The National Association of Securities Dealers' Arbitration of Investor Claims against Its Brokers: Taming the Fox that Guards the Henhouse

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The National Association of Securities Dealers’ Arbitration of Investor Claims Against its Brokers: Taming the Fox that Guards the Henhouse

Nearly eight trillion dollars in stock wealth evaporated when the stock market boom of the 1990s met the bust of the early 2000s.¹ The bull market of the 1990s lasted so long that many who had not previously invested in the stock market became dissatisfied with modest but guaranteed bank returns and attempted to join in the stock market’s unprecedented prosperity.² Just as there was an upswing in inexperienced investors, swarms of inexperienced brokers jumped on board to service the new business.³ Not only had these inexperienced investors and brokers never seen a market downturn, but investors allege that their brokers were not properly trained or adequately supervised.⁴ Unfortunately for these inexperienced investors and brokers alike, they entered the market at the worst possible time, when it was at or close to its all-time high.⁵

During the bull market, when investors’ portfolios were growing by leaps and bounds, investors often blindly trusted their

¹. See Cindy Krischer Goodman, Many angry investors suing brokers: Attorneys see increase in cases especially from elderly as $8 trillion in stock wealth evaporates, CONTRA COSTA TIMES, Sept. 9, 2002, available at 2002 WL 25192208.

². See Christine Dugas, Stung by losses, investors place blame on brokers. Many say cash was put in high-risk stocks, then lost, USA TODAY, May 18, 2001, available at 2001 WL 5462815; see also Janice Revell, How Much Do Brokers Have to Hide?, FORTUNE, May 13, 2002 (describing how many Americans poured money into the stock market because they were dissatisfied with the modest returns that insured bank products provide), available at 2002 WL 2190626.

³. See Dugas, supra note 2. The number of registered brokers jumped from 506,000 in 1995 to 672,489 in 2000, a thirty-three percent increase. See id.; see also NASD, NASD Statistics, at http://www.nasdr.com/2380.asp (last visited Feb. 15, 2003) (indicating that the number of NASD licensed brokers increased rapidly during the bull market of the 1990s).


brokers and brokerage firms. When investors suffered severe losses, they placed much more scrutiny on their brokers and brokerage firms’ actions and began finger pointing. The allegations behind the finger pointing seemed to be confirmed by the recent string of Wall Street scandals. Most recently, Wall Street brokerage firms reached a $1.4 billion settlement with securities regulators over alleged conflicts of interest arising from stock research analysts’ fraudulent acts of touting stocks in order to win investment-banking business. The discovery of these scandals leaves little doubt that “the bull market masked many sins.” In fact, for some brokers, research analysts, and brokerage firms, the arrival of the bear market has marked their day of reckoning.

After sustaining heavy losses and with new Wall Street scandals breaking daily, many investors are now looking for a way to recoup their stock market losses. As a result, more investors are filing complaints against their brokers and brokerage firms than ever before. In fact, in just the first two months of

6. See id.
7. See Dugas, supra note 2.
8. Joshua Chaffin, Lawyers Agog as the Banks Spill IPO Beans, FIN. TIMES, Sept. 18, 2002, available at 2002 WL 100563554. Merrill Lynch and other investment firms’ stock analysts have been accused of recommending stocks in order to win investment-banking business from the firms of the stocks they touted. Id. Additionally, Goldman Sachs, Credit Suisse First Boston, and other investment banks are under investigation for the ways in which they distributed IPO shares. Id. The highly publicized accounting scandals, including those of Enron, Worldcom, Global Crossing, and Tyco have left many investors questioning the integrity of Wall Street and the regulatory organizations in charge of monitoring the industry. Id.
10. See Dugas, supra note 2 (quoting Indiana Securities Commissioner Brad Skolnik).
11. See Craig, supra note 2.
12. See id.; Chaffin, supra note 8.
13. See Dugas, supra note 2; see also Heike Wipperfurth, Litigation jumps; winning tougher: Number of settlements drops, investors’ awards likely to be small, CRAIN’S N.Y. BUS., July 29, 2002, available at 2002 WL 9594014.
2003 the National Association of Securities Dealers (NASD) could receive nearly half the number of complaints that it received in all of 2002.\textsuperscript{15} Investors who file complaints are often surprised to learn that they will never see their day in court; instead, a securities arbitration panel will resolve their dispute.\textsuperscript{16} The NASD provides the primary arbitration forum in which investors resolve their grievances against their brokers and brokerage firms.\textsuperscript{17}

The NASD is the largest Self Regulatory Organization (SRO) in the world; all Wall Street brokerage firms and brokers are required to be members.\textsuperscript{18} The NASD is responsible for protecting investors from wrongful acts of its members by investigating, regulating, and disciplining its licensed brokers and member brokerage firms.\textsuperscript{19} The Securities and Exchange Commission (SEC) is responsible for the oversight of the NASD as mandated by section 19 of the Securities Act of 1933.\textsuperscript{20} This oversight includes the review of all NASD rule-making activity and all NASD disciplinary actions.\textsuperscript{21} Further, the SEC has the authority to proceed directly against the NASD in the event that the NASD fails to adequately enforce its own rules.\textsuperscript{22}

Despite SEC supervision, the NASD is relied upon for the day-to-day policing of brokers and their firms.\textsuperscript{23} The NASD, however, is the securities industry's trade group and its $400 million budget is funded entirely by securities firms and stock

\begin{itemize}
\item \textsuperscript{16}See Goodman, \textit{supra} note 1.
\item \textsuperscript{18}Noelle Knox & Barbara Hansen, \textit{Brokerage watchdog fights for credibility; Conflicts of interest, lack of action cost NASD the faith of investors}, USA TODAY, May 24, 2002, available at 2002 WL 4726676.
\item \textsuperscript{19}Id.
\item \textsuperscript{22}See id.
\item \textsuperscript{23}See Revell, \textit{supra} note 2.
\end{itemize}
brokers. As a result, the NASD is charged with the responsibility of representing both its members and the investing public. Due to this potential conflict, the NASD and, more particularly, its arbitration program have received close examination from regulators and investors. As the securities regulators' investigations of Wall Street scandals transition into investor claims against their brokers and brokerage firms, the NASD's arbitration program will likely be further scrutinized.

The potential conflicts of interest caused by the NASD's dual role, of representing both its members and the investing public, is a growing concern for Congress, the SEC, State Legislatures, and investors alike. This Note explores the validity of many investors' perceptions that their interests take a back seat to the interests of NASD member firms in the NASD's resolution of investor claims. The first section of this Note briefly discusses the background and history of securities arbitration. The second section highlights the narrowing differences between securities arbitration and traditional litigation. The third section comments on recent developments in securities arbitration and on whether investors with successful claims are adequately compensated. Finally, the fourth section covers the perception of conflicts of interest between the NASD and investors and how investors, their lawyers, State Attorneys General and State Legislatures are attempting to remedy the situation.

I. SECURITIES ARBITRATION BACKGROUND

Arbitration has been used as a method of resolving securities industry disputes for approximately 130 years.

24. See id.; Knox & Hansen, supra note 18.
25. See Revell, supra note 2.
26. See id.
27. See Craig, supra note 9.
28. See infra notes 33-186 and accompanying text.
29. See infra notes 33-54 and accompanying text.
30. See infra notes 55-117 and accompanying text.
31. See infra notes 118-141 and accompanying text.
32. See infra notes 142-186 and accompanying text.
However, arbitration has only recently become the primary mechanism for resolving securities industry disputes. In 1953, the Supreme Court in Wilco v. Swan held that mandatory pre-dispute arbitration agreements were not enforceable because such agreements required investors to waive their statutory right to resolve their disputes in a court of law. In 1987, however, the Supreme Court validated the securities industry’s use of mandatory pre-dispute arbitration agreements in Shearson/American Express Inc. v. McMahon. In McMahon, the Court stated that it upheld mandatory pre-dispute arbitration agreements because the SEC has “expansive power to ensure the adequacy of the arbitration procedures employed by the SROs [including the NASD].” Since McMahon, nearly all brokerage firms require investors to sign a contract that includes a mandatory pre-dispute arbitration clause in order to open a brokerage account. Investors often open new investment accounts without realizing that they have agreed to arbitrate future claims they may have against their broker.

As disputes arise with their brokers, investors have three major options for securities arbitration forums. In 1989, the SEC approved securities arbitration programs for the three major SROs: the NASD, the New York Stock Exchange (NYSE), and

36. Shearson/American Express Inc. v. McMahon, 482 U.S. 220 (1987) (validating pre-dispute arbitration agreement claims brought under the Securities Exchange Act of 1934). By validating pre-dispute arbitration clauses used by brokerage firms, McMahon effectively eliminated the use of the traditional court system to resolve investor claims because most federal securities claims are based upon the Securities Exchange Act of 1934. Nichols, supra note 34, at 69. It was not until 1989, when the Court decided Rodriguez de Quijas, that Swan, covering claims brought under the Securities Act of 1933, was actually overruled. Id.
37. See Nichols, supra note 34, at 69.
38. See Marilyn Blumberg Cane & Marc J. Greenspon, Securities Arbitration: Bankrupt, Bothered & Bewildered, 7 STAN. J. L., BUS. & FIN. 131, 134 (2002); Knox & Hansen, supra note 18.
39. See Cane & Greenspon, supra note 38, at 134.
the American Exchange (AMEX). Following the SEC's approval of the SRO arbitration programs, the NYSE, AMEX, and the NASD each created arbitration programs to settle investor claims. The SEC remains responsible for the oversight of these securities arbitration forums. To administer its arbitration program, the NASD created a subsidiary, The National Association of Securities Dealer Dispute Resolution, Inc. (NASD-DR), which was intended to provide an independent securities arbitration forum separate and distinct from the NASD and its members. The NASD-DR is the securities arbitration forum for most investors, resolving over ninety-percent of individual investors' claims against brokers and their firms.

The first step in a NASD-DR arbitration is the filing of the statement of claim with the NASD-DR. The relaxed nature of arbitration does not require formal pleading; an informal letter detailing the relevant facts and the remedies sought will suffice. The amount in controversy will determine whether one or three arbitrators will hear the claim. Typically, unless the amount in controversy is less than $50,000, three arbitrators will hear the dispute. The hearing is less formal than a trial, but similarly includes opening statements, direct and cross-examination of witnesses, and closing statements. After the record is closed the

41. Id. at §15.3[2].
42. Id. at §15.1[1].
43. Id.
44. See GENERAL ACCOUNTING OFFICE, supra note 17, at 19-20.
45. See id; Moore, supra note 14.
47. See John C. Anjier & George Denegre, Jr., Disputes between Customers and Brokers/Brokerage Firms, 49 LA. B.J. 283, 285 (2002).
49. See NASD Manual, supra note 48, at 7576 (Rule 10308(b)).
50. See generally id. (identifying how arbitration panels are composed and a number of different objections that may allow the various participants to change the composition of the panel).
51. See Anjier & Denegre, supra note 47.
arbitrator(s) should render an award within thirty days. The panel's award is typically final and is subject to appeal only under limited circumstances. Unless the matter is under appeal, the arbitration panel's award must be paid within thirty days of receipt.

II. SECURITIES ARBITRATION AND LITIGATION IN COURT: A CONVERGING ROAD?

The original purpose of the SRO arbitration programs was to provide a fast, efficient, and cost-effective means of resolving securities disputes. Even today, the NASD-DR describes its arbitration process as a quick and inexpensive substitute to judicial litigation. In response to the perceived conflict of interest created by the fact that the securities industry is the primary forum for individual investors to resolve their disputes against securities industry members, a number of changes have been made to the NASD-DR arbitration format. These changes have made securities arbitrations more complex, time-consuming, and costly.

Despite the original intent and the NASD-DR's description, NASD-DR arbitration resembles litigation more and more every day. For example, new rules allow for expanded discovery, pre-hearing conferences, a record of the hearing to

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52. See NASD Manual, supra note 48, at 7587 (Rule 10330(d)).
53. See infra notes 91-100 and accompanying text.
54. See NASD Manual, supra note 48, at 7588 (Rule 10330(h)).
55. See Black & Gross, supra note 46, at 998. "Arbitration generally has been considered a simpler adjudicatory process than litigation because of its abbreviated discovery procedures, the absence of a jury selection process, the limited availability of appeal, and the less frequent resort to the use of motions." LiPTON, supra note 33, at §4:2.
57. See Black & Gross, supra note 46, at 1003.
58. Id.
59. Id. at 998.
60. See NASD Manual, supra note 48, at 7585-86 (Rule 10321) (detailing the various methods of discovery available in NASD-DR arbitrations).
be made, the publication of arbitration awards, and an arbitrator selection process. Under the new arbitrator selection process that went into effect on November 17, 1998, the parties to the NASD-DR arbitration mutually select who will arbitrate their claim. Prior to November 17, 1998, the securities industry chose the arbitrators that heard suits against its members. In addition to newly enacted rules and procedures, the SEC, in conjunction with the NASD, has proposed a number of NASD-DR arbitration rule changes, including the creation of a means for developing arbitration precedent through arbitrator opinions.

The Federal Arbitration Act (FAA) and NASD-DR rules do not require arbitrators to issue written opinions. Arbitration opinions, much like those rendered in common law courts, could provide much needed precedent for other arbitrators to use when faced with similar claims. Perhaps, more importantly, requiring arbitrators to provide the rationale behind awards would provide brokers and investors with concrete evidence of the specific conduct that constitutes a violation. Approximately seventy-

61. *Id.*
62. *Id.* at 7587 (Rule 10326).
63. *Id.* at 7588 (Rule 10330(f)).
64. *Id.* at 7574-79 (Rule 10308).
Under the new process, NASD supplies a list of up to 15 names that are selected by computerized rotation of the arbitrator roster. The parties can strike anyone from the list and rank the remaining arbitrators according to their preferences. If the parties cannot agree, they are assigned the next available arbitrator on the computerized list to fill any remaining vacancies.

*Id.* See generally NASD Manual, *supra* note 48, at 7574-79 (Rule 10308) (detailing the arbitrator selection process); Nichols, *supra* note 34, at 73 (outlining the arbitrator selection process).
66. *See* Nichols, *supra* note 34, at 73.
69. *See* Black & Gross, *supra* note 46, at 992. The vast majority of securities claims are handled in arbitration and arbitration panels do not write opinions. *Id.* Because of the lack of written opinions, the applicable securities law has been somewhat “frozen.” *Id.* Although the nature of the securities markets has changed tremendously since McMahon, the courts have few opportunities to generate relevant precedent. *Id.* Even when the courts do have such an opportunity their precedent may or may not be followed by the arbitrators. *Id.*
70. *See* Cane & Greenspon, *supra* note 38, at 152.
percent of broker-dealers "support federal legislation requiring arbitrators of securities disputes to write a brief statement explaining the reasons for their decisions." Investors also welcome the prospect of requiring written opinions, but changes of this nature make NASD-DR arbitration slower, less efficient, and more costly.

According to David S. Ruder, a former chairman of the SEC and former member of the NASD Arbitration Policy Task Force, "the increasingly litigious nature of securities arbitration has gradually eroded the advantages of SRO arbitration." One such frequently touted advantage of NASD-DR arbitration is the speed in which disputes are resolved. In 1998, before the recent increase in securities arbitration, the average NASD-DR arbitration lasted nearly seventeen months. The NASD-DR arbitration system is "already showing signs of stress" in attempting to accommodate the recent record numbers of


72. See id.

73. See Black & Gross, supra note 46, at 1003.

74. Id. at 1004. Several factors commonly cited as contributing to the litigious nature of arbitration include: (1) the significant increase in motions relating to discovery, eligibility, statutes of limitations, and other pre-hearing matters; (2) a perceived increase in lawyering illustrated by extensive discovery requests, stonewalling, and delay tactics; (3) frequent appeals to the courts to challenge the eligibility of an arbitration claim or to raise a statute of limitations defense; (4) a movement away from relaxed evidentiary and procedural standards common to arbitration; and (5) much longer hearings, often in excess of the one or two days that is expected for the resolution of investor claims. Id.

75. See supra notes 55-56 and accompanying text.

76. See GENERAL ACCOUNTING OFFICE, supra note 17, at 29, 32. In 1998, the average time between an investor's claim being filed and an arbitration decision being rendered was 519 days. Id. at 29. The average time it took to litigate the fifteen individual securities claims included in the GAO report from the time of filing the claim to final judgment was 930 days. Id. at 32. These numbers may be a bit misleading because the 930 days includes only fifteen cases that actually made it to a final court decision. Id. Because the vast majority of securities claims are arbitrated, the GAO Report was unable to include a large number of litigated cases for comparison purposes. Id.; see also Bill Deener, Report Ranks Brokerage Firms Based on Number of Investor Complaints, DALLAS MORNING NEWS, May 29, 2002 (providing additional statistics regarding the duration of securities arbitrations), available at 2002 WL 21527713.
arbitration claims. Also, proposed new rules, such as requiring written opinions, would impose additional stress on the system and substantially increase the duration of NASD-DR arbitrations. Further, the recent $1.4 billion settlement may make matters even worse because, as part of the settlement, regulators will release the evidence they uncovered during their investigations. This new evidence may expose numerous additional scandals of which the public is currently unaware. A likely result of this information release will be a surge in arbitration claims filed with the NASD-DR. The potential flood of complaints combined with the proposed new rules could further erode the efficiency of NASD-DR arbitration.

While NASD-DR arbitrations are beginning to resemble litigation in courts of law, one surprising place of divergence is in the application of the law. In deciding McMahan, the Supreme Court assumed that arbitrators would apply the law in resolving arbitral disputes. However, there is mounting evidence that arbitrators do not reference the applicable law in their deliberations. Even if NASD-DR arbitrators attempt to apply the law, they often do not have securities or legal backgrounds and receive little training on the complexities of securities law. According to Linda Fienberg, president of NASD Dispute Resolution, the NASD-DR has “purposely sought a panel that is not professional and not primarily securities lawyers” because

77. See Cohn, supra note 15.
78. See GENERAL ACCOUNTING OFFICE, supra note 17, at 32.
79. See Cohn, supra note 15.
80. Id.
81. Id.
82. See id.; Black & Gross, supra note 46, at 1003-1004.
83. See Black & Gross, supra note 46, at 992.
85. See Black & Gross, supra note 46, at 992 (giving some clear examples of arbitration decisions going against the law).
86. Id. NASD-DR selects its arbitrators from a broad cross-section of people, diverse in culture, profession, and background. NASD, Become an Arbitrator, at http://www.nasdadr.com/arb_brochure.htm.asp (last modified Feb. 4, 2003). The only requirements to become a NASD-DR arbitrator are that candidates must have five years of full-time business or professional experience, pass the application process, attend a four-hour training course, and pass a test at the end of the course. Id.
专业责任

报告中提到，大多数受访者希望他们的仲裁小组模仿陪审团，而不是法官。事实上，为了对抗行业偏见的观念，纳斯达克-DR要求涉及投资者的仲裁必须由一个由与证券行业无关的背景的多数仲裁员组成的小组来审理，除非双方同意否则。88

通常，即使适用法律明确，仲裁员也会得出与法律相悖的结果。9

然而，缺乏书面意见使无法审查仲裁员的法律推理。9

双方有上诉其仲裁小组决定的权利，但纳斯达克-DR仲裁小组决定的司法审查是“有限且高度审慎的。”91

《联邦仲裁法》提供了对纳斯达克-DR仲裁裁决司法审查的法定限制，92 但法院表示，可能有其他可以撤销仲裁裁决的理由

In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—(1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) 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; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

88. See NASD, Become an Arbitrator, supra note 86. NASD-DR arbitrations are decided by one or three arbitrators depending on the size of the dispute. NASD, Arbitration Procedures, at http://www.nasdadr.com/arb_procedures.asp#who (last modified Mar. 5, 2001).
89. See Black & Gross, supra note 46, at 992.
90. Id.
91. Sheet Metal Workers' Int'l Ass'n Local Union No. 359 v. Madison Indus. Inc., 84 F.3d 1186, 1190 (9th Cir. 1996).
92. WMA Sec. Inc. v. Wynn, 32 Fed. Appx. 726, 730 (6th Cir. 2002) (stating that the FAA limits judicial review of arbitration awards). See generally 9 U.S.C. § 10 (enumerating the statutory circumstances under which an arbitration award may be modified or corrected).

Id.
or corrected.\textsuperscript{93} Courts rarely reverse NASD-DR arbitration awards "even in the face of erroneous interpretations of the law."\textsuperscript{94} A NASD-DR arbitration award will be set aside "only in very unusual circumstances such as fraud, corruption, or a decision in manifest disregard of the law."\textsuperscript{95} For an award to be in "manifest disregard of the law," the governing law must be "well defined, explicit, and clearly applicable," and the error must be "obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator."\textsuperscript{96}

Without written explanations of awards, the standard of review applied by the courts has no practical application because it is nearly impossible to determine the legal reasoning of the arbitrator(s).\textsuperscript{97} In fact, NASD-DR arbitrators are instructed not to provide the reasons for their decision because they are considered invitations to judicial review.\textsuperscript{98} Often the only real question that courts may review is whether the parties agreed to arbitrate the dispute in the first place.\textsuperscript{99} Despite the fact that there is no mechanism in place to ensure that NASD-DR arbitrators adhere to the applicable statutory law, they are often the first and only decision maker in securities arbitrations.\textsuperscript{100}

The lack of strict adherence to statutory law in NASD-DR arbitrations may work to the investors' advantage.\textsuperscript{101} While

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\textsuperscript{93} See Cane & Greenspon, supra note 38, at 148.
\textsuperscript{94} A.G. Edwards & Sons, Inc. v. McCollough, 967 F.2d 1401, 1402 (9th Cir. 1992).
\textsuperscript{96} Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930, 933-34 (2d Cir. 1986).
\textsuperscript{97} See Cane & Greenspon, supra note 38, at 151.
\textsuperscript{98} Id. at 159.
\textsuperscript{99} See Sheet Metal Workers' Int'l Ass'n Local Union No. 359, 84 F.3d at 1190. "Ordinarily, state contract law will control whether the parties have in fact agreed to submit the controversy to arbitration." HAZEN, supra note 40, at §15.2.
\textsuperscript{100} See Black & Gross, supra note 46, at 1031.
\textsuperscript{101} Id. at 1039.
\end{flushright}
brokers' defenses are typically stronger on the law, customer complaints are typically stronger on principles of equity, such as hardship and betrayal.\textsuperscript{102} According to a prominently placed quote at the beginning of the arbitrator's manual given to all NASD-DR arbitrators, "[e]quity is justice in that it goes beyond the written law.... [I]t is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail."\textsuperscript{103} Principles of equity and fairness are frequently applied in arbitrations, whereas such principles are not usually taken into account for investors in courts of law.\textsuperscript{104} In most instances, the applicable securities law is unfavorable to the investor.\textsuperscript{105} The application of equity in NASD-DR cases can work to an investor's advantage by allowing arbitrators to award them partial damages, as opposed to a court of law where the same claimant would receive nothing.\textsuperscript{106}

An additional benefit of arbitration to investors is that the less stringent arbitration rules do not present many of the harsh obstacles investors face when attempting to pursue a judicial remedy.\textsuperscript{107} A major complication investors face in bringing securities litigation claims is the Private Securities Litigation Reform Act of 1995 (PSLRA).\textsuperscript{108} The PSLRA codified stringent pleading requirements for securities fraud claims.\textsuperscript{109} Under the PSLRA, in order to plead securities fraud the plaintiff must "state with particularity facts giving rise to a strong inference that the

\textsuperscript{102} Id.


\textsuperscript{104} See ARBITRATOR'S MANUAL, supra note 103; Lowenfels & Bromberg, supra note 103, at 999-1000, 1017.

\textsuperscript{105} See Black & Gross, supra note 46, at 1036-40.

\textsuperscript{106} See Lowenfels & Bromberg, supra note 103, at 1002.

\textsuperscript{107} See generally HAZEN, supra note 40, at §12.12 (describing the federal court requirements under PSLRA).


\textsuperscript{109} Id.; see also HAZEN, supra note 40, at §12.13 (describing the federal court requirements under PSLRA).
defendant acted with the required state of mind." Requiring investor plaintiffs to plead fraud allegations with specificity in order to survive a motion to dismiss can cripple an investor's claim before the investor has a chance to prove his case.

In litigation, even when investors timely file and survive a motion to dismiss, they still face the substantial risk of having their claims summarily dismissed. According to the General Accounting Office (GAO), approximately 70% of securities related court cases included in their study were dismissed. Only 12% of these securities cases were decided in court, of which investors won about 73%. The massive expenses incurred by investors who are able to reach trial are often in the hundreds of thousands of dollars and can consume entire awards.

Investor success rates in securities litigation are a far cry from the success investors enjoy when they arbitrate their claims through the NASD-DR. Given these statistics, many wonder why broker-dealers lobbied so hard for securities arbitration forums in the first place.
III. RECENT DEVELOPMENTS IN NASD-DR ARBITRATIONS: ARE INVESTORS WITH SUCCESSFUL CLAIMS BEING ADEQUATELY COMPENSATED?

In 2001, the number of NASD-DR arbitration claims filed increased by 24% from 2000. Filings in 2002 surpassed the record number of claims filed in 2001 by 11%. In 2003, the upward trend will likely continue as thousands of new claims are filed in response to recent Wall Street settlements, and as securities regulators release the findings of their investigations that led to the settlements. After the release of the findings, investor anger will likely boil over, translating into a substantial increase in the number of arbitration claims filed with the NASD-DR in 2003.

With the number of claims rising and bottom lines shrinking due to the bear market, brokers and their firms are defending themselves against investors' claims more vigorously than ever. In 2002, the percentage of claims settled fell to 37% as compared to 44% in 2001, far lower than the 60% settlement levels seen in the 1990s. Of the claims that proceeded through arbitration, NASD-DR arbitration panels awarded investors compensation between 53% and 61% of the time in each of the past five years. Although the investor wins more often than not, the arbitration awards generally fall far short of the actual losses sustained.

Under NASD-DR arbitration, investors with successful claims are not likely to walk away with a significant percentage of

118. See NASD, Dispute Resolution Statistics, supra note 4.
119. Id. In 2002, investors filed 7,704 NASD-DR arbitration claims, an eleven percent increase over the 6,915 claims filed in 2001. Id.
120. See Craig, supra note 9; supra notes 79-82 and accompanying text.
121. See Cohn, supra note 15.
122. See Wipperfurth, supra note 13.
123. See NASD, Dispute Resolution Statistics, supra note 4; see also Wipperfurth, supra note 13 (supporting the assertion that brokerage firms are fighting back against investor claims harder than ever).
124. See GENERAL ACCOUNTING OFFICE, supra note 17, at 24.
125. See Moore, supra note 14.
126. See id.
their market losses, which often exceed one million dollars. In 2001, NASD-DR arbitration panels awarded a total of $112 million. Typical investor claims range from $200 to $23.5 million. The median NASD-DR arbitration award was $31,000, whereas the median investor claim was $64,000. NASD-DR arbitrators award more than half of the amount investors claim in only 37% of the cases. This data suggests that arbitration panels are "splitting the baby" and applying equity principals in order to provide investors with partial awards that they would not be so fortunate to receive in courts of law. In addition to the small percentage of their claim that investors typically receive when they are successful in procuring an award, lawyers' contingency fees often consume 40% of the ultimate recovery. If an investor is successful and procures a $50,000 award, she can expect to wind up taking home less than $10,000 after paying arbitration expenses.

The problem of adequate compensation for investors with successful claims is further complicated by the fact that investment firms often do not pay the judgments against them. According

127. See Wipperfurth, supra note 13.
128. See Moore, supra note 14.
129. See GENERAL ACCOUNTING OFFICE, supra note 17, at 28 (reporting the range of investor claims in 1998).
130. See Wipperfurth, supra note 13 (reporting the average arbitration award in 2001).
131. See GENERAL ACCOUNTING OFFICE, supra note 17, at 28 (reporting the average investor claim in 1998).
132. Id. at 26.
133. See supra notes 104-06 and accompanying text; Lowenfels & Bromberg, supra note 103, at 1017 (describing "splitting the baby" as awarding claimants a portion of their damage demands even when a court would likely award the same claimants nothing).
134. See Goodman, supra note 1. The average contingency rate for personal injury is 25%, while the average contingency rate for a NASD-DR arbitration is 40%. Id. So many investors are attempting to pursue securities claims that attorneys specializing in NASD-DR arbitrations enjoy the luxury of being extremely selective with the cases that they choose to accept and will often turn away promising claims that are less than $100,000. Id. Investors represented by attorneys are 27% more likely to receive an award. GENERAL ACCOUNTING OFFICE, supra note 17, at 26.
136. See Bell, supra note 56.
to a study by the GAO, securities firms and brokers pay NASD-DR awards less than half of the time. The NASD reviewed why so few arbitration awards were being paid and found that 90% of the claims involved firms that had dropped out or had been forced to leave the NASD. Additionally, most of these firms were insolvent, making collection difficult regardless of the forum in which the judgment was rendered. “Not surprisingly, many plaintiffs’ attorneys are requiring claimants to pay them on an hourly basis, as opposed to more manageable contingency fees.”

The high percentage of unpaid NASD-DR arbitration awards, combined with the fact that the awards for successful claims often fall far short of the claimed amount, creates many problems for investors and raises questions about the NASD-DR arbitration process and the securities industry’s role in the settlement of investor claims.

IV. CONFLICTS OF INTEREST AND THE NASD: WHAT IS BEING DONE TO PROTECT INVESTORS?

While the conflicts of interest surrounding both the Enron accounting scandal and Wall Street analysts’ fraudulent stock recommendations have garnered a great deal of attention recently, the potential conflict of interest between the NASD and the

137. See GENERAL ACCOUNTING OFFICE, supra note 17, at 26. Current NASD rules allow investors to take their claims against defunct brokerage firms to court. Press Release, NASD, NASD Streamlines Arbitration Process for Claimants Filing Against Defaulting Suspended or Terminated Industry Respondents (Sept. 19, 2002) (on file with the N.C. Banking Institute), available at http://www.nasdr.com/news/pr2002/release_02_043.html (last visited Feb. 15, 2003). Since October 14, 2002, investors with claims against defunct brokerage firms may arbitrate their claims with the NASD through a streamlined procedure. See id. Under this system, a hearing is not conducted. Id. Instead a verdict is rendered by a single arbitrator based upon the Statement of Claim and supporting documentation provided by the claimant. Id. If there is an arbitration award, the claimant can take the award to court for enforcement. Id. This system provides an inexpensive means of getting an enforceable award against a brokerage firm that has been terminated by the NASD or is defunct. Id.

138. See GENERAL ACCOUNTING OFFICE, supra note 17, at 70.

139. See id. at 33.

140. Cane & Greenspon, supra note 38, at 138. But see supra note 134 and accompanying text (stating that the 40% contingency fee lawyers typically require for NASD-DR arbitrations is relatively high).

141. See supra notes 137-40 and accompanying text; Wipperfurth, supra note 13.
brokerage industry has slipped under the radar. The NASD is financially dependent on the same institutions and people it is responsible for regulating and disciplining. This financial dependence significantly detracts from the NASD’s credibility with the public. Congress, the SEC, state regulators, and many investors have expressed concern regarding the fairness and impartiality of maintaining arbitration forums that are sponsored and administered by the securities industry.

Much of the public perceives that the NASD is hesitant to punish its rule-breaking members, thus failing to adequately protect investors. This perception is bolstered by the fact that the NASD did not take immediate disciplinary action against firms or research analysts for making fraudulent stock recommendations in order to win investment-banking business. As a result of the NASD’s hesitation to act against its members, New York Attorney General, Eliot Spitzer, conducted his own investigation of the biased research ratings, stating, “[t]he self-regulatory organizations that are supposed to be there to protect (investors) have failed, and I’m not waiting any longer for them to act.” Merrill Lynch, the first target of Spitzer’s investigation, settled with New York State. In that settlement, Merrill Lynch agreed to pay a $100 million fine and stop compensating its stock analysts based on the amount of investment banking revenue they generate, but rather on the performance of the analysts’ recommendations. In response to Merrill Lynch’s settlement with New York, the NASD

142. See Knox & Hansen, supra note 18.
143. See supra note 24 and accompanying text.
144. See Knox & Hansen, supra note 18.
145. See General Accounting Office, supra note 17, at 4; see also Nichols, supra note 34, at 64 (stating that “both investors and Congress have expressed concern about the fairness of securities industry-sponsored and administered arbitral forums”).
146. See Knox & Hansen, supra note 18.
147. See id.
148. Id.
149. See id. Elliot Spitzer is currently conducting investigations of at least five other investment banks for touting stocks in order to gain investment banking business. See id. In addition to the $100 million Merrill Lynch settlement, other Wall Street firms have recently reached a $1.4 billion settlement with securities regulators for similar actions. Craig, supra note 9.
150. See Knox & Hansen, supra note 18.
has proposed new rules to curb potential conflicts of interest between research analysts’ recommendations and investment banking revenue.\textsuperscript{151} Although the NASD eventually took action, the NASD’s after-the-fact response may have detracted from its already damaged credibility.\textsuperscript{152}

The investing public relies on the NASD to monitor, regulate, and investigate complaints against its 662,311 registered brokers and 5,392 member brokerage firms.\textsuperscript{153} In 2002, the NASD received 4,495 customer complaints,\textsuperscript{154} a 32\% decrease from 6,584 in 2000.\textsuperscript{155} The decline in customer complaints between 2000 and 2002, the same period when customers were filing record numbers of arbitration claims with the NASD-DR against brokers and firms, is counter-intuitive.\textsuperscript{156} The likely reason that many investors filed arbitration claims with the NASD-DR without complaining to the NASD is because most NASD investigations end with a no-action letter.\textsuperscript{157} The no-action letter informs the investor that the NASD is closing its investigation without taking any disciplinary action against the broker and/or firm in question.\textsuperscript{158} Lawyers representing investors in NASD-DR arbitrations view NASD no-action letters as the “kiss of death” to their arbitration claims because NASD-DR arbitration panels typically follow the NASD’s lead, and thus they opt to skip the NASD complaint process and avoid the possibility of receiving the letter.\textsuperscript{159} The NASD has recently changed its policy to give the complaining investor the


\textsuperscript{152} See supra notes 144, 146 and accompanying text.

\textsuperscript{153} See NASD, Statistics, supra note 3 (providing updated data current as of January 13, 2003).

\textsuperscript{154} Id.

\textsuperscript{155} Id. The NASD received 5,155 customer complaints in 2001. Id.

\textsuperscript{156} Id.

\textsuperscript{157} See Knox & Hansen, supra note 18.

\textsuperscript{158} Id.

\textsuperscript{159} Id.
Thus, this change, which allows investors to avoid the no-action letter, may increase customer complaints to the NASD.

Although the NASD changed its no-action letter policy, it did not change the way customer complaints are investigated and resolved. In 2002, the NASD received 4,495 customer complaints and suspended or expelled 814 brokers and 10 firms. Because the NASD takes disciplinary action against its members less than 20% of the time, investors and their attorneys question whether the NASD properly investigates or resolves customer complaints. Consequently, many investors feel that reporting inappropriate broker conduct to the NASD will do nothing more than hurt their NASD-DR arbitration claim.

Investors and their lawyers are not alone in their failure to report broker misconduct to the NASD. With record numbers of arbitration claims being filed with the NASD-DR and investors obtaining relief in a majority of them, critics question why the NASD is not sanctioning more brokers and firms. Currently, no effective mechanism exists for NASD-DR arbitrators to report broker misconduct back to the NASD. NASD-DR arbitration panels rarely report even the most outrageous cases of broker misconduct to the NASD. According to Philip Aidikoff, President of the Public Investors Arbitration Bar Association, “after the money is paid in a settlement or award, these guys [the

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160. *Id.* On May 23, 2002, “the NASD’s board of directors voted to change the working of the no-action letter it sends to investors when it closes an investigation and, more importantly, will give investors the choice of whether the NASD sends a letter at all.” *Id.* The Public Investors Arbitration Bar Association has been trying for years to change the NASD no-action letter policy. *Id.*

161. *Id.*

162. *Id.*

163. See NASD, *Statistics,* supra note 3. This is the total number of NASD suspensions and expulsions and are not actions taken solely in response from customer complaints. *Id.*

164. See *id.*; Knox & Hansen, *supra* note 18.

165. Knox & Hansen, *supra* note 18. (according to Pat Sadler, a lawyer in Georgia, who serves on the NASD’s national arbitration and mediation committee).

166. See *id.*

167. *Id.*

168. See *id.*

169. See *id.*
brokers] are still in the business, they’re still doing the same thing—and that’s frightening.” Even Mary Schapiro, president of the NASD’s regulatory division and a former SEC Commissioner, agreed that there is a need to better educate NASD-DR arbitrators to report egregious conduct to the NASD. The NASD-DR’s failure to report broker misconduct to the NASD, combined with the NASD’s frequent failure to take action even when misconduct is reported, further call the NASD and NASD-DR’s allegiances into question.

The California Legislature recently opined on the question of arbitrators’ allegiances by passing Senate Bill 475. While not directly targeting the securities industry, this amendment to the California Code of Civil Procedure is intended to build public confidence in the arbitration process. Senate Bill 475, which went into effect July 1, 2002, requires arbitrators to disclose much more information pertaining to potential conflicts of interest. Under the amendment, arbitrators are required to disclose significant personal relationships they might have with parties to the arbitration or to lawyers on either side, as well as potential conflicts their extended family members may have with the parties. California now requires more detailed arbitrator disclosure than is required under NASD-DR rules. Further, the legislation permits either party “to disqualify arbitrators based on

170. Id.
171. See id.
172. See id.
174. See CAL. CIV. PROC. CODE §1281.85.
175. Id.
176. See id.; Bauder, supra note 173. Depending of the size of the claim, the arbitration panel is typically made up of three individuals, one industry insider and two people from the public that are considered outsiders. Id. “There are often questions about those purported outsiders.” Id. In many cases, the public arbitrator is someone with a connection to the securities industry, such as a former broker or lawyer who provides advice to brokerage houses. Id.
disclosure of a broad array of information and requires courts to vacate arbitral awards if the arbitrator failed to make a required disclosure.”

As a result, a number of NASD-DR arbitrators pulled out of pending arbitrations and the NASD refused to appoint any new arbitrators in California, bringing arbitrations there to a halt.

The NYSE and NASD filed suit in federal district court in Oakland seeking a declaratory judgment that California law cannot be applied to their national, federally-regulated arbitration procedures. The district court judge dismissed the suit, but the decision is likely to be appealed; the NYSE and NASD-DR are currently “weighing their options.” The securities industry feels that their arbitrators already meet strict disclosure rules and that the California rules are unnecessary and unduly burdensome.

California officials and investors felt differently, believing the NASD-DR’s challenge of a law that would lend much needed credibility to their arbitrations is sending the wrong message to the public. Many believe that calling for less disclosure when the public is demanding more detracts further from the NASD-DR’s tarnished public image. A dangerous precedent is at stake for

178. Id.
179. See Bauder, supra note 173. The fact that some NASD-DR arbitrators pulled out of arbitrations after this act was put into place caused many to wonder why they left. Id.
180. See Perino, supra note 177, at 2.
184. See JB, supra note 183.
the NASD-DR because if the California legislature is ultimately allowed to impose its own rules on securities arbitrations, other state legislatures would be allowed to make their own rules as well. The final decision on this issue will be significant because the possibility of different rules in each state could completely undermine the federally regulated national arbitration programs currently in place.

V. CONCLUSION

While a number of problems remain with the NASD's self-regulation of the securities industry and the NASD-DR’s resolution of investor complaints, the proverbial fox, does not run unrestrained. The NASD-DR’s role in the resolution of investor complaints will take center stage as the current Wall Street scandal investigations transition into unprecedented numbers of investor arbitration claims. When this occurs, it will likely be found that despite the investor perception of a pro-industry bias, investors fare much better in NASD-DR arbitrations than they would in courts of law. The statistics show that the NASD-DR arbitration process overwhelmingly favors investors, while traditional litigation seemingly favors the securities industry. Further, the SEC and the NASD work in conjunction to fix the problems with the regulation and resolution of investor complaints as they arise. The NASD frequently proposes new rules to deal with problems, but change is often slow because new rules must be approved by the SEC. Unfortunately, the new rules designed to promote fairness come at the expense of efficiency.

185. See SEC Brief, supra note 182.
186. Id.
187. See supra notes 79-81 and accompanying text.
188. See supra notes 106, 113-16, 123-25, 133 and accompanying text.
189. LIPTON, supra note 33, at §4:2. “Arbitration generally has been considered a simpler adjudicatory process than litigation because of its abbreviated discovery procedures, the absence of a jury selection process, the limited availability of appeal, and the less frequent resort to the use of motions.” Id.
190. See supra note 67 and accompanying text.
191. Id.
192. See supra notes 20-21 and accompanying text.
193. See supra notes 72-78 and accompanying text.
Efficiency is, after all, the reason why litigation has been replaced by arbitration in the securities industry.\textsuperscript{194} While not perfect, current NASD-DR arbitration procedures go to great lengths in attempting to maintain a delicate balance between fairness and efficiency.

NASD-DR arbitrations, unlike litigation, remain true to their original purpose of providing a faster, more efficient, and cost-effective means of resolving securities disputes.\textsuperscript{195} At the same time, NASD-DR arbitrations seemingly favor investors, not the securities industry.\textsuperscript{196} If the NASD is a fox watching the henhouse of investors, Congress, the SEC, state officials, and investor advocates provide formidable restraints that prevent the fox from taking advantage of the situation and leave him, instead, licking his chops.

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\textsuperscript{194} See supra notes 55 and accompanying text.
\textsuperscript{195} See supra notes 55-57 and accompanying text. But see supra note 74 and accompanying text.
\textsuperscript{196} See supra notes 113-16, 123-25 and accompanying text.