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THE ROLE OF THE COURTS IN THE SECURITIES INDUSTRY

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Judge Duffy will examine the use of arbitration in resolving customer complaints in the securities industry. The role of the federal courts in securities arbitration have diminished since the U.S. Supreme Court upheld the validity of arbitration clauses in securities agreements.[1] Judge Duffy will also propose changes to the arbitration system that will increase the role of the courts.

JUDGE KEVIN THOMAS DUFFY:[2]

Ladies and gentlemen, it is a pleasure to address an outstanding group of industry leaders. In 1990, I had the opportunity to present my views on dispute arbitration to a securities industry group. I stated then that the advantages of arbitration were its informal nature, its limited discovery, its lack of binding precedents, and its lack of an appeal process. I also, however, stated that these same aspects were also the

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[1] *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987); Rodriguez De Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 485 (1989); *see also* Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements, 52 Fed. Reg. 39,216, 39,217 (1987) (to be codified at 17 C.F.R. § 240.15c2-2) (proposed Oct. 21, 1987) (rescinding Rule 15c2-2 of the Exchange Act of 1934, which deemed failure to disclose inapplicability of such clauses to federal securities claims to be a fraudulent, manipulative or deceptive act" within the meaning of the Exchange Act).

[2] Federal District Judge in the Southern District of New York: B.A., 1954, Fordham College; LL.B., 1958, Fordham University School of Law; Associate, Whitman, Ravison & Coulson, New York, N.Y. (1961-1966); Partner, Gordon & Gordon, New York, N.Y. (1966-1969); Regional Administrator of the SEC, New York Regional office (1969-71).

disadvantages of arbitration.[3] I noted that arbitration was intended to be a quicker and cheaper method of dispute resolution as compared to formal litigation.[4] Today, I will critically examine the securities industry arbitration process and propose a government alternative.

I. *INFORMALITY IN ARBITRATION*

Over the last eight years formality has crept into the arbitration process. A number of self-regulatory organizations have developed detailed rules and handbooks to regulate the arbitration process.[5] Formal mediation is now generally undertaken at the commencement of the arbitration process. Moreover, there is now a formal bar association that specializes in investor arbitration.[6]

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[3] *See* Matthew Press, *Arbitration of Claims Under the Securities Exchange Act of 1934: Is Exclusive Jurisdiction Still Justified?*, 77 B.U. L. REV. 629, 650-53 (1997) (discussing disadvantages of securities arbitration such as, *inter alia*, lack of procedural protections, lack of uniform standards on which to base awards, and inhibition of the development of federal law based on specific factual disputes).

[4] *See* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc., 473 U.S. 614, 628 (1985) (stating that a party agreeing to arbitration "trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration."); *But see* Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 672-73 (1996) (criticizing the "myth" enunciated in *Mitsubishi Motors Corp.* "that arbitration is as appropriate for virtually all disputes as is litigation").

[5] *See, e.g.*, Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 488-90 (1996) (discussing the role of self-regulatory organizations in developing the Uniform Code of Arbitration as a means of harmonizing their separate rules).

II. *LIMITED DISCOVERY*

Eight years ago arbitration discovery was limited. Claimants in securities arbitration are now entitled to document discovery from brokerage firms.[7] Discoverable documents include client account histories, broker-dealer research on disputed securities, individual broker personnel files, compliance manuals and as many more documents as the arbitrator will allow.[8]

III. *LACK OF BINDING PRECEDENT*

Arbitration awards are easy to research but have limited value. The National Association of Securities Dealers ("NASD") will provide a list of an arbitrator's recent awards in any NASD sponsored arbitration.[9] The Securities Arbitration Commentator will provide complete background on all awards ever granted by a specific arbitrator.[10] This information is of limited value because there are no formal opinions and the awards, do not have the effect of binding precedent.[11] Thus, claimants have received awards

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[6] Public Investors Arbitration Bar Association. *See* Quinn, *Investor Taking Stockbroker to Arbitration Doesn't Stand a Chance Without Lawyer's Help*, BUFFALO NEWS, May 14, 1997, at B9.

[7] UNIF. CODE OF ARBITRATION §20 (1996); *But see* Press, *supra* note 3, at 652 ("[T]hough arbitrators have some power to compel discovery, it is limited by local statute and may in some cases be insufficient to compel the production of important documents or testimony from distant jurisdictions.") (citation omitted).

[8] *See* Quinn, *supra* note 6, at B9 (recommending documents that investors should obtain to prepare for securities arbitration).

[9] *See id.*

[10] *See id.*

[11] *See* Press, *supra* note 3, at 643.

simply because they have lost money or have suffered some other harm.[12] Substantial punitive damages were awarded against a broker-dealer that intentionally failed to produce discovery documents.[13]

IV. *LACK OF AN APPEAL PROCESS*

Without fear of reversal on appeal, securities arbitrators decide cases without referring to precedent.[14] Arbitrators often do not have any knowledge of the industry, the securities laws, and the applicable basis of liability.[15] There are no formal rules to follow in deciding claims. It may be that fewer rules are necessary for the arbitration process to reach a quick resolution. Obviously, an appeal process would delay claim resolution.

V. *QUICK RESOLUTIONS*

Arbitration claims, during this bull market, will be heard within 10 months. In a bear market, claims will increase and the speed of resolution will decline. In contrast, the federal courts system handles simple cases within a two-year period. The current relative speed of arbitration resolution is of questionable advantage. Originally, the securities industry assumed that arbitrators would know enough about the industry to render quick

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[12] *See id.* at 651 (noting that "arbitrators may decide awards on a purely equitable basis" and are "free to award what they feel the circumstances of the case require").

[13] *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117, (2d Cir. 1991).

[14] *See* Perry E. Wallace, *Securities Arbitration After McMahon, Rodriguez, and the New Rules: Can Investors' Rights Really be Protected?*, 43 VAND. L. REV. 1199, 1248 (1990) (noting that arbitration process does not involve strict application of legal principles or substantial legal research).

[15] *See* Shelly R. James, *Arbitration in the Securities Field: Does the Present System of Arbitration Between Small Investors and Brokerage Firms Really Protect Anyone?*, 21 J.

resolutions.[16] The speed of resolution is now regarded as the result of a lack of industry knowledge on the part of arbitrators.

VI. *LOWER COST*

A recent *Wall Street Journal* article suggested that arbitration is not a low cost alternative to formal litigation.[17] The cost of the arbitration may be $400 or more, while the filing fee in federal district court is $120. Moreover, the increased use of discovery will only increase the aggregate amount of legal fees incurred in the arbitration process as a whole. Thus, the cost savings benefit of arbitration is eroding.

VII. *PROPOSAL*

The claims of securities industry customers should return to the federal courts. Arbitration is not a mandatory solution to resolving customer complaints. The security industry arbitration process is really a court specializing in reviewing customer complaints. The securities laws should be amended to provide for an administrative tribunal to hear customer claims. This tribunal would issue written opinions, follow precedent, and be subject to an appeal process. Moreover, punitive damages could be

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CORP. L. 363, 385 (1996) (noting that "public arbitrators" required to hear claims under NASD rules are not necessarily from the securities field).

[16] *See id.*

[17] *See* Deborah Lohse, *Investors' Arbitration Costs Are Increasing*, WALL ST. J., June 30, 1997, at C1.

eliminated and punishment could be directed against an individual broker rather than the entire broker-dealer firm.[18]

There are other administrative tribunals within the federal court system. The Securities and Exchange Commission has administrative tribunals. The Social Security system utilizes such tribunals. Bankruptcy courts are in fact administrative tribunals with Article I Judges. In fact, Bankruptcy Courts constitute a unit of the district court and receives its authority from the district courts in which it sits. This same concept could be applied to an administrative tribunal authorized to hear the complaints of securities customers.

VIII. *CONCLUSION*

It has been said that arbitration is only successful when both sides trust the arbitrator's decision. The securities industry and the investing public are unhappy with the arbitration process. This suggests that the arbitration process must be fixed. I recommend fixing the process while the market is bullish and customer claims are low.

[18] *See* Katsoris, *supra*, note 5, at 518 (noting the likelihood of appeal on an award for punitive damages due to its unusual nature).