PIABA Opposes Mandatory Industry Arbitrators

For nearly twenty years, brokerage firms have required their customers to resolve their investment-related disputes before arbitration panels, rather than in court. The Financial Industry Regulatory Authority ("FINRA"), in which brokerage firms are members, conducts virtually all of these arbitrations. FINRA's rules require that, unless all parties agree otherwise, cases involving more than $25,000 be heard by three arbitrators, one of whom must be a "non-public" or "industry" arbitrator, as they are more commonly known. Industry arbitrators include individuals who are or have been associated with the securities business, and professionals such as lawyers or accountants who, in the last two years, devoted 20% or more of their professional work to securities industry clients.[1] This means that customers who have been wronged by members of the securities industry may only seek recovery of their losses through mandatory arbitration in which arbitrators with economic ties to the securities industry will sit in judgment of their claims. PIABA believes that FINRA's rule requiring industry arbitrators to serve in arbitrations between customers and industry members unfairly and systemically tilts the scales against customers.

In FINRA arbitrations, not only are members of the securities industry called upon to judge the conduct of their peers, but they are given a significantly disproportionate say in the process. FINRA's Basic Arbitrator Manual advises

arbitrators that in determining liability, "[w]hen the case is highly technical, the industry arbitrator might begin the discussion to help clarify industry terminology or practices." Ironically, the undue influence of the industry arbitrator is further highlighted in the "*White Paper on Arbitration in the Securities Industry*" published in October 2007 by the Securities Industry and Financial Markets Association ("SIFMA").[2] SIFMA, which is the securities industry's trade association, describes one particular virtue of the industry arbitrator:

> 'Industry' arbitrators also benefit the public panelists as they can serve to educate them about financial products and services, industry customs and practices and other legal industry-related issues.

The SIFMA White Paper goes so far as to suggest that because of the presence of industry arbitrators on panels, "parties need not call expert witnesses in order to educate a panel about certain products or industry practices." The suggestion that industry arbitrators serve as *de facto* expert witnesses should be deeply troubling for customers. In the first place, the influence of the mandatory industry arbitrator is not counter-balanced by any requirement that one of the other arbitrators have the qualifications to offer a more investor or regulatory-oriented analysis of securities industry products and practices. Second, industry arbitrators who offer their opinions on these topics are not subject to cross-examination about any errors or biases that make their opinions unreliable. As a result, customers may lose their

cases on the basis of "expert opinions" that they never have an opportunity to confront or even hear.

The role of the industry arbitrator as the panel's FINRA-appointed expert on industry products and practices has become increasingly problematic for customers who have been injured by industry-wide illegal and unethical practices that have come to light in recent years. The list of Wall Street scandals relating to products and practices that have lost investors billions of dollars over the last decade is distressing and lengthy, but must include, even in abbreviated form:

> (a) the wholesale perversion of Wall Street research on "tech" stocks in favor of brokerage firms' investment banking clients;[3]
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> (b) abuses in the trading and sales of mutual funds;[4]
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> (c) deceptive seminars and marketing schemes aimed at the elderly and newly retired;[5]
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> (d) fraudulent and unsuitable sales of variable annuities, especially to seniors and for tax-deferred accounts;[6]
>
> (e) fraudulent practices in connection with the securitization and retail sales of products backed by subprime loans;[7] and
>
> (f) dishonest and deceptive practices in connection with the conduct of auctions of "auction rate securities" ("ARS") and the mismarketing of such securities as money market or CD equivalents.[8]

The major Wall Street firms and many lesser known ones have been named in class actions, investigated, and/or sanctioned for misconduct in one or more of these areas, many of which were accepted as "business as usual" in the securities industry. Yet the victims of these wrongs must select the arbitrators who will decide their claims from lists that include industry members whose own firms may have engaged in similar practices. These arbitrators are likely to be reluctant to find another firm liable for conduct that may be the subject of litigation or regulatory proceedings against their own employers. This conflict of interest creates at the least the appearance of bias. Worse still, if, as SIFMA points out, industry arbitrators serve to "educate" other panel members, that "education" may consist of persuading them that the practices at issue are acceptable because "everyone does it". Thus, conduct that a judge or jury might remedy with a recovery of full damages may be excused altogether, or minimized with "compromise" awards.

The on-going consolidation of brokerage firms within the securities industry has compounded potential conflicts for industry arbitrators. In recent years, such well-known firms as Dean Witter, Prudential Securities, A.G. Edwards, Paine Webber, and now Bear Stearns, have been the subjects of takeovers by other broker-dealers. Faced with this trend, industry arbitrators may be reluctant to award substantial damages against firms that could well become their future

employers.[9] The same economic considerations may influence lawyers or accountants who serve as industry arbitrators, since their clientele may include brokerage firms that could be acquired by the firm whose conduct is at issue in the case before them.

PIABA is not alone in questioning the fairness of the mandatory industry arbitrator. The North American Securities Administrators Association ("NASAA"), which represents the state securities regulators in all 50 states, has taken the position that there is no justification for mandatory industry arbitrators. NASAA persuasively presented its reasoning in testimony before the U.S. Subcommittee on the Judiciary:[10]

> The very notion of having a matter heard by a panel of independent arbitrators assumes that they come to the arbitration process with no preconceived opinion or interest in any party or issue at conflict. However, industry arbitrators bring their particular experiences, based on their firm's training, policies and procedures, to the decision-making process. As evidenced by industry scandals and regulatory enforcement actions, the industry's way of doing things is not always in conformance with the law. Even if the industry arbitrator has no preconceived notions, the industry arbitrator creates a presumption of bias that is contrary to the principles of fair play and substantial justice. Do courts in complex medical malpractice cases insist that one physician be empanelled in the jury box to "educate" the other jurors? Clearly, such a requirement in a judicial proceeding would be dismissed as creating a bias that would taint the final ruling and pervert the concept of a fair hearing. It is also disconcerting that the industry believes that the public arbitrators are not capable of

> understanding a case and rendering a decision. If that is indeed true, investors should not be forced to bring their case in such a forum. NASAA submits that intellectual honesty should not be discarded at the door of the arbitration forum.

The view that the arbitration playing field has been tilted against the investor is also borne out by an impartial study commissioned by the Securities Industry Conference on Arbitration ("SICA")[11] entitled "*An Empirical Study: Perceptions of Fairness of Securities Arbitrations.*" That study, which included a comprehensive survey of participants in arbitrations decided in 2005 and 2006, found that over 70% of customers were not satisfied with the outcome of their cases, 62% felt that the process was unfair, and more than a third (36.5%) believed that the industry arbitrator had favored a securities industry party in their case.

In the final analysis, the requirement of a mandatory industry arbitrator is antithetical to the integrity of the arbitration process and to the fundamental principle that finders of fact should be disinterested in the outcome of the cases they decide.[12] If, as it claims, the mission of FINRA truly is investor protection, it must provide a forum where controversies between customers and brokerage firms are decided by arbitrators who are truly impartial.

[1] Under FINRA's rules for arbitrator selection, the parties are given basic background information about potential arbitrators, and then may use a limited number of "strikes" to narrow down the number of possible panel members. Unlike jurors in court cases who can be questioned in order to uncover possible bias, potential arbitrators are not required to answer questions concerning matters such as their involvement in business practices similar those at issue in the case to be decided.

[2] White Paper, pp. 36-37. The White Paper is available at:
http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

[3] In 2002, Bear Stearns & Co., CS First Boston, Deustche Bank, Goldman Sachs, J.P. Morgan Chase & Co., Lehman Brothers, Inc., Merrill Lynch & Co., Morgan Stanley, Salomon Smith Barney, Inc., and USB settled charges by state and federal agencies concerning the undue influence of investment banking relationships on favorable stock research reports. *See*, http://www.sec.gov/new/press/2002-179.htm.

[4] In 2004, fifteen firms settled NASD and SEC charges relating to unfairly depriving customers of mutual fund breakpoints. The firms included Wachovia, UBS, American Express Financial Advisors, Raymond James, Legg Mason, Bear Stearns, Lehman Brothers and Linsco Private Ledger. *See*, http://www.sec.gov/news/press/2004-17.htm. In 2005, the NASD fined Citigroup, American Express and Chase Investment Services for improper sales of Class B and C shares of mutual funds. *See*,
http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/p013648.

[5] A joint report by the SEC, NASAA and FINRA found a pervasive pattern of misleading, fraudulent, and unsuitable sales practices in investment seminars sponsored by securities firms for senior citizens. *See*, "*Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars*" (Sept. 2007), available at: http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.

[6] *See*, "*Joint SEC/NASD Report On Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*" (June, 2004), available at http://www.sec.gov/news/studies/secnasdvip.pdf. As stated in *Money Magazine* (January, 2000 ed)," *variable annuities come with plenty of drawbacks: their fees are high, they're brain-numbingly complicated…they're often pushed on investors for inappropriate uses, such as IRA rollovers…*" Variable annuities often have large surrender fees and tax penalties that can tie up an investor's money for many years. However, they also generate some of the highest commissions of any products brokers sell. Thus, annual sales in 2007 were over $160 billion and net assets invested in variable annuities exceed $1.35 trillion dollars. Insurance Information Institute, Facts and Statistics,
http://www.iii.org/media/facts/statsbyissue/annuities/?table_sort_761676=3.

[7] The SEC, FINRA, Justice Department and the states have initiated dozens of investigations relating to subprime securitization and sales. *See*, *"Prosecutors Widen Probes Into Subprimes" Wall Street Journal* (Feb. 8, 2008); The Bureau of National Affairs, Inc., *In Three Dozen Subprime Investigations SEC Is Asking 'Who Knew What, When'*, 40 Securities Regulation & Law 7 (Feb. 18, 2008); David Scheer and Jesse Westbrook, *Brokers Probed by FINRA on Mortgage Securities Sales, Person Says*, Bloomberg.com (Jan. 4, 2008) available at http://www.bloomberg.com/apps/news?pid=20601087&sid=apNYRLoCVcUk&refer=home; Edward Hayes, *FINRA Joins Mortgage Storm*, Wolters Kluwer Financial Services (Feb., 4, 2008), available at http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=02-04-08; *USA Today*, *Regulators' Subprime Mortgage Cases*, Feb. 18, 2008 available at http://www.usatoday.com/money/economy/2008-02-18-4194118666_x.htm.

[8] Firms that have been implicated in ARS misconduct include: TD Ameritrade; Banc of America Securities; Bear Stearns & Co., Inc.; Citigroup Global Markets; Deutsche Bank; A.G. Edwards, Inc.; E-Trade; Goldman Sachs & Co.; H&R Block; Lehman Bros. Inc.; J.P. Morgan Securities, Inc.; Merrill Lynch Pierce Fenner & Smith, Inc.; Morgan Keegan & Company, Inc.; Morgan Stanley; Oppenheimer; Piper Jaffray & Co.; Raymond James; RBC Dain Rauscher, Inc.; SunTrust Capital Markets, Inc.; UBS; Wachovia Capital Markets, Inc.; and Wells Fargo & Co. The SEC's 2006 Consent Order against 15 firms for fraudulent practices in connection with ARS can be found at http://www.sec.gov/litigation/admin/2006/33-8684.pdf. A number of class actions brought on behalf of ARS purchasers are identified at http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080422/REG/323114373/1010/rss01&rssfeed=rss01 and http://www.girardgibbs.com/auctionrate.html .

[9] A 2007 study of arbitration awards between 1999 and 2004 demonstrated that customers were less successful in bringing claims against large brokerage firms. Indeed, the average amount a customer could expect to win in a large claim (over $250,000) against a large brokerage was only 12% of the amount claimed. Edward S. O'Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes – A Statistical Analysis of How Investors Fare,* (2007) available at: http://www.slcg.com/pdf/workingpapers/Mandatory%20Arbitration%20Study.pdf.

[10] NASAA Testimony Regarding S.1782, the Arbitration Fairness Act of 2007, Testimony of Tanya Solov, Dec. 12, 2007, available at
http://www.nasaa.org/Issues__Answers/Legislative_Activityt/Testimony/7660.cfm.

[11] SICA is comprised of representatives of the self-regulatory organizations which sponsor arbitration programs, SIFMA, the North American Securities Administrators Association and three public members. SICA's arbitration study, released in February, 2008, was based on a survey of arbitration participants conducted by Pace University School of Law, with the assistance of the Cornell University Survey Research Institute. The study is available at http://www.law.pace.edu/files/finalreporttosica.pdf.

[12] In opposing mandatory industry arbitrators, PIABA does not mean to suggest that all industry arbitrators are biased or unfair to investors. Quite to the contrary, many such arbitrators can and do serve honorably. However, PIABA's position is that in no instance should customers, who are required to arbitrate, also be required to have an industry arbitrator on the panel deciding their case.