

ELEMENTS OF A FAIR AND EFFICIENT SECURITIES ARBITRATION SYSTEM

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INTRODUCTION

In January of 1996, the Arbitration Policy Task Force ("Task Force") of the National Association of Securities Dealers, Inc. ("NASD") delivered to the NASD Board of Governors its Securities Arbitration Reform Report ("Task Force Report").¹ The report presented a series of proposals for improvement of the securities arbitration system administered by the NASD subject to the oversight of the Securities and Exchange Commission ("SEC"). The Task Force expressed its belief that its recommendations would improve the fairness and efficiency of NASD arbitration. The Report has received both praise and criticism,² and the NASD has sought to implement many of its recommendations.

These comments describe a model for a fair and efficient securities arbitration system and review the suggestions for improvement to the NASD system made by the Task Force. Evaluation of the NASD model will be better accomplished in the context of a set of assumptions regarding the objectives of the parties to arbitration. Stated generally, the parties to arbitration seek a fair, relatively speedy, and relatively inexpensive means of resolving disputes. Mutually agreed binding arbitration replaces judicial means of settling disputes and offers a

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1. SECURITIES ARBITRATION REFORM, REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASS'N OF SECURITIES DEALERS, INC. (Jan. 1996) [hereinafter TASK FORCE REPORT]. The author of this article was Chairman of the Task Force. The process by which the Report was created is described in David S. Ruder, *Securities Arbitration in the Public Interest: The Role of Punitive Damages*, 92 NW. U. L. REV. 69 (1997).

2. Critical comment and some praise appears in Thomas J. Stipanovich, *Punitive Damages and the Consumerization of Arbitration*, 92 NW. U. L. REV. 1 (1997) and Constantine N. Katsoris, *The Betrayal of McMahon*, 24 FORDHAM URB. L.J. 221 (1997). See also Richard E. Speidel, *Punitive Damages and the Public Interest Model of Securities Arbitration: A Response to Professor Stipanovich*, 92 NW. U. L. REV. 99 (1997).

dispute resolution system that many argue is superior to litigation.³

I. THE NATURE OF SECURITIES INDUSTRY CUSTOMER DISPUTES

As a beginning point, securities arbitration provides an advantage over litigation because experienced arbitrators will be familiar with the types of conduct alleged to be wrongful. The most important overall concern in evaluating arbitration is whether the system is desirable for settling disputes between securities firms and their customers. These disputes usually involve easily measurable customer losses and also frequently involve disagreements regarding oral representations, fiduciary responsibilities, and customer expectations.⁴ Although the primary wrongdoer usually is the registered representative who has dealt directly with the customer, recovery is inevitably sought from the firm based upon theories of direct participation, failure to supervise, or respondeat superior.⁵

Theories of liability stem from both the securities law anti-fraud provisions and broker-dealer fiduciary duties. The conduct involved usually follows a familiar pattern characterized under recognizable headings, including:

1. false and misleading recommendations;⁶
2. recommendations made without a reasonable basis;⁷
3. guarantees against loss;⁸
4. recommendations that are not suitable to the customer's investment objectives, financial resources and needs, including recommendations regarding options or other derivative securities;⁹
5. transactions that are excessive in size and frequency (churning);¹⁰
6. unauthorized transactions;¹¹
7. stealing or misuse of the customer's funds or securities;¹²
8. market manipulation;¹³
9. failure to obtain the best execution when routing customer orders;¹⁴

3. TASK FORCE REPORT, *supra* note 1, at 7.

4. The most comprehensive set of regulatory rules relating to broker dealer conduct with regard to customers is the NATIONAL ASS'N OF SEC. DEALERS, NASD CONDUCT RULES 2100-3380 (1997) [hereinafter NASD CONDUCT RULES].

5. See generally ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD 15:1-15:371 (1997).

6. NASD CONDUCT RULES, *supra* note 4, at IM-2310-2(b)(4)(B).

7. SEC Rule 10b-5, codified at 15 U.S.C. § 78j (1994).

8. NASD CONDUCT RULES, *supra* note 4, at 2330(e).

9. *Id.* at 2310(a).

10. *Id.* at IM-2310-2(b)(2).

11. *Id.* at IM-2310-2(b)(4)(A)(iii).

12. *Id.* at IM-2310-2(b)(4)(A)(iv).

13. Securities Exchange Act of 1934 § 9, 15 U.S.C. § 78j (1994).

14. NASD CONDUCT RULE *supra* note 4, at 2320.

10. trading ahead of customer limit orders,¹⁵ customer block trades,¹⁶ or firm research reports;¹⁷
11. switching customer investments between various mutual funds;¹⁸
12. entering into transactions with customers that are not reasonably related to the current market price of the security (unfair mark-ups);¹⁹
13. excessive commissions;²⁰
14. mishandling of margin accounts;²¹
15. violation of prospectus delivery requirements.²²

Although allegations of broker dealer wrongdoing involve a fairly broad range of conduct, all of the allegations involve securities industry practices. Resolution of customer disputes is therefore likely to be better if the persons resolving the disputes are familiar with the securities industry. This premise provides a strong rationale for a securities arbitration system in which the arbitrators are familiar with securities industry practices. As a means of providing securities industry expertise, the NASD permits appointment of one securities industry arbitrator to each panel of three arbitrators.²³ The Task Force Report recommended increased arbitrator training.²⁴

II. NASD INDEPENDENCE

Critics of the NASD arbitration system frequently complain that the system is inherently unfair because it is administered by the NASD, whose members are securities firms who will be defendants in securities arbitration. In this sense, the system inherently involves an appearance of impropriety. One answer to the critics is that the SEC oversees the arbitration system through approval of rule proposals and its regular inspection program.²⁵ A second answer is that the NASD, through NASD Regulation, Inc., has separated administration of its arbitration program from its Nasdaq Stock Market operation and thus has created an independent securities arbitration system.²⁶

A third and equally important response to the independence question is that if the arbitrators are selected by the parties to the arbitration, are well-

15. *Id.* at IM-2110-2.

16. *Id.* at IM-2110-3.

17. *Id.* at IM-2110-4.

18. *Id.* at IM-2310-2(b)(3).

19. *Id.* at IM-2440.

20. *Id.*

21. *Id.* at 2520.

22. Securities Exchange Act of 1933 § 5, 15 U.S.C. § 77e (1994).

23. NATIONAL ASS'N OF SEC. DEALERS, CODE OF ARBITRATION PROCEDURE, Rule 10308 (1997) [hereinafter NASD CODE OF ARBITRATION PROCEDURE].

24. TASK FORCE REPORT, *supra* note 1, at 109.

25. Ruder, *supra* note 1, at 71-74.

26. As recommended by the TASK FORCE REPORT, *supra* note 1, at 151-53.

qualified, are well-trained, and are subject to evaluation, the arbitrators will provide adequate protection against charges of bias or incompetence. In fact, the arbitrators are central to the success of the system.²⁷

III. ARBITRATOR SELECTION, QUALITY, TRAINING, AND PERFORMANCE

The process for selection of arbitrators should have two goals: first, the selection of unbiased, competent, experienced arbitrators, and second, opportunity for the parties to participate in arbitrator selection.

The Task Force struggled with the question whether arbitrators should be professionals who could bring expertise and procedural consistency to the arbitration process or whether they should be lay persons who would provide the informal and equitable characteristics customarily associated with arbitration. The Task Force recommended that arbitration panels continue to be composed of one industry member with knowledge and expertise regarding brokerage firm operation and securities matters and two public arbitrators.²⁸ In recognition of the increasing procedural and substantive complexity of securities arbitration, the Task Force also recommended that panel chairs "should be required to demonstrate a strong command of NASD arbitration procedure and general arbitration techniques, as well as familiarity with industry practices and substantive law."²⁹ This conclusion was reached despite the probability that as a result the NASD arbitrators would become more professional.

In order to enhance arbitrator competency, the Task Force also recommended increasing arbitrator compensation,³⁰ expanding the arbitrator pool,³¹ increasing the scope, frequency, and quality of mandatory arbitrator training,³² and requiring arbitrator evaluation of co-panelists.³³ If these steps are taken, the quality of arbitrators and the quality of arbitration should improve.

Even more important than arbitrator competency is lack of bias, accompanied by the parties' belief that the selection process is fair. Observing that the parties have limited input on the choice of arbitrators, the Task Force recommended that the NASD implement a list selection system similar to that used by the American Arbitration Association.³⁴ Under this system, the parties would be presented with three separate lists of candidates. The first would contain the names of three or more public arbitrators qualified to be panel chairs; the second, the names of five or more other public arbitrators; and the third, the names of five or more industry arbitrators. The parties would be given the opportunity to rank the

27. *See id.* at 93-113.

28. NASD CODE OF ARBITRATION PROCEDURE, *supra* note 23, at Rule 10308.

29. TASK FORCE REPORT, *supra* note 1, at 111.

30. *Id.* at 104.

31. *Id.* at 104-07.

32. *Id.* at 109-12.

33. *Id.* at 101.

34. *Id.* at 94.

names on the list and to strike those who were unacceptable. This process would continue for three rounds before the NASD Arbitration Department would be empowered to appoint the arbitrators. The Task Force recognized that in the near future there might not be enough qualified persons to allow three selection rounds. It urged the use of a modified list system in the near future and the full list selection process in the long run.

IV. THE THREE TIER SYSTEM

For the most part, customer claims in the securities arbitration system are relatively small. Substantial numbers of arbitration claims seek damages, exclusive of punitive damages, in amounts less than \$50,000. These claims are so small that the customer will expend considerable portions of any recovery on legal fees. In recognition of the desirability of providing expedited procedures for small claims, the NASD utilizes a three tier system. The Task Force supported that system and made minor suggestions for change. It recommended that the ceiling for simplified arbitration that permits a single arbitrator to decide matters without a hearing be raised from \$10,000 to \$30,000; that the standard rules requiring three arbitrators be applied to all claims in excess of \$30,000 (except for claims not exceeding \$50,000 which would be decided by a single arbitrator unless one of the parties objected); and that the NASD's voluntary pilot program for large and complex cases be continued.³⁵ The simplified arbitration system offers opportunity for efficient disposition of small claims, and the program for large and complex cases recognizes that some cases may require procedures more like those present in court litigation.

V. PROCEDURAL FAIRNESS, EFFICIENCY, AND SPEED

With regard to standard arbitration, the Task Force made a series of recommendations designed to increase the fairness, speed, and efficiency of the arbitration process. It noted that NASD arbitration has become too litigious and that procedural matters were not being settled with the desirable efficiency. It recommended that:

1. parties be required to produce essential documents early in the process without awaiting a discovery request;³⁶
2. document and information requests be limited, and that depositions be permitted only in exigent circumstances;³⁷
3. arbitrators and panel chairs be selected earlier,³⁸ play a much greater role in the discovery process,³⁹ enforce sanctions for non-compliance with the discovery rules,⁴⁰ make determinations on statutes of

35. *Id.* at 71-76.

36. *Id.* at 82-83.

37. *Id.* at 84-86.

38. *Id.* at 91-92.

39. *Id.* at 86.

40. *Id.* at 87-88.

limitations⁴¹ and other dispositive issues,⁴² and supervise all other aspects of the arbitration process.

These suggested improvements in the procedural aspects of the securities arbitration system should increase fairness, speed, and efficiency. Placing greater responsibility on the arbitrators to resolve problems should also help to avoid claims that the NASD arbitration process is dominated by the NASD staff.

VI. COSTS

A securities arbitration system substitutes private dispute resolution for a state or federal judicial system. The choice of a private system means that a non-governmental means of meeting costs must be established. The NASD finances its arbitration system through a combination of arbitrator related fees and general assessments on all member firms. The Task Force recommended an increase in the NASD budget,⁴³ with the member firms bearing a significantly greater portion of the increased costs.⁴⁴ In combination with lower legal fees associated with expedited arbitration, the cost to the claimant is certainly no greater than would be the case in court litigation.

VII. MEDIATION AND EARLY NEUTRAL EVALUATION

The Task Force Report recognized the NASD's efforts to promote mediation, a voluntary, non-binding system in which a mediator assists the parties in obtaining a mutually acceptable settlement.⁴⁵ It also identified early neutral evaluation, in which a skilled evaluator examines the dispute and offers each party a neutral evaluation of the strengths and weaknesses of that party's case, hopefully improving the chances for settlement based upon realistic understandings of the chances for success.⁴⁶

The Task Force endorsed both systems for dispute resolution. It recommended that the NASD expand the voluntary mediation program⁴⁷ and initiate a two year pilot early neutral evaluation program.⁴⁸ Both programs should be helpful in assisting parties to resolve their disputes without resort to binding arbitration. These processes are not regularly available in judicial systems.

VIII. THE SIX YEAR ELIGIBILITY RULE

Securities arbitration in the NASD is subject to an "eligibility rule" providing that no claim will be eligible for arbitration if six years have elapsed

41. *Id.* at 31.

42. *Id.* at 86.

43. *Id.* at 143.

44. *Id.* at 144.

45. *Id.* at 47-50.

46. *Id.* at 51.

47. *Id.* at 54-55.

48. *Id.* at 56.

from the event or occurrence giving rise to the dispute.⁴⁹ This rule operates much like a statute of limitations and has fostered extensive litigation, created great uncertainty, greatly increased the burdens on the NASD staff, and contributed to the erosion of investor confidence in the arbitration process.⁵⁰

The Task Force regarded the eligibility rule as a strong impediment to the goals of fairness, efficiency, and speed. It recommended that the rule be suspended for a three year period and replaced by "procedures to resolve dispositive motions on statute of limitations grounds."⁵¹ This recommendation resulted in substantial concern regarding reliance on statutes of limitation,⁵² which in turn resulted in a substitute NASD proposal.⁵³ Hopefully, the new NASD proposal will help to solve the vexing problems created by the six year eligibility rule. The goal is the same—to reduce the procedural complexity of the arbitration system.

IX. PUNITIVE DAMAGES

The most controversial recommendation in the Task Force Report was the recommendation that punitive damage awards be limited to "the lesser of two times compensatory damages or \$750,000."⁵⁴ This recommendation was designed to solve the vexing problems caused by the inclusion of punitive damages claims in more than fifty percent of all cases filed in NASD arbitration.⁵⁵ The possibility that extremely large punitive damages may be awarded against a brokerage firm usually causes the firm to treat arbitration as major litigation that must be addressed with all available weapons, including use of procedural devices. Lawyers for customers respond with equally combative measures.⁵⁶

Arguments for and against punitive damages are forceful. Proponents of punitive damages argue that punitive damages should be available in arbitration if they are available in a judicial forum and that punitive damages provide important curbs on customer abuse by brokerage firms.⁵⁷ The firms, on the other hand, argue that punitive damages are inappropriate in an arbitration system that does not provide a right to trial by jury, has no written opinions, and has limited rights to appeal.⁵⁸

The punitive damages cap is but one of a number of the recommendations made by the Task Force for the purpose of improving a securities arbitration system that provides a fair, efficient, timely, and relatively low cost means of resolving investor disputes with their brokers. While undoubtedly not acceptable to

49. NASD CODE OF ARBITRATION PROCEDURE, *supra* note 23, at Rule 10304.

50. Ruder, *supra* note 1, at 79-81.

51. TASK FORCE REPORT, *supra* note 1, at 28.

52. See Ruder, *supra* note 1, at 80.

53. Submitted on June 24, 1997 to the SEC as SR-NASD-97-44: Amendment to Eligibility Rule (NASD CODE OF ARBITRATION PROCEDURE, Rule 10304).

54. TASK FORCE REPORT, *supra* note 1, at 42.

55. *Id.* at 40.

56. *Id.*

57. Ruder, *supra* note 1, at 88-89.

58. *Id.* at 89.

all parties, the suggested punitive damages solution is a fair compromise, and it is crucial to avoiding litigious behavior that interferes with the goals and operation of the securities arbitration system.⁵⁹

X. THE ROLE OF CHOICE

Critics of the securities arbitration system argue that free choice is not available to predispute arbitration agreements because firms do not accept customers who do not want to waive their rights to litigate disputes in court.⁶⁰ Firms note that NASD rules require them to arbitrate customer disputes,⁶¹ so that imposing a similar requirement on customers is not unfair.

The Task Force recognized the argument that customer choice is restricted but nevertheless recommended that the industry should be permitted to continue to utilize predispute arbitration agreements.⁶² The Task Force's first reason was its conclusion that under NASD Rules customers are fairly placed on notice that they are entering into an arbitration agreement and are informed regarding most of the consequences of that agreement.⁶³ Nevertheless, the Task Force recommends the following enhancements to increase investor awareness: (1) an express statement that the Federal Arbitration Act governs securities arbitration;⁶⁴ (2) uniform provisions on critical substantive and procedural issues;⁶⁵ (3) a "plain English" language requirement;⁶⁶ and (4) additional disclosures about legal and procedural differences between court litigation and arbitration, with specific notice regarding the effects of the predispute arbitration agreements on choice of law provisions, collateral court litigation, and punitive damages.⁶⁷

A second and more important reason underlying the recommendation that predispute arbitration be allowed is the belief that securities arbitration provides clear and significant advantages over the civil litigation system. I believe careful comparison of the NASD securities arbitration system with the judicial litigation system supports that contention.

CONCLUSION

These comments do not discuss the steps that the NASD has taken to implement the recommendations of the Task Force. Rather, they stand as a strong reminder of those recommendations and demonstrate the confidence of the Task Force that the NASD, with the oversight of the SEC, will utilize them for the

59. See Ruder, *supra* note 1, at 95–98.

60. TASK FORCE REPORT, *supra* note 1, at 12–13.

61. NASD CODE OF ARBITRATION PROCEDURE Rule 10201, *supra* note 23.

62. TASK FORCE REPORT, *supra* note 1, at 17–18.

63. *Id.* at 19.

64. *Id.*

65. *Id.*

66. *Id.* at 20.

67. *Id.*

purpose of providing a fair, efficient, and speedy securities arbitration system in the public interest.

