

FOCUS ADR—ALTERNATIVE DISPUTE RESOLUTION

Pros, cons of the NASD securities arbitrations

By David Williams Russell



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Partly as a result of the Internet/technologies/telecom bubble of the 1990s, many investors have experienced significant portfolio losses — often money needed to fund their retirements. When investigating possible errors, omissions, malfeasance, or misfeasance of their brokers, financial advisors, investment managers, or investment advisors, many are surprised to learn they are bound to arbitrate their claims in an arbitration administered by NASD Dispute Resolution Inc.

Advantages of NASD arbitrations

- Informal proceeding — NASD arbitration is informal; strict rules of evidence don't apply. Arbitrators have a duty to give both sides a full and fair hearing.

- Qualified arbitrators — NASD arbitrators include securities professionals, accountants, financial advisors, and lawyers. They are required to take NASD-sponsored training courses (at their own expense), to maintain updated background information with NASD, to disclose potential conflicts of interest, and, when selected as arbitrators, to take a written oath and to make detailed disclosure updates available to the parties, who may choose to strike arbitrators from the panel.

- Fewer technical delays — Hearings are informal. Arbitrators are not bound by strict rules of law and procedure. There are fewer of the motions and briefs on legal, procedural issues that frequently lengthen the court litigation process. NASD dispute resolution has issued fairly detailed and specific document discovery guidelines (and timelines). There are no depositions or interrogatories. Consequently, there are fewer delaying discovery motions, conferences, orders, and arguments about discovery and document production.

- More potential avenues for recovery — The NASD arbitration process is part of the securities industry's self-regulatory process. Arbitrators may not feel bound to grant awards only within strict statutory measures of damages. Arbitrators may make awards where they feel there was sloppy supervision of a broker, or a basic unfairness or imbalance in the relationship between customer and broker, even if, in a formal court proceeding, it might be more difficult to establish technical securities law violations and/or entitlements to damages. Alternatively, arbitrators have leeway to mitigate awards against industry respondents where strict statutory guidelines might mandate larger awards.

- Contingent fee representation available — A number of specialized law firms take NASD arbitration cases on a contingency basis. Potential claimants unable to obtain contingency lawyers may choose not to arbitrate less egregious cases, enabling arbitration of more pressing regulatory concerns.

Disadvantages of NASD arbitrations

- Less procedural flexibility — Arbitration rights stem from a contract between the parties. Consequently, although there is a procedure to subpoena relevant information from within the securities industry, it may be difficult or impossible to take discovery outside the industry. Joinder of parties outside the industry is virtually impossible. Although documentary evidence is exchanged, pre-hearing interrogatories and discovery are not part of the process, so the hearing itself usually is the first opportunity to confront opposing witnesses.

- Arbitration is compulsory — It is a boon to the securities industry that arbitration of disputes is required of all customers. This helps keep the securities industry largely self-regulated and facilitates dispute resolution at a lesser cost than court litigation. If claimants perceive that the arbitration system has an industry bias that denies them fair hearings and just compensation, courts may begin to nullify adhesive arbitration agreements, as has already begun to happen in the employment arena.

The front page of the Sunday Business Section of the June 18, 2006, *New York Times* printed claims that NASD arbitrators had hidden industry ties and conflicts; that the arbitration process was too lengthy; that, based on NASD figures, a declining percentage of claimants (from 54 percent in 2001 to 43 percent in 2005) were winning awards; and that more motions and fights over discovery were unduly delaying the NASD arbitration process. If investors perceive that the arbitrations to be unfair, there will be challenges from courts and legislatures.

- Arbitrators are poorly compensated — For the NASD arbitration system to work, good arbitrators must be persuaded to join the system, pay for their own training, and cooperate with the NASD rules on disclosure and conduct. Hearings can be lengthy and grueling. Arbitrators are asked to do a lot of paperwork and keep track of exhibits, while tape recording proceedings, listening to the testimony, refereeing disputes over evidence, and spending days at a time conducting hearings in sometimes-distant locations. Arbitrators are poorly compensated for this — currently about \$50 an hour — far less than an industry professional, lawyer, or financial expert usually makes. Arbitrators are thus virtual volunteers, committed as a public service to making the process work, and willing to sacrifice income for the benefit of investors and the industry.

If NASD member firms are genuinely desirous of preserving their arbitration system, they must continue to attract qualified, dedicated arbitrators. NASD arbitrators should be adequately compensated for their essential role in making a full and fair dispute resolution process available to NASD members and their customers.

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