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McMahon Turns Twenty: The  
Regulation of Fairness in Securities  
Arbitration

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# **McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration**

**Jill I. Gross\***

## **I. Introduction**

Twenty years ago, Eugene and Julia McMahon, investors who alleged that their broker engaged in fraud and excessive trading in their brokerage account, urged the Supreme Court to affirm the Second Circuit Court of Appeals' holding that investors could not vindicate their rights under the Securities Exchange Act of 1934<sup>1</sup> if they were forced to arbitrate their claims.<sup>2</sup> The Court, in *Shearson/American Express v. McMahon*,<sup>3</sup> disagreed. In rejecting the McMahons' argument that federal securities law claims should not be arbitrable as a matter of public policy, the Court repeated a phrase it first penned two years earlier when deciding the arbitrability of an antitrust claim arising under the Sherman Act: "By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their

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\* Associate Professor of Law and Director, Securities Arbitration Clinic, Pace Law School. I owe thanks to Professor Barbara Black and the University of Cincinnati Center for Corporate Law for sponsoring this Symposium, to my colleagues at Pace for their comments and feedback on an earlier draft of this paper at a faculty colloquium, and to Dean Friedman for supporting this project with a Pace Law summer research stipend. Finally, I could not have written this article without the invaluable research assistance from Pace J.D. students Lisa DeBock, Rebecca Cunningham and John Sullivan.

<sup>1</sup> 15 U.S.C. § 78a et seq. (2007) ("Exchange Act" or "'34 Act").

<sup>2</sup> *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94, 96-98 (2d Cir. 1986), *rev'd*, 482 U.S. 220 (1987).

<sup>3</sup> 482 U.S. 220 (1987). The McMahons, whose opening account agreement contained an arbitration provision covering "any controversy arising out of or relating to [their] accounts," resisted arbitration on the grounds that the clause did not encompass claims arising under section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1961 *et seq.* *Id.* at 223 (quoting clause). The Supreme Court reversed the Second Circuit's holding that the '34 Act claims were not arbitrable. The Court ruled that, "[a]bsent a well-founded claim that an arbitration agreement resulted from the sort of fraud or excessive economic power that 'would provide grounds for the revocation of any contract,'" the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.*, supports a presumption of arbitrability for federal statutory claims. *Id.* at 226 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 627 (1985)). Because the McMahons could not meet their burden of showing that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue, the Court rejected their challenge to the arbitrability of their federal statutory claims. *Id.* at 227-38.

resolution in an arbitral, rather than a judicial forum. It trades the procedures and opportunity for review of the courtroom for the simplicity, informality and expedition of arbitration.”<sup>4</sup>

Two years later, in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,<sup>5</sup> the Supreme Court extended its reasoning in *McMahon* to claims arising under the Securities Act of 1933,<sup>6</sup> overruling prior law<sup>7</sup> by finding them arbitrable as a matter of public policy. Because virtually all broker-dealers include a pre-dispute arbitration clause in their customer account agreements,<sup>8</sup> these two decisions produced today’s paradigm of dispute resolution in the securities industry, a paradigm in which securities arbitration is the primary – and mandatory<sup>9</sup> -- mechanism for investors to resolve their disputes with their brokerage firms and brokers.<sup>10</sup>

Two critical assumptions of the *McMahon* decision lie beneath this paradigm. First, the Court assumed that Securities and Exchange Commission (SEC) oversight of the forums that

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<sup>4</sup> *McMahon*, 482 U.S. at 229-30 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985)). Other than *McMahon*, the Court has repeated this exact phrase four times since *Mitsubishi* when endorsing the arbitrability of other federal statutory claims. See *EEOC v. Waffle House, Inc.*, 534 U.S. 279, 296 n.10 (2002) (Title VII and ADA claims); *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 123 (2001) (employment discrimination claims); *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26 (1991) (ADEA claims); *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 481 (1989) (claims arising under the Securities Act of 1933).

<sup>5</sup> 490 U.S. 477 (1989).

<sup>6</sup> 15 U.S.C. § 77a *et seq.* (2006).

<sup>7</sup> *Wilko v. Swan*, 346 U.S. 427 (1953).

<sup>8</sup> While it is widely believed and reported that all broker-dealers include a PDAA in their current customer agreement, to my knowledge, no empirical study has been conducted recently to determine whether any NASD member firm does NOT include such a PDAA. At the time of *McMahon*, in contrast, approximately only 39% of broker-dealers mandated arbitration of customer disputes in cash accounts. See *Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the NYSE, NASD, and AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses*, 54 Fed. Reg. 21144, n.51 (May 10, 1989).

<sup>9</sup> See *The Securities Arbitration System: Hearing Before the H. Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the Comm. on Financial Services.*, 109<sup>th</sup> Cong. 48 (2005) [hereinafter *Hearing*] (Statement of Constantine N. Katsoris, Wilkinson Professor of Law, Fordham University School of Law) (testifying that *McMahon* “virtually transformed” securities arbitration “from a voluntary procedure to a mandatory one”).

<sup>10</sup> If all parties consent, they can opt for mediation in lieu of arbitration. I have concluded that securities mediation is a fair alternative for investors. See Jill I. Gross, *Securities Mediation: Dispute Resolution for the Individual Investor*, 21 OHIO ST. J. ON DISPUTE RESOL. 329 (2006).

administer securities arbitration -- primarily NASD Dispute Resolution (NASD-DR)<sup>11</sup> -- ensured that the arbitration proceeding was fair. To buttress its conclusion that investors can vindicate their federal statutory rights in arbitration, the *McMahon* Court noted that “the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.”<sup>12</sup> This oversight eroded the Court’s hostility to arbitration that had fueled the Court’s contrary judgment in *Wilko*<sup>13</sup> that arbitrators were not competent to decide federal securities law claims.<sup>14</sup>

Second, the Court assumed that the FAA’s provisions for post-award judicial review protected disputants from arbitration unfairness. Although establishing the presumption that “the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights,”<sup>15</sup> the Court also noted that judicial review of an arbitration award is sufficient to ensure that a disputant can effectuate its statutory rights.<sup>16</sup>

Developments in the two decades since *McMahon* warrant reconsideration of these two critical assumptions -- providing the ideal impetus for this Symposium. First, the Supreme

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<sup>11</sup> NASD is the securities industry’s largest self-regulatory organization (SRO) and is registered with the Securities and Exchange Commission as a national securities association pursuant to section 15A of the Securities Exchange Act of 1934. 15 U.S.C. § 78o-3 (2006). NASD Dispute Resolution is a wholly-owned, independent subsidiary of NASD. At the time of *McMahon*, approximately ten different SROs and securities exchanges ran arbitration forums. See Constantine N. Katsoris, *Roadmap to Securities ADR*, 11 FORDHAM J. CORP. FIN. L. 413, 420-21 (2006). Today, due to consolidation and the 2007 merger of the regulatory functions of NASD and the New York Stock Exchange (NYSE), NASD is now the only meaningful forum for securities arbitration, handling more than 95% of the cases. See Letter from Linda D. Fienberg, President, NASD Dispute Resolution to Public Members of Securities Industry Conference on Arbitration (Jan. 26, 2007) (on file with author).

<sup>12</sup> 482 U.S. at 233.

<sup>13</sup> 346 U.S. 427 (1953).

<sup>14</sup> 482 U.S. at 233-34. For a more detailed discussion of this SEC power, see *infra* notes 113-121 and accompanying text.

<sup>15</sup> 482 U.S. at 226.

<sup>16</sup> *Id.* at 232.

Court’s Federal Arbitration Act (FAA) decisions in the past twenty years have imbued the FAA with super-status: the FAA governs virtually every arbitration clause arising out of a commercial transaction,<sup>17</sup> including securities arbitration,<sup>18</sup> applies in both state and federal court,<sup>19</sup> preempts any conflicting state law,<sup>20</sup> and embodies a strong national policy favoring arbitration as an alternative dispute resolution mechanism.<sup>21</sup> This policy naturally disfavors extensive judicial review of arbitration awards, and has led the lower courts to develop a stringent test to prevail on a challenge to the procedural fairness of an arbitration proceeding.<sup>22</sup> Simultaneously, the “vindicating statutory rights” doctrine that the Court alluded to in *McMahon*<sup>23</sup> (which, in turn, originated in *Mitsubishi Motors*)<sup>24</sup> as a basis to overturn an arbitration award has been surprisingly ineffectual for this purpose.<sup>25</sup>

Second, reform of the securities arbitration process has tested the SEC as an oversight body and a gatekeeper of fairness. In the first decade following *McMahon*, the Commission approved numerous rule changes proposed by the SROs – most of which were designed to level

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<sup>17</sup> *The Citizens Bank v. Alafabco, Inc.*, 593 U.S. 52 (2003) (applying FAA to debt restructuring agreements as “involving commerce”).

<sup>18</sup> *Howsam v. Dean Witter Reynolds*, 537 U.S. 79 (2002)

<sup>19</sup> *Southland v. Keating*, 465 U.S. 1 (1984).

<sup>20</sup> *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468 (1989).

<sup>21</sup> *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985).

<sup>22</sup> See *infra* notes 76-93 and accompanying text.

<sup>23</sup> See *McMahon*, 482 U.S. at 229 (declaring that “*Wilko* must be read as barring waiver of a judicial forum only where arbitration is inadequate to protect the substantive rights at issue”).

<sup>24</sup> See *Mitsubishi Motors*, 473 U.S. at 637 (stating that “so long as the prospective litigant effectively may vindicate its statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function”) (emphasis added).

<sup>25</sup> See *infra* notes 105-11 and accompanying text.

the playing field and address criticisms of the process from investor advocates.<sup>26</sup> The well-known 1996 Ruder Report concluded that, while the process was fair, further reform was necessary.<sup>27</sup> That Report recommended more than 70 further changes.

The second decade following *McMahon* witnessed -- at the behest of the SEC -- implementation of virtually every major Ruder Report recommendation.<sup>28</sup> Resulting rule filings generated an unprecedented level of harsh public comment from both sides -- investor and industry. The most recent rule filings have raised new concerns about the equities of requiring arbitrators to issue “explained awards” at the request of a customer,<sup>29</sup> removing subpoena power from attorneys,<sup>30</sup> retaining the industry arbitrator despite an overhaul of the entire Code of Arbitration Procedure for Customer Disputes (“Customer Code”),<sup>31</sup> and codifying motion practice that authorizes arbitrators to dismiss a case before a live hearing.<sup>32</sup>

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<sup>26</sup> 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, 999-1005 (2002) [hereinafter *Making it Up*].

<sup>27</sup> See David S. Ruder, Chair, *Securities Arbitration Reform*, Report of the Arbitration Policy Task Force to the Board of Governors, National Association of Securities Dealers, Inc. (Jan. 1996) [hereinafter *Ruder Report*].

<sup>28</sup> Linda D. Fienberg and Kenneth L. Andrichik, *The Arbitration Policy Task Force Report: A Report Card*, 76 U. CIN. L. REV. \_\_\_ (2008).

<sup>29</sup> See Notice of Filing of Proposed Rule Change to Provide Written Explanations in Arbitration Awards Upon the Request of Customers or Associated Persons in Industry Controversies, 70 Fed. Reg. 41065 (proposed July 15, 2005). For a more detailed analysis of the benefits and drawbacks of this rule proposal, see Barbara Black & Jill I. Gross, *The Explained Award of Damocles: Protection or Peril in Securities Arbitration*, 34 SEC. REG. L. J. 17 (2006).

<sup>30</sup> See Order Approving Proposed Rule Change to Revise Rule 10322 of the NASD Code of Arbitration Procedure, Pertaining to Subpoenas and the Power to Direct Appearances, 72 Fed. Reg. 1353 (Jan. 11, 2007).

<sup>31</sup> See Order Approving Proposed Rule Change to Amend Rule 10308 of the NASD Code of Arbitration Procedure Relating to the Classification of Arbitrators, 71 Fed. Reg. 62026 (Oct. 20, 2006).

<sup>32</sup> See Notice of Filing of Proposed Rule Relating to Motions to Decide Claims Before a Hearing on the Merits, 71 Fed. Reg. 51879 (proposed Aug. 31, 2006).

The SEC's function as the fairness police, however, has not led to a consensus that securities arbitration is fair.<sup>33</sup> In March 2005, a subcommittee of the House of Representatives' Financial Services Committee held a hearing to better understand how the current arbitration process is working and whether any reforms are needed.<sup>34</sup> Deep polarization emerged: investor advocates complained that the system is unfair, inefficient, expensive, and biased towards industry, while securities industry representatives proclaimed that the arbitration process works well and is fair to all the parties involved.<sup>35</sup> Witnesses with expertise in securities arbitration testified about (and disagreed on the ramifications of): (1) the mandatory nature of securities arbitration;<sup>36</sup> (2) the composition of a three-arbitrator panel to include one industry arbitrator and an overly broad definition of public arbitrators;<sup>37</sup> (3) discovery abuse by brokerage firms;<sup>38</sup> (4) a lack of transparency in arbitrators' decisions;<sup>39</sup> (5) unpaid arbitration awards;<sup>40</sup> and (6) whether

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<sup>33</sup> Compare Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 PACE L. REV. 1 (2004) (examining procedural due process components and finding no inherent unfairness; with Mark A. Tepper, *Survey Says – SRO Arbitration Unfair*, PIABA BAR JOURNAL, Spring 2005, at 12; Charles Gasparino, *Judging Wall Street*, NEWSWEEK, Sept. 6, 2004, at 56; Gary Weiss and David Serchuk, *Walled Off From Justice?*, BUSINESS WEEK, Mar. 22, 2004, at 91; Richard Karp, *Hardball*, BARRON'S, Oct. 20, 2003.

<sup>34</sup> See *Hearing*, *supra* note 9, at 1-121.

<sup>35</sup> *Id.* at 65-79 (Statement of Marc E. Lackritz, President, Securities Industry Association).

<sup>36</sup> *Id.* at 74-75. To open an account with a broker-dealer, most investors must sign an agreement, which contains a clause requiring them to settle any disputes in arbitration. This clause is regulated, both in form and content, by NASD Rule 3110(f). See *infra* notes 45-46 and accompanying text.

<sup>37</sup> At NASD, three-member arbitration panels are appointed to cases involving more than \$50,000 in claimed damages. One member of the NASD panel will be an industry ("non-public") arbitrator and two will be public arbitrators. Industry arbitrators have some sort of business, personal or employment relationship with the securities industry. See NASD Code of Arbitration Procedure, Rules 12400-12402, 12408. Some investor advocates contend that the industry arbitrator "presents an appearance of bias and impropriety to the investing public." See *Hearing*, *supra* note 9, at 105 (Statement of Public Investors Arbitration Bar Association).

<sup>38</sup> In 2003, NASD had to issue a notice to firms "reminding them . . . of their obligations to comply with NASD discovery rules and procedures." NASD Notice to Members 03-70. In 2004, NASD censured and fined several firms for their failure to comply with these rules and procedures. See *Hearing*, *supra* note 9, at 37-38 (Statement of Linda D. Fienberg, President, NASD Dispute Resolution, Inc.).

<sup>39</sup> NASD publicly discloses arbitration awards and during the arbitrator selection process provides information on an arbitrator's past awards, but arbitrators are not required to explain the award or their reasoning. See *Hearing*, *supra* note 9, at 34-35, 37 (Statement of Fienberg); see also Explained Award Rule Proposal, *supra* note 29, and accompanying text.

empirical studies of investor victories are truly success stories.<sup>41</sup> Two Senators wrote to SEC Chairman Cox urging the SEC to enact a rule barring mandatory arbitration clauses from broker-dealers' customer agreements.<sup>42</sup>

In light of these mounting concerns, the *McMahon* Court's unqualified trust in SRO arbitrators to vindicate the statutory rights of investors seems anachronistic. Given that virtually all customer agreements contain pre-dispute arbitration clauses mandating arbitration, we should be especially concerned with the fairness of the securities arbitration process. Should the current paradigm of securities arbitration be redesigned?

Two important scholars at this Symposium answered this question in the affirmative, arguing that securities arbitration is substantively and procedurally unfair under current rules and practices. Professor Jeffrey Stempel, focusing on procedural fairness, called for mandatory enhanced due process protocols in what he labels "mass arbitration" to remedy the potential for procedural unfairness.<sup>43</sup> Professor Stempel also noted that SEC oversight does not appear to prevent procedural unfairness in securities arbitration.

Professor Brunet focused on substantive outcomes and advocated for a new regime in which arbitrators must apply the rule of law to both federal and state claims. To remedy the

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<sup>40</sup> See *Hearing, supra* note 9, at (Opening Statement of Hon. Paul E. Gillmor). As a result of various NASD initiatives, from 1998 to 2004, NASD reduced the percentage of unpaid awards from 60 percent to 15 percent. *Id.* at 39 (Statement of Fienberg).

<sup>41</sup> Any cash award that an investor receives as a result of the arbitration process is considered a "victory" by NASD. Thus a claimant who has a \$5 million claim and receives a \$5.00 award has a victory. See *Hearing, supra* note 9, at (Statement of William F. Galvin, Sec., Commonwealth of Mass.); see also William A. Gregory and William J. Schneider, *Securities Arbitration: A Need for Continued Reform*, 17 NOVA L. REV. 1223, 1240 (1993) (noting that, although investors win more than half of their arbitration cases, the awards are quite nominal in comparison to the amount of their claims).

<sup>42</sup> See Letter from Russell D. Feingold, Senator & Patrick Leahy, Chairman, Committee on the Judiciary, United States Senate, to Christopher Cox, Chairman, United States Securities and Exchange Commission (May 4, 2007) (on file with author); see also Gretchen Morgenson, "Dear S.E.C., Reconsider Arbitration," N.Y. TIMES, May 6, 2007, sec. 3, p. 1.

<sup>43</sup> Jeffrey W. Stempel, *Mandating Minimal Quality in Mass Arbitration*, 76 CINC. L. REV. \_\_ (2008).

perceived lack of substantive fairness, he would also require reasoned awards, expert arbitrators and expanded judicial review of awards.<sup>44</sup> These reforms, he argues, would allow parties to conform behavior to expectations, provide norms to follow, and craft remedies based on violation of the norms.

As I commented at the Symposium, I believe that current regulation of securities arbitration does ensure that it is fair to investors. In Part II of this paper, I explore the various sources of law, including the FAA, which could require fairness in securities arbitration. In this part, I revisit the first critical assumption of the *McMahon* Court that the FAA's provisions for post-award judicial review protect investors from an unfair arbitration process. This part demonstrates that, while the FAA does require "fundamental fairness" in arbitration, courts loosely construe that requirement and find most arbitration proceedings meet it easily. Part III of this paper explores SEC oversight of securities arbitration, particularly in the last ten years. This part revisits the second critical assumption of the Court that this oversight ensures investors can substantively vindicate their federal securities law claims. In this Part, I conclude that SEC oversight does sufficiently regulate the fairness of securities arbitration, and thus the *McMahon* paradigm appears to be working.

## **II. Sources of Law Requiring Fairness**

The modern paradigm of mandatory securities arbitration creates a paramount need for fairness. What law or laws require that a securities arbitration hearing be administered fairly? The potential legal regulators of arbitration fairness include the parties' arbitration agreement, state law, the U.S. Constitution, forum rules, and federal law.

*First*, the parties' arbitration agreement could require a procedurally fair hearing. The preliminary language in the pre-dispute arbitration agreement (PDAA) of any NASD member

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<sup>44</sup> Edward Brunet & Jennifer Johnson, *Substantive Fairness in Securities Arbitration*, 76 U. CIN. L. REV. \_\_\_ (2008).

(which includes all broker-dealers) is mandated<sup>45</sup> by NASD Conduct Rule 3110(f).<sup>46</sup> Rather than providing for rights and protections, this provision announces quite clearly to the customer that s/he is forfeiting rights via the arbitration clause. The PDAA provides no guarantees of fairness.<sup>47</sup>

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<sup>45</sup> NASD does not require that its member firms include a PDAA in their customer agreements, but if they do include one, it must contain the language in Rule 3110(f).

<sup>46</sup> NASD Conduct Rule 3110(f), amended in 2005 in response to a Ruder Report recommendation, provides:

**(f) Requirements When Using Predispute Arbitration Agreements for Customers Accounts**

(1) Any predispute arbitration clause shall be highlighted and shall be immediately preceded by the following language in outline form.

This agreement contains a predispute arbitration clause. By signing an arbitration agreement the parties agree as follows:

(A) All parties to this agreement are giving up the right to sue each other in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed.

(B) Arbitration awards are generally final and binding; a party's ability to have a court reverse or modify an arbitration award is very limited.

(C) The ability of the parties to obtain documents, witness statements and other discovery is generally more limited in arbitration than in court proceedings.

(D) The arbitrators do not have to explain the reason(s) for their award.

(E) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

(F) The rules of some arbitration forums may impose time limits for bringing a claim in arbitration. In some cases, a claim that is ineligible for arbitration may be brought in court.

(G) The rules of the arbitration forum in which the claim is filed, and any amendments thereto, shall be incorporated into this agreement.

(2)(A) In any agreement containing a predispute arbitration agreement, there shall be a highlighted statement immediately preceding any signature line or other place for indicating agreement that states that the agreement contains a predispute arbitration clause. The statement shall also indicate at what page and paragraph the arbitration clause is located.

(B) Within thirty days of signing, a copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document.

(3)(A) A member shall provide a customer with a copy of any predispute arbitration clause or customer agreement executed between the customer and the member, or inform the customer that the member does not have a copy thereof, within ten business days of receipt of the customer's request. If a customer requests such a copy before the member has provided the customer with a copy pursuant to subparagraph (2)(B) of this paragraph, the member must provide a copy to the customer by the earlier date required by this subparagraph (3)(A) or by subparagraph (2)(B).

(B) Upon request by a customer, a member shall provide the customer with the names of, and information on how to contact or obtain the rules of, all arbitration forums in which a claim may be filed under the agreement.

(4) No predispute arbitration agreement shall include any condition that:

(A) limits or contradicts the rules of any self-regulatory organization;

(B) limits the ability of a party to file any claim in arbitration;

(C) limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement;

(D) limits the ability of arbitrators to make any award.

<sup>47</sup> I am not aware of any PDAA in a customer agreement that supplements this language to require additional fairness protections other than incorporating by reference the forum's arbitration code of procedure.

*Second*, state arbitration law could mandate due process-like protections in arbitration proceedings taking place within the state. For example, the Revised Uniform Arbitration Act calls for the arbitrator to “conduct an arbitration in such manner as the arbitrator considers appropriate for a fair and expeditious disposition of the proceeding.”<sup>48</sup> It also insists that at any hearing, parties have “a right to be heard, to present evidence material to the controversy, and to cross-examine witnesses appearing at the hearing.”<sup>49</sup> However, to the extent any state has adopted this as law and thus *requires* due process in securities arbitration, such a law is likely to be preempted by the Exchange Act,<sup>50</sup> or possibly by the FAA.<sup>51</sup>

*Third*, the Due Process Clause of the Fifth Amendment of the United States Constitution mandates procedural fairness in many judicial and quasi-judicial forums.<sup>52</sup> However, despite noble attempts by numerous scholars to develop the argument,<sup>53</sup> courts repeatedly find that private arbitration does not involve state action and therefore the Due Process Clause does not

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<sup>48</sup> Rev. Unif. Arb., § 15 (a).

<sup>49</sup> *Id.*, § 15(d).

<sup>50</sup> *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9<sup>th</sup> Cir. 2005) (finding that '34 Act preempts California's ethics standards for neutral arbitrators in contractual arbitration); *Jevne v. The Superior Court of Los Angeles County*, 111 P.3d 954 (Cal. 2005) (same).

<sup>51</sup> *See Southland v. Keating*, 465 U.S. 1 (1984) (holding that FAA preempts conflicting state law in both state and federal court); *see also* Christopher Drahozal, *Federal Arbitration Act Preemption*, 79 IND. L. J. 393, 395, 420-24 (2004) (observing that “[c]ourts have only begun to address preemption challenges to state laws regulating the arbitration process” and noting that different interpretations of the Supreme Court’s FAA jurisprudence would yield different preemption outcomes for these types of challenges). For a summary of FAA preemption principles, *see* Jill I. Gross, *Over-Preemption of State Vacatur Law: State Courts and the FAA*, 3 J. AM. ARB. 1, 9-19 (2004).

<sup>52</sup> *See* Henry J. Friendly, *Some Kind of Hearing*, 123 U. PENN L. REV. 1267, 1267-68 (1975).

<sup>53</sup> *See* Sarah Rudolph Cole, *Fairness in Securities Arbitration : A Constitutional Mandate*, 26 PACE L. REV. 73, 110 (2005) (concluding that the “close relationship between the SEC and the SROs creates state action when the SROs mandate that their employees participate in arbitration as a condition of their employment”); Richard C. Reuben, *Public Justice: Toward A State Action Theory of Alternative Dispute Resolution*, 85 CAL. L. REV. 577, 615-19 (1997) (arguing that public and private entanglement in enforcing arbitration agreements gives rise to state action) [ck]; 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, 40-47 (1997) (arguing that state action exists at least to the extent courts are relying on a preference for arbitration over litigation to interpret validity and scope of arbitration agreements).

apply to its hearings.<sup>54</sup> In the securities context, despite the consensus of the scholars at the Symposium to the contrary, most courts addressing the issue have concluded that the Due Process Clause does not apply to arbitrations administered by NASD and NYSE because it is a matter of private contract.<sup>55</sup>

*Fourth*, even absent formal Due Process Clause protections, rules of the arbitration forum could require due process-like procedures.<sup>56</sup> Many commercial arbitration service providers, such as the American Arbitration Association (AAA) and the National Arbitration Forum (NAF), provide “Due Process Protocols” for disputes arising out of “mandatory” arbitration.<sup>57</sup> For example, AAA developed the Consumer Due Process Protocol, providing that, for all “Consumer ADR” agreements, all parties are entitled to a fundamentally fair process, including clear notice of the pre-dispute arbitration agreement, reasonable costs, notice and an opportunity to be heard, a hearing at a reasonably convenient location, reasonable time limits, access to information, and all remedies that would have been available if the claim had been pursued in court.<sup>58</sup> Professor Stempel argues that far more enhanced due process protocols are necessary for procedural fairness in consumer and securities arbitration.<sup>59</sup> In addition to notice, a hearing and a neutral

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<sup>54</sup> See Cole, *supra* note 53, at 75, n. 10 (gathering cases); see also Sarah Rudolph Cole, *Arbitration and State Action*, 2005 B.Y.U. L. REV. 1, 4; Margaret Harding, *The Limits of The Due Process Protocols*, 19 OHIO ST. J. DISP. RESOL. 369, 393 (2004); Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C.L.REV. 81, 109 (1992).

<sup>55</sup> See, e.g., *Perpetual Secs., Inc. v. Tang*, 290 F.3d 132, 137-39 (2d Cir. 2002); *Duffield v. Robertson, Stephens & Co.*, 144 F.3d 1182, 1200-1201 (9<sup>th</sup> Cir. 1988), *overruled on other grounds by*, *E.E.O.C. v. Luce*, *Forward*, Hamilton & Scripps, 345 F.3d 742 (9<sup>th</sup> Cir. 2003).

<sup>56</sup> See Paul R. Verkeuil, *Privatizing Due Process*, 57 ADMIN. L. REV. 963, 983-86 (2005) (noting that, even with limited state action, societal institutions have developed many alternatives to the Due Process Clause, including in ADR processes).

<sup>57</sup> See American Arbitration Association, *Consumer Due Process Protocol*, at <http://www.adr.org/sp.asp?id=22019> (last visited May 31, 2007); National Arbitration Forum, *Arbitration Bill of Rights*, at <http://www.adrforum.com/users/naf/resources/ArbitrationBillOfRights3.pdf> (last visited May 31, 2007).

<sup>58</sup> *Id.*

<sup>59</sup> Stempel, *supra* note 43, at \_\_\_.

arbitrator, he argues the forums must adopt additional procedural safeguards that: provide disputants with adequate information; refuse to enforce one-sided forum selection clauses and choice of law clauses lacking any factual linkage to transactions; ensure fair cost-sharing and forum fees; preclude restriction of any judicially-available remedies; do not restrict access to legal services; and require a standard of judicial review that ensures arbitrators follow the law.<sup>60</sup>

In the securities context, NASD's newly overhauled Customer Code – recently approved by the SEC after years of rule-making activity -- includes no formal “Due Process Protocol,” and thus no formal recognition of the full spectrum of due process rights that are recognized via protocols in other forums. However, the latest version of the Customer Code includes provisions that encompass many of these requirements.<sup>61</sup> As discussed *infra*, SEC oversight has led to fair forum rules.

*Fifth*, federal law could mandate fairness. As explored more fully below, both federal arbitration law and federal securities law contribute to regulating the fairness of securities arbitration.

#### **A. Federal Arbitration Law**

Congress enacted the Federal Arbitration Act (FAA) in 1925 “to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts, and to place arbitration agreements upon the same footing as other contracts.”<sup>62</sup> The FAA, section 10, provides grounds on which a court can set aside or vacate an arbitration award.<sup>63</sup> These grounds focus solely on the arbitration process, not the merits. While

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<sup>60</sup> *Id.* at \_\_\_.

<sup>61</sup> *See infra* notes 136-43 and accompanying text.

<sup>62</sup> *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991).

<sup>63</sup> *See* 9 U.S.C. § 10 (2007).

it is well-established that judicial review of arbitration awards is extremely narrow,<sup>64</sup> courts can invoke three FAA-based doctrines to protect a losing party in arbitration from an award resulting from an unfair process. Those three doctrines – fundamental fairness; manifest disregard of the law; and vindicating statutory rights – are detailed below.

*i. Fundamental Fairness.* Before the enactment of the FAA, while acknowledging the general principle that courts should intervene only sparingly in arbitration matters, the federal common law of this country imposed a “fundamental fairness” requirement on commercial arbitration.<sup>65</sup> Courts reasoned that a court asked to set aside an arbitration award is a court sitting in equity, and no court of equity will deny relief from a proceeding demonstrated to be fundamentally unfair.<sup>66</sup>

In 1925, Congress enacted the FAA, which does not contain or mention the words “fair” or “fairness.”<sup>67</sup> The Act neither requires notice of an arbitration hearing, nor does it provide a ground of vacatur for lack of notice.<sup>68</sup> As long as notice is provided pursuant to the arbitration rules designated by the parties in their arbitration agreement, courts will confirm the arbitrator’s award.<sup>69</sup> Moreover, the only reference to a “hearing” is found in FAA section 10(a)(3), which

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<sup>64</sup> See *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 942 (1995).

<sup>65</sup> See *Burchell v. Marsh*, 58 U.S. 344, 349 (1854) (confirming award in a commercial dispute between a retailer and two wholesalers and stating that “after a full and fair hearing of the parties, a court of equity will not set it aside for error, either in law or in fact”); see also *Citizens Bldg. of West Palm Beach, Inc., v. Western Union Tel. Co.*, 120 F. 2d 982, 984 (5<sup>th</sup> Cir. 1941) (“The universal rule in common-law arbitrations is that the parties are entitled to be heard, after reasonable notice, upon the subject matter in dispute.”).

<sup>66</sup> *Burchell*, 58 U.S. at 349.

<sup>67</sup> It does require a decision by an impartial neutral, as a specified ground of vacatur is for “evident partiality” in the arbitrator. 9 U.S.C. § 10(a) (2).

<sup>68</sup> *Gingiss International v. Bormet*, 58 F.3d 328, 332 (7<sup>th</sup> Cir. 1995) (ruling that inadequate notice is not a ground for vacatur under the FAA); *General Universal Systems, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 2003 WL 1884198, \*2 (Ct. App. Tex. 2003) (same). *But see* *Gibbons v. Smith*, 67 Fed. Appx. 52 (2d Cir. 2003) (holding that absence of notice can lead to vacatur under section 10(a)(3) when movant shows “fundamental fairness is violated”).

<sup>69</sup> *E.g., Gibbons*, 67 Fed. Appx. at 54-55 (refusing to vacate award where NASD followed its procedural rules for serving notice of a hearing, and those are not fundamentally unfair); *Smith v. Positive Productions, Inc.*,

provides that the court can vacate an award “[w]here 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.”<sup>70</sup> As a result, after the passage of the FAA, courts struggled to balance the common law need for fairness with the plain meaning of the FAA, which did not appear to mandate sufficient hallmarks of fairness and private due process.<sup>71</sup>

Troubled by the lack of fairness safeguards, courts developed a variety of arguments to support a requirement of fundamental fairness. Some post-FAA courts continued to impose the common law fairness requirement on arbitration hearings arising out of FAA-governed contracts. One of the earliest and oft-cited examples is *Seldner Corp. v. W.R. Grace & Co.*<sup>72</sup> In *Seldner*, the district court considered a challenge to a commercial arbitration award on the grounds that the losing party received neither sufficient notice nor an opportunity to be heard in the arbitration at issue. Although acknowledging that the FAA did not expressly provide for these grounds of vacatur, the court noted that notice and opportunity to be heard are requirements deeply ingrained in English and American jurisprudence and the role of an arbitrator is essentially judicial in nature.<sup>73</sup> Moreover, the court reasoned that the absence of these essential safeguards

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419 F. Supp.2d 437, 444-45 (S.D.N.Y. 2005) (AAA Rules for notice followed); *Papayiannis v. Zelin*, 205 F. Supp.2d 228, 231-32 (S.D.N.Y. 2002) (rejecting losing party’s claim of lack of notice where NASD followed its procedural rules for notice); *General Universal Systems*, 2003 WL 1884198 at \*2 (in NASD arbitration, since forum provided notice pursuant to NASD arbitration rules, party’s failure to receive notice does not render award invalid).

<sup>70</sup> 9 U.S.C. § 10(a) (3) (emphasis added).

<sup>71</sup> Confirming that the FAA does not require due process as it is currently drafted, a Congressman recently proposed legislation, entitled the “Fair Arbitration Act of 2007,” to add a new section 17 to the FAA creating procedural rights akin to “due process” in FAA-governed arbitrations. See Fair Arbitration Act of 2007, S. 1135, 11<sup>th</sup> Cong. (2007); see also SECURITIES ARBITRATION ALERT 2007-18 (May 2, 2007).

<sup>72</sup> 22 F. Supp. 388 (D. Md. 1938).

<sup>73</sup> *Id.* at 392.

in the FAA did not indicate Congressional intent to abolish them in the arbitral setting.<sup>74</sup> The court vacated the award, stating that:

[t]here is apparently no prior decision determining the sufficiency of 'lack of notice and opportunity to be heard' as grounds for the vacation of an award, under section 10 of the [FAA]; but the applicable common law is uniformly well settled, and there is no indication that the [FAA] was intended to effect any change therein, at least so far as it affects this case.<sup>75</sup>

In the decades after *Seldner*, courts seemed to accept the notion that FAA-governed arbitration must contain the common law hallmarks of a fundamentally fair process, even absent an express provision in the FAA.<sup>76</sup> However, courts differed as to how to enforce this notion. At least one circuit explicitly recognizes the non-statutory “fundamental fairness” ground for vacatur of an award.<sup>77</sup> Other courts analyze the statutory grounds in terms of fundamental fairness; i.e., vacatur is limited to the listed statutory grounds and will only be warranted when the alleged violation rises to such a level that the proceedings are rendered fundamentally unfair.<sup>78</sup> For example, this latter approach has led some circuits to develop a “fundamental

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<sup>74</sup> *Id.* at 391.

<sup>75</sup> *Id.*

<sup>76</sup> *See, e.g.,* Newark Stereotypers' Union v. Newark Morning Ledger, 397 F.2d 394 (3<sup>rd</sup> Cir. 1968) (determining that misconduct under §10 will only warrant vacatur when it serves to deny a party of a fair hearing); Totem Marin Tug & Barge, Inc. v. North American Towing, Inc., 607 F.2d 649, 651 (5<sup>th</sup> Cir. 1979) (“All parties in an arbitration proceeding are entitled to notice and an opportunity to be heard”); Ficek v. Southern Pacific Co., 338 F.2d 655, 657 (9<sup>th</sup> Cir. 1964) (affirming award though recognizing that “court may decline to recognize an award if the arbitration proceeding does not meet minimal requirements of fairness-- notice, 'a full and fair hearing,' and a decision based on the 'honest judgment' of the arbitrators”); Petrol Corp. v. Groupment D'Achat Des Carburants, 84 F. Supp 446, 448 (S.D.N.Y. 1949) (citing *Seldner* and stating that “failure to notify the parties of the time and place of hearings, and to afford them an opportunity to be heard are grounds for vacating the award”).

<sup>77</sup> *See* Sheldon v. Vermonty, 269 F.3d 1202, 1206 (10<sup>th</sup> Cir. 2004). In contrast, one circuit court has expressly rejected “fundamental fairness” as a non-statutory ground for vacatur. *See* Hoffman v. Cargill, 236 F.3d 458 (8<sup>th</sup> Cir. 2001).

<sup>78</sup> *E.g.,* Brabham v. A.G. Edwards & Sons, Inc., 376 F.3d 377 (5<sup>th</sup> Cir. 2004).

fairness” test for vacatur under sections 10(a)(2) (arbitrator’s “evident partiality”),<sup>79</sup> 10(a)(3) (“arbitrator misconduct”),<sup>80</sup> and 10(a)(4) (arbitrators “exceeded their authority”).<sup>81</sup>

Under either approach, today’s FAA jurisprudence makes it incontrovertible that an arbitration hearing arising under the FAA must include the classic hallmarks of fairness: notice, a right to be heard and a neutral decision-maker.<sup>82</sup> Thus, courts have vacated awards where the arbitrators refused to hear pertinent evidence,<sup>83</sup> precluded the attendance of one party,<sup>84</sup> or barred testimony of a witness.<sup>85</sup>

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<sup>79</sup> *E.g.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Berry*, 92 Fed. Appx. 243 (6<sup>th</sup> Cir. 2004) (*dicta*) (“arbitrator bias, however, is grounds for vacatur precisely because it makes that forum unable to provide a fundamentally fair hearing”) (internal quotation omitted); *Morelite Construction Co. v. New York City District Council Carpenters Benefit Funds*, 748 F.2d 79 (2d Cir. 1984) (vacating award for evident partiality because a father/son relationship between an arbitrator and a party precluded the possibility of fair proceedings); *In the Matter of the Arbitration Between Sun Refining and Marketing Co. v. Statheros Shipping Corp. of Monrovia*, 761 F. Supp. 293, 299-301 (S.D.N.Y.), *aff’d*, 948 F.2d 1277 (2d Cir. 1991) (vacating award because a biased arbitrator could give rise to unfairness even though there was not sufficient evidence of evident partiality).

<sup>80</sup> *E.g.*, *Lessin v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 481 F.3d 813, 816-17 (D.C. Cir. 2007); *Gulf Coast Industrial Workers Union v. Exxon Mobil U.S.A.*, 70 F.3d 847 (5<sup>th</sup> Cir. 1995); *Totem Marine Tug & Barge, Inc. v. North American Towing, Inc.*, 607 F.2d 649 (5<sup>th</sup> Cir. 1979) (vacating award under 10(a)(3) because arbitrator’s misconduct was sufficiently prejudicial to one party’s interests that it was denied a fundamentally fair hearing); *Kober v. Kelly*, 2006 WL 1993248, \*3 (S.D.N.Y. July 18, 2006) (finding no arbitrator misconduct and confirming award that granted respondent’s motion to dismiss without a merits hearing because claimant had more than one opportunity to be heard).

<sup>81</sup> *Bell Aerospace Co. v. Local 516, Int’l Union, UAW*, 500 F.2d 921, 923 (2d Cir. 1974) (denying motion to vacate award and stating that “[i]n handling evidence an arbitrator need not follow all of the niceties observed by the federal courts. He need only grant the parties a fundamentally fair hearing”).

<sup>82</sup> *See Bowles Financial Group, Inc. v. Stifel, Nicolaus & Co., Inc.*, 22 F.3d 1010, 1012-13 (10<sup>th</sup> Cir. 1994) (gathering cases). *Cf. Sroka Family, LLC v. Prudential Secs., Inc.*, 176 Fed. Appx. 766, 767 (9<sup>th</sup> Cir. 2006) (affirming district court’s dismissal of petition to vacate securities arbitration award due to lack of subject matter jurisdiction because “a review of the fairness of arbitration proceedings does not involve a substantial question of federal law where petitioners were not denied adequate notice, a hearing on the evidence and an impartial decision by the arbitrator”).

<sup>83</sup> *E.g.*, *Hoteles Candado Beach, La Concha and Convention Center v. Union De Tronquistas Local 901*, 763 F.2d 34, 40 (1<sup>st</sup> Cir. 1985) (vacating award for arbitrator’s refusal to hear material evidence constituting misconduct); *Dover Elevator Systems, Inc. v. United Steel Workers of America*, 1998 U.S. Dist. LEXIS 12063 (N.D. Miss. 1998) (vacating award because arbitrator acted in a “fundamentally unfair” manner by preventing party from submitting rebuttal evidence); *Bell Packaging Corp. v. Graphic Communications Int’l Union Local 415*, 1998 WL 748270, \*4 (N.D. Ill. Oct. 2, 1998) (vacating award for fundamental unfairness where arbitrator allowed new allegation to be raised during hearing); *In The Matter of Arbitration Between The Home Indemnity Company v. Affiliated Food Distributors Inc.*, 1997 U.S. Dist. LEXIS 19741 (S.D.N.Y. 1997) (vacating award because “touchstone” of fundamental fairness was absent in arbitrator’s decision).

At the same time, courts give wide latitude to arbitrators in meeting these fairness hallmark and require nothing more. Thus, the FAA's reference to a "hearing" does not require that a hearing be live.<sup>86</sup> For example, in *Air Florida System*, where the only issue decided by the arbitrator was a business valuation, the Ninth Circuit held that:

the failure to hold an oral hearing cannot be deemed misbehavior that prejudiced the FDIC's rights because the FDIC has not shown that its evidence was not amenable to presentation in written form. Admittedly, a 'paper hearing' often will be an inadequate means to determine the facts upon which an arbitration decision must rely. In this case, however, the nature of the decision to be made leads us to conclude that the 'paper hearing' was adequate.<sup>87</sup>

Courts find that arbitrators have the authority to decide pre-hearing motions to dismiss, so long as the arbitrator's refusal to hold a full evidentiary hearing is not fundamentally unfair.<sup>88</sup>

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<sup>84</sup> *Tube and Steel Corp. of America v. Chicago Carbon Steel Prods.*, 319 F. Supp. 1302 (S.D.N.Y. 1970) (vacating award under section 10(a)(3) because panel continued with hearing on date that one party could not attend).

<sup>85</sup> *Tempo Shain Corp. v. Bertek Inc.*, 120 F.3d 16 (2d Cir. 1997) (vacating award for arbitrators' refusal to postpone hearings so as to allow a material witness to testify); *Kaplan v. Alfred Dunhill of London, Inc.*, 1996 WL 640901, \*6 (S.D.N.Y. 1996); *Harvey Aluminum v. United Steelworkers of America*, 263 F. Supp. 488 (C.D. Cal. 1967) (vacating award under 10(a)(3) for refusal to hear testimony of a rebuttal witness).

<sup>86</sup> *See* *FDIC v. Air Florida System*, 822 F.2d 833, 842 (9<sup>th</sup> Cir. 1987) (paper hearing can, in certain cases, satisfy FAA); *see also* *Gray Panthers v. Schweiker*, 652 F.2d 146, 148 (D.C. Cir. 1980) (A "hearing" means any confrontation, oral or otherwise, between an affected individual and an agency decisionmaker sufficient to allow the individual to present his case in a meaningful manner. Hearings may take many forms, including a "formal," trial-type proceeding, an "informal discuss(ion)" ... or a "paper hearing," without any opportunity for oral exchange.)

<sup>87</sup> *Air Florida System*, 822 F.2d at 842.

<sup>88</sup> *See, e.g.,* *Wise v. Wachovia Secs.*, 450 F.3d 265 (7<sup>th</sup> Cir. 2006) (refusing to vacate award where arbitrators granted motion for summary judgment and dismissed claim on papers); *Sheldon v. Vermonty*, 269 F.3d 1202, 1206 (10<sup>th</sup> Cir. 2001); *Tricome v. Success Trade Secs.*, 2006 WL 1451502 (E.D. Pa. May 25, 2006) (denying motion to vacate arbitrators' pre-hearing dismissal); *Allen v. RBC Dain Rauscher, Inc.*, 2006 WL 1303119 (W.D. Wash. May 9, 2006) (refusing to vacate arbitrators' pre-hearing dismissal); *Patton v. J.P. Morgan Chase & Co.*, N.Y.L.J. (Sup. Ct. N.Y. Co. Aug. 23, 2004) (denying motion to vacate award that dismissed arbitration claim without a hearing, finding that such a dismissal does not deny a party fundamental fairness when arbitrator determines there is no relevant or material evidence to present at a hearing); *Warren v. Tacher*, 114 F. Supp.2d 600, 602-03 (W.D. Ky. 2000); *Max Marx Color & Chemical Co. Employees' Profit Sharing Plan v. Barnes*, 37 F. Supp.2d 248, 250-51 (S.D.N.Y. 1999) (recognizing authority of NASD arbitrators to grant pre-hearing dismissal); *Griffin Indus., Inc. v. Petrojam Ltd.*, 58 F. Supp.2d 212, 219-20 (S.D.N.Y. 1999) (noting that "arbitrators are not compelled to conduct oral hearings in every case).

Moreover, most arbitration forums have provisions in their rules for “paper cases,”<sup>89</sup> and courts deem such procedures fundamentally fair.<sup>90</sup>

Illustrating the danger of giving such wide latitude to arbitrators, courts have upheld arbitrators’ decisions to deny a hearing on the grounds that a Statement of Claim did not meet pleading requirements required by rules of civil procedure, rules that are plainly applicable only in courts of law.<sup>91</sup> For example, an Ohio appellate court recently confirmed an award where the panel dismissed the investor’s claims because the claim was facially deficient. The court found that the claimant failed to plead fraud with the specificity required by Federal Rule of Civil Procedure 9(b).<sup>92</sup> In a similar example, the Seventh Circuit upheld an NASD arbitration panel’s decision to grant *summary judgment* to a brokerage firm.<sup>93</sup> These alarming decisions treat securities arbitration as a litigation-like process and deprive disputants of an evidentiary hearing on grounds that simply do not apply to arbitration. Without additional regulation, the limited

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<sup>89</sup> See NASD Code of Arbitration Procedure for Customer Disputes, Rule 12800 (formerly Rule 10302) (providing for paper hearings for disputes involving \$25,000 or less “unless the customer requests a hearing”); AAA Commercial Arbitration Rules, Expedited Procedure E-6 (providing for paper hearings in cases “[w]here no party’s claim exceeds \$10,000... and in “other cases in which the parties agree”); NAF Code of Procedure Rules 25, 28 (designating “Document Hearings” as the default procedure if the claim amount is less than \$75,000); JAMS Comprehensive Procedures, Rule 23 (permitting parties to agree to waive the oral hearing in any dispute).

<sup>90</sup> See *Roberts v. A.G. Edwards & Sons, Inc.*, 2007 WL 597371 (Feb. 21, 2007) (granting motion to confirm arbitration award arising out of NYSE Simplified Arbitration and expressly concluding that simplified arbitration procedures were “fundamentally fair” under the FAA); see also *Papayiannis v. Zelin*, 205 F. Supp.2d 228 (S.D.N.Y. 2002) (confirming award arising out of NASD Simplified Arbitration procedure -- in which arbitrators decide claims less than \$25,000 based on paper submissions only -- despite losing party’s claim that he had no opportunity to be heard); *Warehall v. Pasternak*, 1993 WL 437784 (S.D.N.Y. 1993) (confirming NASD Simplified Arbitration award and finding that Rule 10302 provides ample opportunity to be heard).

<sup>91</sup> See *Wise v. Wachovia Secs.*, 450 F.3d 265 (7<sup>th</sup> Cir. 2006) (affirming denial of motion to vacate award where arbitrators granted respondent’s motion for *summary judgment* before a live hearing); *Reinglass v. Morgan Stanley Dean Witter, Inc.*, 2006 WL 802751 (Ohio Ct. App. Mar. 30, 2006); see also *Vento v. Quick & Reilly, Inc.*, 128 Fed. Appx. 719, 723 (10<sup>th</sup> Cir. 2005) (stating that “we hold that a NASD arbitration panel has full authority to grant a pre-hearing motion to dismiss with prejudice based *solely* on the parties’ pleadings) (emphasis added).

<sup>92</sup> *Reinglass*, 2006 WL 802751, \*3.

<sup>93</sup> *Wise*, 450 F.3d at 268; see also *Prudential Secs. Inc. v. Dalton*, 929 F. Supp. 1411 (N.D. Ok. 1996) (vacating award as fundamentally unfair where panel granted *summary judgment* denying a party an opportunity to present material evidence).

review available under the FAA’s “fundamental fairness” doctrine cannot ensure procedural fairness.

ii. *Manifest Disregard of the Law.*

While the FAA does not explicitly provide for judicial review of the *merits* of an arbitration award,<sup>94</sup> courts of appeal in every circuit have endorsed the extra-statutory ground for vacatur based on “manifest disregard of the law.”<sup>95</sup> Also, the Supreme Court has implicitly endorsed this ground.<sup>96</sup> While the precise test varies from circuit to circuit, most courts agree that, in order to persuade a court to vacate an award on this ground, the losing party must show 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 to the case.<sup>97</sup> Most courts and commentators agree that this standard is very difficult to meet and leaves most disputants with virtually no avenue for appeal if they believe the arbitrators misapplied the law.<sup>98</sup>

This lack of available substantive review has led to proposed reforms, including an explained award requirement,<sup>99</sup> allowing the parties to contractually expand the grounds for

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<sup>94</sup> See 9 U.S.C. § 10 (providing grounds for vacatur based on errors in the arbitration *process*).

<sup>95</sup> See Jill Gross, *Over-Preemption of State Vacatur Law: State Courts and the FAA*, 3 J. AM. ARB. 1, 6-7 (2004).

<sup>96</sup> See *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 942 (1995) (in *dicta*, citing “manifest disregard of the law” as one of grounds for judicial review of an award); *Wilko*, 346 U.S. at 436-37 (“...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”).

<sup>97</sup> See, e.g., *The GMS Group, LLC v. Benderson*, 326 F.3d 75, 76 (2d Cir. 2003).

<sup>98</sup> Stempel, *supra* note 43, at \_\_\_; Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. 123 (2005); Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U.CIN. L. REV. 415 (2003); Norman S. Poser, *Judicial Review of Arbitration Awards: Manifest Disregard of the Law*, 64 Brookl. L. Rev. 471 (1998) (arguing that manifest disregard standard is inadequate).

<sup>99</sup> See Black & Gross, *The Explained Award of Damocles*, *supra* note 29.

review,<sup>100</sup> a looser “manifest disregard” standard, and an additional ground of review for legal errors.<sup>101</sup> Most recently, at the Symposium, Professor Brunet advocated for the adoption of a “rule of law” requirement,<sup>102</sup> and Professor Stempel urged a more substantive appellate-like review of awards.<sup>103</sup>

In my view, however, these suggested reforms have as many potential costs as they do benefits, particularly for the customer claimant. As dramatically shown by Professors O’Hare and Bullard at the Symposium,<sup>104</sup> the current state of the law is terribly anti-investor. Thus, encouraging or forcing arbitrators to strictly apply the law without leaving any room for principles of equity can only worsen the available recoveries for investors. In my view, a “rule of law” approach, explained award requirement, or an “error of law” ground for vacatur will not redress the claims of unfairness, but will have the opposite effect.

*iii. The Mitsubishi Doctrine/Vindicating Statutory Rights.*

As shown above, the lack of stringent review under the FAA leaves potential gaps in the regulation of fairness of securities arbitration, and exposes a flaw in one of *McMahon’s* critical premises. One solution might be for litigants to invoke more forcefully the “vindicating rights” doctrine. This ground for avoiding an unfair arbitration process derives from the Supreme Court’s original pronouncement in *Mitsubishi Motors* that “so long as the prospective litigant effectively may vindicate its statutory cause of action in the arbitral forum, the [federal] statute

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<sup>100</sup> See Sarah Rudolph Cole, *Managerial Litigants? The Overlooked Problem of Party Autonomy in Dispute Resolution*, 51 HASTINGS L. J. 1199, 1262-63 (2000); Edward Brunet, *Replacing Folklore Arbitration with a Contract Model of Arbitration*, 74 TUL. L. REV. 39 (1999).

<sup>101</sup> See Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703 (1999).

<sup>102</sup> Brunet & Johnson, *supra* note 44, at \_\_\_.

<sup>103</sup> Stempel, *supra* note 43, at \_\_\_.

<sup>104</sup> Jennifer O’Hare, *The Retail Investor’s Remedies under the Antifraud Provisions of the Federal Securities Laws*, 76 U. CIN. L. REV. \_\_\_ (2008); Mercer Bullard, *Mutual Fund Shareholder Claims: All Bark, No Bite?*, 76 U. CIN. L. REV. \_\_\_ (2008).

[providing that cause of action] will continue to serve both its remedial and deterrent function.”<sup>105</sup> Under this doctrine, a disputant can claim that an arbitration agreement is not enforceable because an unfair aspect of the arbitration process precludes that party from being able to vindicate his statutory rights.<sup>106</sup>

Thus far, this doctrine has not been successfully invoked in the securities arbitration context. The Supreme Court already has rejected a challenge to SRO arbitration on the grounds that the limited discovery does not allow claimants to vindicate their statutory rights.<sup>107</sup> Moreover, no court has upheld a *Green Tree* challenge to securities arbitration on the ground of excessive fees.<sup>108</sup> Indeed, no court is likely to make such a finding, because NASD subsidizes the arbitrators’ costs and imposes heavier forum fees on member firms than it does on customer or employee claimants. Also, because NASD will waive its filing fees upon a showing of

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<sup>105</sup> *Mitsubishi Motors*, 473 U.S. at 637.

<sup>106</sup> *See Green Tree Financial Corp. v. Randolph*, 531 U.S. 79 (2000) (suggesting that excessive or overly burdensome forum fees, if proven, might bar a court from enforcing an arbitration agreement on the grounds that one party cannot vindicate its statutory rights); *Kristian v. Comcast*, 446 F.3d 25 (1<sup>st</sup> Cir. 2006) (refusing to enforce an arbitration agreement without severing the clause that precludes class action arbitration claims on the grounds that it deprives claimants from vindicating their statutory rights). *See generally* Stephen J. Ware, *The Case for Enforcing Adhesive Arbitration Agreements – with Particular Consideration of Class Actions and Arbitration Fees*, 5 J. AM. ARB. 251, 269-73 (2006) (describing the “effectively vindicate” doctrine and noting that the “Supreme Court has yet to flesh out the [ ] doctrine”).

<sup>107</sup> *Gilmer*, 500 U.S. at 31 (rejecting claimant’s contention that the limited discovery available in NYSE arbitration precluded him from effectively vindicating his rights under the Age Discrimination in Employment Act).

<sup>108</sup> *See Williams v. Cigna Financial Advisors, Inc.*, 197 F.3d 752, 763-64 (5<sup>th</sup> Cir. 1999) (rejecting employee’s contention that arbitrators’ order requiring him to pay one-half of the forum fees prevented him from vindicating his statutory employment claims in NASD arbitration); *Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 170 F.3d 1, 15-16 (1<sup>st</sup> Cir. 1999) (holding that employees failed to show that they could not vindicate their statutory rights in securities arbitration where, under the NYSE rules, plaintiff is unlikely to bear forum fees); *Koveleskie v. SBC Capital Markets, Inc.*, 167 F.3d 361, 366 (7<sup>th</sup> Cir. 1999) (rejecting employee’s argument that forum is inadequate due to high fees); *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Coe*, 313 F. Supp.2d 603, 616 (S.D. W.Va. 2004) (concluding that “the costs associated with [securities] arbitration are not unreasonably burdensome as they do not effectively prevent a plaintiff from enforcing or vindicating his or her rights”). Courts have endorsed this claim in other “mass” arbitration contexts. *See Phillips v. Associates Home Equity Services, Inc.*, 179 F. Supp.2d 40 (N.D. Ill. 2001) (refusing to enforce PDAA and compel arbitration due to prohibitively high costs that preclude borrower from vindicating her statutory rights under TILA); *Cole v. Burns Int’l Security Services*, 105 F.3d 1465 (D.C. Cir. 1997) (pre-*Green Tree*, enforcing PDAA in employment agreement but only because it interprets clause as requiring employer to pay all the arbitrator’s fees).

financial hardship,<sup>109</sup> it would be difficult for a customer or employee claimant to argue that he could not vindicate his statutory rights due to the costs of the forum.

Furthermore, investors would have difficulty demonstrating that the NASD arbitrator selection process will not result in a competent tribunal. The *Mitsubishi* Court itself “decline[ed] to indulge the presumption that the parties and arbitral body conducting a proceeding will be unable or unwilling to retain competent, conscientious, and impartial arbitrators.”<sup>110</sup> NASD Dispute Resolution has been actively monitoring the quality of its arbitrator roster in recent years, and has adopted the Neutral List Selection System for arbitrator selection and has enhanced its training and testing requirements.<sup>111</sup> These improvements in arbitrator quality will make it difficult to show that arbitrator incompetence precludes investors from vindicating their statutory rights.

While these three grounds to challenge procedural and substantive fairness – fundamentally fair, manifest disregard of the law and vindicating statutory rights – keep the forums in check, I do not believe they can *ensure* the fairness of securities arbitration. Likewise, for most forms of mandatory consumer arbitration, the FAA does not ensure a fair outcome for the mandated disputant, the consumer. However, as detailed below, SEC regulation makes securities arbitration different in a meaningful way from other forms of consumer arbitration – which are not regulated by a federal administrative agency. As a result, attacks on “mass arbitration” – as that term is used by Professor Stempel<sup>112</sup> -- are misplaced in the context of securities arbitration.

## **B. Federal Securities Laws**

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<sup>109</sup> NASD Customer Code Rule 12900(a) (1).

<sup>110</sup> *Id.* at 634.

<sup>111</sup> See Fienberg & Andrichik, *supra* note 28, at \_\_\_.

<sup>112</sup> See Stempel, *supra* note 43, at \_\_\_.

As discussed previously, the *McMahon* Court maintained faith in SEC oversight of SRO arbitration to protect investors from arbitration unfairness. Thus, in this section, I explore whether the federal securities laws and their requirement of SEC oversight sufficiently regulate the fairness of SRO arbitration.

The Securities Exchange Act of 1934<sup>113</sup> established a complex scheme to regulate and maintain capital markets as well as to protect the investing public, and created the SEC to administer the Act and oversee these regulations.<sup>114</sup> Under the 1934 Act, a major portion of the day-to-day regulation of broker-dealers and their associated persons was delegated to SROs, subject to SEC supervision.”<sup>115</sup> Since virtually all broker-dealers are members of NASD, “no broker-dealer can escape the self-regulatory system.”<sup>116</sup> Pursuant to this oversight power, the SEC conducts on-site inspections of the SRO forums, requiring the Dispute Resolution staff to be transparent, meticulous in record-keeping, and disclose any reported problems and complaints.<sup>117</sup>

Additionally, in 1975, Congress amended the 1934 Act by authorizing the SEC to, *inter alia*, review *all* proposed SRO rules.<sup>118</sup> These 1975 Amendments added an indispensable layer

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<sup>113</sup> 15 U.S.C. § 78a et seq. (2007).

<sup>114</sup> 15 U.S.C. § 78b (2007).

<sup>115</sup> NORMAN POSER, *BROKER-DEALER LAW AND REGULATION* (3d ed. 2004), § 13.01. The Maloney Act of 1938, 52 Stat. 1070, codified as Section 15A of the 1934 Act, amended the federal securities laws to permit qualified associations of broker-dealers to register with the SEC as national securities associations. 15 U.S.C. § 78o-3 (2004). The NASD is the only national securities association registered pursuant to this provision. *Id.*

<sup>116</sup> POSER, *supra* note 115, at §13.01.

<sup>117</sup> See SEC, Office of Inspector General, *Oversight of Self-Regulatory Organization Arbitration* (Audit 289), at 2, Aug. 24, 1989, available at <http://www.sec.gov/about/oig/audit/289fin.pdf> (last visited May 24, 2007) (reviewing SEC oversight function and noting that the “Division of Market Regulation (MR) reviews SRO arbitration rule filings and the Office of Compliance Inspections and Examinations (OCIE) conducts periodic inspections of SRO arbitration programs to ensure compliance with applicable rules”).

<sup>118</sup> Prior legislation authorized the SEC to review or modify only a narrower set of SRO rules. See POSER, *supra* note 115, at §13.01.

of statutory regulation over SRO arbitration with the express statutory purpose of enhancing investor protection.<sup>119</sup> As an SRO, NASD must file with the SEC any change it proposes in its own rules, including arbitration rules,<sup>120</sup> and await SEC approval.<sup>121</sup> Because the SEC must seek public comment on any rule change, the securities arbitration forums hear – pre-approval -- feedback and criticism from a wide variety of constituencies – including industry groups, regulatory groups, individual brokers, individual investors and investor advocates. The proposed rules can then be modified to meet the valid concerns of the commenters.

As discussed above,<sup>122</sup> the Supreme Court in *McMahon* used this SEC oversight to justify its finding that claims arising under the federal securities laws are arbitrable as a matter of public policy.<sup>123</sup> When the Court in *McMahon* first abrogated prior law<sup>124</sup> by holding that federal

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<sup>119</sup> David S. Ruder, *Securities Arbitration in the Public Interest: The Role of Punitive Damages*, 92 N.W.U. L. REV. 69, 72 (1997) (stating that the presence of “active SEC oversight of the SRO arbitration system provides a major distinguishing characteristic between securities arbitration and other arbitration systems” and that the “oversight is an essential ingredient in assuring a securities arbitration system in the public interest”); *see also* Katherine Van Wezel Stone, *Rustic Justice: Community and Coercion Under the Federal Arbitration Act*, 77 N.C. L. REV. 931, 1007 (1998) (arguing that “[o]ne could distinguish securities industry arbitration cases from other types of cases involving arbitration of statutory claims on the ground that under the Securities Acts, there is the possibility of SEC oversight of the SROs and their arbitration tribunals, a possibility that does not exist when violations of other statutory rights are alleged”).

<sup>120</sup> Ruder, *supra* note 119, at 72 (noting that “the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights”); Edward Brunet, *Toward Changing Models of Securities Arbitration*, 62 BROOK. L. REV. 1459, 1465 (1996) (stating that the “SEC has statutory authority to influence securities arbitration” under section 19 of the 1934 Act).

<sup>121</sup> Securities Exchange Act of 1934, 15 U.S.C. § 78s (b)(1) (2006) (“Each self-regulatory organization shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such self-regulatory organization ... accompanied by a concise general statement of the basis and purpose of such proposed rule change.”). The SEC then publishes the proposed rule change, gives “interested persons” an opportunity to comment on the proposal, and, following the public comment period, approves the rule change if it finds that it “is consistent with the requirements of [the ‘34] Act and the rules and regulations thereunder,” including the requirement that the rule protect investors and be in the public interest. 15 U.S.C. § 78s(b)(2).

<sup>122</sup> *See supra* notes 12-14 and accompanying text.

<sup>123</sup> *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987).

<sup>124</sup> *Wilko v. Swan*, 346 U.S. 427 (1953).

securities law claims were arbitrable,<sup>125</sup> it noted that the 1975 amendments to the 1934 Act gave the Commission new and “expansive power to ensure the adequacy of the arbitration procedures employed by the SROs.”<sup>126</sup> This power includes the authority to “mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.”<sup>127</sup> The Court thus reasoned that, because SEC oversight of SRO arbitration adequately protects investors, arbitration would not deprive investors of the means to enforce their rights under the 1934 Act.<sup>128</sup>

In the first decade after *McMahon*, SEC staff recommended numerous rule changes to make arbitration fairer and more neutral.<sup>129</sup> Substantial discussions of these recommendations among stakeholders culminated in significant reform of SRO arbitration, which was approved by the SEC.<sup>130</sup> These 1989 reforms reflect the SEC’s support of SRO arbitration, albeit with a continuing concern that any rule change protect investors.<sup>131</sup> However, the SEC’s favorable view of SRO arbitration in 1989 was conditioned on its then current belief that firms’ use of arbitration clauses in customer agreements was NOT universal and that customers could open

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<sup>125</sup> *Id.* at 233-34.

<sup>126</sup> *Id.* at 233.

<sup>127</sup> *Id.* at 234.

<sup>128</sup> *Id.* at 231-34.

<sup>129</sup> *Making it Up*, *supra* note 26, at 999-1000.

<sup>130</sup> See Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, 54 Fed. Reg. 21144 (May 10, 1989).

<sup>131</sup> *E.g.*, Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Predispute Arbitration Clauses in Customer Agreements, 54 Fed. Reg. 15860, 15861 (proposed Apr. 19, 1989) (stating that the “proposed rule change is also intended to preserve the rights of public customers, which are guaranteed under the NASD Code of Arbitration Procedure, by prohibiting the imposition of conditions that limit or contradict these rules”). See generally *Making It Up*, *supra* note 26, at 999-1005 (reviewing fairness reforms of securities arbitration). In contrast, others have observed that, during this time frame, the SEC power led to little intervention by the SEC. See Brunet, *supra* note 120, at 1464-66 (contending that “[t]he past and present degree of SEC public interest regulation of securities arbitration reveals an ongoing agency presence but little in the way of regulatory vigor”).

cash accounts without agreeing to mandatory arbitration.<sup>132</sup> The SEC stated that its support of SRO arbitration might change if the use of PDAA's in customers' agreements became more widespread.<sup>133</sup> That change in support has not yet happened; although arbitration is now considered mandatory for individual investors.<sup>134</sup>

In the second decade after *McMahon*, NASD-DR began to implement many of the recommendations of the Ruder Report by reforming its procedural rules to improve the public's perception of fairness. In the ten-year period 1997-2007, NASD filed with the SEC more than 65 rule proposals relating to NASD arbitration.<sup>135</sup> These proposals involve a wide variety of rules and procedures relevant to arbitration, including proposals related to the selection and composition of the arbitration panel, selection of the Chairperson, the classification of arbitrators as public and non-public, the discovery process, subpoenas, location of hearings, the six-year eligibility rule, pleadings standards, motion practice, forum fees and an entire re-write of the Code of Arbitration Procedure to convert it to plain English.

The current version of the Customer Code includes many elements of procedural fairness. The Code requires notice of the claim,<sup>136</sup> an opportunity to be heard,<sup>137</sup> a right to be

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<sup>132</sup> Proposed Rule Change Relating to Predispute Arbitration Clauses in Customer Agreements, 54 Fed. Reg. 21144, 1989 WL 991624, \*23.

<sup>133</sup> *Id.*

<sup>134</sup> *See supra* notes 9, 36 and accompanying text.

<sup>135</sup> All of these rule proposals are available on the NASD website. *See* NASD Dispute Resolution, 2007 *Dispute Resolution Rule Filings*, <http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/RuleFilingsGuidance/2007RuleFilings/index.htm> (last visited June 7, 2007) (providing links to prior years dating back to 1997).

<sup>136</sup> *See* NASD Customer Code Rules 12300 (Filing and Serving Documents) and 12301 (Service on Associated Persons).

<sup>137</sup> NASD Customer Code Rule 12600. A live, evidentiary hearing is not required; NASD arbitrators can decide claims under \$25,000 based solely on paper submissions. NASD Customer Code

represented,<sup>138</sup> a convenient hearing location,<sup>139</sup> and decision by a neutral arbitrator.<sup>140</sup> The Customer Code also allows investors to pursue class action claims in court,<sup>141</sup> permits extensive discovery,<sup>142</sup> and provides for the waiver of filing fees upon ample demonstration of financial hardship.<sup>143</sup> Indeed, the current Customer Code includes many of the enhanced due process protocols that Professor Stempel would want to see to declare a consumer arbitration forum procedurally fair.<sup>144</sup>

More recent rule-making activity confirms that the SEC oversight process has gained more bite. Approval does not appear to be a sure thing. Rather, SEC solicitation of public comment on a proposed rule change has led to a healthy and meaningful review of proposed rules, and has required revisions and changes often in response to problems aired through the public comment process. For example, since 2005, NASD has filed several different versions of a proposal to amend its forum's rules addressing representation of parties in the forum.<sup>145</sup>

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<sup>138</sup> NASD Customer Code Rule 12208.

<sup>139</sup> NASD Customer Code Rule 12213.

<sup>140</sup> NASD Customer Code Rule 12400 (Neutral List Selection System and Arbitrator Rosters), 12408 (Disclosures Required of Arbitrators) and 12414 (Determinations of Arbitration Panel).

<sup>141</sup> NASD Customer Code Rule 12204.

<sup>142</sup> NASD Customer Code Rules 12505-12513 (discovery provisions).

<sup>143</sup> NASD Customer Code Rule 12900(a)(1) ("The Director may defer payment of all or part of the filing fee on a showing of financial hardship"). The panel has the sole authority to decide the allocation of hearing session fees. NASD Customer Code Rule 12902. Also, NASD's Conduct Code 3110 (f) precludes PDAs limited any remedy the arbitration panel can award.

<sup>144</sup> Stempel, *supra* note 43, at \_\_\_.

<sup>145</sup> See Notice of Filing of Proposed Rule Change Relating to Representation of Parties in Arbitration and Mediation, 72 Fed. Reg. 18703 (Apr. 9, 2007) (proposing revised rule, including two amendments, and withdrawing previous proposal, SR-NASD-2005-023). The 2005 proposal codified NASD-DR's current practice to allow an attorney admitted to the bar of any state to represent parties in arbitrations and mediations in its forum without regard to jurisdictional boundaries. Because public comments indicated that the rule filing was ambiguous with respect to the propriety of non-attorney representation and with respect to the required qualifications of attorneys permitted to practice in its forum, NASD withdrew that proposal and tried again, this time explicitly addressing those two issues. *Id.*

Similarly, NASD has attempted numerous times to amend its current rule addressing dispositive motions in arbitration. Staunch opposition by public commenters to each permutation of the rule led to further revision. The first version, proposed in 2003 as part of the larger Code rewrite,<sup>146</sup> for the first time expressly recognized the authority of arbitrators to dismiss claims before a live hearing while urging arbitrators to dismiss claims only in extraordinary circumstances. Public comment on this aspect of the Customer Code rule filing was prolific and critical. Commenters either opposed the codification of motion practice, or believed the phrase “extraordinary circumstances” was too vague and that arbitrators needed more guidance as to what that meant.<sup>147</sup>

In 2006, in response to these comments, and after further internal discussions with the SEC, NASD proposed additional language to clarify the meaning of “extraordinary circumstances” in Proposed Rule 12504.<sup>148</sup> In Amendment No. 5 to the Proposed Customer Code, NASD proposed to add the following language in the Dispositive Motions section of the ruling filing:

For purposes of this rule, if a party demonstrates affirmatively the legal defenses of, for example, accord and satisfaction, arbitration and award, settlement and release, or the running of an applicable statute of repose, the panel may consider these defenses to be extraordinary circumstances. In such cases, the panel may dismiss the arbitration claim before a hearing on the merits if the panel finds that there are no material facts in dispute concerning the defense raised, and there are no determinations of credibility to be made concerning the evidence presented.<sup>149</sup>

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<sup>146</sup> NASD’s omnibus proposal to revise the Code of Arbitration Procedure primarily was designed to simplify the Code, codify certain current practices, and rewrite it more clearly and in plain English. *See Order Approving Proposed Rule Change Related to Reorganization and Revision of NASD Rules Relating to Customer Disputes*, 72 Fed. Reg. 4574, 4575 (Jan. 31, 2007).

<sup>147</sup> *See* Securities and Exchange Commission, *Comments on Rulemaking, Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 Thereto to Amend NASD Arbitration Rules for Customer Disputes*, <http://www.sec.gov/rules/sro/nasd/nasd2003158.shtml> (last visited June 6, 2007).

<sup>148</sup> *See Notice of Filing of Proposed Rule Change Related to Motions to Decide Claims Before a Hearing on the Merits*, 71 Fed. Reg. 51879 (proposed Aug. 24, 2006).

<sup>149</sup> *See* National Association of Securities Dealers, Inc., *Amendment No. 5 to Reorganization and Revision of NASD Rules Relating to Customer Disputes*, available at [http://www.nasd.com/web/groups/rules\\_regs/documents/rule\\_filing/nasdw\\_016478.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_016478.pdf) (May 4, 2006), at 32.

According to NASD, this additional language was crafted to provide arbitrators with more guidance as to when it might be appropriate to grant a party's motion to dismiss a claim before a hearing.<sup>150</sup> Rather than quelling the controversy, this definition sparked even louder protest.

While NASD's intent was to acknowledge parties' ability to move to dismiss entirely frivolous claims and draft a rule making it clear that dispositive motions are appropriate only in very limited circumstances, the rule-making process revealed a sharply divided public on how to go about doing that. The SEC refused to approve a rule proposal based on such harsh public critique. Moreover, the SEC recognized the validity of those commenters who contended that disputed issues of material fact and issues of credibility present in many arbitration claims made it fundamentally unfair to dismiss a claim without affording the claimant an opportunity to complete discovery and present evidence. Thus, the SEC's regulatory oversight function served to ensure the fairness of this rule change.

In sum, these regulatory filings reflect a dynamic rule-making process through which NASD, the SEC, member firms, and the public at large interact with one another in commenting on, critiquing, opposing or supporting and suggesting revisions to the various versions of the rule. NASD proposes rules in response to minor or major flaws exposed by users of the system, addresses SEC staff concerns, and revises rules in response to public comments; the SEC reacts to NASD member's and the public's concerns; and NASD members and the public at large provide input into further rule revisions. The filings also show that the dynamic process does not end until the SEC perceives that the rule strikes the correct balance between free capital markets, regulation and investor protection. In my view, the end result is a set of procedural rules for securities arbitration that ensure fairness.

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<sup>150</sup> *Id.* at 31-32.

#### IV. Conclusion: The *McMahon* Paradigm is Not Outdated

The *McMahon* Court enthusiastically endorsed arbitration as a speedy, inexpensive and informal method of resolving disputes in the securities industry. That Court premised its ringing endorsement on the assumptions that parties would be protected from an unfair process through judicial review of the resulting awards and SEC oversight of the arbitration forums. This Symposium provided an excellent opportunity to review those two assumptions and revisit the *McMahon* paradigm.

My review has led me to conclude that, as a result of SEC oversight, investors have access to a fundamentally fair dispute resolution process that enables them to vindicate their statutory rights, to the same degree as, if not more so than in court. First, while judicial review of FAA-governed arbitration awards is still severely restricted, that review does provide an avenue for a complaint that the arbitration *process* was unfair to one party. Whether through a “fundamental fairness” test, a “manifest disregard of the law” contention, or a “vindicating statutory rights” objection, courts seem unwilling to let stand an arbitration award derived from a demonstrably unfair process. However, because these doctrines are either rarely used or, if used, narrowly construed, the protection implied by the *McMahon* Court’s first doctrinal assumption seems ineffective to *guarantee* a fair arbitration proceeding for investors.

The second assumption that SEC oversight will ensure that securities arbitration remains fair to the investor appears more fail-safe. The SEC does not approve any new or revised arbitration rule unless it demonstrably advances the interests of investor protection.<sup>151</sup> The rule-making process has led to a new Customer Code, effective for all claims filed on or after April

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<sup>151</sup> *McMahon*’s dual premise of FAA and SEC oversight of securities arbitration also creates a paradox. If the SEC has approved NASD rules for notice and a hearing, then how can a party convincingly argue that those same rules are fundamentally unfair within the meaning of the FAA? In other words, the SEC-approval process might strip parties of their right to argue that the arbitration hearing is not fundamentally fair under modern FAA jurisprudence.

16, 2007. This version of the Code contains all of the aspects of a “due process protocol” adopted by other commercial arbitration forums, including that of the American Arbitration Association. Public comment and controversy over aspects of securities arbitration leads to Congressional hearings, and SEC staff inquiry.

If my analysis is correct, why is there so much controversy about the fairness of securities arbitration? I believe that criticisms of the fairness of securities arbitration stem primarily from misunderstandings as to the law, not to defects in the process or failures of the arbitrators. If an investor believes that broker misconduct caused losses in his trading account, but an arbitrator does not award damages to the investor after a hearing on that misconduct, the investor blames the arbitrators, not the anti-investor law. Such misunderstandings lead to disillusionment with the process and *perceptions* of unfairness.<sup>152</sup>

Professor Brunet argues that a “rule of law” model can remedy the substantive unfairness of SRO arbitration. In my view, this is not a viable solution to perceived substantive unfairness because application of the rule of law depends on clear, well-developed law so that the outcome matches the disputants’ expectations. While developed law exists in the consumer context, the law governing broker-dealer relationships with their customers not only is not well-developed, it is frozen.<sup>153</sup> Because the law has not developed for products and markets that arose after 1987, investors don’t know what their rights and responsibilities are in those areas.<sup>154</sup> Moreover, more

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<sup>152</sup> See *Vigorito v. UBS PaineWebber*, 477 F. Supp.2d 481, 487 (D. Conn. 2007) (denying motion to vacate on grounds of evident partiality but declaring that “[t]he Court appreciates plaintiffs’ disillusionment with what they perceive to have been a flawed mandatory arbitration hearing. [Plaintiffs] did not feel welcome in or well-served by the mandatory industry arbitration setting, a sentiment exacerbated by [an arbitrator’s] failure to timely disclose [a potential source of bias]. This conduct cast a shadow over the finality of this arbitration proceeding, and the plaintiffs’ confidence in the fairness of its outcome, particularly where there is no explanation given for the arbitration decision (or dissent).”).

<sup>153</sup> Making it Up, *supra* note 26, at 992-93.

<sup>154</sup> McGuire’s point that NASD Notices to Members fill the gap in setting forth investors’ rights and responsibilities is misleading (*see* The Current State of Securities Arbitration: A Roundtable Discussion, 76 U. CIN.

than half of NASD arbitrators are not lawyers and thus would be hard-pressed to have the expertise to apply the rule of law to the degree that Professor Brunet would like.<sup>155</sup> Thus, substantive fairness is elusive.

Substantive fairness is also relative. Investors' remedies in court are severely limited by current law. Thus, as I have argued in the past, investors fare better in arbitration than in court.<sup>156</sup> They obtain recoveries in 40% of cases that proceed to a hearing; they do not have to overcome barriers to court access; they do not have to incur substantial transaction costs in the form of attorney's fees to engage in extensive discovery processes; and they do not have to meet strict pleading requirements and burdens of proof set forth by anti-investor federal legislation such as PSLRA – legislation designed with the express purpose of making it harder for investors to recover damages.<sup>157</sup>

In fact, today in arbitration, it is probable that Eugene and Julia McMahon would not even allege a '34 Act claim. Why bother? The statute of limitations is far shorter today than it was in 1987 and courts and Congress have raised the bar to make it more difficult for customers to prove scienter on the part of the broker. Instead, most customer arbitrations today are predicated on state securities acts and common law claims such as breach of fiduciary duty,

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L. REV. \_\_ (2008)); Notices to Members do not have the force of law, as they are not subject to the administrative rule-making process, and they cannot be binding on investors who, by definition, are not NASD members.

<sup>155</sup> *Making it Up*, *supra* note 26, at 1027; see also Barbara Black, *Do We Expect Too Much From NASD Arbitrators?*, SECURITIES ARBITRATION COMMENTATOR (Oct. 2004).

<sup>156</sup> *Making it Up*, *supra* note 26, at 1035-40; Barbara Black & Jill Gross, *The Elusive Balance Between Investor Protection and Wealth Creation*, 26 PACE L. REV. 27, 34 (2005).

<sup>157</sup> See, e.g., Jennifer O'Hare, *The Retail Investor's Remedies under the Antifraud Provisions of the Federal Securities Laws*, 76 U. CIN. L. REV. \_\_ (2008); Daniel J. Morrissey, *After the Ball is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals*, 83 NEB. L. REV. 732 (2005) (recognizing anti-investor trend of the law and better opportunity for investor recovery in arbitration). For a discussion of legal obstacles to recovery by mutual fund investors under the Investment Company Act of 1940, see Mercer Bullard, *Mutual Fund Shareholder Claims: All Bark, No Bite?*, 76 U. CIN. L. REV. \_\_ (2008).

negligent misrepresentation and fraud, and draw heavily on principles of equity.<sup>158</sup> As long as they can show they had a reason to trust their broker and the broker violated that trust, the McMahons twenty years later have a chance of obtaining an award.<sup>159</sup> The ultimate irony is that, even though the Supreme Court opened the door to securities arbitration, even without the *McMahon* decision, today's customers would continue to pursue their claims in arbitration. In the end, NASD arbitration of 2007 – with all its flaws – is the better alternative for Eugene and Julia McMahon.

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<sup>158</sup> Morrissey, *supra* note 157, at 754-59; Jill I. Gross, *Securities Mediation*, *supra* note 10, at 370-72.

<sup>159</sup> See David Robbins, *SECURITIES ARBITRATION PROCEDURE MANUAL*, § 5-1 (5<sup>th</sup> ed. 2001).