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Barbara Black
Pace Law School

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Is Securities Arbitration Fair to Investors?

Barbara Black*

Most disputes between customers and their brokerage firms or their salespersons are resolved through arbitration before the National Association of Securities Dealers Dispute Resolution, Inc. (NASD)[1] or the New York Stock Exchange (NYSE),[2] as a result of the Supreme Court's holding in *Shearson/American Express, Inc. v. McMahon*.[3] The *McMahon* Court held that predispute arbitration agreements (PDAAs) contained in customer agreements are enforceable.[4] It concluded that the current arbitration process provided adequate means of enforc-

* James D. Hopkins Professor of Law, Lecture at Pace University School of Law (Feb. 12, 2004).

1. NASD Dispute Resolution, Inc. is a subsidiary of the National Association of Securities Dealers, Inc. (hereinafter NASD) that administers its dispute resolution services. Since the NASD operates the largest dispute resolution forum in the securities industry, I focus on its procedures.

2. Both the NYSE and the NASD are Self-Regulatory Organizations (SROs) as defined in Section 3(a)(26) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(26) (1994).

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

4. *Id*. at 338.

ing federal statutory rights, and by this reasoning a PDAA was the equivalent of a choice of forum clause.[5] *McMahon* was part of two larger trends of the Supreme Court: the Court's general pro-arbitration trend,[6] and its efforts to remove private securities fraud claims from federal court.[7] While the Securities and Exchange Commission (SEC) filed an *amicus curiae* brief in support of securities arbitration, many investor advocates viewed *McMahon* as anti-investor,[8] a view that continues to have support today.

This is an assessment of the current securities arbitration process from the perspective of an investor advocate. In my view, investors may fare better in arbitration than in litigation.[9] Accordingly, the trend to transform securities arbitration into a more judicial process may not be advantageous to investors. There are additional reasons to be concerned about the securities arbitration structure created in response to *McMahon* in light of the proliferation of securities arbitration claims and the demands they place on the current system. Finally, I conclude by addressing the special concerns of the small claims investors.

5. *See id.* at 229-30.

6. *See, e.g.*, Southland Corp. v. Keating, 465 U.S. 1, 10 (1984) (stating that Federal Arbitration Act (FAA) "declared a national policy favoring arbitration"); Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 27-35 (1991) (holding that employment discrimination and statutory age discrimination claims were arbitrable); Green Tree Fin. Corp.–Ala. v. Randolph, 531 U.S. 79, 89-91 (2003) (holding that unsupported assertions that arbitration costs were prohibitive were insufficient to make PDAA in consumer financing agreement unenforceable).

7. *See* Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 415 (2003). I develop many of the ideas sketched out here further in this article. *See generally id.* at 444-53.

8. *See* Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 993 (2002).

9. Arbitration of employment and consumer disputes, in my view, presents greater policy concerns than arbitration of investors' disputes. Given the universality of PDAAs in customer agreements, retail investors realistically have no choice but to agree to arbitration if they wish to purchase securities; they can, however, pursue alternative investment opportunities. In contrast, most people have to work, and many people have to finance life's necessaries; the law should be especially vigilant that these individuals' legal remedies are not curtailed.

Fairness

How can we determine whether securities arbitration is fair to investors? In recent years, customers have been awarded damages in slightly more than fifty percent of the arbitration cases that are decided by arbitrators.[10] This statistic, unfortunately, tells us nothing, since we do not know the merits of any claims, we do not know what amount the "winning" claimants were requesting, and we do not know the outcomes of the many claims that are settled.[11] An informative analysis might be a comparison of the results in securities arbitration with those obtained in either litigation or other arbitration forums. Unfortunately, the U.S. General Accounting Office (GAO) concluded in 2000 that it had no basis to make any such comparisons because caseloads were too small in alternative forums.[12]

There is some empirical support that claimants' attorneys find the Self-Regulatory Organization (SRO) arbitration process sufficiently fair not to seek out other *arbitration* forums. When the Securities Industry Conference on Arbitration (SICA)[13] recently initiated a two-year pilot program offering non-SRO alternatives, there were few participants, and the program was discontinued.[14] In addition, a NASD-sponsored survey of participants in its arbitration forum over a two-year period found the process fair.[15] There is consensus, however, that an inde-

10. NASD Dispute Resolution Statistics, *Results of Customer Arbitration Claims*, *at* http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&nodeId=516&ssSourceNodeId=12 (last updated Sept. 27, 2004).

11. NASD Dispute Resolution Statistics, *How Arbitration Cases Close*, *at* http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&nodeId=516&ssSourceNodeId=12 (last updated Oct. 27, 2004).

12. *See* U.S. GEN. ACCOUNTING OFFICE, REP. NO. GGD-00-115, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS 4-5 (2000), *available at* http://www.gao.gov/new.items/gg00115.pdf.

13. SICA consists of representatives of the SROs, the public and the Securities Industry Association and develops proposals for uniform securities arbitration procedures. *See* Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 488-90 (1996).

14. *See* SEC. INDUS. CONFERENCE FINAL REPORT — PILOT PROGRAM FOR NON-SRO-SPONSORED ARBITRATION ALTERNATIVES (undated) (on file with author).

15. *See* Gary Tidwell et al., *Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations* (Aug. 5, 1999), *available at* http://www.nasd.com/stellent/groups/med_arb/documents/mediation_arbitration/nasdw_009528.pdf.

pendent study of investors' perceptions of the securities arbitration process is warranted.[16]

Absent empirical data, we must explore whether there exists an abstract model of a fair process for resolving disputes between customers and their brokers. In fact, there are two competing models. The first is the traditional model of arbitration where the parties contract for an equitable, informal, and confidential proceeding.[17] The second model, in contrast, assumes that arbitration must at least approximate, if not replicate, litigation. The *McMahon* Court may have assumed the second model when it equated PDAAs with forum selection clauses.[18]

Adherents of the first model attribute its benefits to its *dissimilarity* from litigation. This model has a venerable history dating back to the origins of the NYSE, where members met informally to resolve their disputes. Prior to *McMahon*, this was the operative model at the SROs, where the arbitration procedures were informal and largely aspirational, emphasizing cooperation among the parties.[19]

This model is very attractive if its original premise – that arbitration is the product of a genuine bargain – is accepted. Reality, however, compels the recognition that the PDAA in the customer agreement, like arbitration clauses in consumer and employee agreements more generally, is contained in a standard-form contract where the average retail customer has no choice, since all brokerage firms today include PDAAs in their customer agreements. The SEC, SICA and the SROs recognized that *McMahon* required revision of the securities arbitration process. The SEC pushed for a litigation model, while SICA and the SROs resisted this transformation of the arbitra-

16. *See* Michael A. Perino, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATIONS 33-37 (Nov. 4, 2002), *available at* http://www.sec.gov/pdf/arbconflict.pdf.

17. For an expression of this view, see Robert S. Clemente & Karen Kupersmith, *Pillars of Civilization: Attorneys and Arbitration*, 4 FORDHAM FIN. SEC. & TAX F. 77, 79-80 (1999). Mr. Clemente and Ms. Kupersmith are the former and current Directors of Arbitration at the NYSE, respectively.

18. *See supra* note 6 and accompanying text.

19. *See* Black & Gross, *supra* note 8, at 997.

tion process.[20] In many ways, the SEC won that debate; since *McMahon*, securities arbitration procedures have become more formal, leading a well-respected panel appointed by the NASD to review its procedures to express concern in 1996 that "the increasingly litigious nature of securities arbitration has gradually eroded the advantages of SRO arbitration."[21]

This ongoing debate over the competing models, with thoughtful, well-reasoned positions on both sides, complicates the task of assessing whether investors are treated fairly in the securities arbitration process.

In my view, securities arbitration is a fairer process than many consumer/employee arbitration processes that, because of the Supreme Court's view of preemption,[22] states cannot adequately regulate.[23] Since the SEC has oversight over the SROs and must approve every SRO rule, it has, even before *McMahon*, looked out for investors in revisions to the SRO arbitration rules.[24] I use the components identified by scholars as necessary for procedural fairness in consumer arbitration[25] in this evaluation of the NASD arbitration process.

The NASD procedures are fair with respect to the following components: reasonable notice that the customer is entering a PDAA,[26] right to representation of counsel,[27] right to present ev-

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20. For more detailed discussion of the post-*McMahon* revisions and the positions of the SEC and the SROs, see Black & Gross, *supra* note 8, at 999-1005.

21. NAT'L ASS'N OF SEC. DEALERS, SECURITIES ARBITRATION REFORM REPORT OF THE ARBITRATION POLICY TASK FORCE 7 (1996).

22. Since the Federal Arbitration Act (FAA) applies to arbitration agreements in interstate commerce, states cannot adopt laws that conflict with the FAA's purpose of putting arbitration agreements on an equal footing with all contracts. *See* Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 683 (1996) (holding that the FAA preempted a state law requiring arbitration agreements to have disclosure provisions).

23. For a textbook example of an unfair employment arbitration process, see Hooters of Am., Inc. v. Phillips, 173 F.3d 933, 935 (4th Cir. 1999) (refusing to enforce arbitration clause where the process lacked "the rudiments of even-handedness").

24. *See* Black & Gross, *supra* note 8, at 998-1003.

25. *See, e.g.*, Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TUL. L. REV. 1, 85-98 (1997).

26. *See* NAT'L ASS'N OF SEC. DEALERS, CONDUCT RULES R. 3110(f) *Books and Records (Requirements When Using Predispute Arbitration Agreements with Customers)* (2003), *available at* http://www.cchwallstreet.com/nasd/nasdviewer.asp?

idence,[28] right to present one's case in a convenient geographic forum,[29] and right to adequate relief.[30] I do not intend to discuss these further, but they are all important components of fairness not always found in other consumer/employee arbitrations.

More problematic are the following components:

1. The cost of arbitration. Is it fair to require employees and consumers, including investors, to pay forum fees? Courts generally have low filing fees and waive the fees for those unable to pay them; in contrast, securities arbitration forum fees are based on the amount of claimed damages and the number of hearing sessions and can be significant.[31] The Supreme Court has acknowledged that excessive arbitration fees may unfairly deny consumers access to the forum.[32] In addition, some circuit and state courts have held that in employment disputes where the charge is illegal statutory discrimination, the employer must pay the forum fees.[33] To date, however, courts have not been sympathetic to this argument in the context of securities arbitrations, at least where the investor had a sizable investment portfolio.[34] Moreover, both the NYSE and the NASD have proce-

SelectedNode=3&FileName=/nasd/nasd_rules/RulesoftheAssociation_mg.xml#chp_1_3.

27. *See* NAT'L ASS'N OF SEC. DEALERS, CODE OF ARBITRATION PROCEDURE, R. 10316 (2003), *available at* http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&nodeId=537 [hereinafter NASD CODE 2003].

28. *See* NASD CODE 2003, *supra* note 27, R. 10323.

29. *See* NASD Notice to Members 95-16, *Predispute Arbitration Clauses in Customer Agreements*, 1995 WL 1712330 (National/Federal) (Mar. 1995).

30. Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995) (holding that arbitrators have the power to award punitive damages). The securities industry has consistently fought against punitive damages awards, most recently by arguing that the due process limits of BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996) and State Farm Mut. Auto Ins. Co. v. Campbell, 538 U.S. 408 (2003) are applicable in arbitration. For a judicial acceptance of this view, see Sawtelle v. Waddell & Reed, Inc., 754 N.Y.S.2d 264 (N.Y. App. Div. 2003).

31. *See* NASD CODE 2003, *supra* note 27, R. 10332.

32. *Green Tree Fin. Corp.–Ala.*, 531 U.S. 79.

33. *See, e.g.,* Cole v. Burns Int'l Sec. Servs., 105 F.3d 1465, 1483-85 (D.C. Cir. 1997); McManus v. CIBC World Mkts. Corp., 134 Cal. Rptr. 2d 446, 457-58 (Cal. Ct. App. 2003).

34. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Coe, 313 F. Supp. 2d 603 (S.D. W. Va. 2004); Ritch v. Eaton, No. CIV.A.02-7689, 2002 WL 32107628 (E.D. Pa. Dec. 9, 2002).

dures for fee waivers,[35] and arbitrators can allocate the costs among parties as they deem appropriate.[36]

2. Unbiased decision maker. Most arbitration panels consist of three members, one of whom is an industry representative.[37] Participants select the panel members from computer-generated lists,[38] a recent innovation and an improvement over the past practice where the NASD selected the panelists. There remain, however, three issues about the arbitrator selection process:
   A. The presence of an industry arbitrator. Consumer advocates, looking to the judicial model of an independent decision-maker, question the fairness of a tribunal where one panelist is a member of the securities industry. One of the benefits associated with the arbitration model, however, is decision making by those knowledgeable in the field, and the industry arbitrator provides that expertise. The SEC has not questioned the presence of an industry arbitrator, and at least one independent arbitration forum saw value in industry expertise.[39] Experienced investors' attorneys are divided on this issue.
   B. The "Repeat Player" problem. The dangers of the "repeat player" in arbitration are well recognized; the defendants who regularly use the forum will select arbitrators who decide in their favor, and arbitrators who want to be selected for more arbitrations will curry favor with the repeat players by deciding cases favorable to them. SRO securities arbitration may differ from many other arbitration forums, however, in that the arbitrators' compensation is well below market rate for comparable services.[40] While it is plausible to

35. *See* NASD CODE 2003, *supra* note 27, R. 10332(a).

36. *See* NASD CODE 2003, *supra* note 27, R. 10332(c).

37. *See* NASD CODE 2003, *supra* note 27, R. 10308(b)(1)(B).

38. *See* NASD CODE 2003, *supra* note 27, R. 10308.

39. Before the American Arbitration Association (AAA) effectively ceased operating as a securities arbitration forum, it also classified arbitrators as neutral or industry parties. Effective July 1, 1999, the AAA suspended its securities arbitration rules. *See* AM. ARBITRATION ASS'N, *Supplementary Procedures for Securities Arbitration*, *available at* http://www.adr.org (last visited Oct. 13, 2004).

40. NASD arbitrators are paid $200 for each hearing session (consisting of no more than four hours); a business day typically consists of two hearing sessions.

believe that the brokerage firms strike arbitrators they deem too investor-friendly, it is also plausible to believe that at least those claimants who are represented by experienced counsel strike arbitrators who consistently decide in favor of the industry. As a result, panels frequently consist of arbitrators whom neither party selected.

C. Are public arbitrators truly neutral? There is concern that some arbitrators who are classified as public have present or past connections with the securities industry that call into question their impartiality. The NASD has responded with these concerns by recently tightening the requirements for being a public arbitrator.[41]

In sum, while the NASD procedures have improved considerably, parties can reasonably disagree about the extent to which arbitrators are impartial.

3. Right to Adequate Discovery. Under the NASD procedures, investors have the right to adequate discovery.[42] In actuality, investors may have difficulty obtaining the relevant documents because of blatant disregard of the discovery rules by brokerage firms. Discovery abuses and, more generally, disregard of the forum's procedures may be more prevalent in arbitration than in litigation, because of the differences between arbitrators and judges. Arbitrators, with their occasional service for minimal compensation, may not have either the backbone or the incentive to ensure compliance with the forum's rules in the face of a recalcitrant brokerage firm. Similarly, firms may not have either the respect or the fear of arbitrators that they have toward judges. The practice is so widespread that the NASD recently has taken steps to publicize the problem and reinforce the power of arbitrators to impose substantial

The chair of the panel receives a $75 honorarium per day. *See* NASD CODE 2003, *supra* note 27, IM-10104 (Arbitrators' Honorarium).

41. *See* NASD CODE 2003, *supra* note 27, R. 10308, 10312 (effective July 19, 2004).

42. *See* Self-Regulatory Organizations, Order Granting Approval to Proposed Rule Change by National Association of Securities Dealers, Inc. Creating a Discovery Guide for Use in NASD Arbitrations, 64 Fed. Reg. 49256 (Sec. Rel. No. 34-41833) (Sept. 10, 1999).

sanctions for abuses.[43] It remains to be seen whether these actions will cure the problem.

4. Right to Know Something of the Arbitrator's Rationale. Some knowledgeable observers of the securities arbitration process are critical of the fact that most awards do not provide reasons for the panel's decision. While it is frustrating to lose a significant decision without explanation, realistically a losing party benefits from an explanation only if it provides him with a basis for appeal on the merits.

I recognize that there may be other less tangible and more general benefits if arbitrators are required to give reasons. Requiring arbitrators to give even a brief explanation of their reason can provide a curb against irrational results. Well-intentioned, but time-pressured arbitrators may be too quick to arrive at a decision that initially seems right to them; requiring them to give reasons will provide discipline to help ensure that their decision is well-founded.[44] Another benefit is that parties who are selecting arbitrators will have a basis for better selection if they know more than simply the outcome of previous claims decided by the arbitrator. Finally, and more generally, since arbitrators are playing an important role in a securities arbitration process where it is important that all participants have confidence in the system, there should be more transparency in the decision making process.[45]

The above arguments do have considerable force. Their benefits must be balanced against two related practical difficulties. The first is that the arbitrators do not get paid for writing opinions; their honorarium is based on the number of hearing sessions. While the compensation structure could be revised, it is unlikely that arbitrators would be sufficiently compensated

43. *See* NASD Notice to Members 03-70, Discovery, NASD Reminds Members of Their Duty to Cooperate in Arbitration Discovery Process (Nov. 2003), *available at* http://www.nasdr.com/pdf-text/0370ntm.pdf; NASD, *Discovery Sanctions Rule*; *Accelerated Effectiveness Requested*, File No. SR-NASD-2004-088 (June 8, 2004), *available at* http://www/nasdadr.com/pdf-text/rf04_88.pdf.

44. This argument is similar to the argument that corporate procedure can improve the quality of decisions made by a board of directors. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

45. Another benefit sometimes mentioned is that reasoned awards provide an opportunity for arbitrators to set forth their views on industry practices. This raises a larger issue: whether awards should become the equivalent of judicial opinions.

for the time necessary to craft a reasoned award. The second difficulty, as lawyers know, is that it is more difficult and takes more time to write succinctly and unambiguously. A brief explanation, that to the arbitration panel and perhaps to the parties themselves is clear, may seem ambiguous and confusing from the distance of a reviewing court.

5. Right to Judicial Review. There are very limited grounds for judicial review of arbitration awards, which is consistent with the premise of arbitration that the parties agreed to a binding and final nonjudicial dispute resolution process. Under the FAA, the bases for vacating an award relate to arbitrator misconduct; there is no basis for review of the merits.[46] The Supreme Court has several times referred, without elaboration, to a non-statutory "manifest disregard of the law" standard.[47] To vacate an award because of "manifest disregard," as articulated by the Second Circuit,[48] the party must show, first, that the applicable law is "well defined, explicit, and clearly applicable"[49] and, second, that the arbitrator "appreciate[d] the existence of a clearly governing legal principle but decide[d] to ignore or pay no attention to it."[50] Under this test, the manifest disregard standard is less a review of the merits than another form of arbitrator misconduct – situations where the arbitrators "willfully flouted" the law.[51]

There is, in fact, a great debate over whether arbitrators have to apply the law. In the traditional model of arbitration, arbitrators were expected to do equity and a compromise might be the best result. Under New York law, for example, unless the parties agree otherwise, arbitrators are not bound by the

46. 9 U.S.C. § 10(a)(1)-(4) (2003).

47. The Court first referred to the standard in Wilko v. Swan, 346 U.S. 427, 436-37 (1953), *overruled by* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989), and relied on it in *McMahon* as providing some assurance that investors' statutory rights would be upheld. *McMahon*, 482 U.S. at 233. Another Supreme Court opinion, First Options of Chicago, Inc v. Kaplan, 514 U.S. 938, 942 (1995) also refers to the manifest disregard standard as applicable to securities arbitration awards, again without explanation.

48. Westerbeke Corp. v. Daihatsu Motor Co., 304 F.3d 200, 218 (2d Cir. 2002).

49. *Id.* at 209 (quoting Merrill Lynch v. Bobker, 808 F.2d 930, 934 (2d Cir. 1986)).

50. *Id.* (quoting *Merrill Lynch*, 808 F.2d at 933).

51. *Id.* at 217 (quoting *Merrill Lynch,* 808 F.2d at 933).

law.[52] In contrast, the *McMahon* Court assumed that courts would apply the law,[53] an assumption, however, that is difficult to disprove.

If arbitrators do not give reasons for their awards, it is hard to establish manifest disregard, since a court has to posit that there is no scenario under which the outcome is possible. If, however, the practice develops of arbitrators writing reasoned awards, then it seems likely that courts may begin examining those reasons and conducting a review on the merits. A recent case provides an excellent example of this problem. In *Hardy v. Walsh Manning Securities, LLC*, the arbitration panel found both the firm and the CEO "jointly and severally liable . . . based on the principles of respondeat superior."[54] The district court confirmed the award even though, under black letter law, an employee cannot be held liable on respondeat superior principles, because it found substantial evidence in the record of the CEO's personal involvement in the wrongdoing.[55] The Second Circuit, however, vacated the award as to the CEO and directed a remand to the arbitration panel for clarification of the grounds for imposing liability on the individual, emphasizing that "substantial financial liability should not be imposed upon an individual without a clear basis in law."[56]

While the perception is that judges rarely vacate awards on manifest disregard grounds, my own research leads me to conclude that courts are vacating awards on this basis more frequently, often at the instance of the brokerage firm or individual broker to set aside large customers' awards.[57] Adherents of the judicial model of arbitration may welcome increased judicial review of the merits, but if this trend marks the first step toward viewing arbitration forums like minor league

52. Silverman v. Cooper, 61 N.Y.2d 299, 308 (1984) (citing Lentine v. Fundaro, 29 N.Y.2d 382 (1972)).

53. 482 U.S. 220.

54. 341 F.3d 126, 128 (2d Cir. 2003).

55. *Id*. at 129.

56. *Id.* at 134. On remand, the arbitration panel clarified that it found the CEO primarily liable and intended to impose respondeat superior liability only on the firm. Hardy v. Walsh Manning Sec., Arbitrators' Response (Nov. 10, 2003) (copy on file with author).

57. *See, e.g.*, Wallace v. Buttar, 239 F. Supp. 2d 388 (S.D.N.Y. 2003). This case, and others, are discussed in Black, *supra* note 7, at nn. 140-48 and accompanying text.

courts, that would be a serious erosion of the initial premise of arbitration.

From the investors' perspective, the great advantage of the SRO equitable model of arbitration is that arbitrators may be able to find a remedy for investors that is not supported by the law. Federal securities law, in particular, is not investor-friendly; the Second Circuit, for example, held that a widow with a tenth grade education and no prior investment experience should have read and understood the prospectus for a limited partnership interest recommended by her broker.[58] In addition, brokerage firms will assert that exculpatory language in the customers' agreements reduces their liability. For these reasons, investors are frequently better off in an equitable forum.[59]

Is It Time for Professional Arbitrators?

All the aspects of fairness discussed above relate to the central conundrum of securities arbitration today: Can a quasi-judicial process work effectively without "quasi-judges," decision-makers who would be more like judges than the current NASD arbitrators? Arbitrators are not required to have legal training or to know the applicable law, and, unlike judges, they do not have law clerks to research the law. As they are assigned individual cases and work on a piecemeal basis, they have neither the resources nor much incentive to devote time to caseload management. Perhaps as a consequence, NASD has a problem of backlogged cases and in an effort to reduce the caseload has promoted securities mediation as a more efficient alternative to arbitration.[60] Concern has been expressed about whether the NASD will be able to handle the increase in case filings expected to follow from the scandals involving conflicts of interest among securities analysts.

58. Dodds v. Cigna Sec., Inc., 12 F.3d 346 (2d Cir. 1993).

59. For further development of this argument, see Black & Gross, *supra* note 8, at 1035-40.

60. NASD promotes mediation as a party-driven process, reminiscent of the traditional view of arbitration. *See* NASD, *What is Mediation and How Does Mediation Differ from Arbitration?*, *at* http://www.nasdadr.com/med_alt_path.asp (last visited Oct. 21, 2004).

The securities arbitration system serves a very important role in our capital markets system. Investor confidence in the system is integral to its continued success; investors must have confidence that disputes with their brokers are resolved fairly. The increased SEC oversight over the process since 1987 attests to its importance. The foundation of a fair arbitration system must be the arbitrators themselves. Increasingly, the NASD expects more from its essentially volunteer, nonprofessional corps of arbitrators. I fear that the NASD is building an elaborate structure on a shaky foundation; despite all their good intentions, many arbitrators may not be up to the increased responsibilities the NASD expects from them.

Is it time to seriously consider institution of a staff of full-time professional arbitrators? Unfortunately, the related area of commodities futures provides an unpromising parallel. Instead of arbitration, customers can elect for a reparations process before administrative law judges at the Commodities Futures Trading Commission. A few years ago, the Wall Street Journal reported that one of the two administrative law judges had never ruled in favor of a customer.[61]

Small Claims

I want to conclude with a few words about the special problems of investors with small claims, who frequently cannot obtain legal representation. The process is too complicated for pro se investors, and the simplified arbitration process for claims not exceeding $25,000, where one arbitrator decides a dispute on submitted papers without a hearing,[62] is an unsatisfactory alternative, principally for two reasons. First, many pro se investors may not be capable of composing a document that both sets forth in an orderly fashion the relevant sequence of events and makes a persuasive argument for imposing liability on the broker. Second, most disputes between customers and brokers involve issues of credibility, and the arbitrator has no opportunity to assess the credibility of the parties. Under the current system, the arbitrator can call a hearing to resolve

61. *See* Michael Schroeder, *If You've Got a Beef with a Futures Broker, This Judge Isn't for You*, WALL ST. J., Dec. 13, 2000, at A1.

62. *See* NASD CODE 2003, *supra* note 27, R. 10302.

these issues, but arbitrators understandably may be reluctant to do so, since it defeats the purpose of a simplified arbitration, and the prospect of presenting his case at a hearing is not likely to be viewed as a positive development by a pro se claimant.

Consideration should be given to creating a "small claims" arbitration forum, where a trained, professional arbitrator would hold one hearing session where he would allow the customer and the brokerage firm to tell their side of the story and present their evidence. While the customer may, if he chooses, be represented by an attorney, the firm cannot be represented by counsel, but would send a representative. While either the NASD or the SEC could establish the "small claims" forum, the SEC's involvement may provide small investors with more assurance that the forum is neutral and the process is fair. It would also allow the SEC to become more educated about the problems of small investors.