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Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration

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Virtually all investors today are required to resolve disputes with their brokers through NASD arbitration. The Supreme Court has decided that arbitration is an entirely appropriate forum for investors to vindicate their rights under the securities laws. The Court's view stems from the myth that arbitration provides securities experts who will expeditiously render reasonable and fair decisions in compliance with the law. In practice, however, securities arbitration decisions are usually rendered by non-experts who may not apply or even understand the securities laws.

This Article systematically reviews the NASD arbitration opinions from 2003 and 2004 in order to evaluate the actual rationales of the arbitral awards. This analysis suggests that serious reforms are necessary before one can support the claim that this system provides a principled alternative to adjudication. This Article concludes with a modest proposal to confront the myth of the expert arbitrator.
fraud, we now learn that investment firms, which provide the portal for public investors to enter the market, may be corrupt as well. Many public investors are surprised to learn that they have no right to litigate disputes with their brokers in court. Instead, the mysterious process of securities arbitration is the vehicle through which the vast majority of individual American investors intersect with the laws designed to protect them from fraud and malfeasance. In the wake of the stock market crash of 1929, Congress enacted the Securities Act of 1933 ("the 1933 Act") and the Securities Exchange Act of 1934 ("the 1934 Act") to protect investors from the fraudulent activities and sales practices of unscrupulous promoters and brokers. In spite of congressional directives that courts should adjudicate disputes arising from the securities statutes, virtually all investor claims against brokers are now subject to mandatory arbitration.

This is a heavy burden to shoulder for a dispute resolution system that is founded on the myth that securities experts will expeditiously render reasonable and fair decisions. In practice, decisions in securities arbitrations are usually rendered by non-experts who may not apply or even understand the securities laws. Moreover, the decisions are virtually insulated from judicial review.

Initially, the Supreme Court jealously guarded the public's right to pursue judicial review of claims asserted under the securities statutes and refused to enforce pre-dispute arbitration provisions that brokerage firms commonly placed in new customer account forms. Recognizing the many shortcomings of arbitration, the Court in 1953 declared that mandatory pre-dispute arbitration clauses violated

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public policy as expressed in the securities acts.\textsuperscript{4} Beginning in 1987, however, the Supreme Court changed gears, and citing the federal pro-arbitration policy embodied in the 1925 Federal Arbitration Act ("FAA"),\textsuperscript{5} the Court placed its stamp of approval upon mandatory arbitration to settle disputes between investors and their brokers.\textsuperscript{6}

The current rhetoric of the Court is that arbitration is an entirely appropriate forum in which investors can vindicate their rights under the securities laws. The validity of this principle rests upon the fiction that the arbitral forum presents only a procedural departure from judicial adjudication. Under the Court's worldview, investors can take advantage of streamlined arbitral procedures and still be assured that judicial review will be sufficient to protect their statutory rights.\textsuperscript{7} The procedural story told by the Court, however, does not accurately portray either historical arbitration traditions or modern arbitration practice.

Traditionally, arbitration was a dispute resolution device utilized by members of trade groups to settle differences according to industry rather than legal norms.\textsuperscript{8} There was no expectation that arbitrators would apply legal principles. Early arbitration was marked by informal procedures and expert decisionmakers drawn from the ranks of trade association members. Non-judicial incentives and sanctions among group members rendered arbitration an efficient means to settle disputes according to industry practices. These customs, based upon shared community values, do not describe modern securities arbitration. Moreover, traditional arbitration would not constitute a suitable model for a dispute resolution system for non-industry members to vindicate statutory rights.

In contrast to traditional arbitration customs, modern securities arbitration contains formal litigation-like procedures played out in front of lay arbitrators who may have no industry or legal expertise.\textsuperscript{9} Unlike judicial proceedings, however, in arbitration there are few precedents, little accountability, and virtually no appeal.

\textsuperscript{7} McMahon, 482 U.S. at 231–32.
\textsuperscript{8} See discussion infra Part II.
\textsuperscript{9} See discussion infra Parts III & IV.
Furthermore, these non-reviewable decisions are made by those with marginal qualifications who undergo little if any training in the law they purport to apply or the procedures they are bound to follow. Perhaps more remarkably, arbitrators do not even have to apply the law if they feel that equity demands a different conclusion.

The National Association of Securities Dealers ("NASD") handles the vast majority of securities arbitrations in the United States today. While NASD insists that its arbitration forum is fair and functions smoothly, this claim is difficult to substantiate as NASD awards remain shrouded in relative mystery and anonymity. NASD has captured the market for securities arbitration and because the courts have largely abandoned any pretense of overseeing the arbitration process, one is left to wonder what is really happening in the trenches. Perhaps not surprisingly, the view from the ground floor differs greatly from the view from the Court's ivory tower. In spite of Supreme Court pronouncements to the contrary, securities arbitration is not merely a different forum in which parties can enforce mandatory rules. Instead, it is an entirely different world where non-expert arbitrators make ad hoc decisions that are generally immune from judicial review.

This Article argues that serious reforms are necessary in securities arbitration before one can support the claim that this system provides a principled alternative to adjudication. Utilizing empirical data obtained from a review of all NASD arbitration opinions from 2003 and 2004, this Article attempts to demystify NASD securities arbitration. In Part I, this Article provides a short history of the judicial and regulatory development of securities arbitration and suggests that judicial approval of the modern practice is based upon fictional constructs. Part II describes the variances between modern arbitration practice and the myth that justifies it. Part III demonstrates that, in spite of Supreme Court rhetoric, arbitrators are not applying applicable law and, in fact, receive distinct signals that they need not apply the law. This Part analyzes the 2003 and 2004 NASD awards and highlights the difficulty that courts, regulators, and commentators alike face in accessing and adequately assessing arbitral decisions. Part IV posits that the largest issue facing the arbitration system is the competence of the arbitrators and the lack of procedures to expeditiously handle complex legal issues. With a stated purpose to bring a modicum of

10. See infra notes 48–53 and accompanying text.
11. See discussion infra Part III.
law and order into this dispute resolution system, Part V concludes with a modest proposal designed to ensure that competent decisionmakers utilize sensible procedures to handle investor claims.

I. A CONCISE HISTORY OF SECURITIES ARBITRATION

In 1925, Congress passed the Federal Arbitration Act ("FAA"), which requires courts to enforce arbitration agreements in the same manner as other contracts.\(^{12}\) Section 2 of the FAA provides that pre-dispute arbitration agreements are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."\(^{13}\) The Supreme Court subsequently held that the FAA applied not only to federal courts but that it also preempted inconsistent state laws, thus creating a national policy favoring arbitration.\(^{14}\) Nonetheless, courts decided that some categories of disputes were not subject to mandatory pre-dispute arbitration agreements as a matter of public policy.\(^{15}\) Disputes centering on the federal securities laws were originally put in this category.

In *Wilko v. Swan*,\(^{16}\) the Supreme Court held that a pre-dispute agreement to arbitrate a claim under the Securities Act of 1933 was not enforceable in spite of the FAA because it violated public policy. *Wilko* involved an arbitration agreement contained in a contract between a securities broker and his customer. The customer brought suit in federal court alleging that the broker sold stocks by means of misrepresentations in violation of section 12(2) of the 1933 Act.\(^{17}\) In refusing to compel arbitration in accordance with the parties' contract, the Court stated that the arbitration provision violated both

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15. See Cruz v. PacifiCare Health Sys., Inc., 66 P.3d 1157, 1159 (Cal. 2003) (holding that unfair competition and misleading advertising claims are not subject to arbitration); Broughton v. Cigna Healthplans of Cal., 988 P.2d 67, 79 (Cal. 1999) (holding that claims for public injunctions are not subject to arbitration despite the FAA); Port Wash. Union Free Sch. Dist. v. Port Wash. Teachers Ass’n, 380 N.E.2d 280, 283 (N.Y. 1978) (holding that if arbitrators cannot grant relief without violating public policy, the claim is not subject to arbitration).
17. Id. at 429.
sections 14 and 22 of the 1933 Act, which respectively prohibit waivers of the statute\textsuperscript{18} and place jurisdiction in state and federal courts.\textsuperscript{19}

In response to the broker’s argument that arbitration was simply a different forum in which to adjudicate the parties’ rights and obligations under the 1933 Act, the Court in \textit{Wilko} noted several shortcomings of arbitration. First, unlike the traditional commercial arbitrations of the era, where the sole issue was typically the value of a commodity or the amount due under a contract, disputes under the securities laws were more complicated and required the decisionmakers to rule on issues such as intent and knowledge.\textsuperscript{20} The Court recognized that arbitrators are not judges, or necessarily even lawyers, yet they must make these difficult legal determinations “without judicial instruction on the law.”\textsuperscript{21} The Court also noted that under the FAA there are limited grounds for judicial review,\textsuperscript{22} and the arbitrators’ failure to apply the statute must be “manifest” and must clearly appear from the decision.\textsuperscript{23} Moreover, the arbitration procedures during the \textit{Wilko} era did not require the arbitrators to keep a record or to provide an explanation, thus rendering meaningful judicial review virtually impossible.\textsuperscript{24}

Although little changed in securities arbitration in the ensuing thirty-four years, in the 1987 case of \textit{Shearson/American Express, Inc. v. McMahon},\textsuperscript{25} the Court abruptly changed course and enforced a pre-dispute arbitration agreement in a brokerage contract much like the arbitration contract it had earlier invalidated in \textit{Wilko}. While the dispute at issue in \textit{McMahon} involved section 10(b) of the 1934 Act, and the Court paid lip service to this distinction, in reality the \textit{McMahon} decision represented a new pro-arbitration philosophy

\textsuperscript{18} Securities Act of 1933 § 14, 15 U.S.C. § 77a (2000) ("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.").

\textsuperscript{19} \textit{Id.} § 22, 15 U.S.C. § 77v (placing concurrent jurisdiction for 1933 Act claims in the federal and state courts).

\textsuperscript{20} \textit{Wilko}, 346 U.S. at 435–36.

\textsuperscript{21} \textit{Id.} at 436. In \textit{Wilko}, the arbitration agreement apparently was under the auspices of the American Arbitration Association ("AAA"). \textit{Id.} at 439.


\textsuperscript{23} \textit{Wilko}, 346 U.S. at 436.

\textsuperscript{24} \textit{Id.}

\textsuperscript{25} 482 U.S. 220 (1987).
now embraced by the Court.\textsuperscript{26} Like the 1933 Act at issue in \textit{Wilko}, the 1934 Exchange Act contains a non-waiver provision.\textsuperscript{27} However, in \textit{McMahon}, the Court construed the non-waiver provision to apply only to a waiver of substantive rights, not procedural rights.\textsuperscript{28} Characterizing access to the judicial system as mere procedure, the Court upheld the arbitration contract. In so holding, the Court rejected McMahon's contention that the arbitration process was inadequate to protect his substantive statutory claims. Citing its previous decision in \textit{Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.},\textsuperscript{29} the Court stated that arbitrators are capable of handling complex legal issues and that it found "no reason to assume at the outset that arbitrators will not follow the law."\textsuperscript{30} The Court further noted that the \textit{Wilko} opinion reflected "a general suspicion of the desirability of arbitration and the competence of arbitral tribunals,"\textsuperscript{31} a viewpoint with which the \textit{McMahon} Court no longer agreed.\textsuperscript{32}

Justices Blackmun, Brennan, and Marshall, dissenting in \textit{McMahon}, took issue with what they called the majority's implied reliance upon improvements in the arbitration process since the \textit{Wilko} case was decided.\textsuperscript{33} While recognizing that modern securities arbitrations take place in accordance with a uniform arbitration code that did not exist in 1953,\textsuperscript{34} the dissent noted several persisting deficiencies in the arbitration process. For example, arbitrators are not bound by precedent and are discouraged from providing written opinions.\textsuperscript{35} Moreover, contrary to the assertion of the \textit{McMahon}
majority, under the FAA there is no avenue for meaningful judicial review as such review is limited to four narrow statutory grounds along with the difficult "manifest disregard for the law" standard suggested by the Wilko opinion.  

It appears that the McMahon Court's newfound acceptance of arbitration in securities disputes was largely informed by the Securities and Exchange Commission ("SEC"), which, in a change of position, filed an amicus brief arguing in favor of the arbitrability of securities claims. The SEC stressed to the Court that since 1975, it had obtained broad regulatory authority over the stock exchanges and other self regulatory organizations ("SROs") that provide the vast majority of arbitration forums. The SEC convinced the Court that through its oversight function it could ensure that SRO arbitrations were adequate to protect investors.

In the decade before McMahon, the SEC had facilitated the formation of the Securities Industry Conference on Arbitration ("SICA") to develop uniform arbitration rules to govern arbitrations before SROs. The SICA includes representatives from the SROs, 

36. Id. at 257–58.
38. SROs are defined in section 3(a)(26) of the 1934 Act and include the national securities exchanges, such as the New York Stock Exchange and the American Stock Exchange and the National Association of Securities Dealers, Inc. (NASD), the largest SRO. 15 U.S.C. § 78c(a)(26) (2000). The 1934 Act requires that each registered broker-dealer firm become a member of a SRO. See 15 U.S.C. § 78o(b)(8) (2000). Also, pursuant to section 15(a)(1) of the 1934 Act, virtually all broker dealers must register with the SEC. See 15 U.S.C. § 78o(a)(1).
39. Brief for the Securities & Exchange Commission as Amicus Curiae Supporting Petitioners at 2, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44). The dissenting Justices in McMahon took issue with the SEC's assessment of the efficacy of its regulatory powers. The dissent noted that: the Court accepts uncritically petitioners' and the Commission's argument that the problems with arbitration, highlighted by the Wilko Court, either no longer exist or are not now viewed as problems by the Court. This acceptance primarily is based upon the Court's belief in the Commission's representations that its oversight of the SROs ensures the adequacy of arbitration.

McMahon, 482 U.S. at 250 (Blackmun, J., dissenting).
40. For background on the SICA, see Constantine N. Katsoris, SICA: The First Twenty Years, 23 FORDHAM URB. L.J. 483, 488–90 (1996).
the Securities Industry Association, and members of the public.\footnote{41} As consumer arbitrations were voluntary at this time, the SEC's primary impetus in 1977 was to establish a uniform nationwide arbitration system in which investors could resolve small claims that did not justify the expense of litigation.\footnote{42} In 1979, the SICA promulgated and now maintains a Uniform Code of Arbitration that has been adopted with minor variations by the SROs and approved by the SEC pursuant to its authority under Section 19 of the 1934 Act.\footnote{43}

In 1989, two years after \textit{McMahon}, the SEC approved changes in the arbitration rules for the three major SROs: the NASD, the New York Stock Exchange ("NYSE"), and the American Stock Exchange.\footnote{44} In approving these amendments, the SEC engaged in what can best be deemed a negotiation with the SROs rather than a regulation of them.\footnote{45} The changes implemented to the SRO rules primarily involved hearing procedures and did not address recognized deficiencies in the SRO arbitration forums such as the competence and training of the arbitrators or a requirement that arbitrators explain their decisions.\footnote{46} Continuing SEC oversight of SRO arbitrations is modest at best.\footnote{47}

Since the legitimization of the practice in \textit{McMahon}, the vast majority of disputes between investors and broker-dealers are handled pursuant to mandatory pre-dispute arbitration agreements. NASD rules require member broker-dealers to arbitrate disputes

\footnote{41}{Members of the SICA now include the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, NASD, NYSE, the Pacific Exchange, the Securities Industry Association, and three public members.}


\footnote{44}{For a description of these 1989 changes, see Barbara Black & Jill I. Gross, \textit{Making It Up as They Go Along: The Role of Law in Securities Arbitration}, 23 CARDOZO L. REV. 991, 999–1001 (2002) (describing the SEC’s limited success in reforming SRO arbitration rules).}

\footnote{45}{In a system of privatized regulation advocated by conservative administrations, such "deregulation" is to be expected. See Jody Freeman, \textit{The Contracting State}, 28 FLA. ST. U. L. REV. 155 (2000) (noting the tendency of governments to outsource traditional governmental functions to private parties).}

\footnote{46}{See Black & Gross, \textit{supra} note 44, at 998–1003.}

upon customer demand, and in turn most broker-dealers now require their customers to arbitrate as a matter of contract. Employees of member firms must also agree to arbitrate all disputes except those based upon claims of discrimination. NASD, through its subsidiary the NASD Dispute Resolution, Inc. ("NASD-DR"), and the NYSE are the SROs that provide the bulk of arbitration services for the securities industry. Indeed, most arbitration clauses specify that any and all disputes shall be arbitrated pursuant to rules of NASD or the NYSE. Collectively, the NASD and NYSE handle about ninety-nine percent of securities arbitrations, with over ninety percent of the cases proceeding through the NASD forum.

48. See NASD MANUAL § 10301(a), (c) (2005), available at http://nasd.complinet.com/nasd/display/index.html. The NYSE rules are actually broader than those of NASD and require member firms to arbitrate with anyone who has a dispute with a member "in connection with the business of such member ... and/or associated person in connection with his activities as an associated person." NYSE DEP'T. OF ARBITRATION, ARTICLE XI NYSE CONSTITUTION AND ARBITRATION RULES, art. XI § 1, Rule 600 (2003), available at http://www.nyse.com/pdfs/Rules.pdf [hereinafter NYSE RULES 2003]. These SRO rules requiring arbitration upon customer demand have been in place since 1972. Norman S. Poser, Making Securities Arbitration Work, 50 SMU L. REV. 277, 281-82 (1996). For consequences for failure to arbitrate, including expulsion from NASD, see NASD MANUAL, supra, § IM-10100(a).

49. U.S. GEN. ACCOUNTING OFFICE, PUB'N No. GAO/GGD-00-115, ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS 30 (2000) [hereinafter 2000 GAO REPORT] (noting six of the nine largest broker-dealers now include pre-dispute arbitration agreements for cash accounts as well as margin accounts); U.S. GEN. ACCOUNTING OFFICE, PUB'N No. GAO/GGD-92-74, HOW INVESTORS FARE 31 (1992) [hereinafter 1992 GAO REPORT] (noting that all nine of the largest brokerage firms as well as the vast majority of small and medium size firms require their customers to sign pre-dispute arbitration clauses when opening margin or options accounts).

50. NASD MANUAL, supra note 48, § 10201(b).

51. The NASD-DR was created to oversee the NASD arbitration and mediation programs as part of a restructuring in the NASD that took place in July 2000. See MICHAEL PERINO, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATIONS 1 n.1 (2002), available at http://www.sec.gov/pdf/arb_conflict.pdf.

52. A review of the arbitration clauses in the new account agreements used by the top firms ranked by Smart Money, J.D. Power, and Keynote found that eighteen of the top twenty stock brokerages specify the NASD or the NYSE as the forum for arbitration. The NASD is the designated forum for five firms (Ameritrade, Banc of America, CitiTrade, E*Trade, and First Trade). Thirteen firms (American Express, Brown Co., Fidelity, Harris Direct, H&R Block, Merrill Lynch, Morgan Stanley, Quick & Reilly, Scottrade, Seibert, Strong, TD Waterhouse, and Vanguard) indicate that either the NASD or the NYSE would be acceptable as forums for arbitration. Of those, five firms (American Express, Harris Direct, Morgan Stanley, Scottrade, and Vanguard) provide an alternative such as the Municipal Securities Board or an unspecified registered stock exchange of which the parties are members.

53. See PERINO, supra note 51, at 10 n.24.
In January 2000, the SICA initiated a pilot program in which participating brokers gave investors the option to arbitrate disputes in the non-SRO sponsored forums of Judicial Arbitration and Mediation Services, Inc. ("JAMS") or the American Arbitration Association. However, in 2002, at the conclusion of the pilot program, SICA reported that very few investors elected to use the alternative arbitration forums largely due to the increased costs and their attorneys' comfort with the SRO procedures. New filings before NASD arbitrators continue to increase and now number in the thousands each year. NASD's dominance of the market as a provider of arbitration services helps to insulate its arbitration regime from effective review and analysis. A close examination of NASD arbitrations, however, suggests that they fail to adhere to either traditional arbitral norms or the McMahon Court's expectations.

II. TRADITIONAL ARBITRAL NORMS

An implicit rationale for the McMahon Court's approval of mandatory arbitration to settle disputes implicating the securities laws was its comfort with the traditional norms of commercial arbitration.

54. JAMS, founded in 1979, is a for-profit provider of alternative dispute resolution ("ADR") services. JAMS' arbitrators are full-time ADR practitioners largely consisting of retired lawyers and judges. For further information on JAMS, see http://www.jamsadr.com (last visited Nov. 30, 2005). The American Arbitration Association ("AAA") is a non-profit provider of ADR services. AAA neutrals generally have expertise in the area of dispute. Information on AAA is available from http://www.adr.org (last visited Nov. 30, 2005).

55. See SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, TWELFTH REPORT, supra note 34, at 6.


57. See 2000 GAO REPORT, supra note 49, at 7 (noting difficulty in assessing fairness of NASD arbitrations given the few proceedings now arbitrated in other dispute resolution forums).

58. See Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 232 (1987). While the McMahon Court did not expressly base its decision on the benefits of traditional commercial arbitration, it relied heavily on Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985) (decided just two years before McMahon), a case in which the Court extolled the virtues of arbitration over litigation. For example, the McMahon Court stated "that arbitral tribunals are readily capable of handling the factual and legal complexities of [statutory] claims[,]" McMahon, 482 U.S. at 231 (citing Mitsubishi, 473 U.S. at 633–34), and that "the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights." Id. at 232 (citing Mitsubishi, 473 U.S. at 628). In the same portion of the Mitsubishi opinion cited in McMahon, the Mitsubishi Court pointed out the traditional benefits of arbitration included "the simplicity, informality, and expedition of arbitration." Mitsubishi, 473 U.S. at 628. With regards to the norm of expert arbitrators, the Mitsubishi Court stated: "We decline to
Taken at face value, however, the *McMahon* opinion evidences judicial confusion concerning the traditions of arbitration. Historically, arbitration was a popular alternative dispute arbitration mechanism employed by members of homogeneous trade groups. In England, arbitration has been utilized to solve disagreements among members of trade groups since the fourteenth century. Similarly, in the United States, arbitration has existed since the colonial era to resolve disputes between merchants engaged in the same industry. As American trade associations multiplied in the early twentieth century, they spawned an increasing number of arbitration forums to handle disputes among group members. By 1927, there were over 1,000 such trade groups that maintained arbitration systems for their members.

While early pre-dispute arbitration agreements were non-binding, in the sense that courts ordinarily would not specifically enforce the parties’ agreement to arbitrate, the ethics of the trade

indulge the presumption that the parties and arbitral body conducting a proceeding will be unable or unwilling to retain competent, conscientious, and impartial arbitrators.” *Id.* at 634.


61. AM. ARBITRATION ASS’N, *YEAR BOOK ON COMMERCIAL ARBITRATION IN THE UNITED STATES* (1927) (reporting that over 1,000 U.S. trade associations had arbitration systems available for members); see also Nathan Isaacs, *Two Views of Commercial Arbitration*, 40 HARV. L. REV. 929, 934–35 (1927) (discussing the oldest recorded arbitration forum: the New York State Chamber of Commerce); Stone, *supra* note 32, at 976–79 (describing the intersection between arbitration and trade associations).

62. Under the so-called revocability doctrine, agreements to arbitrate were revocable by either side until the award was issued. *See* Home Ins. Co. v. Morse, 87 U.S. 445, 452–55 (1874) (stating that pre-dispute agreements to oust the courts of jurisdiction are null and void); Kulukundis Shipping Co., v. Amtorg Trading Corp., 126 F.2d 978, 982–84 (2d Cir. 1942) (discussing the early English common law regarding arbitration disputes); see also Stone *supra* note 32, at 973–76 (explaining that parties to an arbitration agreement could sue for breach of the contract to arbitrate but that the monetary damages recoverable were fairly negligible). *See generally* Paul D. Carrington & Paul Y. Castle, *The Revocability of Contract Provisions Controlling Resolution of Future Disputes Between the Parties*, 67 LAW & CONTEMP. PROBS. 208 (2004) (describing the revocability doctrine and
groups and the availability of non-legal sanctions apparently caused many members to honor the agreements nonetheless. In many trade groups, a refusal to arbitrate a dispute provided grounds for expulsion from the association along with sanctions that sullied the recalcitrant party's reputation in the business community.

The original purpose of commercial arbitration was not to emulate the judicial system but rather to maintain a system of self governance and provide an informal forum in which disputes could be settled in accordance with industry customs rather than applicable legal rules. For example, the stated purpose of the arbitration forum established by the New York Chamber of Commerce in 1768 was to "[settle] business disputes according to trade practice rather than legal principles." The arbitral system was also viewed as more efficient and less expensive than the judicial system. Another important benefit of commercial arbitration was the expertise of the arbitrators. Disputes between members of specified trade groups or commercial enterprises were often decided by arbitrators who were experts in the industry. Arbitrators were chosen who possessed

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65. LINDA R. SINGER, SETTLING DISPUTES: CONFLICT RESOLUTION IN BUSINESS, FAMILIES, AND THE LEGAL SYSTEM 5 (2d ed. 1994); see also Brunet, supra note 63, at 40 (emphasizing "the application of equitable rather than legal principles to resolve" disputes in "folklore arbitration").

66. Brunet, supra note 63, at 43; Stone, supra note 32, at 970–71.

67. See Bruce L. Bensen, An Exploration of the Impact of Modern Arbitration Statutes on the Development of Arbitration in the United States, 11 J.L. ECON. & ORG. 479, 482 (1995) (noting that expert arbitrators were a widely perceived benefit of arbitration over litigation); Brunet, supra note 63, at 43 (noting that the "selection of a trusted and expert decisionmaker dominated the [traditional] arbitration process").
both the knowledge of the group’s customs and a reputation among their peers to render fair and informed decisions.\(^6\) Indeed, the paradigm of the expert arbitrator was at the forefront of the congressional debates prior to the passage of the FAA in 1925.\(^6\)

Originally, securities arbitration largely followed this intra-industry model that relied upon expert decisionmakers to informally settle disputes according to industry norms.\(^7\) The NYSE facilitated the arbitration of disputes among its members as early as 1845.\(^7\) The 1869 NYSE constitution required exchange members to arbitrate intra-member disputes and permitted arbitration upon the request of non-members so long as they agreed to abide by NYSE rules.\(^7\) As was true in most commercial arbitrations, procedures in the NYSE arbitrations were informal, and the arbitrators were chosen from among industry members who had expertise in the subject matter of the dispute.\(^7\) Even today, intra-industry disputes among members of the SROs are usually handled by expert arbitrators chosen from among industry participants. For example, both the NYSE and the NASD arbitration rules provide that for intra-industry disputes, all arbitrators shall be affiliated with the securities industry.\(^7\)

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70. Professor Brunet refers to this model as “folklore arbitration,” which is his “term for [a] simple model of arbitration, ... characterized by the choice of expert decisionmakers, a speedy process, privacy, informal presentations of evidence, little or no discovery, no right of judicial review, and the application of equitable rather than legal principles to resolve the dispute.” Brunet, supra note 63, at 40.

71. Poser, supra note 48, at 280 (citing New York Stock Exchange Archives (1817–present)).

72. Id. at 281 (citing NYSE CONST. art. III, § 7 (1869)); see also Jonathan Lurie, Private Associations, Internal Regulation and Progressivism: The Chicago Board of Trade, 1880–1923, as a Case Study, 16 AM. J. LEGAL HIST. 215, 220-21 (1972) (discussing the arbitration system at the Chicago Board of Trade).

73. Poser, supra note 48, at 280–81.

74. NASD MANUAL, supra note 48, §§ 10202(b), 10203. Industry arbitrators are also specified for intra-industry disputes under the NASD’s 2004 proposal to revise and
An arbitral forum that decides disputes according to trade practices and customs rather than legal principles, however, is clearly not the model the Supreme Court had in mind in validating mandatory arbitration agreements between investors and members of the securities industry. In *McMahon*, the Court expressly stated that parties in arbitration do not forego substantive statutory rights—they "only [submit] to their resolution in an arbitral, rather than a judicial forum." Subsequently, in *Rodriguez de Quijas v. Shearson/American Express, Inc.*, the Court again characterized pre-dispute arbitration clauses as "in effect, a specialized kind of forum-selection clause." The Court assumed that in forgoing judicial relief, investors were gaining the benefit of a more informal and efficient tribunal populated with expert decisionmakers. In the Court's view, certain procedural enhancements such as a Uniform Code of Arbitration served to further improve the arbitral process. In other words, the Court presumed that arbitration was a procedural, not a substantive, choice. The Court trusted that the arbitrators would follow the law and observed that judicial review, although limited, would be sufficient to ensure that the arbitrators complied with the securities statutes. To the extent that the *McMahon* decision was premised upon the Court's comfort with traditional arbitration, the Court's description of this process varies substantially from the accepted historical norms.

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77. *Id.* at 483 (quoting *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519 (1974)).
78. *Id.; see also McMahon*, 482 U.S. at 232 (commenting that the streamlined arbitration procedures do not necessarily result in a restriction of substantive rights); *Mitsubishi*, 473 U.S. at 633 (noting that parties often agree to arbitrate due to the fact that streamlined procedures best serve their needs).
80. *Id.* at 232; *see also Mitsubishi*, 473 U.S. at 636-37. The *Mitsubishi* Court also noted that:

Where the parties have agreed that the arbitral body is to decide a defined set of claims which includes, as in these cases, those arising from the application of American antitrust law, the tribunal therefore should be bound to decide that dispute in accord with the national law giving rise to the claim.

*Id.*
III. MODERN SECURITIES ARBITRATION

Not only does the McMahon Court's description of securities arbitration not mesh well with the reality of traditional commercial arbitration among trade group members, it also does not accurately explain modern securities arbitration. Modern SRO arbitrations are not characterized by quick, inexpensive, informal decisions rendered by industry peers with expertise in the field. Instead, arbitration procedures increasingly mimic litigation. Unlike judges, however, SRO arbitrators are not chosen for their expertise in securities law or for their reputation among their peers. Moreover, there is little accountability in the arbitration process to ensure that panel members apply the law or render reasonable decisions.

A. Efficiency Trade-Offs

Contrary to popular conceptions, SRO arbitrations are no longer quick or efficient. During the past three years, the average turnaround time for an NASD arbitration that proceeds to a hearing was approximately seventeen months with an overall average turnaround time exceeding fourteen months. Conversely, during this same period of time, the average time for a case to be resolved in federal district court was 9.3 months. The NASD, obviously aware of the delay, apologetically explains on its web site that "[t]he timing of the arbitration process is heavily influenced by Code of Arbitration

81. The increasingly litigious nature of securities arbitration, with the concomitant delays, was noted in 1996 in the report of the Ruder Commission, established by the NASD Board of Governors to provide an independent review and analysis of NASD procedures, NAT'L ASSOC. OF SEC. DEALERS, SECURITIES ARBITRATION REFORM: REPORT OF ARBITRATION POLICY TASK FORCE (1996) [hereinafter Ruder Report], and has been extensively noted in the literature. See, e.g., Black & Gross, supra note 44, at 998-1005.

82. See Dispute Resolution Statistics, supra note 56. This data is consistent with earlier statistics. For example, in 1998, the average processing time in NASD Arbitrations was 519 days or approximately seventeen months. 2000 GAO REPORT, supra note 49, at 29. In 1998, the average processing time for NYSE arbitrations was 311 days. Id.

83. EDWARD BRUNET ET AL., AMERICAN ARBITRATION LAW: A CRITICAL REASSESSMENT (forthcoming 2005); see also uscourts.gov, U.S. District Court—Judicial Caseload Profile, http://www.uscourts.gov/cgi-bin/cmsd2003.pl (setting data for fiscal year 2003 for the U.S. District Courts) (last visited Nov. 24, 2005). The median time to disposition was 8.7 months for years 2002 and 2001, 8.2 months for 2000, 10.3 months for 1999, and 9.2 months for 1998. Id. The GAO reports longer times for judicial decisions in the very few non-class-action securities cases in the federal courts. For the fifteen cases studied in 1997 and 1998, the average time to a decision was approximately thirty months (930 days). 2000 GAO REPORT, supra note 49, at 32. The GAO admits that its data concerning securities litigation is not statistically significant. Id.
Procedures time limits, the parties, and the panel.” Part of the delay is no doubt due to the increasing litigation appendages that have been grafted upon the once simplified arbitration process. Instead of an expedient alternative dispute resolution system, the securities arbitration process has increasingly become more litigious—a development that many believe erodes a major benefit of arbitration.

Prior to *McMahon*, in a period when customers were not required to arbitrate disputes with their brokers, SRO arbitration procedures were fairly informal. With the advent of compulsory arbitration of customer disputes, however, the SROs, with the prodding of the SEC, amended their arbitration codes to include more litigation-like procedures such as discovery, motions to compel, records of hearings, and the publication of award results. One result of these procedural reforms, when combined with the 1998 modification allowing more party autonomy over the selection of panel members, is that the arbitration process is no longer informal or particularly efficient. While claimants need not appear with counsel, most lay investors would find the complexities of arbitration procedures quite daunting. To be sure, there are positive benefits that flow from procedural reforms, such as increased transparencies. Many reforms, such as changes to the discovery process, were instituted in large part to increase fairness to investors. However, to the extent that the *McMahon* Court viewed arbitral efficiency as a

84. See Dispute Resolution Statistics, *supra* note 56.
85. Arbitration is now a hybrid "grafting onto the original arbitration stock, litigation like appendages which satisfy no one, neither those who pine for the simplicity of classic arbitration nor those who would like to see a full-scale return to the procedural niceties of litigation." Joel Leifer, *Developments in Arbitration, Mediation, and Other Alternative Dispute Resolution Techniques*, http://www.seclaw.com/docs/nscp796 (last visited Nov. 23, 2005); see also Brunet, *supra* note 63, at 50-51 (noting that enforcement of arbitration clauses sometimes results in an inefficient outcome).
87. For example, prior to 1989, the NASD Arbitration Code provision on discovery stated: “prior to the first hearing session, the parties shall cooperate in the voluntary exchange of such documents and information as will serve to expedite the arbitration.” NASD Manual (CCH) § 32(b) (1987).
88. See Black & Gross, *supra* note 44, at 997-1002 (detailing the post *McMahon* changes in SRO procedural rules).
89. NASD MANUAL, *supra* note 48, § 10308.
90. See, e.g., Ruder Report, *supra* note 81, at 77-88 (detailing perceived problems with the arbitration discovery process and recommending procedures to quicken the process and increase transparency, with specific calls not to harm the position of the investor).
beneficial trade-off to litigation, its rationale for enforcing compelled securities arbitration now rests upon a faulty foundation.

B. Application of the Law

The holding in McMahon is also premised upon the belief that arbitrators are bound to apply the law in securities cases and thus afford investors mandatory statutory protections. In McMahon, the Court expressly stated that "there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute." In subsequent cases the Court has similarly assumed that judicial review will be sufficient to ensure that statutory rights are vindicated though the arbitration process. These observations by the Court do not hold up well when reflected in the mirror of reality. In spite of the Court’s rhetoric, there is no meaningful judicial oversight to ensure that arbitrators are applying the law, and limited evidence on the ground suggests that SRO panels may not in fact apply the law.

92. Id. McMahon followed on the heels of Mitsubishi, in which the Court enforced an arbitration agreement involving claims under the federal antitrust statutes, stating that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum." Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985).
93. See, e.g., Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 32 n.4 (1991) (upholding arbitration agreement in face of claims under the Age Discrimination in Employment Act and restating proposition that judicial review is sufficient to ensure that statutory rights are vindicated in arbitration).
94. It is unclear whether the majority in McMahon and Gilmer truly believed that courts should review arbitration awards to ensure statutory compliance and therefore was suggesting that the Court’s statement to the contrary in Wilko was either wrong or was now implicitly overruled. If the Court meant to require judicial review of arbitral decisions, lower courts are simply ignoring Supreme Court mandate. See Brunet, supra note 47, at 1474 (arguing that "lower courts have completely ignored these passages from Gilmer and McMahon" requiring judicial review). Alternatively, the Justices, who were in fact quite aware of the tradition of limited judicial review of arbitral awards, may have had different motivations in compelling arbitration of statutory claims. At least the dissenters in McMahon were cognizant of the large disconnect between the majority's premises and the reality of judicial review of arbitral awards. McMahon, 482 U.S. at 258-60 (Brennan, J., dissenting). This suggests that other motives such as clearing the litigation docket in the federal courts may have motivated the McMahon decision. See, e.g., Schwartz, supra note 14, at 30 (arguing that the basis for the judicially created national policy favoring arbitration may be a judicial preference to reduce crowded court dockets).
95. See infra notes 134-68 and accompanying text; see also PERINO, supra note 51, at 7 ("Arbitrators are not bound by precise legal standards, which may benefit investors, [as legal] remedies have become more restrictive."); Black & Gross, supra note 44, at 1040-47
The FAA provides limited statutory grounds for courts to vacate arbitration awards. Grounds for judicial action are generally limited to awards procured by procedural errors, fraud, or arbitrator misconduct.96 The alternative common law standard for judicial vacatur endorsed by most courts is that vacatur is warranted only if the arbitrators "manifestly disregard the law."97

Vacatur under the "manifest disregard" standard of review is appropriate only if the arbitration panel deliberately ignores clear governing law,98 and courts are extremely reluctant to overturn an arbitration award if there is any colorable justification supporting it.99

96. The Federal Arbitration Act, 9 U.S.C. § 10(a) (Supp. II 2002), provides:

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.

97. This standard of review originated from dicta in Wilko, in which the Court, in refusing to compel arbitration of a 1933 Act claim, noted that "the 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." Wilko v. Swan, 346 U.S. 427, 436–37 (1953). While not explaining this dicta, the Court has occasionally referred to the "manifest disregard of the law" standard, most recently in First Options v. Kaplan, 514 U.S. 938, 942 (1995). This non-statutory standard of review has been accepted by the overwhelming majority of federal and state courts. But see Stephen L. Hayford, Law in Disarray: Judicial Standards for Vacatur of Commercial Arbitration Awards, 30 GA. L. REV. 731, 833–34 (1996) (arguing that only grounds for vacatur should be those contained in the FAA).

98. See, e.g., Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S, 333 F.3d 383, 389 (2d Cir. 2003) ("A party seeking vacatur [under the 'manifest disregard of the law' standard] bears the burden of proving that the arbitrators were fully aware of the existence of a clearly defined governing legal principle, but refused to apply it, in effect, ignoring it."); Nat'l DiRussa v. Dean Witter Reynolds, 121 F.3d 818, 821–23 (2d Cir. 1997) (affirming district court's refusal to vacate a clearly erroneous award that failed to award attorneys' fees because the petitioner failed to inform panel that such fees were mandatory under statute). For a critique of this "knowing disregard" standard, see Norman S. Poser, Judicial Review of Arbitration Awards: Manifest Disregard of the Law, 64 BROOK. L. REV. 471, 473–74 (1998) (arguing that current standard of judicial review is inadequate to protect statutory rights and suggesting that courts vacate awards that show "egregious departures from established law").

99. See Hardy v. Walsh Manning Sec., L.L.C., 341 F.3d 126, 134 (2d Cir. 2003) (noting that the panel's proffered reason for award imposing liability on firm CEO was in clear disregard of governing law of which the panel was aware but nonetheless remanding to
Moreover, the “manifest disregard” test, which necessarily requires some inquiry into the arbitrators’ rationale, is nearly impossible to meet unless the arbitration panel provides an explanation for an award. As is explained below, there is a relative paucity of reasoned arbitration awards, and so, predictably, judicial vacaturs under this standard are rare. The “manifest disregard” standard of review also renders the few existing judicial vacatur opinions relatively unhelpful in analyzing whether securities arbitrators do in fact apply the law. Such opinions, while adding to the mix of information, may not be representative of securities arbitrations in

100. See Univ. Commons-Urbana, Ltd. v. Universal Constructors, Inc., 304 F.3d 1331, 1337 (11th Cir. 2002) (“When the arbitrators do not give their reasons, it is nearly impossible for the court to determine whether they acted in disregard of the law.” (quoting O.R. Sec., Inc. v. Prof'l Planning Assoc's., Inc., 857 F.2d 742, 747 (11th Cir. 1988)); Merrill Lynch, Pierce, Fenner & Smith Inc. v. Jaros, 70 F.3d 418, 421 (6th Cir. 1995) (noting that a party seeking to vacate arbitration award faces tremendous obstacle when the panel does not explain an award); see also Stephen L. Hayford, A New Paradigm for Commercial Arbitration: Rethinking the Relationship Between Reasoned Awards and the Judicial Standards for Vacatur, 66 GEO. WASH. L. REV. 443, 474-76 (1998) (commenting that, in the absence of an opinion, courts should not vacate under manifest disregard of the law standard as this requires at the outset a review of the motives of that arbitration panel). Occasionally, a court will take into account the absence of an explanation in vacating an award that appears to manifestly disregard existing law. See, e.g., Halligan v. Piper Jaffray, 148 F.3d 197, 203-04 (2d Cir. 1998) (holding that the failure of the panel to explain its award can be taken into account in applying the manifest disregard standard); Montes v. Shearson Lehman Bros., 128 F.3d 1456, 1464 (11th Cir. 1997) (noting inference of disregard of the law and the “absence of any stated reasons for the decision” in vacating panel decision involving Fair Labor Standards Act).

101. See Barbara Black, The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?, 72 U. CIN. L. REV. 415, 437 (2003) (noting that the author had “found only a handful of awards vacated in customer-broker arbitrations”). In fact, Wallace v. Buttar, 239 F. Supp. 2d 388 (S.D.N.Y. 2003), one of the few decisions unearthed by Professor Black that actually vacated an award, was subsequently overturned by the Second Circuit. Wallace v. Buttar, 378 F.3d 182, 196 (2d Cir. 2004) (upholding the award because there was “barely colorable” justification for it under state law); see also Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S, 333 F.3d 383, 389 (2d Cir. 2003) (explaining that since 1960, the Second Circuit has applied manifest disregard standard in forty-eight cases and vacated only four awards); Richard P. Ryder, Securities Arbitration 2000, in SECURITIES ARBITRATION 2000, at 1141, 1171 (PLI Corp. Law & Practice, Course Handbook Series No. 1196, 2000) (summarizing vacatur petitions from 1988 through 1999). A recent study of the 2,077 awards issued in 2003 indicates that there were 119 vacatur filings, of which were concluded by a grant or denial of vacatur; of those fifty-four, fifteen (or a relatively high twenty-eight percent) were successful, although the data does not indicate on what grounds the vacaturs were granted nor does it control for those petitions that were settled or withdrawn. See Vacatur Statistics Reveal Surprises, SEC. ARB. COMMENTATOR, Feb. 2004, at 12.
general as very few awards are appealed. Moreover, this standard of judicial review of arbitration awards is not designed to determine whether the arbitrators' decision was correct on the merits.

In spite of no meaningful judicial review, it may nonetheless be the case that SRO arbitrators do in fact apply the law. Evidence supporting or refuting this proposition, however, is difficult to obtain given the shortage of explanations for arbitral awards. Neither the FAA nor any state laws require arbitrators to explain their awards. In fact, the SROs have, until recently, both explicitly and implicitly discouraged their arbitrators from rendering written opinions because explanations were considered invitations to judicial review. While NASD awards must be in writing, the NASD arbitration code does not require that the panel's award contain an explanation. Indeed, the current award information sheet utilized by NASD arbitrators to convey the panel decisions to NASD staff does not even contain a

102. See Vacatur Statistics Reveal Surprises, supra note 101 (finding that of 2,077 NASD awards issued in 2003, only 119 or .056% were appealed).

103. See generally Hayford, supra note 100, at 465–76 (explaining standard of "manifest disregard").

104. An earlier survey of commercial arbitrators found that while arbitrators generally believed that they should render a decision in accordance with applicable legal principles, ninety percent of the arbitrators believed that they could ignore the legal rules when necessary to achieve a result they felt was more just. Soia Mentschikoff, Commercial Arbitration, 61 COLUM. L. REV. 846, 861 (1961).

105. See, e.g., Merrill Lynch, Pierce, Fenner & Smith Inc. v. Burke, 741 F. Supp. 191, 194 (N.D. Cal. 1990) (stating that "[a]n arbitrator's award may be made without a explanation of the reasons"); 2000 GAO REPORT, supra note 49, at 15 (stating that arbitrators "are not required to provide a reason or a written opinion when they make an award decision"). The absence of reasoned awards has provoked much academic commentary. See, e.g., Brunet, supra note 47, at 1488–91 (arguing that written opinions would improve quality of arbitration process); Marilyn Blumberg Cane & Marc J. Greenspan, Securities Arbitration: Bankrupt, Bothered & Bewildered, 7 STAN. J.L. BUS. & FIN. 131, 159 (2002) (arguing that awards should contain explanations); Hayford, supra note 100, passim (stressing the importance of reasoned awards); Lynn Katzler, Should Mandatory Written Opinions Be Required in All Securities Arbitrations?, 45 AM. U. L. REV. 151, passim (1995) (discussing the benefits and challenges of requiring opinions in arbitration); Josef Rohlik, Arbitrators Should Write Opinions for Parties and for Courts, 44 ST. LOUIS U. L.J. 933, 938 (2000) (proposing that arbitrators should write opinions that "isolate and resolve the statutory issues" in a case or at least expressly state such issues).

106. Cane & Greenspan, supra note 105, at 159.

107. NASD MANUAL, supra note 48, § 10330. Section 10330(e) of the NASD Code requires that the award contain only a summary of the issues; in practice this summary is prepared by staff. See Richard P. Ryder, Making a Better Award—An Essential Arbitrator Function, NEUTRAL CORNER (NASD Dispute Resolution, New York, N.Y.), Oct. 2002, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_00 9981 (suggesting that awards should contain a more useful summary of the issues).
space for an explanation or opinion. Moreover, NASD arbitrators are paid only a modest honorarium for their services which at present consists of two-hundred dollars per four-hour hearing session with an extra seventy-five dollars per day for panel chairpersons. There is no provision to compensate arbitrators for either preparing for a hearing or for drafting opinions explaining their awards.

Given these constraints, it is not surprising that arbitration panels rarely proffer explanations for their decisions. For example, in 2003, 2,077 customer cases were closed via decisions by NASD arbitrators. Of those 2,077 cases, fewer than five percent of the arbitration awards contained even a brief explanation of the panel’s decision and fewer than half of those included explanations that would be deemed an opinion by any stretch of the definition.

108. NASD, NASD DISPUTE RESOLUTION ARBITRATOR'S REFERENCE GUIDE 82-101 (2005), available at http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_009424.pdf. The award template utilized by NASD staff to draft the awards similarly contains no space for an explanation, but the template does note that the arbitrators may provide a rationale. Id. at 107.

109. NASD Manual (CCH) IM-10104 (2002). These rates are substantially below the rates for arbitrators serving in other commercial arbitration forums. See George H. Friedman, The Level Playing Field, SEC. ARB. COMMENTATOR, July 2001, at 3 (noting that arbitrators in non-SRO forums receive ranging from $750 to $1,000 per day).

110. On June 6, 2005, the SEC approved an NASD proposal for a Code amendment to provide an additional honorarium of $200 to arbitrators for time spent reviewing and deciding discovery motions without a hearing. SEC Release, No. 34-51931, 70 Fed. Reg. 38,989 (July 6, 2005).

111. In January of 2005, NASD proposed an amendment to its Code that would require arbitrators to provide an explanation for their awards if so requested by one of the parties before the first hearing. NASD Rule Filing SR-NASD-2005-032, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013542&ssSourceNodeId=12 (released as Written Explanations in Arbitration Awards, 70 Fed. Reg. 41,065 (proposed Mar. 15, 2005)) (last visited Nov. 24, 2005). Under the proposed rule, each arbitrator would be compensated $200 for each opinion and one-half of this fee would be paid by the parties. The increased fee is quite modest and certainly would not compensate the panel for the time it would take to render a full explanation of the award. Moreover, the proposed rule expressly states that arbitrators need not refer to statutes or cases in their explanations and does not otherwise ensure the quality of explanations. Id. at 5. However, it is a positive change that, if adopted, may at least marginally provide transparency to NASD arbitrations.

112. The remainder of the 7,278 NASD arbitration claims closed in 2003 were resolved by means other than decisions of arbitrators such as mediation, settlement, or withdrawal of the claims. See Dispute Resolution Statistics, supra note 56.

113. There is no readily available database that tracks explanations for NASD awards. Since 2002, NASD awards have been available online through an arrangement with the Securities Arbitration Commentator (“SAC”). NASD, Obtain NASD Arbitration Awards Online, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_009444 (last visited Nov. 24, 2005). SAC, however, notes that it must rely upon its subscribers to send in awards accompanied by accounts of the case, a request necessitated “by the dearth of substantive information appearing in the ‘say-
Similarly in 2004, less than five percent of the 2,423 NASD customer cases closed via an arbitral decision contained any semblance of an opinion explaining the award.\textsuperscript{114}

In spite of the lack of current statistically significant evidence as to whether arbitrators are applying the law, there are many reasons to believe that they are not. First, each new NASD arbitrator is provided with a copy of the SICA Arbitrators Manual that begins with a reminder to arbitrators that they can ignore the law if fairness so requires:

Equity is justice in that it goes beyond the written law. And it 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.

- Domke on Aristotle\textsuperscript{115}

Moreover, the NASD Panel Member Training Guide explicitly instructs arbitrators that they "are not strictly bound by legal precedent or statutory law."\textsuperscript{116} These instructions fly in the face of the Court's express assumption in \textit{McMahon} and \textit{Rodriguez} that arbitration is merely a different forum in which investors can vindicate their non-waivable statutory rights. The NASD then gives its arbitrators the confusing admonition that while they do not have to apply the law, they cannot "manifestly disregard it," because in

\begin{quote}
nothing'" awards. SAC Securities Arbitration Alert (May 3, 2004). Therefore, this 2003 and 2004 data was produced by reviewing all of the NASD arbitration awards published in 2003 and 2004 and culling any awards that had any hint of reasoning contained within them. As the NASD award template provides no space for explanations of awards, the rationale of the panels appeared most commonly in the "awards" section of the documents but also appeared in sections variously labeled as "explanation," "finding of fact," "report of the panel," "arbitrator's report," "panel's report," and "statement of findings," among others.

\textsuperscript{114} In 2004, 2,423 cases were closed after a decision by arbitrators. The remaining 6,621 cases were closed by other means. \textit{See} Dispute Resolution Statistics, \textit{supra} note 56.


\textsuperscript{116} \textit{NASD DISPUTE RESOLUTION, ARBITRATOR TRAINING: PANEL MEMBER COURSE PREPARATION GUIDE}, V1.2, at 172 (2001) [hereinafter \textit{PANEL MEMBER COURSE PREPARATION GUIDE}]; \textit{see also Question and Answer: Understanding and Applying the Law in a Case, NEUTRAL CORNER (NASD Dispute Resolution, New York, N.Y.), Apr. 2005,} http://www.nasd.com/web/idclplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013864 (reporting in NASD's online newsletter for arbitrators, reminding arbitrators that they are not bound by case precedent or statutory law and that they are not to engage in any outside legal research).
some jurisdictions this may provide a ground for a court to overturn a
panel’s decision. Assuming that arbitrators can appreciate the
distinction between not applying the law and not manifestly
disregarding the law, these NASD instructions do not honor the
letter or the spirit of the Supreme Court’s assumption that arbitration
is a mere procedural choice.

The assumption that arbitrators need not apply the law is deeply
ingrained in the culture of arbitration. The 1996 Ruder Commission,
established by the NASD Board of Governors to independently
review and evaluate NASD’s securities arbitration process, merely
suggests in a footnote that arbitrators “consider” statutory and
common law when making decisions. Even the United States
General Accounting Office, which provides some congressional
oversight of SRO arbitration procedures, unapologetically explains
that “[u]like judges, arbitrators are not required to base their
decisions on legal precedent.”

These suggestions that arbitrators may ignore the law where
equity so requires, while reminiscent of an earlier model of
arbitration among members of homogeneous trade groups, are
inconsistent with the dictates of *McMahon* when the claim involves
violations of the federal securities statutes. To be fair, the Court has
not addressed the requirement that arbitrators apply the law to state
statutory or common law claims, but there is nothing in its opinions
indicating that these rights should be treated differently in arbitration
than federal statutory rights. In fact, there is recognition in the


118. At a recent NASD arbitrator training session attended by the author, the new
arbitrators were told that the “manifest disregard” standard was easy to overcome
given that it requires that the law be “clear.” Therefore, it was suggested, so long as one of the
parties argued about the law (and they always do), the law is never clear and the panel
would always have a valid reason to justify its award.


120. U.S. GEN. ACCOUNTING OFFICE, PUBL’N NO. GAO-03-790, EMPLOYMENT
DISPUTES: RECOMMENDATIONS TO BETTER ENSURE THAT SECURITIES ARBITRATORS
ARE QUALIFIED 6 (2003) [hereinafter 2003 GAO REPORT].

121. Jean R. Sternlight & Elizabeth J. Jensen, *Using Arbitration to Eliminate Consumer
Class Actions: Efficient Business Practice or Unconscionable Abuse?*, 67 LAW &
CONTEMP. PROBS. 75, 77-78 (2004) (explaining that while Supreme Court cases to date
involving unconscionability of arbitration clauses have involved federal statutory claims,
its pronouncements should apply with equal force to state statutory and common law
claims as well); Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law
Through Arbitration*, 83 MINN. L. REV. 703, 710-19 (1999) (arguing that because the Court
views arbitration agreements as procedural rather than substantive, the Court would
require arbitrators to apply common law as well as statutory law). It should be noted that
in a few states the issue of arbitral application of the law is a statutory matter, and in
NASD arbitrator instructions that state laws can govern various claims.\textsuperscript{122}

Assuming that the best intentioned SRO arbitrators want to apply the law,\textsuperscript{123} the complex nature of state and federal securities laws makes this a daunting task at best.\textsuperscript{124} NASD arbitrations usually involve a plethora of claims implicating state common law as well as federal and state securities statutes. NASD statistics suggest that, on average, each claim consists of three different causes of action, with the most prevalent claims based upon state common law theories.\textsuperscript{125} Common law allegations can involve complicated and unsettled principles involving agency and fiduciary duties.\textsuperscript{126} Federal and state securities statutes are also extremely intricate. Issues involving secondary liability under these statutes can add multiple layers of complexity to a case.\textsuperscript{127} In addition, arbitrators must understand and apply the implication doctrine and distinguish regulations that

\footnotesize{\textsuperscript{122} See Black & Gross, \textit{supra} note 44, at 997.}

\footnotesize{\textsuperscript{123} See, e.g., NASD DISPUTE RESOLUTION ARBITRATOR'S REFERENCE GUIDE, \textit{supra} note 108, at 86–87, 107 (noting that should the panel award punitive damages or attorneys' fees, it must clearly state the state law or other statutory basis for such an award).}

\footnotesize{\textsuperscript{124} The limited data available suggests that at least some arbitrators (those who provide explanations) indeed try to apply the law in spite of obstacles in their path and contrary SRO instructions. The 2003 and 2004 NASD awards that do contain explanations are peppered with legal references that demonstrate that legal issues dominated the arbitration proceedings.}

\footnotesize{\textsuperscript{125} Black & Gross, \textit{supra} note 44, at 1006–13 (explaining the various legal theories that could result in broker liability under both the federal securities statutes and state statutory and common law). Julius Cohen, a fervent supporter of the FAA, testified before Congress that he did not believe that arbitration was appropriate when complex statutes were involved. Julius Henry Cohen & Kenneth Dayton, \textit{The New Federal Arbitration Law}, 12 VA. L. REV. 265, 281 (1926).}

\footnotesize{\textsuperscript{126} In a few states, brokers are presumed to stand in a fiduciary relationship with their clients. See, e.g., Duffy v. Cavalier, 264 Cal. Rptr. 740, 751 (Cal. App. Dep't Super. Ct. 1989) (finding that a stockbroker owes a fiduciary duty to her customer regardless of whether the customer is sophisticated or unsophisticated); Walston & Co. v. Miller, 410 P.2d 658, 660 (Ariz. 1966) ("[W]hen a broker serves as a customer's agent, he is a fiduciary and owes his principal a duty to communicate certain information to him."). In the majority of states where this issue has been presented, however, the fiduciary relationship is not automatic but depends upon the broker's control over the account. See, e.g., De Kwiatkowski v. Bear, Stearns & Co., Inc., 306 F.3d 1293, 1302 (2d Cir. 2002) (finding that a broker's duty in a nondiscretionary account is limited to carrying out the transaction at hand). See generally Ramirez, \textit{supra} note 43 (describing confusion in state law regarding brokers' duties to clients); Cheryl Goss Weiss, \textit{A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty}, 23 J. CORP. L. 65 (1997) (examining the development of broker liability for breach of fiduciary duty).}

\footnotesize{\textsuperscript{127} See \textit{infra} notes 138–65 and accompanying text.}
provide investors with a private cause of action from those that do not. Arbitrators are not always aided in their task by attorneys for investors, who often use a shotgun approach and allege a multitude of sweeping and overlapping claims. Defense counsel can also obfuscate the issues and present complex defenses based upon confusing legal doctrines. Investors who appear without an attorney face a very difficult task in refuting these defenses.

Furthermore, even if arbitrators comprehend the subtleties of the various claims, the law governing the relationship between investors and brokers is not always clear. Given the ubiquitous use of mandatory arbitration clauses in customer agreements, there have been relatively few opportunities for courts to resolve some of the legal questions that arise in investor/broker disputes. Judicial decisions reviewing arbitral awards under the "manifest disregard" standard are helpful only at the margins given that the courts that apply this standard limit review to the intentional manifest disregard of "well-defined and clearly applicable law." As explained above,

128. When a statute or regulation does not itself provide a private cause of action, courts sometimes imply causes of action. Rarely, however, do courts imply a private cause of action against firms who violate SRO rules. See infra notes 143, 151.

129. Customers who appear in NASD arbitrations without counsel are less successful than their represented counterparts. See 2000 GAO REPORT, supra note 49, at 26-27 (noting that, between 1992 and 1998, investors represented by counsel were twenty-seven percent more likely to receive a favorable award; moreover, in 1992, represented claimants were thirty percent more likely to receive an award greater than fifty percent of the amount claimed and sixty percent more likely to receive an above average award).

130. As is explained elsewhere, utilizing arbitration as the sole method for civil enforcement of securities laws implicating the brokerage community deprives the legal academy of reasoned precedent and hampsters the normal development of the law. Ultimately, the lack of precedent impacts arbitrators who may need judicial guidance in complex areas of the law. See, e.g., Keith N. Hylton, Agreements To Waive or To Arbitrate Legal Claims: An Economic Analysis, 8 SUP. CT. ECON. REV. 209, 243 (2000) (arguing that arbitration contributes to "erosion of the publicly accessible stock of common law rules" and "hinders the development of new rules"); Therese Maynard, McMahon: The Next Ten Years, 62 BROOK. L. REV. 1533, 1554-57 (1996) (arguing that the only case law available to arbitrators with respect to investor/broker fiduciary duty disputes is pre-McMahon); Jean R. Sternlight, Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration, 74 WASH. U. L.Q. 637, 694-96 (1996) [hereinafter Sternlight, Panacea or Corporate Tool?] (arguing that arbitration causes loss of potential for development of law). For a concise analysis of the societal impact of mandatory arbitration, see Jean R. Sternlight, Creeping Mandatory Arbitration: Is It Just?, 57 STAN. L. REV. 1631, 1661-71 (2005) (discussing and evaluating the "public justice critique" against mandatory arbitration).

131. As the United States Court of Appeals for the Second Circuit recently stated, judicial review of arbitral awards under the "manifest disregard standard" is a "severely limited" doctrine used only in "those exceedingly rare instances where some egregious impropriety on the part of the arbitrators is apparent, but where none of the provisions of
the few prior arbitration opinions that may exist are difficult to research\textsuperscript{132} and not of recognized precedential value in any event.\textsuperscript{133}

To be sure, not all investor claims are legally complex, and factual questions such as damages dominate many investor claims. In such situations, arbitrators may be well suited to render a decision, although serious mistakes occur in damage awards as well,\textsuperscript{134} and there is a documented tendency for arbitration panels to "split the baby."\textsuperscript{135}

\textsuperscript{132} See supra notes 104-14 and accompanying text.

\textsuperscript{133} See IDS Life Ins. Co. v. SunAmerica Life Ins. Co., 136 F.3d 537, 543 (7th Cir. 1998) (noting the lack of precedential value in prior arbitration awards); Town of Stratford v. Int'l Ass'n of Firefighters, Local 998, 728 A.2d 1063, 1070 (Conn. 1999).

\textsuperscript{134} See, e.g., Tripi v. Prudential Sec., Inc., 303 F. Supp. 2d 349, 355-56 (S.D.N.Y. 2003) (awarding the claimant three percent of claimed damages, an award that the reviewing court found shocking and "incomprehensible"); infra notes 166-68 and accompanying text.


\textsuperscript{135} See 2000 GAO REPORT, supra note 49, at 23-25 (providing statistics on damages awarded that hover around fifty-one percent); Lewis D. Lowenfels & Alan R. Bromberg, Beyond Precedent, Arbitral Extensions of Securities Law, 57 BUS. LAW. 999, 1017-18 (2002) (noting that arbitrators often split the baby and award investors damages in situations where they would get nothing in court); Paul Joseph Foley, Note, The National Association of Securities Dealers' Arbitration of Investor Claims Against Its Brokers; Taming the Fox that Guards the Henhouse, 7 N.C. BANKING INST. 239, 253-56 (2003) (summarizing awards from 2001 and 2002 and demonstrating propensity of arbitrators to issue partial awards). A possible explanation for this trend may lie in the perception of "repeat" arbitrators that a split award is necessary to continued employment. Furthermore, evidence from studies of juries suggests that juries are subject to certain cognitive biases such as anchoring and extremeness aversion that would tend to result in compromise awards. See Christopher R. Drahozal, A Behavioral Analysis of Private Judging, 67 LAW & CONTEMP. PROBS., 105, 108-14 (2004) (reviewing experimental studies on jury behavior). One would expect to see similar biases in arbitration awards to the extent that SRO arbitrators resemble juries, which is an announced goal of NASD. See Carol X. Vinzant, Law & Order: Client-Broker Disputes, REGISTERED REP., Nov. 2002, at 55 (quoting Linda Fienberg, President of NASD Dispute Resolution as saying, "We have purposely sought a panel that is not professional and not primarily securities lawyers ... something that more closely resembles a jury"), available at http://registeredrep .com/compliance/finance_law_order_clientbroker/. Indeed, statistical findings in the 2000 GAO Report suggest that anchoring does invade NASD arbitration awards. In reviewing awards from 1992-98, the GAO found that investors filing claims for more than compensatory damages were more than twice as likely to receive an award and 43% more likely to receive an award if the broker did not file a counterclaim. 2000 GAO REPORT, supra note 49, at 27. Moreover, of the investors who won a favorable award, the percentage of their total claim actually awarded hovered right around 50%, with a non-
Mistakes also occur even when the law (and the NASD instructions) is relatively straightforward. For example, one area in which the NASD departs from its "you need not apply the law" script is in the award of attorneys' fees. While the NASD Code is silent on this point, NASD does instruct its arbitrators that attorneys' fees can only be awarded to a prevailing party based upon a contractual provision or a statutory mandate. As a prerequisite under the statutes providing for attorneys' fees (and one would assume under virtually all contractual provisions), the party claiming the fees must be the prevailing party. Nevertheless, at least two panels in 2004 awarded attorneys' fees to the claimant while denying relief on the underlying claims.

While arbitrators can confuse even simple legal issues, securities arbitration is even more problematic when the panels confront more complex questions. The 2003 and 2004 NASD awards that contain explanations suggest that NASD arbitrators face difficulty in cases involving complicated legal issues such as secondary liability. For example, one common claim in NASD arbitrations is that the broker polar range of 46%–57%, thus at least suggesting a tendency of the NASD panels to be biased towards compromise. Drahozal, supra, at 115–16. Interestingly, Drahozal notes two empirical studies of non-SRO arbitrations suggesting that arbitrators do not issue compromise awards. Id. at 108–14.

136. PANEL MEMBER COURSE PREPARATION GUIDE, supra note 116, at 193–94. In keeping with this directive, the NASD award information sheet requires the arbitrators to specify the statutory or contractual authority for any attorneys' fees they decide to award. NASD DISPUTE RESOLUTION ARBITRATORS REFERENCE GUIDE, supra note 108, at 87, 107.

137. See Thompson v. Metlife Sec., Inc., NASD Arb. No. 03-06177 (Dec. 8, 2004) (Davis, III, Arb.), available at http://scan.cch.com/aad/200412/03-06177.pdf; Boczon v. Citigroup Global Mkts., Inc., NASD Arb. No. 03-06464 (June 2, 2004) (Jacob, Arb.), available at http://scan.cch.com/aad/200406/03-06464.pdf. In Thompson, the panel found that while respondents did not properly supervise claimants' account, claimants were not damaged and in fact profited from the account. Thompson, NASD Arb. No. 03-06177 at 4–5. Nonetheless, the panel awarded $5,000 attorneys' fees pursuant to Arkansas Code § 16-22-308, a state statute allowing such fees to prevailing parties, a category that did not include claimants. See Marcum v. Wengert, 40 S.W.3d 230, 235–37 (Ark. 2001) (stating that under the attorneys' fees statute, a prevailing party must receive a judgment for at least part of their claims). The panel's reliance upon this statute was also problematic given that it provides for attorneys' fees in contract actions and the panel's decision was based upon negligence. The panel also awarded $10,051 for legal expenses—an award it labeled "compensatory damages." Similarly, in Boczon, a single arbitrator dismissed claimant's claims in their entirety (without explanation) yet awarded attorneys' fees "according to Claimant's request." Boczon, NASD Arb. No. 03-06464 at 1.

138. A party can have secondary, or derivative, liability for the wrongful actions of another if there is a legal basis to hold the non-actor liable. See infra notes 143–45 and accompanying text.
recommended unsuitable investments to a client.\textsuperscript{139} Claims for unsuitability are implicitly based upon some form of misrepresentation actionable under the state or federal securities laws.\textsuperscript{140} Alternatively, common law fiduciary duty or negligence doctrines may provide a cause of action against brokers who make unsuitable recommendations.\textsuperscript{141} While NASD requires its member firms to recommend suitable investments,\textsuperscript{142} there is no direct private cause of action against the firms for breach of this duty or indeed for a violation of other NASD rules.\textsuperscript{143} Instead, if a broker makes an unsuitable recommendation, firms can have derivative liability for the broker’s miscreant action. Such secondary liability could stem from common law agency theories such as respondeat superior in cases where the broker is an employee or control person liability under the federal securities statutes as well as their state counterparts.\textsuperscript{144} Under

\textsuperscript{139} Claims that a broker sold unsuitable securities to the claimant permeate NASD arbitrations. In 2003, unsuitability claims appeared in over 3,000 NASD arbitrations; in 2004 unsuitability claims were made in over 2,600 cases. See Dispute Resolution Statistics, supra note 56.

\textsuperscript{140} See ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 14.69 (2d ed. 2003); Lewis D. Lowenfels & Alan R. Bromberg, Suitability in Securities Transactions, 54 BUS. LAW. 1557, 1558 (1999).

\textsuperscript{141} See Black & Gross, supra note 44, at 1006-13 (cataloging state and federal claims against broker-dealers); Ramirez, supra note 43 (suggesting that federal industry standards create basis for a negligence cause of action); Weiss, supra note 126 (reviewing the common law of broker dealer liability).

\textsuperscript{142} NASD MANUAL, supra note 48, § 2310.


any of these theories, a finding that the broker representative is liable to the claimant under some established legal theory is a prerequisite for imposing secondary liability upon the firm.\textsuperscript{145} Arbitrators, however, do not always appreciate this subtlety and sometimes impose liability against firms while exonerating the individual brokers.\textsuperscript{146} For example, in \textit{Satterfield v. Whale Securities Co.},\textsuperscript{147} a NASD panel imposed liability upon the member firm for a claim of unsuitability while exonerating the broker. In light of the panel's finding that the broker representative was not liable, however, there was no primary violator for whom the firm could be secondarily liable. Similarly in \textit{Brush v. Merrill Lynch Pierce Fenner & Smith, Inc.},\textsuperscript{148} the panel found the Merrill Lynch firm liable for selling unsuitable stocks to the claimants in a proceeding in which the individual brokers were not parties. In the course of its opinion, the panel noted that the brokers were not culpable as they were young and inexperienced and did not realize that the investments were unsuitable. The panel stated that "any mistakes made by the brokers in these cases are largely ones of misfeasance, not malfeasance" and that the problems were not really caused by the brokers but by Merrill Lynch.\textsuperscript{149}

NASD panels make similar errors regarding firm liability on failure to supervise claims,\textsuperscript{150} which like other claims for derivative

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\begin{itemize}
\item For an argument that panels stretch beyond legal precedent in finding even primary liability on such claims, see BROMBERG & LOWENFELS, supra note 140, § 14.69.
\item For strategic reasons, claimants' attorneys sometimes bring their claims only against the brokerage firm. Proffered reasons include the fear that a well meaning but negligent broker may evoke sympathy from panel members. Also, claimants' attorneys report that cases are easier to settle when the brokers are not individually named in the complaint and can therefore avoid a black mark on their compliance forms. NASD's stricter expungement rules have perhaps exacerbated this trend. See Order Approving NASD Proposed Rule Changes Relating to Expungement of Customer Dispute Information, 68 Fed. Reg. 74,667 (Dec. 24, 2003). For investors, the downside to this strategy is that it eliminates a source of NASD information regarding complaints against individual brokers which otherwise would be available in the Central Registration Depository database maintained by NASD. Information concerning the CRD is available at http://www.NASD.com (last visited Nov. 30, 2005).
\item Id. at 3
\item NASD reports that "failure to supervise" is one of most common causes of action alleged in NASD arbitrations. In 2003, claimants made "failure to supervise" allegations in over 3,200 cases. Similarly in 2004, this claim appeared in over 2,700 arbitration proceedings. See Dispute Resolution Statistics, supra note 56.
\end{itemize}
liability, require a primary violator. However, in *Joseph Kenith Revocable Trust v. Morgan Stanley Dean Witter,* the panel inexplicably found the firm liable for failing to adequately supervise its broker while denying all claims against the broker representative himself. In several other 2003 and 2004 awards, the arbitration panels similarly imposed liability upon the firm for negligent supervision even though the allegedly miscreant brokers were not parties to the proceedings or even mentioned in the awards.

Sometimes the arbitration panel notes that the broker is culpable in some fashion even though he or she is not a party to the proceedings. Such rulings themselves are of questionable validity

151. While NASD rules require firms to adequately supervise their brokers, NASD MANUAL, supra note 48, § 3010, there again is generally not an independent private cause of action against the firms for violations of NASD rules. Instead, a brokerage firm may have derivative liability under common law agency theories or federal or state control person statutes. As is true with all claims against a firm, respondeat superior liability depends upon an employment relationship. Control person liability is not so limited but does not impose strict liability. Instead, firms are entitled to a good faith defense that can be negated if the firm did not adequately supervise its brokers. See Carson, supra note 144, at 303–04. Anecdotal evidence suggests that many claimants allege failure to supervise as an independent primary cause of action and that such characterizations are seldom challenged by defense counsel.


given that under some statutes, derivative liability is dependent upon a finding of underlying primary liability, not just culpability. More often, however, when the broker is not individually named as a party, the panel's finding of liability against the firm simply omits all reference to the broker, leaving observers to speculate on the panel's rationale. In their willingness to impose liability on firms on dubious legal grounds, arbitration panels may be inadvertently removing from investors a valuable source of information concerning the broker's conduct as no record of the complaint against the individual broker will appear in NASD records.

Arbitration panels seem to struggle even more when the allegation of secondary liability extends beyond the brokerage firm itself. Such allegations generally arise under circumstances where both the broker personally and the firm have insufficient assets to pay investor damages. In their desire to compensate injured investors, arbitration panels have rendered awards against parties who are not legally liable because they are not statutory control persons or liable under common law agency theories. For example, in Hardy v. Walsh Manning Securities L.L.C., a NASD panel found the firm CEO liable on the grounds of respondeat superior, a ground that was clearly precluded under New York law because the CEO was a co-employee of the primary violator. While statutory control liability was argued, the panel either ignored or rejected these statutory grounds for secondary liability. After an appeal from the federal district court's confirmation of the award, the Second Circuit, in an unusual move, remanded the case back to the arbitration panel for clarification, noting that the arbitrators appear to have disregarded undisputed New York law.

10, 2003) (Tarrer, Arb.), available at http://scan.cch.com/aad/200304/01-06131.pdf (holding a firm liable for failure to supervise non-party broker who violated duty to client). In Decicco v. Colombo, 234 F. Supp. 2d 320 (S.D.N.Y. 2002), the court reviewed a motion to vacate an arbitration award premised on control liability as there was no finding of a primary violation. The court bailed out the panel by finding that implicit in the panel's finding of control liability was a finding of primary liability of the stockbroker who was deceased. Id. at 323.

155. See, e.g., UNIF. SEC. ACT § 509(g)(1) (2002) (providing that collateral participant liability is dependent upon liability of primary violator); Heliotrope Gen., Inc. v. Ford Motor Co., 189 F.3d 971, 978 (9th Cir. 1999) (holding that control person liability under section 20 of the 1934 Act is dependent upon a finding of primary liability under another section of the statute).

156. See generally Carson, supra note 144 (explaining control person liability).


158. See Hardy v. Walsh Manning Sec., L.L.C., 341 F.3d 126, 134 (2d Cir. 2003).
On remand, the arbitration panel admitted that it had made a mistake in holding the CEO liable under the respondeat superior doctrine because the arbitrators did not think that the "fellow employee" rule would protect him given his controlling shareholder and CEO status. The panel continued, however, to explain that it was its intention to also hold the CEO primarily liable given his personal participation in various acts alleged in the complaint. While in some cases it is difficult to discern whether the arbitrators did not understand the law or whether they deliberately chose to ignore it, here it appears that the panel simply misunderstood the impact of the law. Ironically, if the award had indicated the arbitrators' mistaken belief as to the applicability of the fellow servant rule, the Second Circuit court would have probably confirmed the award, as the "manifest disregard" standard requires a knowing disregard of the law.

Lucas v. WestAmerica Investment Group, one of the 2003 NASD arbitration awards, involved a claim of statutory control person liability against officers and directors of the brokerage firm. Under controlling federal law, brokerage firms themselves are presumed to constitute control persons for purposes of the federal securities statutes. Claimants, however, must prove the control status of other named defendants. For statutory control person liability, claimants must at a minimum provide proof that the alleged control person had the actual power to control the activities of the primary violator or indeed exercised control over the primary violator. In Lucas, the claimant sued the individual broker, his

160. Hardy, 341 F.3d at 129. As the court explained:

It is nevertheless the case that an arbitration award should not be confirmed where it can be shown that the arbitration panel acted in "manifest disregard of the law" to such an extent that "(1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether and (2) the law ignored by the arbitrators . . . [was] well defined, explicit, and clearly applicable."

Id. (quoting DiRussa v. Dean Witter Reynolds, Inc., 121 F.3d 818, 821 (2d Cir. 1997)) (citation and internal quotation omitted).


162. See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1573 (9th Cir. 1990) (en banc).
163. See Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065 (9th Cir. 2000); Hollinger, 914 F.2d at 1575.
firm, and the directors and officers of the firm individually.\footnote{164} The claimant alleged that under both federal law and Arizona law the individual directors of the firm constituted control persons due to their status as officers and directors of the firm. Counsel for the directors filed multiple motions seeking to dismiss claims against the directors, given that there was no allegation that they controlled the broker representative who was the only defendant alleged to be a primary violator.\footnote{165} The panel refused to dismiss the case against the individual directors but ultimately and without explanation found no liability against anyone but the broker representative. While the panel decision eventually vindicated the individual respondents other than the broker, the victory arrived after ten days of hearings at a combined cost of hundreds of thousands of dollars in attorneys’ fees and expenses. Both the claimant and the respondents suffered financial harm due to the panel’s long struggle to understand the issues involved.

While the above examples primarily document a tendency of panels to favor the investor in spite of sparse legal claims, there is no reason to believe that investors are always the beneficiaries of the arbitrators’ propensities to misapply the law. For example, in \textit{Tripi v. Prudential Securities, Inc.},\footnote{166} an unexplained award from 2003, the arbitration panel found Prudential liable for selling unsuitable securities but only awarded the claimant $25,000, or three percent of his claimed $800,000 loss. The claimant pressed for an explanation of this award but the panel refused to provide one. After reviewing the hearing transcripts, the district court remanded the case to the panel for an explanation. The court found that while the evidence supported some reduction in damages, “[s]uch a meager award shocks the conscience of this court.”\footnote{167} The district court judge further noted that the decision of the panel was “incomprehensible” and that she would have tossed it out had it been the verdict of a jury.\footnote{168}

\footnote{164} The individual directors were added as respondents after the brokerage firm filed for bankruptcy protection and ceased to be a party to the arbitration due to the stay imposed by the bankruptcy court.  
\footnote{165} In an interesting strategic move, the claimant in \textit{Lucas}, after presenting his case in chief, abandoned reliance upon federal law and instead argued that the individual directors were liable as control persons under Arizona law. While Arizona generally follows federal precedents, there were no state precedents on point. Nevertheless, claimant argued that one day an Arizona court might hold that firm directors could be control people of individual brokers even in the absence of evidence that they controlled the activities of the broker.  
\footnote{166} 303 F. Supp. 2d 349 (S.D.N.Y. 2003).  
\footnote{167} \textit{Id.} at 356.  
\footnote{168} \textit{Id.}
The awards from 2004 contain the first hint of how arbitration panels will handle allegations involving losses allegedly stemming from misleading analyst reports, particularly those attributable to Jack Grubman, a research analyst for Citigroup Global Markets (formerly known as Salomon Smith Barney).\textsuperscript{169} In 2004, there were at least 175 NASD arbitration decisions involving claims against Mr. Grubman and Citigroup. Perhaps not surprisingly, the awards are not consistent. Investors on the whole, however, are not faring well in their attempt to arbitrate these claims in spite of the relative success of regulators and class action plaintiffs who made similar claims in other forums.\textsuperscript{170} Fewer than twenty-five percent of the NASD panels arbitrating claims against Mr. Grubman and his firm in 2004 awarded damages to claimants based upon claims stemming from Mr. Grubman's research reports. On average, claimants who did obtain favorable awards received approximately seventy-seven percent of their claimed damages. Seventeen claimants, in addition, received attorneys' fees. Only twenty of the decisions contained explanations. The stated rationales for the decisions awarding damages to claimants vary greatly and include findings that either Citigroup or Mr. Grubman, or both, violated fiduciary duties, state securities laws, federal securities laws, or NASD rules of conduct.\textsuperscript{171} Where stated,

\begin{itemize}
\item \textsuperscript{169} Solomon Smith Barney was acquired by Citigroup Global Markets, Inc. in 1998.
\item \textsuperscript{170} Citigroup entered into a global settlement with regulators including the SEC, NASD, and the New York Attorney General for its alleged false research reports and agreed to pay $150 million as disgorgement and an additional $150 million in penalties. Mr. Grubman agreed to pay $7.5 million as disgorgement and an additional $7.5 million in penalties. SEC Litigation Release No. 18,111 (Apr. 28, 2003), available at http://www.sec.gov/litigation/litreleases/lrl18111.htm. Apparently, Citigroup was able to settle with regulators without admitting fault and thus the settlements have not helped investors in their arbitration claims. See Jacob H. Zamansky, \textit{Sturm, Drang und Spitzer}, WALL ST. J., Mar. 3, 2005, at A12. Additionally, as part of a class action settlement, Citigroup agreed to pay former WorldCom investors $2.575 billion. \textit{In re WorldCom, Inc.}, [2004–2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,040, at 95,016 (S.D.N.Y 2004). Citigroup's liability exposure in the settled WorldCom class action also involved potential liability under section 11 of the 1933 Act, 15 U.S.C. § 77k (2000). Class actions are not subject to NASD arbitrations, NASD \textit{MANUAL}, supra note 48, § 10301(d), and additional class actions against Citigroup are pending, see \textit{In re Salomon Analyst Litig.}, 373 F. Supp. 2d 252 (S.D.N.Y. 2005).
\end{itemize}
the rationales of the awards denying relief to claimants varied as well but generally involved a finding that the research reports did not contain material misrepresentations. In some cases, the panels made an additional finding that the claimant did not rely upon Grubman's report in making an investment decision. Other awards denying relief are unexplained.

The 2003 and 2004 NASD awards that contain opinions do not comprise a statistically valid sample of the thousands of awards issued in those years. To the contrary, these awards were not chosen for inclusion here randomly but precisely because they included explanations. Without knowing why certain awards contain opinions, one cannot assert with any certainty that they are representative of the quality of awards in general. Intuitively, however, one suspects that given the extra (and presently uncompensated) arbitrator time and attention such opinions evidence, the awards are at least representative of NASD panels’ best efforts to correctly apply the law. Moreover, other commentators, while not undertaking a systematic temporal analysis of a set of data, reach similar conclusions


on the propensity of SRO arbitrators to misapply the law in certain arenas.\textsuperscript{174} As is explained in the following Part, the failure of arbitration panels to fully comprehend the complexity of federal and state laws governing securities disputes is an expected consequence of the panel members’ relative lack of experience and training.

IV. THE MYTH OF THE EXPERT ARBITRATOR

Securities arbitration survives on the popular fiction that SRO expert arbitrators will render reasonable and fair decisions.\textsuperscript{175} This myth was perpetuated by the McMahon amicus briefs submitted by the American Arbitration Association ("AAA") and the SIA, urging the Court to enforce the mandatory pre-dispute arbitration clauses contained in brokerage contracts. Part of the argument put forth by the AAA was the fact that modern arbitrators were "experienced and fully competent to apply the securities laws."\textsuperscript{176} In support of this claim, the AAA noted that eighty percent of AAA arbitrators in its recent securities cases were in fact attorneys and more than half of those were experienced in securities law.\textsuperscript{177} All but two of the non-attorney arbitrators were "business or accounting executives or financial consultants."\textsuperscript{178} Similarly, the SICA argued that the SROs maintained rosters of securities arbitrators "who are well versed in the field."\textsuperscript{179} Today, however, very few securities disputes proceed through the AAA process,\textsuperscript{180} and the claim of SRO arbitrator expertise does not withstand careful scrutiny.

The increased quasi-judicial nature of modern securities arbitration suggests the need for arbitrators versed both in procedural aspects of the arbitration process and substantive securities law.\textsuperscript{181} In

\begin{footnotes}
\item[174] See, e.g., Black & Gross, supra note 44, at 1041–43 (describing three cases in which arbitrators ignored existing law); Lowenfels & Bromberg, supra note 135, passim (analyzing awards where arbitrators have expanded accepted legal rules to award damages to investors).
\item[175] Modern courts and commentators alike point to the virtues of the expert decisionmaker when generalizing about arbitration even though they may be only relying upon a myth. See Edward Brunet & Charles B. Craver, Alternative Dispute Resolution: The Advocate's Perspective 323–26 (1997) (discussing the characteristics of folklore arbitration in detail).
\item[177] Id.
\item[178] Id.
\item[179] Id. at 7.
\end{footnotes}
customer disputes against their securities brokers, however, the value of expert decisionmakers has taken a back seat to other values. After McMahon, neutrality rather than expertise has become the rallying cry for investors forced to arbitrate securities claims against their brokers. Indeed, by validating arbitration agreements between members of the securities industry and their investors, the Court may have inadvertently sounded the death knell for expert SRO arbitrators.

SROs continually strive to meet demands for arbitration panels that are perceived to be neutral. Industry arbitrators, it is feared, will favor industry participants in their disputes with customers or employees.\(^{182}\) One must note that SRO arbitration panels were never populated with facially non-neutral parties as can be the case in commercial arbitrations utilizing the tri-partied system. Under this system, each party is allowed to appoint his or her own arbitrator to serve along with a neutral arbitrator on a three-person panel.\(^{183}\) In contrast, SRO arbitrators have always been independent and neutral in the sense that they do not represent the interests of any one party.\(^{184}\) Rather it was the fact of industry affiliation of particular arbitrators that led to the understandable concern of bias. Therefore, to combat even the perception of bias, the arbitration rules of both the NASD and the NYSE provide that only one arbitrator on a three-person panel can be an industry arbitrator, that is, an arbitrator who has professional or personal ties to the securities industry.\(^{185}\) Any arbitrator assigned to a single arbitrator panel must be a non-industry or public arbitrator.\(^{186}\)

The definition of an arbitrator who is affiliated with the securities industry has been expanding in recent years to encompass many more people. Arbitrators are classified as “non-public” or “industry” panel members if during the past five years they have been associated with a broker or dealer.\(^{187}\) Under recent changes in NASD definitions,

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183. See Byrne, supra note 68, at 1818 (discussing the use of non-neutral arbitrators).
184. See SEC. INDUS. CONFERENCE ON ARBITRATION, supra note 115, at 4–5.
185. NASD MANUAL, supra note 48, § 10308(b); NYSE RULES 2003, supra note 48, Rule 607. Some investor advocates challenge the inclusion of any industry affiliated arbitrators on SRO panels. See PERINO, supra note 51, at 16.
186. NASD MANUAL, supra note 48, § 10308(b)(2); NYSE RULES 2003, supra note 48, Rule 601(f).
187. NASD MANUAL, supra note 48, § 10308(a)(4)(A). The amended rule was designed to further the perception of neutrality by limiting the public arbitrator classification to those who have left the industry for five years or more rather than the three year gap specified in the earlier rule. Those associated with commodities or futures
individuals who have spent twenty or more years in the securities industry can never be classified as public arbitrators even after several years of retirement.\textsuperscript{188} Moreover, professionals such as accountants and attorneys who either have devoted twenty percent or more of their time in the past two years to representing clients who are associated with the securities industry or who are employed by a firm that derives ten percent or more of its income from those associated with the securities industry are deemed to be non-public arbitrators.\textsuperscript{189} Under this classification scheme, even attorneys who devote the vast majority of their time to representing investors are still deemed to be industry arbitrators.\textsuperscript{190}

Public arbitrators are those who do not fall under the “non-public” classification and who are not closely related to them.\textsuperscript{191} Public arbitrators, according to the NASD’s website “are carefully selected from a broad cross-section of people, diverse in culture, profession, and background.”\textsuperscript{192} Public arbitrators do not necessarily have any expertise whatsoever in arbitration procedures or in substantive securities law.

Prior to 1998, the NASD arbitrator selection process partially addressed the issue of arbitrator experience and expertise. During this time, NASD staff or the Director of Arbitration appointed arbitrators from a pool of public and industry candidates maintained
The expertise of the candidates was one criteria utilized by the staff in making selections for particular cases. However, in 1996, the Ruder Commission determined that investors were concerned that the NASD-dominated arbitration selection process indicated a pro-industry bias. This perception likely grew from the multiple roles of the NASD as an industry association funded entirely by its members, a regulator of those members, and a provider of dispute resolution services between members and the investing public. While many broker-dealers view the NASD as a regulator rather than a trade association, this view was not shared among investors and their counsel.

In evaluating NASD's arbitration procedures, the Ruder Commission, like the preceding 1992 GAO report, found no actual evidence of pro-industry bias. Nonetheless, the Ruder Commission


194. ROBBINS, supra note 193, § 10.4. NYSE arbitrators are primarily determined by staff selection which is the default selection mechanism in the absence of a contrary party agreement. NYSE RULES 2003, supra note 48, at 33; see also 2003 GAO REPORT, supra note 120, at 13 (noting that eighty-five percent of NYSE arbitrators are staff selected).

195. See Ruder Report, supra note 81, at 93.

196. In 2000, the SEC approved the creation of a new NASD subsidiary, the NASD Dispute Resolution, Inc., which functions as an independent entity to manage NASD arbitrations. See PERINO, supra note 51, at 1. Perhaps this recent separation of the trade association functions and the dispute resolution function at NASD may partially alleviate the perception of NASD bias.

197. 1992 GAO REPORT, supra note 49, at 35–38; Ruder Report, supra note 81, at 9; see also 2000 GAO REPORT, supra note 49, at 4–5 (updating the 1992 report and finding mixed evidence that could “indicate little or no change in the fairness of the arbitration process”). To demonstrate neutrality, the NASD promulgates statistics showing a fairly static percentage of customer “wins” over the years that hovers around 50%. See Dispute Resolution Statistics, supra note 56. These statistics must be viewed with some degree of skepticism, however, as the reported numbers do not show the damages awarded as compared to those claimed. See Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 261 (1987) (Brennan, J., dissenting); Gary Weiss, Walled Off from Justice?, BUS. WK., Mar. 22, 2004, at 91 (noting that investors rarely are awarded full dollar amount of claims in NASD arbitrations). The 1992 and 2000 GAO reports, however, do take into account, at least in a macro sense, both the percentage of “wins” and the relative damages awarded in making the claim that there is no demonstrated industry bias. The GAO assertion of neutrality seems to be based on an incidence of customer wins approximating 50% (ranging from 46%–59%) during the ten-year study period and a percentage of claimed damages awarded ranging from 46%–61%. See 2000 GAO REPORT, supra note 49, at 23–24. The GAO suggests that some of the variance in customer wins may be due to increased settlements. Id at 24. Similarly, other reviews of the securities arbitration
recommended that "[t]he selection of arbitrators for a case should avoid even the appearance of impropriety." This was also the prevalent view of commentators on this issue. Therefore, in 1998, in line with the recommendations of the Ruder Commission and in a further nod to neutrality over expertise, NASD changed its rules to its current list selection process to lessen the public perception of bias. Under current NASD rules, a computer program generates lists of public and non-public arbitrators from which the parties select the panel members and chairpersons by striking out unacceptable names and ranking those that remain. If the parties do not accept enough arbitrators on the list, the NASD appoints the next arbitrator that the computer program generates, absent recusal for cause. Recently, in conjunction with its proposal for a new customer code, the NASD has proposed a rule change that would result in the selection of arbitrator names on a random rather than a rotational basis.

Under this selection system, there is no guarantee that any arbitrator on a panel hearing a customer dispute will have expertise in the substantive law of the dispute or in the procedural rules that govern the arbitration proceeding, a concern raised by some system for signs of bias have concluded that the system is "fair." See Steven A. Ramirez, Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous, 40 WM. & MARY L. REV. 1055, 1102 (1999) (noting studies that conclude that securities arbitration in broker-customer disputes is fair); see also PERINO, supra note 51, at 8–9 (suggesting that SEC and GAO oversight combined with economic self interest prevent development of a pro-industry bias); id. at 34–37 (noting that available evidence on NASD arbitration outcomes does not suggest pro-industry biases, however independent empirical research is needed).

See Ruder Report, supra note 81, at 94.

See generally Nichols, supra note 182 (detailing the then NASD arbitrator selection process).


201. NASD MANUAL, supra note 48, § 10308(c)(1)(A)–(C).

202. Id. § 10308(c)(4)(B), (d)(1). This change in selection procedure has apparently "improved public perceptions of the fairness" of NASD arbitrations. PERINO, supra note 51, at 19–20, 23, 34; see also GARY TIDWELL ET AL., PARTY EVALUATION OF ARBITRATORS: AN ANALYSIS OF DATA COLLECTED FROM NASD REGULATION ARBITRATIONS 3–4 (1999), available at http://www.nasd.com/web/groups/med-arb/documents/mediation_arbitration/nasdw_009528.pdf (noting that over ninety percent of survey respondents agreed or strongly agreed that arbitration was handled fairly). But see Nichols, supra note 182, at 104 (arguing that a public perception of industry bias will remain unless an independent organization selects arbitrators).


204. The NASD Code provides that if a party requests arbitrators with a particular expertise the lists may include some arbitrators having the designated expertise, but there
arbitration participants. Like the reforms to arbitration itself, which have been almost entirely procedural in nature, most efforts to reform the arbitrator selection process have been to better ensure the reality and appearance of neutrality. However, even the best intended neutral arbitrators will find it difficult to render fair decisions if they do not possess the requisite skills or receive sufficient training to understand the issues. Neutrality, while an obviously desirable quality in a decisionmaker, can only take you so far. As one commentator aptly noted: "Competence as well as innocence matters." 206

One of the major benefits to arbitration over adjudication should be the expertise of the arbitrators who can "theoretically ... render more accurate rulings on complex, technical, and often arcane questions." 207 The availability of competent, expert decisionmakers is a key element attracting businesses to arbitration over litigation forums, which are generally populated with generalist judges and juries. 208 Brokers and investors both expect that competent arbitrators will render fair decisions. 209 Competence for securities arbitrators should encompass both procedural competence, including the ability to understand and expeditiously handle discovery motions, and substantive competence, meaning the ability to understand the legal and factual issues involved in a particular dispute. The legal principles at issue in many securities arbitrations can be difficult and complex even for attorneys and judges to understand and apply; 210 they can be unintelligible to a lay person.

Arbitrator competence can either stem from an arbitrator’s prior educational and professional experience or from directed training. It is difficult to generalize about the competence of NASD arbitrators, given the wide variety of disputes they arbitrate ranging from very

is no guarantee that any such arbitrators will in fact be placed on the panel. NASD MANUAL, supra note 48, § 10308(b)(4)(B).

205. See 2003 GAO REPORT, supra note 120, at 12.


207. PERINO, supra note 51, at 42.


209. See, e.g., 1992 GAO REPORT, supra note 49, at 6 (noting that both the "independence and experience of arbitrators can determine the fairness of decisions").

210. See Black & Gross, supra note 44, at 1006-13 (describing the varied and complex legal theories that can be at issue in securities arbitrations).
simple to very complex claims. There are also regional variations in
the quality of arbitrator pools. It is fair to say, however, that, on the
whole, NASD arbitrators are not substantively or procedurally
qualified to arbitrate complex securities cases either by prior
experience or through NASD training.\textsuperscript{211}

This issue of arbitrator competence is not a new or unrecognized
concern. In 1987, in the immediate aftermath of the \textit{McMahon}
decision that was premised in part on the SEC's assertion that it
would oversee the SRO arbitration procedures, the SEC
recommended to the SICA that SRO arbitrators be trained in the
relevant state and federal securities law.\textsuperscript{212} When the SICA objected,
however, the SEC capitulated and did not require such training when
approving the SRO arbitration rules.\textsuperscript{213} In 1992, in response to a
GAO independent evaluation of SRO procedures and fairness, the
SEC expressed its concern that the imposition of more stringent
qualification or training requirements for arbitrators could
significantly increase the cost of arbitration and “reduce the pool of
qualified arbitrators without materially improving the general quality
of the arbitrator pool or increasing assurances of the independence or
capability of individual arbitrators.”\textsuperscript{214} In 1994, the NASD established
a task force to review and suggest improvements to the securities
arbitration system.\textsuperscript{215} In 1996, the NASD task force, chaired by

\begin{footnotes}
\footnotetext[211]{See infra notes 219–32 and accompanying text. The myth of the expert securities
arbitrator continues to appear in academic commentary. See, e.g., Ramirez, supra note
197, at 1118 (suggesting an expansion of the securities arbitration system in part due to the
advantages of expert arbitrators); Constantine N. Katsoris, \textit{Post-Sawtelle Tremors:
Arbitration Faces New Questions About the Sustainability of Punitive Awards}, \textit{Neutral
web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_010043 (“[A]rbitration
provides the advantage of speedy resolution of securities disputes by persons
knowledgeable in the area . . . .”). Interestingly, at least some courts that are asked to
review arbitral awards have a clearer understanding of the reality of arbitrator expertise.
See, e.g., Wallace v. Buttar, 378 F.3d 182, 190 (2004) (stating that the law assumes that
arbitrators operate on a “blank slate” unless educated by the parties, given that they
“often are chosen for reasons other than their knowledge of applicable law” (citations
omitted)).}

\footnotetext[212]{1992 GAO REPORT, supra note 49, at 58; Mark D. Fitterman et al., \textit{SEC Initiatives
for Changes in SRO Arbitration Rules}, in \textit{SECURITIES ARBITRATION} 1988, at 282 (PLI
Corp. Law & Practice Course, Handbook Series No. 601, 1988) (reprinting a letter from
Richard G. Ketchum, Director of Division of Market Regulation, SEC, to all SICA
members).}

\footnotetext[213]{See 1992 GAO REPORT, supra note 49, at 58.}

\footnotetext[214]{Id. at 61.}

\footnotetext[215]{Ruder Report, supra note 81, at 1. The Ruder Commission noted that the
NYSE’s 1994 Symposium on Arbitration in the Securities Industry “provided a
particularly useful resource.” Id. at 5 n.3.}
\end{footnotes}
former SEC Chair David Ruder, reported that SRO arbitrators were often not qualified to handle the complex issues presented to them.\textsuperscript{216} Recognizing the practical difficulties of creating a professionalized pool of arbitrators, the Ruder Commission made the modest suggestion that the NASD expand both the scope and frequency of mandatory arbitrator training both for panel members and chairpersons.\textsuperscript{217} A few commentators have also noted the difficulties facing lay arbitrators who deal with complex legal issues and have made similar modest proposals.\textsuperscript{218}

SRO arbitrators today, however, still need not be qualified to adjudicate securities disputes and receive virtually no SRO training in the relevant law they are supposed to apply. To qualify as an NASD arbitrator, an applicant must have five years of full-time business or professional experience and at least two years of college credits.\textsuperscript{219} Expertise or training in the substance of NASD disputes is not required. In fact, it appears that the NASD is at times working at cross purposes with these suggestions of increased arbitrator competence. For example, in 2002, the President of NASD-DR stated that NASD "purposely sought a panel that is not professional and not primarily securities lawyers" because most respondents want their arbitration panel to resemble a jury, rather than a judge.\textsuperscript{220} Even industry arbitrators, who by rule comprise a minority of NASD panel members, may not have professional experience relevant to the case

\textsuperscript{216} See id. at 107–08.
\textsuperscript{217} See id. at 109–13.
\textsuperscript{218} See Coffee, supra note 181, at 383 (suggesting that with the transition to a more legalistic model for securities arbitration, the chair of the panel should be an attorney experienced in litigation); Seligman, supra note 206, at 355–56 (arguing that the panel chair should be an attorney skilled in procedures such as discovery because lay arbitrators who can grasp facts and equities of a claim, cannot grasp technical questions of law). Professor Barbara Black, noting the difficulty that lay arbitrators face in handling the complex procedural and substantive issues that arise in securities arbitration, has recently suggested that NASD employ professional arbitrators. Barbara Black, \textit{Do We Expect Too Much from NASD Arbitrators?}, SEC. ARB. COMMENTATOR, Oct. 2004, at 1–5.

\textsuperscript{219} NASD, \textit{Frequently Asked Questions About Becoming an NASD Arbitrator}, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=863 (last visited Nov. 24, 2005). The NYSE has a similar experience requirement which can be waived upon the submission of two letters from professional associates of the applicant endorsing the applicant's experience and character. 2000 GAO REPORT, supra note 49, at 20.

\textsuperscript{220} Vinzant, supra note 135, at 55 (quoting Linda Fienberg, President of NASD Dispute Resolution). This statement from NASD is quite ironic given the generally accepted view that most businesses choose arbitration to escape jury trials. \textit{See}, e.g., Sternlight, \textit{Panacea or Corporate Tool?}, supra note 130, at 684 (arguing that companies' motivation in choosing arbitration is to avoid jury verdicts).
at hand. Recently, in an uncharacteristic nod to arbitral competence, the NASD proposed a new rule requiring the chairperson in customer arbitrations to be either an attorney or an experienced arbitrator—a change that if adopted will marginally improve the quality of the panels at least as to procedural matters. Even the amended rule, however, will not ensure that a lawyer will serve on a panel or that a lawyer who does serve will have any expertise in securities law. Moreover, given the continuing shortage of arbitrators, the recent changes to NASD rules that disqualify attorneys employed by firms that devote as little as ten percent of their practice to representing participants in the securities industry will further deplete the supply of knowledgeable attorneys to serve on panels.

The problem of arbitrators unskilled in the procedure and substance of securities arbitration could be addressed through aggressive training programs. SRO training programs for arbitrators,

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221. One author, after describing the minimal qualifications and training required to serve as an NASD arbitrator, laments:

"[N]otwithstanding the best intentions of even the most dedicated and knowledgeable arbitrators, it cannot, in all good conscience, be assumed that the members of any given arbitration panel will have been fairly educated or trained on the facts and circumstances that will be associated with the claims that we will be asking them to decide."


222. See Neutral List Selection System and Arbitrator Rosters, 70 Fed. Reg. 36,442, 36,445 (June 23, 2005). These minimal standards stand in sharp contrast to the qualifications for those chairing panels hearing employment discrimination disputes. For such matters, the chair must hold a law degree, have ten years of legal experience, have substantial experience with employment law, and not have primarily represented employers or employees within the previous five years. NASD MANUAL, supra note 48, § 10211; 2003 GAO REPORT, supra note 120, at 8.

223. See NASD Member Alert, (Feb. 25, 2004), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002750 (announcing the need for additional qualified arbitrators); see also Ruder Report, supra note 81, at 102 (discussing the shortage of arbitrators).

224. While such attorneys may qualify as "industry arbitrators" under section 10308, two of the three arbitrators on panels must be public and all one-person panels must consist of public arbitrators, NASD MANUAL, supra note 48, § 10308(b)(1), thus leading to a greater problem in finding qualified public arbitrators. See Constantine N. Katsoris, The Composition of SRO Panels, SEC. ARB. COMMENTATOR, Oct. 2003, at 4 (discussing ambiguities in such a percentage rule and suggesting that it may eliminate "many knowledgeable and outstanding candidates of impeccable credentials and integrity at a time when SRO caseloads are exploding and the contents of cases becoming more complicated and complex"). NASD reports that at present it has 3,912 public arbitrators and 2,714 non-public arbitrators on its roster.
however, are now compressed into a shorter time frame than a decade ago.\textsuperscript{225} While the NASD hypes its training sessions as "highly acclaimed," in reality they consist of successful completion of a self-study guide, attendance at a four-hour training course, and successful completion of a trainer evaluation and a multiple choice test.\textsuperscript{226} Ongoing training at both NASD and NYSE is minimal. NASD offers an optional online chairperson training session\textsuperscript{227} and has recently instituted optional mini-training sessions online, each covering a specific topic and taking sixty to ninety minutes to complete.\textsuperscript{228}

Even under the best of circumstances, such minimal arbitrator training does not provide panel members or even panel chairs with the basic skills necessary to understand the complex procedural and substantive issues that may arise in securities arbitration. Moreover, NASD does not endeavor to teach its arbitrators substantive law at all. Instead the training materials and sessions deal almost exclusively with procedural issues.\textsuperscript{229} Even the new mini-topic sessions deal solely with procedural topics such as disclosure duties, sanctions, and expungement hearings.\textsuperscript{230} In fact, the training and instructions that

\textsuperscript{225} See Ruder Report, supra note 81, at 108 (noting that in 1996, mandatory arbitration consisted of a day long, on-site training program).

\textsuperscript{226} See NASD, supra note 192.

\textsuperscript{227} Id. Chairperson training (or equivalent experience) will become mandatory if the SEC approves the NASD proposed new customer code. See Neutral List Selection System and Arbitrator Rosters, 70 Fed. Reg. 36,442, 36,445 (June 23, 2005).

\textsuperscript{228} News Release, NASD, NASD Increase Online Training for Arbitrators (May 26, 2004), http://www.nasd.com/web/idcplg?ldcService=SS_GET_PAGE&ssDocName=NASDW_002826. NASD recently made arbitrator participation in the mini-course on expungement procedures mandatory. The NYSE requires its arbitrators to attend one additional training course every four years, but it reserves the right to waive this requirement. 2003 GAO REPORT, supra note 120, at 11. At least one SEC staff member continues to believe that mandatory ongoing training discourages experienced arbitrators from continuing to serve. See id. at 12.

\textsuperscript{229} See generally PANEL MEMBER COURSE PREPARATION GUIDE, supra note 116 (providing modules and lessons for the training of arbitrators). The Guide consists of three modules, entitled: Prepare to Conduct a Fair and Impartial Hearing (2.5 hours); Conduct a Fair and Impartial Hearing (2.5 hours); and Decide the Outcome of the Case (2 hours). The first two modules address process issues including discovery and testimony as well as issues relating to arbitrator conduct such as disclosure, ex parte contacts, and hearing decorum. The third module contains four lessons: determining liability, determining awards, completing the appropriate documentation, and responding to post-award requests. See id. at 163–232. See generally Black & Gross, supra note 44, at 1027–29 (describing the procedural training provided to arbitrators). NYSE requires one training course on arbitration procedures and conduct issues. See 2003 GAO REPORT, supra note 120, at 11.

\textsuperscript{230} The NASD news release announcing its new "comprehensive" arbitrator training program states:
arbitrators do receive send a multitude of mixed messages at best and, at worst, send messages that countermand Supreme Court pronouncements regarding the application of the law. Far from explaining the law, arbitrator instructions in the NASD Training Guide instruct the panel members that they "are not strictly bound by legal precedent or statutory law" so long as they do not "manifestly disregard the law." Training sessions have even provided hints to new recruits on how to avoid the application of the law.

It is somewhat surprising that so little has been done to address the issue of arbitrator competence. Perhaps the participants and those who comment upon the process have been so concerned with neutrality that competence has been relegated to the background. However, given that this issue of arbitrator competence has been raised by the SEC and the Ruder Commission, as well as by the GAO in its reviews of the SRO arbitration system, it is disappointing that little of substance has been changed to ensure arbitrator competence or to improve training programs. Instead, most recommended changes, even those emanating from the reviewing agencies, have not been designed to further these goals. For example, in 2003, the GAO suggested that the SROs initiate background checks "to help ensure that all NASD and NYSE arbitrators possess the qualifications

NASD Dispute Resolution has introduced Your Duty To Disclose, the first in a series of new online courses developed as part of its comprehensive Arbitrator Training Program. Three additional courses—Discovery--, Abuse & Sanctions, Expungement, and Managing Hearings—are in the works for online release this year, with more installments in development for 2005.

News Release, NASD, supra note 228.

231. See PANEL MEMBER COURSE PREPARATION GUIDE, supra note 116, at 172–73. The Training Guide explains that in some jurisdictions, awards that manifestly disregard the law can be judicially overruled.

232. At a recent onsite panel member training session attended by the author, a co-trainer, who was an experienced arbitrator, suggested to the new recruits that statutory limits on awards of attorneys' fees could be avoided simply by including such amounts within the award itself. While the NASD Regional Director in attendance stated that this was not NASD policy (and indeed the NASD award template makes it clear that there must be a statutory or contractual basis for the award of attorneys' fees), the message was clearly conveyed that in arbitration, anything goes.

233. See 2003 GAO REPORT, supra note 120, at 31–32 (noting that in recent inspections, SEC staff suggested improvements to arbitrator training including longer training courses); 1992 GAO REPORT, supra note 49, at 58 (noting that "[i]n 1987 SEC recommended that SROs implement effective programs to educate arbitrators on a broad range of substantive law, arbitration law and securities law issues that are likely to arise in arbitration," yet no SRO had mandatory training programs); Ruder Report, supra note 81, at 107–08 (recognizing that many arbitrators were not qualified to understand complex securities law claims).
required by their SRO,234 a proposal adopted by NASD and approved by the SEC in 2003.235 This proposal, while perhaps addressing issues of integrity, obviously does nothing to ensure that the SROs have the necessary competence requirements to begin with. In fact, it is a mystery what problem this background check requirement is addressing, as neither NASD nor the NYSE has any evidence that any arbitrator applicant ever falsified any information on his or her application.236 Indeed, there are so few necessary prerequisites to arbitrator service and so little financial incentive to serve that one struggles to discern a motivation to lie.

V. REFORMING SRO ARBITRATIONS

The SRO mandatory arbitration system that handles the vast majority of disputes in the United States between investors and their brokers is in need of serious reform.237 This Article has explained the modern reality that one arbitration forum, the NASD, handles over ninety percent of these arbitrations in a process that barely resembles the traditional norms embraced by the Supreme Court. NASD proceedings are no longer quick or efficient as litigation-like procedures now dominate the process. This procedural departure from the model championed by McMahon, however, involves trade-offs with real benefits to offset the costs. Even though the addition of certain procedural enhancements to SRO arbitrations, such as discovery and record keeping, adds time and expense to arbitration proceedings, such procedures will very likely lead to more informed and accurate results.238 Other departures from the Court’s story, however, are more problematic. While arbitration can fulfill the desire for self-governance among the members of a normative community,239 SRO arbitrators are not expert decisionmakers who

234. 2003 GAO REPORT, supra note 120, at 4.
236. 2003 GAO REPORT, supra note 120, at 34, 44.
237. A recent law review symposium on mandatory arbitration begins with the following introduction: “It is hard to escape the conclusion that the large majority of academic experts on dispute resolution have serious and significant doubts about the wisdom of the Supreme Court’s strongly pro-arbitration stance.” Thomas B. Metzloff, Foreword, 67 LAW & CONTEMP. PROBS. 1, 2 (2004).
238. See Brunet, supra note 63, at 45–47 (explaining that parties who choose their arbitration procedures by contract often provide for some trial like procedures); Maynard, supra note 130, at 1539–45 (explaining how procedural rules promote accuracy at expense of efficiency).
239. See supra notes 58–74 and accompanying text.
can rely upon traditional customary norms to decide disputes equitably. Indeed, given that the arbitration proceedings most often occur between a consumer and an industry member, there are no shared customs or traditions to enforce. Law perhaps is the only truly shared community value in securities arbitration, yet there are no mechanisms in place to ensure that SRO arbitrators apply the law. Arbitral awards need not be explained and are virtually insulated from judicial review. One must pose the question then, if arbitrators need not apply the law, what norm should they apply? Equity is not an absolute concept that exists in a vacuum. Arbitrators often do not have the background nor do they receive sufficient training either to apply the law or to apply equity. The entire system is based upon a fiction embraced, if not created, by the Supreme Court.

Some critics have complained that investors do not voluntarily agree to arbitration given that they have no realistic choice concerning the inclusion of an arbitration clause in their contracts. They stress the reality that in order to invest in the U.S. capital markets, an individual must agree to arbitrate claims against her broker. This argument of adhesion, however, has fallen on deaf judicial ears as courts persist in their zeal to support alternative dispute resolution. It is no answer that on the whole investors fare pretty well in arbitration, and, therefore, while the SRO arbitrations may be compulsory, they are fair. This proposition is supported only by macro statistics showing that investors win about half of the time and collect about half of their claimed damages. No one has explained, however, why such results describe a fair system. It may be that investors should win only twenty-five percent of the time but collect 100% of their claimed damages. As the GAO noted in its 1992 report, “[s]tatistical analysis of overall results indicated little


241. In McMahon, the Court considered and rejected the argument that without more, mandatory pre-dispute arbitrations agreement utilized in the securities industry were non-enforceable contracts of adhesion. Shearson/Amer. Express, Inc. v. McMahon, 482 U.S. 220, 226, 230 (1987).

242. See supra note 197.
about the fairness of individual cases.\textsuperscript{243} Without reasoned opinions, one cannot predict fairness with any degree of accuracy.\textsuperscript{244}

It is also unhelpful to suggest that, while the arbitration system may be flawed, we should not mind because it is flawed in favor of investors. Some commentators suggest that investors may benefit from the tendency of arbitrators to misapply the law in complex cases given that investors' claims are often stronger on the equities while brokers' defenses are stronger on the law. Investors, it is argued, benefit from the apparent propensity of arbitration panels to grant some relief to them even in the absence of a legitimate legal claim.\textsuperscript{245} Therefore, complaints by brokers that NASD panels do not apply the law should be ignored because arbitration was at least initially an industry choice.\textsuperscript{246} One can plausibly make the case through a review of available arbitration opinions that arbitrators tend to stretch or ignore the law to impose liability upon brokers. Given the shortage of arbitral opinions, however, there is no statistically valid evidence to empirically support this claim. It may be that NASD panels are shortchanging investors in the thousands of unexplained awards. But assuming, arguendo, that investors do in fact win favorable awards even in the absence of a valid legal claim, the system still has serious shortcomings. Liability in the absence of a breach of a legal duty will simply result in a wealth transfer among investors with no demonstrable benefit to the market as a whole. As one prominent commentator noted, when a claimant obtains an undeserved settlement,

\begin{itemize}
  \item \textsuperscript{243} 1992 GAO REPORT, supra note 49, at 8. In 1992, the GAO recognized that its analysis indicated little about fairness in individual proceedings and that the "[f]air proceedings in individual cases are important because of the financial consequences of arbitrators' decisions to investors and broker-dealer firms and because those decisions are generally not subject to review." \textit{Id}.
  \item \textsuperscript{244} Comparisons between NASD awards and those issued in other forums may be helpful in assessing fairness, but given the overwhelming market dominance of the NASD forum, there are too few cases in alternative venues to provide a meaningful comparison. See 2000 GAO REPORT, supra note 49, at 5.
  \item \textsuperscript{245} See \textit{PERINO}, supra note 51, at 7; Black & Gross, \textit{supra} note 44, at 1035–40. See generally Lowenfels & Bromberg, \textit{supra} note 135 (arguing that compulsory arbitration offers more protection to consumers than litigation); Marc I. Steinberg, \textit{Securities Arbitration: Better for Investors than Courts?}, 62 BROOK. L. REV. 1503 (1996) (arguing that investors get more favorable treatment in arbitration than they would in federal court).
  \item \textsuperscript{246} Today, SRO rules require brokers and their firms to arbitrate any claims upon customer request. NASD MANUAL, \textit{supra} note 48, § 10301. Therefore we can no longer call the arbitration regime voluntary for industry members any more than for investors. There may be valid reasons for both brokers and investors to question the current arbitration regime.
\end{itemize}
it means the broker is bearing costs that it should not bear—costs that will be passed on, in a competitive industry, to the ninety-nine percent of customers who do not resort to arbitration or litigation. From a public policy perspective, we should be concerned about this dead-weight loss being ultimately imposed on customers.247

There have been numerous suggestions on how to shore up SRO arbitrations and attempt to reconcile the advantages of arbitrations with the mandatory legal rules that the panels should apply. One avenue would be a turn to the revocability doctrine, thereby giving both brokers and customers a real opportunity to contract for arbitration.248 Customers with smaller claims, however, may be disadvantaged, given that SRO arbitrations do provide fairly efficient procedures to settle such disputes, although accommodations could probably be made to handle small claims. One commentator suggests that a task force develop model arbitrator instructions,249 while another argues that arbitrators should be subject to personal liability for ignoring mandatory legal rules.250 Some scholars have argued for enhanced judicial review for statutory claims.251 Many of these proposals for reform depend not only upon a rule that arbitrators

247. See Coffee, supra note 181, at 379.
248. Carrington & Castle, supra note 62, at 207–08, 218–20 (describing the revocability doctrine and statutory abrogation in England and the United States and suggesting that it should be revived).
249. Caruso, supra note 221, at 480.
251. See, e.g., Sternlight, Panacea or Corporate Tool?, supra note 130, at 711 (arguing that courts should set aside arbitral awards that are clearly inconsistent with applicable law); Ware, supra note 121, at 737–42 (arguing for enhanced judicial review of arbitration awards involving mandatory rules). There is an ongoing academic and judicial debate concerning the propriety of parties contracting for increased judicial review. Compare Kyocera Corp. v. Prudential-Bache Trade Services, Inc., 341 F.3d 987, 1000 (9th Cir. 2003) (en banc) (holding that parties cannot contract for increased judicial review of arbitration awards), with Roadway Package Sys., Inc. v. Kayser, 257 F.3d 287, 292–93 (3d Cir. 2001) (upholding parties right to agree to enhanced judicial review). Academics also disagree. For arguments favoring contractual provisions calling for enhanced judicial review, see Brunet, supra note 63, passim (arguing that courts should enforce contracts for enhanced judicial review); Sarah Rudolph Cole, Managerial Litigants? The Overlooked Problem of Party Autonomy in Dispute Resolution, 51 HASTINGS L.J. 1199, 1262–63 (2000) (arguing that party autonomy policies require courts to enforce contracts for enhanced judicial review). For contrary commentary, see Amy J. Schmitz, Ending a Mud Bowl: Defining Arbitration's Finality Through Functional Analysis, 37 GA. L. REV. 123, 123–30 (2002) (arguing for only the minimal review set forth by the FAA); Hans Smit, Contractual Modification of the Scope of Judicial Review of Arbitral Awards, 8 AM. REV. INT'L ARB. 147, 147–51 (1997) (arguing that expanded judicial review is not compatible with the goals of arbitration).
must apply the law but also upon a requirement of written opinions to make judicial review feasible. Meaningful judicial review, however, cannot take place under the current judicial “manifest disregard” standard. Given the pro-arbitration posture of the Court, these proposals, which are of global proportions, are unlikely to find daylight absent congressional intervention or a substantial change in Supreme Court membership.

Given the importance of private actions to enforce rights under the state and federal securities laws, there should be a more immediate solution to bring law and order to securities arbitration. This Article proposes changes to the present system that do not require congressional action or a major shift in Court policy. The proposal, while modest, is designed to get to the root of a major shortcoming of SRO arbitrations—that is, the lack of expert decisionmakers to tackle the complex legal issues that may be presented. First, NASD should instruct its arbitrators that they must apply the law and it should provide at least minimal training to its lay arbitrators on the substantive law they may be asked to apply. Such training alone, however, will not remedy the problem. Given the complexity of the legal issues governing disputes between brokers and their investors, it is virtually impossible to adequately train lay arbitrators in any reasonable period of time.

This Article, therefore, proposes that NASD create a designation for complex cases, either defined by the issues raised or by the dollar amount involved, and institute a formal motion practice for such cases. Upon the request of either party, complex cases would be referred to a motions panel comprised of a single expert arbitrator or a panel of experts constituted for the purpose of ruling on discovery motions and motions clarifying or disposing of some or all of the claims and counter-claims. The motions panel would provide a legal framework to guide the necessary factual determinations made by traditional arbitration panels that would continue to hear the factual claims. It could also decide troublesome discovery issues in an expeditious manner. In this fashion, the panel would perform many of the functions of a judge in a jury trial.

The motions panel could be empaneled to serve in a district for a particular period of time or a new panel could be constituted especially for each case. Panel members could either be private

arbitrators or alternatively, NASD could employ professional hearing officers utilizing the model of governmental administrative agencies. Obviously, efficiency will improve with a more experienced panel, but given the continuing concern of those in the plaintiffs’ bar surrounding the selection of neutral arbitrators, the hearings officer model may be difficult to achieve. Therefore, a model utilizing private experts is probably more viable.

The idea of motions practice before NASD arbitration panels has been somewhat controversial. While there is legal authority that arbitrators can dismiss claims pursuant to dispositive pre-hearing motions, in practice this rarely occurs, and at present no NASD rule governs motion practice. Attorneys therefore file motions in arbitration that mimic those permissible under procedural rules for the judicial system. Often such motions are followed by a paper flurry in which the disputants debate their propriety. There is an unspoken bias in SRO arbitrations that panels should view dispositive motions with much skepticism and proceed as a matter of course to a hearing.

NASD has now proposed a rule to institutionalize this


254. But see Black, supra note 218, at 4-5 (suggesting that the complete arbitration process be relegated to professional one-arbitrator panels comprised of securities experts). While Professor Black's proposal is more far reaching than the one presented by this paper, the one-arbitrator limitation necessitated by cost concerns is problematic given that no appeal is possible. Also, while Professor Black is herself an investor's advocate, she has more faith in a professional system of trained arbitrators (even those employed by an independent organization) than do most claimants representatives, making implementation of her suggestion quite unlikely. See, e.g., Review of the Securities Arbitration System: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Serv., 109th Cong. (Mar. 15, 2005) (statement of Public Investors Arbitration Bar Association), available at http://secure.piaba.org/piabaweb/html/index.php?module=Static_Docs&func=view&f=Press+Releases%2F%2FHIFSC_PIABAStatement_03_15_2005.pdf (complaining about the continued use by SROs of arbitrators who are presently or who in the past were affiliated in any way with the securities industry).


257. At present, the NASD Code omits any reference to a motions practice. The NASD Training Manual lists the three most common matters that are appropriate for dispositive motions: Eligibility, Statute of Limitations and Jurisdiction. PANEL MEMBER COURSE PREPARATION GUIDE, supra note 116, at 58-65.
bias. On October 15, 2003, NASD filed with the SEC a proposal to revise and reorganize its customer arbitration code to officially recognize motions as a part of the arbitration process. Proposed Rule 12503 sets forth the basic rules regarding motion practice, and Proposed Rule 12504 specifically addresses pre-hearing dispositive motions.\(^{258}\) Unfortunately, the NASD proposal explicitly discourages such motions and states that they may be granted only under extraordinary circumstances.\(^{259}\) By way of explanation, NASD states that in general, it "believes that parties have the right to a hearing in arbitration" but that in "certain extraordinary circumstances, it would be unfair to require a party to proceed to a hearing."\(^{260}\) Only statute of limitations motions are exempted from the "extraordinary" requirement.\(^{261}\)

The NASD's grudging attitude towards motions stems from the paradigm that all parties are entitled to their "day in court" and therefore that dispositive or even clarifying motions should not be granted. Some smaller claims no doubt fit comfortably under this rubric and are still appropriate candidates for simplified informal procedures in the context of the hearing itself.\(^{262}\) However, the complex nature of many claims suggests that arbitrations can be handled more efficiently with some semblance of a motion practice handled by decisionmakers with both procedural and substantive expertise.

Part of the need for this proposal is occasioned by attorneys for claimants who style complaints with sweeping generalized claims against brokers or their firms.\(^{263}\) While investors are indeed entitled to a hearing, the hearing should concern relevant facts addressed to established causes of action. Conversely, defense attorneys can obfuscate issues in a manner confusing to lay panel members. In complex arbitration cases, there is no principled reason that the


\(^{259}\) Id.

\(^{260}\) Id. at 36,447.

\(^{261}\) Id.

\(^{262}\) Even smaller claims would no doubt be handled more efficiently with expert arbitrators. See Barbara Black, Is Securities Arbitration Fair to Investors?, 25 PACE L. REV. 1, 13–14 (2004) (suggesting a small claims procedure staffed by professional arbitrators to conduct a one-hearing session).

\(^{263}\) There are no formal pleading requirements for NASD arbitrations. Claimants are simply instructed to provide a written narrative describing the facts of the case and explaining why each of the respondents is liable. See NASD DISPUTE RESOLUTION: UNIFORM FORMS GUIDE (2005), available at http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_007954.pdf.
arbitration rules should not include some procedure that parallels the now well-accepted summary judgments motions in the judicial system. 264 Given that these legal issues will inevitably arise in the proceedings, it makes sense to handle such issues expeditiously without engaging in the sometimes futile attempt to educate lay arbitrators who face great difficulty in understanding complex legal doctrines in a brief space of time. 265 Moreover, the use of pre-hearing motions could in many cases create efficiencies that save the parties time and money.

This suggestion differs substantially from a prior experimental NASD Code provision that established a complex case designation system. 266 This procedure, which has since been repealed, did not address motions nor were the parties guaranteed expert decisionmakers except that the rule required at least one of the panel members to be an attorney. 267 There was no requirement that the attorney be skilled in the procedural or substantive aspects of securities arbitration. The present proposal returns SRO arbitral decisions involving legal issues to the hands of expert decisionmakers. Expertise in both the procedural rules of arbitration and the substantive law of securities transactions is important to a fair resolution of the claims if we assume that law is to be the guiding force in decisionmaking. 268 This proposal requires a change in current

264. See Celotex Corp. v. Catrett, 477 U.S. 317, 327 (1986) ("Summary judgment procedure is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the Federal Rules as a whole, which are designed 'to secure the just, speedy and inexpensive determination of every action.' " (citing FED. R. CIV. P. 1)); EDWARD BRUNET ET AL., SUMMARY JUDGMENT: FEDERAL LAW AND PRACTICE 1 (West Group Supp. 1994).

265. The inability of panels to understand the sometimes complex legal issues may help to explain the propensity of panels to issue compromise awards. See supra note 135.

266. See NASD CODE § 10334 (repealed Dec. 31, 2000). Under former NASD Code § 10334, if a claim exceeded $1 million or all parties agreed, the case would be designated as a complex case. A complex designation entitled the parties to a pre-hearing administrative conference with a member of the NASD administrative staff. The administrative conference was designed to address certain pre-hearing matters such as scheduling, discovery, arbitrator qualifications and selection procedures, and the nature of the claims and defenses. However, following the conference, unless all parties agreed to continue the arbitration under the complex designation, the case proceeded according to regular NASD procedures. If the parties agreed to continue pursuant to § 10334, higher fees were imposed. With procedural enhancements to the NASD arbitration process during the early 1990s, parties were able to appropriate much of the benefit of the complex designation without paying the higher fees and so the complex case procedures were rarely used and were discontinued in 2001.

267. Id.

268. The connection between arbitrator competence and fairness was recognized by the GAO in its 1992 review of the NASD mandatory arbitration system. See 1992 GAO REPORT, supra note 49, at 8.
NASD instructions to arbitrators that they need not apply the law. The entire tenor of this proposed change is that the experts who handle pre-hearing motions would rule based upon legal principles. The arbitration panels that decide the factual issues would be required to follow the legal framework set forth by the experts.

In 1996, the Ruder Commission recognized the lack of expert decisionmakers in securities arbitration but noted several practical difficulties facing NASD in attracting enough qualified arbitrators to handle the increasing NASD caseload.\(^{269}\) The Ruder Commission nonetheless recommended at least the panel chair have a strong command of both procedural and substantive law.\(^ {270}\) The institution of an expert panel to handle legal issues should not pose the same practical problems as those noted by the Ruder Commission because expert arbitrators could expeditiously handle motions for several cases pending simultaneously. Moreover, experts may be more willing to serve on a panel that solely decides legal issues and avoids some of the difficulties inherent in scheduling multi-day fact hearings.

If adopted, this proposal for an expert panel to decide pre-hearing legal issues will provide more accurate and fair arbitral results and will enhance the speed and efficiency that should be the hallmark of arbitrations. A review of the case of *Hardy v. Walsh Manning Securities, L.L.C.*\(^ {271}\) serves as an example. *Hardy* was an arbitration first conducted before an NASD panel in a proceeding that began in November of 1998. The original arbitral award, dated February 2002, imposed liability upon the firm CEO on the stated grounds of respondeat superior.\(^ {272}\) On appeal, the federal district court correctly noted that respondeat superior liability did not apply to the CEO given the well established New York “fellow servant” doctrine. However, the court confirmed the award because in the court’s opinion the arbitration panel had not “manifestly disregarded” the

\(^{269}\) The Ruder Report notes that the NASD caseload increased from 4,400 new filings in 1992 to more than 6,000 new filings in 1995. Ruder Report, supra note 81, at 102. New case filings at NASD continue to increase and numbered 8,945 in 2003 and 8,201 in 2004. Dispute Resolution Statistics, *supra* note 56.

\(^{270}\) Ruder Report, *supra* note 81, at 110–12. Some eight years later NASD has partially addressed the Ruder Commission recommendation in its proposal for a new customer code that will require panel chairs to either be attorneys or experienced arbitrators. *See Notice of Filing of Proposed Rule Change to Amend NASD Arbitration Rules for Customer Disputes, 70 Fed. Reg. 36,442, 36,445–46 (June 23, 2005).* This NASD proposal speaks to procedural expertise but once again does not address substance.

\(^{271}\) 341 F.3d 126 (2d Cir. 2003); *see supra* notes 157–60.

clear law. The claimant appealed the district court decision to the Court of Appeals for the Second Circuit, which agreed that the panel had misapplied the doctrine of respondeat superior, but, in an opinion rendered in August of 2003, remanded the proceeding back to the panel for further explanation. On remand, the panel admitted that it had misunderstood the law of respondeat superior but that in any event it meant to hold the CEO primarily liable given his personal participation in the fraud. The availability of an expert motions panel could have avoided this five-year circus. While the arbitration panel in Hardy included one attorney, the lawyer was an admiralty specialist who was apparently not experienced in securities law. The proposed motions panel, whose members would all have been experts in securities law, would have provided the fact finding panel with the legal framework to govern the case. The motions panel would have instructed that, in order to impose liability upon the CEO, the arbitrators must find that the CEO personally participated in the fraud and perhaps rendered some advice on statutory control liability. Given the panel's ultimate conclusion of primary liability, the investor and the firm alike would have been spared the expense of an additional arbitration hearing and two judicial appeals.

CONCLUSION

Investors who find themselves in disputes with their brokers should have access to a reasoned dispute resolution process. Brokers also are entitled to a fair resolution of claims brought against them for violating the legal rights of investors. The notion that lay SRO arbitrators can apply equity and fairness rather than legal principles, while perhaps suitable in traditional intra-industry arbitrations, makes little sense in the absence of shared community values other than the law. Available evidence demonstrates that arbitrators may not consistently apply the law either because they are instructed that this is not necessary or more likely because they are incapable of understanding the complexities of many of the issues that are presented. If adopted, the recent NASD proposal to require

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273. Hardy v. Walsh Manning Sec. L.L.C., No. 02 CIV 1522(GEL), 2002 WL 2031607, at *4–7 (S.D.N.Y. Sept. 5, 2002), aff'd in part, vacated in part, 341 F.3d 126 (2d Cir. 2003). In the course of its opinion, the court noted that while arbitrators need not explain their decisions, this panel may “have said just enough to create a problem.” Id. at *5.

274. Hardy, 341 F.3d at 133–34.


276. The attorney on the panel was William Hagendorn, a partner in Birmingham Underwood LLP. Mr. Hagendorn's practice is limited to admiralty law.
explanations upon the claimant's request\textsuperscript{277} will at least increase the transparency in the SRO arbitration that is now shrouded in relative mystery. How much transparency is created will in large degree depend upon the quality of the explanations. While this NASD proposal is a positive development, alone it will do nothing to increase arbitrator competence. In fact, if the resulting explanations resemble the few opinions now available, they may serve to highlight the problem of arbitrator competence. The call for more qualified, trained arbitrators, which the SEC first made eighteen years ago, must be answered. A professional panel to handle complex legal issues is a step towards bringing law and order, and thus fairness, to NASD arbitrations.