

# Alternatives

TO THE HIGH COST OF LITIGATION

## DIGEST

INTERNATIONAL INSTITUTE FOR CONFLICT PREVENTION & RESOLUTION

VOL. 26 NO. 10 NOVEMBER 2008

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

COMMENTARY

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]



See author credits on page 190.

(continued on page 189)

[REDACTED]

[REDACTED]

[REDACTED]

**ADR BRIEF • ADR BRIEF • ADR BRIEF**

**NEW SECURITIES ADR PILOT LAUNCHES, ALLOWING INDUSTRY ARBITRATOR REMOVAL**

A program that addresses criticisms about the fairness of securities arbitration processes kicked off successfully last month, with a solid initial response from disgruntled investors seeking to opt into the pilot processes.

Officials at the Financial Industry Regulatory Authority Inc. are cautious in their early assessments, and say they will need to see not only the sign-ups, but the results of the arbitrations that come out of the two-year pilot program before permanent changes are proposed and adopted.

The authority, better known as Finra, is the oversight firm formed last year via a merger of the regulatory arms of the NASD Inc. and the New York Stock Exchange. Finra administers the arbitration and mediation for securities disputes at the markets.

Securities dispute resolution systems have been criticized for years for the alleged coziness of industry arbitrators with the broker-dealers defendants in cases where individual and business customers complain about the way their accounts were handled. The exchanges have maintained that the outcomes are fair, but the pilot program's establishment, as well as other changes, acknowledges the appearance issue regarding the so-called non-public arbitrators.

The pilot program allows plaintiffs to remove all non-public, industry arbitrators from their cases.

Critics still say it is too little, and not fast enough. "The present method of qualifying and selecting [self-regulatory organization] arbitrators is broken beyond repair and needs a complete overhaul," according to Constantine N. Katsoris, a founder of the 31-year-old Securities Industry Conference on Arbitration. SICA is a group of industry, public, and self-regulatory organization representatives that developed a

model arbitration code for broker/dealers' disputes with their customers.

In fact, the limited program doesn't address the arbitrators' qualifications, but how they constitute panels. The pilot currently allows a small number of cases to be taken by each of 11 major industry players.

Just four days after the Oct. 6 launch, the full pilot slate of 10 cases for the first year for Charles Schwab & Co. investors had been filled, according to George Friedman, a Finra executive vice president and director of arbitration. Finra is updating the number of investor complaints opting into the pilot for each provider on the program's FAQ page, accessible via the notices at [www.finra.org](http://www.finra.org). Some of the other participating broker-dealers include Edward Jones, which is taking 18 cases for each of the first two years, Merrill Lynch & Co. and Morgan Stanley, each of which will put 40 cases into each pilot year, and TD Ameritrade Clearing Inc., which will take 10 cases each year.

(continued on next page)

# ADR BRIEF • ADR BRIEF • ADR BRIEF

(continued from previous page)

The "Public Arbitrator Pilot Program" was announced in July. It allows investors in three-arbitrator cases to choose three public arbitrators, instead of the customary two public arbitrators and one non-public arbitrator.

Normally, parties in an investment dispute administered by Finra may strike four of eight names from each of two arbitrator lists, the public list and the nonpublic list.

The pilot procedure allows complainants to remove from the panel all people with industry ties and pick their panel exclusively from the public list. The relationships have been sore spots, with investors often complaining that they believe they aren't getting a fair hearing, even where industry reports and some studies show that the arbitration results reflect balanced outcomes.

Finra has adopted a variety of changes, including a focus on excluding from the public arbitrator ranks individuals with close family ties to Wall Street, and ones whose companies derive significant revenue from the securities industry.

Congress's attention to the Arbitration Fairness Act this session—which would eliminate mandatory predispute arbitration agreements, which are used regularly in broker-dealers' investors agreements—has heightened the perception that reform is needed.

Earlier this year, the market for auction rate securities collapsed when institutions stopped bidding on the floating-price debt instruments, leaving investors in limbo. The situation has added to the pressure for better ADR processes; this summer, Finra removed from consideration as industry arbitrators individuals involved in auction rate securities either personally or via their employers, retroactive to 2005.

## CORRECTION

Editor Russ Bleemer misspelled the name of Kirkland & Ellis partner Michael E. Baumann in last month's lead ADR Briefs item, "California's Top Court: This Isn't *Hall Street*, So Judicial Review Is OK," 26 *Alternatives* 175 (October 2008). He apologizes for the error.

And last month's huge stock market drop is sure to boost the number of claims Finra sees, and therefore increase scrutiny of the arbitration processes.

## Fair But Less Balanced

**The program:** The securities industry ADR administrator now allows parties to remove all industry arbitrators from panels.

**The catch:** It's a pilot, and broker-dealers will only accept handfuls of cases for the next two years.

**Will it improve perceptions?** It already has. Program sign-ups started flowing in immediately. But are the baby steps really necessary? And doesn't this miss the real issue, arbitrator qualifications?

The down 2008 stock market already has increased this year's arbitration claims filings 46%, according to Friedman, to nearly 3,500 cases through the end of September. About a quarter of those cases are related to the sub prime loan defaults and the auction rate problems, he says. The number of cases decided by arbitrators instead of settling beforehand on their own or via mediation also is rising, for the first time in a while, he says.

\*\*\*

The investors get the choice to go into the pilot, not the companies. Rick Berry, Finra vice president and director of administration, explains that investors making program-eligible filings are sent a letter giving them 25 days to opt into the program. George Friedman says that Finra senior leadership is publicizing the program with speaking events that include

a New York County Lawyers Association presentation, as well as programs before the Public Investors Arbitration Bar Association and SICA.

"I definitely want to try the pilot," says New York attorney Stuart D. Meissner, who heads a firm bearing his name that represents claimants in securities arbitration matters—individuals mostly, but occasionally businesses in intra-industry disputes. "I think it's outrageous you have to have someone who must be a member of the industry in every single arbitration. It would be like requiring in court one third of your jury to be in the same profession as the defense."

Characteristic of longtime practitioners, Meissner says the rationale for the industry arbitrators is sound even if the practice doesn't work. "It's supposedly to give an expert view of what went on in a particular case," he says, "but more often than not the particular industry arbitrator doesn't have a particular expertise in the areas as the case evolves. And what it turns into [is] someone who has an inbred bias without the expertise needed for the case. You often have the worst of both worlds."

While he says a neutral financial planner or retired compliance staffer can help an arbitration, Meissner says he usually deals with the issue by "basically put[ting] that out on the table in my summation: 'You have an inbred bias not because you are a bad person, but as a member of the industry.'"

He blames the overall issue on the classification system itself, but says he is optimistic that the pilot will help, though he says the program is too long, and the mandatory nonpublic arbitrator slot already should have been eliminated.

\*\*\*

Finra's George Friedman says pilot programs are the traditional processes for the markets' alternative dispute resolution changes, and it puts the regulators on safer ground when they are backed by supporting results. He cites the success of a pilot program that allowed parties to conduct case administration matters directly with the tribunal chair, rather than through the



# ADR BRIEF • ADR BRIEF • ADR BRIEF

market itself, as well as an abandoned 2000 pilot program allowing disputes to go to private providers—specifically, JAMS and the American Arbitration Association—rather than the SRO forums. The private provider pilot program failed because of higher fees than the SRO forums, and general comfort and familiarity with the longstanding SRO practices, according to a SICA report.

In the long run, Friedman explains, the pilot allows Finra to act quicker to develop the procedures, rather than waiting for the full administrative rulemaking process. Eventually, any new procedures adopted will need to be published in the Federal Register for comments and adopted by the U.S. Securities and Exchange Commission.

For the new pilot, the website FAQs note that Finra will analyze the percentage of investors who choose an all-public panel after electing to participate in the pilot; the results of pilot and non-pilot investor cases, including the percentage of cases that settle before award and how quickly they settle; the length of hearings; and the use of expert witnesses in pilot and non-pilot cases.

The settlement results are key to the final analysis, Friedman says. Rick Berry adds that Finra has amended its tracking procedures to better monitor the use of expert witnesses. The purpose will be to see whether parties

spend more hearing time with experts in the absence of the industry panelist.

Les Greenberg, a Culver City, Calif., attorney who has been a critic of the securities industry dispute resolution practices, is concerned about the assessment and the focus on experts. “The stated criteria indicate that Finra recognizes that ‘non-public’ arbitrators on the panels act as quasi-expert witnesses to the ‘public’ members of the arbitration panels,” he writes in an E-mail to *Alternatives*. “Finra may wish to continue the present procedure of allowing ‘non-public’ arbitrators to convey information privately to the other arbitrators without affording the parties the knowledge of that information or the ability to challenge its accuracy.”

Both Berry and Friedman say that an important part of Finra’s assessment will be feedback from its 15-member National Arbitration and Mediation Committee, which includes public members as well as securities industry professionals and ADR neutrals. (The names and affiliations can be found here: [www.finra.org/Arbitration-Mediation/AboutFINRADR/NationalArbitrationMediationCommittee/p085915](http://www.finra.org/Arbitration-Mediation/AboutFINRADR/NationalArbitrationMediationCommittee/p085915)).

\*\*\*

One veteran securities dispute resolution expert crystallizes many practitioners’ view that the fairness issues rest upon the

arbitrator criteria, and the new program won’t get to the heart of the trouble. “It doesn’t solve the problem [of] ‘Who is a public arbitrator?’” says Constantine N. Katsoris, who is one of SICA’s founders, and a professor at Fordham University Law School in New York.

“The time for mischief is over,” he says. “Let’s have a pool of extremely competent arbitrators, give [parties] a range of five to 10 peremptory challenges, and let the lawyers do their lawyering.”

Noting that the public arbitrator classification is based on a series of exclusions, Katsoris cites as problematic the restrictions on the arbitrator’s family relationships within the securities industry to remain qualified, and the calculation of his or her employer’s percentage of securities industry revenue. “I think it’s absurd,” says Katsoris, who is SICA’s current chairman. His concern is that the dollar limits and connections already sweeps aside too many potential arbitrators. “I’m on the public side,” he says—referring to his SICA role alongside the industry and SRO representatives—“but you have to have a system that is somewhat fair and enforceable.”

In a *Fordham Journal of Corporate & Financial Law* article scheduled to be published this month, “Securities Arbitrators Do Not Grow on Trees,” Katsoris writes that “[t]he time is ripe . . . to explore a more simplified system of arbitrator selection to replace the present byzantine set of rules that increasingly *micro-manage* the qualification guidelines relating to public and industry arbitrators.” (Emphasis is in the original.) He adds that the arbitrator qualifications are impractical or enforceable.

Attorney Stuart Meissner says he isn’t worried about the industry’s ability to recruit qualified public arbitrators without conflicts. But he agrees that arbitrator qualifications is where reform is most needed. “The key component and crux of the entire arbitration system is who is doing the adjudicating, and it must be the number one priority if anyone wants to espouse this forum as being a fair forum,” he concludes. ■

DOI 10.1002/alt.20251

(For bulk reprints of this article, please call (201) 748-8789.)

Cartoon by Leo Cullham



“WHEN THEY FIND OUT YOU’VE BEEN WRONGLY CONVICTED  
THEY’RE GOING TO GIVE YOU A LOT OF MONEY”