), available at August 29, 2007, http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p013541.pdf.

the award, and that they usually did not provide an explanation.[222] Moreover, losing parties in an arbitration often requested written explanations from arbitrators, but that arbitrators were not likely to provide them.[223] Contending that this lack of explanation was a major complaint of losing parties; the NASD reasoned that in order to increase investor confidence in the fairness of the arbitration process, explained decisions should be provided upon request.[224]

The NASD surprisingly admitted that the lack of an explained decision made it "all but impossible for the judiciary to determine whether the panel acted with manifest disregard of the law." [225] But this admission was made to support the NASD's decision to restrict the right to an explained decision to customers and associated persons, thereby reducing the chance that an appellate review would result in vacating an award rendered in favor of the customer or associated person.[226] The proposed rule only allows a member firm an *opportunity* to make an explained decision request, but unlike requests from customers and associated persons, the arbitration panel need not comply with the member's request.[227]

The NASD's proposed rule increases the probability of a successful appeal by requiring the panel to provide a written rationale for an award. Furthermore, the potential use of an explained decision for precedence is apparent.

Not surprisingly, on April 14, 2005, the NASD filed an amendment to the rule proposal which included the following footnoted language:

While Rule 10323 provides the arbitrators shall determine the materiality and relevance of any evidence proffered, NASD intends that, as with current arbitration awards, explained decisions will have no precedential value in other cases. Thus, arbitrators will not be required to follow any findings or determinations that are set forth in prior explained decisions. NASD plans to put a legend on any explained award stating that the award has no precedential value and cannot be cited in any subsequent award.[228]

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[222] Id. at 8.

[223] Id. at 8.

[224] Id. at 8-9.

[225] Id. at 9-10 (citing Dawahare v. Spencer, 210 F.3d 666, 669 (6th Cir. 2000)).

[226] Id. at 10.

[227] Id. at 10.

[228] SEC File No. SR-2005-032, Amendment 1, p. 20, available at http://www.finra.org/web/groups/

On August 2, 2005, the Securities Industry Association ("SIA")[229] provided a comment to the SEC which expressed a "number of significant concerns" regarding the proposed rule, including the likelihood of it increasing the number of motions to vacate; that damage awards would be more likely subject to attack; and the increased potential of such awards being used for precedence.[230] These views were in stark contrast to those expressed by a past president of the Public Investors Arbitration Bar Association ("PIABA"),[231] Robert S. Banks, Esq. Mr. Banks stated that he was a strong proponent of reasoned awards as proposed by the NASD, but conceded that PIABA members were divided on the issue, and that this division was primarily due to the increased possibility that the brokerage firm would file a motion to vacate in response to an award favorable to the investor.[232] In support of his position, Mr. Banks stated that given the importance of the award to the future financial well-being of the claimant, along with the fact that the claimant had no choice but to arbitrate the claim, it was only fair that the claimant learn the reason why he or she won or lost.[233] Additionally, he argued, arbitrators were less likely to reach a compromise award if they were required to render in writing their reasons for the decision.[234] Moreover, Mr. Banks contended that investor representatives would soon discern an arbitrator's knowledge and personal views regarding the duties owed to investors by the securities industry.[235]

To date, the SEC has not yet ruled upon FINRA's 2005 proposed rule regarding explained decisions. However, given FINRA's recently proposed rule amendments requiring an explanatory decision accompanying an order

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rules_regs/documents/rule_filing/p013823.pdf

[229] The SIA, with a membership of nearly 600 securities firms, was the principal trade association representing the securities industry. It has since broadened its base by merging with the Bond Market Association in 2006 to form the Securities Industry and Financial Markets Association ("SIFMA"). See SIFMA's website available at http://www.sifma.org/about.html.

[230] Letter from Edward G. Turan, Chairman of the SIA Litigation and Arbitration Committee, to Jonathan G. Katz, Secretary of the SEC (August 2, 2005) (SIA Comment Letter on file with the SEC).

[231] PIABA is the national bar association dedicated to representing investors involved in disputes with the securities industry. PIABA's website is available at https://secure.piaba.org/piabaweb/html/index.php.

[232] Robert S. Banks, The NASD's Explained Awards Rule Filing, 1553 PLI/Corp 225 (2006).

[233] Id. at 229-30.

[234] Id. at 230.

[235] Id. at 230.

of dismissal for a dispositive motion filed before the end of a claimant's case, it is clear that the SEC will soon have to address the issue of explained decisions in the context of securities arbitrations.

VII. THE PERCEIVED BIAS OF THE INDUSTRY ARBITRATOR

The fairness of a the NASD Arbitration Code mandating an "industry" arbitrator on every three-person arbitration panel - in addition to the proper definition as to what actually constitutes an industry arbitrator versus a public arbitrator - has long been debated.[236] The securities industry has defended the NASD Code of Arbitration requiring an industry representative on a three person panel hearing customer disputes, while investor representatives have been largely against the requirement. However, a recent study regarding NASD arbitrations *appears* to disclose a "substantial level of satisfaction among parties and representatives," although the study was completed by a relatively small number of participants (10-20%) and a disproportional percentage of those parties who considered themselves to be "satisfied" completed the survey, as opposed to those parties who were "dissatisfied."[237]

The aforesaid study notwithstanding, the perceived bias of securities arbitration in favor of the securities industry, particularly as it relates to the industry arbitrator, is a grievous subject among many, if not most, investor representatives. Not atypical of this point of view is the following excerpt from a letter sent to the Director of Arbitration for the NYSE by one practitioner:

> I have been an attorney for twenty nine (29) years. . . I am board certified in business litigation by the Florida Bar, presently serve as President of the Martin County Bar Association, and have served on the Florida Bar's Civil Procedure Rules Committee and Rules of Judicial Administration Committee for many years. I have tried dozens of cases before judges and juries, in the State and

[236] Katsoris, The Composition of SRO Panels?, Securities Arbitration Commentator, Oct. 2003, at 3.

[237] Michael A. Perino, Report to the SEC regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, p. 34 (November 4, 2002) (citing Gary Tidwell, Kevin Foster & Michael Hummel, Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations. (1999)).

> Federal courts of Florida, and I have arbitrated numerous securities claims against broker/dealers. . .
>
> I have found the system of arbitration employed by the NYSE and the NASD to be a tribunal which is unfair, prejudiced, and totally skewered in favor of the securities and against the claimant. . . . I have witnessed securities industry arbitrators and neutral arbitrators clearly biased against claimants, and in favor of the securities industry . . . I have seen attorneys representing the securities brokers who were respondents in my claims behave and engage in conduct that, in a court of law, would be held contemptuous . . .
>
> In short, the system is not just broken, but destroyed and should be abolished. How can claimants receive fair treatment, when one of the arbitrators is a representative of the securities industry . . .[238]

A. SICA's Securities Arbitration Fairness Survey - 2007

Substantial and persistent concerns regarding the perceived bias of securities arbitration has once again prompted a survey of participants regarding the process.[239] The stated purpose of the survey is "to evaluate the fairness of the arbitration of customer claims at both" the NASD and the New York Stock Exchange.[240] Entitled "Securities Arbitration Fairness Survey – 2007," the survey is being conducted for SICA by an affiliate of the Pace University School of Law, the Pace Investor Rights Project.[241] A number of the survey's questions reflect many of the concerns regarding, and arguments against, mandatory arbitration, and include:

> 6b. Were you aware before the dispute arose that the

[238] Letter from Richard H. Levenstein, Esq., to Karen Kupersmith, Director of Arbitration, NYSE (December 21, 2005) (on file with the SEC).

[239] Letter from Constantine N. Katsoris, Securities Industry Conference on Arbitration ("SICA"), to William B. L. Little, Esq., (March 22, 2007) (which included an attachment of SICA's "Securities Arbitration Fairness Survey 2007") (on file with Author).

[240] Id.

[241] Id.

> customer agreement contained an arbitration clause?;
>
> . . .
>
> 7. What was the primary reason this dispute was filed in an arbitration forum? [with potential answers including a belief that arbitration would be faster than court, less expensive than court, more fair than court, provide a larger recovery than court, or was required, or that a lawyer recommended it, among other potential answers];
>
> 8. Before the . . . dispute was filed in arbitration, did you have concerns about the securities arbitration forum? (select all that apply) [with potential answers including that the party was concerned that arbitration would not be a fair process, concerned about the composition of the arbitration panel, and concerned that the arbitrators would be biased, among other potential answers];
>
> . . .
>
> 14d. Would you say that the industry arbitrator favored one side over the other at any time during the dispute?[242]

The survey appears to be quite in-depth and balanced in its questions and manner of presentation, including requesting the party's view of the competency and impartiality of the arbitration panel.[243] For example, one query requested whether the party would have been more satisfied had he or she been provided an "explanation" of the award, and another requested the party's view as to whether the panel applied the law to the dispute.[244] Nonetheless, while surveys may be informative regarding general levels of investor satisfaction regarding the securities arbitration process, they can not serve as a sole substitute for a

[242] Id.
[243] Id.
[244] Id.

> reasoned examination of whether securities arbitration as currently structured provides the constitutional and statutory rights and safeguards owed the individual investor.

B. Arbitrator Classifications

The last major revision to the classification of arbitrators under the NASD Code Arbitration occurred in 2006.[245] The intent of this revision was to "ensure" that the definition of a *public* arbitrator excluded those individuals with "significant ties" to the securities industry.[246]

Additional limitations regarding who may serve as a *public* arbitrator included, among others, restrictions concerning individuals who "work for, or are officers or directors of, an entity that controls, is controlled by, or is under common control with" an entity engaged in the securities business, and individuals who have a spouse or immediate family member "who works for, or is an officer or director of, an entity that is in such a control relationship with" an entity engaged in the securities business.[247]

The SEC noted that the majority of commentators believe fairness dictated that arbitrators with any ties to the securities industry should be completely excluded from arbitration panels deciding customer disputes.[248] As support for the exclusion of the *industry* arbitrator, these commentators argue that expert testimony should be substituted for the industry arbitrator's so-called *expertise*, that the securities industry has coerced the industry arbitrator to reduce the amount of compensation awarded, and that the industry arbitrator is "inherently biased."[249]

Moreover, the definition of who qualifies as a *public* arbitrator came under harsh attack. In particular, commentators stated that certain attorneys with significant relationships with the securities industry would still qualify

[245] Order Approving Rule Change to the Classification of Arbitrators, Exchange Act Release No. 54,607, 71 Fed. Reg. 62026 (October 20, 2006).

[246] Id. at 62027.

[247] Id. at 62027.

[248] Id. at 62028 (October 20, 2006) ("The majority of commentators expressed the view that the mandatory inclusion of arbitrators who are involved in the securities industry on arbitration panels creates an unfair burden for investors seeking redress, and stated that arbitration panels should be comprised only of individuals with no ties to the securities industry.").

[249] Id at 62028.

as public arbitrators. Under the rules, an attorney whose firm receives millions of dollars in fees from the securities industry would still qualify as a "public" arbitrator so long as the law firm's securities-related annual revenues did not meet or exceed a 10 percent threshold for the prior two years.[250]

As one investor representative succinctly commented:

> When the investor asks who the arbitrators are, you tell him or her that one of the three must come from the securities industry. That alone creates a strong appearance, not to mention a frequent reality, that the industrys [sic] pecuniary interests will influence the outcome. Then, as if that were not bad enough, you have to tell the investor that the other two public arbitrators might be attorneys who represent securities brokerage firms . . . can you see how someone might think that arbitration before such a panel was going to be a kangaroo court?[251]

C. The NASD Responds

In reaction to this criticism that even with a 10% threshold regarding annual revenue from broker-dealer clients, an attorney whose firm generates substantial legal fees defending the securities industry in NASD arbitration could still qualify as a *public* arbitrator, on March 12, 2007, the NASD filed a proposed rule to further amend the definition of a public arbitrator for both the NASD Customer Code and the NASD's code of arbitration for industry disputes.[252] As it relates to the NASD Customer Code, the NASD currently proposes that Rule 12100(u) be amended to include an annual revenue limitation such that a "public arbitrator" could not be:

> an attorney, accountant, or other professional whose firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1) relating to any customer

[250] Id. at 62028

[251] Letter from Scot Bernstein, Esq., to Jonathan G. Katz, Secretary, SEC (September 20, 2005) (on file with the SEC).

[252] See Notice of Proposed Rule Change to Amend the Definition of Public Arbitrator, Exchange Act Release No. 56,039, 72 Fed. Reg. 39110 (July 10, 2007).

> disputes concerning an investment account or transaction, including but not limited to, law firm fees, firm fees, and consulting fees. . .[253]

While the proposed $50,000 annual revenue limitation regarding *customer dispute* related revenue should certainly reduce the concern held by a number of investor representatives that "an arbitrator classified as public might work for a very large law firm that derived less than 10% of its annual revenue from broker-dealer clients, but still receives a large dollar amount of such revenue,"[254] there would still exist a substantial loophole for revenue which was not related to a customer dispute "concerning an investment account or transaction" so long as such revenue did not meet or exceed the 10% threshold.[255] An obvious example of law firm revenue qualifying for this loophole would include legal fees generated from broker-dealer clientele for underwriting services.

VIII. THE NASD - NYSE MERGER: THE BIRTH OF FINRA

On November 28, 2006, the NASD and NYSE announced a consolidation plan which would merge the regulatory functions of the two SROs into one private-sector regulator.[256] On January 21, 2007, the NASD announced that its member firms approved the By-Law changes required for the consolidation.[257] The stated purpose behind the creation of a single SRO was cost reduction and elimination of overlapping regulation.[258]

The SEC approved the merger on July 26, 2007.[259] This consolidation created a single arbitration forum, known as the Financial Industry

[253] File No. SR-NASD-2007-021, p. 3 (March 12, 2007), available at http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p018808.pdf.

[254] Id. at pp. 9-10.

[255] Id. at pp. 9-10.

[256] Press Release, NASD Member Firms Embrace Streamlined, More Efficient Regulation (January 21, 2007), available at http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P018334.

[257] Id.

[258] Id.

[259] Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Exchange Act Release No. 56,145, Fed. Reg. 42169 (July 26, 2007).

Regulatory Authority ("FINRA") under the auspices of the current President of NASD Dispute Resolution.[260] Initially, pending NYSE arbitration cases will be administered by FINRA pursuant to the NYSE Regulation Arbitration Rules, while those pending with the NASD will be administered by FINRA pursuant to the NASD Code of Arbitration.[261] All arbitration and mediation cases filed on or after August 6, 2007, will be administered by FINRA pursuant to the NASD Code of Arbitration.[262]

As a result of the merger, investors will realistically be reduced to a single SRO arbitration forum to resolve their individual disputes with their broker-dealer. The surviving arbitration forum will have a virtual monopoly over securities arbitrations and therefore will logically be less inclined to respond to individual investor representatives' concerns regarding perceived fairness issues.

A. Concerns Expressed Regarding the Merger by SICA's Public Members

Recently the public members of SICA ("SICA's Public Members"),[263]

[260] Press Release, Schapiro Announces Leadership and Structural Moves for New, Consolidated SRO. (March 16, 2007), available at http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P018829.

[261] Administration information available at http://www.finra.org/ArbitrationMediation/index.htm.

[262] Id.

[263] SICA's Public Members' particular mission in SICA's continuing role of ensuring "an arbitration process that protects public investors' rights in securities arbitration" was described by them as follows:

> The Public members voice their concerns and make recommendations for reform. SICA's three voting Public Members are augmented by the experience of the Emeritus Public Members. No Public Member is affiliated with the securities industry. While the Emeritus Public Members do not have a vote, as the Public Members do, they can also attend meetings, receive agenda books, submit agenda items, invite guests and participate in the discussions, all of which benefits public investors and aids the perception of integrity and fairness in monitoring the SRO arbitration system.

See Letter from Public Members of SICA to the Honorable Christopher Cox, Chairman, The United States Securities and Exchange Commission (January 12, 2007) (on file with the SEC) (signatories to the letter comprised the full membership of SICA's Public Members, including then current members Theodore G. Eppenstein, Constantine N. Katsoris, and J. Pat Sadler, and emeritus members Peter R. Cella, Thomas R. Grady, and Thomas J. Stipanowich).

in a letter addressed to the Honorable Christopher Cox, Chairman of the SEC, went on record with their concerns regarding the pending NASD-NYSE regulatory merger and the fairness of arbitration in general.[264] SICA's Public Members stated primary concerns included whether a single arbitration forum "maintained and funded by the securities industry will only heighten the suspicion long held by many public investors" that the SRO arbitration system was not independent, nor fair.[265] SICA's Public Members argued that the "real issue" raised by the pending NASD-NYSE regulatory merger is whether the Consolidated SRO should be the sole provider of the mandatory securities arbitration forum versus having this "critical function" instead shared with, or given completely to, an arbitral body completely independent of the securities industry.[266] SICA's Public Members cited the long-term downward trend of favorable awards rendered to the public customer in securities arbitration and the fact that even when there is an award in favor of the public customer, the amount ordered frequently is only a small percentage of the losses suffered, "sometimes not even enough to pay for their costs to arbitrate."[267]

SICA's Public Members further argued that a single *independent* arbitration forum, with not only SEC oversight and securities industry participation, but also public investor participation, would reduce the public's perception that securities arbitration is an unfair process.[268] However, an even stronger alternative to mandated SRO arbitration was presented by SICA's Public Members in the following passage from the January 12, 2007 letter:

Another alternative to compulsory SRO arbitration would be to again provide the public investor with the right to choose to bring grievances to

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[264] Id.

[265] Id.

[266] Id.

[267] Id. SICA's Public Members further state the following in support of their view that there exists a strong public perception that arbitration is not a fair process:

. . . the public has been warned by a well-respected journalist that: "If you're an investor who has filed an arbitration case against your stockbroker, you would be wise to steel yourself for an irrational and unjust outcome."

Id. (citing Gretchen Morgenson, FAIR GAME; When Winning Feels A Lot Like Losing, New York Times, Business Section, December 10, 2006, p. 1.).

[268] Letter from Public Members of SICA, to the Honorable Christopher Cox, Chairman, The United States Securities and Exchange Commission (January 12, 2007) (on file with the SEC).

court or to arbitration. While not all cases would be susceptible to resolution in court (for example, claims under $25,000), it would permit the public investor the choice as was their right prior to 1987.[269]

The NASD responded to the SICA's Public Members' January 12, 2007, letter in a January 26, 2007, letter addressed to them and authored by Linda D. Fienberg, NASD Dispute Resolution President, in which she challenged "any notion that NASD's arbitration" was unfair.[270] Ms. Fienberg cited a 1999 report which analyzed surveys submitted by participants in NASD arbitrations in which the report's author concluded that parties to NASD arbitrations are "overwhelmingly satisfied with the fairness of the forum.[271] Ms. Fienberg further argued that there already had been a steady migration by investors to the NASD arbitration forum such that its estimated share of 2006 arbitrations concerning investor-broker disputes would total 94%.[272]

To rebut the SICA's Public Members' statement that customers' "chances of winning an award had substantially dwindled to around forty-three percent by 2006," Ms. Fienberg argued that it would be "empirically dubious" to conclude that the question of an arbitration forum's fairness could be based upon "outcome rates over a period of time."[273] Ms. Fienberg proffered an opinion that *publicity* regarding regulatory action may act to increase the percentage of frivolous claims along with her view that experienced respondents' attorneys tend to settle the strongest cases

[269] Id.

[270] Letter from Linda D. Fienberg, President of the NASD, to Theodore G. Eppenstein, Esq., Peter R. Cella, Esq., Constantine N. Katsoris, Thomas R. Grady, Esq., J. Pat Sadler, Thomas J. Stipanowich, SICA's Public Members, p. 2 (January 26, 2007) (on file with the SEC, and copied to each standing SEC Commissioner, various members of Congress, and other interested individuals).

[271] Id. at 2 (citing Gary Tidwell, Kevin Foster, and Michael Hummel, Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations, at 3 (August 5, 1999)). For additional support, Ms. Fienberg cited Michael Perino, Report to the SEC Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, at 51 (November 4, 2002) (said report is available at http://sec.gov/pdf/arbconflict.pdf.). Ms. Fienberg directly quoted Professor Michael A. Perino as stating that all "available empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair." Id.

[272] Letter from Linda D. Fienberg, President of the NASD, to Theodore G. Eppenstein, Esq., Peter R. Cella, Esq., Constantine N. Katsoris, Thomas R. Grady, Esq., J. Pat Sadler, Thomas J. Stipanowich, SICA's Public Members, p. 2 (January 26, 2007).

[273] Id. at 3.

filed by investors, and that most customer cases settle or are withdrawn, as being factors which may explain a decreasing trend of favorable arbitration awards being rendered to investors.[274]

Ms. Fienberg sought to dispel the SICA's Public Members' notion that investors should be allowed to choose another non-SRO arbitration forum or to avoid arbitration altogether by having the right to file suit in court. The NASD Dispute Resolution's President cited to the failed 2000 SICA Pilot program in which investors were offered, in lieu of filing with an SRO arbitration forum, the option to file with JAMS or the American Arbitration Association.[275] This program's failure, in part, was ostensibly due to these non-SRO forums' higher fees and investors' "general degree of comfort with existing and more familiar SRO procedures."[276] Ms. Fienberg argued against the suggestion that customers should have the right to file their claims in a court of law by simply citing *McMahon* and subsequent Supreme Court case law approving mandatory arbitration as determinative of the issue, and quoting *Gilmer* regarding the Court's "strong endorsement of the federal statutes favoring this method of resolving disputes."[277]

In its order approving the NASD-NYSE regulatory merger, the SEC recognized and addressed many of the concerns held by the SICA's Public Members, as well as other commentators, regarding the consequences of the proposed consolidation and many other long-standing complaints such as the required "industry" arbitrator and the very existence of mandatory SRO arbitration.[278] Nonetheless, the SEC still found that the proposed merger was consistent with Exchange Act's requirement that an association's rules must: "be designed, among other things, to prevent fraudulent and manipulative practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest"[279] because FINRA would maintain a fair arbitration forum for both NYSE and NASD

[274] Id. at pp. 3-4.

[275] Id. at p. 6.

[276] Id. at p. 6.

[277] Id. at p. 6 (quoting Gilmer v. Interstate/Johnson Lane Corporation, 500 U.S. 20, 30 (1991).

[278] See Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Exchange Act Release No. 56,145, 72 Fed. Reg. 42169, 42188-89 (July 26, 2007).

[279] Id. at 42188.

claims and other SROs.[280] Thus, the SEC clearly opined that the current state of mandatory SRO arbitration was fair to the investor, and would, post-merger, remain fair.

Of particular note, the SEC cited the economic benefit of having a single, merged arbitration forum; the NASD's experience in administering an arbitration forum; the NASD's ability to sanction its members; policy considerations under the FAA; and the NASD's stated commitment to reflect upon the commentators' concerns over the use of dispositive motions and to address the issue of arbitrator classification when it *harmonizes* its rules with that of the NYSE.[281]

The SEC also stated that the issue of whether an investor should have the right to choose a judicial forum versus an arbitration was outside the scope of the rule change, while still noting that the Supreme Court in *McMahon* had previously upheld the use of pre-dispute mandatory arbitration agreements.[282]

IX. FAIRNESS IS IN THE EYES OF THE BEHOLDER

One commentator asserts that the Supreme Court's favorable opinion of SRO arbitration is based on the *myth* that arbitration panels include securities "experts," that these panels are sufficiently competent to issue decisions in an efficient and reasonable manner, and that the decisions reached by them are in compliance with the law, when, *in fact*, the panels typically hold no expertise regarding the issues and the panel members may not apply, or even understand, the law.[283] The same commentator further opines there is an evidentiary basis to conclude that arbitrators may not consistently apply the law because of prior instructions that the law's application is not necessary, or that they simply are not competent to do so because of a lack of personal comprehension of the law or the factual dispute at issue.[284]

Another commentator finds fault in the arbitration selection process due to the appearance of bias emanating from the mandated *industry*

[280] Id. at 42188.

[281] Id. at 42188-89.

[282] Id. at 42188.

[283] Jennifer J. Johnson, Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration, 84 N.C. L. Rev. 123 (2005).

[284] Id. at 179.

arbitrator.[285] The same commentator also states there is often a "cram down" of an arbitrator whom neither party selected due to the attorneys having collectively stricken the entire list of arbitrators based upon the arbitrators' respective individual past award histories consistently favoring either investors or the securities industry.[286] The same commentator further states that there exists the perception that many "public" arbitrators in fact have significant ties to the securities industry.[287]

Additional doubt about the fairness of the SRO arbitration process is derived from the belief by many practitioners that the limited document and information discovery afforded under the NASD Customer Code is difficult to obtain due to the securities industry having little respect for complying with NASD discovery procedures because they simply do not believe that an arbitration panel will be as likely as a sitting judge to sanction them for their discovery violations and related behavior.[288] Another characteristic which casts doubt upon the fairness of arbitration is the lack of adequate judicial review resulting from the standard of "manifest disregard" for the law.[289] To vacate an award under this standard, not only must a party show that the law is "well defined, explicit, and clearly applicable," but that the arbitrator "appreciate[d] the existence of a clearly governing legal principle but decide [d] to ignore or pay no attention to it."[290] In essence, a party must basically prove arbitrator misconduct in order to have the award vacated.

There is also the argument that given the substantial filing fees, pre-hearing and hearing costs levied by the NASD - from a pure cost of recovery perspective - litigation has become a relative bargain. It is not atypical for a four-day arbitration evidentiary hearing, coupled with the costs of pre-hearing conferences, to produce fees and expense billings from the NASD totaling substantially in excess of $10,000. Unlike courts of law, arbitration panels commonly assess 50% of the NASD's fees and expenses to a claimant even though the claimant was awarded compensatory damages at the hearing. Factoring in the tendency of arbitration panels to "split the baby," whether it relates to arbitration fees and expenses or to the actual

[285] Barbara Black, Is Securities Arbitration Fair to Investors?, 25 Pace L. Rev. 1, 7 (2004).

[286] Id. at 7-8,

[287] Id. at 8.

[288] Id. at 8.

[289] Id. at 10.

[290] Id. (citing Westerbeke Corp. v. Daihatsu Motor Co., 304 F.3d 200, 218 (2d Cir. 2002)).

award provided to the "successful" claimant, the claimant's net recovery may be reduced to a fraction of what may have been awarded in litigation by a judge or a jury strictly adhering to a judge's instructions on the law.

The primary expense foregone in securities arbitration is that of depositions. However, the claimant's expense of deposing the stockbroker, branch manager, and compliance officer would usually be substantially less than paying the hearing fees generated by a three-person arbitration panel.[291] This substantial potential expense stands as both a psychological and monetary barrier to the FINRA arbitration forum for many defrauded investors, even when investors' attorneys are quite willing to handle claims on a contingency fee basis. Although FINRA may waive its fees based on a showing of "hardship," this waiver is not automatically given and the final determination of hardship is customarily not decided prior to incurring the hearing expenses.[292]

An experienced and ethical investor representative must, at the outset of the attorney-client relationship, discuss with the client the potential expenses associated with a FINRA securities arbitration, the downward trend of favorable customer awards, and the reality that even when a customer prevails on the underlying merits, there is a propensity for arbitration panels to "split the baby" for both expenses and damages. As a result, many investors who have strong cases on the merits and have lost substantial retirement assets, but are not *per se* destitute, have foregone filing an arbitration claim, but would have filed a civil lawsuit if the civil forum had been available.

Thus, it is understandable why United States Representative Edward Markey once remarked that "Christians had a better chance against the lions than many investors and employees will have in the [arbitration] climate being created."[293]

There are, of course, two sides to every coin. The same commentator who finds multiple faults with NASD arbitration also appreciates a certain

[291] The NASD fee for a three-person panel hearing a customer claim alleging damages between $100,000.01 and $500,000.00 in damages is $1,250.00 per hearing session. A typical four-day arbitration evidentiary hearing involves eight hearing sessions, in addition to one or more pre-hearing sessions. See NASD Code of Arbitration Procedure for Customer Disputes § 12902 (2007).

[292] See NASD Code of Arbitration Procedure for Customer Disputes § 12900 (a)(1) (2007).

[293] Carole Silver, Models of Quality for Third Parties in Alternative Dispute Resolution, 12 Ohio St. J. on Disp. Resol. 37, 89 (1996).

fairness with the NASD process, including a pre-dispute arbitration agreement which provides reasonable notice, the right to retain counsel and to present evidence, a convenient geographical location for the evidentiary hearing, and the right to adequate relief.[294]

Furthermore, arbitration with FINRA generally allows the claimant to have the dispute resolved in a more timely manner than litigation.[295] Arguably, the panel will typically include one or more arbitrators who might have some expertise, or are at least be conversant, with the issues before the arbitration panel, along with the opportunity that an equitable standard will be applied to arguably render, the "fairest" result.[296] For example, civil litigation of an investor's claim in a jurisdiction which applies a strict contributory negligence standard might prevent an investor from receiving any recovery whatsoever even when, comparatively, a brokerage firm could be substantially more at fault. Moreover, the statutes of limitations in many jurisdictions are substantially shorter than the NASD Customer Code's six-year eligibility rule. Thus, an investor claim filed in civil litigation might be more likely dismissed upon these grounds, whereas in arbitration the investor might have been awarded a substantial portion of his or her compensatory damages regardless of the statutes of limitations.

The securities industry's opinion regarding the value of arbitration is clear. In a comment letter to the SEC, the SIA is on record as stating:

> . . . tens of thousands of cases have been litigated through arbitration and the process has been repeatedly recognized as providing a "fair, efficient, and less expensive means of resolving disputes between investors and their brokers."
>
> The process in place to select the arbitration panel is also already balanced and very transparent. . .
>
> The arbitration process itself is also a far more efficient and cost-effective means of dispute resolution than traditional litigation. . .

[294] Black, supra note 285, at 5.

[295] See Farah Z. Usmani, Inequalities in the Resolution of Securities Disputes: Individual or Class Action; Arbitration or Litigation, 7 Fordham J. Corp. & Fin. L. 193, 220 (2001).

[296] Id. at 220-21.

> Customers are . . . far more likely to obtain through the arbitration process the opportunity to actually air their grievances at hearing and receive a prompt decision than though a traditional judicial proceeding, where numerous discovery procedures and pre- [sic] and pre-trial motions, as well as the determination of substantive and procedural legal issues, can delay and render prohibitively expensive the customer's "day in court" and the issuance of a final judgment.[297]

X. RECENT CONGRESSIONAL ACTION - THE ARBITRATION FAIRNESS ACT OF 2007

Congressional oversight of the post-*McMahon* regulatory framework governing investor disputes between individual investors and their broker-dealers has recently culminated in, and contributed to, the recent filing in the 110th Congress of identical House and Senate bills, each titled the *Arbitration Fairness Act of 2007* ("the Arbitration Fairness Act"), by Congressman Henry C. "Hank" Johnson, Jr., D-Ga., and Senator Russell D. Feingold, D-Wis.[298] The intent of the Arbitration Fairness Act is to render invalid and unenforceable any pre-dispute arbitration agreement which requires arbitration of employment, consumer, or franchise disputes as defined by the Act, in addition to disputes arising under laws intended to either protect civil rights or "to regulate contracts or transactions between parties of unequal bargaining power."[299] As currently drafted, the Arbitration Fairness Act would invalidate and leave unenforceable mandatory pre-dispute securities arbitration agreements entered into between individual investors and their broker-dealers.[300]

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[297] Letter from Edward G. Turan, Chairman of the SIA Litigation and Arbitration Committee to Jonathan G. Katz, Secretary of the SEC, SIA Comment Letter, (August 2, 2005) (on file with the SEC).

[298] H.R. 3010, 110th Cong., 1st Sess. (2007); the identical companion Senate Bill is S. 1782, 110th Cong., 1st Sess. (2007).

[299] Id.

[300] The House and Senate Bills define a consumer dispute as meaning:

a dispute between a person other than an organization who seeks or acquires real or personal property, services, money, or credit for personal, family, or household purposes and the seller or provider of such property, services, money or credit . . .

The Arbitration Fairness Act is not the first attempt by members of Congress to legislatively address the impact of the *McMahon* decision on mandatory pre-dispute securities arbitration agreements. The *Securities Arbitration Reform Act of 1988* ("Securities Arbitration Reform Act"),[301] which would have declared as impermissible *mandatory* pre-dispute securities arbitration agreements, was introduced as both a response to *McMahon* in addition to restoring investor confidence in the securities industry after the market crash of 1987.[302] The Securities Arbitration Reform Act was intended to require that all pre-dispute securities arbitration agreements entered into by investors with their broker-dealers were done so on an informed and voluntary basis, and that the broker-dealers did not compel these agreements as a condition of doing business.[303] The SEC unanimously voted to oppose[304] the bill and it died in Committee.[305] The

Id. Moreover, the vast majority of individual investors do not have bargaining power equal to that of their broker-dealer, thereby providing a second rationale under the Act to render void and unenforceable a pre-dispute securities arbitration agreement.

[301] H.R. 4960, 100th Cong., 2nd Sess. (1988).

[302] See Mandatory Arbitration in Securities, Hon. Rick Boucher of Virginia, Congressional Record --- Extension of Remarks, 134 Cong. Rec. E2233-01, 1988 WL 173445 (Cong. Rec., June 30, 1988) for the following statements from Mr. Boucher's introduction of the Securities Arbitration Reform Act on the House floor:

Is it any wonder that a customer who had lost a good deal of their money through unsanctioned trades by their broker, who had no choice but to sign an arbitration agreement in order to open his or her account, who may not have even been aware that they were giving up their right to go to court when they signed the agreement, and who felt that the arbitration system run by the industry had treated them unfairly, would not have confidence in dealing with the securities industry again?

. . .

Many people in the securities industry have argued to me that their research indicates that the arbitration system is not only fair, but actually works to the customer advantage. If that is indeed the case, then there should be no problem in presenting the evidence to the customer at the time of contract origination in which case I would expect the majority of customers to sign arbitration clauses willingly.

In short if arbitration is attractive to the consumer they will go to arbitration willingly. If the industry operated arbitration system cannot be shown to give the consumer a fair shake it is clearly unfair to mandate that they sign compulsory arbitration agreements as a condition for dealing in securities. Our legislation will resolve this issue by making it clear that arbitration clauses are voluntary, and that the signing of such an agreement is not a precondition for a customer to enter into a securities account agreement.

Id.

[303] Id.

[304] See SEC Votes to Oppose Legislation Barring Mandatory Arbitration Clauses, Sec. Reg. &

following commentary was later made regarding the Act's demise:

The fact remains that passing a bill which would allow customers to litigate disputes against brokers is difficult, due to the securities industry's well-financed and powerful lobby in Washington.[306]

Past Congressional concerns regarding the federal securities regulatory scheme concerning investor protection has also resulted in the generation of several GAO reports which, at times, have addressed the securities arbitration process. As discussed above, in the wake of *McMahon* and *Rodriguez*, Congress soon requested that the GAO study the SRO arbitration process.[307] In addition to the 1992, 2000, and 2003 GAO reports, *supra*,[308] in recent years the GAO has issued studies concerning "unscrupulous brokers," microcap stock fraud, unpaid arbitration awards, arbitrator background disclosure, and SIPC policy disclosure.[309]

Attempts to read the "tea leaves" regarding any congressional action relating to securities arbitration should include an examination of the March 17, 2005, testimony taken in an open hearing before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services and in particular the opinions proffered by Congressman Barney Frank, D-Mass., during that hearing.[310] Mr. Frank was the primary congressman who questioned

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L. Rep. (BNA) Vol. 20, No. 27, p. 1054 (July 8, 1988).

[305] Mahlon M. Frankhauser and Linda M. Gardner, An Up-To-Date Review of Judicial, Legislative, and Regulatory Developments in Arbitration with Financial Institutions, 46 Wash. & L. Rev. 583, 621 (1989).

[306] William A. Gregory and William J. Schneider, Securities Arbitration: A Need for Continued Reform, 17 Nova L. Rev. 1223, 1246 (1993).

[307] Gen. Acct. Off., Rep. No. GGD-92-74, Securities Arbitration: How Investors Fare, p. 2 (1992).

[308] See supra notes 130, 136, and 182.

[309] Gen. Acct. Off., Rep. No. GAO-03-811, Update on Matters Related to the Securities Investor Protection Corporation, (2003); Gen. Acct. Off., Rep. No. GAO-01-653, Steps Needed to Better Disclose SIPC Policies to Investors, (2001); Gen. Acct. Off., Rep. No. GAO-01-654R, Evaluation of Steps Taken to Address the Problem of Unpaid Arbitration Awards, (2001); Gen. Acct. Off., Rep. No. GAO-01-162R, Procedures for Updating Arbitrator Disclosure Information (2001); Gen. Acct. Off., Rep. No. GAO/GGD-00-115, Actions Needed to Address Problem of Unpaid Awards (2000); Gen. Acct. Off., Rep. No. GAO/GGD-98-204, Responses to GAO and SEC Recommendations Related to Microcap Stock Fraud (1998); Gen. Acct. Off., Rep. No. GAO/GGD-94-208, Actions Needed to Better Protect Investors Against Unscrupulous Brokers (1994); Gen. Acct. Off., Rep. No. GGD-92-74, Securities Arbitration: How Investors Fare (1992).

[310] See The Securities Arbitration System: Hearing Before the Subcomm. on Capital Mkt.s,

witnesses representing the major SROs, the securities industry, and investor representatives. Mr. Frank has a stated record of being pro-investor rights, including calling for increased funding of the SEC.[311] He is also the sponsor of a House bill to amend the 1934 Act which would give greater voice to shareholders on the issue of executive compensation by providing them an advisory, albeit non-binding, vote on the issue.[312] Currently, Mr. Frank is chairman of the House Committee on Financial Services.

During the March 17, 2005, hearing Mr. Frank expressed his belief that the pre-dispute arbitration agreement was a contract of adhesion, and questioned why arbitration should not be made voluntary.[313] Mr. Frank elicited testimony from the NASD that an opt-out provision in an arbitration agreement would not act as an obstacle to the NASD's oversight ability for those investors who chose arbitration.[314] While Mr. Frank expressed his opinion that the NASD and the SIA made a "good case" for arbitration, he still believed that the current framework for SRO securities arbitration should be reformed.[315] Moreover, he stated that the NASD and the SIA had still not shown why arbitration should be mandatory.[316] Additionally, Mr. Frank also questioned both the necessity of an *industry* arbitrator being a

Ins. and Gov't Sponsored Enter.s of the Comm. on Fin. Services, 109th Cong. (2005).

[311] Regarding the resignation of former SEC Chairman Harvey Pitt, Mr. Frank's office issued a press release which stated in part the following:

The resignation . . . is a welcome development, one which I have called for repeatedly in order to protect the nation's investors and restore confidence in our equity markets. I would hope that the White House would take this opportunity to nominate a replacement who: (1) has a demonstrated commitment to the interests of investors; (2) possesses broad experience with the capital markets and enforcement matters; (3) is unburdened by conflicts of interest; and (4) will actively pursue a reform agenda that faithfully implements the Sarbanes-Oxley Act.

Press Release, Statement from Frank on the Resignation of SEC Chairman Harvey Pitt (November 6, 2002) (Congressional Office of Barney Frank, Mass.); see also Press Release, Mass., Statement on the Failure of the Bush Administration to Put the Sarbanes-Oxley Law into Effect (December 19, 2002) (Congressional Office of Barney Frank, Mass.).

[312] H.R. 1257, 110th Cong. (as passed by the House, April 20, 2007) ("To Amend the Securities Exchange Act of 1934 to Provide Shareholders with an Advisory Vote on Executive Compensation.").

[313] The Securities Arbitration System: Hearing Before the Subcomm. on Capital Mkt.s, Ins. and Gov't Sponsored Enter.s of the Comm. on Fin. Services, 109th Cong. 20 (2005).

[314] Id. at 21.

[315] Id. at 21.

[316] Id. at 22.

member of the arbitration panel,[317] and the argument that an explanatory arbitration award would allegedly "detract from the flexibility and superiority of arbitration over litigation."[318]

In expressing a more favorable view of securities arbitration, Congressman Jim Ryun, R-Kan., then Vice Chair of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, closed the hearing by citing the apparent efficiency of securities arbitration and noted that while it had "room for improvement," unless "something is completely broken, let's be careful in fixing it."[319]

A. The Leahy-Feingold Letter

On May 4, 2007, the Chairman of the Senate Judiciary Committee, Senator Patrick J. Leahy, D-Vt., co-authored, with fellow committee member, Senator Feingold, a letter to SEC Chairman Christopher Cox calling for the SEC to promulgate a rule that would prohibit a broker-dealer from mandating that an investor, as a condition to opening a securities account, agree to a pre-dispute securities arbitration clause within the new account agreement between the broker-dealer and the investor.[320] Citing the "enhanced judiciary remedy" afforded by the 1933 Act and the 1934 Act, the beneficial "threat of public prosecution" by individual investors, and the Congressional intent that this "special judicial remedy be widely available to investors," the Mr. Leahy and Mr. Feingold declared that mandatory pre-dispute securities arbitration agreements denied most investors their right to invoke the courts when seeking redress under the Acts or state law.[321]

Mr. Leahy and Mr. Feingold conceded that past regulation by the SEC, which required greater disclosure regarding the broker-dealer's inclusion of a pre-dispute securities arbitration clause in its standard contracts, may have been sufficient when investors had the opportunity to obtain financial services from other broker-dealers that did not mandate such clauses in their

[317] Id. at 22.

[318] Id. at 23.

[319] Id. at 24-25.

[320] Letter from U.S. Senator Patrick Leahy, Chairman of the Committee on the Judiciary, and U.S. Senator Russell D. Feingold, Member of the Committee on the Judiciary, to Christopher Cox, Chairman of the SEC (May 4, 2007) available at http://feingold.senate.gov/pdf/ltr_050407_mandarb.pdf.

[321] Id. at 1.

new account agreements.[322] However, such contractual disclosure notwithstanding, Mr. Leahy and Mr. Feingold argued that it was now a practical impossibility for an investor to open a brokerage account without being required to enter into an agreement with the broker-dealer which mandates that any dispute between the parties be resolved through arbitration, and that this has resulted in the *involuntary* selection of arbitration by an investor.[323] Thus, Mr. Feingold and Mr. Leahy posited, it is currently insufficient for the SEC, in fulfilling its primary obligation of investor protection, to merely require adequate disclosure of an agreement to resolve disputes via arbitration, but instead the SEC must now require that broker-dealers afford investors the right to opt for the judicial process as an alternative to arbitration.[324]

Mr. Leahy and Mr. Feingold contended that one of the presumptions underlying the *McMahon/Rodriguez* line of cases was that securities arbitration broadened the choice of forums in which claimants could pursue their claims, but that this presumption was no longer operative given the near universal requirement that investors arbitrate their disputes with their broker-dealers.[325] Moreover, despite the SEC's efforts to "ameliorate the most troubling aspects of arbitration," Mr. Leahy and Mr. Feingold argued that securities arbitration as now practiced still waived constitutionally protected judicial rights due to the lack of judicial oversight of the discovery process; the absence of the state and federal rules of evidence, and mandated written opinions by arbitrators stating either their finding of facts or legal analysis; and the lack of adequate judicial review.[326]

Mr. Leahy and Mr. Feingold cited to the SEC's Division of Market Regulation for its 1988 opinion that a potential benefit arising from competition between SRO sponsored arbitration and the courts for investor claims would include the maintenance of the SRO securities arbitration forum's fairness and efficiency.[327] Moreover, Mr. Leahy and Mr. Feingold stated that while the SRO securities arbitration forum held appeal for the more "straightforward" claims, including those involving damages of less significant amounts, the broad discovery afforded by litigation may be

[322] Id. at 2.
[323] Id. at 2.
[324] Id. at 2.
[325] Id. at 2-3.
[326] Id. at 3.
[327] Id. at 4.

essential for an investor to prove his or her case.[328] Providing guidance to Chairman Cox as to how to rectify the present adhesive nature of the investor/broker-dealer contractual relationship, Mr. Leahy and Mr. Feingold recommended two solutions to the SEC regarding this "problem": 1) an outright ban on all mandatory pre-dispute securities arbitration agreements; or 2) requiring that the investor be given the right to choose between entering into a pre-dispute securities arbitration agreement or retaining the right of the judicial forum in which to resolve any future dispute with his or her broker-dealer.[329]

B. The Arbitration Fairness Act of 2007

Less than three months after Mr. Leahy and Mr. Feingold requested that the SEC take action regarding the use of mandatory pre-dispute arbitration agreements by the securities industry, Mr. Feingold filed the *Arbitration Fairness Act of 2007*.[330] While there should be little doubt that the widespread use of mandatory pre-dispute securities arbitration agreements helped foment the circumstances which brought about this legislative action, it appears that the primary concern motivating the Arbitration Fairness Act's proponents involves the increased utilization of mandatory pre-dispute arbitration agreements in "everyday" contracts for consumer goods and services, in addition to employment and franchise agreements.[331]

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[328] Id. at 4.

[329] Id. at 2.

[330] S. 1782, 110th Cong., 1st Sess. (2007).

[331] See Press Release, Public Citizen Urges Support for the Arbitration Fairness Act of 2007, Statement of Joan Claybrook, President, Public Citizen, (July 12, 2007) available at http://www.publiccitizen.org/pressroom/release.cfm?ID=2472 for the following:

With mandatory predispute arbitration privatizing our civil justice system – a system we fought a revolution for – fairness in the marketplace is undermined and consumers are denied any remedy for fraud and deception. The insertion by business entities of arbitration clauses in everyday contracts forces individuals to forgo their right to a court or jury if dangerous products, services or workplaces harm them.

. . .

Privatizing justice benefits big corporate benefits like national banks and insurance companies but does not help ordinary citizens. Corporations have figured out that simply by inserting an arbitration clause in contracts for everyday consumer goods and services or employment, they can usually evade accountability for any harm they cause or laws they break – laws meant to protect consumers and employees from the misuse and abuse of corporate power in the market place.

Id. See also Statement of U.S. Senator Russ Feingold At a Press Conference with Public Citizen

Of particular note, the Arbitration Fairness Act's findings include that: 1) the Federal Arbitration Act was intended to be applicable to "commercial entities of generally similar sophistication and bargaining power"; 2) the Supreme Court has extended the scope of the FAA to controversies between parties of unequal bargaining, including consumer and employment disputes, thereby forcing millions of consumers and employees to relinquish their right for a judge or jury to adjudicate their claims; 3) the agreements to arbitrate are contracts of adhesion, and that most consumers and employees entering into these agreements do not comprehend the rights being forsaken; 4) profits compel private arbitration companies to structure the arbitration process to the advantage of "corporate repeat players"; 5) the lack of meaningful case law related to arbitration decisions hinders the advancement of public law concerning civil rights and consumer rights along with allowing arbitrators to substantially dispense with following either the law or the procedure of the particular arbitration forum; 6) the lack of a public record and the private nature of arbitration are ill-suited for the adjudication and protection of civil rights and consumer rights; and 7) unfair terms in many instances are included by corporations in the arbitration agreement which disadvantage the individual party - including the release of substantive statutory rights, class action prohibitions, and the forced arbitration of claims at hearing sites hundreds of miles from where the individual claimant may reside – while many courts have upheld "even egregiously unfair mandatory arbitration clauses in deference to a supposed

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on Protecting Consumers from Unfair Credit Card Contracts (September 27, 2007) available at http://feingold.senate.gov/~feingold/statements/07/09/20070927mb.htm for the following:

Arbitration is often touted as a more efficient and less expensive alternative to litigation. That can certainly be the case, but only in situations where both parties freely choose arbitration on terms that ensure a level playing field. Unfortunately, more and more companies are requiring people to enter into binding mandatory arbitration agreements as a condition to obtaining a job, a credit card, or a franchise.

. . .

We need to restore choice to the consumer, and we can do that by enacting legislation that prohibits pre-dispute arbitration clauses in contracts between parties with unequal bargaining power. In July of this year, I introduced legislation, the Arbitration Fairness Act of 2007, that would do just that. . . . Under [this] legislation, contracting parties would still be allowed to choose arbitration, but that choice would have to be freely made after the dispute arises. It would no longer be presented to the consumers as a precondition of doing business – an offer they cannot refuse.

Id.

Federal policy favoring arbitration over the constitutional rights of individuals."[332]

The securities industry swiftly responded to the proposed Arbitration Fairness Act by asserting its staunch opposition to the bill in testimony before the House Subcommittee on Commercial and Administrative Law,[333] in addition to the Securities Industry and Financial Markets Association ("SIFMA") issuing a sixty-seven page position paper – the *White Paper on Arbitration in the Securities Industry* (the "SIFMA White Paper") – defending the thirty year history of arbitration by portraying it as a fair and efficient forum for resolving disputes between investors and the brokerage industry.[334] The American Financial Services Association ("AFSA") argued that passage of the Arbitration Fairness Act would operate to end *all* arbitration of disputes relating to consumer, employee, and franchise claims.[335] Moreover, the AFSA asserted, arbitration is economical, affordable, and fair, and that the majority of all arbitrations were resolved in the consumer's favor.[336] Declaring that the Arbitration Fairness Act's "overly broad and vague language and retroactive application are constitutionally suspect and will introduce widespread uncertainty into the economy and the courts," the AFSA argued that the Arbitration Fairness Act would "largely dismantle" arbitration and effectively eradicate the ability for consumers and employees to obtain redress for the small claims which most typify those asserted in arbitration.[337]

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[332] See S. 1782, 110th Cong., 1st Sess. (2007).

[333] See Written Testimony of the American Financial Services Association, House of Representatives, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, H.R. 3010, The Arbitration Fairness Act of 2007 (October 25, 2007) available at http://www.afsaonline.org/cms/filerepository/HR3010TestimonyOct2007.pdf; see also Testimony of Securities Industry and Financial Markets Association, Before the House Subcommittee on Commercial and Administrative Law, United States House of Representatives, Hearing on "H.R. 3010, The Arbitration Fairness Act of 2007" (October 25, 2007), available at http://www.sifma.org/legislative/testimony/pdf/Arbitration-testimony-1025.pdf.

[334] Securities Industry and Financial Markets Association, White Paper on Arbitration in the Securities Industry (October, 2007), available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

[335] Written Testimony of the American Financial Services Association, House of Representatives, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, H.R. 3010, The Arbitration Fairness Act of 2007, p. 2 (October 25, 2007).

[336] Id. at 2-3.

[337] Id. at 4.

The SIFMA White Paper contends that SRO securities arbitration:

> affords investors the opportunity to have their claims heard close to home, before highly trained and experienced arbitrators, in a forum that has proven to resolve disputes as fairly as the judicial system, and much faster and less expensively

and that the concerns that prompted the Arbitration Fairness Act relate to "unsupervised" arbitration programs utilizing untrained arbitrators, conducting hearings far from a claimant's residence, and charging the consumer with hidden costs.[338] SIFMA argues that the SEC has exercised expansive regulatory oversight regarding the SRO arbitration process for over thirty years;[339] investors are better protected by SRO arbitration procedures than those employed by non-SRO arbitration forums;[340] SRO arbitration has proven to be more efficient and less costly than litigation; and the "overwhelming weight of the evidence illustrates that securities arbitration is fair to investors."[341]

SIFMA cites a study by Deloitte Haskins conducted for the period of October 1, 1987 through June 30, 1988 – which found that arbitration was on average $12,000 less costly than litigating a dispute in a judicial forum – for the proposition that securities arbitration is more cost effective than litigation, stating that study found for the.[342] SIFMA further argues that this differential would have substantially increased given that litigation costs have increased over time. However, SIFMA does not address either the substantial rise in arbitration forum fees, or the increased utilization of experts by investors and the industry in all stages of the arbitration process.

The SIFMA White Paper contrasts the heightened pleading standards under the Private Securities Litigation Reform Act of 1995 ("PSLRA"),[343] in addition to the requirement under the Federal Rules of Civil Procedure that requires claims alleging fraud being pled with *particularity,*[344] with the

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[338] Securities Industry and Financial Markets Association, White Paper on Arbitration in the Securities Industry, p. 1 (October, 2007).

[339] Id. at 8.

[340] Id. at 16.

[341] Id. at 31.

[342] Id. at 29.

[343] Id. at 31-32, citing § 15 U.S.C. 78u-4(b)(1)(2000).

[344] Id. at 31, citing Fed. R. Civ. P. 9(b).

more lenient pleading standards allowed under FINRA securities arbitration as an additional rational why investors are better off with securities arbitration.[345] This argument, in addition to SIFMA's reliance upon statistics disclosing that in the year 2006, 18 percent of NASD arbitrations were closed after a hearing compared to only 1.3 percent of all federal civil cases having been heard, from March 31, 2005 through March 31, 2006, by judge or jury, provides solid support for SIFMA's position that an investor is better off in arbitration than litigation.[346] SIFMA does concede, however, that in arbitration many claims are grounded upon state or common law and therefore are not subject to the PSLRA's strict pleading requirements.[347]

When declaring that securities arbitration is fair to the investor, the SIFMA White Paper takes particular exception to the claimants' bar in general and the O'Neal-Solin Report in particular.[348] SIFMA argues that the recent downward trend regarding investors obtaining favorable arbitration awards as being due more to the collapse of the stock market in the early 2000s, the increase in the number of cases which settle versus going to hearing, and the overly aggressive marketing by claimants' attorneys for clients resulting in the prosecution of frivolous claims (including claims based upon analyst fraud), than any inherent structural bias against the investor.[349]

Given the 2007 ascendancies of Congressman Frank to the Chairmanship of the House Committee on Financial Services and Senator

[345] Id. at 32.

[346] Id. at 33, citing Federal Judicial Caseload Statistic[sic], March 31, 2006, Table C-4, available at http://www.uscourts.gov/caseload2006/tables/C04Mar06.pdf.

[347] Id. at 32.

[348] Id. at 37-47. In particular, the SIFMA White Paper criticizes the O'Neal-Solin study for basing its analysis on recent win and recovery rates while ignoring the historical context during the time period in which investors were increasingly less successful in obtaining positive arbitration awards. Id. at 37-38. Moreover, the SIFMA White Paper argues that the decline in recovery rates was due to it being allegedly "widely known and well accepted that claimants tend to overstate the amount of damages requested in their statements of claims." Id. at 44. However, this argument fails to explain why recovery rates would decline for this period if this penchant for overstating damages, by logical extension, would have also existed prior to the early 2000s market collapse. Moreover, any substantial increase in damages claimed during the early 2000s is arguably more rationally explained by the substantial decline in market values resulting in considerable, and in untold instances devastating, investor losses than by any increased predilection by the claimants' bar to overstate their clients' damages.

[349] Id. at 37-38.

Leahy to the Chairmanship of the Senate Judiciary Committee, there stands a greater chance for direct congressional reformation of the arbitration process than has been present in the recent past. But this potential for Congressional reform is tempered with the reality that the last substantive change to securities arbitration relating to Congressional action took place in 1975.[350] Furthermore, as Chairman of the Committee on Financial Services, Mr. Frank has taken a more even-handed approach to his oversight responsibilities than was initially expected by the financial services industry.[351] Additionally, it can be expected that the SEC will maintain its position that securities arbitration is a fair forum for investors, in addition to the financial industry itself continuing to assert a decade's long substantial defense of mandatory pre-dispute securities arbitration agreements.

XI. CONCLUSION

Contrary to the opinion expressed by the *McMahon* Court, the NASD arbitration process has not shown itself to be adequate as a means of fulfilling the Congressional intent of providing for investor protection via the 1933 and 1934 Acts. For several years, the percentage trend of investors recovering damages has steadily fallen. Conversely, the costs for an investor to prosecute his or her arbitration claims under the federal securities laws has risen to virtually prohibitive levels.

The NASD Code of Arbitration no longer reflects a simple, efficient medium for the economical resolution of securities disputes. Instead it exhibits the characteristics of the Federal Rules of Civil Procedure but without the procedural safeguards of full discovery, fair award of costs to the prevailing party, explanatory orders, a sitting judge, and appellate review. The practice of securities arbitration is more contentious than in previous times, arguably due to the lack of judicial oversight.

However, there has been no indication that the Supreme Court would entertain revisiting its decision in *McMahon*. Additionally, the SEC

[350] See supra note 50 regarding the amendment to § 19 of the 1934 Act concerning SRO oversight by the SEC.

[351] 'Radical' Frank Calms Corporate Fears as He Pushes House Agenda, Bloomberg.com, April 17, 2007, available at http://www.bloomberg.com/apps/news?pid=20601070&sid=aJpnCFd0t6hk&refer=politics.

certainly does not appear likely to reconsider its policy of favoring SRO arbitration.[352] Thus, further revisions to the NASD Customer Code appear to be the only realistic current route in any quest to fulfill the *McMahon* rationale.

FINRA should redouble the NASD's past efforts to obtain approval for explained decisions. Such a rule would let sunlight shine upon the arbitration panel's rationale in rendering its award or order of dismissal. The benefit of increased investor confidence in the fairness of the arbitration process, especially one which is forced upon the claimant, would clearly outweigh any perceived detriment. Requiring explained decisions would not be likely to generate a flood of motions to vacate unfavorable awards in consideration of the strict judicial standard required to find "manifest disregard" of the law, but would provide some foundation to vacate an award in the most egregious instances.

The SEC should review the current procedural rule mandating the *industry* arbitrator. In litigation, a prospective juror fitting the profile of the industry arbitrator would be the first one to be struck by an investor's counsel because of perceived bias for the industry respondent. Furthermore, brokerage firms invariably retain one, if not two, expert witnesses to prepare profit/loss summaries and to testify regarding the duties owed by the stockbroker to the customer. Consequently, the investor is almost always forced to retain a securities expert for rebuttal in cases involving substantial losses. Thus, in most cases involving substantial losses, there is no need for an industry arbitrator.

However, any future revision of the NASD Customer Code which eliminates the industry arbitrator should be even-handed. Thus, neither those who have, directly or indirectly, received compensation from the representation of customers in broker-dealer disputes, nor those who have received compensation from the securities industry, should be allowed to serve on an arbitration panel.

McMahon argues that SRO arbitration is adequate to vindicate investors' rights under the federal securities laws. However, *Green Tree Financial* recognizes that arbitration costs can be prohibitive by stating:

[352] Recently, the SEC was reportedly considering allowing public companies to amend their by-laws to mandate arbitration to resolve shareholder disputes, thereby limiting litigation, especially class action lawsuits. See Kara Scannel, SEC Explores Opening Door to Arbitration, Wall Street Journal April 16, 2007, at 1.

It may well be that the existence of large arbitration costs could preclude a litigant such as Randolph from effectively vindicating her federal statutory rights in the arbitral forum.[353]

Arbitration costs were relatively small at the time of the *McMahon* decision. Subsequently, NASD arbitration filing fees, pre-hearing and hearing session costs have risen substantially. The use of expert witnesses is now commonplace. A new GAO study regarding the presumed lower costs and efficiency of SRO arbitration is now in order. Such a study, involving both federal and state judicial forums, should compare civil litigation involving investors and their investment advisers with customer claims resolved in SRO arbitration. In particular, this GAO study should focus on comparing litigation and arbitration costs, settlement rates and amounts, and the success rates viewed not only from the perspective of compensation being awarded, but the percentage awarded based upon the total damages asserted. The GAO study should include the relative efficiency between the two forums (civil litigation and SRO arbitration) by comparing the average times these forums require to conclude a proceeding, from the initial filing to the date of an award or judgment, including any appellate review.

Lastly, the ever-increasing costs for a customer to bring before FINRA an arbitration claim and the overwhelming economic power of the brokerage firm must be addressed. One investor representative has posited that the customer should be allowed to opt out of arbitration unless the member firm agrees in advance to pay for all FINRA fees related to the arbitration, whether or not the customer is awarded a recovery. Such a requirement would substantially level the playing field.

Arbitration can be a fair, efficient forum for the resolution of commercial disputes. Unfortunately, there exists a significant perception that SRO securities arbitration as currently structured is not impartial or economical. Nonetheless, the continued good-faith reformation efforts of those parties most interested in the process – the SEC, FINRA, SICA, PIABA and SIFMA – appear to be SRO securities arbitration's best hope to substantiate *McMahon*'s belief that SRO securities arbitration really does provide the investor with the protections intended by Congress when it enacted the Securities Act of 1933 and the Securities Exchange Act of 1934.

[353] Green Tree Financial, 531 U.S. 79, 90 (2000).

Moreover, absent immediate reformation of the securities arbitration process, then legislative reform efforts such as the Arbitration Fairness Act may garner sufficient political support to eventually gain passage. Ironically, if the enactment of the Arbitration Fairness Act or similar legislation comes to pass, then the securities industry may look fondly back at the more lenient dictates proposed almost twenty years ago under the failed Securities Arbitration Reform Act.