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Financial Abuse of the Elderly: Protecting the Vulnerable

Lisa A. Catalano and
Christine Lazaro

The number of Americans who are at or near retirement is increasing every year as the Baby Boomer Generation ages.[1] It is estimated that in 2007, over 50 million Americans were aged 60 and older and over 90 million were aged 50 and older (more than 30% of the population).[2] In 2007, baby boomers controlled over $13 trillion in household investible assets, representing over 50% of total U.S. household investible assets.[3] As more and more Americans fall into the category of "seniors", and retirement savings become available to investment professionals, greater scrutiny must be paid to the unique issues faced by these individuals, and what can be done to protect them.

Steps have already been taken at both the federal and state levels to protect seniors. At the federal level, this article will explore regulatory and legislative actions taken by the different federal regulators and Congress designed to heighten sensitivity to issues unique to senior investors and enhance protection from abusive practices such as the misuse of professional designations and failure to adequately disclose the risks and characteristics of an investment product. At the state level, the rules regarding the use of senior designations, and the legislation that have been enacted to address elder financial abuse will be discussed.

I. Federal Protections

A. Regulatory Activity

On July 17, 2006, the Securities and Exchange Commission (SEC)[4] convened its first Senior Summit to examine how the various securities regulators could better coordinate efforts to protect seniors from investment fraud. The findings of a study (the "Investor Fraud Study")[5] funded by the NASD Investor Education Foundation were released.

The Investor Fraud Study examined why the elderly are victimized by fraud. Some of the findings were expected,

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[1] "Baby boomers" are persons born during the post-World War II baby boom.

[2] U.S. Census Bureau, *Population Estimates Program: 2007 Population Estimates*. The U.S. Census Bureau considers a baby boomer as someone born during the birth boom between 1946 and 1964.

[3] Sue Asci, "*Retirement of boomers will create market for advisers*", InvestmentNews (November 5, 2007).

[4] Congress established the Securities and Exchange Commission in 1934 to enforce the newly-passed securities laws, to promote stability in the markets and, most importantly, to protect investors. *See* http://www.sec.gov/about/whatwedo.shtml. All websites referenced in this paper were last visited on November 3, 2008.

[5] "*Investor Fraud Study Final Report*", NASD Investor Education Foundation (May 12, 2006), available at http://www.sec.gov/news/press/extra/seniors/nasdfraudstudy051206.pdf.

while others were a surprise. Most surprisingly, the assumption that victims of fraud do not know as much about investment concepts as non-victims turned out to be flawed. The Investor Fraud Study found that victims scored higher than non-victims on eight financial literacy questions. Other findings included that fraud pitches were tailored to the psychological needs of the victims, and that fraud victims were more likely to listen to sales pitches and were more optimistic about the future.

i. Scrutiny of "Free Lunch" Seminars

Following the release of the Investor Fraud Study, the SEC and the North American Securities Administrators Association (NASAA)[6] announced a coordinated initiative to help protect seniors.[7] As part of the initiative, securities regulators conducted a series of on-site examinations of broker-dealers, investment advisers, and other financial services firms that offer "free-lunch" sales seminars. The Financial Industry Regulatory Authority (FINRA)[8] describes "free lunch" seminars as "free seminars that promise to educate [invitees] about investing strategies or managing money in retirement—often with an expensive meal provided at no cost."[9] The results of those examinations were reported at the second Senior Summit held on September 10, 2007 (the "2007 Report").[10] 105 out of 110 examinations conducted found some problem or deficiency.

The 2007 Report concluded that free lunch seminars often targeted seniors. Invitees are offered attractive inducements to attend the seminars, which are often held at upscale hotels, restaurants, retirement homes and golf courses. Some seminars offered door prizes or other prizes such as tote bags or cruises. The seminar advertisements and mailers were often designed to imply urgency, using phrases such as "Act Now!" and "Seating is Limited!" Some of the advertisements and mailers used scare tactics targeted to seniors, such as, "If you're retired, *YOU'RE A TARGET* and you cannot afford to miss this workshop!" and "How to Protect your Nest Egg from The Retirement *Vultures*" (emphasis in the original). The seminars had titles such as "Senior Financial Survival Seminar" and "Senior Financial Safety Workshop." The financial advisors presenting the seminars sometimes used titles that represented that they had some special training, knowledge or certification, such as "Certified Senior Advisor" , "Elder

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[6] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. It's membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. *See* http://www.nasaa.org/About_NASAA.

[7] "*Securities and Exchange Commission and North American Securities Administrators Association Launch Program to Protect Senior Investors*," joint SEC and NASAA press release (May 8, 2006), available at http://www.sec.gov/news/press/2006/2006-65.htm.

[8] The Financial Industry Regulatory Authority (FINRA) is the largest non-governmental regulator for all securities firms doing business in the United States. FINRA oversees nearly 5,000 brokerage firms, about 173,000 branch offices and approximately 677,000 registered securities representatives. FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. *See* http://www.finra.org/AboutFINRA/index.htm.

[9] "'*Free Lunch' Investment Seminars—Avoiding the Heartburn of a Hard Sell*," FINRA Investor Alert (September 10, 2007), available at http://www.finra.org/InvestorInformation/InvestorAlerts/FraudsandScams/FreeLunchInvestmentSeminars-AvoidingtheHeartburnofaHardSell/P036745.

[10] "*Protecting Senior Investors: Report of Examination of Securities Firms Providing "Free Lunch" Sales Seminars*" by the Office of Compliance Inspections and Examinations, Securities and Exchange Commission, North American Securities Administrators Association, Financial Industry Regulatory Authority (September 2007), available at www.finra.org/reports.

Care Asset Protection Specialist", or "Chartered Retirement Planning Counselor" .[11] The 2007 Report concluded that "firms should redouble efforts to ensure that the investment recommendations they make to seniors are suitable in light of the particular customer's investment objectives. With the growing senior demographic, firms might consider specific training for their registered representatives and investment advisers regarding sales to senior investors."[12]

ii. FINRA Speaks: Heightened Protections for Seniors

a. *Suitability Standards*

Following publication of the 2007 Report, FINRA focused its efforts on providing specific guidance to the firms it regulates regarding the duties owed to senior investors. In October 2007, FINRA issued a Regulatory Notice entitled "Senior Investors" in which it urged firms to review and enhance their policies and procedures regarding special issues that are common to senior investors in light of the exponentially growing population of seniors.[13] While FINRA does not have different rules for seniors that would impose heightened duties and obligations, FINRA explained that factors such as age and life stage should weigh into the duties and obligations owed to these customers, particularly in such areas as suitability of recommendations and communications aimed at senior investors.

With respect to suitability obligations, FINRA emphasized that while the suitability rule[14] does not expressly refer to such issues as a customer's age or life stage, these are crucial factors in the consideration of the suitability of investment recommendations because an investor's time horizon, risk tolerance, tax status, and liquidity needs may change over time. FINRA suggested that, in order to assist in making appropriate recommendations to senior investors, in addition to those factors enumerated in NASD Rule 2310, firms should also inquire as to such things as current employment status and plans of future employment, the customer's primary expenses and whether they still carry a mortgage, current and future sources of income, the amount of income needed to cover expenses, retirement savings and allocation of those investments, liquidity needs, financial and investment goals, and health care coverage.[15]

b. *Product Concerns*

FINRA also reminded firms that while they are not obligated to protect customers from risk they want to take, firms do have the duty to understand any products recommended by their employees and to provide the customers with a balanced presentation of the products, explaining not only the benefits, but the risks and costs associated as well. Particular areas of concern to FINRA's examiners are the recommendation of products that have withdrawal penalties or are otherwise illiquid

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[11] *Id.*

[12] *Id.* at 26.

[13] FINRA Regulatory Notice 07-43 (FINRA RN 07-43) (September 2007), available at http://www.finra.org/RulesRegulation/NoticestoMembers/2007NoticestoMembers/P036815.pdf.

[14] NASD Rule 2310 is FINRA's "suitability rule". Rule 2310 provides that in recommending "the purchase, sale or exchange of any security [to a customer] a member shall have reasonable grounds for believing that the recommendation is suitable . . . [based on] the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Prior to executing a recommended trade, the firm is also required to make reasonable efforts to obtain information concerning the customer's financial and tax status, investment objectives and "such other information used or considered to be reasonable by such member or registered representation in making recommendations to the customer." NASD Rule 2310 (2008).

[15] *See* FINRA RN 07-43 at p. 2.

such as variable annuities.[16] Indeed, there is a FINRA rule proposal currently pending with the SEC to revise the rules, predominantly found in NASD Interpretive Material 2210-2, and sets forth guidelines governing communications with the public about variable insurance products. The proposed rules would, among other things, prohibit any representation that would imply that a variable insurance product is a mutual fund, or that it is a short-term, liquid investment. The rules would also require a balanced presentation with respect to such features as guarantees and riders, and provide extensive guidance regarding the provision of comparative illustrations.[17] Other areas of concern involve variable life settlements, complex products such as collateralized debt obligations and the recommendations to obtain a home equity mortgage or make early withdrawals of retirement savings to invest.[18]

c. *Professional Designations*

Another major area of concern is the misleading use of professional designations. FINRA is particularly concerned with those designations that imply that the individual has expertise in financial or estate planning for seniors, i.e., "certified senior adviser," "senior specialist," "retirement specialist," or "certified financial gerontologist". Qualification requirements vary greatly among professional designations and run the gamut from a very rigorous curriculum to simply paying a fee.[19] Moreover, a survey revealed that about one-half of senior investors were more inclined to take a professional's advice when they were told that the professional had special accreditation to advise on senior financial issues.[20] Firms were cautioned that a title or designation that falsely represents one's expertise may be a violation of various rules.[21] FINRA advised firms to take supervisory steps to prevent abusive use of titles or designations such as eliminating the use of titles including words like "senior" or "retirement" entirely, or maintaining an approved list of designations that would require committee review for any deviation.[22]

d. *"Free Lunch" Seminars*

FINRA also re-addressed its concerns regarding the use of aggressive and misleading sales tactics that are aimed at seniors at "free lunch" seminars. FINRA urged firms to insure that their policies and procedures with respect to sales seminars were adequate to prevent such abuse. Some "best practices" previously suggested were: centralizing the process for reviewing and approving proposed seminars and the advertising and other materials to be utilized; centralizing the process for the creation of all seminar and related marketing materials; submission of proposed seminars and related materials with plenty of lead time for review and comment; prior approval of seminar guest speakers; clear written guidance as to what is permissible and in compliance with the securities laws, regulatory requirements, and the firms own policies and a checklist to assist in the process; and random attendance

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[16] *Id.* at pp. 3-4.

[17] *See* FINRA Regulatory Notice 08-39 (July 2008) for details of the rule proposal, available at http://www.finra.org/Industry/Regulation/Notices/2008/P038982.

[18] FINRA RN 07-43 at p. 4.

[19] FINRA maintains a database of different designations and their qualifications at http://apps.finra.org/DataDirectory/1/prodesignations.aspx.

[20] *Id.* at p. 5.

[21] For example, NASD Rule 2210 (2008) and NYSE Rule 472 (2008), both of which prohibit false, exaggerated, unwarranted or misleading statements in communications with the public, and the anti-fraud provisions of the federal securities laws.

[22] FINRA RN 07-43 at p. 5.

by branch managers or other firm employees to observe the seminars and report and identify any compliance issues.[23]

iii. The Regulators Endorse "Best Practices"

In February 2008, the SEC, NASAA and FINRA undertook a new initiative to document the practices being developed by financial services firms concerning their interactions with senior investors to ensure that firms deal fairly with senior investors.[24] The initial results of the initiative were shared at the third Senior Summit (the "2008 Report"), which was held on September 22, 2008.[25] The 2008 Report analyzed the practices that financial services firms had enacted to address the appropriateness of their interactions with senior investors, both at the servicing level and at the supervision and compliance levels.

The 2008 Report addressed nine different areas:

- getting started: how firms are thinking of ways to remodel their supervisory and compliance structures to meet the changing needs of senior investors;
- communicating effectively with senior investors;
- training and educating firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse);
- establishing an internal process for escalating issues and taking next steps;
- encouraging investors of all ages to prepare for the future;
- advertising and marketing to senior investors;
- obtaining information at account opening;
- ensuring the appropriateness of investments; and
- conducting senior-focused supervision, surveillance and compliance reviews.[26]

The 2008 Report's findings were that financial services firms have taken varied approaches to implementing different policies relating to senior investors to address the above areas. With regard to communications with seniors, for example, financial services firms are increasing the frequency of their contact with senior investors, encouraging the designation of emergency or alternate contacts for the firm, and educating investors about the benefits of having a power of attorney, in addition to other steps.[27]

Additionally, firms are increasing their training of their employees to identify issues such as diminished capacity and elder financial abuse.[28] Firms are also developing procedures so that if a securities professional

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[23] *Id.* at p. 6. FINRA also highlighted the issues of diminished capacity and suspected financial abuse, which are particular to senior investors. FINRA set forth practices that some firms had implemented to deal with these issues. *Id.* at pp. 7-8. These issues would be addressed more fully in the fall of 2008 as part of the report issued for the third Senior Summit. *See* discussion *infra*. FINRA also urged firms to be proactive in providing investor education materials to seniors.

[24] "*Notice of Solicitation of Public Views Regarding Practices Being Developed to Deal with the Increasing Number of Senior Investors*" SEC Release No. 34-57308 (February 11, 2008), available at http://www.sec.gov/rules/other/2008/34-57308.pdf.

[25] "*Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors*" by the Office of Compliance Inspections and Examinations, Securities and Exchange Commission, North American Securities Administrators Association, Financial Industry Regulatory Authority (September 22, 2008), available at http://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf.

[26] *Id.* at p. 2.

[27] *Id.* at pp. 5-6.

[28] *Id.* at pp. 6-9.

identifies an issue, there is clear direction on the next steps to take.[29] In addition, they are reviewing marketing materials to ensure that they are in accord with the procedures outlined pursuant to the 2007 Report.

In line with the model rule on the use of senior designations discussed below, firms are implementing similar procedures and direction.[30] Firms are obtaining additional information from senior investors at the time of account opening.[31] With this additional information, firms are implementing additional reviews of the accounts of senior investors to ensure the appropriateness of investments.[32]

Firms were also found to be enhancing their supervisory and surveillance reviews of accounts to pay special attention to the issues relating to seniors' accounts.[33] Although the 2008 Report was not published as an addition to or modification of existing regulatory obligations of financial services firms, the report does encourage firms to indentify practices that will help them better serve senior investors.[34]

B. Regulatory Disciplinary Actions

Both the SEC and FINRA have pursued a number of disciplinary actions against firms and individuals for abuses that targeted senior investors. Often the cases involve Ponzi schemes, or tactics to encourage early retirement so that the brokers can obtain access to individuals' retirement money.

i. SEC Actions

Between 2005 and 2007, the SEC brought approximately 40 enforcement actions involving abuses against seniors, some of which involved multi-million dollar Ponzi schemes.[35] In *SEC v. D.W. Heath and Associates*, for example, the SEC brought an enforcement action involving a $144.8 million Ponzi scheme whereby seniors in southern California were invited to workshops where free food was offered and they were sold notes that were purportedly safe and guaranteed. The victims were ultimately robbed of their retirement money.[36] Additionally, in *SEC v. Earthly Mineral Solutions, et al.*, the SEC sued two Nevada companies and their officers in connection with a $20 million Ponzi scheme involving mining interests. The defendants convinced investors to liquidate their IRAs and to invest in the mining interests with false promises of guaranteed returns of between 7 and 9%.[37]

The SEC also filed two emergency actions in

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[29] *Id.* at p. 9.

[30] *Id.* at pp. 11-13.

[31] *Id.* at p. 13.

[32] Firms are also implementing heightened reviews of specific products and limitations on the sales of certain products and riders, such as those discussed at p.4 *supra. Id.* at pp. 14-16.

[33] *Id.* at pp. 16-18.

[34] *Id.* at p. 16.

[35] Advising Seniors About Their Money: Who is Qualified—And Who is Not?: Hearing Before the Special Committee on Aging, 110th Cong. 25-26 (September 5, 2007) (statement of Chairman Christopher Cox, U.S. Securities and Exchange Commission), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:40538.pdf.

[36] *SEC v. D.W. Heath & Associates, Inc., Private Capital Management, Inc., Private Collateral Management, Inc., PCM Fixed Income Fund I, LLC, Daniel William Heath, and Denis Timothy O'Brien,* No. CV 04 - 02949JFW(Ex)(C.D. Cal.), SEC Lit. Rel. No. 19287 (June 28, 2005).

[37] *SEC v. Earthly Mineral Solutions, Inc., Natural Minerals Processing Company, Roy D. Higgs, Frank L. Schwartz, and Rick Lawton*, Civil Action No. 2:07-CV-01057 (D. Nev.), SEC Lit. Rel. No. 20237 (August 10, 2007).

2007 to halt ongoing fraudulent activities. The first involved a $55 million scheme involving AmeriFirst Funding Inc., Amerifirst Acceptance Corporation and their principals. They were accused of "baiting and switching" – that is, they lured investors with advertisements for FDIC insured CDs and then convinced the investors to purchase "Secured Debt Obligations" (SDOs), falsely representing that they had little to no risk and were guaranteed by a commercial bank. The SEC was successful in enjoining the defendants and freezing any remaining assets. The second emergency action was brought against Secure Investment Services to halt a $25 million Ponzi scheme allegedly targeting hundreds of senior who purchased fractional ownership interests in life insurance policies. The company was run by a father/daughter team who were alleged to have falsely represented the nature of life insurance policies called "viaticals" and failing to disclose the poor financial condition of the investment venture. The defendants were alleged to have stolen $700,000 of investor funds for their personal use.[38]

More recently, in the spring of 2008, the SEC charged an Orthodox Jewish broker with fraud for allegedly preying on elderly members of his own congregation. The broker had thirty five customer complaints on his Form U-4 which he received at several firms over several years. Thirty three of the complaints were settled for approximately $4.6 million.[39]

ii. FINRA Actions

Since January 2005, FINRA has brought approximately 100 disciplinary actions involving fraud related to seniors. As of September 2007, FINRA had 70 open investigations regarding senior related issues.[40]

In September 2006, FINRA fined Securities America, Inc. of Omaha, Nebraska $2.5 million for failure to supervise a broker alleged to have lured former employees of Exxon Corp. into early retirement with exaggerated promises of high returns. The firm was also ordered to pay more than $13.8 million in restitution. The former Exxon employees, ranging in ages from 50 to 60, met the Securities America broker at seminars where they were advised to retire early and liquidate their 401(k) and pension plans and to invest in such products as variable annuities, Class B or C share mutual funds and exchange-traded funds. The broker represented that the investors could withdraw certain percentages from their investments without depleting their retirement

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[38] *SEC v. AmeriFirst Funding, Inc., AmeriFirst Acceptance Corporation, Jeffery C. Bruteyn and Dennis W. Bowden*, Civil Action No. 3:07-CV-1188-D (N.D. Tx., SEC Lit. Rel. No. 20236 (August 9, 2007)).

[39] *See* http://www.registeredrep.com/advisorland/career/sec_charges_gross_0923/index.html (September 2008). Additional enforcement actions involving instances of fraud targeted at seniors include: *SEC v. C. Wesley Rhodes, Jr., Rhodes Econometrics, Inc., the Rhodes Company, and Resource Transactions, Inc.*, Civil Action No. CV06-1353-MO (D. Or.), SEC Lit. Rel. No. 20144 (June 5, 2007) (defendant was accused of defrauding seniors out of $38 million. He represented that the funds were being invested in stocks and bonds, but instead, he was purchasing sports memorabilia and vintage cards. The defendant hid his activities by sending the investors fictitious account statements.); *SEC v. One Wall Street, Inc., Donte C. Jarvis, Alan Brown, Willis "Bill" White III, and Cecil Baptiste, a/k/a John Latorri*, 06 Civ. 4217 (NGG) (ARL) (E.D.N.Y.), SEC Lit. Rel. 20123 (May 22, 2007) (defendant was alleged to have induced investors to purchase $1.6 million of a stock based on false and misleading statements.); *SEC v. Empire Development Group, et al.*, 07 CIV 3896 (S.D.N.Y.), SEC. Lit. Rel. No. 20122 (May 18, 2007) (defendants were accused of raising $2 million through the sale of unregistered securities of bogus real estate development companies through the use of high pressure sales tactics and cold-calling. The defendants were alleged to have used the funds to purchase personal residences.)

[40] http://www.finra.org/Newsroom/NewsReleases/2007/P036809 (September 2007).

accounts and promised exaggerated returns. The investors suffered millions of dollars in losses of their retirement nest eggs.[41]

In June 2007, Citigroup Global Markets was fined $3 million by FINRA and ordered to pay approximately $12.2 million in restitution to former BellSouth employees. Citigroup was accused of failing to supervise brokers who used misleading sales materials promising exaggerated future earnings without disclosing any associated risks at several seminars for hundreds of BellSouth employees. The employees retired early giving up secure pensions believing they could afford to retire early based on the exaggerated return projections. The investors lost a substantial portion of their retirement assets when the rates of return promised did not come to fruition. In addition to the fine and restitution ordered against the firm, several brokers were also ordered to pay substantial fines ranging from $30,000 to $125,000 and were temporarily suspended from the industry.[42]

C. Legislative Action

A few days before the SEC's second Senior Summit, the United States Senate Special Committee on Aging conducted a hearing entitled "Advising seniors about their money: Who is qualified – and who is not?"[43] Testimony was provided by the SEC, the Attorney General of Minnesota, the secretary of the Commonwealth of Massachusetts, NASAA, the Financial Planning Association, the National Association of Insurance Commissioners, Allianz Life Insurance of North America and the Society of Certified Senior Advisors.

Chairman Christopher Cox of the SEC testified about the multi-faceted approach taken by the SEC to attack the problem of financial fraud against the elderly. He testified about the investor education efforts of the SEC and the targeted examinations and aggressive enforcement actions with which the commission was involved. Chairman Cox discussed the 2006 Senior Summit and the 2007 Senior Summit which was to take place the following week. He stated that "the SEC is working hard to forge a national solution to this urgent problem."[44]

Joseph Borg, the president of NASAA, stated "[s]tate regulators, as the first line of defense for investors, are at the forefront in detecting the problem of senior abuse and responding to it aggressively. We believe the most effective weapons against fraud are vigorous enforcement, investor education and innovative regulations."[45] He stated that NASAA found two areas of senior abuse especially troubling – the free lunch seminars and misleading professional designations. As discussed above[46], NASAA participated in the examinations that preceded the 2007 Report, and NASAA has issued a Model Rule on Senior Designations. Mr. Borg also recommended that Congress consider

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[41] http://www.finra.org/PressRoom/NewsReleases/2006NewsReleases/P017386 (September 2006).

[42] http://www.finra.org/Newsroom/NewsReleases/2007/P019240 (June 2007). The New York Stock Exchange had also been proactive in cases involving elder financial abuse. In one action, for example, a broker was censured and barred for three years from membership, employment or association with any member or member organization for unauthorized trading causing losses in excess of $1.3 million in several seniors' accounts. *Kenneth Edward Stephens*, Decision 06-216, 2006 WL 3900166 (N.Y.S.E. Hearing Board December 13, 2006).

[43] Advisings Seniors About Their Money: Who is Qualified—And Who is Not?: Hearing Before the Special Committee on Aging, 110th Cong. 25-26 (2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:40538.pdf.

[44] *Id.* at 12.

[45] *Id.* at 52.

[46] *See* p. 2, *supra*.

enhanced penalties for senior abuse.[47]

Nicholas Nicolette, the president of the Financial Planning Association also testified. Mr. Nicolette testified that financial planners have a fiduciary duty to their clients, and suggested that others in the field should have the same duty. He stated,

> [t]oday, individuals are required to make more financial decisions that impact the quality of their lives than ever before. We have a responsibility to create an environment in which they can seek guidance and make decisions with confidence that their interests are being put first…If an insurance agent, or any professional, uses a title or marketing materials suggesting he or she acts in the client's best interest, then they should be held to a fiduciary standard.[48]

Prescott Cole, on behalf of the Coalition to End Elder Financial Abuse, submitted written testimony to the Committee. The Coalition made several recommendations to the Committee, including a recommendation that "[t]he government should declare, as a matter of public policy, that elders who have been victimized by predators using misleading designations have a private cause of action for financial elder abuse."[49]

On June 27, 2008, Senators Casey and Kohl introduced a bill to the Senate to enhance penalties for violations of securities protections targeted at seniors.[50] The bill was referred to the Committee on Banking, Housing, and Urban Affairs. The proposed bill defines as a senior "an individual who is 62 years of age or older." The bill calls for enhanced penalties for violations of the Securities Act of 1933 (15 U.S.C. 77b *et seq*.), the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq*.), the Investment Company Act of 1940 (15 U.S.C. 80a *et seq*.), and the Investment Advisers Act of 1940 (15 U.S.C. 80b *et seq*.) when the victim is a senior. Specifically, the bill increases various financial penalties by up to $50,000 when the violation is directed towards, targeted at, or is committed against an individual who is a senior at the time of the violation.

II. State Protections

A. NASAA Model Rule on Senior Designations

On March 20, 2008, NASAA adopted the Model Rule on the Use of Senior-Specific Certifications and Professional Designations (the "Model Rule").[51] The Model Rule prohibits the misleading use of senior and retiree designations, and considers it an unethical business practice. The Model Rule also provides a mechanism whereby a state may recognize the legitimacy of certain designations conferred by an accredited organization.[52]

The Model Rule specifically prohibits the "use of a certification or professional designation that indicates or implies a level of occupational qualifications obtained through education, training, or experience that the

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[47] *Id.* at 53.

[48] *Id.* at 62.

[49] *Id.* at 188.

[50] S. 3219, 110th Congress, 2d Session.

[51] On April 1, 2008, NASAA's membership approved the rule.

[52] The full text of NASAA's Model Rule on the Use of Senior-Specific Certifications and Professional Designations is available at http://www.nasaa.org/content/Files/Senior_Model_Rule_Adopted.pdf.

person using the certification or professional designation does not have."[53] It further prohibits the:

> use of a certification or professional designation that was obtained from a designating or certifying organization that: (i) is primarily engaged in the business or instruction in sales and/or marketing; (ii) does not have reasonable standards or procedures for assuring the competency of its designees or certificants; (iii) does not have reasonable standards or procedures for monitoring and disciplining its designees or certificants for improper or unethical conduct; or (iv) does not have reasonable continuing education requirements for designees or certificants in order to maintain the designation or certificate.[54]

Many designations and certifications are obtained by simply paying a fee to the organization, and the individual using the designation does not have any additional education or expertise. Certain of these designations are used in connection with marketing materials purporting to be written by the individuals using the designations, when in fact, the materials have been written by the organization conferring the designation. "We detected a growing problem for senior investors and have responded to it aggressively with a regulatory solution. I urge all NASAA members to adopt this model rule within their jurisdictions as soon as possible," said Karen Tyler, North Dakota Securities Commissioner and President of NASAA.[55]

In sum and substance, the NASAA Model Rule prohibits: The use of certifications or professional designations if they have not actually been earned or are nonexistent or self-conferred; using a certification or designation that implies a certain level of qualifications that the individual does not possess; and using a certification or designation obtained by certain non-qualifying organizations. The rule does not apply to job titles that indicate one's seniority or standing within their firm, or that specifies their area of specialization within their firm.

New Hampshire became the first state to enact legislation based on NASAA's Model Rule.[56] Several other states have adopted regulations based on the Model Rule. Virginia's Administrative Code considers it prohibited business conduct to use a senior or retiree designation in such a way as to mislead any person.[57] Washington enacted a new chapter of its Administrative Code dedicated to regulating the use of senior designations[58] in addition to amending other chapters.[59] Several other states have proposed regulations and legislation pending. Alabama has a proposal pending to amend its Administrative Code.[60] California has proposed amendments to its Corporations Code and its Insurance Code which would also criminalize the misuse of senior

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[53] §1(c).

[54] §1(d).

[55] "*State Securities Regulators Announce New Model Rule on the Use of Senior Certifications and Professional Designations*", NASAA press release (April 1, 2008), available at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/8423.cfm.

[56] N.H. Rev. Stat. §421-B:6, effective January 1, 2009.

[57] Va. Admin. Code tit. 21, § 5-20-280.A.26, effective July 1, 2008.

[58] Wash. Admin. Code § 460-25A, effective July 20, 2008.

[59] Washington also amended Wash. Admin. Code §§ 460-21B-060, 460-22B-090 and 460-24A-220, effective July 20, 2008.

[60] Alabama proposed enacting Rule No. 830-X-30.28 on July 7, 2008.

designations.[61] Florida's Department of Financial Services has proposed amendments to its existing rules, and adoption of a rule based on the Model Rule.[62] Missouri has proposed amending its rules regarding dishonest or unethical business practices by both broker-dealers and investment advisors to incorporate the terms of the Model Rule.[63] In Montana, the State Auditor and Commissioner of Securities have proposed the adoption of several rules based on the Model Rule.[64]

In June 2007, prior to NASAA's adoption of the Model Rule, Massachusetts had enacted a rule substantially similar.[65] Massachusetts became the first state to specifically address the problem of the fraudulent and misleading use of senior designations. Like the Model Rule, Massachusetts provided for a process whereby individuals could request that an organization issuing certain designations be recognized by the Secretary of the Commonwealth, and it would then be permissible to use a designation obtained by that organization. The Secretary is to maintain a listing of all accredited organizations that he has recognized.

B. Elder Financial Abuse Statutes

Despite the pervasiveness of fraud targeted at seniors and the resulting financial or economic abuse, most states do not provide a private right of action (civil remedies) for the wronged individuals for such abuse separate and apart from the civil remedies that apply generally to investors. One of the states that appears to provide such protection, however, is Florida. Florida's statute entitled the "Adult Protective Services Act"[66] appears to be very broad and provides for a private right of action, permitting punitive damages, as well as recovery of attorney's fees and costs.[67]

The statute provides that "a vulnerable adult who has been abused, neglected, or exploited as specified in this chapter has a cause of action against any perpetrator . . ."[68] A "vulnerable adult" is defined as a "person 18 years of age or older whose ability to perform the normal activities of daily living or to provide for his or her own care or protection is impaired due to a mental, emotional, physical, or developmental disability or dysfunctioning or brain damage or the infirmities of aging."[69]

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[61] California proposed amendments to its Corporations Code by adding section 25405 (introduced on February 20, 2008 and last amended in the Senate on June 24, 2008) and to its Insurance Code by adding section 787.1 (introduced on February 20, 2008 and last amended in the Senate on July 2, 2008).

[62] Florida has proposed amendments to Rule 69W-600.013, Fla. Admin. Code, and has proposed the adoption of Rule 69W-600.0133, Fla. Admin. Code.

[63] On March 31, 2008, Missouri proposed amendments to Mo. Code Regs. Ann tit. 15, § 30-51.170 and Mo. Code Regs. Ann tit. 15, § 30-51.172. The proposal has not yet been filed in the Missouri register.

[64] On August 14, 2008, Montana published notice of a public hearing to consider the adoption of the proposed rules, Montana Administrative Register Issue No. 15, M.A.R. Notice No. 6-180.

[65] Mass. Regs. Code tit. 950, § 12.204(2)(i), effective June 1, 2007.

[66] Fla. Stat. Ann. §§ 415.101 *et seq*. (2004).

[67] The statute, however, has been strictly construed. *See e.g. Beaver v. Florida Health Sciences Center, Inc.*, 2004 WL 5272113, No. 02-05227 (Fla. Cir. Ct. Jan. 5, 2004) (holding that, because Chapter 415 contains various punitive and criminal provisions, it must be considered a penal statute and must be given a strict construction. The court held that because the plain language of the statute only provided a remedy against a "perpetrator" and did not explicitly provide a remedy to the plaintiff against a corporate entity such as the defendant that operates acute care hospitals, plaintiff could not maintain a remedy against the defendant pursuant to the statute.)

[68] Fla. Stat Ann. § 415.111 (2004).

"Exploitation" occurs when a person who:

> 1) stands in a position of trust and confidence with a vulnerable adult and knowingly, by deception or intimidation, obtains or uses or endeavors to obtain for use, a vulnerable adult's funds, assets, or property with the intent to temporarily or permanently deprive a vulnerable adult of the use, benefit, or possession of the funds, assets, or property for the benefit of someone other than the vulnerable adult; or
>
> 2) knows or should know that the vulnerable adult lacks the capacity to consent, and obtains or uses, or endeavors to obtain or use, the vulnerable adult's funds, assets, or property with the intent to temporarily or permanently deprive a vulnerable adult of the use, benefit or possession of the funds, assets, or property for the benefit of someone other than the vulnerable adult.[70]

In addition to Florida, California has enacted an elder abuse statute entitled the "Elder Abuse and Dependent Adult Civil Protection Act".[71] Pursuant to the statute, taking, secreting, appropriating or retaining (or providing assistance in taking, secreting, appropriating or retaining,) the real or personal property of any elder or dependent adult to a wrongful use or with intent to defraud or both constitutes "financial abuse".[72] The statute requires an award of attorneys' fees and costs and provides for imposition of punitive damages.[73]

A Nevada statute provides that a person who exploits an older or vulnerable person is liable for two times actual damages.[74] Exploitation is defined as:

> any act taken by a person who has the trust and confidence of an older person or a vulnerable person or any use of the power of attorney or guardianship of an older person or a vulnerable person to: (1) Obtain control, through deception, intimidation or undue influence, over the money, assets or property of the older person or vulnerable person with the intention of permanently depriving the older person or vulnerable person of the ownership, use, benefit or possession of

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[69] Fla. Stat Ann. § 415.101 (26) (2004).

[70] Fla. Stat Ann. § 415.102(7)(a) (2004). The statute has yet to be interpreted in the context of an investor's claims against a broker-dealer for fraudulent sales practices or in other financial abuse contexts such as Ponzi schemes. The statute has been construed, however, in the context of a class action suit against an insurance company and its parent companies alleging that defendants defrauded plaintiffs into purchasing deferred annuities that matured after their actuarial life expectancies. In *Migliaccio v. Midland National Life Ins. Co.*, 2007 WL 316873, No. CV 06-1007 CASMANX (C.D. Cal. Jan. 30, 2007), defendants moved to dismiss the Florida Adult Protective Services Act claim asserted by one of the plaintiffs on the grounds that the 73 year old plaintiff failed to assert that he was a "vulnerable adult" as defined by the act (i.e., that "he suffered impairment as a result of his age that would affect his ability to perform normal activities or care for himself.") *Id.* at *7. The court held that plaintiff's failure to allege that he is a "vulnerable adult" whose "ability to perform the normal activities of daily living or to provide for his or her own care or protection is impaired due to a mental, emotional, long-term physical, or developmental disability or dysfunctioning, or brain damage, or the infirmities of aging" was fatal to his elder abuse claim. *Id.* at *8. The court did not reach the issue of whether plaintiff otherwise asserted a valid claim pursuant to the Florida elder abuse statute. In a later case, a Florida court held that in order to state a claim against an acute care hospital pursuant to section 415.111 of the act, the complaint must allege that the plaintiff was a "vulnerable adult" at the time of the alleged misconduct, that the defendant was a "caregiver" and that the defendant committed "abuse", "neglect" or "exploitation". *Bohannon v. Shands Teaching Hospital and Clinics, Inc.,* 983 So.2d 717, 721 (Fla. 1st DCA 2008). The court's discussion, however, of the requisite "caregiver" allegation was in dicta.

[71] Cal. Welf. & Inst. Code §§ 15600 *et seq.* (2005).

> his money, assets or property; or
> (2) Convert money, assets or property of the older person with the intention of permanently depriving the older person or vulnerable person of the ownership, use, benefit or possession of his money, assets or property.[75]

Where the person is found to have acted with recklessness, oppression, fraud or malice, the statute requires payment of attorney's fees and costs.[76]

Utah similarly provides a private civil right of action for "exploitation" of vulnerable adults.[77] "Exploitation" is defined as situations in which a person

> (i) is in a position of trust and confidence, or has a business relationship, with the vulnerable adult or has undue influence over the vulnerable adult and knowingly, by deception or intimidation, obtains or uses, or endeavors to obtain or use, the vulnerable adult's funds, credit, assets, or other property with the intent to temporarily or permanently deprive the vulnerable adult of the use, benefit, or possession of the adult's property, for the benefit of someone other than the vulnerable adult;
> (ii) knows or should know that the vulnerable adult lacks the capacity to consent, and obtains or uses, or endeavors to obtain or use, or assists another in obtaining or using or endeavoring to obtain or use, the vulnerable adult's funds, assets, or property with the intent to temporarily or permanently deprive the vulnerable adult

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[72] In contrast to Florida courts' interpretation of the Florida Adult Protective Services Act, the California statute has been construed more liberally. While the California statute also has yet to be interpreted in the context of broker-dealer liability per se, one court has held that a class action complaint asserted against an insurance company sufficiently stated a claim to survive defendant's FRCP 12(b)(6) motion. In *Negrete v. Fidelity and Guaranty Life Ins. Co.*, 444 F.Supp.2d 998 (C.D. California 2006), plaintiffs brought a class action against an insurer alleging that the insurer engaged in fraudulent sales practices in connection with the solicitation, offer and sale of deferred annuities to seniors aged 65 and older where the date that the distribution payments from the annuity were to begin was beyond the annuitant's actuarial life expectancy. The complaint alleged that the insured engaged in aggressive marketing of the unsuitable annuities to seniors, abandoned internal supervisory policies that limited the issuance of annuities to seniors and that it engaged in a "churning" scheme involving deceptive practices to deplete the accumulated cash value of an existing annuity. Plaintiffs asserted a claim under the California Welfare and Institutions Code Section 15600, *et seq*. Defendant moved to dismiss pursuant to FRCP 12(b)(6) on the grounds that it did not "take" or "secrete" plaintiff's real or personal property. Rather, defendant argued that plaintiff voluntarily entered into the annuity contract in an arms length commercial transaction and, thus, had access to the funds at all times. The court concluded, however, that the plaintiff's allegations were sufficient to state a claim under the Elder Abuse Act. Before reaching its conclusion, the court explained that the California Elder Abuse Act "was enacted to protect elders by providing enhanced remedies which encourage private, civil enforcement of laws against elder abuse and neglect." *Id.* at 1001. The court held that plaintiff's allegations that the insured fraudulently acquired millions of dollars through the use of deceptive practices were sufficient to state a claim for wrongful "taking" pursuant to the statute. *Id.* at 1002-1003. In accord with the *Negrete* court's interpretation of the statute, it appears that an investor may be able to sustain a cause of action against a broker-dealer for fraudulent sales practices. The viability of such claims pursuant to the statute, however, has yet to be tested.

[73] Cal. Welf. & Inst. Code § 15610.30(a) (2005).

[74] Nev. Rev. Stat. 41.1395(1) (2003).

[75] Nev. Rev. Stat. 41.1395(4)(b) (2003).

[76] Nev. Rev. Stat. 41.1395(2) (2003).

[77] Utah Code Ann. § 62A-3-314 (2007).

of the use, benefit, or possession of his property for the benefit of someone other than the vulnerable adult;
(iii) unjustly or improperly uses or manages the resources of a vulnerable adult for the profit or advantage of someone other than the vulnerable adult;
(iv) unjustly or improperly uses a vulnerable adult's power of attorney or guardianship for the profit or advantage of someone other than the vulnerable adult;
(v) involves a vulnerable adult who lacks the capacity to consent in the facilitation or furtherance of any criminal activity; or
(vi) commits sexual exploitation of a vulnerable adult.[78]

A "position of trust and confidence" is defined in relevant part as a person who "has a legal or fiduciary relationship with a vulnerable adult, including a court-appointed or voluntary guardian, trustee, attorney or conservator."[79] A prevailing plaintiff may recover attorney fees and costs. The same holds true for a prevailing defendant where it is found that the action was "frivolous, unreasonable, or taken in bad faith."[80]

Illinois' "Elder Abuse and Neglect Act"[81] criminalizes financial exploitation of elderly or disabled persons. Financial exploitation occurs when a person in a position of trust or confidence knowingly and by deception or intimidation obtains control over the property of an elderly person or a person with a disability or illegally uses the assets or resources of an elderly person or a person with a disability. The illegal use of the assets or resources of an elderly person or a person with a disability includes, but is not limited to, the misappropriation of those assets or resources by undue influence, breach of a fiduciary relationship, fraud, deception, extortion, or use of the assets or resources contrary to law.[82]

The statute provides a civil remedy after someone has been charged by information or indictment with the crime of financial exploitation regardless of conviction and fails to return the property after a written demand has been made by the victim or the victim's legal representative. The statute provides for treble damages, as well as reasonable attorney fees and costs.[83]

Oregon and Tennessee specifically limit actions by the elderly against financial institutions or broker-dealers for financial abuse. Generally, an action may be maintained only when there has been a conviction for financial abuse or for "knowing abuse, neglect or exploitation".[84,85]

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[78] Utah Code Ann. § 76-5-111(4) (2007).

[79] Utah Code Ann. § 76-5-111(1)(p)(iii) (2007).

[80] Utah Code Ann. § 62A-3-314 (2007). The statutes pursuant to Illinois, Nevada and Utah laws have not been construed in the context of broker-dealer liability or other pure financial abuse cases.

[81] 720 Ill. Comp. Stat. § 5/16-1.3 (2004).

[82] 720 Ill. Comp. Stat. § 5/16-1.3 (a) (2004).

[83] 720 Ill. Comp. Stat. § 5/16-1.3 (g) (2004).

[84] *See e.g.* Or. Rev. Stat. § 124.115 (2003) and Tenn. Code Ann. §§ 71-6-102 (2004) and 71-6-117 (2007), respectively.

Conclusion

Protection of the elderly has become a priority at the state and the federal levels as the number of baby boomers entering their golden years increases. Both regulators and the legislatures are committed to expanding the protections currently afforded to this portion of the population. Although more action is being taken across the board, there is a need for consistent protection of the baby boomer generation at both the federal and state levels. There is little consistency between the protections available to a senior investor who happens to reside in Washington and one that resides in New York. It is important, that no matter where the investor lives, they have the same protections.

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[85] In other states, an action for the financial exploitation of seniors may possibly be asserted pursuant to either a consumer fraud or deceptive trade practices act. Delaware, for example, has both a Consumer Fraud Act (Del. Code Ann. tit. 6, § 2511 *et seq*. (2002)) and a Deceptive Trade Practices Act (Del. Code Ann. tit. 6, § 2531 *et seq.*(2002)). The Consumer Fraud Act pertains to "merchandise" which is defined as any "objects, wares, goods, commodities, intangibles, real estate or services." Del. Code Ann. tit. 6, § 2511(6) (2002). While the act does not explicitly apply to "securities", it does not appear to have been construed as excluding securities from its coverage. The Deceptive Trade Practices Act has been held to apply not only to unfair or deceptive trade practices that interfere with the promotion and conduct of another business, but also to actions brought by consumers. *See e.g. Roberts v. American Warranty Corp.*, 514 A.2d 1132 (Del. Super. 1986) (action by buyer of used car against automobile dealer.) Its applicability, however, does not appear to have been tested in the context of an action by an investor against a broker-dealer. If a violation of either statute is found to have occurred against a senior, the statute provides for treble damages. *See,* Del. Code Ann. tit. 6, § 2583 (2002).

Storm Clouds In Arbitration

Laurence S. Schultz

Storm clouds are gathering in the investor arbitration system. The Arbitration Fairness Act of 2007[1] is pending in both the House and the Senate which, if adopted, would ban mandatory predispute arbitration agreements. The Obama victory and Democratic majorities in the House and Senate have given the legislation new life. And in the venue of investor arbitration, compelling evidence continues to accumulate that the Financial Industry Regulatory Authority (FINRA)[2] arbitration system is unfair. Of course, FINRA has steadfastly maintained its arbitration system is fair to investors, but the data suggests otherwise.

The Regulators and Industry Retreat From the Numbers

For years, regulators and the brokerage industry have cited SRO arbitration statistics in support of their position that investor arbitration is fair. More recently, as investor arbitration results have deteriorated, these groups have changed their approach. They now downplay the numbers and focus their arguments on how arbitration structure, rules, and procedures provide a fair forum for investors.

In contrast, attorneys who represent investors, while watching their clients lose arbitrations at ever-increasing rates, and with their winning cases yielding declining recoveries, have become outspoken in their criticism of the arbitration system. And they contend that any meaningful evaluation of arbitration fairness must be supported by arbitration statistics. This article will examine the changing statistics and how they have impacted the fairness debate.

The Importance of Win-Rate Statistics

It would seem obvious that a basic test in evaluating a dispute resolution system is how often one side prevails over the other. Logic would also seem to dictate a related test: When claimants prevail, how much do they recover in relation to the amount of their losses?

Any fair and just dispute resolution process, no matter what its structure, rules or procedures, must result in reasonable win rates and reasonable recovery rates on behalf of claimants. Of course, what is fair, and what is a reasonable win rate or a reasonable recovery rate, are subjective and may be argued at length. But under any circumstances, winning and losing and the size of the wins in relation to the amounts lost must be recognized as essential elements in evaluating the reasonableness and fairness of the system.

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[1] Arbitration Fairness Act of 2007, H.R. 3010, S. 1782 (2007).

[2] FINRA was established in July 2007 through the consolidation of various functions of the National

A Win Is Not Always a Win

In recognition of the importance of arbitration statistics, FINRA has routinely reported an annual investor "win rate," which is the percentage of arbitration awards where investors receive at least some money.[3] But FINRA's statistics do not take into account that what has been customarily called a "win" often is not a victory for the investor. For example, FINRA's win statistics include any monetary award, even though the award is only a nominal amount in relation to the investment losses. And these statistical "wins" even include awards where arbitrators have assessed costs and forum fees against a claimant in excess of the monetary award to the claimant. And win does not take into consideration whether the arbitration panel awarded the "winning" claimant his or her attorney fees, which statistics show are usually not awarded in arbitration.

The failure to award investors their attorney fees is particularly significant since contingent fee agreements, which are common in arbitration, typically reduce an investor's recovery by one-third or more. This means that unless attorney fees are awarded, even investors with strong cases often may have little chance of recovering a reasonable percentage of their investment losses.

But while annual win rates may not necessarily reflect true economic victories for the claimant, they do indicate a measure of investor success, particularly when comparing current results to data from prior years, involving many thousands of arbitrations. They can also indicate patterns, developments, and changes in the arbitration system as a whole, which information can be essential in evaluating the performance of the arbitration process.

When Win Rates Were in Vogue

In the past, regulators routinely referenced win rates in addressing the fairness of the arbitration system. Investor win-rate percentages were considered an important element in FINRA's position that arbitration is fair to investors. In testimony before a congressional subcommittee in 2005, Linda D. Fienberg, President of NASD-DR, told committee members that NASD arbitration was fair to investors, emphasizing that investors received compensation in 55% of the arbitration awards over the previous five years.[4]

The U.S. General Accounting Office also cited investor win rates when it first analyzed SRO arbitration results in 1992, referencing investor wins in 59% of the arbitration decisions in 1989 and 1990.[5] The GAO also looked at the quality of the wins based on the percentage of investor claims (exclusive of punitive damage claims) which were recovered. The GAO found an average investor recovery rate (before payment of attorney fees) of approximately 61%.[6] Comparing these win and recovery statistics to securities arbitration results of the American Arbitration Association, the GAO found no indication of a pro-industry bias in SRO arbitrations.[7]

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[3] In describing arbitration results, practitioners and commentators commonly refer to "wins" and "losses" and "win rates"; however, FINRA does not use these terms in its statistical reports, and typically refers to "customer awards." Nevertheless, the terms "win" and "win rate" will be used here.

[4] Linda D. Fienberg, President, NASD Dispute Resolution, Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives March 17, 2005, http://www.finra.org/PressRoom/SpeechesTestimony/LindaFienberg/P013652.

[5] U.S. General Accounting Office, *Securities Arbitration: How Investors Fare* (1992) at 5, 35-38.

[6] *Id*. at 38-39.

[7] *Id.* at 60.

In 2000, the GAO updated its analysis, again addressing the investor win rate and recovery rate.[8] It found that during the period 1992 through 1998, the win rate had declined from 60% to about 51%, and the recovery rate fell from 61% to 51% of the amount claimed (again, excluding punitive claims and before attorney fees).[9] The GAO made no determination as to the significance of the declines, suggesting that they may not indicate a change in the fairness of the arbitration system, citing the regulators' speculation that the win rate fell as a result of increased settlements.[10]

And until recently, the Securities Industry and Financial Markets Association (SIFMA), the brokerage industry's trade association, cited the SRO win rate in its support for mandatory arbitration. In March 2005, Securities Industry Association President Marc E. Lackritz, testifying before a congressional subcommittee, contended SRO arbitration is fair and effective, in part based on a 52.56% win rate in 31,001 cases decided between 1980 and 2001, and a 55% NASD win rate for the year 2004.[11]

But during the last few years, a dramatic change has occurred in the arbitration win rate. From 1999 through 2007, NASD/FINRA win rates have declined substantially from 61% to just 37%. NASD/FINRA's win-rate statistics for the period 1997 through 2007 are shown in the following table:

NASD/FINRA's 1997-2007 Investor Arbitration Win Rate

Year	Win Rate	Year	Win Rate
1997[12]	58%	2003[13]	49%
1998[13]	60%	2004[13]	47%
1999[12]	61%	2005[13]	43%
2000[14]	53%	2006[13]	42%
2001[13]	54%	2007[13]	37%
2002[13]	53%		

The investor win rate of just 37% in 2007 is a stark confirmation of the reversal in the win-rate numbers in just the last eight years. In 1999, 61% of investors received a monetary recovery, while in 2007, 63% of investors received ***no*** recovery. And even worse, not only are investors now experiencing zero recovery in 63% of their cases, which means the brokerage industry enjoys total victory, the brokerage industry also has partial victories in all but a few of the 37% so-called investor wins because arbitrators ruling for investors rarely award even close to 100% of their losses (see *The Recovery Rates* below). Even more discouraging, losing investors, and even most of the winning investors, almost without exception, are assessed forum fees that can run into thousands of dollars.

Another striking element of the win-rate

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[8] U.S. General Accounting Office, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards* (2000) at 4-5.

[9] *Id.* at 4-5, 7, 44.

[10] *Id.* at 44. Query: Did the win rate fall as a result of increased settlements, or did settlements increase as a result of the fall of the win rate?

[11] Marc E. Lackritz, President, Securities Industry Association, before the Committee on Financial Services, U.S. House of Representatives (Mar. 17, 2005) at 2-3.

[12] *Securities Arbitration Commentator*, Vol. X, No. 8 at 17.

[13] *Securities Arbitration Commentator,* Vol. XI, No. 10 at 7.

[14] FINRA statistics, http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/ index. htm. Data was not available on FINRA's Web site for years prior to 2000. A check of the FINRA Web site on April 30, 2008 revealed that the results for 2000, 2001, and 2002 had recently been deleted. The results set forth for FINRA reports in this table for those years were obtained prior to the deletion.

decline is the 8% drop from 1999 to 2000. As noted below, the regulators and brokerage industry are quick to blame declining investor results on events such as the tech bubble and analyst scandal. But these events postdated the dramatic 2000 win-rate drop, which was the largest one-year decline in the history of mandatory arbitration.

The Recovery Rates

As noted above, prior to the recent decline in investor arbitration results, regulators also considered the percentage of claimed losses recovered by the investor in evaluating investor arbitration. The GAO specifically cited recovery rates in its 1992 and 2000 reports.

Recovery rates have been recently analyzed in detail. In 2007, attorney Daniel Solin and Professor Edward O'Neal issued a research report evaluating arbitration fairness for securities cases which analyzed SRO arbitration awards from 1995 through 2004 and determined the following recovery rates:

Solin/O'Neal: Award as a Percent of Amount Claimed[15]

Year	Percent	Year	Percent
1995	59%	2000	61%
1996	61%	2001	58%
1997	63%	2002	49%
1998	68%	2003	49%
1999	62%	2004	50%

PIABA's analysis of the 2006 NASD awards determined an average recovery rate before payment of attorney fees and costs as set forth below:

PIABA Report of Compensatory Damages Awarded as a Percentage of Compensatory Damages Claimed in NASD Arbitrations

Year	Percent
2006	36.76%

Not only are investor recovery rates declining in tandem with win rates, the decline is accelerating.

The Brokerage Industry's and Regulators' Defenses Against Deteriorating Statistics

In spite of a declining investor win rate in seven of the last eight years from 61% to 37% and a similarly declining recovery rate, FINRA, SIFMA, and other defenders of mandatory arbitration doggedly maintain the system is fair to investors. But they have shifted their win-rate position 180° from arguing that the investor win rate is a cornerstone measure of arbitration fairness to rationalizing that the lower investor win rates are no longer meaningful. In its October 2007 White Paper, SIFMA rejected the significance of current FINRA published win rates in explicit and stark contrast to its prior position, stating:

> The rate at which claimants prevail over a specific period of time is not an empirically valid basis on which to judge the fairness of a dispute resolution forum.[16]

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[15] Edward S. O'Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare* (2007) at 11. It has been noted by Solin and O'Neal, as well as other commentators, that figures reflecting the amount recovered in relation to the amount claimed in arbitration proceedings are subject to variables and, in particular, may be affected by inflated damage claims, which may render these figures less meaningful in evaluating arbitration awards. It must, however, be noted that recovery-rate figures follow the pattern of continuing decline in investor win rates. Further, there are no empirical data to support the argument that inflated claims materially impact recovery-rate statistics. FINRA has recently adopted a hearing script change designed to have claimants confirm their damage requests during the arbitration hearing, which may give greater assurance as to the accuracy of losses claimed for the purpose of calculating recovery rates.

[16] Securities Industry and Financial Markets Association, *White Paper on Arbitration in the Securities Industry* (Oct. 2007) at 39.

As arbitrators zero out investors in ever-increasing numbers, those who stubbornly contend the system remains fair, now claim that mounting decisions in favor of the brokerage industry and against investors are largely caused by forces unrelated to the arbitration process itself. They point to a flood of tech-bubble and analyst claims, which began in 2002-2003, many allegedly handled by inexperienced lawyers. They contend that the tech crash also generated inflated damage claims. And they contend that most analyst scandal claims failed because investors could not show reliance on industry-wide fraudulent buy recommendations. Then there is an overriding fallback position that brokerage firms increasingly settle stronger claims, leaving the weak cases to be lost, and that under any circumstances there are now more settlements, meaning more fairness. Of course there are no data published to support these arguments. But even if these arguments are accepted at face value, time has passed most of them by, and they have little application to 2006 statistics and even less to 2007 statistics.

The Tech Bubble and Analyst Scandal Are History

By 2006 and 2007, the tech bubble and analyst cases had all but disappeared from the arbitration system.

The tech bubble initially burst with a crash in the spring of 2000, reaching a market low in the summer of 2002. The analyst scandal was publicly admitted in all its gory detail in 2003. To be sure, these events generated large numbers of claims and a substantial increase in the NASD case load. NASD reported that filings increased from 5,558 in 2000 to an all-time high of almost 9,000 in 2003. But filings then declined to 8,201 in 2004, 6,074 in 2005, and down to 4,614 in 2006, which was substantially less than pre-crash levels. In fact, the number of filings in 2006 was the lowest since 1992, eight years before the crash. Filings in 2007 dropped even further to 3,238, a new all-time record low.[17]

The number of awards in customer cases followed a similar pattern. Customer cases decided reached a high of 1,894 in 2004 and declined to 1,610 in 2005, falling to just 1,011 in 2006. By 2007, the number of awards rendered was down to an all-time low of 671.[18]

By 2006 and 2007, the tech bubble and analyst scandal simply were no longer a factor. This was confirmed by PIABA's analysis of over 1,000 NASD 2006 awards which revealed only 15 awards indicating analyst claims.

Furthermore, as noted above, the tech bubble and analyst scandal had not yet occurred when the win rate took its largest one-year drop from 61% to 53% in 2000.

The Arbitration System Is Failing

From an investor's perspective, the arbitration system is failing, and FINRA arbitration no longer provides a viable method for dispute resolution for investor claims. Any objective view of the 2006 win-rate decline to just 42%, and then the appalling 2007 falloff to 37%, confirms that fairness in FINRA arbitration is at its nadir. The 2007 37% win rate combined with just a 36.7% recovery rate is simply unacceptable. Even if the recovery rate has improved for 2007, the vast majority of the investors who win their cases are still losing a larger percentage of their claimed losses than they are recovering, assuming their recovery rate remained less than 50%.

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[17] FINRA statistics, *supra* note 13. It should be noted that FINRA includes intra-industry claims in its filing statistics which comprise an estimated one-third of the totals.

[18] *Id*.

The Impact of Settlements

Perhaps the weakest argument that arbitration is fair in spite of mounting investor arbitration losses and declining recovery rates is the contention that an increase in the number of settlements shows fairness because in settlements, investors get some money. The argument goes that if investors get some money, a settlement must be treated as a "win." Then there is the contention that the industry settles the good cases, leaving the weak cases to be lost, thereby negatively distorting the win/loss results. These arguments have become an integral part of the regulators' and industry's fairness analysis.

Settlements Treated as Investor Wins

In Linda Fienberg's March 2005 testimony to the House Subcommittee on Financial Services, she emphasized that settlements when combined with awards resulted in some monetary return to roughly 75% of the claimants.[19] And FINRA's report of the 2007 statistics, which disclosed the abysmal 37% win rate, included a figure which combined both awards and settlements, stating that 80% of claimants received money from **both** awards and settlements in FINRA arbitration.[20]

In his 2005 testimony, SIA President Lackritz cited a combined 2004 settlement/win rate resulting in customers collecting money in three-fourths of NASD and NYSE cases as reflecting a system unbiased against customers.[21]

And as the win rate declined to just 42% in 2006, SIFMA continued to trumpet settlements in its October 2007 White Paper, pointing out that combining the 42% win rate with settlements resulted in two-thirds of investors receiving money.[22]

Settling Good Cases Does Not Distort Arbitration Results

Claiming that industry settlements of good investor cases adversely affect the win rates is truly specious.

It has forever been true that brokerage firms are inclined to settle the good customer cases. This strategy is not new and does not have any greater impact on recent arbitration win/loss statistics than on the numbers from earlier years.

Furthermore, there is no basis for FINRA and SIFMA construing a settlement as equivalent to an investor win. This position ignores the basic fact that just as there is a strong incentive for the industry to settle good investor cases, there is a strong incentive for investors to settle their bad cases. Investor attorneys who discover fatal weaknesses in their clients' cases have little motivation to arbitrate a loser and are inclined to encourage a nuisance-value settlement. Few investors are willing to endure the time, stress, and expense of arbitrating a case they are told they will lose. And it is common for experienced attorneys to include provisions in their fee agreements that allow them to withdraw if they conclude their client's case is a loser.

The fact is that the motivations for settlement are many and varied, and settlements may be good or bad for investors. There is simply no way of telling if a settled case would have been won or lost.

No legitimate analysis of arbitration fairness can use settlement statistics to pad the win

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[19] Fienberg, *supra* note 3 at 1.

[20] FINRA statistics, *supra* note 13.

[21] Lackritz, *supra* note 10 at 3.

[22] SIFMA White Paper, *supra* note 15 at 64.

rates.

Why Arbitrate If You Can't Win?

It must also be emphasized that, contrary to the position of FINRA and SIFMA, an increase in the number of settlements does not indicate arbitration is fair. The number of settlements has increased for sure, but not because the arbitration system is successful, but rather because it is unsuccessful.

The declining win rates and declining recovery rates over the last eight years actually have had a downward spiraling effect. Claimants have been forced into settlements, be their cases good or bad. Faced with only a 37% possibility of winning their cases and, if they "win," getting an average of only about 36% of their losses, claimants are inclined to enter into a settlement and avoid the possibility of a zero or nominal recovery. Certainly the settlement pressure is much stronger than it was back in 1999 when the GAO reported a 60% win rate and a 61% recovery rate.

In contrast to showing fairness, the increase in the number of settlements in all likelihood reflects an investor disaffection with the arbitration system. It is not a good thing. It is a bad thing. Why arbitrate if you can't win?

Smaller Win/Recovery Rates Equal Smaller Settlements

Furthermore, it cannot be overemphasized that the declining win and recovery rates result in ever-smaller settlements for distressed claimants. How can a claimant whose savings and retirement funds are at stake afford to demand a high settlement and gamble on arbitration with a 63% chance of getting a zero award? Moreover, even if the claimant is fortunate enough to beat the odds and win, he/she is facing an average recovery of only 36.76% of the losses. To add insult to injury, as described below, it is virtually certain that the claimant will be assessed substantial fees and costs. Claimants almost have to settle.

Even mediators may cite the investors' poor prospects in arbitration in their effort to encourage settlement at a reduced figure.

Arbitration More Favorable than Court?

An often-heard argument in support of the fairness of arbitration is the claim that investors receive better results in arbitration than in court. However, these arguments are never supported by data which relate to investor claims decided in court.

The obvious reason is that in the 20 years since *Shearson/American Express, Inc. v. McMahon*,[23] mandatory arbitration has left only a handful of individual investor securities cases in court. The vast majority of court securities cases are now class actions which, if not settled, are tyically decided on motion. Both factually and legally, class actions bear little relationship to individual an investor's claim. There simply is no basis for comparing their results.

The last meaningful analysis of investor results in court was in the 2000 GAO arbitration study which reviewed results from the late 1990s. This was well after the 1987 *McMahon* decision, but it took some time for the brokerage industry to convert its customer agreements to provide for predispute mandatory arbitration. As a result, many investors were still able to file their claims in court during the 90s. The GAO analyzed investor securities and commodities court results during 1997 and 1998.

The GAO identified 817 securities and commodities cases that were terminated between January 1997 and December 1998 at five federal district courts. It identified 121 to be securities-related disputes between individual investors and their broker-dealers. Of those 121 cases, 85 were dismissed for reasons such as being remanded to

[23] 482 U.S. 220, 107 S. Ct. 2332 (1987).

arbitration or transferred to another district.

Fifteen securities cases were actually decided by the courts. Investors won 11 of the 15. Claims were quantified in 10 of the 11 victories, and claimants won 100% of the amount claimed in 7 of the 10. Investors were also awarded punitive damages in 5 of the 7 cases in which punitive damages were requested.[24]

The fact that investors experienced a win rate of 73%, and 70% of the winners with quantified damages received a full recovery, strongly suggests that the court system may be more favorable to investors than arbitration where the win rate is 37% and recoveries average just over 36% of the amount claimed. It is little wonder that predispute arbitration clauses now dominate the entire brokerage industry.

Investor Fairness Surveys

The 2008 SICA Survey

In February 2008, the Securities Industry Conference on Arbitration (SICA) released the most comprehensive survey conducted to date of investors who had participated in NASD and NYSE arbitrations.[25] The survey was conducted in response to a 2002 arbitration study funded by the SEC, which emphasized the need for an empirical analysis of investors' perceptions of arbitration fairness.[26]

The findings of the SICA study confirmed the customer perception that arbitration is unfair to investors. The findings include:

- ***Percentage of Damages Recovered:*** Of 704 customers who had winning awards and indicated the percentage of claimed damages recovered, 68.46% received less than 50% of the damages originally claimed; and 46.02% received less than 25%.[27]
- ***Arbitration Panel Not Impartial:*** Of 966 customers responding, 40.58% said that the arbitration panel was not impartial, and only 24.84% said the panel was impartial.[28]
- ***Not Satisfied with Outcome:*** Of 1,105 customers responding, 70.77% were not satisfied with the outcome, and only 22.17% were satisfied.[29]
- ***Arbitration as a Whole Unfair:*** Of 1,038 customers responding, 62.62% did not feel that the arbitration process as a whole was fair, and only 27.84% thought it was fair.[30]
- ***Would Not Recommend Arbitration:*** Of 1,032 customers responding, 51.55% would not recommend arbitration to others to resolve their securities disputes, and only 32.17% would recommend arbitration.[31]
- ***Not a Favorable View of Arbitration:*** Of 1,075 customers responding, 60% did not have a favorable view of securities arbitration for customer disputes, and only 27.72% had a

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[24] GAO Unpaid Awards Report, *supra* note 7 at 33.

[25] Jill I. Gross and Barbara Black, *Perceptions of Fairness of Securities Arbitration: An Empirical Study, Report to the Securities Industry Conference on Arbitration* (Feb. 6, 2008).

[26] Michael Perino, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitration* (Nov. 4, 2002).

[27] SICA Survey, *supra* note 24 at 24.

[28] SICA Survey, *supra* note 24 at 30.

[29] SICA Survey, *supra* note 24 at 38.

[30] SICA Survey, *supra* note 24 at 45.

[31] SICA Survey, *supra* note 24 at 43.

favorable view.[32]

- ***Too Expensive:*** Of 922 customers responding, 49.13% felt arbitration was too expensive, and only 25.27% felt it was not too expensive.[33]
- ***Arbitration Unfair Compared to Court:*** Of 532 customers responding, 75.55% of customers found arbitration very unfair or somewhat unfair as compared to court.[34]
- ***Arbitration Not Fair to All Parties:*** Of 1,104 customers responding, 61.3% did not agree that arbitration was fair for all parties, and only 24.6% agreed with this statement.[35]
- ***Arbitration Not Without Bias:*** Of 1,203 customers responding, 49.2% did not agree that arbitration was without bias for all parties, and only 19.1% agreed with this statement.[36]

As noted above, this survey included claimants in cases decided in 2005 and 2006. In those years, the win rates were 43% and 42%, respectively. In 2007, the win rate was just 37%. One may assume that had the survey been taken today, the results would reflect even greater dissatisfaction with the securities arbitration process.

The Tidwell Fairness Survey

Overwhelming Investor Approval of Arbitration

The securities industry routinely cites the 1999 Tidwell survey to support its argument that investors believe the arbitration process is fair.[37] The Tidwell survey was based upon "Party Evaluation of Arbitrators" questionnaires completed in connection with arbitration proceedings from December 1, 1997 through April 1, 1999. Co-author of the survey, Gary Tidwell, joined the NASD in 1998, prior to completion of the survey.

Ninety-two percent of the responding claimants agreed with the statement that "at this point my case appears to have been handled fairly and without bias." Questionnaires completed by respondents reflected similar results. The authors concluded, "Our data reflects the parties' overwhelming approval of the arbitrators who heard their case."[38] The survey response rate was between 10% and 20%.

Questionnaire Presented at Hearing

The Tidwell survey notes that at the commencement of the hearing, the chairperson advises the parties that they will

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[32] SICA Survey, *supra* note 24 at 44.

[33] SICA Survey, *supra* note 24 at 41.

[34] SICA Survey, *supra* note 24 at 47.

[35] SICA Survey, *supra* note 24 at 52.

[36] SICA Survey, *supra* note 24 at 53.

[37] Gary Tidwell, Kevin Foster, and Michael Hummel, *Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitration* (1999). Mr. Tidwell served as an assistant professor of law at the United States Military Academy at West Point. He also served on the National Arbitration in Mediation Committee ("NAMC") of the NASD and chaired the NAMC Arbitrator Recruitment Qualifications and Training Subcommittee. In 1998, Mr. Tidwell joined the NASD Regulation Office of Dispute Resolution as its director in charge of neutral recruitment training and testing. In December 1999, he was appointed vice president of NASD Regulation, and in 2000 he was appointed executive director of the NASD's Institute for Professional Development.

[38] *Id.* at 54. It is difficult to understand how any objective person could state this conclusion from the survey without adding the phrase, "before the results had been disclosed."

be asked to voluntarily evaluate the arbitration process at the conclusion of the arbitration by responding to the written questionnaire.[39] Tidwell goes on to say that at the conclusion of the hearing, the chairperson passes out the questionnaire and again requests the parties to complete the questionnaire and mail their responses to a designated independent educational institution. The parties are encouraged to complete the questionnaire before receiving the award, but there is no deadline given.[40]

Parties Orally Confronted with Fairness Question During Hearing

Since well before 1999, continuing until just recently, the NASD chairperson's arbitration hearing script provided that at the conclusion of every arbitration and **prior to handing out the questionnaires,** the chairperson asks whether the parties had a "full and fair" opportunity to be heard.[41]

Parties Asked to Respond with Arbitrators Present – Pressure

Bear in mind that at the point where the chairperson asks each party and each party's attorney if they have had a "full and fair" opportunity to be heard, the parties have just completed their closing arguments, and the case has not been decided. All the arbitrators are listening attentively to the parties' responses to the fairness question. There is significant pressure on parties and their attorneys to answer this question affirmatively because no one wants to offend the arbitrators who have yet to deliberate and decide their case. As might be expected, the attorneys and parties almost always answer "yes," they have had a full and fair opportunity to present their case. There is no upside to saying "no."[42]

The Second Shoe Drops – Questionnaire Received and Read

It is only after this fairness question has been asked and answered that the chairperson passes out the written questionnaire (which is the heart of the Tidwell survey}, for the claimant to evaluate the arbitration, and requests that the questionnaire be sent in before the case is decided. And it is only after the claimant has received and had an opportunity to read the questionnaire that the claimant realizes that the questionnaire essentially repeats the same fairness question to which the claimant has already responded affirmatively.

So the dilemma is that the claimant has just affirmed in front of the three arbitrators that he/she has had a full and fair opportunity to be heard. Now the claimant is being asked to put in writing whether he/she agrees or disagrees with the statement: "At this point my case appears to have been handled fairly and without bias."

The Trap Is Sprung

Under the circumstances, there is only one way the claimant can answer the question, and that is to agree. To indicate otherwise would suggest the claimant had lied to the panel at the close of the hearing. The 92% affirmative response comes as no surprise.

Can the questionnaire possibly be considered a fair and objective survey? No. It is instead

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[39] *Id.* at 10.

[40] *Id.*

[41] *See* http://www.finra.org/web/idcplg?IdcService=SS_GET_PAGE&siteId=5&siteRelativeUrl=%2FArbitrationMediation%2FResourcesforArbitratorsandMediators%2FGeneralInformationandReference%2Fp038344&ssUrlPrefix=/&PrinterFriendly=1. Effective April 28, 2008, this language was deleted from the script.

[42] More experienced counsel adopted a policy of qualifying their response to avoid waiving a vacatur challenge to the arbitration.

a trap.

A Fundamentally Unfair Question

Furthermore, how can a person be asked to evaluate the fairness of an arbitration before the result is disclosed? The question is unfair on its face.

The Tidwell survey is of no value in evaluating the arbitration process.

Conclusion

It is obvious that FINRA arbitration is failing the investor. Its failure is confirmed by the arbitration statistics which neither FINRA nor the industry can deny. It is also confirmed by investors themselves in response to the SICA survey.

The fact is that the industry is prevailing in almost two-thirds of the arbitrations, and paying only about one-third of the amount claimed in those cases it loses. But ironically, the success of the brokerage industry in arbitration may well be its own undoing. As the public understands and appreciates the inequities of this system, the likelihood that arbitration will become voluntary is ever-increasing.

The Enhanced Arbitration Appeal Amendment: A Proposal to Save American Jurisprudence from Arbitration, Modeled on the English Arbitration Act of 1996

Drew Gulley

Drew Gulley is a student at Hofstra University School of Law with an anticipated graduation date of May 2009. His article was the winner of PIABA's inaugural Student Writing Competition. Mr. Gulley serves as Editor-in-Chief of the Hofstra Law Review and will clerk for Judge Edward Prado, Fifth Circuit Court of Appeals, upon graduation. *Drew would like to thank the editors and staff of the Hofstra Law Review, in particular Lindsey Karl, David Arnold, and Renato D. Matos for their masterful work; and his family for their love and support.*

I. Introduction

Arbitration, once relegated to commercial parties and disdained by the courts, has realized an expansive place in our adjudicatory regime.[1] Even the local consumer who wishes to exterminate a termite infestation may find herself shunted to arbitration in a dispute with the exterminator.[2] Our modern arbitral system, and statutory restrictions on judicial review, reveals a simple truth: "Arbitration is power, and courts are forbidden to look behind it."[3]

This Note does not seek to join judicial hostility toward arbitration. It does, however, ask lawmakers and practitioners to reinvigorate a suspicion of arbitration—to ask why we send almost any claim to a binding, private, non-precedential process, and what affect this practice has on our jurisprudence.

The central theme of this Note is that, to save our "way of law" from too much of a good thing, we must alter our approach to the judicial review of arbitral awards. Arbitration is not likely to lose its allure, but if it is to be an integral part of a remedial regime, arbitration must be brought into the fold.

Critics of arbitration have rarely "focused directly on whether arbitration in general . . . is consistent with public justice."[4] Rather, commentators have critiqued discrete effects of arbitration and recommended novel reforms using tools found within the American experience.[5] The agitation for change is growing and developing considerable momentum.[6]

An exemplary model for change in this country is England,[7] a nation with a long history of arbitration and the more recent English Arbitration Act of 1996 ("Arbitration Act 1996").[8] This Note proposes an amendment to the Federal Arbitration Act ("FAA"), modeled on the Arbitration Act 1996, to create an enhanced process of appeal from arbitration awards in certain circumstances.

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[1] *See* Thomas E. Carbonneau, *Arbitral Justice: The Demise of Due Process in American Law*, 70 TUL. L. REV. 1945, 1946-47 (1996); Christopher R. Drahozal & Raymond J. Friel, *Consumer Arbitration in the European Union and the United States*, 28 N.C. J. INT'L L. & COM. REG. 357, 370 (2002) (quoting Felton v. Mulligan, (1971) 124 C.L.R. 367, 385 (Austl.)) ("[B]y the early 1970s, Judge Windeyer of the High Court of Australia felt confident enough to state that: 'the grandiloquent phrases of the eighteenth century condemning ousting of the jurisdiction of courts cannot be accepted in this second half of the twentieth century as pronouncement[s] of a universal rule.'").

[2] *See* Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 268-69 (1995).

[3] Heinrich Kronstein, *Arbitration Is Power*, 38 N.Y.U. L. REV. 661, 699 (1963).

[4] Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1664 (2005) [hereinafter Sternlight, *Creeping Mandatory Arbitration*].

Part II of this Note outlines the history of arbitration in the United States and England, with an emphasis on significant changes that have fundamentally altered arbitration in both countries over the last 30 years. The problems of the American arbitration system are illustrated in Part III, focusing primarily on the fundamental inadequacy of expansive arbitration to continue the growth of the common law or to provide clarity through precedential statutory interpretation. Part IV contains the recommendation to cure those ills: the Enhanced Arbitration Appellate Amendment ("EAAA") and its procedural process. Finally, Part V is devoted to potential arguments against the EAAA, rebuttals and benefits of adopting this Note's recommendation.

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[5] Christine Godsil Cooper, *Where Are We Going With* Gilmer*?—Some Ruminations on the Arbitration of Discrimination Claims*, 11 ST. LOUIS U. PUB. L. REV. 203, 241 (1992) ("There must be a mechanism for the rediversion of issues of public policy and statutory construction back into the courts. This can be handled at the front end by removing such issues from arbitration, or at the back end by providing for judicial review of arbitration awards on such matters."); Robert Pitofsky, *Arbitration and Antitrust Enforcement*, 44 N.Y.U. L. REV. 1072, 1081 (1969) (recommending the issuance of "written opinions including something like the findings of fact and conclusions of law presently contained in . . . court opinions"); Sternlight, *Creeping Mandatory Arbitration*, *supra* note 4, at 1673 (positing a "thought experiment" of the formation of a controlled arbitration system with governmentally appointed arbitrators); Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 705, 710 (1996) [hereinafter Sternlight, *Panacea*] (recommending increased state control of arbitration, yet ultimately rejecting enhanced arbitral review by courts other than those avenues provided by the FAA); Clyde W. Summers, *Mandatory Arbitration: Privatizing Public Rights, Compelling the Unwilling to Arbitrate*, 6 U. PA. J. LAB. & EMP. L. 685, 732 (2004) (recommending an amendment to restrict arbitration of adhesion contracts); Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703, 741 (1999) (challenging the Supreme Court to either "(1) reverse its decisions that claims arising under otherwise mandatory rules are arbitrable or (2) require de novo judicial review of arbitrators' legal rulings on such claims"); Michael A. Scodro, Note, *Arbitrating Novel Legal Questions: A Recommendation for Reform*, 105 YALE L.J. 1927, 1959-60 (1996) (proposing "an amendment to the FAA to provide for a procedure, analogous to federal-state certification, whereby parties can receive a federal court's decision on a novel point of law raised in arbitration"). The commentator nearest to my solution, Professor William Park, argues that,

> [a]t a later stage, the United States might consider replacing the existing grounds for judicial vacatur of awards with at least part of the analogous provisions in the English law. The clear emphasis on substantive excess of authority and serious procedural irregularity, contained in sections 67 and 68 of the English Act, provide more focused guidance for dealing with arbitral misbehaviour than the rather unsystematic scatter-gun approach of section 10 of the Federal Arbitration Act. In addition, at some point American consumers of arbitral services should probably be given the option to have an award reviewed for error of law, similar to the opportunity now provided under the English statute.

William W. Park, *The Interaction of Courts and Arbitrators in England: The 1996 Act as a Model for the United States?*, 1 INT'L ARB. L. REV. 54, 67 (1998) [hereinafter Park, *Interaction*]. Similarly, Professor Jeffrey Stempel has recently argued for the adoption of appellate review: "To the extent possible, arbitration awards should receive appellate review as searching as that applied to court cases of similar magnitude and complexity." Jeffrey W. Stempel, *Keeping Arbitrations From Becoming Kangaroo Courts*, 8 NEV. L.J. 251, 267 (2007). Because I do not feel that all errors of law should be reviewed, and questions of fact should be not be reviewed by courts, this Note's recommendation, although enhancing the possibility of arbitral appeal, is narrowly tailored to produce precedent and enhance the common law.

[6] *See generally* Jean R. Sternlight, *Introduction: Dreaming About Arbitration Reform*, 8 NEV. L.J. 1, 1 (2007) [hereinafter Sternlight, *Dreaming*] (introducing a major symposium devoted entirely to proposals for changes to the American arbitral regime).

[7] England and Wales have been part of the same legal system since 1536. *See* Laws in Wales Acts 1535, 27 Hen. 8, c. 26 (repealed 1993). Although officially the law of "England and Wales or Northern Ireland," for the sake of brevity and clarity, all references will be simplified as "English" or "England."

[8] Arbitration Act 1996, c. 23.

II. Arbitration: A History and the Recent Charge Toward Our Current Regime

A. The Shared History of Arbitration in the United States and England

The United States inherited a legacy of law grown from common law roots.[9] England is the progenitor of American common law[10] and from those shared roots also came arbitration.[11] Through much of our history, we shared with England a distrust of a system that threatened to oust the courts of their jurisdiction.[12] During this period of judicial hostility, lasting well into the twentieth century, it was not uncommon for arbitrators to "interact[] with the courts in rendering their awards."[13]

American judicial antipathy to arbitration, and the sharing of responsibilities between United States courts and their arbitral counterparts, changed dramatically in the twentieth century.[14] This movement, which also shifted the American practice away from the English, has been characterized by its most important feature: "[A]rbitrators [are] almost entirely insulated from judicial intervention."[15] The FAA codified this new understanding.[16]

B. Arbitration in the United States

1. The Genesis of the Federal Arbitration Act and Arbitration Thereafter

Prior to the adoption of the FAA in 1925, arbitration in the United States was a distrusted, maligned and circumscribed practice.[17] The legislative history of the FAA has recently come under close academic

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[9] Roscoe Pound, *Justice According to Law*, 14 COLUM. L. REV. 1, 18-19 (1914).

[10] *See generally* Stewart Jay, *Origins of Federal Common Law: Part One*, 133 U. PA. L. REV. 1003 (1985) (tracing the evolution of common law in England and colonial America).

[11] Larry J. Pittman, *The Federal Arbitration Act: The Supreme Court's Erroneous Statutory Interpretation, Stare Decisis, and a Proposal for Change*, 53 ALA. L. REV. 789, 796-97 (2002) (noting the similar features of American and English arbitration in the early Twentieth Century); Shelly Smith, Note, *Mandatory Arbitration Clauses in Consumer Contracts: Consumer Protection and the Circumvention of the Judicial System*, 50 DEPAUL L. REV. 1191, 1196 (2001). Arbitration is ancient. *See, e.g.*, Pittman, *supra*, at 793 (discussing the use of arbitration in the Medieval period).

[12] The distaste of arbitration is said to stem from Lord Coke's decision in the Vynior's Case, (1609) 8 Co. Rep. 81b, 77 Eng. Rep. 597, 598-600 (K.B.). *See also* John R. Allison, *Arbitration Agreements and Antitrust Claims: The Need for Enhanced Accommodation of Conflicting Public Policies*, 64 N.C. L. REV. 219, 222-25 (1986) (noting the ancient nature of arbitration and the antagonism of the English common law system beyond that of other formal legal systems); Drahozal & Friel, *supra* note 1, at 367 (quoting Horton v. Sayer, (1859) 4 H. & N. 643, 157 Eng. Rep. 993, 996) ("Under traditional English common law, a contractual clause that purported to oust the jurisdiction of the courts was void as being contrary to public policy. As Pollock CB stated, 'the superior courts of law cannot be ousted of their jurisdiction by the mere agreement of the parties . . . .'"); Philip G. Phillips, *Rules of Law or* Laissez-Faire *in Commercial Arbitration*, 47 HARV. L. REV. 590, 591 (1934) ("Business arbitrations may be essential, but proper balance and strict control by the courts is imperative.").

[13] Scodro, *supra* note 5, at 1940.

[14] Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 404 (1967) (holding that an arbitration tribunal should decide questions of arbitrability in the first instance).

[15] Scodro, *supra* note 5, at 1940.

[16] The Federal Arbitration Act was originally called the Unites States Arbitration Act. Act of Feb. 12, 1925, ch. 213, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1-16 (2000)); *see also* Leo Kanowitz, *Alternative Dispute Resolution and the Public Interest: The Arbitration Experience*, 38 HASTINGS L.J. 239, 256 (1987); Phillips, *supra* note 12, at 596-97 (providing a humorous and extensive list of subjects once specially reserved for piecemeal arbitration statutes).

[17] *See, e.g.*, Bernhardt v. Polygraphic Co. of America, 350 U.S. 198, 203 (1956); Tobey v. County of Bristol, 23 F. Cas. 1313, 1321 (C.C.D. Mass. 1845) (Story, J.); *see also* Drahozal & Friel, *supra* note 1, at 374.

scrutiny,[18] revealing an adoption process fraught with compromise and gloss.[19]

In the early 1920s, Julius Henry Cohen, a lawyer from New York, spearheaded the incarnation of the FAA that shuttled from committees to the floor of Congress and passed into law.[20] Cohen, a practitioner at the forefront of New York's arbitration work, was active in state associations and committees.[21] New York had one of the more expansive arbitration statutes, adopted in 1920.[22] The FAA, modeled on the New York statutes, was intended to improve the lot of American business by "cut[ting] the Gordian knot of the law's delay."[23] This philosophy was acknowledged in Cohen's comments before the Joint Hearings of the Senate and House Subcommittees.[24]

Despite the FAA's advance, arbitration in America initially remained a little used dispute resolution device.[25] Indeed, until the mid-1950s, arbitration was tied to the fundamental contractual relationship of commercial parties, existing only when parties sought commercial contracts containing arbitration clauses.[26] The understanding of these parties indicated that arbitration was "not considered [a] surrogate[] for adjudication in a court of law."[27] The narrow reach of arbitration would change dramatically in the ensuing decades, with the Supreme Court unleashing the binds, perceived and judicial, on arbitration.[28] The Supreme Court does not appear to ground its expansive arbitration decisions on the FAA's legislative history; as Justice O'Connor commented in *Allied-Bruce Terminix Cos. v. Dobson*,[29] "the Court has abandoned all pretense of ascertaining congressional intent

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[18] Margaret L. Moses, *Statutory Misconstruction: How the Supreme Court Created a Federal Arbitration Law Never Enacted by Congress*, 34 FLA. ST. U. L. REV. 99, 101-10 (2006); Pittman, *supra* note 11, at 825-30; Imre S. Szalai, *The Federal Arbitration Act and the Jurisdiction of the Federal Courts*, 12 HARV. NEGOT. L. REV. 319, 340-42 (2007); Katherine Van Wezel Stone, *Rustic Justice: Community and Coercion Under the Federal Arbitration Act*, 77 N.C. L. REV. 931, 986-87 (1999).

[19] Moses, *supra* note 18, at 110; Szalai, *supra* note 18, at 342. *But see* Christopher R. Drahozal, *In Defense of* Southland*: Reexamining the Legislative History of the Federal Arbitration Act*, 78 NOTRE DAME L. REV. 101, 107 (2002) (addressing legislative history of the FAA and arriving at the conclusion that the FAA was intended be applied to state courts).

[20] Moses, *supra* note 18, at 102-10. The Supreme Court recently addressed the legislative history of the FAA. *See* Hall Street Assocs. v. Mattel, Inc., 128 S. Ct. 1396, 1406 n.7 (2008).

[21] Moses, *supra* note 18, at 101 (noting that Cohen served as general counsel for the New York State Chamber of Commerce).

[22] Julius Henry Cohen & Kenneth Dayton, *The New Federal Arbitration Law*, 12 VA. L. REV. 265, 266 (1926) (citing 1920 N.Y. Laws ch. 295).

[23] *Id.*; *see also* Moses, *supra* note 18, at 102.

[24] *Arbitration of Interstate Commercial Disputes: J. Hearings Before the Subcomms. of the Comms. on the Judiciary on S. 1005 and H.R. 646*, 68th Cong. 16 (1924) (statement of Julius Henry Cohen).

[25] *See, e.g.*, Kulukundis Shipping Co. v. Amtorg Trading Corp., 126 F.2d 978, 986 (2d Cir. 1942); Stephen L. Hayford, *Federal Preemption and Vacatur: The Bookend Issues Under the Revised Uniform Arbitration Act*, 2001 J. DISP. RESOL. 67, 67-68 (2001) [hereinafter Hayford, *Federal Preemption*].

[26] Hayford, *Federal Preemption*, *supra* note 25, at 67-68.

[27] *Id.*

[28] *See, e.g.*, Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 449 (2006); Doctor's Assocs. v. Casarotto, 517 U.S. 681, 688 (1996); Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 281 (1995); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 636-37 (1985); Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 217 (1985); Southland Corp. v. Keating, 465 U.S. 1, 16 (1984); Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 406-07 (1967).

[29] 513 U.S. at 265.

with respect to the [FAA], building instead, case by case, an edifice of its own creation."[30]

Modern American arbitration is almost unrecognizable from its disfavored ancestor. As summed up by Professor Thomas Carbonneau, arbitrators are now "entitled, as a matter of law, to rule upon securities, RICO, civil rights and any other type of claim, no matter what the import to the public interest . . . ."[31] Modern arbitration under the FAA is far removed from the dispute resolution process envisioned between sophisticated commercial parties enjoying relative parity.[32] Simply put, "the bandwagon may be on a runaway course."[33] To check that runaway coach, courts are currently provided with few options under the FAA.

2. Standards of Review for Arbitration Awards Under FAA Section 10(a)

The FAA secured the arbitral solution from courts of law jealous and protective of their jurisdiction. In doing so, however, the FAA also limited the corrective possibility of appeal.[34] It is important to address the options currently accommodated by the FAA to review the award of an arbitration panel before reaching this Note's proposal to alter the review process.

The only judicial allowance for vacatur of an arbitral award made explicit in the FAA is found in section 10(a) of that Act.[35] The enumerated provisions do not allow an appeal on the merits of the dispute.[36] Under a literal reading, section 10(a) is not an appeal of the dispute at all—merely an opportunity for a court to correct gross procedural errors.[37] Each of the provisions speaks to the composition and conduct of the panel, rather than to the nature of the dispute or merits of the action.[38] Absent statutory provisions, courts were constrained, when presented with an unsavory arbitration award, to create novel vacatur review standards outside of those provided in the FAA.

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[30] *Id.* at 283 (O'Connor, J., concurring). In the recent case of *Hall Street Assocs. v. Mattel, Inc.*, 128 S. Ct 1396 (2008), Justice Souter discussed the work of Congress prior to the adoption of the FAA. *Id.* at 1406 n.7. Justice Souter's footnote (which was not joined by Justice Scalia) may signal a return to legislative history when the Court is presented with a question under the FAA. Justice Souter's conclusion that the legislative history supports a limitation of party ability to contract for expanded judicial review beyond section 10(a) of the FAA will likely be open to intensive future critique, particularly when that conclusion is set parallel to arguments supporting the primacy of party autonomy. *See, e.g.*, Sarah Rudolph Cole, *Revising the FAA to Permit Expanded Judicial Review of Arbitration Awards*, 8 NEV. L.J. 214, 214 (2007).

[31] Carbonneau, *supra* note 1, at 1955; *see also* Jay R. Sever, Comment, *The Relaxation of Inarbitrability and Public Policy Checks on U.S. and Foreign Arbitration: Arbitration Out of Control?*, 65 TUL. L. REV. 1661, 1676 (1991) (illustrating similar expansive jurisdiction).

[32] *Prima Paint*, 388 U.S. at 409-10, 414 (Black, J., dissenting).

[33] Harry T. Edwards, *Alternative Dispute Resolution: Panacea or Anathema?*, 99 HARV. L. REV. 668, 668 (1986). There are intimations that the jurisdiction of arbitrators is growing yet more expansive. *See* Szalai, *supra* note 18, at 322 (addressing circuit split "whether a federal court's jurisdiction to enforce an arbitration agreement under the FAA may be based on the federal nature of the underlying dispute to be submitted to arbitration").

[34] Cohen & Dayton, *supra* note 22, at 273 ("There is no authority and no opportunity for the court, in connection with the award, to inject its own ideas of what the award should have been.").

[35] 9 U.S.C. § 10(a) (2000).

[36] *Id.*

[37] *See* Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. REV. 81, 116 (1992) (arguing that even the original champion of the FAA, Julius Henry Cohen, allowed for "a remarkably active role for the courts in preserving procedural protections for the arbitral parties").

[38] 9 U.S.C. § 10(a).

3. Non-Statutory Standards of Review for Arbitration Awards

Despite the express grant of judicial review for only those reasons contained in section 10(a), a number of federal circuit courts have recognized the existence of "nonstatutory" grounds for vacatur.[39] Among the recognized grounds are "a 'manifest disregard' of the law by the arbitrator, a conflict between the award and a clear and well established 'public policy,' an award that is 'arbitrary and capricious' or 'completely irrational,' and a failure of the award to 'draw its essence' from the parties' contract."[40] Every circuit but the Federal Circuit allows vacatur outside the grounds allowed by section 10(a).[41]

Those circuits recognizing non-statutory grounds for arbitral vacatur base their opinions on a dated and overruled case from the Supreme Court: *Wilko v. Swan*.[42] With increasing confusion, circuit courts stretch and warp the dicta of *Wilko* to accomplish vacatur of awards deemed to lack procedural or substantive backing.[43]

C. Arbitration in England

The English have a long and storied history of arbitration.[44] Courts in England regularly and loudly rebuffed the advance of arbitration.[45] Objection to arbitration in England eventually sublimated into statutory control, yet English courts remained entitled to interfere in the jurisdiction of arbitral tribunals.[46] England has continued to update its statutory regime for arbitration, reflecting changing attitudes and relationships with arbitration.[47]

1. England's History of Statutory Control

The courts of England, as condoned by governing statute, exercised great power over arbitration; these statutes served to "control the substantive norms that arbitrators appl[ied]" to the dispute.[48] As early as the mid-nineteenth century, the "special case" practice had emerged, "whereby [arbitrators] rendered their awards in the form of alternative outcomes, leaving it to the courts to choose among them based on their

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[39] Stephen L. Hayford, *Law in Disarray: Judicial Standards for Vacatur of Commercial Arbitration Awards*, 30 GA. L. REV. 731, 739 (1996) [hereinafter Hayford, *Law in Disarray*].

[40] *Id.*

[41] Stephen L. Hayford, *A New Paradigm for Commercial Arbitration: Rethinking the Relationship Between Reasoned Awards and the Judicial Standards for Vacatur*, 66 GEO. WASH. L. REV. 443, 461 (1998) [hereinafter Hayford, *A New Paradigm*].

[42] 346 U.S. 427 (1953), *overruled on other grounds by* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 481, 485 (1989). For an example of *Wilko*'s use, see Merrill Lynch, Pierce, Fenner & Smith v. Bobker, 808 F.2d 930, 933 (2d Cir. 1986) (citing *Wilko* in a determination of the doctrine of manifest disregard as applied to arbitral review).

[43] James M. Gaitis, *Unraveling the Mystery of* Wilko v. Swan*: American Arbitration Vacatur Law and the Accidental Demise of Party Autonomy*, 7 PEPP. DISP. RESOL. L.J. 1, 2-3 (2007); Stephen L. Hayford, *Unification of the Law of Labor Arbitration and Commercial Arbitration: An Idea Whose Time Has Come*, 52 BAYLOR L. REV. 781, 870-71 (2000) [hereinafter Hayford, *Unification of the Law*].

[44] *See* Park, *Interaction*, *supra* note 5, at 64.

[45] *See* Kulukundis Shipping Co. v. Amtorg Trading Corp., 126 F.2d 978, 983 n.14 (2d Cir. 1942) (quoting Scott v. Avery, (1856) 10 Eng. Rep. 1121, 1138, 5 H.L.C. 811, 853 (H.L.) (commentary of Lord Campbell)).

[46] *See, e.g.*, Arbitration Act, 1950, 14 Geo. 6, c. 27, § 21 (allowing parties to seek court intervention through the "statement of [the] case" procedure).

[47] *See* Arbitration Act 1996, c. 23; Arbitration Act 1979, c. 42; Arbitration Act 1975, c. 3; Arbitration Act, 1950, 14 Geo. 6, c. 27; Common Law Procedure Act, 1854, 17 & 18 Vict., c. 125; Civil Procedure Act, 1833, 3 & 4 Will. 4, c. 42, § 39 .

[48] Scodro, *supra* note 5, at 1940.

judgment about specified legal questions that had arisen during the arbitration."[49] Additionally, courts exercised the "common-law power . . . to set aside awards for an error of law or fact on the face of the award . . . ."[50]

With the adoption of the English Arbitration Act of 1979 ("Arbitration Act of 1979"),[51] the "special case" practice fell away.[52] In the time between the Arbitration Act of 1979 and the adoption of the Arbitration Act of 1996, judicial review of arbitration awards went through a number of permutations.[53] In 1982, the House of Lords handed down its decision in *The Nema*,[54] restricting the intervention of national courts severely in "one-off" arbitrations.[55] *The Nema* outlined a standard of limited judicial review, which, along with its companion case three years later, *The Antaios*,[56] was largely adopted in England's latest codification of arbitral law.[57]

2. Arbitration under the English Arbitration Act of 1996

The Arbitration Act of 1996 was a shift in England's arbitration paradigm.[58] Commentators have been generally warm to its modifications.[59] The Arbitration Act of 1996 seriously curtailed the opportunity of a court to interfere with the proceeding of an arbitration.[60] In short, the "inherent jurisdiction of the courts" is no longer sufficient to justify intervention.[61]

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[49] *Id.* Somewhat surprising when juxtaposed against our current antipathy to judicial review of arbitration awards, the special case once found limited purchase in the United States. Under an old version of Massachusetts's law, questions of law "may" be referred to a court; this lenient "may" transforms into a "shall" upon request of all parties. MASS. GEN. LAWS ch. 251, § 20 (1959). Additionally, if a party sought review "before the award becomes final . . . the superior court may in its discretion instruct the arbitrator or arbitrators upon a question of substantive law." MASS. GEN. LAWS ch. 251, § 20 (1959). Illinois' original arbitration act was modeled on England's contemporary. Phillips, *supra* note 12, at 614. Connecticut and Pennsylvania also enjoyed slightly modified forms of England's arbitration act. *Id.*

[50] Okezie Chukwumerije, *Reform and Consolidation of English Arbitration Law*, 8 AM. REV. INT'L ARB. 21, 43 (1997).

[51] Arbitration Act 1979, c. 42.

[52] *Id.* at § 1(1) ("In the Arbitration Act 1950 . . . section 21 (statement of the case for a decision of the High Court) shall cease to have effect . . . .").

[53] *See generally* Paul A. C. Jaffe, *The Judicial Trend Toward Finality of Commercial Arbitral Awards in England*, 24 TEX. INT'L L.J. 67, 72-86 (1989) (discussing Arbitration Act 1979 and judicial review thereafter).

[54] Pioneer Shipping Ltd. v. B.T.P. Tioxide Ltd. ("The Nema"), [1982] A.C. 724 (H.L. 1981).

[55] *Id.* at 742-43. A "one-off" arbitration involves a contract that was specifically negotiated between parties, as opposed to the standard contract forms often employed in general commerce. *See* Jaffe, *supra* note 53, at 68 n.4. *The Nema* established that leave to appeal from an arbitration award varied according to the type of case at issue. *Id.* at 74-75.

[56] Antaios Compania Naviera S.A. v. Salen Rederierna A.B. ("The Antaios"), [1985] A.C. 191, 203-04 (H.L. 1984). *The Antaios* reaffirmed the holding of *The Nema* and further clarified access to appeal to the higher courts. *See* Jaffe, *supra* note 53, at 76-77.

[57] CMA CGM S.A. v. Beteiligungs-KG MS "Northern Pioneer" Schiffahrtsgesellschaft mBH & Co., [2002] EWCA (Civ) 1878, (2003) 1 W.L.R. 1015, 1024-25 (C.A.).

[58] Tom Birch Reynardson, *Reconciling Cost Control With Justice*, 1 INT'L ARB. L. REV. 115, 115 (1998); *see also* Lord Saville, *The Arbitration Act 1996: What We Have Tried to Accomplish*, 13 CONSTRUCTION L.J. 410, 410 (1998).

[59] Oliver Browne, *London v. Paris: Territorial Competition in International Commercial Arbitration*, 7 INT'L ARB. L. REV. 1, 6 (2004) ("Since 1997 . . . English law has established itself as being amongst the world's more progressive arbitration regimes.").

[60] Chukwumerije, *supra* note 50, at 27.

Judicial control of arbitration in England may now be divided into two species: assessment of the arbitral procedure and review of the award.[62] When a court addresses arbitral procedure, it is "concerned [with] . . . ensuring that the tribunal is independent and free from bias, that it acts within its jurisdiction, that the parties are given equal opportunity to present their respective cases and that the arbitration otherwise conforms with the mandatory procedural laws of the seat of arbitration."[63] In its review of the arbitral award, the English courts are controlled by section 69 of the Arbitration Act of 1996.[64] A restriction on the jurisdiction of the courts was clearly intended by the drafters:

> We have very severely limited the right to apply to appeal from an arbitration award. . . . You have to demonstrate that the arbitrator was obviously wrong, or in a case of general public importance, that his conclusion was at least open to serious doubt. . . . You can only apply to appeal on a point of English law. . . . You will not be able to appeal on questions of fact dressed up as questions of law. . . . More importantly still, we have inserted . . . 69(3)(d) of the Act . . . [so that it must be] "just and proper in all the circumstances for the court to determine the question." This new provision means that over and above the court being satisfied that the tribunal was obviously wrong in law, or (in a case of general importance) that its conclusion was at least open to serious doubt, there will have to be something else which makes it just and proper for the court to substitute its own decision for that of the tribunal. This should, and is intended to make successful applications for leave to appeal from an arbitration award very rare indeed.[65]

As illustrated by the foregoing commentary by Lord Saville, the final portion of section 69 is intended to further limit the interference of national courts, as "just and proper" circumstances must be weighed against party autonomy and intent.[66] There is some indication that courts have taken the new boundaries to heart, avoiding interference and limiting appeals.[67]

Section 69 is not a mandatory provision of the Arbitration Act of 1996.[68] To opt out of section 69, parties must do so by express written agreement or grant the panel leave to make its award without reasons.[69] There is some authority that section 69 will be unavailable if

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[61] *Id.* (noting that jurisdiction for court interference is now allowed only where so provided by the Act).

[62] *Id.* at 41.

[63] *Id.*

[64] *See* Arbitration Act 1996, c. 23, § 69.

[65] Saville, *supra* note 58, at 412 (quoting Arbitration Act 1996, c. 23 § 69(3)(d)).

[66] *Id.*

[67] CMA CGM S.A. v. Beteiligungs-KG MS "Northern Pioneer" Schiffahrtsgesellschaft mBH & Co., [2002] EWCA (Civ) 1878, (2003) 1 W.L.R. 1015, 1021 (C.A.) ("So far as [this court is] aware, this is the first time that permission to appeal to this court has been granted pursuant to section 69 of the [Arbitration Act 1996].").

[68] Taner Dedezade, *Are You In? Or Are You Out? An Analysis of Section 69 of the English Arbitration Act 1996: Appeals on a Question of Law*, 9 INT'L ARB. L. REV. 56, 59 (2006).

[69] *Id.* at 60; *see also* Park, *Interaction*, *supra* note 5, at 62. The possibility of exclusion is a significant development: "Under the Arbitration Act 1979, there was an ability to exclude the right to appeal on a point of law but such rights were restricted, in relation to domestic agreements, special categories and statutory arbitrations." Dedezade, *supra* note 68, at 59.

parties select a set of arbitration rules incorporating an exclusion of appeal.[70]

Procedurally, section 69 is simple to follow. Section 69(2) allows an appeal from an arbitral award if all parties to the arbitration agree.[71] If the parties to the arbitration are unable to agree, the permission to appeal will be granted by the court "only if the court is satisfied . . . that the determination of the question will substantially affect the rights of one or more of the parties . . . ."[72] Upon a finding that the question substantially affects the rights of a party, permission to appeal from the arbitration to the court will be granted after the arbitration panel issues its award, "on the basis of the findings of fact in the award," in two circumstances: first, "the decision of the tribunal on the question is obviously wrong" or second, "the question is one of general public importance and the decision of the tribunal is at least open to serious doubt . . . ."[73] The threshold for permission is lower if the party seeking appeal is able to convince the court of the presence of a "question of general public importance."[74] The lowered standards for appeal provided in the Arbitration Act of 1996 are compensation for the hurdle presented by the test derived from *The Nema*: The presumption that an appeal from an arbitral award is improper in all but the most extreme circumstances.[75]

The appealing party must clearly state a question of law to the court and explain why the appeal should be granted.[76] The court may decide whether to grant the appeal with or without a hearing.[77] Under the Arbitration Act of 1996, there is a presumption that a hearing is not necessary or allowed.[78] This presumption, however, is not always followed.[79] The appealing party makes its request of the court at some risk: "On an appeal under this section the court may confirm the award, vary the award, remit the award to the tribunal, in whole or in part, for reconsideration in the light of the court's determination, or set aside the award in whole or in part."[80] The court's decision on the appeal is treated as a final judgment and is therefore granted limited appeal: Only if "the court considers that the question is one of general importance or is one which for some other special reason should be considered by the Court of Appeal."[81]

III. Inherent Problems with the United States' Arbitral Regime

The American approach to arbitration is troublesome for at least five reasons: (1) it cripples the ability of our courts to make the precedents that support our common law

[70] *See* Lesotho Highlands Dev. Auth. v. Impregilo SpA, [2005] UKHL 43, (2006) 1 A.C. 221, 224-25 (H.L. 2005); Steven Friel, *Excluding the Right to Appeal Under s.69 of the Arbitration Act 1996 by Reference to the Rules of an Arbitral Institution*, 9 INT'L ARB. L. REV. N26, N26 (2006).

[71] Arbitration Act 1996, c. 23, § 69(2)(a).

[72] *Id.* § 69(3)(a); Dedezade, *supra* note 68, at 63.

[73] Arbitration Act 1996, c. 23, § 69(3)(c); Dedezade, *supra* note 68, at 63.

[74] Dedezade, *supra* note 68, at 64.

[75] *Id.*

[76] *Id.* at 66.

[77] *Id*.

[78] Arbitration Act 1996, c. 23 § 69(5).

[79] *See* Dedezade, *supra* note 68, at 66-67.

[80] *Id.* at 66.

[81] Arbitration Act 1996, § 69(8); *see also* Henry Boot Constr. Ltd. v. Malmaison Hotel Ltd., [2000] 3 W.L.R. 1824, 1826 (C.A. 2000); Dedezade, *supra* note 68, at 66.

foundation and statutory interpretations; (2) arbitration tribunals are not required (outside of discrete exceptions) to publish reasons for their awards, thus denying public and legislative response to arbitration awards; (3) the statutory grounds for vacatur, and the judicially created non-statutory grounds for vacatur, are often in conflict; (4) the pre-emptive nature of the FAA limits the ability of states to expand judicial review of federal or state issues; and (5) parties may not contractually expand opportunities for judicial review when agreeing to arbitrate. When combined, these problems with the current system necessitate an amendment to the FAA to create a process of enhanced arbitral appeal.

A. Precedent: An Embattled and Endangered Foundation

American law is one of common law roots.[82] It is founded upon *stare decisis* and statutory interpretation by the courts.[83] The continued growth of the common law and the interpretation of statutory law are threatened by the unabated proliferation of arbitration.[84] The threat comes from a single truth: Arbitration does not make law. Although an arbitration tribunal may use adjudicatory tools such as discovery, witnesses and reasoned awards, any award by the tribunal may not be relied upon as precedent.[85] Because an arbitration proceeding is a matter of simple contractual enforcement, decided by private adjudicators, an arbitral award is enforceable only agains the parties to the arbitration agreement. At one point, the Supreme Court recognized the distinction between simple contractual claims and claims implicating a public interest: "[Arbitration] cannot provide an adequate substitute for a judicial proceeding in protecting . . . federal statutory and constitutional rights . . . ."[86] The Supreme Court has dynamited its earlier stopgaps, releasing a flood of arbitration.[87] This section will demonstrate the strangulation of court precedent in one important area: securities. Before this individual branch of the law is assessed, however, it is necessary to look at the entire tree and ground specificity in general theory.

In an influential article, Professor Owen Fiss laid out a challenge to the practice of court avoidance:

> Adjudication uses public resources, and employs not strangers chosen by the parties but public officials chosen by a process in which the public participates. These officials, like members of the

[82] Heinrich Kronstein, *Business Arbitration—Instrument of Private Government*, 54 YALE L.J. 36, 36 (1944).

[83] BENJAMIN CARDOZO, THE NATURE OF THE JUDICIAL PROCESS 149 (1921).

[84] Kronstein, *supra* note 82, at 36 ("The growth in the United States of this extra-legal use of arbitration, subject at no juncture to judicial supervision, should challenge the complacent and stir those who would place public interest before private gain."); Jean R. Sternlight, *Is the U.S. Out on a Limb? Comparing the U.S. Approach to Mandatory Consumer and Employment Arbitration to that of the Rest of the World*, 56 U. MIAMI L. REV. 831, 835 (2002) [hereinafter Sternlight, *Out on a Limb*] (noting that a hallmark of mandatory, binding arbitration is the "eliminati[on] [of] the claimant's right to present claims to a judge or jury[,] . . . [thereby] preventing litigants from setting public precedents").

[85] Allison, *supra* note 12, at 240; Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1107 (1993); Mitchell H. Rubinstein, *Altering Judicial Review of Labor Arbitration Awards*, 2006 MICH. ST. L. REV. 235, 262.

[86] McDonald v. City of W. Branch, 466 U.S. 284, 290 (1984) (announcing this limitation of arbitration in the context of § 1983 claims); Smith, *supra* note 11, at 1222-23. Additionally, the Supreme Court has stated that "arbitral procedures [are] less protective of individual statutory rights than are judicial procedures . . . ." Barrentine v. Arkansas-Best Freight Sys., Inc., 450 U.S. 728, 744 (1981).

[87] *See* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 232 (1987) (discussing arbitration precedent); *see also* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) (declaring that federal policy favors arbitration).

> legislative and executive branches, possess a power that has been defined and conferred by public law, not by private agreement. Their job is not to maximize the ends of private parties, nor simply to secure the peace, but to explicate and give force to the values embodied in authoritative texts such as the Constitution and statutes: to interpret those values and to bring reality into accord with them.[88]

Professor Fiss leveled his critique against settlements;[89] arbitration is readily analogous to settlement. The comparison is compelling: like settlement, arbitration is intended to facilitate the whims of private preferences.[90] Furthermore, the practice of arbitration takes from the courts the disputes that will allow the court to hear and decide.[91] Judge Harry Edwards expressed similar concern: "An oft-forgotten virtue of adjudication is that it ensures the proper resolution and application of public values. In our rush to embrace alternatives to litigation, we must be careful not to endanger what law has accomplished . . . ."[92] Judge Edwards further framed the issue when he warned, "by diverting particular types of cases away from adjudication, we may stifle the development of law in certain disfavored areas."[93]

The proponents of the FAA conceded that the new arbitration regime was "simply a new procedural remedy" and therefore not outside of the broader adjudicatory framework.[94] A contemporary to the drafting of the FAA addressed the alternative dispute resolution system with trepidation:

> Strongly as I favor arbitration, we, as lawyers, must never forget that our law is an inheritance from all the ages. We have worked out certain definite principles, certain definite rights, certain definite remedies. They are subject to improvement; they are subject to clearer statement; they are subject to greater exactness; and they are subject to enormous improvement in their practical application, but I do not think we are ready to throw them overboard and to substitute for them the arbitrary unappealable will of a single individual entrained perhaps in this our legal inheritance.[95]

This eloquence is particularly potent in our current age of expanding arbitration. We are witness to the creeping engulfment of once-inarbitrable subjects by arbitration.[96] Even the driving force behind the FAA, Julius Henry

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[88] Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1085 (1984).

[89] *Id.*

[90] Margaret M. Moses, *Can Parties Tell Courts What to Do? Expanded Judicial Review of Arbitral Awards*, 52 U. KAN. L. REV. 429, 429 (2004) (remarking that "[a]rbitration is a private system of justice, made possible by the parties' consent").

[91] Fiss, *supra* note 88, at 1085.

[92] Edwards, *supra* note 33, at 676. The economic foundation for public adjudication has been equally well-demonstrated. *See* William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 236-40 (1979).

[93] Edwards, *supra* note 33, at 679 (recognizing civil rights, family law and the legal rights of the poor as such "disfavored" areas).

[94] *See* Cohen & Dayton, *supra* note 22, at 279.

[95] Address of United States Circuit Judge Julian Mack (Nov. 19, 1925), *in* 7 LECTURES ON LEGAL TOPICS 1925-1926, at 107 (Assoc. of Bar of the City of N.Y. eds., 1929).

[96] *See, e.g.*, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 238 (1987) (holding claim under Securities Act of 1934 arbitrable); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 636-37 (1985) (holding antitrust claims arbitrable); Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 217 (1985) (holding that claims must be split between arbitration and litigation in the presence of an arbitration agreement); Sues v. John Nuveen & Co., 146 F.3d 175, 182 (3d Cir. 1998) (holding Title VII claim arbitrable).

Cohen, acknowledged that "[n]ot all questions arising out of contracts ought to be arbitrated . . . [i]t is not the proper method for deciding points of law of major importance involving constitutional questions or policy in the application of statutes."[97] The inarbitrable subjects featured in Cohen's commentary – cases involving constitutional questions and statutory interpretation – are exactly those subjects now featured in arbitration.[98]

The danger of arbitration may be simply drawn: "Public policy issues need public resolution."[99] Arbitration is not a public process.[100] Some commercial actors choose arbitration, at least in part, for its confidential nature.[101] This privacy comes at a price: courts are unable to prune the law, the public is denied an understanding of law applications and Congress is unaware of problematic statutes.[102]

Courts are allowed to act only when confronted with a "real party" to a controversy.[103] A federal court may not issue advisory opinions.[104] Without a real party in interest, and the facts presented in the proceeding, a federal court may not interpret the law. Arbitration takes the party from the court. Under the expanded interpretation of the FAA by the Supreme Court, it has been argued that the Court has "delegated to arbitrators what is essentially the judicial power of the State."[105] Absent any judicial review, when a court confirms the award of a tribunal, "[it] adopts the arbitrator's decision as its own, and that decision is enforced like any other ruling of the court."[106]

The court is a public institution: The proceedings, papers and decisions typically all become part of the public record.[107] In this manner, the public is able to recognize and understand the law as applied—to modify and check behavior accordingly.[108] The public learns about applicable law from the dispute and acts as a court of public opinion.[109] In confidential arbitration, "something very

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[97] Cohen & Dayton, *supra* note 22, at 281; *see also* Edwards, *supra* note 33, at 671-72.

[98] *Compare* Cohen & Dayton, *supra* note 22, at 281 (noting that "[arbitration] is not the proper method for deciding points of law of major importance involving constitutional questions or policy in the application of statutes") *with* cases cited *supra* note 28.

[99] Cooper, *supra* note 5, at 241.

[100] Ware, *supra* note 5, at 707-08.

[101] Richard E. Speidel, *Arbitration of Statutory Rights Under the Federal Arbitration Act: The Case for Reform*, 4 OHIO ST. J. ON DISP. RESOL. 157, 161 (1989).

[102] Geoffrey C. Hazard, Jr. & Paul D. Scott, *The Public Nature of Private Adjudication*, 6 YALE L. & POL'Y REV. 42, 59 (1988) ("Ordering by public justice produces decisions resting on considerations that transcend the immediate dispute and the immediate parties.").

[103] FED. R. CIV. P. 17(a)(1) (2007).

[104] United Pub. Workers of Am. v. Mitchell, 330 U.S. 75, 89 (1947) ("As is well known, the federal courts established pursuant to Article III of the Constitution do not render advisory opinions.").

[105] Moses, *supra* note 18, at 144.

[106] Ware, *supra* note 5, at 708.

[107] *See, e.g.*, Nixon v. Warner Commc'ns, Inc., 435 U.S. 589, 597 (1978) (discussing the common law right to inspect and copy public records, including court records).

[108] Cooper, *supra* note 5, at 214-15.

[109] William W. Park, *Amending the Federal Arbitration Act*, 13 AM. REV. INT'L ARB. 75, 104 (2002) [hereinafter Park, *Amending*] ("By their public nature, court cases often create behavioral rules to guide business conduct outside a particular dispute."); Sternlight, *Out on a Limb*, *supra* note 84, at 839 ("When litigation is brought in court, the public has the opportunity to learn about alleged illegal acts.").

wrong can happen and be shielded from review."[110] Arbitration, once a purely commercial function, has become a confidential forum where questions of great public importance are resolved.[111]

An arbitrator serves at the behest of the parties to the arbitration. There is no compelling reason for the arbitrator to contemplate the greater good or the public interest because the arbitrator does not answer to the public as a member of government.[112] Under the rules of most arbitration organizations, parties select the members of the arbitration tribunal.[113] Most arbitration organizations provide for a neutral arbitrator to chair a panel of party-appointed arbitrators.[114] The selection of a "neutral" arbitrator is an implicit recognition that a party's own selection of an arbitrator necessarily leads to inferences of favoritism toward the selecting party. A judicial assignment is random, unbiased and traditionally free from intimations of conflict.[115]

Through the appellate process, the law is vetted and molded.[116] The courts are the check upon congressional action.[117] It is clear that federal courts, under Article III, Section 2, of the Constitution,[118] and state courts, under the Supremacy Clause,[119] must follow the law of the land when rendering their decisions. Because arbitrators serve at the behest of the parties and are not bound by the Constitution, it is not certain that arbitral awards must comport with the law.[120] Jurists have noted that some sacrifices or procedure and process in arbitration are acceptable as a

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[110] Cooper, *supra* note 5, at 215.

[111] Speidel, *supra* note 101, at 206 (noting that "unlike commercial arbitration, where the limitations of arbitration may be strengths, statutory rights pose issues of public law which require a vindication that arbitration may be unable consistently to provide"); Di Jiang-Schuerger, Note, *Perfect Arbitration = Arbitration + Litigation?*, 4 HARV. NEGOT. L. REV. 231, 242 (1999).

[112] Bret F. Randall, Comment, *The History, Application, and Policy of the Judicially Created Standards of Review for Arbitration Awards*, 1992 BYU L. REV. 759, 783 ("The arbitrator, often a non-lawyer, is merely a contract-reader. She is entirely beholden to the parties and their contract. While the judiciary should generally defer to the merits of an arbitration award, federal courts should not abdicate their essential role of enforcing the laws of the land and representing the public.").

[113] *See* American Arbitration Association Commercial Arbitration Rule 12 (2007), *available at* http://www.adr.org/sp.asp?id=22440.

[114] *Id.* Rule 13. The neutrality of these organizationally-appointed arbitrators has recently come into question. *See* Nathan Koppel, *Arbitration Firm Faces Questions Over Neutrality*, WALL ST. J., Apr. 21, 2008, at A3 (discussing suit against the National Arbitration Forum, Inc., alleging that the arbitration provider favored debt collectors over consumers in arbitrations). One of the notable exceptions to the practice of allowing for a neutral third party arbitrator to be selected by the parties is the securities industry, in which it is typical for a single neutral arbitrator to be appointed from a pool of approved or certified arbitrators. *See* DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 10-4 (5th ed. 2008).

[115] *See, e.g.*, S.D.N.Y. & E.D.N.Y. Rules for the Division of Business Among District Judges R. 1 (discussing the "Individual Assignment System" of the Southern District of New York), *available at* http://www1.nysd.uscourts.gov/rules/rules.pdf.

[116] Marin Roger Scordato, *Post-Realist Blues: Formalism, Instrumentalism, and the Hybrid Nature of Common Law Jurisprudence*, 7 NEV. L.J. 263, 270 (2007).

[117] *See* Marbury v. Madison, 5 U.S. (1 Cranch) 137, 176-77 (1803).

[118] U.S. CONST. art. III, § 2.

[119] *Id.* at art. VI, cl. 2.

[120] Ware, *supra* note 5, at 719-21 (citing the survey contained in Soia Mentschikoff, *Commercial Arbitration*, 61 COLUM. L. REV. 846, 861 (1961)).

function of party autonomy.[121] For the purposes of this discussion, however, it is enough to note that regardless of the law used, the award remains non-precedential.[122] In this manner, the scope of a piece of legislation remains unaddressed. Even if an arbitration tribunal arrives at the conclusion that the applicable law is inapplicable and therefore denies one party recovery, that assessment will not be deemed meritorious or subject to rejection through the appellate process.[123] Parties denied recovery are left questioning the efficacy of arbitration and the merit of congressional action.[124]

Congress, through the political process, can transform law to accommodate the concerns reflected in a court's ruling.[125] Court rulings serve an important social notice function.[126] This notice is also important to lawmakers. Congress, in the course of legislative compromise, recognizes that "ambiguous statutory language" will later be interpreted by the courts.[127] If Congress does not agree with the application of law on real parties, Congress can change the law.[128] However, "[d]ecisions contrary to congressional intent, if they take place in arbitration, will likely go unnoticed."[129]

The failure of precedent caused by unrestricted and unreviewable arbitration is evident in one unique subject area: securities.

The Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") collectively provide the foundation of America's regulated economy.[130] At the time of the adoption of the Acts, many felt that the collapse of the market

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[121] Am. Almond Prod. Co. v. Consol. Pecan Sales Co., 144 F.2d 448, 451 (2d Cir. 1944) (Learned Hand, J.) ("They must content themselves with looser approximations to the enforcement of their rights than those that the law accords them, when they resort to [arbitration's] machinery.").

[122] 9 U.S.C. § 10(a) (2000); Allison, *supra* note 12, at 240.

[123] For a recent example of this process outside the arbitration context, see *Lawrence v. Texas*, 539 U.S. 558, 578 (2003) (reversing the lower court and holding the applicable law unconstitutional).

[124] Professor Sternlight developed a compelling image in a recent article:

> [An] analogy might be carbon monoxide, a gas which silently and secretly has a deleterious impact on the global environment. Permitting companies to use mandatory pre-dispute arbitration clauses to prevent consumers and employees from enforcing their rights may ultimately have a devastating impact on the laws that are intended to ensure that employees and consumers are treated fairly.

Sternlight, *Out on a Limb*, *supra* note 84, at 861.

[125] *See* United States v. Lopez, 514 U.S. 549, 552 (1995), *superseded by statute*, Pub. L. 104-208, § 657, 110 Stat. 3009-370 (1996) (amending law, after a finding of unconstitutionality by the Supreme Court, to insert a nexus sufficient to accommodate Commerce Clause concerns).

[126] Cooper, *supra* note 5, at 214 ("How can a citizen know the commands of the law if its elucidation is shrouded in secrecy? How can continuing content be given to the concept of discrimination if arbitrators determine what is permissible or impermissible, yet only the immediate parties learn what that is?").

[127] John V. O'Hara, Comment, *The New Jersey Alternative Procedure for Dispute Resolution Act: Vanguard of a "Better Way"?*, 136 U. PA. L. REV. 1723, 1746 (1988).

[128] Sever, *supra* note 31, at 1678 ("[T]he Court has now read [the FAA] as creating an almost untouchable and separate, decisionmaking [sic] institution . . . [it is unclear] what such a separation will mean for the parties involved in the arbitration and for the lawmakers who may wish to ensure proper application of their laws.").

[129] Scodro, *supra* note 5, at 1952.

[130] *See* 15 U.S.C. § 78a *et seq.* (2000); 15 U.S.C. § 77a *et seq.* (2000); *see also* STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 104 (2005).

in the Great Depression could be traced to shady deals and opaque accounting practices.[131] The intent behind the Acts was to shed light on the securities markets, as "sunlight is said to be the best of disinfectants."[132] It is ironic that claims under these Acts are now being shunted to arbitration, a *private* dispute resolution method, a method graced by less sunlight than many bank vaults.

Securities law is noted for its reliance on development through court decisions.[133] The judicial cultivation of securities law led then-Justice Rehnquist to comment: "When we deal with private actions under [the securities laws], we deal with a judicial oak which has grown from little more than a legislative acorn."[134]

In *Scherk v. Alberto-Culver Co.*,[165] the Supreme Court began to move toward the modern relationship between securities law and arbitration. The *Scherk* Court held that a claim involving an international commercial transaction under section 10(b) of the Exchange Act was arbitrable.[136] In *Shearson/American Express, Inc. v. McMahon*,[137] two customers brought claims against a securities broker, alleging fraud under section 10(b) of the Exchange Act, its regulatory counterpart, SEC Rule 10-b5 and the Racketeer Influenced and Corrupt Organizations Act ("RICO").[138] The Supreme Court held that an arbitration agreement between the broker and the customers precluded court action.[139] In a subsequent case, the Supreme Court also held claims under the Securities Act to be arbitrable.[140]

A federal circuit court also found an arbitration agreement binding in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*,[141] in which an investor sued his broker over a short-sale dispute.[142] The SEC rule at issue was not settled and there was little law on the application of the rule.[143] An arbitrator on the panel commented that the claim came "down to . . . a matter of interpretation of the law . . . and we now hopefully have to come up with the right answer on this law, and it is a very gray area."[144] Because "[a]n arbitrator cannot disregard law that is not sufficiently clear and well settled," an award by an arbitration panel applying unsettled law would not be subject to judicial review under the

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[131] CHOI & PRITCHARD, *supra* note 164, at 104.

[132] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 92 (New ed. 1932).

[133] *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (finding an implied private cause of action in Rule 10b-5 of the Exchange Act).

[134] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

[135] 417 U.S. 506 (1974).

[136] *Id.* at 515-17, 519-20.

[137] 482 U.S. 220 (1987).

[138] *Id.* at 223. RICO may be found at 18 U.S.C. § 1861 *et seq.* (2000).

[139] *McMahon*, 482 U.S. at 238.

[140] Rodriguez de Quijas v. Shearson/Am. Express Inc., 490 U.S. 477, 485 (1989). *Rodriguez de Quijas* overruled *Wilko*, thereby calling into question the manifest disregard doctrine. *Id.*; *see also* Brad A. Galbraith, Note, *Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the "Manifest Disregard" of the Law Standard*, 27 IND. L. REV. 241, 249 (1993).

[141] 808 F.2d 930 (2d Cir. 1986).

[142] *Id.* at 931.

[143] *Id.* at 933.

[144] *Id.* (quoting arbitrator).

manifest disregard doctrine.[145]

In 1991, Professor Norman S. Poser noted the prevalence of arbitration agreements in the contracts between brokers and investors:

> Today, arbitration has largely . . . replaced litigation as the method of resolving disputes between customers and their brokers. A recent report . . . states that all of the nine largest brokerage firms, which, in the aggregate, handle the accounts of about seventy-five percent of all individual customers, require their customers to sign predispute arbitration clauses when they open margin or option accounts. Thus, customers who wish to borrow money from their brokers in order to purchase securities, or who wish to participate in the options market, are almost always required to sign arbitration agreements.[146]

The numbers of securities arbitrations today may be assumed to represent an even greater percentage of disputes between brokers and investors.[147] Recognizing the prevalence of arbitration in the securities industry, the SEC adopted uniform procedures governing arbitration.[148] Even the parties in the stronger bargaining position, the brokerage firms, may be adversely affected by a lack of predictability due to an absence of judicial precedent in securities law.[149] Following the Supreme Court's imprimatur of securities arbitration, there has been a "marked decrease in court decisions addressing broker-customer relations, resulting in a freeze of the relevant law."[150]

The expanding arbitration of disputes is an example of the withering of American common law. However, a dearth of precedents is not the only disorder stemming from the American arbitral regime.

B. Reasoned Awards are Uncommon and Unwelcome in American Arbitration

American arbitrators typically do not issue written rationales for their awards.[151] Indeed, some arbitral organizations actively discourage their arbitrators from writing the reasoning behind an award.[152] Curiously, the United States is one of only a few nations that issues arbitration awards in the absence of written findings of fact or conclusions of law.[153]

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[145] Scodro, *supra* note 5, at 1939.

[146] Poser, *supra* note 85, at 1101 (citing U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 28 (1992)).

[147] Margaret M. Harding, *The Cause and Effect of the Eligibility Rule in Securities Arbitration: The Further Aggravation of Unequal Bargaining Power*, 46 DEPAUL L. REV. 109, 118-19 (1996) (finding that arbitrations by securities organizations increased 800% between 1980 and 1994); Poser, *supra* note 85, at 1100-01 (noting that between 1985 and 1990, the number of arbitrations sponsored by securities organizations rose from 2800 to 5300).

[148] Order Approving Proposed Rule Changes Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 34-26805, 54 Fed. Reg. 21144, 21144-55 (May 16, 1989).

[149] Poser, *supra* note 85, at 1110; *see also* Summers, *supra* note 5, at 710 (noting the same irony in employment arbitration).

[150] Park, *Amending*, *supra* note 109, at 105-06.

[151] MARTIN DOMKE, DOMKE ON COMMERCIAL ARBITRATION § 29:06, at 435-36 (Rev. ed. 2002).

[152] Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 259 (1987) (Blackmun, J., concurring in part and dissenting in part); Cooper, *supra* note 5, at 215. This practice may be changing in certain circumstances and under certain organizations. *See* American Arbitration Association, National Rules for the Resolution of Employment Disputes, Rule 34(c) (2005), *available at* http://www.adr.org/sp.asp?id=22075 (requiring a written award absent a contrary request by the parties); A.B.A., DUE PROCESS PROTOCOL FOR MEDIATION AND ARB. OF STATUTORY DISPS. ARISING OUT OF THE EMP. RELATIONSHIP 3 (1995), *available at* http://www.bna.com/bnabooks/ababna/special/protocol.pdf.

Absent reasoned awards, "[t]he parties and their counsel are provided no reliable indicia of whether the arbitrator's decision was founded on a full understanding of the material facts and a proper interpretation and application of the relevant provisions of their contract and the applicable law."[154] A judge, when presented with an award unaccompanied by findings, commented: "For all we know, the arbitrators concluded that the sun rises in the west, the earth is flat, and damages have nothing to do with the intentions of the parties or the foreseeability of the consequences of a [contractual] breach."[155]

Some critics have called for action, requesting reasoned awards in certain situations.[156] One scholar commented: "[H]ow can we build up a unified system of commercial law and practice and code regulation unless [reasoned awards] are used? Without them we have a hodgepodge of nothingness, and business is not helped nor arbitration aided by the mistakes or wisdom of others."[157] The absence of reasoned awards hurts commercial parties because it does not instruct them how to modify future behavior or structure future transactions.[158] The absence of a reasoned award may even encourage parties to seek court vacatur, as the losing party is unable to assess the foundation of the award.[159]

C. Statutory Grounds for Vacatur, and Judicially Created Non-Statutory Grounds, are Chaotic and Often in Conflict

In a weighty article, Professor Stephen L. Hayford demonstrated, federal circuit by federal circuit, the inconsistently enunciated and applied standards for both statutory and non-statutory vacatur of arbitration awards.[160] There is "substantial disagreement" between the circuits about whether judicially-created

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[153] Eric van Ginkel, *Reframing the Dilemma of Contractually Expanded Judicial Review: Arbitral Appeal vs. Vacatur*, 3 PEPP. DISP. RESOL. L.J. 157, 214 (2003).

[154] Hayford, *A New Paradigm*, *supra* note 41, at 447.

[155] Perini Corp. v. Greate Bay Hotel & Casino, Inc., 610 A.2d 364, 392 (N.J. 1992) (Wilentz, C.J., concurring), *abrogated by* Tretina Printing, Inc. v. Fitzpatrick & Assocs., Inc, 640 A.2d 788, 791-93 (N.J. 1994).

[156] Stephen Hayford & Ralph Peeples, *Commercial Arbitration in Evolution: An Assessment and Call for Dialogue*, 10 OHIO ST. J. ON DISP. RESOL. 343, 404 (1995) (recommending reasoned awards upon request of the parties); Thomas J. Stipanowich, *Rethinking American Arbitration*, 63 IND. L.J. 425, 486 (1988); Galbraith, *supra* note 174, at 261 (advocating the use of written opinions only when requested by parties, lest arbitration become too similar to litigation). In the field of securities arbitration, attorney and author David Robbins has argued for a strong endorsement for reasoned awards. *See* ROBBINS, *supra* note 114, at § 13-13. The Financial Industry Regulatory Authority ("FINRA") recently proposed amendments to the National Association of Securities Dealers Rules ("NASD Rules") to require an arbitrator to provide an explained ruling upon the joint request of the parties. Financial Industry Regulatory Authority, Inc., Form 19b-4 Proposed Rule Change (Oct. 14, 2008), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p117215.pdf

[157] Phillips, *supra* note 12, at 606.

[158] Park, *Amending*, *supra* note 109, at 104.

[159] Hayford, *A New Paradigm*, *supra* note 41, at 447.

[160] As described by Professor Hayford:

> Four circuit courts of appeals can be described as being in a state of extreme confusion with regard to the non-statutory grounds for vacatur: the Sixth, Ninth, Fifth, and Seventh. The case law in each of those four circuits contains one or more unequivocal assertion that the exclusive grounds for vacatur of commercial arbitration awards are those set forth in section 10(a) of the FAA, juxtaposed with one or more opinions recognizing and applying a non-statutory ground for vacatur.

Hayford, *Law in Disarray*, *supra* note 39, at 764-65. Professor Hayford has since updated his survey of the courts, noting that twelve of thirteen circuits, with the exception of the Federal Circuit, now recognize some form of non-statutory vacatur. Hayford, *Unification of the Law*, *supra* note 43, at 870.

grounds for vacatur are viable.[161] This confusion is compounded by the "increased willingness" of the circuit courts to go beyond arbitral awards and assess the reasoning and interpretation of the merits of the disputes before them.[162] The circuit courts appear to be in a "struggle[]" to reach a proper standard of review, a debate not yet resolved by the Supreme Court.[163]

International experience indicates that despite the commercial desire for finality, parties in arbitration sometimes desire a "safety net" of judicial review.[164] The FAA should be amended to alleviate the confusion and forum shopping inherent in conflicting circuit standards by enunciating clear opportunities and guidelines for court review.[165]

E. Parties are Unable to Contractually Expand Judicial Review of Arbitration Proceedings and Awards

An amendment to the FAA to accommodate expanded judicial review is crucial in light of the Supreme Court's recent decision limiting the ability of parties to expand contractually the judicial review of their arbitral awards.[166] Arbitration is fundamentally a contractual exercise.[167] Despite the desire of some parties to expand judicial review of arbitration decisions by contract, party autonomy is not recognized in this area.[168] Without congressional action to amend the FAA, party contractual expansion of the judicial review of arbitration awards is futile.[169]

F. The Judicial Review of Arbitration Awards Must Change

Standards for review of arbitral awards under the FAA are substantially identical to their original incarnation.[170] The FAA provides a mere "skeletal structure" for the regulation of arbitration in the United States.[171] The growth of arbitration has been driven entirely by the decisions of the Supreme Court, yet the FAA has not evolved with the times.[172] Put succinctly, "[t]he Act is as ill-suited to such use as an all-terrain vehicle."[173]

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[161] Hayford, *Law in Disarray*, *supra* note 39, at 746. To date, "[o]nly the Fourth Circuit has unequivocally rejected the nonstatutory grounds for vacatur." *Id.* at 764 (citing Remmey v. PaineWebber, Inc., 32 F.3d 143, 146 (4th Cir. 1994), *cert. denied*, 513 U.S. 1112 (1995)) ("The statutory grounds for vacatur permit challenges on sufficiently improper conduct in the course of the proceedings; they do not permit rejection of an arbitral award based on disagreement with the particular result the arbitrators reached.").

[162] Hayford, *Law in Disarray*, *supra* note 39, at 735-36.

[163] Galbraith, *supra* note 174, at 250.

[164] Park, *Amending*, *supra* note 109, at 104 (citing CODE JUDICIAIRE Art. 1717(4) (Belg.) (enacted in 1985, amended on May 19, 1998)).

[165] van Ginkel, *supra* note 187, at 212 (recommending same, with Arbitration Act 1996, c. 23, § 68(2) as a model for a "more extensive list of grounds on which an award can be set aside").

[166] Hall Street Assocs. v. Mattel, Inc., 128 S. Ct. 1396, 1400 (2008); *see also* Kevin A. Sullivan, Comment, *The Problems of Permitting Expanded Judicial Review of Arbitration Awards Under the Federal Arbitration Act*, 46 ST. LOUIS U. L.J. 509, 510 (2002) (noting a circuit split over "whether parties to an arbitration agreement could agree to federal court appellate review of an arbitration award").

[167] JEAN-FRANCOIS POUDRET & SEBASTIEN BESSON, COMPARATIVE LAW OF INTERNATIONAL ARBITRATION § 1.1.1, at 3 (2007).

[168] *Hall Street Assocs.*, 128 S. Ct. at 1403; *see also* Rubinstein, *supra* note 85, at 247-53 (collecting and discussing cases both for and against contractual expansion of judicial review); Jiang-Schuerger, *supra* note 111, at 232-33 (same).

[169] *Hall Street Assocs.*, 128 S. Ct at 1403; *see also* Sullivan, *supra* note 210, at 560.

[170] Act of July 30, 1947, ch. 392, 61 Stat. 669, 669-74 (codified as amended at 9 U.S.C. §§ 1-15 (2000)).

[171] Hayford, *Federal Preemption*, *supra* note 25, at 68; Cole, *supra* note 30, at 214.

To satisfy the need for clarification and consistency, for-profit arbitral institutions, such as the American Arbitration Association and Judicial Arbitration and Mediation Services, Inc., have promulgated rules for commercial arbitrations.[174] The piecemeal nature of these rules, despite their popularity, is "not an effective substitute for well thought-out legislative reform."[175]

Enhanced arbitral appellate review cannot be founded in the current form of the FAA, or squeezed into the non-statutory grounds for vacatur. To accomplish expanded review, Congress must act to amend the FAA.[176]

IV. Recommendation for Reform

A. The Enhanced Arbitration Appeal Amendment ("EAAA")

Since American courts dramatically changed perspective on the use of arbitration, little has been recommended to reconcile the American stance with its English counterpart.[177] Commentators have gazed longingly across the waters to England and ultimately shied away from dramatic reform.[178] England, with its long history of arbitration and its more-frequent assessment and modification of the relationship between arbitration tribunals and courts of law, is a worthwhile source of possible change to America's arbitration regime.

Arbitration in England has been altered over the course of the twentieth century by amendments to its Arbitration Act—each substantially changing the English approach to arbitration.[179] Arbitration in the United States, on the other hand, has flourished not from continued tweaking of the FAA, but from the changing interpretation of the FAA by the courts.[180] The FAA is long overdue for an overhaul. [181]

The stewardship of American law by the courts, despite the increasing use of

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[172] Ware, *supra* note 5, at 712-13.

[173] Park, *Amending*, *supra* note 109, at 76.

[174] Hayford, *Federal Preemption*, *supra* note 25, at 68.

[175] *Id.*

[176] Jiang-Schuerger, *supra* note 111, at 248.

[177] *See* Park, *Interaction*, *supra* note 5, at 55 ("Measured by the plumb lines of both efficiency and justice, the syncretistic legislation offers an optimal balance of finality and fairness in private dispute resolution. Contemplating this impressive achievement, thoughtful American lawyers are likely to ask whether English-style arbitration reform would succeed in the United States."); *see also* van Ginkel, *supra* note 187, at 219 (describing the Arbitration Act 1996 as "well thought out, fairly complete, and accessible").

[178] *See* Phillips, *supra* note 12, at 610-11; *see also* Stephen A. Hochman, *Judicial Review to Correct Arbitral Error – An Option to Consider*, 13 OHIO ST. J. ON DISP. RESOL. 103, 112-13 (1997) (critiquing the Arbitration Act of 1996 in the context of U.S. judicial non-statutory review of arbitration awards); van Ginkel, *supra* note 187, at 219 (arguing that the Arbitration Act 1996 could be a model for improvements to the FAA, but stating that "[c]ontrary to the provision under the English Arbitration Act for arbitral appeal by leave of the court only on questions of law and only when certain conditions have been met, a somewhat more open system of appeal may be preferable for the United States"); Park, *Interaction*, *supra* note 5, at 67 ("[A]t some point American consumers of arbitral services should probably be given the option to have an award reviewed for error of law, similar to the opportunity now provided under the English statute."); Scodro, *supra* note 5, at 1961 (acknowledging English arbitral law, but ultimately arguing for a certification process for novel questions of law arising in an arbitral context, similar to the current process from federal courts to state courts).

[179] *See* Arbitration Act 1996, c. 23; Arbitration Act 1979, c. 42; Arbitration Act 1975, c. 3; Arbitration Act, 1950, 14 Geo. 6, c. 27.

[180] *See* Sternlight, *Panacea*, *supra* note 5, at 664.

[181] *See* Sternlight, *Dreaming*, *supra* note 6, at 1.

arbitration, will be best served by an amendment to the FAA. This Note proposes an amendment to section 10 of that Act. The proposed amendment, to immediately follow section 10(a), would read:

(b) An arbitral award must be in writing, accompanied by reasons for the award sufficient
to allow judicial review;

(c) A district court may engage in enhanced judicial review of an arbitral award when:

(1) Parties mutually agree to submit an appeal or

(2) A question of law substantially affects the rights of a party and

(a) The appeal raises a novel question of law or

(b) The question of law implicates a matter of general public significance;

and the decision of the arbitral tribunal is at least open to serious doubt.

What follows is an examination of this proposed appellate process and the benefits of enhanced arbitration appeal.

B. Models for Standards of Review

Despite its absence in the United States, appeal from an arbitral award is not rare among nations.[182] Their courts center the threshold inquiry on whether "the question of law will substantially affect the rights of one or more of the parties, or that the point of law is of general public importance."[183]

Section 69 of England's Arbitration Act of 1996 is the best model for an amendment to the FAA. This is not an arbitrary model: England has long been a world center for arbitration.[184] Our English counterparts seem to understand that the growth of common law requires fertilizing and weeding.[185] We should not, however, adopt section 69 wholesale.[186]

1. The Procedure of the Proposed Arbitral Appellate Process

An appeal under the EAAA would follow the intention of section 69 of the Arbitration Act of 1996 in large measure, but fit within the United States federal appellate process. A party seeking appeal would petition a federal district court for review in the *situs* of the arbitration (i.e., in the district in which the arbitration panel was constituted). Appeal would also be possible in a federal district court situated in the jurisdiction in which a party seeks to enforce the award.[187] The appeal could begin only after the arbitators reaches their final award. In this manner, courts would avoid intrusion into the

[182] van Ginkel, *supra* note 187, at 194-96 (noting unlimited appeal in Belgium and France (for domestic arbitrations only) and limited appeal in England, Australia, Hong Kong (for domestic arbitrations only), New Zealand, and Singapore "if the court finds that certain conditions have been met").

[183] *Id.* at 196.

[184] Browne, *supra* note 59, at 1.

[185] Frederick A. Mann, *Private Arbitration and Public Policy*, 4 CIV. JUST. Q. 257, 267 (1985) ("[I]t is in the highest interest of the State, that it is a matter of public policy of great import to maintain a principle of judicial review of arbitration not only to develop the law, but also to ensure the administration of justice and thus to avoid the risk of arbitrariness.").

[186] Park, *Amending*, *supra* note 109, at 77-78 ("Part of the peculiar U.S. genius has been our ability to adapt (rather than adopt) inventions from abroad.").

[187] Kanowitz, *supra* note 16, at 273 ("Review of an arbitration award by a court of first instance may also be referred to as an appeal.").

competence of tribunals, while still serving as a check on the question of law at issue.[188] Unlike the ability of parties to opt out of section 69 review under Arbitration Act of 1996,[189] parties would be unable to close out court review. The key rationale behind the EAAA is to rectify the drought of precedent. Allowing parties to avoid court review by agreement will not resolve that problem. An opt-out provision may place greater strain on the already disparate bargaining positions of many employees, consumers and investors forced to arbitrate. The unavailability of an opt-out provision will be tempered by the strictures discussed below.

This appeal process would look similar to the process of appeal from a federal circuit court to the Supreme Court.[190] The process of petitioning for leave to appeal is crucial to the EAAA: An appeal remains a discretionary function of the court and not a unilateral claim of right by the appealing party.[191] Appeal would automatically be granted, however, if the arbitral parties mutually agreed to submit an appeal.[192] Because an amendment to the FAA expanding judicial review must implicate the subject matter jurisdiction of the federal courts, parties seeking review must comport with the requirements of diversity and amount in controversy.[193] It is also essential for the continued development of precedential opinions to maintain a vehicle for parties to reach the court on disputes involving federal questions.[194]

The United States appellate procedure, governed by statute,[195] will also apply to a denial of an appeal by a district court. United States federal circuit courts draw a distinction between an interlocutory matter and a final decision: Only when a decision "leaves nothing for the court to do but execute the judgment" will a circuit court take review.[196] If a district court accepts a party's appeal of an arbitral award under the EAAA, a district court decision would clearly be a final decision. However, like the English appeal, there will be an additional hurdle: Appeal from the district court to the circuit court is not one of right; therefore, the district court must certify that the question is one which should be granted an appeal.[197]

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[188] In this procedure, my amendment is distinct from a prior proposal for the adoption of a process, similar to a "certified question" from a federal court to its sister state court during the course of an ongoing arbitration:

> [I]f a party to a private arbitration raises a statutory claim that she believes would constitute a novel question for the federal courts, she may ask the arbitrator to certify that question to a federal district court. It is for the arbitrator (1) to make the factual determination of whether the legal claim is dispositive of the case, given the facts as she finds them, and (2) to examine case law presented by the parties or that she herself discovers to determine whether the question is novel.

Scodro, *supra* note 5, at 1959-60.

[189] Browne, *supra* note 59, at 3, n.18.

[190] 28 U.S.C §§ 1253, 1254, 1257, 2101 (2000).

[191] SUP. CT. R. 10 (2007).

[192] *See* Arbitration Act 1996, c. 23, § 69(2)(a).

[193] 28 U.S.C. § 1332 (2000). As noted in one critique of the FAA: "Parties do not automatically have a federal case merely because they have brought arbitration decisions to a federal court under the FAA. A federal court may not hear an arbitration case unless diversity or a federal issue dispute exists." Jiang-Schuerger, *supra* note 111, at 238.

[194] 28 U.S.C. §§ 1331, 1367 (2000).

[195] *Id.* §§ 1291, 1292.

[196] Catlin v. United States, 324 U.S. 229, 233 (1945), *superseded by statute*, 9 U.S.C. § 15, Pub. L. No. 100-669, 102 Stat. 3969 (1988).

[197] *See* Arbitration Act 1996, c. 23, § 69(8).

2. The Subject Matter of the New Arbitral Appellate Process

It is important that a district court's inquiry remain centered on a "question of law." Arbitration is best as a fact-finding institution.[198] The court should not disturb pure questions or evaluations of fact. Of course, even the English courts have bandied about the distinction between a question of law and a question of fact.[199]

Under the Arbitration Act of 1996, a "question of law" is defined simply as a domestic law of England.[200] The practical effect of this simple definition is important: "[The] cases seem[] to . . . delimit the questions of law which can be appealed to questions of English law. These cases support the proposition that awards based on applicable foreign law are likely to be excluded."[201]

Appeals under the EAAA would be limited to questions of law arising from the law of a state or the laws of the United States. The Supreme Court appears cognizant of the need to maintain province over United States law in international arbitration.[202] District courts must dismiss appeals under the new amendment absent a question implicating United States law. Additionally, the question of law asserted by an appealing party must be either a novel question of law or a question of general public significance.

a. Novel Questions of Law

The adjudication of a novel question of law is the opportunity of a court to announce, by its opinion, a new standard or test.[203] An opportunity for appeal on a novel question of law is not currently available under the Arbitration Act of 1996.[204] Appeals on novel questions of law must, however, be allowed and thereby ensure the growth of our law. A novel question of law is not easily defined. They are often described as questions of first impression. Often, these questions are "call 'em when you see 'em." It is the burden of the party seeking appeal to convince the district court that the question at issue raises a novel question of law.[205]

b. Questions of General Public Significance

A question of law implicating general public significance should, by its very nature, be reviewed in a public forum. Because the importance of questions of public significance is clear, recommendations to keep these questions from the scope of arbitration have been made for United States arbitration.[206] The subjects discussed previously – antitrust employment discrimination and securities – often involve matters of public importance. It

[198] Cohen & Dayton, *supra* note 22, at 281.

[199] Stewart R. Shackleton, *Annual Review of English Judicial Decisions on Arbitration—2000*, 4 INT'L ARB. L. REV. 178, 194 (citing Whistler Int'l Ltd. v. Kawasaki Kisen Kaisha Ltd. ("The Hill Harmony"), [2001] 1 A.C. 638, 647 (H.L. 2000)).

[200] Arbitration Act 1996, c. 23, § 82(1).

[201] Dedezade, *supra* note 68, at 62.

[202] Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 638 (1985) (recognizing that domestic courts would have the opportunity, at the award enforcement stage, to review the application of national antitrust law).

[203] *See, e.g.*, United States v. Alvarez-Machain, 504 U.S. 655, 659 (1992).

[204] Arbitration Act, 1996, c. 23, § 69.

[205] *Cf.* Demco Invs. & Commercial SA v. Se Banken Forsakring Holding Aktibolag, [2005] EWHC (Comm) 1398, [2005] 2 Lloyd's Rep. 650, 658 (Q.B.D. 2005).

[206] Kronstein, *supra* note 82, at 68 (arguing "that government and private parties be permitted the right to appeal to the courts in all arbitration cases provided the public interest is affected").

is important, however, to establish a high threshold for the determination of a question of general public significance, lest appeal become too commonplace and burdensome. Similar to an appeal for a novel question of law, it will be the burden of the party seeking appeal to impress upon the district court the general public significance of the question. Although a novel question of law may often be characterized as a question of general public significance, the terms are not synonymous and a distinction should be made between the two avenues for appeal.

3. Awarding of Costs to a Party as a Cautionary Tool

As a cautionary measure, the costs of the appeal may be levied against the party unsuccessfully seeking appeal. Imposition of costs against a party is traditionally appropriate where a party brings suit on a frivolous or obviously weak claim.[207] A party should only appeal the decision of an arbitration panel with good cause. A district court's refusal to accept an appeal from an arbitration award may thus be treated as a frivolous or overtly meritless attempt to prolong the dispute. The imposition of costs will force parties to adequately sound their arguments for appeal before making that significant, time consuming and costly step.

4. Reasoned Awards Must Become a Crucial Component of American Arbitral Practice

If the EAAA is to be successful, district courts must have some basis for a grant of appeal. This foundation may be set upon the procedures of the EAAA and a new requirement for arbitrators to provide parties with a reasoned or explained award. In prior practice, courts often refused to review arbitral awards because courts could not assess the rationale for the award and thus were uncomfortable extending their review into the realm of the arbitration panel's competence.[208] Reasoned awards are not common in American arbitration, but they are not an oddity.[209] America appears to be one of the few countries in which reasoned awards are not prevalent.[210] It is time for the United States to bring its practice to the level of the international community.

V. The Benefits From Enhanced Appeal of Arbitral Awards

A. Promoting Precedent

Enhanced appellate review of arbitral awards will promote the continued development of American law. As stated by Professor William Park, "judicial review of awards on the legal merits of the case . . . fertilizes legal development by creating a publicly available 'legal capital' of new principles to meet changing commercial circumstances."[211] The

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[207] This is a long-standing traditional power of appellate courts. See, for example, M.C. & L.M. Ry. Co. v. Swan, 111 U.S. 379, 387-89 (1884) in which the court held:

> Here the plaintiffs in error wrongfully removed the cause to the Circuit Court. . . . its effect is, to defeat the entire proceeding which they originated and have prosecuted. . . . [I]n order to give effect to its judgment upon the whole case against them, to do what justice and right seem to require, by awarding judgment against them for the costs that have accrued in this court.

Id.; *see also* Hochman, *supra* note 222, at 115.

[208] Brunet, *supra* note 37, at 88.

[209] *Id.* at 89 (1992) (noting that is it "customary practice" for labor arbitration panels to write opinions).

[210] van Ginkel, *supra* note 187, at 214.

[211] Park, *Amending*, *supra* note 109, at 105.

English system long demonstrated a desire to encourage the development of the common law through court interaction with arbitration.[212] The success of the English approach to the development of precedent was noted during its use.[213] Indeed, some feel that the English system now restricts the development of English law too much.[214] The United States, because of its liberal arbitration policies, needs a mechanism to maintain the "fertilization" of our common law.[215]

Some scholars are more restrained in their assessment of the state of American precedent. Professor Christopher Drahozal notes that "it is the rare case that contributes to the development of the law in a significant way."[216] Professor Thomas Carbonneau has found that only about seven percent of employment arbitration awards are "equivalent of substantial judicial opinions on employment law," with the remainder constituting "purely factual determinations."[217] Mandatory arbitration of customer-broker disputes does not appear to have dramatically slowed the flow of court cases.[218] However, cases such as *Bobker*,[219] in which the law is unsettled, demonstrate the continued growth of American precedent: not all questions of law are answered; every statute has not been interpreted. The crucial point is not the number of cases that fall into arbitration, those that reach a court or the percentage of disputes involving significant matters; it is the importance of each case and its affect on precedent.

In recent years, some federal courts have adopted the practice of issuing unpublished or non-precedential opinions.[220] Circuits using selective publishing have adopted rules to determine when decisions are published; the Federal Circuit's rules are designed to promote precedents, particularly in cases of first impression or general public interest.[221] The cases captured by the publication rules are the disputes that encourage precedent and promote the development of the law.

With the adoption of the Arbitration Act of 1996, England limited the right to appeal an arbitration award.[222] It is important to note, however, that the right to appeal under the Arbitration Act of 1996 has not been entirely destroyed.[223] Under the Act, England still

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[212] Dedezade, *supra* note 68, at 59.

[213] Phillips, *supra* note 12, at 616 ("The opinions rendered in special cases seem to have helped make law not only for other arbitrations, but for general usage as well.").

[214] Paul Ardetti, a member of a Committee that drafted a generally positive critique of the Arbitration Act 1996, excepted from the Committee's report:

> I differ from this conclusion [that no changes to the Arbitration Act 1996 are necessary] as follows. The quality of the Common Law underpins the success of this jurisdiction, both in arbitration and the Court, and the Act is too restrictive of the timely development of the Common Law. This has not changed as a result of the survey. Some updating of the Act therefore continues to be of paramount importance to arbitrators, lawyers and the parties they serve, in my view.

REPORT ON THE ARBITRATION ACT 1996 (2006), at 23 n.2, *available at* http://www.idrc.co.uk/aa96survey/Report_on_Arbitration_Act_1996.pdf.

[215] Park, *Amending*, *supra* note 109, at 105.

[216] Christopher R. Drahozal, *Is Arbitration Lawless?*, 40 LOY. L.A. L. REV. 187, 209 (2006).

[217] Thomas E. Carbonneau, *Arbitral Law-Making*, 25 MICH. J. INT'L L. 1183, 1205 (2004).

[218] Poser, *supra* note 85, at 1102.

[219] Merrill Lynch, Pierce, Fenner & Smith v. Bobker, 808 F.2d 930, 933-34 (2d Cir. 1986).

[220] *See* FED. CIR. R. 47.6; Beth Zeitlin Shaw, Casenote, *Please Ignore this Case: An Empirical Study of Nonprecedential Opinions in the Federal Circuit*, 12 GEO. MASON L. REV. 1013, 1013-14 (2004) ("The Federal Circuit disposes of many cases without publishing opinions. In fact, the Federal Circuit issues an average of 77% of its opinions as 'unpublished' decisions . . . .").

offers a "split-level approach to judicial review" in which parties may exercise an "optional right to appeal points of English law, coupled with a non-waivable opportunity to seek judicial review of an arbitration's fundamental procedural regularity."[224]

The limited arbitral appeal in England is, for most purposes, exactly what United States arbitration needs. The criteria are such as to "discourage all but the most serious of challenges . . . . Leave to appeal will not be granted unless the arbitrators' decision is 'obviously wrong,' or the question is one of general public importance and the decision is 'open to serious doubt.'"[225]

B. Promoting Clear Arbitral Decisions

Along with the enhanced appellate process, the EAAA would require arbitrators to provide a basic reasoned or explained award, including a brief statement of findings of fact, applicable law and law application. A brief reasoned award is useful for the future conduct of the parties, serving as a guide to their commercial interactions.[226] As Professor Park notes, "[a]nnulment of aberrant awards . . . has an *in terrorem* effect that helps to reduce problems at earlier stages, since most arbitrators are understandably adverse to the public rebuke inherent in having their awards vacated."[227] Additionally, with an enhanced appellate process in place,

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[221] As compiled by Ms. Shaw:

> According to the Federal Circuit's Internal Operating Procedures, the court publishes opinions meeting one or more of the following criteria:
>
> (a) The case is a test case.
>
> (b) An issue of first impression is treated.
>
> (c) A new rule of law is established.
>
> (d) An existing rule of law is criticized, clarified, altered, or modified.
>
> . . . .
>
> (g) A legal issue of substantial public interest, which the court has not sufficiently treated recently, is resolved.
>
> . . . .
>
> (i) A new interpretation of a Supreme Court decision, or of a statute, is set forth.
>
> (j) A new constitutional or statutory issue is treated.
>
> (k) A previously overlooked rule of law is treated.
>
> . . . .
>
> (n) A panel desires to adopt as precedent in this court an opinion of a lower tribunal, in whole or in part.

Zeitlin Shaw, *supra* note 264, at 1017 (citing FED. CIR. R. INTERNAL OPERATING PROC. 10).

[222] *See* Arbitration Act 1996, c. 23, §§ 1(b), 69.

[223] Richard Clegg, *The Role of Courts in Arbitration*, 16 CONSTRUCTION L.J., 462, 463 (2000) ("With respect to appeals of general public importance, the test in the 1996 Act of 'open to serious doubt' would appear to be a lower test than the former 'strong prima facie case'. To that extent, the 1996 Act has widened the door to appeals.").

[224] Park, *Interaction*, *supra* note 5, at 55.

[225] *Id.* at 62.

[226] Park, *Amending*, *supra* note 109, at 104.

courts may easily do away with the conflicting non-statutory grounds for vacatur, as congressional intent would be clearly reflected in the EAAA.[228]

The EAAA will not only help the courts, but will help lawmakers as well. As statutory interpretations contrary to legislative intent go unnoticed in arbitral proceedings, an enhanced appeal method will ensure that new or controversial legislation is publicly interpreted.[229]

C. Promoting Arbitration

Enhanced judicial review under the EAAA will have beneficial effects on arbitration as a dispute resolution method.[230] The desire of parties to seek arbitration will only increase with the knowledge that arbitrators are likely to produce "good" awards.[231] A statutorily constructed arbitration appellate process allows parties to make significant decisions regarding their choice of law provisions. Parties may skirt the potential problems inherent in an arbitration award based on an unsettled law by avoiding that law, leaving potentially problematic statutory constructs until the courts have a say.[232]

Arbitration, as a private dispute resolution mechanism, exists at the behest of parties in a contractual relationship.[233] Parties to arbitration are believed to knowingly relinquish the right to pursue judicial remedies in exchange for the speed, reduced cost and finality of arbitration.[234] Some lament that expanding the opportunities for parties to appeal an arbitration award to a court would give parties "a second bite at the apple."[235] These critics argue that a party to arbitration is "stuck with the result" of the arbitration, so long as the tribunal followed proper arbitral procedures.[236]

The exchange of adjudication for arbitration does not, however, replace one system of law for another. As the Supreme Court famously noted:

> By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum. It trades the

[227] *Id.* at 98; *see also* Klaus Peter Berger, *The Modern Trend Towards Exclusion of Recourse Against Transnational Arbitral Awards: A European Perspective*, 12 FORDHAM INT'L L.J. 605, 656-57 (1989) ("The constant threat of judicial review along clearly defined criteria leads arbitrators to pay due regard to the interests of the parties and factual and legal setting of the case, thus further contributing to more legality in arbitral proceedings."). It is this Note's contention that "more legality" in arbitration is, in fact, a good thing.

[228] Hayford, *Law in Disarray*, *supra* note 39, at 842 (noting that the increased use of arbitration will also increase the number of awards vacated on non-statutory grounds, eventually requiring the U.S. Supreme Court to address those grounds); Park, *Interaction*, *supra* note 5, at 67 (arguing that sections 67 and 68 may be used to defeat the current "scatter-gun" approach to vacatur).

[229] Scodro, *supra* note 5, at 1952.

[230] Sever, *supra* note 31, at 1696 ("[L]imited judicial review may prove essential to the health and survival of both domestic and international arbitration.").

[231] Park, *Amending*, *supra* note 109, at 98.

[232] *See* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 637 n.19 (1985) (noting party inclusion of a choice-of-law provision in an international contract).

[233] *See* POUDRET & BESSON, supra note 211, § 1.1.1, at 3.

[234] Speidel, *supra* note 101, at 160; Sullivan, *supra* note 210, at 549.

[235] Hayford, *Law in Disarray*, *supra* note 39, at 841; Hochman, *supra* note 222, at 113; Sullivan, *supra* note 210, at 509.

[236] Hayford, *Law in Disarray*, *supra* note 39, at 841; Sever, *supra* note 31, at 1693 (noting same critiques).

> procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration.[237]

The Supreme Court resoundingly supports arbitration, often with the cachet of a reduced docket dangling before the judiciary.[238] The argument against expanded appeal therefore assumes that court review will dramatically increase the time and expense of the dispute, along with the burgeoning court docket.[239] To the Supreme Court, "[i]t seems to matter little what the ultimate implications are for individual rights or the institution of arbitration."[240] The continued development of our system of law is undoubtedly worth more than a simple court schedule. A congested docket is better served by "new courts and . . . the expenditure of additional public resources upon the judiciary."[241]

Arbitration is intended, and assumed, to be cost-effective and speedy.[242] To avoid defeating these alleged benefits of arbitration, federal courts have traditionally limited their review of arbitral awards.[243] As an initial matter, the purported benefits of arbitration are not substantially supported by empirical evidence.[244] The alleged speed and frugality of arbitration are increasingly questioned as arbitration becomes *de rigueur*.[245] The opportunity for judicial review, it is argued, will destroy the benefit of finality.[246] However, the English arbitral regime has not been so cavalier with the realities of arbitral finality:

> The drafters of the [Arbitration Act of 1996] rightly rejected . . . foreclosing the option of appeals, an approach that harshly implies an irrebuttable presumption that parties to arbitration assume the risk that their arbitral awards might contain substantive errors. Such a presumption is not founded on any empirical evidence

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[237] *Mitsubishi Motors Corp*., 473 U.S. at 628.

[238] Carbonneau, *supra* note 1, at 1957.

[239] Galbraith, *supra* note 174, at 259; Sullivan, *supra* note 210, at 551.

[240] Carbonneau, *supra* note 1, at 1957-58.

[241] *Id.* at 1957.

[242] Cohen & Dayton, *supra* note 22, at 269; Kanowitz, *supra* note 16, at 255.

[243] *See* Office of Supply, Gov't of the Rep. of Korea v. N.Y. Navigation Co., 469 F.2d 377, 379 (2d Cir. 1972); Galbraith, *supra* note 174, at 259.

[244] Carbonneau, *supra* note 1, at 1959 (noting that as the scope of arbitration increased, "so did lawyer participation in the process and the adversarial tenor of arbitral proceedings"); Kim Dayton, *The Myth of Alternative Dispute Resolution in the Federal Courts*, 76 IOWA L. REV. 889, 896 (1991) ("ADR [in federal districts using the system] has not resulted in speedier resolution of federal civil cases, has not reduced backlogs, and has not affected the incidence of civil trials."); Poser, *supra* note 85, at 1107 ("As the volume of cases [in securities arbitration] has increased, delays of many months, or even a year or more, between the time of filing a demand for arbitration and the time of the hearing have become the rule."); Summers, *supra* note 5, at 696-98 (comparing filing costs of courts and arbitrations and finding that arbitration costs are not significantly less than court costs). The critique of arbitration's devolution has come to the attention of the public media. *See, e.g.*, Richard Karp, *Wall Street's New Nightmare: For Brokerage Firms, Arbitration Has Turned Unexpectedly Nasty*, BARRON'S, Feb. 21, 1994, at 15; Nathan Koppel, *When Suing Your Boss Is Not an Option*, WALL ST. J., Dec. 18, 2007, at D1 (discussing claims of sex discrimination and rape by an individual employed in Iraq, subject to compulsory arbitration).

[245] Engalla v. Permanente Med. Group, Inc., 43 Cal. Rptr. 2d 621, 640 (Cal. Ct. App. 1995) (finding that HMO delayed appointment of neutral arbitrator until after plaintiff's death), *rev'd*, 938 P.2d 903, 925 (Cal. 1997); Carrie Menkel-Meadow, *Pursuing Settlement in an Adversary Culture: A Tale of Innovation Co-Opted or "The Law of ADR"*, 19 FLA. ST. U. L. REV. 1, 3 (1991) (noting the increasingly adversarial and legal nature of ADR).

[246] Hayford, *A New Paradigm*, *supra* note 41, at 504.

> that arbitrating parties inevitably prefer finality to the right of appeal; neither is it necessarily supported by the legitimate expectation of the parties.[247]

To preserve the arbitration process from the courts, some have recommended the use of arbitration appellate bodies.[248] This option does not rectify the stultification of precedent or significantly ameliorate other concerns such as arbitrator bias or confidential outcomes.[249]

Dramatic change frightens many; legal professionals are certainly no exception. Arbitration is a moneymaker—for the counsel involved in the dispute and, through economic impact, for the host city and the arbitrators.[250] Practitioners and parties opposed to expanded arbitral appeal claim that American arbitration would become so cumbersome and unpredictable that commercial entities will sail for friendlier shores.[251] History may be full of migration, but the EAAA is unlikely to inspire one. Indeed, there is authority that enhanced appeal may even make a forum a more attractive *situs* for arbitration.[252]

The choice of an arbitral *situs* often depends on extra-legal concerns.[253] For example, "[g]eography and history usually matter more to the choice of an arbitral situs than the efficiency of the legal environment."[254] England and Switzerland enjoyed popularity as arbitral seats while still enforcing enhanced review procedures in their respective national courts.[255] The special case procedure drew arbitrators' ire prior to its abolishment,[256] yet England's preeminent position in modern maritime and insurance practice ensured a steady stream of arbitrations.[257]

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[247] Chukwumerije, *supra* note 50, at 46.

[248] Hayford & Peeples, *supra* note 190, at 405-06.

[249] van Ginkel, *supra* note 187, at 200-02 (dismissing the possibility of appeal to an appellate arbitration body); Phillips, *supra* note 12, at 624.

[250] Browne, *supra* note 59, at 6 ("Hosting a large number of arbitration proceedings brings money into the economy of the host location and spotlights that location as a leading, sophisticated legal centre, in turn bringing in even more money.").

[251] Reynadson, *supra* note 58, at 115 (lamenting the plight of arbitration in London prior to the adoption of the Arbitration Act 1996, with parties seeking New York as a more amenable seat).

[252] According to Queen's Counsel V.V. Veeder: "[I]t is an English oddity which has helped to make English Commercial law the most useful and popular system of law in world trade. It remains unthinkable that the symbiotic link should be broken between commercial arbitration, the development of the English law and the English Commercial Court . . . ." *quoted in* Dedezade, *supra* note 68, at 59.

A compelling argument for the EAAA and its ability to *attract* arbitration may be the "failed experiment" of Belgium and its mandatory "'non-review' of awards." Park, *Amending*, *supra* note 109, at 104 (citing CODE JUDICIAIRE Art. 1717(4) (Belg.) (enacted in 1985, amended on May 19, 1998)). Belgium sought to attract parties by adopting a regime disallowing all judicial review of arbitration. *Id.* The regime proved unpopular. *Id.*; *see also* Bernard Hanotiau & Guy Block, *The Law of 19 May 1998 Amending Belgian Arbitration Legislation*, 15 ARB. INT'L 97, 98 (1999). Belgium subsequently amended its law to allow for a default "safety net" of judicial review. Park, *Amending*, *supra* note 109, at 104.

[253] Browne, *supra* note 59, at 4-5 (highlighting cost, culture, and competence as the primary factors considered by parties).

[254] Park, *Interaction*, *supra* note 5, at 64.

[255] *Id.*

[256] Anthony Diamond and V. V. Veeder, *The New English Arbitration Act 1996: Challenging an English Award Before the English Court*, 8 AM. REV. INT'L ARB. 47, 47 (1997) (noting the aspersions cast upon the special case procedure by practitioners).

In a 2006 survey, practitioners resoundingly supported the retention of the possibility of appeal under the Act.[258] Of those who desired change, the majority thought that "[section] 69 [was] too narrow at present."[259] Additionally, a 2003 survey by International Financial Services revealed that "[m]ore international and commercial arbitrations take place in London than in any other city in the world."[260] Commercial parties, despite the desire for finality, still desire correct decisions and good law. The EAAA balances the commercial desire for finality and the public desire for precedent creation.

If the United States adopts enhanced appeal of arbitration awards, it need not fear isolation. Other nations, like England, allow greater judicial review.[261] Indeed, unlimited appeal is allowed in Belgium and France for domestic arbitrations and limited appeal is permitted in England, Australia and Hong Kong.[262] New Zealand and Singapore sanction appeal "if the court finds that certain conditions have been met"—most important, the question must be on a point of law of "general public importance."[263]

There will undoubtedly be costs for enhanced appeal of arbitration awards. Lawyers and judges are notoriously wedded to the language of their professions—an amendment would require that they "must learn a new lexicon of untested notions, procedures and nomenclature[;] [w]ords that drew their meaning from decades of application must yield to inventive interpretation, perhaps increasing expensive litigation over the meaning of novel concepts."[264] Learning and renewal, however, come with each shift in American jurisprudence or congressional action. An unwillingness to budge simply cannot be a sound reason to avoid change. After all, "change we need" are the watchwords of our newly elected president.[265]

VI. Conclusion

Arbitration, as a dispute resolution regime, is both popular and prevalent. Although it is unlikely to overtake adjudication, we must nonetheless be cognizant of the significant and deleterious effect that overly expansive arbitral jurisdiction has on the development of American law. In this age of arbitration, the challenge "will not be to legitimate the arbitral process, but rather to find suitable means of placing necessary limits upon its newly found statutory autonomy."[266] The best limit for arbitration is not found in a constriction of the jurisdiction or scope of arbitration. Rather, it is one that solves the risk to American jurisprudence—an enhanced appellate

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[257] Park, *Interaction*, *supra* note 5, at 64.

[258] REPORT ON THE ARBITRATION ACT 1996, *supra* note 258, at 16 (60% of respondents thought that the possibility of appealing should be retained in its current basis; 15% argued for abolition of all appeal; and 20% recommended changing the tests for granting leave to appeal).

[259] *Id.* at 17.

[260] INTERNATIONAL FINANCIAL SERVICES, LONDON, LEGAL SERVICES 11 (2003), *available at* http://www.ifsl.org.uk/research/index.html.

[261] *See, e.g.*, Arbitration Act 1996, c. 23, § 69.

[262] van Ginkel, *supra* note 187, at 194-96.

[263] *Id.* at 196.

[264] Park, *Interaction*, *supra* note 5, at 65. This has been the case in England. *See* Clegg, *supra* note 267, at 462-64.

[265] Senator Barack Obama, Nomination Acceptance Speech at the Democratic National Convention (Aug. 28, 2008), http://www.demconvention.com/barack-obama (last visited Dec. 2, 2008).

[266] Ulrich Drobnig, *Assessing Arbitral Autonomy in European Statutory Law*, *in* THOMAS CARBONNEAU, LEX MERCATORIA AND ARBITRATION: A DISCUSSION OF THE NEW LAW MERCHANT 201 (Thomas E. Carbonneau, ed., rev. ed. 1998).

process for arbitration awards. With limited appeals of arbitration awards, the law may grow, statutes may be interpreted and both arbitration and adjudication will benefit from the achievement of greater exactness.

Will the Arbitration Fairness Act of 2007 Make Securities Arbitration Fair?

Taylor Dalton

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Introduction

Waiting in Congress is the Arbitration Fairness Act ("AFA"), which is proposed as an amendment to the Federal Arbitration Act ("FAA"). Securities arbitration in the United States is governed by both the current FAA and case law handed down by the United States Supreme Court. There is much speculation as to how this amendment will affect the current state of securities arbitration. Is securities arbitration inherently unfair? Will the AFA actually improve fairness in securities arbitration? Will giving investors a choice in deciding which forum to resolve a dispute actually be in the best interest of those investors? These questions embody both the worries and hopes surrounding the future of the AFA.

This Article will address these questions and evaluate the proposed "fairness" of the AFA. It will begin by examining the current state of securities arbitration, the history of the proposed amendment to the FAA, and the direct effects of the proposed amendment on the current system of securities arbitration. Next this arguments both for and against the proposed amendment by pro-investor groups and groups that represent the interests of broker-dealers will be examined.[1] Finally, the beneficial effects of the AFA will be presented, arguments criticizing arbitration as inherently unfair will be critiqued, and other more direct alternatives to improving fairness will be proposed.

I. The Amendment and Its Potential Effects

A. *The Current State of American Securities Arbitration*

The American system of arbitration is governed by the FAA and its interpretation by the United States Supreme Court. The FAA is codified in the United States Code at Title 9 and consists of three chapters. The first chapter, sections 1–16, discuss the domestic law of arbitration. The other two chapters incorporate the international instruments of arbitration, the New York Arbitration Convention and the Inter-American Arbitration Convention. The act was created to validate arbitration as a legitimate forum for dispute resolution and grant arbitration the autonomy it needed to function effectively.[2] The act ended an era of judicial hostility toward arbitration and created a strong federal policy favoring arbitration.[3] Over time the Supreme Court has considerably

[1] The term broker-dealers refers to any entity that would be across the table from an investor in a dispute.

[2] Thomas E. Carbonneau, Arbitration in a Nutshell 55 (2007)

[3] *Id.*

expanded the scope of the statute.

Federal policy in favor of arbitration generally validates an agreement to arbitrate. Further, the Supreme Court's decisions regarding arbitration have modified the statute such that federal courts have upheld even adhesionary and unilateral provisions for arbitration.[4] There are a few state courts, however, that have resisted this strong policy towards validating pre-dispute arbitration agreements.[5] There are gaps in the FAA. For example the statute does not contain a *kompetenz-kompetenz* provision, i.e. a provision giving the arbitral tribunal the ability to rule on the question of whether it has jurisdiction, but the courts have filled these gaps to keep the FAA a functioning regulatory scheme.[6]

The practice of securities arbitration is a long-standing one, and the FAA generally controls securities arbitration clauses. However, in *Wilko v. Swan*[7] the Supreme Court ruled that an arbitration clause in a brokerage contract was unenforceable for claims arising under Section 12(2) of the Securities Act of 1933 ("Securities Act"), regardless of the strong federal policy favoring arbitration, because it violated Section 14 of the Securities Act . The Securities Act expressly prohibited investors from waiving statutorily-established rights like the right to bring a claim in federal or state court. This practice of invalidating pre-dispute arbitration clauses ended with *Shearson/American Express, Inc. v. McMahon*,[8] in which the Supreme Court declared that claims brought under the Securities Exchange Act of 1934 and the Racketeer Influenced and Corrupt Organizations Act (RICO) statute could be submitted to arbitration. The Court reasoned that to defeat the presumption of arbitrability of claims the act or regulation must contain a congressional command mandating that the courts resolve the claim.[9] *McMahon* effectively limited the holding of *Wilko* to the Securities Act of 1933.[10] The Court finally laid *Wilko* to rest in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[11] when it emphasized that arbitration was "merely a form of trial" that did not have an impact upon substantive rights. The Court declared the Securities Act's non-waiver provision applied only to the legislation's substantive provisions.

Following the decisions in *McMahon* and *Rodriguez* securities arbitration became a cottage industry within the financial markets. Unfortunately, because the arbital awards are unpublished, the average investor remained wholly uninformed about securities laws and the process itself. Securities arbitration is regulated by private organizations called self-regulating organizations ("SROs"). Before July 2007, these SROs included the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD"). Both participated in the Securities Industry Conference on Arbitration ("SICA") which would regularly meet to discuss SRO arbitration and revise the Uniform Code of Arbitration. At the top of the regulatory ladder, the Securities and Exchange Commission ("SEC") oversees all of the activity of the SROs. Each SRO had its own rules for arbitration and changes to those

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[4] *See Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989).

[5] *See e.g.*, *Armendariz v. Foundation Health Psychcare Services, Inc.*, 6 P.3d 669 (2000).

[6] CARBONNEAU, *supra* note 2, at 69; *see also First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995).

[7] 346 U.S. 427 (1953).

[8] 482 U.S. 220 (1987).

[9] CARBONNEAU, *supra* note 2, at 55.

[10] *See McMahon*, 482 U.S. at 234.

[11] 490 U.S. 477 (1989).

rules were required to be submitted for approval by the SEC at the close of a public comment period. The NASD handled the majority of the securities arbitration cases in forty-seven official locations throughout the country.

In July 2007, the SEC approved the consolidation of the NASD and the member regulation, enforcement, and arbitration functions of NYSE into the newly created Financial Industry Regulatory Authority ("FINRA").[12] This consolidation was expected to create a more efficient regulatory scheme: removing duplication, and protecting investors. FINRA is now the only forum for securities arbitration. Each proceeding is governed by the Code of Arbitration Procedure which is the same set of rules that existed under NASD. Disputes between investors and broker-dealers generally are resolved in front of a panel of three arbitrators, except in small cases which often use one arbitrator. One of the arbitrators is an industry expert and the other two are considered public arbitrators based on definitions found within the NASD Code of Arbitration Procedure. Each side chooses a panelist from a list of potential arbitrators provided by FINRA. FINRA considers a dispute resolved in favor of the investor if the investor receives any positive award—regardless of amount. After a claim is filed with FINRA, it may take about eighteen months to reach a hearing that may last four or five days, or even longer depending upon the complexity of the claims involved. A decision, called an Award, will then be issued within thirty days. The party who loses at hearing has the right to file a motion to vacate that Award in court. Under the FAA, a motion to vacate an arbitration award must be based on the very specific grounds of corruption, fraud and arbitrator misconduct.[13]

B. *History of the Amendment*

The Arbitration Fairness Act is a proposed bill that will amend the FAA. The AFA's purpose is to eliminate mandatory pre-dispute arbitration clauses in consumer, employee, and franchise contracts.[14] Democratic U.S. Senator Russ Feingold of Wisconsin introduced the bill to the Senate and democratic Representative Henry Johnson of Georgia introduced the bill to the House on July 12, 2007.

Three months before the introduction of the bill, democratic Senator Patrick Leahy of Vermont and Senator Feingold sent a letter to SEC Chairman Christopher Cox calling for the SEC to promulgate a rule that would prohibit broker-dealers from requiring their customers to sign mandatory pre-dispute securities arbitration agreements before investors could purchase their services.[15] The senators cited the 1933 and 1934 Securities Acts and their "enhanced judicial remedy" and claimed that mandatory pre-dispute securities arbitration agreements denied investors' rights to bring their claims in the courts.[16] The SEC has not responded to the letter.

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[12] "Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.," Securities and Exchange Commission, (Release No. 34-56145; File No. SR-NASD-2007-023) (July 26, 2007) Available at http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf.

[13] See the Federal Arbitration Act, 9 U.S.C. § 10.

[14] William B. L. Little, "Fairness is in the Eyes of the Beholder," 60 BAYLOR L. REV. 73, 139–41 (2008).

[15] *Id.*

[16] *Id.*

The bill was introduced as a "pro-arbitration" measure bringing back the original intent of the FAA of fairness in arbitration.[17] Part of the congressional findings for the AFA state that

> "a series of United States Supreme Court decisions have changed the meaning of the Act so that it now extends to disputes between parties of greatly disparate economic power [resulting in] millions of consumers and employees [having] to give up their right to have disputes resolved by a judge or jury . . . ."[18]

Another finding claimed that relegating securities dispute resolution to arbitration limits meaningful law development.[19]

This is not the first attempt by Congress to address the post-*McMahon* environment of securities arbitration. The Securities Reform Act of 1988 was intended to level the playing field by requiring that these pre-dispute securities arbitration agreements were entered into by investors on an informed and voluntary basis, without compulsion by the broker-dealers.[20] The SEC opposed the bill and it eventually died in Committee.[21]

Given the fact it is an election year and Congress' focus on the ongoing financial crisis, the FAA stood little chance of beingbegin enacted before the election in November. The AFA is currently in hearings in the Subcommittee on the Constitution in the Senate and in the House, the AFA is forwarded to the full Committee on the Judiciary.

C. *Effects to the Current System If the Amendment is Enacted*

The Arbitration Fairness Act proposes to amend sections one and two of the Federal Arbitration Act in Title 9. The AFA will have two major effects to the current arbitration regime in the United States. First, pre-dispute arbitration agreements will no longer be valid and enforceable if those agreements require arbitration of "an employment, consumer, or franchise dispute; or a dispute arising under any statute intended to protect civil rights or to regulate contracts or transactions between parties of unequal bargaining power."[22] Second, the validity or enforceability of an agreement to arbitration shall be determined by a court, under federal law, rather than an arbitrator, regardless of the terms of the contract.[23] The AFA exempts arbitration provisions in collective bargaining agreements from the proposed provisions.[24]

By invalidating pre-dispute arbitration agreements, the proposed Act will force investors and broker-dealers to choose a forum after a dispute has arisen. The AFA in effect gives investors the unilateral choice in deciding whether to litigate or arbitrate. It should be noted that, if the investor chooses arbitration, the broker is obligated to arbitrate under the NASD code of Arbitration.[25] The Act also will strip arbitrators of the power to determine whether an agreement is valid. This will involve the courts in the process of

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[17] Senator Feingold, Congressional Record—Senate S9144-S9145 (July 12, 2007).

[18] *Id.*

[19] *Id.*

[20] Little, *supra* note 14.

[21] *Id.*

[22] Arbitration Fairness Act of 2007 (Introduced in Senate) S. 1782

[23] *Id.*

[24] *Id.*

[25] [NASD Code of Arbitration].

arbitration at a new and intimate level.

II. ARGUMENTS

A. *Pro-investor Arguments for the AFA*

Pro-investor groups like the Public Investors Arbitration Bar Association ("PIABA") support the AFA. The President of PIABA stated that it is the top priority of the organization to support the ban of mandatory arbitration.[26] He points to the fact that the investors are forced into giving up their constitutional right to bring a claim in court.[27] He also notes that investors are forced to arbitrate in a system that is essentially an extension of the securities industry itself.[28] The inherent unfairness of mandatory arbitration is that the investors are forced into giving up their right to the court system in order to receive the services of brokers and that the system is unfair on its face.[29] PIABA notes that investors lose in arbitration against broker-dealers sixty percent of the time.[30] PIABA acknowledges that arbitration should still be an option, but an option that can be chosen once a dispute arises.[31]

Supporters of the AFA claim that the act will improve fairness by giving investors the choice not to arbitrate. Pro-investor groups claim that the current system of securities arbitration is an unfair process. Arbitration can be very expensive because of the administrative fees and the ongoing costs of the arbitrators' service. These costs can be prohibitive for some investors. Also, securities arbitration is not a transparent process and discovery is far more limited than in civil litigation.[32] Allowing investors the choice to litigate will also likely allow meaningful law on investor protection to be developed, if investor and broker-dealers litigated. The AFA will also allow investors to escape the FINRA monopoly on securities arbitration and use the courts as an alternative forum for dispute resolution.[33] Supporters also question the impartiality of the industry arbitrator, claiming that the industry arbitrator brings nothing more than bias to the arbitration proceeding.[34]

According to recent studies, investors have a negative perception of the arbitration process.[35] This negative perception might stem from the fact that one of the arbitrators

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[26] *PIABA Supports Arbitration Fairness Act of 2007* (October 31, 2007) available at https://secure.piaba.org/piabaweb/html/modules/ContentExpress/img_repository/October312007.pdf

[27] *Id.*

[28] *Id.*

[29] *PIABA Supports Feingold Johnson Proposal to Ban Mandatory Arbitration* (December 12, 2007) https://secure.piaba.org/piabaweb/html/modules.php?op=modload&name=Sections&file=index&req=viewarticle&artid=522&page=1.

[30] *Id.*

[31] *Id.*

[32] Senator Feingold, Congressional Record—Senate S9144 (July 12, 2007).

[33] Committee on the Judiciary, Subcommittee on the Constitution. Hearing on S. 1782, The Arbitration Fairness Act of 2007. Statement of the Public Investors Arbitration Bar Association In Connection with the Subcommittee's Review of the Securities Arbitration System, at 6 (Dec. 12, 2007). https://secure.piaba.org/piabaweb/html/modules/ContentExpress/img_repository/December122007.pdf [hereinafter PIABA Statement].

[34] *Id.*

[35] 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), *available at* http://www.law.pace.edu/files/finalreporttosica.pdf [hereinafter *Perception Study*]; *see also* PIABA Statement, *supra* note 33.

on the panel is from the securities industry, the apparent non-transparency of arbitration awards, and the overall "secret" nature of the arbitration process.[36] Giving investors choices empowers them, and by empowering investors, their perception of the process may improve. Improving investor perception is key to having a well-functioning system that provides parties with fair and satisfying results.[37]

The North American Securities Administrators Association ("NASAA") recommends that Congress amend the AFA to make it explicitly applicable to securities arbitration.[38] The NASAA also notes that Congress should examine the arbitration procedures and possibly reform the process itself.[39] The NASAA points out that at the time of the *McMahon* decision investors were comprised of a small group of wealthy individuals who had other sources of retirement income such as a defined benefit pension plan.[40] The demographic of investors has changed dramatically since the *McMahon* decision and now investors are school teachers, firefighters, and other public servants.[41] These new investors expanded the once limited population of investors and have less power against large firms. The NASAA also points to the "take-it-or-leave-it" arbitration clauses as being inherently unfair.[42] The broker-dealers have more resources as well as their familiarity with the arbitration process thereby giving them an unfair advantage. Allowing investors to choose litigation will help bring back balance.[43]

B. *Broker-Dealer Arguments Against the AFA*

The Securities Industry and Financial Markets Association ("SIFMA"), representing the interests of the industry, claims that the AFA will undermine the current structure of securities arbitration, which is quick, efficient, and fair to both investors and broker-dealers alike.[44] The SIFMA White Paper on Arbitration in the Securities Industry is a study that SIFMA conducted and which it uses to

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[36] *Perception Study*, *supra* note 35; *see also* PIABA Statement, *supra* note 33.

[37] *Perception Study*, *supra* note 35.

[38] NASAA letter to Sen. Feingold regarding S. 1782, the Arbitration Fairness Act of 2007 (Sept. 24, 2007) http://www.nasaa.org/content/Files/FeingoldS1782.pdf; NASAA Letter to Rep. Johnson regarding H.R. 3010, the Arbitration Fairness Act of 2007 (Oct. 1, 2007) http://www.nasaa.org/content/Files/JohnsonHR3010.pdf; NASAA Letter to Rep. Sánchez and Rep. Cannon Regarding H.R. 3010, the Arbitration Fairness Act of 2008 (July 15, 2008) http://www.nasaa.org/content/Files/NASAA-HR-3010-letter-7-15-08.pdf.

[39] NASAA letter to Sen. Feingold regarding S. 1782, the Arbitration Fairness Act of 2007 (Sept. 24, 2007) http://www.nasaa.org/content/Files/FeingoldS1782.pdf; NASAA Letter to Rep. Johnson regarding H.R. 3010, the Arbitration Fairness Act of 2007 (Oct. 1, 2007) http://www.nasaa.org/content/Files/JohnsonHR3010.pdf; NASAA Letter to Rep. Sánchez and Rep. Cannon Regarding H.R. 3010, the Arbitration Fairness Act of 2008 (July 15, 2008) http://www.nasaa.org/content/Files/NASAA-HR-3010-letter-7-15-08.pdf.

[40] NASAA Testimony Regarding S. 1782, the Arbitration Fairness Act of 2007 (Dec. 12, 2007) at 3, http://www.nasaa.org/content/Files/Testimony.Arbitration121207.pdf [hereinafter NASAA Testimony].

[41] *Id.*

[42] *Id.* at 4.

[43] *Id.* at 5.

[44] SIFMA Testimony on H.R. 3010, The Arbitration Fairness Act of 2007, at 1 (Oct. 25, 2007) http://www.sifma.org/legislative/testimony/pdf/Arbitration-testimony-1025.pdf [hereinafter SIFMA Testimony].

make its assertions regarding securities arbitration.[45] SIFMA claims that the speed of arbitration allows for both parties to resolve a dispute quicker and therefore at a lower cost than an extended court proceeding.[46] SIFMA points to various studies that indicate that having an "industry" arbitrator sit on the arbitration panel does not, in fact, impact the investors' chance of receive a fair result.[47] SIFMA also points to the ability of the arbitration forum to hear a wider range of investor claims.[48] SIFMA points to its own study that shows that twenty percent of arbitration claims are heard by arbitrators, whereas, one and a half percent of claims brought to court are decided by a judge and jury.[49] Therefore arbitration allows for investors to avoid early dismissal by procedural or jurisdictional failures. Also, if an investor succeeds in court, she will almost definitively face appeal by the securities firm. In addition, small claims that get arbitrated, would not likely be litigated. Further, broker-dealers and their advocates point to the heavy regulation by the SEC and FINRA that ensure the fairness of the arbitration process.

SIFMA claims that the proposed act will create more costly litigation and is not based on sound public policy.[50] The American Financial Services Association ("AFSA"), also representing the financial industry, argued that the AFA would end all arbitration disputes as to consumer, employee, and franchise claims.[51] AFSA claims that the AFA will make dispute resolution in the securities industry uncertain.[52] In addition, opponents to the bill also argue that if passed, it will open the door to large class action law suits and will provide little justice to aggrieved consumers.[53]

III. ANALYSIS

A. *The Benefits of the AFA to Investors and a Note on Investor Choice*

If passed, the Arbitration Fairness Act will directly benefit investors, and possibly indirectly the entire securities arbitration process. The AFA will directly benefit investors by allowing them the unilateral choice to avoid a form of dispute resolution that they view as unfair. This will improve investor perception of securities arbitration to an extent because they will no longer feel forced into arbitration by the strong broker-dealers. This change in perception is key in making securities arbitration a functional and adequate dispute resolution system. Giving investors the choice to choose to litigate or arbitrate might create incentives for FINRA to reform the securities arbitration process in an effect to make it more attractive to investors choosing a forum to resolve their dispute. These reforms will be an indirect effect of the AFA that will improve the fairness of securities arbitration, or at least the perception of fairness in the arbitration process.

However, one should have some concerns

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[45] *White Paper on Arbitration in the Securities Industry: The success story of an investor protection focused institution that has delivered timely, cost-effective, and fair results for over 30* years, http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

[46] SIFMA Testimony, *supra* note 44, at 2.

[47] *Id.* at 2–3.

[48] *Id.* at 3–4.

[49] *Id.* at 3.

[50] *Id.* at 5.

[51] Little, *supra* note 14, at 142.

[52] *Id.*

[53] Arbitration Coalition Letter, *available at* http://www.sifma.org/regulatory/comment_letters/55212994.pdf.

regarding investors' new power of choice. Because of how securities arbitration is established, the AFA will create unilateral choice in the investor. If the investor chooses arbitration, the broker is obligated to arbitrate under the NASD code of Arbitration.[54] Advocates for the AFA claim that choice is paramount in promoting fairness in arbitration; however, the Arbitration Fairness Act only creates unilateral choice for the investor.[55] Also, because investor perception of arbitration is so negative, given a choice, the investor will likely choose to litigate. However, litigation may not be the best choice for the investor. Courts have a higher threshold for claims, under the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995 ("PSLRA"), and weak claims by investors may not survive. Even though many claims in arbitration are not subject to PSLRA's strict pleading requirements, because they are based on state or common law, the threshold requirements for bringing a claim in court are still much higher than in arbitration.

B. *Criticism of Arguments that Securities Arbitration is Inherently Unfair*

It is important to note that it highly contested whether securities arbitration is an inherently unfair process. If it was, then giving investors a choice to either arbitrate or litigate would be a poor solution to the problem. If arbitration was inherently unfair, then it should either be abolished or extensively reformed. Arbitration could stand some reforms to enhance its appearance to investors, but the claim that arbitration is an inherently unfair process forced upon investors may be more hyperbole than truth. Following are a few criticisms of the arguments used in favor of the AFA that claim, or implicitly seem to claim, that arbitration is an inherently unfair form of dispute resolution.

PIABA and supporters of the Act point to the low "win" rates of investors in securities arbitration.[56] These proponents point to these numbers as indicators of the process's inherent unfairness. This criticism fails to take into account the fact that weaker investor claims are likely to go to arbitration and stronger investor claims would likely be settled before arbitration. Broker-dealers would want to preempt good investor claims from going to arbitration and not risk significant liability exposure. This criticism of arbitration also fails to compare these win rates to potential win rates for investor claims brought in court. As noted earlier, many investor claims that would be heard in arbitration would not pass the high threshold requirements for litigated claims. Also, it is likely that the same phenomena of pro-investor claims being settled before the dispute resolution proceeding would manifest itself if investors chose to litigate.

As an institutional claim, critics of arbitration also point to a lack of oversight of the arbitration proceedings. However, having oversight by a judicial body simply makes arbitration an arm of the court system, not an alternative. Also, the argument that arbitration stymies case development is weakened by the fact that SEC discipline is directed at misconduct and malfeasance. Because the regulation is focused on these "bad acts" of broker-dealers, it is a good source of pro-investor development in securities law. If case law was the source of development, then there would be the possibility that case law unfavorable to investors would develop because of weak claims brought by investors. SEC regulation of the industry is a much more efficient method of development that favors the

[54] [NASD Code of Arbitration].

[55] American Association for Justice, "Arbitration Fairness Act Protects Americans From Abusive Corporate Practices," (April 2, 2008) http://www.reuters.com/article/pressRelease/idUS161640+02-Apr-2008+PRN20080402 ("Arbitration can only be a valid and effective method of resolving disputes when both parties agree voluntarily, not when it is forced upon people to limit their legal rights.").

[56] PIABA Statement, *supra* note 33.

investor overall.

Critics claim that if the system is fair, then investors will choose it. This is a flawed assumption given the negative perception of arbitration by investors. If investors view arbitration as inherently unfair they are not likely to choose it. Furthermore, it is likely that parties may not agree on the appropriate forum to resolve a dispute after the dispute arises.[57] Both the investors and broker-dealers would chose the forum that would best ensure the most favorable outcome for themselves. It is likely that the choice of forum will conflict and this will create more delays, cost, and animosity.

C. *Direct Reform by the Securities Regulation Agencies Might Be More Efficient and Have a Greater Positive Impact on Investor Perception*

Direct reforms to the arbitration system would be a better solution to the reservations that investors feel towards securities arbitration and would cause less disruption in the current state of securities arbitration. Indirectly affecting change has more transaction costs in changing the securities arbitration system from a too far removed position, namely the legislature. PIABA admits that a fair and unbiased system of securities arbitration would be an attractive method of dispute resolution for investors.[58] To improve investor perception of the arbitration process there should be more transparency in the process.[59] NASAA also calls for a congressional examination of the procedures and for reforms in the process.[60] NASAA calls for the elimination of the industry arbitrator on arbitration panels and a new definition of an investor "win" in FINRA statistics to address the fact that the definition is not accurate.[61]

Also, given the consolidation of the arbitration forums into FINRA, possibly creating more choice in arbitration forums would create competition, choice, and fairness. This may help perception as well as create incentives for the arbitration forum to create features that will attract investors. PIABA notes in its statement to Congress that before the consolidation of arbitration forums into the single forum of FINRA, investors had a choice between at least ten different forums, with differing rules and policies, which promoted overall fairness in arbitration.[62] NASAA also points to the consolidation of securities arbitration into the single FINRA forum as a source of possible unfairness.[63]

As hinted at above, the legislature may not be the best choice to make these changes. PIABA says that only Congress can remedy the unfairness of pre-dispute arbitration clauses.[64] However, the legislature may be too far removed from the industry to make efficient change that greatly improves investor perception of the arbitration process.

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[57] SIFMA Testimony, *supra* note 43.

[58] PIABA Statement, *supra* note 33.

[59] *Perception Study*, *supra* note 35.

[60] NASAA letter to Sen. Feingold regarding S. 1782, the Arbitration Fairness Act of 2007 (Sept. 24, 2007) http://www.nasaa.org/content/Files/FeingoldS1782.pdf; NASAA Letter to Rep. Johnson regarding H.R. 3010, the Arbitration Fairness Act of 2007 (Oct. 1, 2007) http://www.nasaa.org/content/Files/JohnsonHR3010.pdf; NASAA Letter to Rep. Sánchez and Rep. Cannon Regarding H.R. 3010, the Arbitration Fairness Act of 2008 (July 15, 2008) http://www.nasaa.org/content/Files/NASAA-HR-3010-letter-7-15-08.pdf.

[61] NASAA Testimony, *supra* note 39.

[62] PIABA Statement, *supra* note 33.

[63] NASAA Testimony, *supra* note 39.

[64] PIABA Statement, *supra* note 33.

Improving investor perception towards securities arbitration may not change at all by simply giving them a choice. Efficiently reforming the arbitration process with minimal disruption to the current state of securities arbitration may be a more cost effective alternative to enacting the AFA. The SEC and the other agencies regulating securities arbitration, with their powers of regulation, would be better suited to make the arbitration proceedings both more transparency and apparently fair.

Conclusion

The Arbitration Fairness Act, if passed, will likely bring about positive change in the perception of securities arbitration process directly, and will indirectly lead to beneficial reform of securities arbitration to appeal to investors when deciding whether to litigate or arbitrate. The Act's biggest impact will likely be on investors' perception of dispute resolution in the securities industry. This change in perception is key in having a system that can adequately satisfy both parties desire in the context of a dispute. The fairness of securities arbitration may be indirectly improved in an effort to attract investors to choose to arbitrate, but the most direct and efficient way to change investor perception is to directly reform securities arbitration, not by the legislature, but through conscientious reform by the SEC. The bottom line is that the AFA will empower investors and indirectly improve perception and possibly affect reform, but it is not the most direct or efficient way to make securities arbitration more "fair."

Recent Arbitration Awards

Jason M. Kueser

Aubrey and Martha Wright v. Morgan Keegan & Company, Inc.,
FINRA Case No. 08-00315

Claimants were two retirees who were promised safety and fixed income returns. No risk of investment loss was ever disclosed. The securities sold to Claimants were mislabeled. In 2007, certain securities were denominated as "preferred" shares; however, these same securities were denominated as "Below investment grade asset backed securities" in 2008. As the value of the securities dropped significantly, Respondent failed to contact Claimants at any time.

Claimants' claims related to, among other things, Claimants' investments in the following funds: RMK High Income Fund; RMK Multi-Sector High Income Fund; RMK Strategic Income Fund; and, RMK Advantage Income Fund.

Claimants requested compensatory damages of $109,552.44, plus punitive damages, interest, attorneys' fees, and costs.

Claimants asserted the following causes of action: misrepresentations and omissions; violation of the Georgia Securities Act of 1973; breach of fiduciary duty; violation of NASD conduct rules; negligence; failure to supervise; breach of contract; common law fraudulent misrepresentation; and vicarious liability.

Respondent raised various affirmative defenses.

Award: $90,052.00 in compensatory damages, Claimants' filing fee, and all hearing session fees.

Claimants' Counsel: Andrew Stoltmann, Esq., Stoltmann Law Offices, P.C.

Respondent's Counsel: Peter Anderson, Esq. and S. Lawrence Polk, Esq., Sutherland Asbill & Brennan, L.L.P.

Claimants' Expert: Rick Evans

Respondent's Expert: Steve Scales

Arbitrators: Joyce Glucksman (Chair), Robert A. Dean (Public), and Perry Lee Taylor, Jr. (Non-Public)

This case is significant because it represents an early victory in what will be a long line of arbitration cases related to Morgan Keegan's development, management, marketing, and sale of its proprietary bond funds. These funds have lost

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over 90% of their value in the last few years because of their concentration in very risky CDOs and other structured products. At the hearing, Claimants' counsel focused on the fact that the securities at issue were dead last among their peer group in performance and that there was a large margin of differential between these securities and the second-lowest performer in the respective peer groups.

Ruby S. Roos Trust, Allen D. Roos and Dean L. Roos, Successor Trustee, Leslie O. Roos Trust, Allen D. Roos and Dean L. Roos, Successor Trustee, and Cecilia Johnson v. Capital Growth Financial, LLC, Wachovia Securities, LLC, VSR Financial Services, Inc., Rebecca L. Engle, Brian J. Schuster, Peter Lahti, and Paula Turner, FINRA Case No. 07-00905

This case is one of 15 arbitrations involving a total of 180 Claimants who were represented by counsel. The Rooses were 90-year old retired farmers, and Ms. Johnson is a hairdresser. Respondents Schuster and Engle were partners with a long history in the business of operating out of a small Nebraska farm community. They worked for five broker/dealers over seven years. While with Wachovia, they were introduced to American Capital Corporation, which was raising money for its various start-up endeavors through a series of debt/equity private placements. Subsequently, they became associated with Capital Growth Financial ("CGF"). The brokers received 10% commissions, and ultimately sold private placements issued by CGF itself. Discovery revealed these private placements were sold primarily to people in Nebraska. Ultimately, these transactions benefitted only Respondents.

Claimants alleged that Respondents improperly invested their assets in several aggressive and high-risk securities that were unsuitable given their stated investment objectives of conservative growth for the purpose of their retirement. Claimants also alleged that Respondents made these unsuitable recommendations for the sole purpose of generating fees and commissions and without regard to the financial interests of Claimants. Claimants further alleged that the member firms who employed Engle, Schuster, Lahti and Turner failed to properly supervise their actions, and as a result, are liable for any damages caused to Claimants. None of the Claimants were accredited.

Prior to the arbitration hearing, Claimants settled their claims against VSR Financial Services, Inc., Peter Lahti, and Paula Turner. In addition, Claimants dismissed their claims against Rebecca L. Engle prior to hearing because of her Chapter 11 bankruptcy. Claimants requested $297,700 in compensatory damages against the remaining Respondents.
Claimants asserted the following causes of action: Violation of Nebraska state regulatory requirements; negligence; breach of fiduciary duty; failure to supervise; unjust enrichment; violation of federal securities laws; violation of the Investment Advisors Act of 1940; and breach of contract.

Respondent raised various affirmative defenses.
Award:

- Capital Growth Financial, LLC liable to Claimants Ruby S. Roos Trust, Allen D. Roos and Dean L. Roos, Successor Trustee, Leslie D. Roos Trust, Allen D. Roos and Dean L. Roos Successor Trustee:
    - $83,850 in compensatory damages
    - $27,559 in interest
- Capital Growth Financial LLC liable to Claimant Cecilia Johnson:
    - $18,081 in compensatory damages
    - $6,764 in interest
- Wachovia Securities, LLC liable to Claimants Ruby S. Roos Trust, Allen D. Roos and Dean L. Roos, Successor Trustee, Leslie D. Roos Trust, Allen D. Roos and Dean L. Roos Successor Trustee:

  - $83,585 in compensatory damages
  - $27,559 in interest
- Wachovia Securities, LLC liable to Claimant Cecilia Johnson:
  - $18,081 in compensatory damages
  - $6,764 in interest
- Brian J. Schuster liable to Claimants Ruby S. Roos Trust, Allen D. Roos and Dean L. Roos, Successor Trustee, Leslie D. Roos Trust, Allen D. Roos and Dean L. Roos Successor Trustee:
  - $83,585 in compensatory damages
  - $27,559 in interest
  - $222,301.65 in punitive damages
- Wachovia Securities, LLC liable to Claimant Cecilia Johnson:
  - $18,081 in compensatory damages
  - $6,764 in interest
  - $49,691.06 in punitive damages

Claimants' Counsel: J.L. Spray, Esq., Mattson, Ricketts, Davies, Stewart & Calkins.

Respondents' Counsel: Capital Growth Financial, LLC ("CGF") was represented by Neil S. Baritz, Esq., Baritz & Coleman, LLP, until a Notice of Withdrawal was filed on January 25, 2008. After which, CGF appeared *pro se*. Wachovia Securities, LLC was represented by Todd Ratner, Esq. (in house counsel). VSR Financial Services, Inc. was represented by Patrick B. Griffin, Esq., Kutak Rock, LLP. Rebecca L. Engle was represented by Martin M. Berliner, Esq., Berliner McDonald, P.C. until a Notice of Withdrawal was filed on or about August 17, 2007. After which, Rebecca Engle was represented by Gary M. Saretsky, Esq., Saretsky Hart Michaels & Gould, P.C. Brian J. Schuster was represented by Gary A. Klein, Esq., Klein & Sallah, LLC, until a Notice of Withdrawal was filed on or about August 8, 2007. After which, Schuster appeared *pro se*. Peter Lahti was represented by Richard Jeffries, Esq., Cline, Williams, Wright, Johnson & Oldfather, LLP. Paula Turner was represented by Kevin R. McManaman, Esq., Knudsen, Berkheimer, Richardson & Endacott, LLP, until a Notice of Withdrawal was filed on or about October 15, 2007. After which, Paula Turner was represented by Gary M. Saretsky, Esq., Saretsky Hart Michaels & Gould, P.C.

Claimants' Non-testifying Expert: Howard B. Scherer

Respondents' Expert: None

Arbitrators: Robert L. Agusto (Chair), Jonathan B. Gilbert (Public), and Elayne Morgan (Non-Public)

The award is significant both because of its size and the different parties. The award against Wachovia was significant because the date of purchase was after Engle and the Claimants had moved from Wachovia. The key evidence related to presale activity was mismanagement of this remote branch office and Wachovia's knowledge of Engle's activities after she left the firm.

Bayan and Feda Abu Jamous v. Wachovia Securities, Inc., A.J. Keyser, Robert Schneller, and Prudential Bache Commodities, LLC,
FINRA Case No. 07-03227

Claimant Bayan was the owner of a gas station who purchased CDs and mutual funds through Wachovia Bank. During a visit to the bank to reinvest a CD that had matured, Claimant was referred to one of Wachovia's Registered Representatives. The Registered Representative told Claimant that because of his knowledge of "the oil business," he should invest in oil futures contracts. Prudential Bache Commodities was the commodities arm for Wachovia Bank.
The new account documents misstated Claimants' investment experience. During the first week after the account was opened, Claimants profited by $40,000. However,

over the subsequent seven weeks, the account sustained losses that completely depleted Claimants' life savings. Due to the leverage in the futures contracts, a number of the trades potentially exposed Claimants to as much as $15 million in losses. Prudential Bache Commodities, LLC was named as a Respondent in the arbitration; however, because FINRA did not have jurisdiction over it, Claimants did not pursue any claims against Prudential at the hearing.

Claimants requested $650,000 in compensatory damages, plus pre- and post-judgment interest, costs, attorneys' fees, and punitive damages.

Claimants asserted the following causes of action: fraud, conversion, breach of contract, breach of fiduciary duty, negligence, failure to supervise, and unsuitable transactions.

Respondents raised various affirmative defenses.

Award: Wachovia Securities, Inc. and A.J. Keyser were liable to Claimants for $525,000 in compensatory damages.

Claimants' Counsel: Kevin P. Conway, Conway & Conway.

Respondents' Counsel: Andrew R. Park (in house counsel) appeared on behalf of Wachovia Securities, Inc., A.J. Keyser, and Robert Schneller

Claimants' Expert: Bob Lowry

Arbitrators: Donald B. Vaden (Chairperson), Arthur B. O'Connell (Public), and John J. Muldowney (Non-Public)

This case is significant because it was a futures case that was tried in FINRA arbitration. Moreover, the award represented a substantial percentage of Claimants' out of pocket losses.

Jeffrey Nielsen, Hidden Glade Properties, LLC, Evans Creek, LLC, and Guaranty Escrow of MN, Inc. v. Charles Schwab & Co., Inc. and Darin J. Beckering,
FINRA Case No. 07-03069

Claimant Nielsen owned Hidden Glade Properties, LLC, Evans Creek, LLC, and Guaranty Escrow of MN, Inc. Claimants expressed a need for investment options into which they could deposit, on a short-term basis, proceeds from the sale of real estate interests until the proceeds could be reinvested pursuant to §1031 of the Internal Revenue Code. Respondents recommended the Schwab Yield Plus fund.

Claimants contended that Respondents failed to disclose any risks related to the Yield Plus fund and argued that the fund was unsuitable for any investor who wanted to hold shares in the fund for less than one year. Given Claimants' need to have access to the principal on a short-term basis to accomplish the desired tax benefits, the arguments in the case focused on the specific issue of investment time horizon.

Claimants requested $667,000 in compensatory damages, plus attorneys' fees, costs, interest, and punitive damages.

Claimants asserted the following causes of action: Violation of the Minnesota Securities Laws and negligence.

Respondents raised the following defenses: Ratification, estoppel, laches, and failure to mitigate. Specifically, Respondents argued that Claimants were presented with a full disclosure of the risks; however, presented minimal evidence in support of this defense. Respondents also argued that Claimants received statements, which provided changes in value of shares in the fund and that the true cause of Claimants' loss was the market. Respondents specifically focused on Claimant Nielsen's success in the real estate business.

Award: $542,340 in compensatory damages.

Claimants' Counsel: James K. Langdon, Dorsey & Whitney, LLP

Respondents' Counsel: Gregory Scanlon, Esq. (in house counsel)

Claimants' Expert: Paul Litteau, Scottsdale, Arizona (suitability)

Respondents' Expert: None.

Arbitrators: Mark S. Gleason (Chair), Arthur Richard Tow (Public), and Lee T. Beske (Non-Public)

This case is significant because it is one of the first Schwab Yield Plus cases to go through arbitration. The Minnesota arbitration panel awarded more than 80% of Claimants' alleged compensatory damages, despite his success in the real estate investment business.

Kayvan Karoon v. First Montauk Securities Corp.,
FINRA Case No. 07-02690

Claimant owned a small broker-dealer with institutional customers, and affiliated his business with Respondent, a larger, regional brokerage firm. The broker-dealer ultimately became a division of Respondent. Pursuant to their agreement, Claimant furnished customer business, while Respondent furnished licenses, infrastructure, and $60,000 in "transition financing." To avoid the risk that Claimant's revenues might fall short of his projections, Respondent structured the transition financing as a forgivable loan. The promissory note forgave $10,000 immediately and $50,000 at a later date. Forgiveness did not depend upon a lapse of time, but upon Claimant's generation of gross commissions of at least $500,000.

While building his gross commissions, Claimant agreed to accept an 80% payout. Upon reaching $500,000 in gross commissions, his payout was to increase to 90%. Meanwhile, the 10% difference would amortize the loan, and if Claimant never attained $500,000 in commissions, Respondent would retain the 10%. If Claimant reached $500,000, the $50,000 accumulated until then [$500,000 x (90% - 80%) = $50,000] would be "forgiven."

Claimant argued that since the forgiven amount had previously been collected, Claimant should have received a $50,000 refund. Respondent disputed this based upon the forgiveness clause, which read: "First Montauk will provide transition financing in the amount of $60,000 of which $10,000 will be forgiven upon the effectiveness of your NASD registration. The remaining $50,000 will be forgiven once you have achieved $500,000 in commissions (after the deduction of all applicable clearing charges)." Claimant generated the $500,000, but Respondent withheld the $50,000.

Respondent claimed that the term "forgiveness" meant that Claimant would amortize the $50,000 loan balance with a share of his commissions, and that when he finished paying, the loan would be deemed "forgiven" and Respondent would keep the money. Claimant, on the other hand, argued that "forgiveness" required that the $50,000, once "forgiven," would be refunded.

Claimant sought repayment of the $50,000 forgiven principal amount, plus pre-award interest, attorney's fees, and punitive damages.

Respondent denied liability and asked for an award of attorney's fees.

Respondent offered to call witnesses to discuss the "intent" of the term "forgiveness." Claimant opposed this effort, relying on the "plain language of the contract." *Kashner Davidson Securities Corp. v.* Mscisz, 531 F.3d 68, 74-75 (1st Cir. 2008); *Vital Basics Incorporated v. Vertrue Incorporated*, 472 F.2d 12, 17 (1st Cir. 2006); *Labor Relations Div. of Constr. Indus. v. Int'l Brotherhood of Teamsters*, 29 F.2d 742, 745 (1st Cir. 1994). The arbitrators decided to hear witnesses, but

ultimately read the agreement in light of the conventional meaning of "forgiveness."

At the conclusion of the hearing, the arbitrators said they would deliberate that same day. Two weeks later, Respondent moved to reopen the proceedings, to introduce another witness whom they deemed essential. Claimant opposed the motion, asserting that although no written decision had yet been issued, the arbitrators had completed their central tasks and were no longer "*functus officio," i.e.,* no longer had legal authority to take further action. *New Jersey Bldg. Laborers' Dist. Councils and Local 325 v. Molfetta Industries Co., Inc.*, 2008 WL 3833460 (D.N.J. August 13, 2008); *Office Workers v. Brownsville General Hospital*, 186 F.3d 326, 331 (3d Cir. 1999). The arbitrators denied the motion to reopen and issued their decision.

Claimant asserted the following causes of action: breach of employment contract; breach of the covenant of good faith and fair dealing; breach of fiduciary duty; fraud; and conversion.

Award: Compensatory damages of $50,000, plus interest of $9,550.80 (based upon the New Jersey statutory rate for three years). Additionally, the Panel assessed payment of all forum fees ($5,600) against Respondent.

Claimant's Counsel: George Brunelle, Esq., Brunelle & Hadjikow. Claimant was previously represented by Paul A. Lieberman, Esq., Hamburger Law Firm, LLC.

Respondent's Counsel: Robert I. Rabinowitz, Esq. (in house counsel).

Arbitrators: David L. Becker (Chair), Richard V. Adams (Non-Public), and Philip W. Gaffney (Non-Public).

This case is significant as the Panel disregarded Respondent's evidence as to the "intent" of the term "forgiveness." In addition, although the agreement at issue did not contain a provision for pre-award interest, the arbitration Panel awarded pre-award interest against Respondent. Although the Panel did not state its reason for the award, Claimant's counsel feels the Panel awarded interest as a form of sanction. Respondent challenged as ambiguous a term ("forgiveness") that an industry panel found to be customary and clear. Respondent's position led to extensive testimony about the meaning of that term, and caused commensurate expense to the opposing party. Respondent added a further layer of complexity to the case with repetitive motions to disqualify their adversary counsel and a final motion to reopen the hearing for additional testimony. Such tactical decisions, even when supported by law and potential evidence, pose a clear risk of provoking arbitrators into exercising their discretion in favor of the opposing party. In this case, they awarded a substantial amount of pre-award interest to Claimant, and imposed all of the forum fees on Respondent.

Cases & Materials

Timothy A. Canning

Following are summaries of recent cases and other material that may be of interest, from state and federal courts involving arbitration and/or securities, arranged generally by topic**.**

Before The Arbitration: Compelling/Resisting Arbitration

Enforcing Arbitration Agreements:

Nelson v. American Apparel, Inc.
(Cal.App. 10/28/2008) 2008 WL 4713262

A clause requiring arbitration of breaches of a settlement agreement is not rendered ntains a separate clause requiring a "faux arbitration" on the underlying merits.

In a fact pattern reminiscent of settlement agreements extracted by brokerage firms prior to FINRA's revision of the CRD expungement rules, the defendants in this sexual harassment suit agreed to pay plaintiff $13 million, but extracted from plaintiff an agreement to participate in a "faux arbitration". According to the settlement agreement, the arbitration was to be held on stipulated facts, with the arbitrator to be selected by and paid for by the defendants. The stipulated facts would inexorably lead the arbitrator to issue an award in favor of defendants; in fact, the language of the arbitrators' award was recited word for word in the settlement agreement.

The settlement agreement provided that the defendants would then issue a press release stating that an arbitration award was rendered in defendants' favor on the sexual harassment claim. There was also a confidentiality agreement in the settlement agreement, as well as an arbitration provision governing any breaches of the settlement agreement.

After signing the agreement, the plaintiff and her attorney refused to participate in the "faux arbitration". Defendants then asserted that the plaintiffs violated the confidentiality provisions in the settlement agreement, and brought a motion to compel arbitration of that claim. The trial court refused to compel to arbitration, which was reversed by the court of appeals.

According to the court, if the appeal involved a petition to compel the "faux arbitration", there would be considerations of illegality, injustice, and fraud which would affect the court's powers as a court of equity to enforce the "faux arbitration." If defendants were seeking to enforce a duty to arbitrate

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under the "faux arbitration" provision -- which was designed to lead to the issuance of a press release whose purpose was to mislead journalists and the public – then, as the court stated, the result of the appeal would have been materially different. But the petition to compel arbitration was expressly directed only at breach of the confidentiality provisions in the settlement agreement, and on that ground, the court ordered the parties to arbitration.

Challenging Arbitration Agreements: Unclean Hands

May v. J.P. Turner & Co., LLC
(D. Colo. 10/6/2008) 2008 WL 4533922

A suspected false document and vitriolic language by opposing counsel is not enough to warrant enjoining an arbitration on "unclean hands" grounds.

In this action by a former broker for declaratory relief to enjoin an arbitration filed by his former brokerage firm employer, the brokerage firm moved to dismiss on the grounds that there were two binding arbitration agreements that covered the dispute – the employment agreement and the broker's U-4.

After holding that those agreements encompassed the dispute, the court then addressed whether there were any "legal constraints external to the parties agreement that forecloses arbitration." In particular, the broker argued that JP Turner had unclean hands, for three main reasons.

First, JP Turner failed to disclose the existence of the employment agreement in its original arbitration filing, from which (according to the employee) the court could infer that the agreement did not exist at that time. However, the court concluded that JP Turner had no reason to disclose the agreement in its original arbitration filing.

Second, the former employee argued that the employment agreement JP Turner ultimately did turnover was "highly suspect" and in particular the signature page was simply appended to another document. The court concluded that because of the U-4 arbitration provisions, it didn't matter whether the employment agreement contained an arbitration clause or not.

Third, the employee argued that JP Turner's counsel's use of vitriolic language made it inequitable to require the employee to submit to that kind of verbal abuse. The court concluded that JP Turner was exercising its contractual right to arbitration and that its counsel was simply employing forceful advocacy.

Arbitration Required Under FINRA Rules: Terminated Member

Buice v. WMA Securities, Inc.
(S.C.App. 10/14/2008) --- S.E.2d ----, 2008 WL 4613634

An arbitration clause requiring arbitration to be held under NASD rules "then in effect" referred to NASD rules in effect at the time the arbitration proceeding was filed; since NASD rules at the time the arbitration was filed gave public customers the right to withdraw their arbitration claim against terminated members, public customers were not compelled to arbitrate their claims.

In this matter, WMAS and its owner, Hubert Humphrey, sought to compel public customers to arbitrate their claim at the NASD. The public customers initially filed their claim at the NASD. However, when the NASD informed them that WMAS was no longer an NASD member firm and therefore they did not have to submit to arbitration at the NASD, the public customers filed a court action against WMAS and Humphrey.

WMAS and Humphrey both contended that the arbitration clause contained in the new account agreement required the public customers to arbitrate claims under the NASD rules that were in effect at the time the account agreement was signed. At the time

the agreement was signed, NASD rules did not contain an exception for terminated members.

The court rejected WMAS' arguments. The crux of the analysis of the arbitration agreement hinged on a determination of how the phrase "then in effect" modifies the set of NASD rules to be applied in the arbitration. The court concluded that the phrase "then in effect" clearly and unambiguously refers to the NASD rules existing at the time the matter is sent to arbitration.

WMAS' inclusion of the NASD as the specified arbitration forum and applicable rules limited WMAS' ability to make a colorable argument that arbitration should be compelled despite the clear exclusion under NASD Rule 10301 for those whose memberships have been terminated. This is also represented in the legislative history of Rule 10301.

The court held that Humphrey was subject to the same conclusion, because both Humphrey and WMAS have taken the position that their interests were indistinguishable.

Compelling Arbitration: Class Actions

Serino v. Lipper
(N.Y.A.D 10/28/2008) 866 N.Y.S.2d 159, 2008 WL 4707485

Whether FINRA's rules barring arbitration of a class action claim would also bar arbitration of a class action claim at the AAA is a question for the AAA arbitrator to decide.

In this brief opinion, the court sends to the arbitrator the tantalizing question of whether FINRA's rule barring arbitration of class actions would apply in an arbitration before the AAA.

Here, defendant Lipper moved to compel arbitration of a putative class action suit before the American Arbitration Association. The dispute arose out of a failed investment in a partnership. The partnership agreement contained a broad arbitration clause, requiring, among other things, that "[a]ll disputes and questions whatsoever" arising under the agreement should be submitted to arbitration, either before FINRA or the AAA. The plaintiffs attempted to avoid arbitration on the grounds (among others) that FINRA rules prohibited arbitration of class actions.

The court ruled that the question of whether FINRA rules prohibit class arbitration before the AAA is for the arbitrator to decide. (AAA arbitration rules may arguably permit arbitration of class action claims unless the arbitration agreement prohibits it.)

Waiver of Arbitration: Litigation Conduct

Gordon v. Dadante
(6th Cir. 9/23/2008) 2008 WL 4372951

A party does not waive its right to compel arbitration by participating in litigation, where the party's litigation conduct is not completely inconsistent its contractual right to arbitration

Here, the Sixth Circuit Court of Appeals reversed the district court's decision in Gordon *v Dadante* (ND Ohio 3/29/2007) 2007 WL 949657.

H & R Block Financial Advisors, Inc. ("HRBFA") was one of several brokerage firms that held accounts for a Fund. Certain investors filed a complaint against the Fund, alleging that the Fund was a Ponzi scheme replete with misrepresentations, false account statements, manipulated accounts, and improper self-dealing. The investors requested, *inter alia*, that the court freeze the assets of the Fund, and appoint a receiver over the remaining assets the Fund, including those held at HRBFA.

HRBFA participated in the litigation to protect its rights regarding a margin debt in some of the Fund's accounts that it held. HRBFA then filed an arbitration claim with the NASD, and sought to stay the litigation. The district court denied HRBFA's motion, finding that HRBFA

had waived its right to arbitrate its dispute over the validity of the margin debt because it had been so active in the litigation.

The appellate court reversed. The instances relied upon by the district court did not reflect conduct by HRBFA that was completely inconsistent with its reliance on its contractual right to arbitration.

First, and perhaps most importantly, there were no substantive claims directed against HRBFA in the lawsuit; it was named a defendant merely as a stakeholder. HRBFA did not have an affirmative obligation to invoke its contractual right to arbitration before a claim was filed against it.

Second, this was not a case where the party claiming a right to arbitrate has been unresponsive to the lawsuit and sat idly by, neither answering the complaint nor seeking arbitration. And this was not a case where the party has parried the attacks of the opposing party by denying a duty to arbitrate until a motion for default judgment was filed against it and then claiming a right to arbitrate in the hope of receiving more favorable treatment.

HRBFA was a mere stakeholder in the underlying action and did not file any substantive claims against any other party in the suit nor did any other party in the suit file claims against it. HRBFA merely attempted to defend and protect its rights under the Account Agreement. Its procedural maneuvers to do so were not completely inconsistent with its reliance on the right to arbitration and it had no obligation to invoke its right to arbitration earlier.

Compelling Arbitration: Uniform Submission Agreement and Refusal To Arbitrate

Bernard v. Hildebrand
(La.App. 8/6/2008) --- So.2d ----, 2008 WL 3056349

A signed Uniform Submission Agreement constitutes an agreement to submit existing controversies to arbitration, even where there is no pre-dispute arbitration agreement between the parties; a party's withdrawal with prejudice of their arbitration claim after signing a Uniform Submission Agreement is tantamount to a refusal to arbitrate.

In this matter, employees of Kansas City Southern Railroad filed a claim against their brokers, alleging that the brokers had mismanaged their retirement accounts. The employees filed their claim with the NASD. In so doing, each of the employees voluntarily signed an NASD Arbitration Uniform Submission Agreement.

While the arbitration was pending, the arbitration panel requested that the parties produce any pre-dispute arbitration agreement existing between them. Neither of the parties was able to produce such an agreement. The employees then informed the panel that, based upon the lack of any pre-dispute agreement, they were "withdraw[ing] their uniform submission agreements" and requesting that the arbitration proceeding be "dismissed without prejudice."

The employees then filed a lawsuit against the brokers, and the brokers moved to compel arbitration. While that motion was pending, the NASD issued a letter to the parties, stating that the arbitration matter had been closed as "Withdrawn with Prejudice".

After receiving NASD's response, the brokers then filed a revised motion to stay and to dismiss. The brokers argued that the Uniform Submission Agreements bound the employees to arbitrate their claims. They further claimed that NASD's act of closing the arbitration as "withdrawn with prejudice" "operate[d] as an adjudication on the merits."

The trial court found that the employees were bound to arbitrate by virtue of the signed USA, and then dismissed their civil action with prejudice.

The appellate court agreed with the trial court's conclusion that a pre-dispute arbitration agreement was not required where the parties executed a post-dispute arbitration agreement, such as the Uniform Submission Agreement. Parties may agree to the submission to arbitration of existing controversies without any previous contract to do so.

However, the appellate court reversed the trial court's dismissal with prejudice. Under Louisiana's Binding Arbitration Law, when a valid arbitration agreement exists, the court can only stay proceedings and/or compel the parties to proceed to arbitration upon the application of one of the parties. Subsequent to the rendition of an arbitration award, a court may only confirm, vacate, or modify an award.

Louisiana law provides that the court shall stay the trial of an action in order for arbitration to proceed if any party applies for such a stay and shows (1) that there is a written arbitration agreement, and (2) the issue is referable to arbitration under that arbitration agreement, as long as the applicant is not in default in proceeding with the arbitration. A party in default is a party who has "fail[ed] or refus[ed] ... to perform under a written agreement for arbitration."

In other words, the court can only determine (1) whether there is a dispute as to the making of the agreement, and (2) whether a party has failed to comply with the agreement. If it determines that those two facts are not in issue, the court "shall issue an order directing the parties to proceed to arbitration in accordance with the terms of the agreement."

The Uniform Submission Agreement was an arbitration agreement. The employees' withdrawal of their arbitration claim was tantamount to a failure to comply with the agreement.

As the dismissal with prejudice was a result not contemplated by the applicable statutes, the court reversed the trial court's judgment of dismissal with prejudice.

Compelling Arbitration: Uniform Submission Agreement and Subsequent Proceedings

Cercone v. Merrill Lynch, Pierce, Fenner & Smith
(Ohio App, 8/21/2008) 2008 WL 3870657

After an arbitration was removed from the NASD's arbitration docket at the request of the parties, the fact that a USA had been signed by one of the parties does not prevent that party from subsequently asserting its claims in court.

By way of background, Merrill Lynch had hired Cercone (the employee) as a financial advisor. When he was hired, the employee negotiated for and received an upfront payment of $975,000 from Merrill Lynch, in the form of a "forgivable loan." The "forgivable loan" was paid off by monthly payments that Merrill Lynch provided to the employee under the condition that he remained employed at Merrill Lynch for at least five years. In the event the employee resigned or was terminated for cause prior to the expiration of the five years, the employee agreed he would pay Merrill Lynch the portion of the loan not paid.

Within 5 years of hire, Merrill Lynch terminated the employee and demanded immediate payment of the loan. Merrill Lynch claimed it terminated the employee for cause based on complaints made by several female employees that the employee sexually harassed them. The employee contended he was not terminated for cause, but was terminated because he suffers from Attention Deficit Hyperactivity Disorder ("ADHD").

Merrill Lynch commenced an arbitration proceeding against the employee with the NASD, contending that the employee was obligated to repay the promissory note. The employee asserted a counterclaim, contending in part that he was relieved of his obligation to repay the note because Merrill Lynch did not terminate him for cause, and also alleged claims for disability discrimination, deceptive trade practices, intentional infliction of emotional distress, constructive discharge, and retaliation.

During the pendency of the arbitration, Merrill Lynch's counsel sent a letter to the NASD, on behalf of both parties advising it that the parties had settled and that the NASD should dismiss the case. The NASD sent a response letter on April 28, 2006 informing the parties that the case was being removed from the arbitration docket. The letter also advised that "if this case has not settled or should not have been withdrawn, please notify this office by May 8, 2006. After May 8, 2006 has elapsed, NASD Dispute Resolution will not reopen this case."

However, the parties were unable to agree on how to structure the payment plan in order to avoid tax consequences to the employee; therefore, the parties were unable to settle.

After the parties had reached an impasse regarding settlement, the employee filed a court action against Merrill Lynch. The employee alleged he was discriminated against because of his ADHD, that his termination violated public policy, and the defendant's conduct constituted intentional infliction of emotional distress.

Merrill Lynch responded by filing a motion to compel arbitration and to dismiss the proceeding, or, in the alternative, to stay the proceeding. Merrill Lynch argued mandatory arbitration was required because the employee waived his right to pursue his claims in a state court action because he participated in a prior arbitration proceeding in which he raised his claims.

The court concluded that the employee did not voluntarily agree to arbitrate his claim of discrimination (under NASD rule 10201(b)) by raising his counterclaim in the prior arbitration, which had included a claim of discrimination.

The court took a narrow view of what is encompassed in a USA. In order to invoke the NASD's jurisdiction to hear the arbitration, the parties must submit a statement of the claim, a filing fee, and a form entitled Uniform Submission Agreement ("USA"), in which the parties agree to submit the dispute to arbitration and agree the NASD rules governing arbitration apply. Here, Merrill Lynch submitted such a form in conjunction with its desire to enforce payment on the note; the employee also filed a form regarding his counterclaim.

The USA states, "The undersigned parties hereby submit the present matter in controversy, as set forth in the attached statement of claim * * * and all related counterclaims * * * to arbitration * * * ." (Emphasis added).

This wording alone clearly shows that the employee was consenting to arbitration before the NASD only for that proceeding and not future proceedings. It was undisputed that the employee's counterclaim was never decided by the NASD because the NASD dismissed the case and the parties failed to reopen the arbitration prior to the NASD's deadline.

Moreover, if the parties desired to again pursue arbitration before the NASD, they would have to file a new statement of claim, submission agreement, and pay another filing fee. Therefore, the NASD treats a refiled claim as a new claim.

Similarly, the court has held in other cases that "the vacation of an arbitration award on procedural grounds leaves the parties as they were at the beginning of the process, and they are entitled to begin anew." Although the instant case concerns a dismissal of an

arbitration and not a vacatur of the arbitration, the court concluded that the same principle applies.

The court also rejected Merrill Lynch's argument that the employee waived his right to bring his claim in the state court by consenting to the first arbitration. Instead, the employee's consent to arbitration only applied to that proceeding and not to future proceedings. The court framed the question as being whether the agreement to arbitrate, when the arbitration is dismissed, prevents one of the parties from pursuing a claim in court. The court did agree that if the arbitration was still pending, the party could not change its legal remedy midstream.

During The Arbitration

Attachment in Aid of Arbitration

Savanna Investors, LLC v. Vaughn
(Conn. Super. 7/30/2008) 2008 WL 4021333

Where arbitrators have the authority to issue orders for prejudgment attachment of assets, a party cannot obtain that relief in court.

In this case, the plaintiff sought a prejudgment attachment on defendant's assets, while an arbitration between the parties was pending at the AAA. The court declined to issue an order for *pendente lite* relief in aid of a currently pending arbitration proceeding.

Under Connecticut state law, when a prejudgment attachment is sought in aid of arbitration, there is a threshold requirement that the plaintiff must show (in addition to those required for a prejudgment attachment in a civil action), that of necessity for judicial intervention into the domain of the arbitration panel.

According to the court, if interim arbitral relief were shown to be available under a governing set of rules of arbitration procedure, the plaintiff obviously would not have had to "wait for a final arbitral award" to secure its claims, and it would have suffered no "irretrievable loss" of its rights. The clear implication is that judicial intervention would not have been found to be "necessary" if there was a tribunal with powers to enter interim relief orders and prejudgment remedies.

In light of the availability of arbitral relief *pendente lite* under the AAA Commercial Arbitration Rules, the court concluded that the plaintiff failed to make the requisite showing that this case presented an extraordinary situation calling for judicial intervention in the arbitration process or that plaintiff's rights to security in the assets or property of the defendant Company would be irretrievably lost by having to present those claims for interim relief to the arbitration panel.

Attachment in Aid of Arbitration

Arnold Chase Family v. UBS,
(D. Ct. 8/4/2008) 2008 WL 3089484

FINRA rules governing customer arbitrations do not prohibit customers from asking a court for a prejudgment remedy in aid of a pending arbitration.

In April 2008, plaintiffs commenced an arbitration against UBS before FINRA regarding their claim that they invested funds in securities that were allegedly represented to be "cash alternatives," when they were not, and as a consequence, plaintiffs were injured financially. At or around the same time, plaintiffs filed this action seeking an attachment of UBS assets of approximately $150 million to secure any award they may receive from the arbitration. UBS responded by moving to dismiss plaintiffs' application for an attachment under Rule 12(b)(6) of the Federal Rules of Civil Procedure because, according to UBS, the rules of FINRA "prohibit judicial proceedings concerning matters pending in arbitration."

According to UBS, the broad language of Rule 12209 evidences FINRA's intent to bar any ancillary legal proceedings involving

claims in arbitration. Furthermore, UBS contends that prejudgment remedies are unnecessary in connection with FINRA arbitrations because FINRA rules require payment of all awards within thirty days of issuance. FINRA members must certify in writing that an arbitration award was paid, and FINRA can sanction a member that fails to pay an arbitration award. In this regard, UBS notes that the SEC approved FINRA's arbitration rules as adequate to protect securities customers such as plaintiffs.

All parties agree that plaintiffs are bound by Rule 12209; the only question is what judicial proceedings does Rule 12209 prohibit. While the court viewed UBS's position as plausible, the Court rejected it, for several reasons.

First, in the Second Circuit, courts have historically entertained requests for provisional remedies during the pendency of arbitrations and have viewed the judicial consideration of such requests as consistent with, and not contrary to, the spirit of the Federal Arbitration Act and a party's right to submit a dispute to arbitrators and not courts.

Despite the seemingly broad language of Rule 12209, there is no indication whatsoever that the rule was intended, as UBS contends, to "prohibit judicial proceedings concerning matters pending in arbitration." Nowhere in any of the explanatory materials regarding customer arbitrations published by FINRA-and there is an abundance of such materials from lengthy lists of Frequently Asked Questions to Arbitration Guides-does FINRA ever say that Rule 12209 bars all judicial proceedings while an arbitration is pending, let alone that the intent of Rule 12209 is to prevent customers from invoking the historic powers of courts to provide provisional remedies in aid of arbitration. Nor did FINRA when it amended Rule 12209 explain that the purpose of the rule is to prevent customers from seeking prejudgment remedies. Indeed, as UBS acknowledges, FINRA has never explained what judicial proceedings Rule 12209 is intended to prohibit.

Rule 12209 and its predecessor have not been construed by courts as barring any judicial proceeding while an arbitration is pending. UBS conceded that a party could go to court to compel a recalcitrant party to participate in a FINRA-commenced arbitration.

Rule 12209 can be construed in a way that allows courts to consider awarding the provisional remedies they have historically provided in aid of arbitration and still give meaning to the rule's language. Additionally, Rule 12209 can be construed to bar parties from submitting to courts the same "matters raised in the arbitration."

Fourth and finally, UBS's arguments about the need for provisional remedies in securities arbitrations and the role of the SEC might be sufficient to cause FINRA to adopt a rule that bars such relief. However, it was far from clear that provisional remedies are completely unnecessary in securities arbitrations.

While UBS undoubtedly has sufficient assets to respond to any arbitration award in this case, that is not necessarily true of every member broker. Not every member participant in FINRA arbitrations has the resources of UBS. Moreover, one only has to recall what happened recently with Bear Stearns to understand why some customers might like to have the security of knowing that if they prevail in arbitration, assets will be available to satisfy any award.

The court denied UBS's motion to dismiss, but did not (in this opinion) address whether it would grant plaintiff's request for provisional remedies.

The Six Year Rule: Its Effect On Subsequent Litigation

Griffin v. Goldman, Sachs & Co.
(S.D.N.Y. 9/23/2008) 2008 WL 4386768

The fact that arbitrators dismissed an arbitration under FINRA's six-year rule did not

create judicial rights and remedies where such rights did not previously exist; where the court had previously ordered the parties to arbitration, the parties could not return to court after the arbitration had been dismissed.

Plaintiff, a former public customer of defendant, had filed a statement of claim in FINRA Dispute Resolution. Plaintiff alleged common law and statutory fraud, breach of contract, and breach of fiduciary duties against Defendants. Defendants then sought a permanent stay of the arbitration in New York state court, arguing that plaintiff's claims were untimely under New York law. Plaintiff, in turn, removed the action to federal court on diversity grounds.

The federal court decided that whether plaintiff's claims were timely under the New York statute of limitations was to be decided in arbitration, and not by the courts. On that basis, the court denied Defendants' motion for a permanent stay of arbitration and granted plaintiff's motion to dismiss the proceeding, referring the parties to arbitration to determine whether plaintiff's claims were timely filed.

After returning to arbitration, the arbitrators decided that plaintiff’s claims were ineligible for FINRA arbitration pursuant to the “six year rule”. The Chair of the arbitration panel expressly stated that the Panel's ruling was without prejudice and that the matter could be pursued by Plaintiff Griffin in court.

Plaintiff then sought to reopen her case in federal court. The court, however, granted defendants’ motion to dismiss plaintiff’s court case, on the grounds that the court had already determined that plaintiff’s exclusive remedy was in arbitration.

As the court reasoned, in holding that the statute of limitations question was within the scope of the parties' arbitration agreement, the court necessarily decided that a valid and enforceable arbitration agreement applies to the parties' controversy. In other words, the court must have first recognized that the parties were bound by an agreement to arbitrate before considering whether the statute of limitations question was encompassed within that agreement's scope.

At that point in the proceeding, plaintiff had an opportunity to contest the court's determination that the parties were bound by the arbitration agreement. Notably, rather that contesting that such an obligation existed, plaintiff consistently sought to enforce the parties' obligation to arbitrate, until plaintiff received an adverse ruling from the arbitrators.

Plaintiff argued to the court that because her arbitration claims were dismissed, FINRA Rule 10304(b) now permitted her claims to be heard in court. The court agreed that a claim dismissed under FINRA's 6-year rule is not necessarily time-barred under the applicable jurisdiction's statute of limitations.

However, according to the court, Rule 10304(b) does not create judicial rights and remedies where they did not exist before. Rather, its purpose is to make clear that it leaves any existing judicial rights and remedies intact. But the court had already decided that the Agreement provides for an arbitral, not a judicial, remedy. A dismissal of an arbitration under FINRA's 6-year rule does not alter plaintiff's judicial rights and remedies. It does not create a right to a judicial resolution when the court previously determined that such a right did not exist.

In other words, plaintiff's unsuccessful pursuit of her claims in an arbitral forum did not relinquish the contractual obligation to arbitrate.

The court noted that plaintiff was not without a remedy. Pursuant to the Agreement, Plaintiff, at her election, had the right to choose among the arbitral forums identified in the agreement. In her initial attempt to arbitrate, plaintiff chose to pursue her claims in FINRA Dispute Resolution, which abides by a rather strict 6-year time limitation for

submission. Plaintiff would have been well-advised to file her claims in a forum that does not impose such a rule, such as the American Arbitration Association or the Municipal Securities Rulemaking Board. That right remained intact, according to the court.

Filing Fees Do Not Cap Amount of Damages

Carroll v. Ferro
(N.C.App. 9/2/2008) 665 S.E.2d 594

Where an arbitration provider has a fee schedule which varies depending upon the amount of damages claimed, paying a filing fee for a certain amount of claimed damages does not cap the amount of damages an arbitrator could award.

In this non-securities case, the plaintiff filed an arbitration claim against the defendant at the AAA. Plaintiff paid a filing fee which under AAA rules is the fee applicable for a claim under $1,000,000. Plaintiff later submitted a letter to the arbitrator estimating the total amount of his claim. A few days before the arbitration hearing, the arbitrator sent a letter informing the parties that the administrative fees for the case limited the parties' recovery. Ultimately, however, the arbitrator awarded plaintiff a much larger amount.

Defendant sought to modify or vacate the arbitration award, arguing that the parties agreed to cap the award, and therefore the award in excess of that amount was an award on a matter not submitted. Defendants' argument was based on the AAA's requirement of a non-refundable initial filing fee when a claim is filed. These administrative fees are billed in accordance to a schedule which requires higher fees for claims above certain amounts.

The court held that the fee schedule was not an unequivocal limit on the parties' damages. Neither the contract requiring arbitration nor the AAA rules specify that recovery would be capped based upon submission of an initial filing fee. Further, since the arbitrator had the authority to construe the AAA rules to allow the award to exceed $1,000,000, the court held that the arbitrator did not "award on a matter not submitted to him".

Arbitrator Selection Process Insufficient To Show Bias

Jonas v. Deutsche Bank Securities
(Mass. Super., 9/13/2008) 2008 WL 4368235

Even if rendering an award in favor of a public customer means that the arbitrator would not be selected in future FINRA arbitrations, that still was insufficient to show bias sufficient to warrant vacatur of an arbitration award; further, the arbitrators' plain ignorance of the law, even if true, also did not warrant vacatur.

In this matter, a panel of three FINRA arbitrators dismissed the claims brought by the plaintiff Susannah Jonas against the defendant Deutsche Bank Securities. Jonas had sought recovery of the roughly $174,000 she had invested through her IRA account at Deutsche Bank in Collegeclub.com. She alleged that the Deutsche Bank broker who had sold her this stock, Jody Nachman, had made misrepresentations to her and that the investment was not suitable for her financial needs and objectives in an IRA account.

In seeking to vacate the award, Jonas contended that FINRA arbitrators recognized that awards favoring customers will cause securities dealers to strike them from future lists or to rank them poorly, resulting in their being chosen less often to serve as arbitrators. Since arbitrations can prove lucrative for arbitrators, Jonas contends that this selection process inherently encourages arbitrators to favor securities dealers, so that the securities dealers will then rank them highly in future cases.

Implicit in this argument is that securities dealers keep better tabs on the decisions of arbitrators than do customers (or, more precisely, the attorneys representing customers in these arbitrations), an

assumption of which the court was dubious. Even if this implicit assumption were true and even if it resulted in arbitrators worrying about the effect a large customer award may have on their future as an arbitrator, this risk would still fall far short of the bias required under the Act to vacate an arbitration award-"evident partiality." The court also noted that at the arbitration hearing, Jonas declared that she was content with the arbitrators selected.

Jonas also contended that the arbitrators conducted the hearing in a manner as to substantially prejudice her rights, by refusing to accept the copies of cases her attorney sought to give to the arbitrators in support of her legal arguments regarding the interpretation of the New Hampshire Uniform Securities Act.

Prior to the closing of the record in the arbitration, Jonas's counsel sought to offer as evidence these cases. Deutsche Bank's counsel objected, and correctly stated that the proper course under NASD procedure was for the claimant to submit a brief and for the respondent to submit a brief in opposition. The arbitrators stated that they did not need the cases or the briefs.

The court held that since the arbitrators' clear errors of law are insufficient to vacate the Award, their plain ignorance of the law, even if proven, would also be insufficient.

Post-Hearing Submissions To The Arbitrators

SR-FINRA-2008-005
73 Fed. Reg. 60738 (10/14/2008); FINRA Regulatory Notice 08-62

The SEC has approved a proposed FINRA rule limiting submissions that parties can make to arbitrators after the arbitrators have rendered an award or where the case has otherwise been closed.

Under the new rules, parties may not submit documents to arbitrators in cases that have been closed except under the following limited circumstances: 1) as ordered by a court; 2) at the request of any party within 10 days of service of an award or notice that a matter has been closed, for typographical or computational errors, or mistakes in the description of any person or property referred to in the award; or 3) if all parties agree and submit documents within 10 days of service of an award or notice that a matter has been closed.

The new rules, effective November 24, 2008, are codified as Rule 12905 of the Code of Arbitration Procedure for Customer Disputes and Rule 13905 of the Code of Arbitration Procedure for Industry Disputes (the Codes).

1 Exchange Act Release No. 58739 (October 6, 2008), 73 Federal Register 60738 (October 14, 2008) (File No. SR-FINRA-2008-005).

Motion to Amend Answer & Allocation of Damages

Joseph Stevens & Co., Inc. v. Cikanek
(N.D. Ill. 7/9/2008) 2008 WL 2705445

Arbitrators' failure to allocate an award between the trustee as an individual and the trust of which he was the trustee is not grounds for vacating the award, nor is the arbitrators' failure to grant a motion to amend an answer grounds for vacatur.

In this matter, a brokerage firm (Joseph Stevens) sought to vacate an adverse FINRA arbitration award, rendered in favor of an individual customer and the trust for which the individual was the grantor and the trustee. Among other grounds, Joseph Stevens asserted that the arbitration panel failed to consider its motion to amend its answer to include defenses to the claims by the trust. In support of this argument, Joseph Stevens cites Federal Rule of Civil Procedure 15(a), which mandates that leave to amend "shall be freely given when justice so requires."

The fact that the arbitration panel did not expressly address - and thereby implicitly

deny - Joseph Stevens' motion did not provide a ground for vacatur. The record supported a finding that Joseph Stevens had sufficient notice in the initial Statement of Claim that the trust was, in fact, a party to the proceedings. Joseph Stevens, therefore, had the opportunity to include any counterclaims or cross-claims related to the trust in its original answer. Joseph Stevens could also have moved to amend its answer at any time between when it filed the original answer, and when the hearing began. During this eight-month period, Joseph Stevens freely produced documents related solely to the Trust Account at the request of the individual customer.

Joseph Stevens further alleged that the chairman of the arbitration panel improperly failed to consult with a majority of the panel by choosing to ignore the motion to amend. An NASD rule requires that "all rulings and determinations of the panel be by a majority of the arbitrators."

There was no evidence, however, that a majority of the panel felt that the motion should be explicitly considered or decided, and no violation of this rule could have occurred unless that was the case. The panel's silence as to the motion reinforces that the arbitrators did not accept Joseph Stevens's argument. Under 9 U.S.C. § 10, the alleged actions of the chairman do not warrant vacatur.

Joseph Stevens also argued that it would be improper to award the trust's damages directly to the individual trustee. While this argument fails because the individual, as trustee, did have the right to personally collect any award of damages to the trust, it raised another issue. The award specified a single amount of damages to be awarded to the individual. It is unclear how much of this award was meant for the trust and how much was designated for the individual in his individual capacity.

This, however, was not a problem. The individual is bound, as trustee, to act in the best interest of the grantor and beneficiaries to the trust. It is thus his duty to allocate the proper amount of the award to the trust. If the beneficiaries feel that he has failed to do so, they may bring a separate action against him for breach of fiduciary duty.

After The Arbitration

Expungement

Karsner v. Lothian
(C.A.D.C. 7/15/2008) 532 F.3d 876

An expungement recommendation in a FINRA arbitration award may not be a confirmable award subject to the FAA's perfunctory standards for confirming an award.

The Maryland Securities Commissioner sought to intervene as of right in an arbitration confirmation proceeding. In the underlying arbitration brought by a former customer against Karsner (and others), the parties reached a settlement agreement which included a stipulation for expungement of the claim from the records of the CRD. The CRD is a database of certain events regarding stockbrokers, including arbitrations brought by customers, which is owned by NASAA and the various states, but is managed by FINRA.

Pursuant to the settlement agreement in the underlying arbitration, the arbitrators had recommended in their arbitration award that the customer complaint and the ensuing arbitration be expunged. (The broker, Karsner, had over 20 other stipulated expungement recommendations in other awards arising out of customer complaints.) When the broker brought an action to confirm this arbitration award (which included the expungement recommendation), the Maryland Securities Commissioner sought to intervene. The district court denied the motion to intervene and confirmed the arbitration award including the expungement recommendation; the court of appeals reversed.

The court agreed that the Commissioner had a substantial interest in ensuring the integrity of the CRD records.

The court held that the Commissioner had satisfied all four prerequisites to intervene as of right, which are: (1) the application to intervene must be timely; (2) the applicant must demonstrate a legally protected interest in the action; (3) the action must threaten to impair that interest; and (4) no party to the action can be an adequate representative of the applicant's interests.

The Commissioner's satisfaction of the second, third and fourth factors was straightforward: the second factor because Maryland has a recognized property interest in the CRD (pursuant to the agreement between NASAA and NASD and Maryland law); the third factor because the action threatened to alter the CRD by expunging information about Karsner; and the fourth factor because neither Karsner nor the public customer who had settled with Karsner represented the Commissioner's interest in protecting the integrity of the CRD. The court also concluded that the Commissioner's motion to intervene was timely, satisfying the first factor.

The court then instructed the district court that if the Commissioner successfully moves to void the district court's confirmation order on remand, the district court may not subsequently grant expungement relief to the broker without identifying a source of authority-other than section 9 of the FAA-giving it the power to do so. Rule 2130(a) requires a broker-dealer member of FINRA (like Karsner) to "obtain an order from a court of a competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief." NASD Rule 2130(a) (emphases added).

Regarding the confirmation of an arbitration award "containing expungement relief," the court concluded that a mere recommendation of expungement relief was insufficient. Instead, the arbitration award must direct expungement. And if the NASD member asks the court itself to "direct" expungement, Rule 2130(b) requires that NASD be named as a party unless NASD waives the requirement upon certain "affirmative judicial ... findings." NASD Rule 2130(b).

The court also noted that although the NASD Rules require SEC approval, the Rules do not come within the meaning of the Securities Exchange Act (15 U.S.C. § 78aa), which gives a federal court "exclusive jurisdiction of violations" of rules and regulations promulgated under the SEA.

Expungement

In re Johnson (Summit Equities, Inc.)
(N.Y.Sup. 10/2/2008) 864 N.Y.S.2d 873, 2008 WL 4456935

An arbitration award recommending expungement of a broker's CRD record must contain specific affirmative factual findings justifying the expungement recommendations, along with the portions of the record on which those findings are based, before the award can be confirmed.

After permitting the New York Attorney General to intervene in two proceedings seeking confirmation of two arbitration awards recommending expungement, the court in this matter provided an extensive review of the CRD, its role in the securities industry, and the history of NASD rules on expungement, and its interplay with the standards for confirming arbitration awards under state and federal arbitration law. The court declined to confirm the awards, on the grounds that the awards did not contain sufficient affirmative factual findings regarding the expungement recommendations.

The court began its analysis with the principle that statutes or regulations applicable to a particular field may establish additional requirements to be met by arbitrators in rendering their awards, which in turn creates additional grounds for modification or vacatur of the arbitration award. The court concluded

that NASD expungement rules constituted such additional requirements.

The Rule and its accompanying expungement scheme are founded on the policy of the NASD that expungement of customer complaints constitutes "extraordinary relief," to be granted only in limited circumstances. Under the newly defined grounds for expungement, arbitrators may only grant expungement relief when the case falls within one of these three categories. These changes, along with the new affirmative findings standard, require the court to independently scrutinize requests for expungement relief before confirming these portions of arbitration awards.

The SEC and NASD expected courts to play an active role in examining the record to ensure that only appropriate cases be approved for expungement. When the NASD imposed these limitations on expungement relief, they placed enhanced reliance on the reviewing courts to make sure those only appropriate cases, which "[meet] one of the three criteria" are approved for expungement.

A court's review of an expungement award requires a careful balancing of the deferential standard usually applicable to the review of arbitration awards with the more exacting review arising out of NASD policy strictly limiting expungements. Confirmation of an arbitral expungement award is proper only when the court is satisfied that the arbitrator's award has met the standards of the new regulatory scheme; vacatur is only appropriate in conformity with the standards discussed above.

Simply repeating the language from Rule 2130 in the award cannot be considered a finding which is “affirmative.” In the absence of any reference at all to the specific facts of the case, the determination is devoid of any affirmative factual finding. Only statements which contain evidentiary facts and demonstrate that the circumstances of Rule 2130(b)(1) exist in the particular case constitute factual findings that support the conclusions represented by the Rule's standards.

The general principles requiring confirmation of arbitration awards were inapplicable to these awards, because the court was entirely unable to infer the arbitrators' affirmative findings from their awards or other pronouncements in the proceedings. Furthermore, the ability of state regulators, as well as NASD officials, to assess the need for their involvement in the proceeding is similarly undermined where affirmative factual findings were not made.

The court specifically rejected the dictum in *Karsner* that an expungement “recommendation” could not be confirmed under the Federal Arbitration Act. The court here concluded that the *Karsner* approach disregards both the language of the Rule and its intent as revealed in its drafting history. Moreover, according to this court, the interpretation of the expungement rules advanced by the NASD is entitled to deference, because the issue involves the agency's interpretation of its own rule.

As the arbitrators in both proceedings failed to make affirmative factual findings to support their awards of expungement relief and the parties did not furnish record support for such relief, the court concluded that it had insufficient information to enable it to complete the review required by Rule 2130. Accordingly, the court remanded the cases to the original FINRA Dispute Resolution arbitrators, with a direction to provide amended awards containing specific affirmative factual findings justifying the expungement recommendations, along with the portions of the record on which those findings are based, in sufficient detail to enable the court to conduct a meaningful, albeit limited, judicial review as required by Rule 2130.

Challenging/Confirming Arbitration Awards

Scope of Review

Cable Connection, Inc. v. DIRECTV, Inc. (Cal. 8/25/2008) 44 Cal.4th 1334, 190 P.3d 586

The FAA's prohibition on contractually expanding the scope of judicial review of arbitration awards did not preempt state arbitration law, which permits parties to limit arbitrators' authority to deciding disputes only in accordance with law and providing for judicial review of arbitrators' error of law.

In this matter, the California Supreme Court held that, under California law, parties can contractually limit the power of arbitrators so that the arbitrators can only render decisions that are "in accordance with law", thereby enabling the courts to review those decisions for errors of law. The parties in this case had an arbitration agreement that provided, "[t]he arbitrators shall not have the power to commit errors of law or legal reasoning, and the award may be vacated or corrected on appeal to a court of competent jurisdiction for any such error." The California Supreme Court concluded that this contract provision is enforceable under state law.

Preliminarily, the court rejected the idea that *Hall Street Associates, L.L.C. v. Mattel, Inc.* (2008) --- U.S. ----, 128 S.Ct. 1396, 1404-1405, declared a policy with preemptive effect in all cases involving interstate commerce. Instead, the Supreme Court reviewed the application of FAA provisions for judicial review that speak only to the federal courts. The Court unanimously left open other avenues for judicial review, including those provided by state statutory or common law. Had the majority meant to impose a uniform national policy requiring judicial review solely on the grounds stated in the FAA, it would not have left open the possibility of trial court review under its "case management authority independent of the FAA." Nor did *Hall Street* address whether the FAA provision for vacatur "where the arbitrators exceeded their powers" is applicable when the agreement specifically limits the arbitrators' powers by providing for an award governed by law and reviewable for legal error. Furthermore, a reading of California's arbitration law that permits the enforcement of arbitration agreements for merits review is fully consistent with the FAA's policy guaranteeing the enforcement of private contractual arrangements.

Turning to California law, the court concluded, based on its prior cases, that contractual limitations in an arbitration agreement may alter the usual scope of review of arbitration awards. If the parties constrain the arbitrators' authority by requiring a dispute to be decided according to the rule of law, and make plain their intention that the award is reviewable for legal error, the general rule of limited review has been displaced by the parties' agreement. Their expectation is not that the result of the arbitration will be final and conclusive, but rather that it will be reviewed on the merits at the request of either party. That expectation has a foundation in the statutes governing judicial review, which include the ground that "[t]he arbitrators exceeded their powers."

The court reviewed prior California case law on arbitration, stating that the court has consistently recognized that an exception to the general rule assigning broad powers to the arbitrators arises when the parties have, in either the contract or an agreed submission to arbitration, explicitly and unambiguously limited those powers.

The policy favoring arbitration without the complications of traditional judicial review is based on the parties' expectations as embodied in their agreement, and California's Arbitration Act rests on the same foundation. Accordingly, policies favoring the efficiency of private arbitration as a means of dispute resolution must sometimes yield to its fundamentally contractual nature, and to the attendant requirement that arbitration shall proceed as the parties themselves have

agreed. The scope of judicial review is not invariably limited by statute; rather, the parties, simply by agreeing to arbitrate, are deemed to accept limited judicial review by implication. It follows that they may expressly agree to accept a broader scope of review.

However, to take themselves out of the general rule that the merits of the award are not subject to judicial review, the parties must clearly agree that legal errors are an excess of arbitral authority that is reviewable by the courts.

Arbitration provisions calling for review of the merits have also been condemned as attempts to create jurisdiction where none exists. But the California Arbitration Act authorizes review on the ground that an award exceeds the arbitrators' powers. Because those powers are circumscribed by the terms of the parties' agreement, there is no jurisdictional impediment to contracts limiting the arbitrators' authority by subjecting their award to correction for legal error.

The court also addressed a concern that arbitration is so different from judicial proceedings that courts would be unable to adequately review the substance of arbitrators' decisions. There is a ready solution to that problem, in the familiar rule that the decision under review is presumed correct on matters where the record is silent.

The judicial system reaps little benefit from forcing parties to choose between the risk of an erroneous arbitration award and the burden of litigating their dispute entirely in court. Incorporating traditional judicial review by express agreement preserves the utility of arbitration as a way to obtain expert factual determinations without delay, while allowing the parties to protect themselves from perhaps the weakest aspect of the arbitral process, its handling of disputed rules of law.

Vacatur: Failure to Follow FINRA Rules

Kashner Davidson Securities Corp. v. Mscisz
(1st Cir. 6/27/2008) 531 F.3d 68

An arbitration panel's failure to follow FINRA rules may be a sufficient basis for vacating an arbitration award under the "manifest disregard of the law" standard for vacatur.

In the underlying arbitration between the parties, an NASD arbitration panel dismissed several of Mscisz's counter-claims against Kashner Davidson Securities Corp. and third-party claims against Kashner, Meister, and Varchetto. The Panel first stated in the presence of the parties that its decision to dismiss these claims involved consideration of the merits. Then, after recessing for a brief executive session, the Panel announced that the dismissal was a sanction pursuant to NASD Code Rule 10305. After the dismissal, the Panel took evidence on the remaining claims and entered an arbitration award in favor of Kashner.

After carefully reviewing the provisions of the NASD Code (the "Code"), which were incorporated into the parties' arbitration agreement, and the Panel's explanation of its decision, the court concluded that the Panel manifestly disregarded the law by dismissing Mscisz' counterclaims and third-party claims as a sanction in contravention of the explicit terms of the Code, which specify that such a sanction can be entered only after lesser sanctions have been imposed and have proven ineffective.

Mscisz claims that the Panel acted in manifest disregard of the law by inappropriately relying on NASD Rule 10305, which specifies that claims can be dismissed with prejudice as a sanction only if lesser sanctions have failed to achieve the compliance the panel seeks.

Although the first element under rule 10305 was arguably satisfied here because the Panel could have concluded that the appellants willfully and materially failed to comply with an order, the second element

was not met. The Panel had not previously imposed lesser sanctions on the appellant and therefore had not demonstrated that sanctions short of a dismissal were ineffective. Indeed, only weeks before the claims were dismissed in March, the Chairman of the Panel expressly denied the appellees' requests for sanctions. It is clear, therefore, that the unambiguous language of the Rule was disregarded.

The court went on to conclude that the arbitrator's misapplication of the clear language of the rule could only be deemed an intentional and willful disregard of the law. The court reasoned that the NASD rules became part and parcel of the arbitration contract between the parties, serving as the procedural rules governing the arbitration proceeding. Thus, if the arbitrators disregarded the plain and unambiguous language of the governing arbitration agreement by disregarding the plain and unambiguous language of the NASD rules, the arbitrators acted in manifest disregard of the law and the award failed to draw from the essence of the arbitration agreement.

The brokerage firm contended that the Panel could not have acted in manifest disregard of the law because the NASD Code is a set of private dispute resolution rules, not a body of law. In rejecting that argument, the court stated that the NASD rules became part and parcel of the arbitration contract, serving as the procedural rules governing the arbitration proceeding. Thus, if the Panel disregarded the plain and unambiguous language of the governing arbitration agreement, it acted in manifest disregard of the law and failed to draw its award from the essence of the agreement.

The court also specifically rejected the broker's contention that Rule 10324 gave the arbitrators broad authority to interpret NASD rules. The court stated that with "respect to the authority to interpret [under rule 10324], the Panel's disregard of the unambiguous text of a Code provision cannot be deemed a mere interpretation. To find otherwise and expand the concept of 'interpretation' to include the Panel's dismissal decision in this case would be tantamount to giving NASD arbitration panels a blank check to dismiss claims with prejudice in contravention of an explicit provision of the Code. Our deference to the decisions of arbitrators does not extend that far."

Vacatur: Statutes of Limitation Do Not Apply In Arbitration

Broom v Morgan Stanley
(Wash App. 9/2/2008) 2008 WL 4053440

State statutes of limitations do not apply in FINRA arbitrations; an arbitration award dismissing a claim on statute of limitations grounds was properly vacated under the "error of law" standard applicable in Washington state.

In this action for alleged mismanagement of an investment account, an NASD arbitration panel dismissed virtually all claims against the investment firm and its agent as untimely under state statutes of limitations. The superior court vacated the award, ruling that statutes of limitations do not bar the pursuit of claims in arbitration. Because the superior court correctly interpreted Washington law, and because the rules governing the parties' arbitration proceeding did not allow the arbitrators to apply statutes of limitations that were not applicable to those proceedings, the court affirmed the superior court's judgment.

Preliminarily, the court rejected Morgan Stanley's argument that the FAA provided the standards for vacatur of an NASD arbitration award. The court held that Morgan Stanley waived that argument by not raising it earlier, as it is an affirmative defense.

The court then applied the "error of law" standard under Washington law, for reviewing private arbitration awards. Applying that standard, the court held that Washington statutes of limitations do not bar claims in arbitration proceedings, and the arbitrators committed an error of law by applying those

statutes of limitations in dismissing claimant's arbitration.

The court rejected Morgan Stanley's contention that NASD Code section 10304, and in particular the language, "This Rule shall not extend applicable statutes of limitations", authorized the arbitrators to apply state statutes of limitations in the arbitration proceedings. According to the court, nothing in section 10304 can reasonably be read as authorizing arbitrators to apply statutes of limitations that, by their express terms, do not apply to arbitration proceedings. In fact, the subsequent history of the section suggests that it is simply a warning that the six-year limit for arbitrations does not extend "applicable statutes of limitation" in court actions.

Even assuming that this rule addresses the arbitrators' authority, it does not confer authority to apply statutes of limitations that are not "applicable." A statute is "applicable" either by virtue of the substantive law applied, in this case Washington law, or the arbitration agreement. Neither basis for applying the relevant statutes of limitations was established in this case. The court concluded, therefore, that section 10304 did not authorize the arbitrators to apply statutes of limitations to the claims before them, and that the superior court properly vacated the arbitrators' decision under Washington's error of law standard for reviewing arbitration awards.

Vacatur: Exclusion of Evidence

Householder Group v. Caughran
(E.D. Tex. 9/17/2008) --- F.Supp.2d ----, 2008 WL 4254586

FINRA rules do not obligate arbitrators to enter the default of a party who fails to timely answer a statement of claim; and where a witness testifies live at a hearing, the exclusion of prior tape recorded testimony of that witness is not sufficient grounds to vacate an award.

In the arbitration underlying this motion to confirm, an employee of SunAmerica executed a forgivable, 5-year promissory note with SunAmerica Securities, Inc. Caughran (the employee) was terminated by SunAmerica within the 5 year period. SunAmerica submitted its claim for the outstanding balance owed on the promissory note to arbitration with the NASD. SunAmerica's claim ultimately was assigned to The Householder Group ("Householder").

Caughran asserted counter-claims against Householder, which Householder did not timely answer. The arbitrators entered an award in favor of Householder and against Caughran.

In seeking to vacate the award, Caughran contended that the panel exceeded its powers by failing to grant his motion for a default judgment. Apparently, Caughran filed third-party claims against Householder. Caughran argued that since this third-party failed to timely file an answer to his claims under NASD rule 10314(e), he was entitled to the entry of a default judgment against Householder; the panel's failure to do so warranted vacatur of the award.

The court rejected this contention. The court concluded that NASD rules do not mandate the entry of a default judgment if an answer is not timely filed. The arbitration panel was not required by the NASD rules to enter a default judgment.

Caughran also contended that he was denied a fair hearing because he was not permitted to introduce into evidence certain tape recorded conversations and the transcripts thereof, a recording which Caughran insists revealed that one of the cross-respondents committed perjury. However, that person testified live at the arbitration hearing; accordingly, Caughran could have cross-examined that individual about any alleged perjury at the arbitration hearing.
The court confirmed the arbitration award against Caughran.

Vacatur: Public Policy

Legacy Trading Co., Ltd. v. Hoffman
(W.D. Okla. 8/18/2008) 2008 WL 3876034

FINRA arbitrators' failure to decide a motion to dismiss is not grounds for vacating an award; and an award against a member firm and its non-member holding company could not be vacated on public policy grounds.

In this matter, a former employee of Legacy moved to confirm an NASD arbitration award in his favor. The employee asserted causes of action for breach of his employment contract and for the non-receipt of commissions and other compensatory damages.

Among other things, Legacy had argued to the arbitrators that it was a holding company for another company. The other company was a NASD member firm, whereas the holding company was not. According to Legacy, the employee was employed by the holding company, not by the broker-dealer NASD member firm.

The court rejected Legacy's opposition to confirmation. Among other arguments, Legacy contended that the arbitrators' award violated public policy, in that the award effectively created a contractual obligation between the employee and the Broker/Dealer when no such contract existed. The court held that Legacy did not establish a public policy violation sufficient to overturn the arbitrators' award, because the arbitration panel's decision in favor of the employee did not violate a clearly expressed law.

Turning to the question of the panel's failure to decide Legacy's motion to dismiss, failure to decide a motion to dismiss is not grounds for vacatur, the court concluded. Legacy had an opportunity to fully brief the motion to dismiss, and there is no indication that the arbitration panel violated clearly expressed law during the arbitration proceeding. Furthermore, arbitration is an alternative forum governed to a large extent by its own principles, and not limited by the rules of evidence, the rules of law, or even the canons of construction in the reading of documents. In handling an arbitration proceeding, an arbitrator need not follow all the niceties observed by federal courts.

Therefore, given the inherent fact that arbitration proceedings are more informal and designed to be expedited, the Court concluded that even if the panel did not rule on Legacy's motion to dismiss, that is not a proper basis to vacate an arbitration award as a violation of public policy.

Collecting The Award: Insurance Coverage

In re SRC Holding Corp.
(8th Cir. 10/27/2008) 545 F.3d 661

A brokerage firm's insurance policy's exclusion of claims arising out of violations of federal and state securities laws also excluded coverage for claims alleging violations of FINRA/NASD rules.

This action by a bankruptcy trustee for coverage under an insurance policy issued to the debtor (a brokerage firm) arose out of the brokerage firm's underwriting and sale of certain bonds to investors. The brokerage firm, Miller & Schroeder ("M & S"), underwrote $140,000,000 worth of Heritage Bonds, and M & S brokers in California sold the bonds in twelve municipal offerings. All of these bonds were eventually defaulted upon. Purchasers of the Heritage Bonds initiated lawsuits and arbitration proceedings against M & S, M & S brokers, and M & S directors and officers.

The bond purchasers in these cases alleged wide-ranging theories of liability, including violations of federal securities laws, state securities laws, the common law, and the rules and regulations governing members of the National Association of Securities Dealers (NASD). Some of these claims allege that M & S directors and officers were directly involved in illegal securities transactions,

while others name M & S directors as defendants solely because they were directors and officers exercising general authority over M & S's involvement in the Heritage Bond transactions.

M&S's "D&O" insurance carrier denied coverage of those claims. After defending and losing the Heritage Bond cases, M&S filed for bankruptcy. The bankruptcy trustee asserted that M&S's D&O policy covered the Heritage Bond claims. The bankruptcy court and the district court agreed; the court of appeals reversed.

The court of appeal held that the insurance policy contained a broad exclusion that excluded these claims from coverage. The exclusion precluded coverage for claims that alleged actual violations of the enumerated federal and state securities laws, and it also precluded coverage of "any Claim based on, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving any actual or alleged violation of" those laws.

Notwithstanding the unqualified plain language of the exclusion, the bankruptcy court concluded that this provision only "excludes covered actions taken in connection with the sale of Miller & Schroeder securities but not otherwise." The district court adopted the same qualified and restricted interpretation of the exclusion. Both courts relied, in part, on the deposition testimony of the insurance broker who sold the policy, who testified that this standard-form securities exclusion is typically intended to exclude coverage for liability resulting from the insured's sale of its own stock.

The court of appeals held that both lower courts erred by relying on extrinsic evidence of the parties' intent in order to create an ambiguity in the exclusion.

Instead, the plain policy language was clear, that if the same set of operative facts underlies both the federal-and state-law securities violations and the alleged violations of other, unenumerated legal authority, such as the NASD rules, the broad, plain language of the exclusion excludes coverage for all of those violations.

The bond purchasers in the underlying litigation alleged that M & S and its directors and officers engaged in misconduct and wrongful acts in conjunction with the underwriting and sale of the Heritage bonds. Because each of the allegations of NASD rule violations relies on the same set of facts and alleged wrongful acts which underlie the securities law violation allegations, the NASD allegations stand on and share the same factual foundation and were, in the court's view, well within the "arising out of" exclusionary language of the policy.

The court concluded, "Boiled down, the Trustee's and the Intervenors' attempts to turn this D & O policy into one providing E & O coverage fail."

Public Investors Arbitration Bar Association

June 26, 2008

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2008-019
Rule Proposal Regarding Standards and Supervisory Requirements for Deferred Variable Annuities

Dear Ms. Harmon:

Thank you for the opportunity to comment on the above-referenced proposal to amend NASD Rule 2821 regarding sales practice standards and supervisory requirements for transactions in deferred variable annuities. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA respectfully requests that the SEC reject the proposed rule.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules relating to the supervision of the sale of deferred variable annuities, due to their extremely large annual sales volume combined with widespread sales practice abuses, no doubt attributable to the high commissions paid on these products. We also note that the victims of these abuses are predominately senior citizens who have a particular need for the protections effective supervision can provide.

The Insurance Information Institute reported that as of December 31, 2007, the net assets invested in variable annuities amounted to $1.485 trillion and variable annuity sales for 2007 exceeded $160 billion.[1] It is quite clear that many American savers and investors have committed significant money to variable annuities, and it is of utmost importance that these products be closely scrutinized.

[1] *See* http://www.iii.org/media/facts/statsbyissue/annuities/.

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I. The Extensive Criticism of Variable Annuities Demonstrates that *Greater* Supervision of These Financial Products Is Needed

FINRA proposes to change Rule 2821 to reduce the supervision burden for broker-dealers selling deferred variable annuities. It appears that the main purpose of these changes is to lower costs, especially for broker-dealers that "offer low-priced alternatives and do not allow recommendations or use transaction-based compensation." However, based on the widespread criticism of variable annuities sales practices, including by FINRA, these products actually deserve ***more*** supervision, not less.

The North American Securities Administrators Association ("NASAA") has been highly critical of variable annuities. NASAA placed variable annuities on its list of the "Unlucky 13" investor traps[2] and often lists them in its annual Top Ten investment scams. In 2005, the California Department of Corporations placed these products at #2 for their "Dirty Dozen" investment scams.[3]

FINRA has expressed concerns about variable annuities numerous times throughout the last decade. For example, NASD Notice to Members 99-35 discusses the lack of liquidity of variable annuities due to their surrender charges for early withdrawals, and warns registered representatives about the unsuitability of these products for many investors.

NASD Notice to Members 00-44 also emphasized concern about variable annuity sales.

NASD Notice to Members 04-45 warned that variable annuities are complex investments and should not be sold to unsophisticated customers. This notice cataloged numerous disciplinary actions involving variable annuity sales abuses.

Other Notices to Members, including 96-86 and 07-43, alerted members and associated persons to be careful when recommending variable annuities to customers. The NASD's May 27, 2003 and March 2, 2006 Investor Alerts are further examples of the SRO's continuing concern with these products.

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[2] *See* http://www.nasaa.org/nasaa_newsroom/current_nasaa_headlines/4240.cfm (last visited June 12, 2008) (stating that "Variable annuities are only suitable for a very small percentage of the investing public and generally are not appropriate for most seniors").

[3] *See* http://www.corp.ca.gov/press/pdf/2005/nr0503.pdf (last visited June 12, 2008).

FINRA's repeated warnings to its members concerning problems in variable annuity sales have failed to curb the widespread abusive sales practices. As a result, FINRA recently adopted Rule 2821 imposing explicit and more stringent sales practice standards and supervisory requirements for these products. FINRA now seeks to relax the members' supervision of these products as required by Rule 2821. This is simply unacceptable.

II. Limiting the Application of Rule 2821 to "Recommended" Transactions Creates a Loophole for Brokers to Abuse the System

Rule 2821 as originally adopted applied to all deferred annuity purchases. The proposed amendment to NASD Rule 2821 would limit the rule's application to ***recommended*** annuity purchases and exchanges. Unsolicited variable annuity purchases would have very little supervision; indeed, under the proposed revisions there would be no principal review whatsoever.

An obvious threshold concern with FINRA's proposal is that a broker, seeking a large commission where suitability issues are present, may easily mark an order as non-recommended when in fact the transaction was recommended. FINRA recognized this flaw in its proposal.

The SEC release states that "FINRA emphasizes . . . that members must implement reasonable measures to detect and correct circumstances when brokers mischaracterize recommended transactions as non-recommended." Thus, FINRA acknowledged that a broker's simply mismarking the confirmations and orders as "not recommended" would allow these sales to pass with reduced supervision. This creates great potential for abuse, particularly since there would be no required principal review of the claimed non-recommended variable annuity transactions. For a financial product which has received so much criticism for unsuitable sales, misleading terms, commissions, and fees, the amendment provides too much room for abuse by brokers and gives them a loophole to bypass meaningful supervision, merely by designating a sale as "not recommended."

FINRA comments in the SEC release state the purpose of the rule is to keep costs low, especially for firms that offer low-priced alternatives. FINRA adds that the "vast majority of purchases and exchanges of deferred variable annuities" are recommended by the broker. If that is indeed true, then it should not be materially more expensive to supervise ***all*** – recommended and non-recommended – variable annuity transactions. Supervision of all transactions adds relatively low incremental cost.

FINRA states in its explanatory material that limiting principal review of variable annuity transactions to "recommended" transactions tracks with FINRA's general suitability obligation in Rule 2310. FINRA ignores that the "Know Your Customer" rule of NYSE Rule 405 imposes extensive supervision responsibilities without any limitation to "recommended" transactions. Furthermore, FINRA's reference to the general suitability obligation of Rule 2310 ignores the experiences of the past decade which have compelled stringent standards to address widespread variable annuity abuses and which have set these products apart from general securities.

PIABA believes FINRA rule proposals should place investor protection above the industry's objective for minimizing its supervisory burden. Accordingly, PIABA opposes any reduction in the coverage and scope of the suitability rules as they apply to deferred variable annuity transactions.

III. The Proposed Rule Affords No Protections Against Unsuitable Subaccount Reallocations

PIABA also emphasizes its concern that Rule 2821 as originally adopted applies only to "***initial***" subaccount allocations and that this provision is left unchanged in the proposed amendment. This leaves brokers free to make subsequent subaccount reallocations with little or no supervision. Changes in the allocation of the subaccounts of variable annuities (as well as additional deposits in the annuities) are just as important to investors as the initial allocation.[4] Some brokers make it a practice to reallocate the subaccounts quarterly or yearly. Allowing brokers to reallocate annuities without principal review is a recipe for disaster and is another example of compromising investor protection for the convenience of the brokerage industry.

Brokers have different incentives for making various subaccount allocations. For example, a broker may get higher fees or commissions for having a higher allocation of stocks or stock-based mutual funds than fixed income or cash investments. A broker can simply reallocate the variable annuity at any point after the initial purchase to create the most fees or commissions for himself or herself, and this would go completely unchecked. Under the proposed rule, the broker is free to ignore investor suitability determinations after the initial purchase.

While we recognize that the question of applying Rule 2821 supervisory standards to subaccounts was not addressed in the proposed rule, PIABA believes

[4] *See* Notice to Members 00-44.

that such a provision is essential to investor protection and that the amendment should be modified to include this provision.

IV. One of the Few Positive Changes to the Proposed Rule Is Weakened by the Supplementary Materials

PIABA supports the change to 2821(b)(1)(B)(iii). The current rule states when making suitability determinations for exchanges, the broker must take into consideration whether an exchange has been made in the customer's account within the last 36 months. The proposed rule deletes the word "account" from that section, effectively changing the rule to mandate the broker to consider whether the customer – in any account – had an exchange within the last 36 months. PIABA believes this is a positive step.

Unfortunately, this language is weakened by the Supplementary Materials. Under Supplementary Materials Section .05, the broker must determine whether the customer had any exchanges at the same brokerage firm, which should be accomplished rather easily. However, according to Section .05, the broker's "reasonable effort" in determining whether exchanges have been made at ***other*** brokerage firms is limited to asking the customer.

Many financially unsophisticated customers may not understand whether or not they have had exchanges. The broker will be relying on those who cannot always be expected to give accurate information about their exchanges. Although it is certainly commendable that brokers are required to document their inquiry and response from the customer under Section .05, the brokers' source of information may be too unreliable.

Conclusion

The proposed amendment to Rule 2821 is a regrettable attempt by FINRA to weaken the standard of supervision for variable annuities essential for investor protection. The importance of preserving the provisions of Rule 2821 as adopted is demonstrated by the pattern of industry abuse in marketing these investments. We therefore urge rejection of the proposal; however, we support the provision expanding the suitability consideration to exchanges in accounts other than the

account in which the purchase is made. We also support an amendment to Rule 2821 that would apply its supervisory standards to subaccount reallocations.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

s/Laurence S. Schultz
Laurence S. Schultz
President, 2007-2008

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Public Investors Arbitration Bar Association

June 13, 2008

VIA E-MAIL TO PUBCOM@FINRA.ORG

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1500

Re: FINRA Regulatory Notice No. 08-25
Proposed Consolidated FINRA Rules
Governing Books and Records Requirements

Dear Ms. Asquith:

The Public Investors Arbitration Bar Association ("PIABA") appreciates the opportunity to provide the Financial Industry Regulatory Authority with the following comments regarding the Proposed Consolidated FINRA Rules Governing Books and Records Requirements.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules which govern the arbitration process. We are particularly interested in the availability and accuracy of brokerage industry documents when disputes arise.

Proposed FINRA Rule 4512(a)(1)(C) would eliminate the requirement that the signature of the registered representative introducing the account be included on the customer account information. This rule change is simply a bad idea. Investor disputes often focus on information in new account documents. Questions arise in arbitration as to the authenticity and accuracy of new account documents and information. It therefore is important for firm procedures to assure that new account information is signed and dated by both the registered representative and the responsible manager. These verifications assist in confirming the validity of the new account information and ultimately will provide protection for the firm if the documents are challenged. Providing signatures on new account information imposes no significant burden on the registered representative or the manager who accepts the account. Signatures and dates of those responsible for these documents are an important element in assuring their authenticity.

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We are pleased to express our qualified support for Proposed FINRA Rule 4513. As a general proposition, PIABA favors longer, more reliable records retention. In general, we therefore support any rule which fosters that end. Requiring member firms to preserve customer complaint records for a period of at least four (4) years is an improvement to the current three-year retention rule.

However, our support for the current proposal is qualified because we prefer to see the record retention requirement extended to at least six (6) years. This six-year period would match the eligibility provisions for customer disputes contained in Rule 12206. It would also make the retention period for customer complaints consistent with the six-year period proposed for retention of customer account information.[1] In the age of electronic storage, there should be little argument over reasonably increasing the time periods for document retention. Whereas the document retention rules once posed a burden in terms of finding warehouse space, electronic storage space may be obtained efficiently.

We also believe that the proposed rule should include a provision that requires the industry to produce covered records, upon written request, to customers and former customers within a reasonable time at no charge.

Respectfully submitted,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

Laurence S. Schultz
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[1] *See* Proposed Rule 4512 Supplemental Material .01.

Public Investors Arbitration Bar Association

June 13, 2008

VIA E-MAIL TO PUBCOM@FINRA.ORG

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
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Washington, DC 20006-1500

Re: FINRA Regulatory Notice No. 08-24
Proposed Consolidated FINRA Rules
Governing Supervision and Supervisory Controls

Dear Ms. Asquith:

The Public Investors Arbitration Bar Association ("PIABA") appreciates the opportunity to provide the Financial Industry Regulatory Authority with comments regarding the Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls.

We recognize that the proposed rules will effect important substantive and structural changes in brokerage industry supervision and that any proposed rule will be subject to SEC publication for public comment. We therefore offer our comments with the acknowledgment that PIABA will submit additional and more detailed commentary at such time as the SEC publishes the proposals.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules which govern the arbitration process. We are also particularly interested in the rules which govern the conduct of securities firms and their representatives. These rules are in place primarily to protect the nation's investors and savers, as well as to provide a minimum industry standard upon which the public and regulators can rely.

The effort of FINRA to consolidate the rules of the NASD and the NYSE is worthwhile, and we support many of the proposals to streamline the rules and avoid the duplications of the past. However, some of these proposed rule changes go far beyond "consolidation," and create essential issues for the protection of the investing public.

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The concerns which we encourage FINRA to address prior to submission to the SEC involve areas that we perceive as important to a customer's ability to hold a broker-dealer and its associated persons responsible for improper conduct. We note that throughout the Proposed Rules there is a move away from specific rules and prescriptive provisions to a "more flexible approach to certain supervision requirements.[1]" Those of us who represent the investing public against members of the industry who violate the rules, know all too well the difficulty in proving a violation of a rule, a regulation, or a law without a clear statement of what that rule, regulation or law is. We are concerned that the term "flexible" appears to be a euphemism for "reduced" or "diminished" supervision requirements. We strenuously oppose any changes that reduce the protection of consumers or that will make proof of misconduct more difficult.

PIABA Is Opposed to "Principles-Based Regulation"

The proposed rule includes numerous references to "risk-based" review or examination. Recently there has been a great deal of discussion of "risk-based" review in the same breath as "principles based" regulation. These concepts have become popular in Europe and have recently been promoted by the Federal Reserve Chairman[2] and the Secretary of the Treasury[3], among others. To the extent that FINRA's use of the "risk-based" concept may signal a first step down the slippery slope of "principles based" rules and regulation, PIABA takes this opportunity to go on record as strongly opposing such a trend.

Given the accelerating pace of industry-wide scandals in recent years, it is our belief that more, rather than fewer, bright-line rules are needed. Unscrupulous members of the industry have had enough difficulty keeping their conduct in line with specific rules; one can hardly expect that their behavior would improve under a generic set of "principles." If the purpose of regulation is to protect the investing public, we do not see how a move toward less specificity will accomplish the purpose.

Moreover, "principles-based regulation" is entirely unsuitable and inappropriate for a self-regulatory organization like FINRA. We point out two primary reasons.

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[1] FINRA Regulatory Notice 08-24, p. 3.

[2] Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform, March 31, 2008, available at http://www.ustreas.gov/press/releases/hp897.htm.

[3] Ben S. Bernanke, "Regulation and Financial Innovation" (speech, Financial Markets Conference, Federal Reserve Bank of Atlanta, Sea Island, GA, May 15, 2007), available at www.federalreserve. gov/boarddocs/Speeches/2007/20070515/default.htm

First, without clear rules by which compliance professionals can monitor and train registered representatives, supervisors, and officers of broker-dealers, compliance professionals will lose any ability to impose even superficial control over misconduct. Those being monitored can rightly say that they haven't broken any rule or crossed any bright line, and they can rightly say it is only the compliance professional's opinion that a "principle" has been violated.

Second, in enforcement by the SEC or other regulators, or in arbitration by customers who have been wronged by an industry person, the ability to prove a violation which will subject the violator to sanctions or an award of monetary compensation will be greatly diminished if the regulator or the consumer can point to no clear rule that has been violated.

Our position is in line with that of many compliance professionals. For example, in the August 6, 2007 *Securities Industry News*, one compliance professional was quoted as saying: "Our clients are compliance professionals. They do not want principles-based regulation. [The new approach] will be a significant industry shift in that most broker-dealers want to maximize profit. But clear rules are helpful for compliance professionals. If the compliance professional can no longer use the rule to instruct the broker-dealer about what to do, it will increase tension. . . . The downside is that it will be harder for compliance professionals. Compliance has a seat at the table now. I would like to think that the idea of a principles-based rules system is that you get to the underlying idea of risk, and doing the right thing. But if there are not clear rules, you wonder how far the line is going to get pushed."

Further, while it may be contended that "principles-based regulation" can work for a true governmental regulatory agency provided the agency is fully funded with adequate staff to perform the needed tasks, the same cannot be said for an SRO, where critics would say the "fox guards the henhouse." Certainly, pressure for an SRO to be lenient in enforcing rules against its own members can more easily be brought to bear than when rule enforcement is by an independent governmental regulatory agency.

Even those who favor principles based regulation recognize that, with the extent of agency capture in the United States, and the failure to properly fund independent regulators, we are not ready for such a change. As one commentator put it: ". . . a principles-based system relies on dedicated, well-funded regulators who are interested in regulating.[4]" That definition cannot apply to any self-

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4 James Surowiecki, "Parsing Paulson," The New Yorker, April 28, 2008.

regulatory organization. FINRA should not be moving toward "principles based regulation" now or in the future.[5]

Risked-Based Review and Examination

The proposed rule is peppered with the terms "risk-based review," "risk-based examination" and "risk-based principles." For example, Proposed Rule 3110(b)(2) requires that all transactions related to the securities business of a firm be subject to a registered principal's review to be evidenced in writing. By itself, this is a clear and enforceable rule, and registered principals know exactly what is expected of them. However, the Supplementary Material, in paragraph .06, provides that "a member may use a risk-based review system to comply with Rule 3110(b)(2)." The term "risk-based" also appears for review of correspondence (Supplementary Material to Rule 3110, paragraph .09) and for annual examination of transfers of funds between customers and brokers or between customers and third parties (Proposed Rule 3110(c)(2)(A)(iv)).

Nowhere is the term "risk based" defined. Thus, proposed rules provide for a "risk based" standard with no meaningful direction as to the type of review, examination or principles. One obvious concern is that FINRA will view the concept of "risk-based" review of offices and "risk based" supervision of brokers with reference to the level of "risk" to the broker-dealer, as opposed to the level of "risk" to the customer.

While we support any FINRA proposal to provide greater protection to the investing public, we emphatically oppose any efforts to diminish or erode consumer protections. We view the reference to "risk-based" rules or regulation as the first step toward such erosion. We urge FINRA to establish well-defined standards which will assure that everyone will understand the rules, and there can be no question what is expected of members of the industry.

Non-Reporting of Oral Complaints

Proposed Rule 3110(b)(5) would limit the customer complaints which a firm is required to "capture, acknowledge, and respond to." Specifically, the firm

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[5] The oft-stated rationale in favor of principles based regulation is that it will improve our nation's competitive position in the capital markets. This is a doubtful proposition. Indeed, the historical success of the United States in attracting capital from investors around the world is due in large part to the perception that investors receive greater protection in our country than elsewhere. We believe the United States can retain its preeminence only by continuing to assure that our markets are the safest place in the world for investors. A move toward principles based regulation is precisely the wrong way to go.

would need to "capture, acknowledge, and respond to" written complaints only, thereby allowing firms to conceal oral complaints from customers. This proposal is purely and simply "anti-consumer" and benefits the firm and its associated persons over the customer. A better approach to this issue would be to require firms to provide the customer with a form to file a complaint. If the customer does not choose to write the complaint, the member should reduce the complaint to writing, offer its counter statement to the oral complaint, and send a copy to the customer. The firm should then be required to report the complaint along with the firm's response.

Many customers, in our experience, are unable or reluctant to put their thoughts in writing. When the financial services industry is ready to restrict their sales efforts to those persons who possess a college education or are able to demonstrate a reasonable comfort level, and an ability, to write the English language with coherence, then requiring written complaints may make some sense and be appropriate. Since the financial services industry routinely solicits customers of all education levels, and of all financial levels, the industry should make sure that even those who do not type, cannot write well, and/or are intimidated by the thought of writing a letter, are given the same ability to complain and have their complaints recorded and heard by regulators.

Moreover, it must be recognized that communications between a broker and client are almost always oral, typically conducted over the telephone. Accordingly, it may be expected that most complaints are, at least initially, communicated orally. The fact that they are communicated in this way makes them no less a complaint, nor does it make the complaint any less important to the client. Simply put, the exclusion of unwritten complaints ignores the essential character of broker-customer relations. Requiring complaints to be in writing before they are acknowledged is clearly inconsistent with FINRA's stated objective of protecting the investing public.

Proposed FINRA Rule 3110(b)(3)

Proposed Rule 3110(b)(3) provides that outside activities are subject to supervision if the firm "gives its written approval." This language may be construed to suggest that if the firm did not give written approval for outside activities, it would not have responsibility for supervision of the associated person relating to these activities. The rule should clearly state the obligation of the firm to supervise associated persons to detect and prevent unapproved activities.

An additional concern in Proposed FINRA Rule 3110 relates to the exception proposed from the general supervisory requirements of Proposed

FINRA Rule 3110 (b) for bank-related securities activities involving a "dual employee." This change would put the industry in a bifurcated claim situation. Bank employees above the registered representative level are often not registered. Therefore, any claim against the individual registered representative would need to be arbitrated through FINRA, but the "lobby broker" firm may contend that it was permitted to justifiably rely on the bank employees. In addition, a claimant could not compel the bank to arbitrate, so the claimant would also need to pursue a claim in court. This would create unacceptable additional expense and burden on the customer.

Limitation of Reporting to Firms Grossing at Least $150 Million

Former NYSE Rule 342.30 required members of the Exchange to report certain information relating to specified issues. Proposed FINRA Rule 3120(b) would retain the substantive reporting requirements of the NYSE Rule, but would only require such reporting by firms who had exceeded $150 million in gross revenues on the prior year's FOCUS reports. The Regulatory Notice, at page 10, explained the limitation as follows:

> Under the proposed rule, firms subject to the supplemental information requirement would have to include in the following year's reports a tabulation of the previous year's customer complaints and a discussion of the previous year's compliance efforts in a number of specified areas, such as trading and market activities, investment banking activities and sales practices. FINRA believes the $150 million threshold serves as an appropriate benchmark to identify those firms for which this additional information is most beneficial given the nature and complexity of the firms' activities, and by using FOCUS report data, firms can easily and readily determine whether they are subject to the enhanced information requirement.

The Regulatory Notice seems to suggest that the "supplemental information" is somehow excessive and that its reporting would be an unnecessary burden for firms with less than $150 million gross revenues. PIABA believes this is exactly the type of information that all firms, irrespective of size, should be required to report.

Retention of Correspondence and Internal Communications

Paragraph .12 of the Supplementary Material to Proposed Rule 3110 states:

> Each member shall retain the internal communications and correspondence of associated persons relating to the member's investment banking or securities business for the period of time and accessibility specified in SEA Rule 17a-4(b). The names of the persons who prepared outgoing correspondence and who reviewed the correspondence shall be ascertainable from the retained records, and the retained records shall be readily available to FINRA, upon request.

By conforming the rule on the retention of correspondence and internal communications to that of the SEC Rule 17a-4(b), FINRA continues the retention period at just three years. This can be a significant impediment to the ability of consumers to pursue legitimate claims. While securities statutes often have limitations periods expiring in three years or less, the FINRA eligibility rule permits arbitration claims to be brought within six (6) years of the event or occurrence. Furthermore, many state statutes also have limitations periods extending to six years and possibly more when the various tolling rules are applied, and many state limitations periods have no application to arbitration. Accordingly, the document retention periods should not be reduced. To do so only makes it more difficult for a customer to prove a violation of a rule, regulation, or law.

The record retention requirement for most customer-oriented documents should be at least six (6) years. This six-year period would match the eligibility provisions for customer disputes contained in FINRA Rule 12206. In the age of electronic storage, there should be little argument over reasonably increasing the time periods for document retention. Whereas the document retention rules once posed a burden in terms of finding warehouse space, electronic storage space may be obtained at near-zero cost.

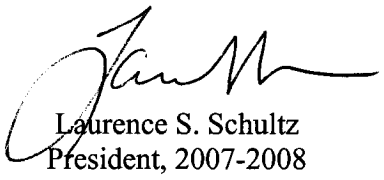
In addition, PIABA would like to see a rule requiring that these kinds of records, as well as any other customer-related documents, be made available upon request to customers and former customers within a reasonable time and at no charge.

Conclusion

PIABA appreciates the opportunity to comment on these important rule changes before they are submitted to the SEC. These changes are broad in scope and will materially affect the supervisory responsibilities of the brokerage industry. Because of the scope and importance of these changes, PIABA will continue to review these FINRA's proposals; and as noted above, we anticipate that we will have further substantive comments at the time these proposals are published by the SEC for comment.

Respectfully submitted,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION



Laurence S. Schultz
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Public Investors Arbitration Bar Association

May 27, 2008

VIA E-MAIL TO PUBCOM@FINRA.ORG

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1500

Re: Proposed Revisions to Forms U4 and U5
FINRA Regulatory Notice 2008-20

Dear Ms. Asquith:

On behalf of the Public Investors Arbitration Bar Association (PIABA), I am pleased to comment on the above-referenced proposed changes to Forms U4 and U5.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules which govern the arbitration process. PIABA members are regular users of the CRD system and believe that all public investors should have free and unfettered access to information about their brokers.

As advocates for investors with grievances against persons in the securities industry, PIABA members have a special interest in full and fair disclosure of available information concerning customer complaints, court actions, and arbitrations alleging wrongdoing by FINRA registered persons. As such, we support the proposed rule change that requires reporting of arbitration cases in which a registered person is not named as a party respondent, but in which a registered person's conduct is nonetheless the subject of the claimant's misconduct allegations against the member firm. We oppose any dollar value threshold for the reporting of settlements and/or awards in FINRA arbitration proceedings. Finally, we question the wisdom of the proposed rule change that would permit member firms to amend the reason for termination of a registered person's employment without a court order or arbitration award.

PIABA Supports Requiring Reporting of All Arbitration Claims Alleging Sales Practice Misconduct by a Registered Person

The first proposal would revise Questions 14I(2) and (3) on Form U4 and Questions 7E(2) and (3) on Form U5 to require firms to report, as customer complaints, allegations of sales practice violations made in arbitration claims and

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Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

civil lawsuits against registered persons who are not named as parties in those proceedings. PIABA supports this rule change without reservation.

PIABA is deeply concerned about the lack of integrity of the CRD system. The CRD system provides the underpinning of FINRA's BrokerCheck system. As such, it is used by public investors who desire to obtain information about their broker, or about a broker to whom they are considering entrusting their life's savings. Self-regulatory organizations and state regulators utilize the system in carrying out their regulatory functions, and the CRD system is jointly owned by FINRA and the North American Securities Administrators Association ("NASAA"). The accuracy and integrity of the system are of utmost importance to the public.

Unfortunately, the CRD system falls far short of the accuracy which its users have a right to expect. A number of factors have contributed to this. One factor has been the proliferation of expungement orders. FINRA has taken and continues to take action to ensure that the expungement procedure is not abused. PIABA supported FINRA's most recent rule proposal in this regard.[1]

Another problem has been, quite simply, failure to report. We note with approval that FINRA has increased its disciplinary filings against firms and brokers that refuse or neglect to make timely reports to the CRD.

A third problem is the subject of this proposed revision to the Forms U4 and U5. Under the current reporting system, a written complaint such as a letter to a FINRA member firm alleging that a registered person committed a sales practice violation must be reported, but a written allegation of such a violation contained in the text of an arbitration statement of claim or civil lawsuit complaint is not required to be reported unless the registered person is also named as a party to the proceeding.

The current system thus mandates a Form U4 filing and CRD public disclosure of a sales practice complaint by an investor who feels sufficiently aggrieved to send a note, or even an e-mail, to a member firm, but does not require disclosure of the identical claims of investors who feel aggrieved enough to sue the firm with identical allegations but where the registered person is not named in the case caption as a party. This has led to many anomalous results, and PIABA strongly feels that there is no supportable rationale for permitting the non-reporting of these claims. For example, where a public investor chooses not to name an individual registered representative in the caption of an arbitration claim upon the advice of counsel, that broker will not be required to report the claim.

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[1] *See* Letter of Laurence S. Schultz, President of PIABA, to Nancy Morris, SEC, dated May 16, 2008. PIABA's comment letters are accessible through http://www.piaba.org.

It is important to note that, for a variety of strategic reasons, many attorneys recommend to their clients that they name only the firm in an arbitration proceeding. Yet if that same customer had gone to a different attorney who filed the same claim, but named the individual representative as a respondent in the arbitration, the broker would have to report the claim. There is no reason to have different reporting requirements for the same conduct, depending upon the attorney's strategic decision to name or not name the individual wrongdoer as a respondent.

In addition, this reporting loophole impacts arbitration settlement negotiations between the parties, dictated by the named registered person's objective of avoiding a permanent report on the CRD. Under the current rules, if a named registered person participates in a settlement of $10,000 or more, the settlement will appear on the registered person's CRD. However, if the named registered person and the firm arbitrate the claim to a zero award, the CRD disclosure may be removed from the reporting system. The current rule thus encourages claimants' counsel not to name individual registered persons as arbitration respondents, in order to avoid providing the member firm an artificial incentive to arbitrate, rather than settle the claims.

The net effect of the current system is that complaints of serious wrongdoing by registered persons who are not named in proceedings are not reported on the CRD. The proposed rule change will close this problematic loophole in the reporting rules and promote full and fair disclosure of customer complaints charging misconduct by registered persons.

PIABA Opposes Any Arbitrary Dollar Value Threshold
for Reporting of Arbitration Awards and Settlements

Both the current rule requiring the disclosure of claims settled for $10,000 or more and the proposed change requiring disclosure of settlements of $15,000 or more impose a completely arbitrary threshold for reporting arbitration settlements. PIABA views the change from $10,000 to $15,000 as relatively immaterial; as a matter of principle, however, PIABA opposes *any* monetary threshold for the reporting of settlements.

Both the current rule and the proposed change permit registered persons to essentially ensure that they will retain a "clean" CRD if only they pay the customer a relatively small sum (currently, $9,999 – under the proposal, $14,999). The amount of such a settlement may be far less than the amount by which the customer was damaged by the registered person's conduct, and the conduct giving rise to the arbitration claim may in some instances be egregious. This reporting threshold gives registered persons an incentive to settle claims

below the settlement reporting threshold for the sole purpose of eliminating the risk of having an arbitration award reported on the CRD.

PIABA believes that the proposed change should be revised to eliminate any monetary threshold for the reporting of settled claims, and require all settled sales practice claims to be reported. Prospective customers and other persons can then decide for themselves in an environment of full disclosure whether a relatively modest financial settlement of a customer case is a material factor in their evaluation of the ability, integrity, and trustworthiness of a registered person.

PIABA Opposes Giving Member Firms Free Rein to Amend the Reason for Termination of Employment of Registered Persons

Under current practice, as recited in the proposed changes, member firms do not have the ability to amend the reason for termination or date of termination after the initial filing of Form U5. Instead, member firms can place a Registration Comment on the WebCRD to explain "unusual circumstances or irregularities in an individual's registration history that: (1) relates to the date or reason for termination on the Form U5; and (2) cannot be addressed otherwise through a form filing . . . ." Alternatively, the member firm or registered persons may follow the expungement procedure set forth in NASD Rule 2130.

FINRA proposes to allow member firms to amend the reason for, or date of, termination without any arbitration award or court order. Member firms would, however, have to give a reason for the change. FINRA would notify other regulators and the broker-dealer currently employing the person (if the person is with another firm) when a reason for termination or date of termination has been amended.

PIABA has no objection to the rule proposal insofar as it relates to the change in the date of termination. Obviously, if an error is made in the date reported, that should readily be subject to correction. However, PIABA is concerned about granting the same latitude to firms wishing to make changes in the *reasons* for a broker's termination.

While it is certainly more expedient for member firms to amend the reason for termination of a registered person without a court order or arbitration award, PIABA is concerned about the potential for abuse and collusion. In some circumstances, departing registered persons have financial disputes with member firms. For example, promissory notes may exist to repay a registered person's "draw" against commissions, or a registered person may be obligated for a portion of a sum advanced by the member firm to resolve a customer arbitration or satisfy an arbitration award. Certainly, where the member firm and departing registered person have financial issues to resolve and may be otherwise adverse,

it is possible that amendment of the reason for termination of the registered person may become a subject of bargained-for exchange as the parties negotiate their other issues.

The present rule's requirement that a member firm obtain an arbitration award or court order in order to make an amendment to the reason for termination serves an important purpose by requiring member firms to explain the reason(s) for the change to an impartial decision maker. The current process effectively requires the member firm to make a verified statement setting forth a legitimate reason for the change in the reason for termination. While sharp practices unfortunately may develop under any set of rules, and while the current requirement of judicial/arbitral approval of changes does not guarantee accurate and transparent reporting, the proposed change lessens rather than increases the likelihood of trustworthy information and increases the potential for collusion.

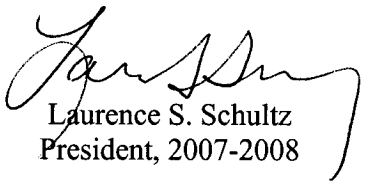
Conclusion

For the above reasons, PIABA respectfully requests that FINRA approve the changes to reporting on Forms U4 and U5 with respect to arbitration claims in which registered persons' conduct is complained of but as to which registered persons are not named as party respondents. We favor elimination of any arbitrary monetary threshold for the reporting of customer arbitrations and oppose permitting member firms to unilaterally change the reasons for a broker's termination.

Thank you for your consideration.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION



Laurence S. Schultz
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Upcoming Events:

Deadline for receiving submissions to the Spring 2009 *Bar Journal*, February 23, 2009

PIABA Board of Directors Meeting, March 14-15, 2009. New Orleans, LA.

PIABA Board of Directors Meeting, July 18-19, 2009. Location to be Announced

PIABA Securities Law Seminar, October 28, 2009. La Costa Resort & Spa, Carlsbad, California

PIABA Annual Meeting, October 29-31, 2009. La Costa Resort & Spa, Carlsbad, California

PIABA Annual Business Meeting and Election of Directors. October 29, 2009. La Costa Resort & Spa, Carlsbad, California

PIABA Board of Directors Meeting, November 1, 2009 La Costa Resort & Spa, Carlsbad, California

For more information pertaining to upcoming PIABA meetings, contact the PIABA office or visit the PIABA website at www.PIABA.org.

New Members

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Christopher Mills	(404) 556-2350
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