SECURITIES ARBITRATION
COMMENTATOR

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IN THIS ISSUE

The Disappearing Non-Public Arbitrator

Is the Debate Over Eliminating the Industry Arbitrator About to Become Moot?

One of the most rigid planks in the arbitration platforms of the North American Securities Administrators Association, PIABA, the Consumer Federation of America and other organizations that represent, or speak on behalf of, the public investor is the proposition that the SRO requirement of a non-public or "industry" arbitrator on customer panels should be eliminated. The Non-Public Arbitrator, although in the minority on customer-related Panels, is considered potentially dominant, because of his/her industry background and knowledge, and presumptively biased, because of his/her financial dependence upon, or career attachment to, the securities industry.

When the results of SICA's "Perception of Fairness" Study of SRO (NASD and NYSE) arbitrations were released in early 2008 (SAC Ref. No. 2008-06-01), NASAA President Karen Tyler (ND) surmised in a public response that investors view the securities arbitration forums as "biased and unfair." NASAA's Arbitration Project Group chair Bryan Lantagne (MA) said the Study supports what state regulators believe, i.e., that investors "are forced to participate in [a forum that] is rigged against them." President Tyler urged FINRA and the SEC to act on the Study's result and called for the "removal of the mandatory industry arbitrator and a prohibition on ties to the industry on the part of the public arbitrator."

The statistics that the Public Investors Arbitration Bar Association highlighted from the SICA Study were the negative views of investors about arbitration. According to PIABA's Release on the Study, "[o]ver 62% believed the arbitration process was unfair, 60% had an unfavorable view of arbitration and 70% were dissatisfied with the outcome." President Laurence S. Schultz commented that the Study "confirms once and for all that investors who have been involved in arbitration distrust the arbitration process and have concluded it is biased and unfair." These findings justify action by FINRA and the SEC "to reform mandatory investor arbitration," Mr. Schultz urged.

Interestingly, the SICA Study did not find direct dissatisfaction with the Non-Public Arbitrator on the Panel, although there were many survey respondents who felt the Panel was not impartial. Nevertheless, the Study has added momentum to the swirl of controversy surrounding the Non-Public Arbitrator. In past years, the push to eliminate the Non-Public Arbitrator has spurred a transference of action towards assuring that the two Public Arbitrators on the Panel in customer disputes were, indeed, unaffiliated with the securities industry.

FINRA has changed the criteria for Public Arbitrator classification numerous times since 1989, when the classifications were established, and more times in recent years than in the past. Those classification changes have been stretched to an immoderate, almost sublime, degree at this point,

cont'd on page 2

DISAPPEARING NPA *cont'd from page 1*

leaving little room for further changes that might assuage Non-Public Arbitrator critics. In fact, the dialogue of recent times has shifted to a more public visibility – one that is less focused on working for change within the arbitration process. In late June 2008, NASAA held a luncheon rally, entitled "Arbitration is Broken: How Can It Be Fixed?" at which President Tyler explained that NASAA has turned from its more neutral position of simply encouraging a thorough examination of the fairness of the securities arbitration process to actively seeking remedies that will fix a broken system.

Both PIABA and NASAA, and many other consumer groups more used to working in legislative arenas, have turned their focus towards legislative fixes. Both have publicly advocated legislation that would end so-called mandatory (i.e., contract-based) arbitration of securities disputes. Such legislation seriously considered in the last Congress and will almost certainly return, in one form or another, to the bill hopper of the 111th Congress.

This pressure from critics, and the sincere threat that SRO arbitration could be replaced, has caused FINRA, as the successor to both NASD and NYSE arbitration, to cast about for additional ways in which it can demonstrate the forum's fairness for investors. The newly adopted Explained Awards Rules, which make arbitral explanations mandatory upon the mutual request of the parties, was likely a product of these pressures, advanced to counter a perception challenge, but with small likelihood of practical application.

On the other hand, FINRA has been moving, in an *ad hoc* way, toward gradually accomplishing informally that which it has publicly indicated it will not propose formally, i.e., an end to the role of the Non-Public Arbitrator. Recently, the SEC approved a FINRA Rule change that will allow a single Arbitrator to decide claims under the Customer and Industry Codes that seek compensatory damages of $100,000 or less. That upward shift in the claims level, which takes effect on March 30, 2009, will double the number of cases available for decision by a single Arbitrator and, in virtually all eligible, customer-related cases, that single Arbitrator will be a Public Arbitrator.

FINRA estimates the number of claims in the $100,000-and-under category to constitute about one-third of all cases filed. Add to that the customer cases with claims of $100,000 that will be heard by a single Public Arbitrator under a two-year Pilot (the Public Panel Pilot Program) that commenced October 6, 2008. Eleven of the largest brokerage firms have committed to allow a set number of cases to be heard in this fashion, at the option of the complaining customer claimant.

In 2008, these eleven firms were involved in 93 of the Customer-Member Awards that concerned compensatory claims in excess of

cont'd on page 3

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DISAPPEARING NPA *cont'd from page 2*

$100,000. These same firms have committed to arbitrating 276 cases under the Pilot. Given that one in six customer-related cases actually reaches an arbitral decision, we expect that about half (276/(6 x 93)) of the eligible cases will be heard before an All-Public Panel. Some of the customer cases over $100,000 will be eligible for an All-Public Panel anyhow, because of another FINRA-sponsored program.

Broker-dealers that entered into regulatory settlements concerning auction-rate securities have agreed to arbitrate claims for consequential damages before a single Public Arbitrator under a special arbitration procedure agreed to by the settling broker-dealers. FINRA reports that some 300 claims were filed in 2008 that involve auction-rate securities problems. We cannot say how many of these claims qualify for the special arbitration procedures, but we can say that the bulk of the ARS problems probably lay with the houses that entered into regulatory settlements. In any case, the foregoing suggests that the eleven brokerage firms in the Pilot Program will likely be dealing with an All-Public Panel in about 60-70% of their customer-related arbitration disputes. These firms account for 40% of the Awards involving customer claims exceeding $100,000.

The Non-Public Arbitrator continues to have a considerable role in the great majority of the FINRA arbitrations. Special programs and Small Claims cases aside, All-Public Panels are not common in FINRA arbitrations. In the Chart below, which covers the four years between 2005 and 2008, we found All-Public Panels in just 5-8% of the Customer-Member (over $25,000 claimed) Awards. The percentage rose a bit in 2008, but the dramatic shift to All-Public Panels lay in the years ahead.

This "Panel Composition" Chart will form a baseline for comparison to see, in the years ahead, just how great the shift in panel composition will be. As one can see, the shift away from the All-Industry Panels in intra-industry disputes, especially those commenced by employees, began years ago. From 2005 to 2008, Mixed Panels, in which Public Arbitrators form the majority, decided 69-78% of the claims brought by employees. All-Public Panels are used in statutory discrimination cases and, even in Member-Employee cases, 29-37% of the decided cases involve Mixed Panels. With the introduction of the new single Arbitrator provision, those industry cases involving $100,000 or less, which would have formerly required a Mixed Panel, will now be decided by a Public Arbitrator.

Incidentally, note that the number of Awards issued in intra-industry cases has remained relatively stable

cont'd on page 4

PANEL COMPOSITION CHART 2005-2008

(FINRA Only - Includes Stipulated Awards; Excludes Awards w/ Claims ≤ #25k)

Year	Type Dispute	Total # Awards	Panel Composition		
			All-Public	All-Industry	Mixed
2005	C-M	1,971	117 (6%)	3 (N/A)	1,851 (94%)
	E-M	117	9 (8%)	22 (19%)	86 (73%)
	M-E	165	13 (8%)	103 (62%)	49 (30%)
2006	C-M	1,241	62 (5%)	2 (N/A)	1,177 (95%)
	E-M	117	7 (6%)	19 (16%)	91 (78%)
	M-E	150	6 (4%)	89 (59%)	55 (37%)
2007	C-M	675	42 (6%)	1 (N/A)	632 (94%)
	E-M	115	10 (9%)	23 (20%)	82 (71%)
	M-E	168	4 (2%)	108 (63%)	56 (33%)
2008	C-M	420	32 (8%)	1 (N/A)	387 (92%)
	E-M	107	9 (8%)	24 (23%)	74 (69%)
	M-E	133	3 (2%)	91 (69%)	39 (29%)

1. TypeDispute: C/M=Customer-Member (Customer as Claimant); E-M=Employee-Member (Employee as Claimant); M-E=Member-Employee (BD as Claimant ag. Employee)
2. Mixed Panels are generally comprised of two Public and one Non-Public Arbitrator; Panels with only one Public Arbitrator are counted as Mixed.

DISAPPEARING NPA *cont'd from page 3*

throughout the four-year period, while customer-related Awards have declined from almost 2,000 Awards in 2005 to just 420 in 2008. This dramatic shift on the customer side verifies, we think, that the significant decline in cases filings during this period was attributable almost entirely to a drop in customer-related claims.

To the extent the number of claims exceeding $100,000 increases with the recent surge in customer claims, more cases will be eligible to satisfy the Pilot Program requirements and more cases will remain that will involve the Non-Public Arbitrator. Still, we believe, the All-Public Panel will play a predominant role in FINRA arbitration over the next few years. Will that prospect dissolve opposition to the Industry Arbitrator or, indeed, to mandatory arbitration? Probably not.

One salutary consequence of the All-Public cases will certainly be that more data will be available to test the impact of the Industry Arbitrator on Award outcomes. We examined the Industry Arbitrator's role in a 2005 edition of SAC ("Industry Arbitrator Award Survey," 2005 SAC, No. 4(1), available at "View Award Surveys," www.sacarbitration.com). In that survey, we only had for comparison to Mixed Panel Awards those matters decided by single Public Arbitrators and those involving dissenting arbitrators. There were problems with each. The new data should be plentiful and more directly comparable. Will it settle the debate? Probably not.

Award Survey Refinements/Revisions

Top BDs in Arbitration (2003-2007)

Subscribers continue to comment upon the Award Survey we published in 2008 SAC 1. As a result of a couple of those comments, we return in this article to make one change and a couple of improvements to the Charts we presented in that Survey. The Survey, readers may remember, named the "Top Broker-Dealers in Arbitration" for a five-year period from 2003 to 2007 and presented Award results for each of the 18 selected brokerage firms. The Award results were analyzed to reflect customer and employee win rates and recovery rates with regard to each firm.

We explained in the text accompanying the Charts that, in surveying the five-year period, we had adjusted for name changes and mergers along the way. In one case, Ameriprise, we stated that we had also searched for Awards involving Securities America and American Express Financial Advisors. Perhaps we did, but a subscriber inquiry led us to find that we failed to include those search results from AEFA and Securities America when presenting the Ameriprise results in Chart II of our article. The revised Chart II, which appears on page 5, cures that omission.

Another subscriber reminded us that, in at least one past SAC Survey, we had utilized the size of the broker sales force as a comparison indicator to place in perspective the differing Award results from one broker-dealer to the next. During our survey period, almost $800 million was awarded to winning customers in arbitration. That sizeable sum, when spread over approximately 4,500 "winning" Awards during the survey period, yields an impressive six-figure average. When spread over the entire broker population, however, that $800 million reduces to about $1,200 per registered representative (RR). The costs of misfeasance and malfeasance are considerable, but the fault lies with a relatively small minority.

By comparing the sales force size of each broker-dealer in our Award Survey, we adjust for the differences in size among the firms and see more clearly how different firms actually fare in arbitration. In a new Chart on page 6 of this issue, we list the 17 broker-dealers from our original survey (Prudential does not appear in this Chart), the amounts awarded to customers during 2003-2007, the number of retail RRs the firm employed at the close of the survey period, and the average annual cost per broker of paying arbitration Awards to customers.

The ranges are wide, both among houses that pursue the same kind of business and among those that pursue differing business models. One stark distinction we saw in pursuing this dollars-per-broker analysis appears in terms of the different business models. The online shops that rely heavily on self-directed trading have arbitration costs per broker each year that are small in contrast with the wirehouse business model. Fidelity, a mutual fund distributor, takes the prize for the lowest cost per broker. The so-called "indies" reflect a variety of experiences, but generally do better than the national and regional houses.

UBS turned in the best performance among the national wirehouses and that, despite a blockbuster Award in 2005. Bear Stearns had a relatively small sales force that catered to a high-end clientele and that is reflected in the relatively large amounts at stake in arbitrations involving that firm. We adjusted for one Award that totaled more than $16 million, because Bear Stearns only had to pay $200,000 of that amount, but the firm still came in at the top of the listing with an average payout per broker of almost $8,000!

We hope this additional perspective regarding the Top BDs analysis proves helpful to our readers. SAC thanks to the helpful subscriber who made the suggestion to go this route. We welcome similar suggestions for future SAC Award Surveys.