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## Securities Arbitrators Do Not Grow On Trees

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## ARTICLES

### SECURITIES ARBITRATORS DO NOT GROW ON TREES\*

*Constantine N. Katsoris*<sup>◊†</sup>

Humpty Dumpty sat on a wall. Humpty Dumpty had a great fall.  
All the King's horses, and all the King's men, couldn't put  
Humpty together again.<sup>‡</sup>

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† Although the following individuals do not necessarily agree with the conclusions of this article, I would like to thank and acknowledge The Honorable Joseph M. McLaughlin, James E. Buck, Robert S. Clemente, Romaine L. Gardner, Philip J. Hoblin, Jr., Louis A. Korahais, Richard P. Ryder, and James D. Yellen for offering their invaluable comments and insights.

‡ Humpty Dumpty is a character in a nursery rhyme portrayed as an anthropomorphic egg. Most English-speaking children are familiar with the rhyme. The fact that Humpty Dumpty is an egg is not actually stated in the rhyme. In its first printed form, it is a riddle, and exploits for misdirection the fact that "humpty dumpty" was 18<sup>th</sup> Century reduplicative slang for a short, clumsy person. Whereas a clumsy person falling off a wall would not be irreparably damaged, an egg would be. The rhyme is no longer posed as a riddle, since the answer is now well known. See [http://wikipedia.org/wiki/Humpty\\_Dumpty](http://wikipedia.org/wiki/Humpty_Dumpty).

## I. INTRODUCTION

As the public increasingly invests in the securities markets,<sup>1</sup> litigation between the securities industry and its customers has mushroomed.<sup>2</sup> Although the number of cases litigated varies from year to year, it is expected to continue to rise as a result of an expanding savings base, increased volume, the introduction of new products, and expanded electronic trading.<sup>3</sup> At present, securities disputes are primarily channeled into arbitration or submitted to mediation, principally at a forum provided by the Financial Industry Regulatory Authority (FINRA).<sup>4</sup>

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1. In addition to direct investments, the public also increasingly invests indirectly through Mutual Funds, IRAs, Keogh plans and other pension devices. See William J. Holstein, et al., *Can the Fed Santa Save Christmas?*, U.S. NEWS & WORLD REP., Dec. 18, 2000, at 40. "Nearly half of U.S. households now have some stake in the market through mutual funds, pension funds, 401(k)'s or direct equity holdings." *Id.*

2. See SEC. INDUS. CONFERENCE ON ARBITRATION, THIRTEENTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION (Oct. 2005), <http://www.nyse.com/pdfs/SICA2005.pdf> [hereinafter THIRTEENTH REPORT]; see also Mara Der Hovanesian, *Ruined by 401(k) Predators*, BUS. WK., July 14 & 21, 2008, at 063-64.

3. See Aaron Lucchetti & Alistair MacDonald, *Inside Exchanges' Race to Invent New Bets*, WALL ST. J., July 6, 2007, at A1; see also Anne Kates Smith, *Ordinary People May Really Get to Trade Like Pros*, U.S. NEWS & WORLD REP., Dec. 11, 2000, at 78; Pallavi Gogoi, *Rage Against Online Brokers*, BUS. WK., Nov. 20, 2000, at EB98; Michael Schroeder & Rebecca Buckman, *SEC Chief Wants Online-Trading Firms To Disclose the Risks of Internet Dealing*, WALL ST. J., May 4, 1999, at C23; *The Battle of the Bourses*, ECONOMIST, May 29, 2008, at 77; Gretchen Morgenson, *Brokerage Puts Limit on Stocks Analysts Hold*, N.Y. TIMES, July 11, 2001, at A1; Richard Karp, *Dueling for Dollars: If the Bear Returns, Wall Street's Arbitration Wars Will Escalate*, BARRON'S, Nov. 16, 1998, at 24; Saul Hansell, *New Breeds of Investors, All Beguiled by the Web*, N.Y. TIMES, May 16, 1999, § 3, at 1; C. Evan Stewart, *The Securities Industry in the 21st Century*, N.Y.L.J., Apr. 16, 1999, at 5; Charles Gasparino & Rebecca Buckman, *Horning In: Facing Internet Threat, Merrill To Offer Trading Online For Low Fees*, WALL ST. J., June 1, 1999, at A1; Pat Wechsler, *It's 8 P.M., and Mom's Out Trading*, BUS. WK., June 14, 1999, at 44; *A Nation of Shareholders?*, INVESTOR'S BUS. DAILY, June 21, 1999, at A4; Anne Kates Smith, *Roads to Riches*, U.S. NEWS & WORLD REP., June 28, 1999, at 66.

4. In 2007, the NASD Regulation changed its name to FINRA upon its consolidation with NYSE Regulation. See *infra* notes 26 and 68 and accompanying text; see also Constantine N. Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279 (1984) [hereinafter Katsoris I].

In general, arbitration and mediation provide the advantage of a speedy resolution of securities disputes by persons knowledgeable in the area, without excessive costs. Unless such procedures are fair in fact as well as in appearance, however, their popularity as a means of settling securities disputes will greatly diminish, especially if the public is limited to applying these procedures to resolve their disputes before only one self-regulating organization (SRO), FINRA.

Over the last few decades, the resolution of public securities disputes has also become more complex. Accordingly, the need for qualified, knowledgeable arbitrators – and the manner in which they are selected – has become increasingly important. To better understand the rules presently governing the qualification and selection of arbitrators, we must first look to the development and evolution of the present system and explore the judicial developments that have directed most of these disputes into SRO forums.<sup>5</sup>

Some argue that the system of selecting arbitrators isn't broken and only needs additional fine-tuning by further clarifying the qualifications of arbitrators.<sup>6</sup> Unfortunately, the myriad of inflexible rules as to who qualifies as an arbitrator merely attempts to compensate for, rather than address, the reality that the public investors *must* resolve their grievances before SRO forums. In the long run, these rules could compromise the integrity and viability of SRO arbitration. This Article respectfully suggests, therefore, that the current system resembles Humpty Dumpty after his great fall: the present method of qualifying and selecting SRO arbitrators is broken beyond repair and needs a complete overhaul.

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5. See *infra* notes 12-20 and accompanying text.

6. See SEC. ARB. ALERT 2008-25, NASAA FORUM ON SECURITIES ARBITRATION (July 9, 2008). “Discordant calls for an end to ‘mandatory’ arbitration clauses and/or the use of Industry Arbitrators gathered voice and rang in concert at a recent . . . forum [on June 24, 2008] sponsored by the North American Securities Administrators Association.” *Id.* (emphasis omitted).

NASAA has turned from its more neutral position of simply encouraging a thorough examination of the fairness of the securities arbitration process to actively seeking remedies that will fix a broken system, according to Karen Tyler, President of NASAA. There is no choice in the current system, which is dominated by FINRA and investors believe that that forum is “biased and unfair.” In order to restore “choice, fairness and balance,” NASAA supports restoration of the investor’s “fundamental right” to choose between court and arbitration and the elimination of the Non-Public (“Industry”) Arbitrator position on customer-related cases.

*Id.*

## II. BACKGROUND OF SECURITIES ARBITRATION

Arbitration is hardly a modern day phenomenon. Aristotle wrote:

Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks to the law, and the reason why arbitrators were appointed was that equity might prevail.<sup>7</sup>

The arbitration of customers' securities disputes traces back to the NYSE in 1872.<sup>8</sup> Thereafter, numerous other SROs established arbitration programs for the settlement of such disputes.<sup>9</sup>

*A. Judicial Developments*

An unresolved dispute between an investor and his broker ordinarily winds up in arbitration because of a pre-dispute arbitration agreement entered into at the time the investor opened the brokerage account.<sup>10</sup> Indeed, such agreements are widespread, particularly in the case of margin, option or other accounts involving credit.<sup>11</sup> Under the United States Arbitration Act (the "Federal Arbitration Act" or "Arbitration Act"), agreements to arbitrate future disputes are usually

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7. See SEC. INDUS. CONFERENCE ON ARBITRATION, THE ARBITRATOR'S MANUAL (Aug. 2007), <http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p009668.pdf> [hereinafter ARBITRATOR'S MANUAL] (quoting Domke on Aristotle).

8. PHILIP J. HOBLIN, JR., SECURITIES ARBITRATION: PROCEDURES, STRATEGIES, at 1-2 (N.Y. Inst. of Fin. 1988); see also DEREK ROEBUCK, ANCIENT GREEK ARBITRATION 6 (Holo Books The Arbitration Press) (2001).

The earliest substantial body of evidence of the way a community resolved disputes by arbitration is in the Greek language, though there are earlier sources from other civilisations which testify to its regular use. As early as 1700 (or possibly 1900) BC, the bombastic opening of the laws of Hammurabi proclaims him, among all his other astonishing attributes: the perfect arbitrator . . . .  
*Id.* (citation omitted).

9. See HOBLIN, *supra* note 8; see also Deborah Masucci & Robert S. Clemente, *Securities Arbitration at Self-Regulatory Organizations: NYSE and NASD Administration and Procedures*, 949 PLI/CORP 99, 106 (July-Aug. 1996).

10. See Katsoris I, *supra* note 4, at 292.

11. See Ann C. Stansbury & Justin P. Klein, *The Arbitration of Investor-Broker Disputes: A Summary of Developments*, 35 ARB. J. 30, 32 (1980).

specifically enforceable.<sup>12</sup> The United States Supreme Court, however, carved out an exception to this mandate in 1954 in *Wilko v. Swan*.<sup>13</sup> In *Wilko*, the Court faced the difficult choice between the Arbitration Act's mandate to arbitrate, and provisions in the Securities Act of 1933 (the "1933 Act" or "Securities Act") intended to protect a customer's rights.<sup>14</sup> After expressing some mistrust of arbitration, the Court in *Wilko* concluded that Congress' desire to protect investors would be more effectively served by holding unenforceable pre-dispute arbitration agreements relating to issues arising under the 1933 Act.<sup>15</sup>

Subsequently, many federal courts *presumed* that the *Wilko* exception for 1933 Act claims also extended to the Securities Exchange Act of 1934 (the "1934 Act" or "Exchange Act"), and thus refused to compel arbitration for customers' claims arising under the 1934 Act,

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12. 9 U.S.C. §§ 1-14. Section 2 of the Arbitration Act provides: "A written provision in . . . a contract evidencing a *transaction involving commerce* to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." *Id.* § 2 (emphasis added). Because the Federal Arbitration Act applies to claims arising from transactions involving interstate commerce, and because securities dealings usually involve such transactions, state securities claims, as well as those arising under the federal securities laws, are usually arbitrable. *See Katsoris I, supra* note 4, at 292.

13. 346 U.S. 427 (1953).

14. *See Katsoris I, supra* note 4, at 293-94. *Compare* 9 U.S.C. § 2 (stating that "[a] written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable . . .") with 15 U.S.C. § 771(a)(2) (allowing an investor to "sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security").

15. *Wilko*, 346 U.S. at 418. *Wilko* involved an action brought by a customer against a securities brokerage firm to recover damages under the liability provisions of Section § 12(2) of the Securities Act for alleged misrepresentation in the sale of securities. *Id.* at 428-38. Civil liabilities arise under the 1933 Act when any person

offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . .

15 U.S.C. § 771(a)(2).

despite the presence of pre-dispute arbitration agreements.<sup>16</sup>

More than three decades after *Wilko*, the Supreme Court in *Shearson/American Express, Inc. v. McMahon*<sup>17</sup> cleared up prior misconceptions by holding that the *Wilko* exception did not apply to 1934 Act claims. Moreover, soon thereafter, the Supreme Court in *Rodriguez de Quijas v. Shearson/American Express, Inc.*<sup>18</sup> undid the *Wilko* exception entirely, holding that pre-dispute arbitration agreements would be upheld, even as to issues arising under the 1933 Act.<sup>19</sup> With the *Wilko* barrier effectively removed by *McMahon* and *Rodriguez*, most securities disputes are now arbitrated at an SRO forum pursuant to pre-dispute arbitration agreements.<sup>20</sup>

### B. Creation of SICA/Role of the SEC

Prior to 1976, most SROs had divergent rules governing the administration of securities arbitration disputes.<sup>21</sup> In June 1976, the SEC solicited comments from interested persons regarding the feasibility of developing a “uniform system of dispute grievance procedures for the adjudication of small claims.”<sup>22</sup> After conducting a public forum at which written and oral comments were received, the SEC’s Office of Consumer Affairs issued a report recommending the adoption of procedures for handling investor disputes and the creation of a new entity to administer the system.<sup>23</sup>

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16. See Constantine N. Katsoris, *Securities Arbitration After McMahon*, 16 FORDHAM URB. L.J. 361, 364-67 (1988) [hereinafter Katsoris II]. But see Katsoris I, *supra* note 4, at 301. “Thus, although *Scherk* involved a 10b-5 claim arising out of an international securities transaction, the Court’s suggestion that the *Wilko* prohibition be limited to 1933 Act claims should be followed in domestic cases as well.” *Id.* (emphasis added).

17. 482 U.S. 220 (1987).

18. 490 U.S. 477 (1989).

19. See Roberta S. Karmel, *Arbitration and the Demise of Wilko v. Swan*, N.Y.L.J., June 15, 1989, at 3.

20. See Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 487 (1996) [hereinafter Katsoris III].

21. See Katsoris I, *supra* note 4, at 283.

22. Settling Disputes Between Customers & Registered Brokers & Dealers, Exchange Act Release No. 12,528, 9 SEC Docket 833, at 834, 1976 SEC Lexis 1469, at \*2 (June 9, 1976).

23. An Integrated Nationwide System for the Resolution of Investor Disputes,

Before implementing the proposal, the Commission invited further public comment.<sup>24</sup> In response, several SROs proposed the establishment of a securities industry task force to consider the development of “a uniform arbitration code and the means for establishing a more efficient, economic and appropriate mechanism for resolving investor disputes involving small sums of money.”<sup>25</sup> As a result of this suggestion, the Securities Industry Conference on Arbitration (SICA) was established in April 1977, consisting of representatives of various SROs,<sup>26</sup> the Securities Industry Association (SIA)<sup>27</sup> and the public.<sup>28</sup>

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Exchange Act Release No. 12,974, 10 SEC Docket 955, 1976 SEC LEXIS 389 (Nov. 15, 1976).

24. *Id.* at 955-56.

25. SEC. INDUS. CONFERENCE ON ARBITRATION, FIFTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, at 2 (1986) [hereinafter FIFTH REPORT].

26. The following SROs were represented: the American (ASE), Boston (BSE), Cincinnati (CSE), Midwest (MSE), New York (NYSE), Pacific (PSE), and Philadelphia (PHSE) Stock Exchanges, the Chicago Board Options Exchange (CBOE), the Municipal Securities Rulemaking Board (MSRB), and the National Association of Securities Dealers, Inc. (NASD). *See* FIFTH REPORT, *supra* note 25, at 3. After 1997, the MSRB would not accept new arbitration claims, after which the NASD assumed responsibility for the arbitration of municipal securities disputes. *See MSRB Turns To NASD Arbitration to Handle Municipal Securities Disputes*, SEC. ARB. COMMENTATOR, Oct. 1997, at 5. In 1998, the ASE agreed to merge with the NASD. *See American Stock Exchange Proposes Closing “AmEx Window” When It Opens As NASD Subsidiary*, SEC. ARB. COMMENTATOR, Oct. 1998, at 10-11. After September 1998, the Philadelphia Stock Exchange no longer accepted new arbitration claims for filing. *See Philadelphia Stock Exchange Proposal to End Its Arbitration Program Approved by SEC*, SEC. ARB. COMMENTATOR, Oct. 1998, at 10. Instead, members thereafter became subject to the NASD Code. *Id.* Moreover, in 2007, NASD and NYSE Regulation were consolidated into the Financial Industry Regulatory Authority (FINRA). *See infra* note 68.

27. FIFTH REPORT, *supra* note 25, at 3. The SIA is a trade association for the securities industry. The SIA is now known as the Securities Industry and Financial Markets Association (SIFMA). *See* SICA Mission Statement *infra* note 69.

28. *See* SEC. INDUS. CONFERENCE ON ARBITRATION, TENTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, at 1-2 (1998) [hereinafter TENTH REPORT]. Peter R. Cella, Jr., Esq., Mortimer Goodman, Esq., and this author served as the public members of SICA at its creation in 1977. *Id.* at 3. In 1983, Justin Klein, Esq., was added as the fourth public member of SICA. *See id.* Commencing on December 31, 1989, the then current public members’ terms began to expire, one each year. They were then each eligible for reappointment for one new four-year term. All new members will serve for four years and *are eligible* for reappointment to one additional four-year term. The public members whose terms are not expiring will



The Commission then invited proposals from SICA to improve the methods for resolution of investors' small claims.<sup>29</sup> SICA developed a simplified arbitration procedure for resolving customer claims of \$2,500 or less,<sup>30</sup> and issued an informational booklet describing small claims procedures (the "Small Claims Booklet").<sup>31</sup> Realizing, however, that the development of a small claims procedure was only a first step, SICA went on to develop a comprehensive Uniform Code of Arbitration (the "Uniform Code") for the securities industry.<sup>32</sup> The Uniform Code established a uniform system of arbitration procedures to cover all claims by investors, whether large or small.<sup>33</sup> In addition, SICA prepared an

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determine the appointment of new members or their reappointment. The appointment, or reappointment, may be vetoed by a two-thirds vote of the non-public members of SICA. *Id.* Mortimer Goodman concluded his term in 1990 and was replaced by James E. Beckley, a sole practitioner from Wheaton, Illinois. In 1995 Justin P. Klein concluded his term and was replaced by Thomas R. Grady of Grady & Associates, Naples, Florida. In July of that same year SICA voted to return the public membership to three voting members upon the conclusion of this author's term in 1997. In 1996 Peter R. Cella concluded his term and was replaced by Professor Thomas J. Stipanowich, who was reappointed in 2000 to serve a second term. In 1998, James E. Beckley concluded his term and was replaced by Theodore Eppenstein, of Eppenstein and Eppenstein, New York. Mr. Eppenstein was reappointed in 2002. In 2000, Mr. Grady was reappointed to a second term and concluded his term on the Conference in 2003. Mr. Grady was replaced by this author, who returned to active status and Chair of SICA meetings. Upon the expiration of the term of Professor Stipanowich in 2004, he was replaced in 2005 by Pat Sadler, an attorney from Atlanta, Georgia. *See THIRTEENTH REPORT, supra* note 2, at 2-3. With the adoption of a new Mission Statement by SICA to reflect FINRA's predominant SRO role (*see infra* notes 66-70), SICA adjusted the terms of the present public members going forward to expire as follows: Pat Sadler (through 2008), Theodore Eppenstein (through 2010) and Constantine N. Katsoris (through 2012).

29. *See generally* Implementation of An Investor Dispute Resolution System, Exchange Act Release No. 13,470 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,136 (Apr. 26, 1977).

30. *See FIFTH REPORT, supra* note 25, at 3. SICA subsequently raised the jurisdictional limit of small claims to \$5,000, then to \$10,000, and then again to the present \$25,000. *See TENTH REPORT, supra* note 28, at 3.

31. *See SEC. INDUS. CONFERENCE ON ARBITRATION, FIRST REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, at EXHIBIT D: PROPOSALS TO ESTABLISH A UNIFORM SYSTEM FOR THE RESOLUTION OF CUSTOMER DISPUTES INVOLVING SMALL CLAIMS (Nov. 1977) [hereinafter FIRST REPORT].*

32. *See UNIFORM CODE OF ARBITRATION (as amended), reprinted in FOURTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, at EXHIBIT C (Nov. 1984) [hereinafter UNIF. CODE OF ARB.].*

33. *See FIFTH REPORT, supra* note 25, at 2-3.

explanatory booklet for prospective claimants (the “Procedures Booklet”),<sup>34</sup> explaining procedures under the Uniform Code. To a large extent, the Uniform Code incorporated and harmonized the rules of the various SROs and codified other SRO procedures that they had previously informally followed without officially including in their rules.<sup>35</sup>

The participating SROs adopted the original Uniform Code in 1979 and 1980.<sup>36</sup> Between the time of its initial adoption and the *McMahon* case in 1987, various revisions were made to both the Uniform Code and the Procedures Booklet.<sup>37</sup> With the significant influx of additional and often more complex cases resulting from the *McMahon* decision,<sup>38</sup> numerous issues and safeguards that previously had only been discussed at SICA without final action (when SRO arbitrations were largely voluntary) were reconsidered and implemented, such as: (1) expanded discovery procedures; (2) the qualification, background, training, selection and evaluation of arbitrators; (3) challenges for cause; (4) the method of transcribing and preserving the record of an arbitration hearing; and (5) burdens on SROs resulting from the anticipated increase in case load.<sup>39</sup>

Although some of the resultant changes nudged SRO arbitration somewhat closer to litigation, these changes were thought necessary in order to prevent trial by surprise and ambush.<sup>40</sup> For rules to be effective

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34. See SEC. INDUS. CONFERENCE ON ARBITRATION, THIRD REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, at 5 (1980) [hereinafter THIRD REPORT]; see also SEC. INDUS. CONFERENCE ON ARBITRATION, ARBITRATION PROCEDURES (1980) [hereinafter PROCEDURES BOOKLET]. After *McMahon*, SICA consolidated the Small Claims booklet into the Procedures Booklet. SEC. INDUS. CONFERENCE ON ARBITRATION, SIXTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, at 3 (1989) [hereinafter SIXTH REPORT].

35. Katsoris I, *supra* note 4, at 284.

36. FIFTH REPORT, *supra* note 25, at 4. Once SICA adopts a new rule, each SRO must then generally go back to their respective organizations in order to get a rule change. The rule change is then submitted to the SEC for approval. Accordingly, there is often a time lag between SICA approval and SRO implementation. Unfortunately, sometimes some SROs have not followed SICA’s lead. See Constantine N. Katsoris, *SICA Does The Bell Toll For Thee?*, SEC. ARB. COMMENTATOR, Jan. 1994, at 1.

37. See FIFTH REPORT, *supra* note 25, at 4-6.

38. In the year before *McMahon*, 2,837 cases were filed at the various SROs, whereas in the year following *McMahon*, that figure more than doubled to 6,097 cases filed. See TENTH REPORT, *supra* note 28, at 38.

39. See SIXTH REPORT, *supra* note 34, at 1-3.

40. See Katsoris II, *supra* note 16, at 370-71. Pre-hearing exchange of information between the parties was greatly expanded so that each side could better prepare for the

and fair, however, they cannot be cast in stone. Accordingly, SICA continued to monitor the actual performance of the Uniform Code, and held meetings to further fine-tune and adjust its provisions as the need arose.<sup>41</sup> In addition to the SEC, other organizations such as the Commodities Futures Trading Commission (CFTC), the American Arbitration Association (AAA), and the North American Securities Administrators Association (NASAA) also routinely participated by invitation in these meetings.<sup>42</sup> In addition, so as to not lose their expertise, the public members whose terms had expired were also invited to attend as *emeritus* members.

To date, over *one hundred fifty thousand* cases, including small claims, have been filed with participating SROs since the initial approval of the Uniform Code.<sup>43</sup> Moreover, in order to make the Uniform Code more user-friendly, the SEC insisted that future amendments to SRO codes be made in *Plain English*.<sup>44</sup> Accordingly, SICA translated the entire Uniform Code in 2001 (the “Old Uniform Code”) into “Plain English,” and references to the Uniform Code hereafter will be to the present Uniform Code (the “New Uniform Code”), unless otherwise indicated.<sup>45</sup>

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actual hearing instead of being surprised at the hearing. *Id.* at 373.

41. *Id.* at 364.

42. *Id.* NASAA is now a voting member of SICA.

43. See THIRTEENTH REPORT, *supra* note 2, at 10. The bulk of these arbitrations were, until recently, handled before the NASD and the NYSE. See Constantine N. Katsoris, *Roadmap to Securities ADR*, 11 FORDHAM J. CORP. & FIN. LAW 413, 525-34 (2006) [hereinafter Katsoris IV] for a breakdown of the arbitrations handled by the various SROs between 1980 and 2005.

44. The SEC indicated that future amendments to the Uniform Code should be made in “Plain English”. Through a research project sponsored by the Fordham University School of Law, in cooperation with the NYSE’s Department of Arbitration, a draft of the entire Uniform Code was prepared in “Plain English” and submitted to SICA for its consideration. See TENTH REPORT, *supra* note 28, at 5.

45. The Plain English rules are set forth primarily in Rules 421 and 461 of Regulation C under the Securities Act of 1933, and Items 501, 503, and 508 of Regulation S-K. New Rule 421(d) requires issuers to draft the front and back, cover pages, as well as the summary and the risk factors sections of registration statements in Plain English. The rules set forth six Plain English principles with which the issuer must “substantially” comply: (1) short sentences; (2) definite, concrete, everyday language; (3) the active, rather than the passive, voice; (4) tabular presentation or “bullet lists” for complex information whenever possible; (5) no legal jargon or highly technical business terms; and (6) no multiple negatives. Securities Act Rule 421(d)(2),

## III. PERCEPTIONS OF FAIRNESS/SICA SURVEY

In 2002, the Securities and Exchange Commission sponsored a study by Professor Michael Perino regarding the operation of arbitrator disclosure requirements in securities arbitration.<sup>46</sup> Among other things, Professor Perino sought empirical data on the experience of investors in securities arbitration, and determined that the most comprehensive study of investor outcomes was the Government Accounting Office's (GAO) 1992 report, "Securities Arbitration: How Investors Fare."<sup>47</sup> The report examined results in arbitration over an eighteen-month period between 1989 and 1990. It found "no evidence of a systematic pro-industry bias" in arbitrations sponsored by the NASD, NYSE, and other SROs when compared to arbitrations conducted by the AAA.<sup>48</sup> Among other things, the GAO noted that in SRO arbitrations, panels found for investors in about 59% of arbitrations versus 60% of AAA-sponsored arbitrations, and prevailing investors received average awards of about 61% of the damages claimed, as opposed to awards averaging 57% of amounts claimed in AAA proceedings.<sup>49</sup>

In addition, Professor Perino's report concluded "that there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations."<sup>50</sup> Nevertheless, the Perino report "recommended minor enhancements to disclosure and other related rules to provide additional assurances to investors that arbitrators are in fact neutral and impartial."<sup>51</sup> Specifically, Professor Perino's report made

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17 C.F.R. § 230.421(d); *see also* SEC, Office of Investor Educ. & Assistance, A PLAIN ENGLISH HANDBOOK (Aug. 1998), <http://www.sec.gov/pdf/handbook.pdf>; Tamara Loomis, *Plain English, SEC Guidelines Give Good Writing a Good Name*, N.Y.L.J., Aug. 10, 2000, at 5. *See generally* Katsoris III, *supra* note 20, for a comparison of the old version of the Code and the translated new version.

46. *See* MICHAEL PERINO, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATIONS (Nov. 4, 2002), <http://www.sec.gov/pdf/arbconflict.pdf> [hereinafter PERINO REPORT].

47. *Id.* at 31.

48. *Id.*

49. *Id.*

50. *Id.* at 48.

51. SEC. INDUS. CONFERENCE ON ARBITRATION, TWELFTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, at 4-5 (2003) [hereinafter TWELFTH REPORT].

four recommendations:

- (1) Amend arbitration rules to emphasize that all arbitrator conflict disclosures are mandatory;
- (2) Re-examine the definitions of public and non-public arbitrators;
- (3) Provide greater transparency with respect to challenges for cause by including the cause standard in the rules;
- (4) Sponsor independent research to evaluate the fairness of SRO arbitrations.<sup>52</sup>

In 2003, SICA discussed Professor Perino's recommendations and decided to sponsor independent research to evaluate the fairness of SRO arbitrators.<sup>53</sup> Great care was taken to ensure the integrity of the study both as to contents and reporting; and, after examining proposals from various vendors, SICA entered into an agreement with Pace University in 2005 to conduct the recommended study.

An eight-page survey was prepared under SICA's direction (the "Survey"), which reflected the input of numerous constituencies. The Survey was distributed by SICA to nearly thirty thousand participants in customer-initiated arbitrations at NASD Dispute Resolutions and the New York Stock Exchange filed between January 1, 2002 through December 31, 2006 and closed during 2005 and 2006. Over three thousand responses were received and processed.<sup>54</sup>

The Survey was designed to assess participants' perceptions of: (1) the fairness of the SRO arbitration process; (2) the competence of arbitrators to resolve investor's disputes with their broker-dealers; (3) the fairness of SRO arbitration as compared to their perceptions of fairness in securities litigation in similar disputes; and (4) the fairness of the outcome of arbitrations.<sup>55</sup>

In response, 3,087<sup>56</sup> surveys were returned to and processed by

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52. *Id.*

53. THIRTEENTH REPORT, *supra* note 2, at 6.

54. See JILL I. GROSS & BARBARA BLACK, PERCEPTIONS OF FAIRNESS OF SECURITIES ARBITRATION: AN EMPIRICAL STUDY, REPORT TO THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION (Feb. 6, 2008), <http://www.law.pace.edu/files/finalreporttosica.pdf> [hereinafter PERCEPTIONS STUDY]; see also *SICA Report on Arbitration's Fairness*, SEC. ARB. COMMENTATOR, Apr. 2007, at 10-11 [hereinafter *SICA Report*].

55. PERCEPTIONS STUDY, *supra* note 54, at 1, 48.

56. *Id.* at 12.

Cornell University's Survey Research Initiative, which provides survey research, data collection, and analysis services to a wide range of academic, non-profit, governmental and corporate clientele. Thereafter, a report (the "Perceptions Study"<sup>57</sup>) was prepared by Professors Jill I. Gross<sup>58</sup> and Barbara Black,<sup>59</sup> and was presented to SICA on February 6, 2008 and publicly released by SICA that same day.<sup>60</sup>

The Perceptions Study documents the results of an empirical study (through a one-time mailed survey) of survey participants' perceptions of fairness of securities SRO arbitrations involving customers.<sup>61</sup> Not surprisingly, the Survey and Perceptions Study were perceived differently, depending on one's perspective. Perhaps the Honorable William Hughes Mulligan best captured the basis for this discrepancy in his speech before the New York County Lawyers Association after his appointment to the United States Court of Appeals for the Second Circuit:

I am, of course, delighted to renew my contacts with the practicing profession after spending so many years with academicians and law students. Exactly half the lawyers who have appeared before me since I ascended the bench have been pleased with my appointment.<sup>62</sup>

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57. *Id.*

58. Jill I. Gross, Associate Professor of Law and Director, Investor Rights Clinic (a/k/a Securities Arbitration Clinic), Pace University School of Law. A.B. Cornell Univ.; J.D. Harvard Law Sch. Professor Gross has served as an NASD arbitrator, represented both customers and brokers in NASD and NYSE arbitrations, and has written and lectured extensively on securities arbitration. *See* Jill I. Gross, Curriculum Vitae, <http://www.law.pace.edu/files/facultyCVs/jillgrosscv2007.pdf>.

59. Barbara Black, Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law, B.A. Barnard Coll.; J.D. Columbia Univ. Law Sch. Professor Black was the founder and previously the Co-Director of the Securities Arbitration Clinic at Pace University School of Law. She writes and lectures extensively on securities regulation, securities arbitration, and investors' rights. *See* Barbara Black, Curriculum Vitae, <http://www.law.uc.edu/faculty/docs/black.pdf>.

60. *See* PERCEPTIONS STUDY, *supra* note 54.

61. *Id.* at 1 (citation omitted).

62. MULLIGAN'S LAW 45 (William Hughes Mulligan, Jr., ed., Fordham Univ. Press 1997) (emphasis added); *see infra* note 69.

One of the more neutral analyses of the Perceptions Study described its findings as follows:

According to the [Study], the survey responses were representative of the various target categories of lawyers (31%), brokerage firms (15%), associated persons (7%), and customers (45%). The Study achieved an adequate geographic distribution, and reflected a representative cross-section of participants based upon amount of claim, amount of damages awarded, and the manner of resolution. Generally, the authors report, the Study found that participants felt that the arbitrators listened well, gave parties enough time to present, appeared competent, and understand the issues and the law. They also believed that the discovery process secured the information necessary to prove their case or mount a defense. However, their perceptions were more mixed about the arbitrators' impartiality and whether they applied the law. Finally, participants were often dissatisfied with the outcome, felt an explanation would have been helpful, and customers were generally more negative about the process than non-customers.<sup>63</sup>

A copy of the Survey and Perceptions Study, consisting of seventy-one pages, can be viewed on the Pace University website,<sup>64</sup> enabling each individual to assess and interpret for themselves the contents, results, and interpretation thereof.

#### IV. THE CHANGING LANDSCAPE

At the end of 2005, seven SROs were still participating members of SICA.<sup>65</sup> More importantly, however, of the 6,555 cases reported by the SROs that year, the NASD reported 6,074 and the NYSE reported 463, an aggregate exceeding 99% of all such filed cases.<sup>66</sup> Moreover, in 2006, the NASD and NYSE announced an impending consolidation of their regulatory functions, which included their arbitration and mediation departments.<sup>67</sup> Indeed, this consolidation became effective on

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63. *SICA Report*, *supra* note 54, at 10.

64. *See PERCEPTIONS STUDY*, *supra* note 54.

65. *See THIRTEENTH REPORT*, *supra* note 2, at 1.

66. *See Katsoris IV*, *supra* note 43, at 525-34.

67. Press Release, SEC, SEC Gives Regulatory Approval for NASD and NYSE

July 30, 2007, resulting in the largest non-governmental regulator for securities firms doing business in the United States.<sup>68</sup> To reflect this forum consolidation for the resolution of securities disputes into essentially one SRO, i.e., FINRA, SICA amended its mission statement to reflect its changing role, as follows:

The Securities Industry Conference on Arbitration (“SICA” or the “Conference”) was formed in 1977 to develop nationwide uniform rules governing the arbitration of disputes between broker/dealers and customers at securities industry self-regulatory organizations (“SROs”). The Conference initially prepared and adopted a uniform code for investors small claims, providing for the resolution of disputes based on the submission by the parties of pleadings alone. Subsequently a uniform code of arbitration (“Uniform Code” or “Code”) covering all disputes, including small claims, between customers and broker/dealers regardless of amount, was drafted and adopted. These rules were subsequently adopted by SROs in accordance with the procedures set forth in Section 19 of the Securities Exchange Act of 1934, as amended, and Rule 19b-4 thereunder. In addition, the Conference prepared and published several written materials explaining the arbitration procedures for investors and a training manual for arbitrators to assist them in carrying out their responsibilities. These written materials are distributed by the SRO and have been freely reproduced and are periodically updated by SICA.

The Conference is composed of representatives of SROs with arbitration programs, the Securities Industry and Financial Markets Association (“SIFMA”), three members of the public (“Public Members”), and a representative from the North American Securities Administrators Association (“NASAA”). In addition, members of the staff of the Securities and Exchange Commission (“SEC” or “Commission”), the Commodity Futures Trading Commission (“CFTC”), the American Arbitration Association (“AAA”), a representative of the law schools with securities arbitration clinics, and the former Public Members (“Emeritus Members”) are invited to attend the meetings of the Conference.

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Consolidation (July 26, 2007), <http://www.sec.gov/news/press/2007/2007-151.htm>.

68. *We Are FINRA — the Financial Industry Regulatory Authority*, THE NEUTRAL CORNER (FINRA, Washington, D.C.), Sept. 2007, at 1, available at <http://www.finra.org/ArbitrationMediation/Neutrals/Education/NeutralCorner/P036755>.



In July 2007, NASD and NYSE Regulation consolidated their member regulation, enforcement, and dispute resolution programs, forming a new SRO, FINRA (the Financial Industry Regulatory Authority). With the completion of the arbitration and mediation program consolidation, FINRA is expected to handle the large majority of all SRO securities disputes. SICA's pre-consolidation mission was to serve as a cooperative effort of the securities industry, the SROs, and the public, working with the SEC, to implement a uniform system of arbitration, to monitor that system, to change it as appropriate or required, and to serve as a think tank to explore new ideas. With FINRA's emergence, SICA's mission changed primarily as a broad-based, open forum for interested constituents to discuss current issues in securities arbitration and mediation, to monitor SRO securities arbitration and mediation programs, and to provide independent feedback and to make recommendations for change to SROs on the rules, regulations, policy, procedures and operation of their dispute resolution forums.<sup>69</sup>

Since the consolidation of the NASD and NYSE arbitration programs basically left FINRA as the sole provider of an SRO forum for the resolution of securities disputes, outcries calling for alternative options resurfaced. Among the suggested alternatives were: maintaining multiple forums;<sup>70</sup> creating a separate independent non-SRO forum;<sup>71</sup> renewing the ability of investors to pursue their remedies in court;<sup>72</sup> and,

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69. See SICA minutes of November 28, 2007, a copy of which are on file with the author.

70. See Katsoris IV, *supra* note 43, at 470-76; see also *id.* at 473-74 (describing SICA's attempt at an alternative Pilot Program in lieu of SRO arbitration).

71. *Id.* at 470-73; see also *id.* at 472 n.294 ("A single independent forum entails exactly what it indicates – a forum independent from actual, inferential, subtle, practical or any kind of imaginable pressure. The forum should be independent of the industry, independent of the plaintiff's bar, and other than the SEC's general oversight role, independent of that regulatory body."); Stephen G. Sneeringer, *A SICA Experiment*, SEC. ARB. COMMENTATOR, Nov. 2002, at 1.

72. See Katsoris IV, *supra* note 43, at 475-76.

Indeed, permitting such alternative access to the courts has considerable merit and appeal, and would help defuse escalating tensions regarding the selection and qualification of arbitrators. Unfortunately, however, there is no free lunch; and such re-entry to the courts would trigger a ripple effect. By freeing claimants from the yoke of mandatory contractual arbitration, the industry would surely counter – in the interest of maintaining a level playing field – that it too should then be similarly freed from the mandatory obligation to arbitrate, which is presently imposed by the SROs upon its members (whether there is an agreement to arbitrate or not). Moreover, flooding the courts with thousands of securities disputes would saddle the courts,

finally eliminating the category of industry arbitrators – permitting only so-called *public arbitrators* to qualify at SRO forums.<sup>73</sup> Most of these alternative options to a single SRO forum have previously been extensively discussed elsewhere,<sup>74</sup> and it is not the purpose of this Article to presently delve into their overall merits.

Securities arbitration will remain a dispute resolution option regardless of whether there is one SRO forum or many, or whether arbitration is mandatory or voluntary. As such, it must be fair to all participants both in fact and appearance. The success of any arbitration program does not lie in a litany of rules that seek to micro-manage the process, but rather in the integrity and quality of the arbitrators who hear and decide a case.<sup>75</sup> Accordingly, this Article focuses on the lingering

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claimants, and respondents with additional costs and delays. In addition, depending on the extent and manner in which access to the courts was allowed, the troublesome intertwining/bifurcation dilemma of having similar facts being simultaneously tried before different tribunals could resurface. Furthermore, once the exclusivity of the arbitration remedy is breached, we will probably gradually drift towards a significantly weaker SRO arbitration system where interest and resources in maintaining a level playing field will wane over time; for, instead of being constantly vigilant to insure that the playing field does not tilt one way or the other, complacency will appear and a ‘*let’s fix it*’ attitude will be replaced by ‘*if you don’t like the rules, why don’t you go to court.*’ In this regard, I might add that it was after *McMahon* that most of the belt-tightening in SRO arbitration occurred.

*Id.* (emphasis added); *See also* Arbitration Fairness Act of 2007, S. 1782, 110th Cong. (2007); Michael P. Bruyere & Meghan D. Marino, *Making Arbitration Truly Mandatory*, TR. & EST., July 2008, at 22.

Florida adopted a statute, effective July 1, 2007, that provides:

A provision in a will or trust requiring the arbitration of disputes, other than disputes of the validity of all or a part of a will or trust, between or among the beneficiaries and a fiduciary under the will or trust, or any combination of such persons or entities, is enforceable.

By expressly providing for the enforceability of arbitration clauses in trust documents, the Florida legislature solves a pervasive problem. The most significant obstacle in enforcement of such provisions may be the requirement that parties to an arbitration must themselves voluntarily submit to the process. Put another way, because a grantor can create a trust without the beneficiaries’ approval, the beneficiaries will not automatically be bound to arbitration provisions included in the document.

*Id.* at 23-24.

73. *See* Katsoris IV, *supra* note 43, at 435; Constantine N. Katsoris, *Should McMahon Be Revisited?*, 59 BROOK. L. REV. 1113, 1152 [hereinafter Katsoris V].

74. *See supra* notes 71-74; *see also* Katsoris IV, *supra* note 43, at 469-76.

75. Indeed, the neutrality of some arbitration forums, such as the National Arbitration Forum (NAF), has come under severe criticism. *See* Robert Berner and Brian Grow, *Banks vs. Consumers (Guess Who Wins)*, BUS. WK., June 16, 2008 at 072

and troublesome issue of how we select arbitrators for the resolution of securities disputes.<sup>76</sup>

#### V. THE QUALIFICATION AND SELECTION OF ARBITRATORS

The rules and regulations governing the qualifications and selection of arbitrators are derived primarily from two separate Codes of Arbitration. The Uniform Code, as discussed in Part II.B, was intended to be the model for all SROs to follow. Pertinent sections of the FINRA

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(“NAF is nothing more than an arm of the collection industry hiding behind a veneer of impartiality,” says Richard Neely, a former justice of the West Virginia supreme court who as part of his private practice arbitrated several cases for NAF in 2004 and 2005.”); see also *U.S. News: Arbitration Firm Faces Questions over Neutrality*, WALL ST. J., April 21, 2008 at A3; Ashby Jones & Andrew Batson, *Concerns About China Arbitration Rise*, WALL ST. J., May 9, 2008 at B1. “We push for neutrality,” says John Tecklenburg, Alcoa Inc.’s general counsel for Asia, of his

strategy on negotiating venue. “We don’t always get Sweden or Switzerland or Singapore, but sometimes we do.” CIETAC’s arbitrations are similar to those in the west, in that panels generally consist of three arbitrators, two of which are hand-picked by the parties in dispute. But there are differences. In the west, if the parties can’t agree on a third, or lead, arbitrator, they generally let the arbitrators they have chosen make the pick. But in China, if the parties can’t agree, CIETAC chooses the third. “That’s an extraordinarily risky proposition,” says Frances Kao, a lawyer at Skadden, Arps, Slate, Meagher & Flom LLP. Ms. Kao advises her clients to cut down the risk by putting a requirement in their business contract that a CIETAC-appointed arbitrator meet certain qualifications. But the strategy isn’t foolproof. “You still really don’t know what you’re going to get,” she says.

*Id.* As to the neutrality of SRO forums, there is the additional safeguard of the oversight role of the SEC and SICA that is not available in other consumer arbitration programs.

76. Nor is the manner in which we select judges free from controversy. See *Torts and Courts*, ECONOMIST, Apr. 12, 2008, at 36.

Justice is meant to be impartial. To this end, Britain’s judges are appointed for life. In America federal judges are as well. But in 39 states some or all judges must face election and re-election, often with unbecoming hoopla. An election to the Supreme Court of the state of Wisconsin has just involved about \$5.5m and more than 12,000 aired advertisements. *Habeus circus*, one might say.

*Id.*; see also *O’Connor Project at Fordham Law*, N.Y.L.J., Apr. 11, 2008, at The Back Page (“Fordham University School of Law hosted a day-long program . . . entitled ‘Enhancing Judicial Independence.’ The program was sponsored by the Sandra Day O’Connor Project on the State of the Judiciary and Fordham Law’s Louis Stein Center for Law and Ethics.”).

Code and its predecessor the NASD Code, however, realistically govern the present system of SRO arbitration.

A. The Uniform Code

*1. Selection and Challenges to Arbitrators*

For historical analysis, the Uniform Code should be examined in two stages, i.e., the Old Uniform Code and the New Uniform Code, which was re-written in Plain English.<sup>77</sup>

Initially, the Old Uniform Code provided that the Director of Arbitration of the SRO choose the panel and its chairperson, and directed that the *majority of the panel of arbitrators be public arbitrators (not be from the securities industry)*, unless the public customers or “non-members” requested otherwise.<sup>78</sup> In addition, the Old Uniform Code provided that each party would have one peremptory challenge, but was later amended to also provide for unlimited challenges for cause.<sup>79</sup>

This method of selection was later significantly changed by SICA and reflected in sections 16 and 17 of the New Uniform Code,<sup>80</sup> which then provided for: a hearing with a *single* arbitrator for claims between \$25,000 and \$100,000, *unless* either party requests three arbitrators; and an automatic hearing with three arbitrators for claims over \$100,000 (or where no dollar amount is claimed or disclosed).<sup>81</sup> On March 21, 2006, however, sections 16(a) and (b) of the New Uniform Code were further amended so as to provide that claims: (a) over \$25,000 and up to \$100,000 *must* be heard by a single arbitrator; (b) over \$100,000 and up to \$200,000 will be heard by a single arbitrator *unless* either party requests three arbitrators; and (c) over \$200,000 (or where no dollar amount is claimed or disclosed) will be heard by three arbitrators.<sup>82</sup>

Moreover, instead of the SRO selecting the arbitrators, the New Uniform Code now provides that the parties may jointly select the arbitrators. Otherwise, the parties are provided with two randomly gen-

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77. See Constantine N. Katsoris, *The Resolution of Securities Disputes*, 6 FORDHAM J. CORP. & FIN. L. 307, 381-418 (2001) [hereinafter Katsoris VI]; see also *supra* notes 44-45 and accompanying text.

78. See Katsoris III, *supra* note 20, at 497.

79. *Id.* at 500.

80. See UNIF. CODE OF ARB., *supra* note 32.

81. See Katsoris IV, *supra* note 43, at 438.

82. See *id.*

erated lists of arbitrators – one of public arbitrators and one of securities industry arbitrators – from the SRO’s panel (list selection method).<sup>83</sup> Under the list selection method, if three arbitrators hear a case, a party may strike any or all of the names from the lists without providing an explanation, and number in order of preference the remaining names on the list, if any.<sup>84</sup> “Arbitrators are invited to serve based upon the parties’ mutual preference ranking.”<sup>85</sup>

In the event the parties cannot agree on an arbitrator from the list provided, a second list is submitted to the parties.<sup>86</sup> The second list contains three names for each vacancy to fill out the panel.<sup>87</sup> Each side has one strike per vacancy from that list without providing an explanation.<sup>88</sup> The parties’ list of mutually acceptable arbitrators, in order of the parties’ indicated preferences, will thus fill any subsequent vacancies.<sup>89</sup> If a full panel cannot be appointed through this process, however, the Director of Arbitration appoints additional arbitrators.<sup>90</sup> To reduce the risk that such intervention by the Director of Arbitration could result in the appointment of a replacement arbitrator who was unacceptable to either party, the New Uniform Code permits one overall peremptory

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83. *See id.* If one arbitrator hears the case, each party receives only one list of public arbitrators. UNIF. CODE OF ARB., *supra* note 32, § 17(b)(1).

84. *See* UNIF. CODE OF ARB., *supra* note 32, § 18. “If one arbitrator hears a case, a party may strike any or all of the names from the list without providing an explanation.” *Id.* § 18(a)(1). The NASD had adopted a different version of list selection, where each party has unlimited challenges to the original list, then the NASD appoints the remaining needed panel members to which there are no automatic strikes, only those for cause. *See* Douglas J. Schulz, *The New NASD Arbitrator Selection Process*, SEC. ARB. COMMENTATOR, Mar. 1999, at 2.

85. TENTH REPORT, *supra* note 28, at 4-5.

86. Katsoris IV, *supra* note 43, at 439.

87. *Id.*

88. UNIF. CODE OF ARB., *supra* note 32, § 18(a)(2). The NASD does not provide for a second list, whereas the NYSE did under a pilot program; however, the NYSE subsequently also eliminated this second list. *See* News Release, NYSE, NYSE Arbitration Receives SEC Approval to Provide Public Investors and Non-Members Choice of Arbitrator Selection Method (Dec. 1, 2005), <http://www.nyse.com/press/1133437154798.html>; *see also* Constantine N. Katsoris, *A Life Without SICA*, SEC. ARB. COMMENTATOR, July 2004, at 1.

89. Katsoris IV, *supra* note 43, at 439. *See generally* UNIF. CODE OF ARB., *supra* note 32, § 17(c)(3); TENTH REPORT, *supra* note 28, at 5.

90. *See* Katsoris IV, *supra* note 43, at 439-40.

challenge per case to each side to such SRO administrative appointments.<sup>91</sup>

## 2. Disclosures Required By Arbitrators

Section 19 of the Code<sup>92</sup> requires each arbitrator “to disclose to the Director [of Arbitration] any circumstances that might preclude such arbitrator from rendering an objective and impartial decision.”<sup>93</sup> After *McMahon*, the section was expanded to parallel Canon II of the Code of Ethics for Arbitrators in Commercial Disputes (the “Code of Ethics”)<sup>94</sup> by explicitly imposing a duty upon the arbitrator to disclose *any* potential conflict – an ongoing duty which continues throughout the proceeding.<sup>95</sup> To facilitate this process, arbitrators receive a copy of the Arbitrators’ Code of Ethics when they are assigned to a case, in order to highlight the types of disclosures required. They also receive a copy of SICA’s Arbitrators’ Manual,<sup>96</sup> “which was developed to instruct arbitrators concerning their duties and responsibilities.”<sup>97</sup>

Before *McMahon*, the Director had been authorized to remove an arbitrator before the commencement of the first hearing based upon information disclosed pursuant to Section 19.<sup>98</sup> After *McMahon*, the Director was further empowered to effect such removal after hearings had already commenced based upon information required to be disclosed, but not known to the parties when the arbitrator was selected.<sup>99</sup>

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91. *Id.* at 440.

92. UNIF. CODE OF ARB., *supra* note 32, § 19.

93. *Id.*; SEC. INDUS. CONFERENCE ON ARBITRATION, SECOND REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, § 11 at A-5 (1978) [hereinafter SECOND REPORT].

94. Katsoris IV, *supra* note 43, at 440; FINRA, AAA/ABA CODE OF ETHICS FOR COMMERCIAL ARBITRATORS, <http://www.finra.org/ArbitrationMediation/Rules/RuleGuidance/P009525> [hereinafter CODE OF ETHICS].

95. For example, the Code of Ethics requires that an arbitrator reveal any direct or indirect financial or personal interest in the outcome of the arbitration, and any existing or past financial, business, professional, family, or social relationships, which are likely to affect impartiality or might reasonably create an appearance of bias. CODE OF ETHICS, *supra* note 94; see Katsoris III, *supra* note 20, at 501 n.113.

96. ARBITRATOR’S MANUAL, *supra* note 7.

97. *Id.*; see also Katsoris III, *supra* note 20, at 501.

98. See Katsoris III, *supra* note 20, at 501.

99. See SEC. INDUS. CONFERENCE ON ARBITRATION, ELEVENTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION (2001) [hereinafter ELEVENTH

To further clarify the Director's authority to remove sitting arbitrators, section 19(d)(1) of the New Uniform Code was subsequently amended to specifically provide that the Director will remove or disqualify from appointment any arbitrator who the Director concludes *intentionally* has failed to disclose *material* information as to his or her background, experience, potential or existing conflicts of interest or bias.<sup>100</sup>

### 3. Classification of Arbitrators

Although the Uniform Code always provided that the majority of the arbitrators on any panel involving a public customer or non-member consist of Public Arbitrators (i.e., not affiliated with the securities industry), the Old Uniform Code gave little guidance as to who qualified as a Public Arbitrator.<sup>101</sup> The original version of the Procedures Booklet simply described Public Arbitrators as "individuals who are neither associated with, nor employed by a broker-dealer or securities industry organization."<sup>102</sup> SICA initially left this test flexible, to ensure that the knowledge and experience of many needed and qualified persons was not lost. It soon became apparent, however, that the category of Public Arbitrators required a clearer definition. Accordingly, Guidelines for the Classification of Public Arbitrators were added to the Procedures booklet; and, after *McMahon*, SICA further restricted the Public Arbitrator qualifications.<sup>103</sup>

The Uniform Code does not expressly require that arbitrators must be attorneys.<sup>104</sup> Nevertheless, as cases have become more complicated,

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REPORT].

100. See THIRTEENTH REPORT *supra* note 2, at 4; see also Gretchen Morgenson, *When Arbitrators Are Their Own Judges*, N.Y. TIMES, August 12, 2007, at N7.

The problem is that the potential arbitrators are trusted to volunteer their own possible conflicts of interest. . . . For investor advocates, the potential for conflicts among arbitrators ranks high on the list of arbitration problems. They say that requiring arbitrators to volunteer their conflicts with little policing of those disclosures is an honor system that can lead to abuse.

*Id.*

101. Katsoris III, *supra* note 20, at 498.

102. *Id.*

103. *Id.*; see Constantine N. Katsoris, *The Composition of SRO Panels?*, SEC. ARB. COMMENTATOR, Oct. 2003, at 3 [hereinafter Katsoris VII].

104. Indeed, "more than half of [eligible] FINRA arbitrators are not lawyers . . . ." Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 493, 519 (2008).

and discovery and other issues more extensive, it is rare that a panel does not have at least one member who is an attorney. Interestingly, the Code approaches the definition of a Public Arbitrator differently from the way it describes an Industry Arbitrator. It defines the former through a process of exclusion, whereas it affirmatively lists the qualifications of an Industry Arbitrator.

The Code describes a Public Arbitrator as one who is *not* an Industry Arbitrator, and then proceeds to further exclude from the definition: (1) brokers and registered investment advisers and persons who are retired from the securities industry; (2) persons who had been employed in the industry in the past three years; (3) professionals (i.e., attorneys or accountants) who devote 20% or more of their work efforts to securities industry clients; and (4) spouses of industry personnel.<sup>105</sup> Moreover, a person will also not be classified as a Public Arbitrator under the Code if a member of the household could be classified as a securities Industry Arbitrator.<sup>106</sup>

In addition, Section 16 of the New Uniform Code was subsequently amended to further restrict those who could be classified as Public Arbitrators, by providing that an attorney, accountant or other professional whose *firm* derives 20% (10% threshold in the FINRA Code) or more of its annual income from securities industry representation cannot be classified as a Public Arbitrator.<sup>107</sup> Similarly, an employee of a bank or financial institution engaged in or supervising those engaged

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105. See SIXTH REPORT, *supra* note 34, § 8(a); Katsoris IV, *supra* note 43, at 434.

106. See SIXTH REPORT, *supra* note 34, § 8(a). The FINRA Code's disqualification is broader in that it prohibits a person from being classified as a Public Arbitrator if a member of his or her immediate family (which includes a member of one's household) could be classified as an Industry Arbitrator. See FINRA CODE OF ARBITRATION PROCEDURE § 12,100(u)(7), *infra* note 111 and accompanying text.

107. See Katsoris VII, *supra* note 103. In discussing the merits of such amendments, one of the key issues for SICA was, percentage-wise, how low to set the bar. Shortly after SICA adopted the twenty percent threshold, the NASD unilaterally cut that threshold in half to 10% over a two year period.

Regardless of the merits of percentage disqualification, I respectfully suggest that a 10% threshold is too low because it will create too large a dragnet. As well intentioned as the rule may be, I suspect that the net effect will result in an administrative nightmare for the SROs and cull from the ranks of *public arbitrators* many knowledgeable and outstanding candidates of impeccable credentials and integrity, at a time when SRO caseloads are exploding and the contents of the cases becoming more complicated and complex.

*Id.* at 4.



in effecting transactions in securities cannot be classified a Public Arbitrator,<sup>108</sup> nor can one who is a registered investment adviser.<sup>109</sup>

On the other hand, the Uniform Code defines a securities Industry Arbitrator in an affirmative way, namely as an individual who:

- (1) is or is associated with either:
  - a member of an SRO
  - a securities broker/dealer
  - a government securities broker
  - a government securities dealer
  - a municipal securities dealer
  - a member of a registered futures association or any commodity exchange
  - a person registered under the Commodity Exchange Act; or
- (2) has been associated with any of the above within the last three (3) years; or
- (3) has retired from or spent a substantial part of a career with any of the above; or
- (4) is an attorney, accountant, or other professional who within the last two years devoted 20 percent or more of his or her time to any person or entities enumerated in (c)(1).<sup>110</sup>

### B. Present FINRA Code

Since FINRA is realistically now the sole provider of SRO arbitrations, a closer examination of the FINRA Code is essential. The FINRA Code provides for a similar dual arbitrator classification system – Non-Public (i.e., Industry) and Public; Section 12,100 defines these categories as follows:

(p) Non-Public Arbitrator

The term “non-public arbitrator” means a person who is otherwise qualified to serve as an arbitrator and:

- (1) is, or within the past five years, was:
  - (A) associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer);

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108. See SIXTH REPORT, *supra* note 34, § 8.

109. See *id.* § 8(a)(3).

110. See *id.* § 8(a)(2).

(B) registered under the Commodity Exchange Act;

(C) a member of a commodities exchange or a registered futures association; or

(D) associated with a person or firm registered under the Commodity Exchange Act;

(2) is retired from, or spent a substantial part of a career engaging in, any of the business activities listed in paragraph (p)(1);

(3) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in paragraph (p)(1); or

(4) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities futures or options or supervises or monitors the compliance with the securities and commodities laws of employees who engage in such activities.

For Purposes of this rule, the term “professional work” shall not include mediation services performed by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.

\* \* \* \*

(u) Public Arbitrator

The term “public arbitrator” means a person who is otherwise qualified to serve as an arbitrator and:

(1) is not engaged in the conduct or activities described in paragraphs (p)(1)-(4);

(2) was not engaged in the conduct or activities described in paragraphs (p)(1)-(4) for a total of 20 years or more;

(3) is not an investment adviser;

(4) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past two years from any persons or entities listed in paragraphs (p)(1)-(4);

(5) is not employed by, and is not the spouse or an immediate family member of a person who is employed by, and entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business;

(6) is not a director or officer of, and is not the spouse or an immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under the common control with, any partnership, corporation, or other organization that is engaged in the securities business; and

(7) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (p)(1)-(4). For purposes of this rule, the term immediate family member means:

- (A) a person's parent, stepparent, child, or stepchild;
- (B) a member of a person's household;
- (C) an individual to whom a person provides financial support of more than 50 percent of his or annual income; or
- (D) a person who is claimed as a dependent for federal income tax purposes.

For purposes of this rule, the term "revenue" shall not include mediation fees received by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.<sup>111</sup>

More recently, and in addition to the previously discussed percentage thresholds for doing business with the industry,<sup>112</sup> FINRA has further restricted the definition of Public Arbitrator by preventing an attorney, accountant or other professional from being classified as a Public Arbitrator if that person's firm derived at least \$50,000 in annual revenue in the past two years from professional services rendered to a broker-dealer client, relating to disputes concerning investment accounts or transactions.<sup>113</sup> In the case of large multinational firms, this seemingly well-intentioned rule could automatically exclude thousands of potentially outstanding candidates for the sake of a relatively miniscule

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111. FINRA, CODE OF ARBITRATION PROCEDURE § 12,000, [http://finra.complinet.com/en/display/display.html?rbid=1189&element\\_id=1159000927](http://finra.complinet.com/en/display/display.html?rbid=1189&element_id=1159000927) [hereinafter FINRA CODE].

112. See *supra* notes 105-07 and accompanying text.

113. See *Dispute Resolution News*, THE NEUTRAL CORNER (FINRA, Washington, D.C.), Aug. 2007, at 9, available at <http://www.finra.org/ArbitrationMediation/Neutrals/Education/NeutralCorner/P036755>; see also SEC Rel. No. 34-57,492, 2008 SEC Lexis 592 (Mar. 13, 2008). A firm's annual revenue is deemed to include, without limitation, law firm fees, accounting firm fees, and consulting fees. *Id.*

\$50,000 fee for a firm that size. It would be much like hunting for mosquitoes with an elephant gun.

C. Should We Repair or Replace the Present  
System of Arbitrator Selection?

The battle to define who is an Industry Arbitrator and who is a Public Arbitrator has been an ongoing struggle since the two classifications were first established by SICA over 25 years ago. The discussion has become more heated, however, now that FINRA has realistically become the sole SRO provider. For example, “looming on the horizon . . . is a related and more fundamental issue, namely suggestions that the industry arbitrator classification be eliminated altogether, leaving only a shrinking pool of public arbitrators on SRO panels.”<sup>114</sup> Understandably, the industry will view such an action as an attempt to “stack the deck” against it.<sup>115</sup> Assuming *arguendo*, however, that the securities industry would accept the unilateral elimination of the Industry Arbitrator altogether as part of some global compromise,<sup>116</sup> that hardly resolves the lingering and troublesome issue of defining the surviving class of Public Arbitrators which is presently done through a long series of exclusionary rules of who a Public Arbitrator isn’t.<sup>117</sup>

Arbitrators have been compared to both judges and jurors. It should be noted, however, that arbitrators not only decide the outcome of a dispute, but in the process must also rule on a myriad of issues such as discovery, pleadings, qualification of witnesses, admissibility of evidence, and so much more. In this sense, therefore, they are more like

114. Katsoris IV, *supra* note 43, at 435.

115. *Id.* Folklore has it that many in the industry had resisted insertion of the AAA as an alternate forum because of the belief that AAA arbitration panels in certain jurisdictions, notably Florida, were overloaded by former claimants’ attorneys.

116. See Mike Barris, *Test Lets Investors Pick Form of Arbitration Panel*, WALL ST. J., July 25, 2008, at C4. FINRA announced the launching of a two year pilot program in the fall of 2008 that will allow investors making arbitration claims to choose a panel free of an industry arbitrator. *See id.*

The pilot program will allow some investors making arbitration claims to choose a panel made up of three public arbitrators instead of two public arbitrators and one nonpublic arbitrator, as is currently the norm. Six firms – Merrill Lynch & Co., Citigroup Inc., UBS AG, Wachovia Corp., Morgan Stanley and Charles Schwab Corp. – have volunteered to participate, Finra said.

*Id.*

117. See *supra* notes 105-09, *infra* notes 125-35 and accompanying text.

judges than jurors, though they do perform the function of both.<sup>118</sup>

The dual classification system was established by SICA at a time when SRO arbitration was in its infancy and, basically, a voluntary process. It was also in effect when the issue of fairness of arbitration was raised before the Supreme Court in *Shearson/American Express, Inc. v. McMahon*.<sup>119</sup> Over one hundred fifty thousand arbitrations have been filed under this dual classification system at the various SROs since the enactment of the Uniform Code.<sup>120</sup> During this period, I have participated as a Public Arbitrator and mediator in scores of such cases; and, more recently, was instrumental in the establishment of a securities resolution clinic at Fordham to represent investors who found it difficult to obtain counsel.<sup>121</sup>

No matter the route of dispute resolution, complaints and criticisms of the decision-makers are sure to surface. Absent isolated complaints of conflicts or incompetence of arbitrators, which surface from time to time regarding both Public and Industry arbitrators, this author has personally found the overall competence and integrity of arbitrators to be excellent.

Constantly improving the pool of arbitrators is and always should be a priority. The author's experience has been that the dual classification system, together with the list selection procedure, initially brought a balance to the process. Moreover, the author observed many cases where experienced case management was the key ingredient to justice, particularly in situations not specifically covered by the Uniform Code or in arbitrator training.<sup>122</sup> Unfortunately, however, the present

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118. See Barbara Black, *Do We Expect Too Much From NASD Arbitrators?*, SEC. ARB. COMMENTATOR, Oct. 2004, at 1.

Yet the premise of a panel consisting of lay decision-makers who receive nominal consideration for hearing disputes on an occasional basis goes largely unchallenged. As the Second Circuit recently reminded, we should not presume that arbitrators are capable of understanding and applying legal principals "with the sophistication of a highly skilled attorney."

*Id.* (citation omitted).

119. See 482 U.S. 220 (1987).

120. See *supra* note 43.

121. See Constantine N. Katsoris, *Securities Arbitration: A Clinical Experiment*, 25 FORDHAM URB. L.J. 193 (1998) ("[O]nce a case is accepted, the full panoply of ADR procedures should be available, as with private representation. . . . [I]f mediation is practical, it should also be available to the clinic. Similarly, if an award has to be confirmed or vacated, the clinic should also be able to do so.").

122. See JOSEPH JETT, BLACK AND WHITE ON WALL STREET (William Morrow &

system now considers past experience or relationships as an inflexible litmus test in determining arbitrator bias, and automatically precludes competent arbitrators from qualifying. This is a mistake!

Consider the hypothetical case of a Director of a law school clinic that handles cases for public claimants on a *pro bono* basis, or a former prosecutor of securities fraud cases, or a retired federal or state court judge. Suppose that Director or former prosecutor or jurist each has five children – four of whom are claimant’s attorneys and the fifth just recently became employed by a brokerage firm – should such a relationship automatically disqualify any of them from sitting as an arbitrator? Unfortunately, even if said individuals had previously served admirably as Public Arbitrators in scores of previous cases, they would thereafter be barred from sitting either as a Public or Industry Arbitrator.

Admittedly, no system is perfect. Alternative methods of selection should be explored, particularly since SRO arbitration presently is: (a) basically mandatory; (b) solely at FINRA; and (c) increasingly prevalent and complex over the last twenty-five years. The time is ripe, therefore, to explore a more simplified system of arbitrator selection to replace the present byzantine set of rules that increasingly *micro-manage* the qualification guidelines relating to public and industry arbitrators.

Both the existing Uniform and FINRA Codes contain restrictions regarding arbitrator qualification that are either impractical, at best, or simply unenforceable. For example, §12,100(p)(3) of the FINRA Code classifies as a Non-Public Arbitrator an attorney, accountant or other professional who has devoted 20% or more of his or her professional work in the last two years to clients engaged in the business activities listed in §12,100(p)(1)(A)-(D).<sup>123</sup> If the principal purpose of the Indus-

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Co. 1999). In describing the three person arbitration panel (all lawyers) that heard his case, the author observed:

For the next five months, I spent nearly three days of each week in a hearing room at NASD offices on Whitehall Street, listening to an identical parade of witnesses repeat everything they’d told the SEC. But this time things were different. The three NASD panelists were the cream of the crop. They knew finance and trading. The hearing was halted on several occasions so that the chief arbitrator could check his trading positions with his broker. The panelists were not prepared to accept nonsensical arguments.

*Id.* at 355-56.

123. See FINRA CODE, *supra* note 111, §12,100(p)(1). The business activities include being:

- associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer);

try Arbitrator is to add securities experience to the panel, how is that accomplished by including an accountant who simply audits the financials or prepares tax returns of clients associated with the securities industry?

Similarly, how does FINRA expect to enforce the provisions of §12,100(u)(4), which exclude from the definition of Public Arbitrator an attorney, accountant or other professional whose firm derived 10 percent or more<sup>124</sup> (20% threshold in the Uniform Code<sup>125</sup>) of its annual revenue in the past two years from any persons or entities listed in §12,100(p)(1)-(4)?<sup>126</sup> In applying a firm's representation percentage disqualification rule for Public Arbitrators (10% for FINRA,<sup>127</sup> 20% for SICA<sup>128</sup>) FINRA will surely have to hire a set of auditors to effectively monitor the process.<sup>129</sup> Otherwise, without oversight and enforcement, the rule is meaningless and misleading.

Furthermore, in applying the percentage threshold rule, differences of opinion will surely surface as to how to calculate income from securities industry representation. For example, is drawing a lease of office space for the parent, subsidiary or major shareholder of a brokerage firm considered such representation? Similarly, what is the effect of jointly representing a brokerage firm together with several other unrelated claimants or defendants in a non-securities matter? Are fees from representing a broker *against* his or her firm considered income from securities industry representation? Moreover, how do we handle the dilemma where, in the same year a *firm* receives 20% of its income from an industry client, it contemporaneously derives the remaining 80% of its income from representing third parties against the industry?

Another problem is the shifting economics of one's practice as it cuts across annual periods. Suppose a firm's industry practice was 8% in 2003, 21% in both 2004 and 2005, and 12% in 2006 and a lawyer in that firm was appointed a Public Arbitrator on a lengthy case late in

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- registered under the Commodity Exchange Act;
  - a member of a commodities exchange or a registered futures association; or
  - associated with a person or firm registered under the Commodity Exchange Act . . . .

*Id.*

124. *See id.*

125. *See* Katsoris VI, *supra* note 77, at 404.

126. *See* FINRA CODE, *supra* note 111.

127. *See id.* §12,100(u)(4).

128. *See* Katsoris VII, *supra* note 103, at 3, and accompanying text.

129. *See id.*

2004 that unavoidably spanned three years. Does that arbitrator's status change in 2005 or 2006?

In addition, suppose an arbitrator innocently miscalculates the percentage threshold and inadvertently sits on a case as a Public Arbitrator, renders a decision, and subsequently discovers he has violated the percentage guidelines, or that a member of his immediate family or household has become employed by the industry. Can there be a challenge to the award?

Such a post-award challenge on the ground of arbitrator ineligibility was made in *Bulko v. Morgan Stanley DW, Inc.*,<sup>130</sup> where the claimant argued to vacate an award in favor of respondents on the grounds that the arbitrator was ineligible to sit as an Industry Arbitrator because she did not qualify as *an attorney, accountant or other professional* who has devoted 20 percent or more of his or her professional work in the previous two years to clients who are engaged in the securities industry.<sup>131</sup> In reversing the lower court's vacatur, the Fifth Circuit reasoned that the arbitrator's appointment was, "at most, a trivial departure not warranting vacatur."<sup>132</sup> It is worthy of note, however, that in *Bulko*, the challenge involved an *Industry Arbitrator*, was not bias related, and reasonable pre-appointment due diligence would have uncovered the arbitrator's inactive status as an attorney, which formed the basis of claimant's post-award objections to her qualifications.<sup>133</sup> Unlike *Bulko*, however, such due diligence would generally not be possible at the pre-appointment stage, in the case of computing and

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130. *Bulko v. Morgan Stanley DW, Inc.*, 450 F.3d. 622 (5th Cir. 2006). The case involved a complaint against Morgan Stanley and one of its registered representatives over a \$16 million customer loss. The arbitration panel sided with Morgan Stanley. That decision was appealed by Bulko's attorney, who argued that the industry participant did not qualify because she had spent less than 20% of her time working in securities litigation in the previous two years. The U.S. District Court for the Northern District of Texas reversed the arbitration panel's decision and ordered a new panel selected to hear the complaint. Morgan Stanley appealed that decision to the Fifth Circuit, which sided with Morgan Stanley and stated in its ruling that both parties signed off on the panel before the hearing. *Id.*

131. See FINRA CODE *supra* note 111, §12,100(p)(3).

132. *Bulko*, 450 F.3d. at 626.

133. See *id.* Before her appointment, the arbitrator openly took inactive status in 1999 with the Texas State Bar. *Id.* at 624.



applying the percentage threshold qualification rules previously discussed.<sup>134</sup>

Furthermore, in applying either the percentage qualification standards,<sup>135</sup> or a fixed threshold amount,<sup>136</sup> there are also timing issues to be considered as to when and how much income is recognized. For example, in calculating income or percentages thereof, do we contemplate a calendar or fiscal year; do we use the cash method, the accrual method, or some hybrid method? Moreover, are we interested in net or gross income, or gross receipts (billable time plus disbursements) or net receipts (excluding disbursements); and how do we calculate pending contingent fees?<sup>137</sup>

The present system of characterizing arbitrators by rigid criteria that automatically judge their impartiality discourages many fine arbitrators from even applying. It unnecessarily weeds out some of the most capable and honorable candidates simply because of their prior work experiences or those of their relatives. By analogy, should we similarly automatically exclude former prosecutors or criminal defense attorneys or their relatives from qualifying as a judge in a criminal case?

## VI. CONCLUSION

How disputes between the investing public and the securities industry will be resolved in the future is unpredictable. It is certain, however, that such disputes will continue to arise and, *whether access to the courts will be available or not*, arbitration, in some form or other,

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134. See *supra* notes 124-30 and accompanying text.

135. See *id.*

136. See *supra* note 113 and accompanying text.

137. See Robert Weinberg & Steven Martini, *What a Jittery Economy Really Means to Law Firms*, THE VOICE OF EXPERIENCE (ABA Senior Lawyers Div., Chicago, Ill.), Spring 2008, at 1.

Too many firms now equate cash with profit; they do their bookkeeping on a cash basis, and if they end the month with more money in the till than they paid out, they think the difference is profit. But the truth is often the reverse. How? Consider the firm that settles a case yielding a contingency fee of \$120,000. If the firm's monthly overhead is \$100,000, cash basis accounting shows the firm \$20,000 ahead for the month. (That is, discounting any other fees paid that month). Accrual accounting, on the other hand, might show that the firm billed only \$80,000 during the month as against that \$100,000 in salaries and overhead and thus that, setting aside the \$120,000, the firm actually lost \$20,000.

*Id.*

will be part of that resolution mosaic. Thus, the securities arbitrations process, whether voluntary or mandatory, must in all events offer a level playing field that provides all participants a fair hearing on the merits by knowledgeable, competent, ethical, impartial arbitrators who can handle the difficult and complicated cases that are sure to surface in the future.

The present system complicates the SROs' management role by making it increasingly difficult, if not impossible, to administer. At the same time, it either excludes many fine arbitrators from qualifying, or discourages them from even seeking qualification. Nor is it reasonable or fair to *automatically* exclude or discourage large groups of qualified and experienced people simply because of their experiences, or those of their relatives.<sup>138</sup>

Instead, perhaps the time has come to eliminate this mischief, and let the lawyers accept greater responsibility in the selection of the arbitrators.<sup>139</sup> To this end, the author has for several years suggested that the present system is no longer practical or feasible. Like Humpty Dumpty, the present fragmented, micro-managed dual classification system is beyond repair. Indeed, it should be replaced by one that provides for: (a) a single *all-inclusive* pool of qualified arbitrators; in conjunction with (b) some form of list selection; (c) a reasonable number of peremptory challenges;<sup>140</sup> and (d) unlimited challenges for cause.<sup>141</sup> *It is time to let the lawyers do their lawyering!*

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138. A significant number of professionals have switched roles in the litigation landscape over the course of their careers, i.e., from representing claimants to representing respondents or from acting as a prosecutor to later acting as a defense attorney.

139. "[A]rbitrator selection is critically important to the fair and expeditious resolution of arbitration claims. . . . [S]ophisticated litigators also know . . . that there is no such thing as a 'one-size-fits-all' arbitrator." Deborah Rothman & Jeff Kichaven, *Litigators' Views and Goals Vary On Selecting Their Arbitrators*, ALTERNATIVES, (CPI Institute For Dispute Resolution, New York, N.Y.), Jan. 2004, at 1.

While it is axiomatic that practitioners want arbitrators who are smart and follow the law, there are exceptions to that rule. 'If I have a really bad case, I have to make sure I don't have too smart an arbitrator,' explains Patricia Glaser, a litigation partner at Century City, Calif.'s Christensen, Miller, Fink, Jacobs, Glaser, Weil & Shapiro. 'If I have a case that's better on the equities than the law, I want someone who's not too concerned with technicalities. If it's not as good emotionally, I want a technocrat, someone who's a stickler.'

*Id.* at 14.

140. Anywhere between five to ten peremptory challenges should be more than adequate. Such peremptory challenges plus the oversight role of the SEC should ensure

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unbiased yet experienced panels. See *The Securities Arbitration System: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the Comm. on Financial Services*, 109th Cong. 48 (2005) (statement of Constantine Katsoris), <http://financialservices.house.gov/media/pdf/109-11.pdf>; see also Katsoris IV, *supra* note 43, at 436.

141. The issue of whether to challenge an arbitrator for cause usually revolves around the possibility of personal relationships between the arbitrator and one of the parties or attorneys or witnesses; however, such inquiries have been expanded to include product relationships. For example, suppose: (i) A is an Industry Arbitrator who works for brokerage house X; (ii) A has been appointed to a case where brokerage house Y is a respondent; (iii) the nature of the complaint involves misrepresentation regarding the liquidity of auction-rate securities; and (iv) both firms X and Y actively marketed those securities in a similar manner. Is a challenge to A's sitting as an arbitrator in Y's case to be considered as one for cause, or must it count as a peremptory challenge because there is no personal relationship between A and Y? It would appear that although A is not personally connected with firm Y by employment, he is connected by product substance, in that both X and Y similarly marketed this identical product in a supposedly misleading manner. Thus, a challenge to A should be considered for cause without consuming a precious peremptory one, for if A ruled against Y on auction-rate securities, he could be injuring his own firm. See Jane Bryant Quinn, *Arbitration Tilting More Against Investors*, Bloomberg.com, July 30, 2008, [http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist\\_quinn&sid=aNtvdwXZwSbQ](http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_quinn&sid=aNtvdwXZwSbQ). "By keeping the people involved with auction-rate securities in the panelist pool, FINRA forces customers' lawyers to use up their challenges to get rid of them." *Id.*; see also Daisy Maxey, *Twist for 'Auction Rate' Cases*, Wall St. J., Aug. 9, 2008, at B2, available at <http://www.careerjournal.com/article/SB121824050544426069.html>.