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VIA EMAIL: NazarethA@SEC.gov

Ms. Annette L. Nazareth, Director  
Division of Market Regulation  
SECURITIES AND EXCHANGE COMMISSION  
450 Fifth Street, NW  
Washington, D.C. 20549-0609

Re: Severe Problems with NASD Arbitration and Questionable SEC Oversight

Dear Ms. Nazareth:

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## **I. Introduction**

Public customers of securities brokerage firms are, in effect, required to agree to arbitrate future disputes before Self-Regulatory Organization-sponsored arbitration forums. Substantially, all such arbitrations occur before the facilities of NASD Dispute Resolution (“NASD”).

The current watchword of Securities Industry Conference on Arbitration is: “Arbitrators should realize that they are viewed by parties in an arbitration proceeding much as a judge would be viewed in a court of law.” (The Arbitrator’s Manual [8/04] (“Manual”), p. 3.) However, the operational reality is far from “a judge ... in a court of law.”

For approximately thirty (30) years, while serving as an NASD arbitrator or as legal counsel for either claimants or respondents appearing before NASD hearing panels, I have witnessed the NASD arbitration system evolve. In the low volume 1970s, circuit-riding Staff would participate in arbitrator deliberations. In the 1980s and early 1990s, a Staff member would attend/observe each hearing session. From the mid-1990s to the current time the NASD has: (1) ceased to provide arbitrator training in substantive law; (2) effectively discouraged use of the law in the arbitration decision-making process; and, (3) not implemented an effective means to evaluate arbitrator competence.

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I have recently conducted a multi-month internet based study of NASD arbitration, which involved communications with more than 1,000 NASD arbitrators. The study showed that the NASD impliedly informs arbitrators to, in effect, "do justice," but does not provide the tools to accomplish that goal. One very active and candid NASD arbitrator informed me, in part:

Although we receive from both parties, reams of papers with case law, not once in any case during a hearing or during any deliberations has any one referred to them. ... We do not need case law. Simply, does one plus one equal two. That's what we try to determine.

In another instance, a Regional Director of NASD caused an arbitrator, who is well-versed in securities law, to be recused from a hearing panel on the ground of bias as she wished to share her knowledge of applicable case law with co-panelists and the parties. In other instances, non-attorneys invented their own versions of substantive law in order to render decisions.

The recently amended Section 3110(f) of the NASD Manual causes its member firms to convey the false and misleading impression to public customers that arbitrators are required to and/or do employ legal reasoning to reach their decisions. It fails to state that the NASD: (1) does not provide its arbitrators with training in substantive law; (2) discourages use of the law in the arbitration decision-making process; and, (3) has not implemented an effective means to evaluate whether arbitrators consider substantive law in their decision-making processes.

Pursuant to the provisions of the Freedom of Information Act ("FOIA"), I recently requested documents from the Securities and Exchange Commission ("SEC") to determine whether the SEC fulfilled certain oversight responsibilities. It appears that either the SEC is fully aware of NASD arbitration deficiencies and condones such practices or its oversight leaves much to be desired.

## **II. My Background**

From 1971 to 1973, I served as the Associate General Counsel and/or Compliance Director of Mitchum, Jones & Templeton, Inc., a regional New York Stock Exchange Member Firm.

From 1973, I have been engaged in the private practice of law as a sole practitioner where substantially all representation dealt with financial/investment litigation. I have represented many individual investors and more than twenty (20) regional securities brokerage firms before arbitration panels and in

various state and federal courts in hundreds of securities industry related disputes. I no longer represent securities brokerage firms.

I was admitted to the NASD panel of arbitrators in 1976. Also, I have served on the panels of arbitrators of the American Arbitration Association, Pacific Stock Exchange, NYSE and Municipal Securities Rule Making Board. Further, I serve the Los Angeles civil courts and the Los Angeles County Bar Association as an arbitrator.

### **III. NASD Resists the Use of Applicable Law by Arbitrators in Customer Disputes**

One can reasonably conclude that the NASD disdains an arbitrator's knowledge and/or use of applicable law in customer disputes. Without that knowledge, rendering a fair and just arbitration decision becomes a farce.

#### **A. Importance of Arbitrator Knowledge of Applicable Law**

An arbitrator's knowledge of the law applicable to disputes is especially important. If an arbitrator does not understand the applicable law, the arbitrator cannot determine which facts are relevant and which are not or their significance. Thus, justice is not served. Current ambiguous NASD guidelines to arbitrators to "do justice" or render "fair and equitable" decisions are, effectively, no guidelines and an excuse to foster and enable incompetence.

#### **B. GAO Report (1992) Recommended Arbitrator Training**

Congress requested that the GAO study the arbitrator education process. ["In response to the concerns of industry members and individual investors, the Chairmen of the House Committee on Energy and Commerce and its Subcommittee on Telecommunications and Finance, and the Chairman and four members of the Senate Committee on Banking, Housing, and Urban Affairs requested that we examine arbitration practices in the securities industry. As agreed with the Committees and Subcommittee, we examined issues related to ... the selection and training of arbitrators." Securities Arbitration --- How Investors Fare, United States General Accounting Office, Report to Congressional Requestors, May 1992, GAO/GGD-92-74 ("GAO Report"), p. 21.]

The GAO Report expressly stated that it did not deal with the fairness of the arbitration process. ["GAO's review ... did not directly address the fairness of the arbitration process." GAO Report, p. 6.] By implication, the GAO Report did not deal with lack of fairness that would result from an arbitrator's lack of knowledge of applicable law.

The GAO Report partially responded to the Congressional request, which dealt with “training.” The GAO Report dealt with training in the “arbitration process,” i.e., procedure as opposed to substantive issues, e.g., applicable law. [“Recommendations to SEC. GAO recommends that the Chairman, SEC, require SROS that administer arbitration forums to ... establish a system to ensure these arbitrators are adequately trained....” GAO Report, p. 61.]

By 1992, the GAO, SEC and NASD were able to examine years of arbitration experience with respect to thousands of arbitration hearings. Yet, they suggested an additional study as to providing “better” arbitrator training. [“Finally, with respect to our recommendation concerning arbitrator training, SEC stated that ‘it would be appropriate to study whether there are cost-effective means to assess arbitrators’ training needs and provide better training.’ This action is consistent with the intent of our recommendation, and the SROS told us they plan to begin such a study.” GAO Report, p. 63.] In 1996, the NASD published the results of such a study with specific recommendations. (See, Section III.C, below.) Thirteen (13) years have passed since the GAO Report was issued; however, the NASD has not implemented adequate arbitrator training, which would benefit the investing public and the securities industry.

The SEC commented to the GAO that the NASD should expand arbitrator training and evaluation efforts. [“Nevertheless, while the SROs should expand their training efforts, the Staff does not believe that a prescription of specified courses should, or could, become an acceptable substitute for careful, varied evaluation by the arbitration departments to assure the independence and capability of arbitrators.” GAO Report, p. 102.] Subsequently, the NASD eliminated its training program related to applicable law and informally advises panelists to ignore applicable securities under threat of being recused from serving as an arbitrator on the ground of bias. (See, Sections III.E.1 and III.E.4, below.)

**C. Ruder Task Force Report (1996) Recommended that the NASD Implement a Program to Train Arbitrators in Substantive Law**

The “Securities Arbitration Reform --- Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc.” (January 1996) (“Ruder Task Force Report”) recommended that the NASD improve arbitrator training as to applicable law and implement an effective evaluation procedure concerning arbitrator competence. The Ruder Task Force Report stated, in part:

Many securities arbitration participants expressed concerns about the selection, quality, and training of arbitrators. .... Commentators also

complained about the quality and training of the arbitrators. They felt that the arbitrators lacked sufficient expertise in the relevant substantive law...

....

The two characteristics for which arbitrators received the lowest ratings in both the 1993 and 1994 surveys were "ability to cope with complex material" and "ability to analyze problems and identify key issues."

....

We recommend that the scope and frequency of arbitrator training be expanded even further. In particular, we believe that there should be a continuing education requirement beyond the introductory session presently required of new arbitrators. Appropriate programs should be available for all levels of experience, emphasizing ... relevant areas of substantive law.

....

The training requirements should be applied flexibly based upon an arbitrator's demonstrated knowledge of relevant substantive law.... The requirements should be structured, however, to ensure that arbitrators remain current with important new developments in ... and relevant law. (Emphasis added.)

Ms. Linda D. Fienberg, Esquire, was the "Task Force Reporter" of Ruder Task Force Report. Subsequently, she became President of NASD Dispute Resolution. The NASD has not implemented the aforesaid recommendations.

Since, 1993, the NASD has ceased offering training in applicable law. (See, Section III.E.1, below.) However, in 2004, the NASD sought authority from the SEC to charge arbitrators additional training fees to provide a "two-hour ... session... on ... videotaped training on civility." (SR-NASD-2004-001) The NASD did propose a rule concerning "arbitrator web literacy," but that was withdrawn. (SR-NASD-2004-122)

**D. NASD Requires That Intra-Industry Disputes Be Heard Before Arbitrators Who Have Extensive Knowledge of Applicable Law**

The NASD recognizes that knowledge of the law is important and is willing and able to employ very competent arbitrators in intra-industry disputes, but not in customer oriented disputes.

Parties receive some assurance that arbitrators are knowledgeable of applicable law only in disputes among NASD members or NASD members and their employees. In those matters, arbitrators are required to have "substantial familiarity with employment

law,” “ten or more years legal experience” or “experience litigating” and apply a “legal standard.”<sup>2/</sup>

The NASD should have the same concern for the correct application of the law and the competence of arbitrators in customer disputes as it does in intra-industry disputes. Parties to customer disputes should not be treated as second class citizens.

**E. NASD Prefers That Customer Disputes Be Heard Before Arbitrators Who Have Little or No Knowledge of Applicable Law**

**1. Cessation of Arbitrator Educational Forums**

In 1993, the NASD ceased educating arbitrators as to applicable law. Prior to 1993, the NASD (Los Angeles Region) would conduct Arbitrator Educational Forums. All members of the arbitration panel were invited (without charge) to the Arbitrator Educational Forums, which were held in grand ballrooms of local hotels. Speakers presented topics of current interest, including applicable law, and the sessions were opened to questions from all present.

**2. Rules Provide Little or No Guidance**

The Manual and the NASD Code of Arbitration Procedure provide little or no guidance to arbitrators as to how to learn and/or deal with applicable law.

The NASD informs arbitrators that they are viewed by the parties “much as a judge would be viewed in a court of law.” (Manual, p. 3.) However, it further informs arbitrators that they are not really required to follow the law in rendering their decisions. [“Deliberations. ... Arbitrators are not strictly bound by case precedent or statutory law. Rather, they are guided in their analysis by the underlying policies of the law and are given wide latitude in their interpretation of legal concepts. The NASD offers no guideline to determine what “the underlying policies of the law” are or how and in what manner to recognize or interpret a “legal concept.”

Arbitrators may not receive any help from the disputing parties to learn the applicable law as the NASD does not require Claimants to state the applicable law. [“The Statement of Claim shall specify the relevant facts, the remedies sought and whether a hearing is demanded. ... The Statement of Claim shall specify the relevant facts and the remedies sought.” NASD Code of Arbitration, Sections 10302, 10314.] The NASD only requires that the parties plead facts vis-à-vis set forth applicable law.

The NASD will not advise arbitrators of the applicable law. [“Function of the Arbitration Staff. The Director will assign a staff member to every case. The responsibility of the staff is to advise the panel concerning arbitration procedures. The staff members are not advocates, nor do they research legal issues. Staff members are on call and may be present to see that the sessions run smoothly and all rules are properly observed.” Manual, p. 25.]

Many arbitrators lumber under the erroneous assumptions that they are forbidden from doing independent legal research and that they may not consider any legal authority unless it is presented by the parties. (See, Section III.E.4, below.) Arbitrators are only advised that they may read a rule referred to by a party. [“Before the hearing. ... Arbitrators should not make independent factual investigations. Nothing, however, prohibits an arbitrator from reading the text of a rule referred to in a party’s pleading (e.g., if the complaint charges a violation of a suitability rule, the arbitrator may read the rule).” Manual, p. 21.] Arbitrators are impliedly restricted from conducting independent legal research. In at least one instance, an NASD Regional Director reprimanded an arbitrator for trying to educate co-panelists and legal counsel as to applicable case law. (See, Section III.E.4, below.)

An arbitrator’s quest for truth and justice should not be dependent upon the supposed competence of attorneys representing the parties. There is no assurance that attorneys for the parties know or would present arbitrators with an objective statement of applicable law or that arbitrators would accept briefs on what counsel believe to be the applicable law. [“Admissibility of Evidence. ... Although most arbitration claims present questions of fact that the panel will be able to decide on the evidence, some parties may rely on a specific law or statute. Generally, the party who has raised a legal issue will offer the panel a brief setting forth the law or statute and how it applies to the facts of the case. The arbitrators may encourage such a party to cover the issues orally. If the brief is accepted, the other party should be afforded an opportunity to respond. The arbitrators may also request that the parties submit briefs on any issue when the arbitrators feel a brief will assist them in deciding the case.” Manual, pps. 27-28.] (Emphasis added.) Many attorneys for the parties, relying upon the erroneously assumed infinite wisdom of arbitrators, tend not to present any legal authority to support their positions. Some have applied irrelevant legal theories to their factual situations, while ignoring applicable law. Some misrepresent the applicable law.

### **3. The NASD Has Been Unresponsive to Requests for Arbitrator Training in Applicable Law**

In 1992 through 1993, I attempted to encourage the NASD to cease the practice of frequent use of certain arbitrators and to educate arbitrators as to applicable law. The



NASD, in substance, stonewalled both efforts. Details of my efforts are set for in my public comments dated February 10, 2005 to SR-NASD-2004-164.

**4. Unpublished NASD Policy to Discourage Arbitrator Knowledge or Use of Applicable Law**

NASD arbitrators have uniformly revealed their misunderstanding that they are forbidden to employ legal authority not cited by the parties in their decision making process. They gathered that misinformation from non-publicly available “training materials” used in their NASD introductory training sessions.

The NASD policy requires that an arbitrator’s extensive knowledge of securities law and requests for full disclosure to co-panelists and the parties be considered as bias, when it should be considered as a demonstration of competence. An NASD Regional Director recently attempted to dissuade an arbitrator, who is well-versed in securities law and experienced in securities litigation/arbitration, from informing co-panelists and attorneys for the parties of applicable case law. (The relevant legal opinion describes the decision making process/criteria without specifying whether the ultimate decision was in favor of the plaintiffs or defendants.) The arbitrator desired to learn the attorneys’ opinions as to whether the case law was applicable to the matter and, if so, how it was applicable. The co-panelists refused to consider the law (as they believed that such would be a violation of some unspecified rule as the parties did not supply the legal authority) and/or allow its disclosure to the parties. The NASD Regional Director solicited a promise from the arbitrator not to employ that law in the decision-making process. When the arbitrator refused to disregard the law, the NASD Regional Director suggested that the arbitrator invite and grant a party’s motion for recusal based on grounds of bias. After the motion was granted, the two remaining arbitrators granted a motion to strike from the record all questions asked by the recused arbitrator and all answers thereto.

On February 20, 2005, I wrote to Ms. Jean I. Feeney, Vice President & Chief Counsel of the NASD Dispute Resolution, with a copy to Ms. Linda D. Fienberg, wherein I described the above situation and inquired as follows:

1. What is the NASD’s policy on the subject of arbitrators learning and employing the law in deciding cases? Are NASD arbitrators forbidden from independently researching the law and/or employing one’s own knowledge of specific applicable cases? Does the NASD policy forbid arbitrators to employ any knowledge of the law not presented by the parties? Must the arbitrator accept the law as stated by legal counsel?

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2. What should the arbitrator do if he/she is aware that the attorneys are incorrectly stating the law or, simply, not aware that it exists? Are NASD arbitrators forbidden from informing legal counsel of the parties and fellow panelists of apparently applicable law of which the arbitrator is aware and asking for counsels' versions of whether the law is applicable and, if so, how the law applies to the facts presented at the hearing?

3. If an arbitrator knows of specific applicable law, does the NASD forbid the arbitrator from employing it in the decision making process? Are NASD arbitrators who are aware of applicable law, which the arbitrator believes counsel are not aware, required to provide the parties with an opportunity to remove the arbitrator from the panel based upon grounds of bias?

On March 1, 2005, I supplemented that letter by stating, in part:

My inquiry deals with requests for information that should be readily known to the NASD, e.g. "What is the NASD's policy on the subject of arbitrators learning and employing the law in deciding cases?" There is no request that the NASD create a policy if one does not currently exist. If one exists, the NASD should be able to set forth the policy. If one does not exist, the NASD could simply inform me that none exists.

In her letter dated March 24, 2005, Ms. Feeney responded.

On March 31, 2005, I replied to Ms. Feeney's failure to respond to my questions and her revelation that the NASD provides some arbitrators with training that is contrary to publicly stated NASD policy, by stating, in part:

There are eight (8) questions included in three (3) categories. Your letter ignores most of them. You mention an irrelevant hypothetical situation where "the arbitrators are unsure of applicable law. You state, "[I]f they (arbitrators) feel that counsel is misstating the law," which is a small part of Question No. 2. You deal with "arbitrators do their own research" vis-à-vis an arbitrator who already knows the law as they were "well-versed in law and experienced in securities litigation/arbitration." You mention "going outside the record ... (denies) the parties the opportunity to argue, for example, that the particular case is or is not relevant" when the fact situation was that an NASD Regional Director attempted to dissuade the arbitrator from revealing her legal knowledge to

her co-panelists and the parties and not to use that knowledge in the decision-making process.

You claim that the “online chairperson training material” states, “[A]rbitrators should not conduct their own research.” The “online chairperson training material” is not publicly available and, thus, constitutes a secret NASD policy. Further, that secret NASD policy is inconsistent with the NASD’s publicly available pronouncements. Also, NASD arbitrators, whose eligibility to chair panels was grandfathered, would not be aware of such policy. *The Hearing Procedure Script* and the *NASD Dispute Resolution Information and Forms for Arbitrators Conducting Arbitrations in the State of California* contain no admonition regarding legal “research.” You quote from *The Arbitrator’s Manual*, where it states, “Arbitrators should not make independent factual investigations. Nothing, however, prohibits an arbitrator from reading the text of a rule referred to in a party’s pleading....” Nothing in *The Arbitrator’s Manual* prohibits an arbitrator from conducting legal “research,” however that term is defined. *The Arbitrator’s Manual* also states, “Arbitrators should realize that they are viewed by parties in an arbitration proceeding much as a judge would be viewed in a court of law.” Every attorney, who has practiced in a court of law, knows that judges, in addition to reading materials supplied by the parties, are permitted to and often do their own legal research. Further, without viewing the entire document, I do not know whether your quote was taken out of context, e.g. whether the word “research” refers to an independent investigation of facts. If you will provide a copy of the pertinent section(s) of the “online chairperson training materials,” I will further respond.

The NASD’s aforesaid secret policy has engendered a systemic manifest disregard of the law in the arbitration decision-making process.

...

Officers of the court, including employees of the NASD, should not encourage, permit or condone such manifest disregard of the law.

....

Again, you are specifically requested to provide an answer to each of the originally posed questions. (Single underline emphasis added.)

Ms. Feeney has not responded to my aforesaid letter dated March 31, 2005.

The NASD is stonewalling my efforts to learn specifics of its unpublished policies concerning the use of substantive law in the arbitration process. The NASD has failed and, thus, refused, to provide an answer to any of the aforesaid questions. One may

reasonably assume that the NASD procedures are totally devoid of any respect for the use of law in the arbitration decision-making process and the NASD has no respect for those who are aware of and wish to employ the applicable law as, at least, a starting point in their decision-making process.

#### **IV. NASD Has Caused Its Arbitrators to Create Their Own Rules to Decide Cases**

Since February 2005, I have communicated with more than 1,000 NASD arbitrators via email while seeking information as to their opinions/experiences on the subject of the NASD arbitration process. Excerpts from a few of the most revealing email communications, which show that NASD arbitrators employ their own rules to decide cases, are set forth as follows:

##### **A. Some Arbitrators Have No Use for the Law**

**A:** I have been a Panelist (public)... Since 1996 I have been selected to serve on 65 cases (15 are still active). 19 have gone to hearing. In addition I have been Chairman of 28 of these cases. Other than a couple of single arbitrator cases all of the cases have been with 3 Panelists. The majority of the people have been Public arbitrators which included many Attorneys, also many are Industry people. Although we receive from both parties, reams of papers with case law, not once in any case during a hearing or during any deliberations has any one referred to them. In every case I have been selected to serve on, ALL the Panelists approach the matter totally neutral. All we look for are the facts. What we try to determine is what was laid out in the statement of claim real. (sic) ... Please note that we look at each case for specific information relating to that case. We do not need case law. Simply, does one plus one equal two. That's what we try to determine.

##### **B. Some Arbitrators Employ an Ambiguous "Fair and Equitable" Approach**

**A:** I ... have been on dozens of panels, including chairing many. ... My greatest concern is the steady drift of arbitration cases toward the equivalent of full blown court cases, with voluminous exhibits and citations, etc., etc., etc. It used to be the objective to arrive at a fair and equitable outcome in a streamlined way to save time and money. ...

**LG:** ... The real question is setting those "fair and equitable" standards. What is "fair and equitable" to one arbitrator may not be to another. There

need to be guidelines so that parties have some idea what their risks are in not settling an arbitration cases. To me, the law represents publicly known principles that the courts or legislatures have spent much time trying to set forth as to what is "fair and equitable" in specified situations. Those guidelines demonstrate what facts are relevant and what are not. The law is the best guideline of which I am aware. At least, it is the best starting point. Since, arbitration is tending to be like civil courts, the NASD needs to train all arbitrators to handle it and have an effective evaluation system. ... The moral of the story --- the NASD needs to train everyone in a lot more than just being civil to one another and needs an effective means to weed out incompetents.

**A:** Re "fair and equitable": you give me food for thought on the need to hold to strict legal standards on arbitration cases. Do we have to come completely to that? Hopefully, we do not. ... As for arbitrator evaluations --- I completely agree and was going to mention it in my earlier e-mail. I can think of one ... arbitrator who should have been weeded out long ago.

**C. Some Arbitrators Recognize That They Lack Needed Legal Skills and Desire Written Guidelines**

**A:** I have been following with interest your recent collections of emails on NASD arbitration. I am a public arbitrator, who is not an attorney. My experience is only a few years and several cases old, but I would like to add a few comments.

...

2. I recently completed a case where I was the only panelist. The claimant was not represented by an attorney, but rather had their papers submitted by a member of the family who was not a claimant in the case. The respondent, of course, was represented by an attorney. ... I contacted the NASD administrator on this case, asking to be informed of the NASD's official definition of churning, so I would not have to take the opinion of one of the parties without getting corroboration. I was told that I had to make my decision based solely on the papers filed by the parties, and that NASD would not provide an answer to my question. ...

3. Based on the preceding paragraph, I believe that it would be most useful if NASD-DR provided arbitrators with a definition of such common terms as churning, suitability, etc., so we would all have a common basis for making decision on these charges. With due respect, these definitions should be written in a non-legalese manner, so those of us who are not attorneys will be able to understand them. (Underline emphasis added.)

**LG:** The NASD places arbitrators in a position to seriously impact the lives of the parties, but, since about 1993, has ceased to provide the tools to do the task properly. Further, NASD non-publicly available “training materials” may discourage arbitrators from doing one’s own legal “research.” ...

**A:** I have neither the background nor the incentive to do my own legal research. I would, however, be willing to access NASD reference materials written in a laymen's language which would help me understand the issues in a specific case.

**LG:** You seem to be looking for something similar to approved jury instructions. Juries in both federal and state courts are provided with legal guidelines before they consider the factual issues. ...

**A:** I am not unaware of what churning is. My issue was that respondent's attorney stated something to the effect that, "...the NASD's definition of churning requires that the following conditions be met: a)...., b)...., c)..." . He then went on to demonstrate that the claimant had not met those conditions. Rather than simply take respondent's word for it, and thereby invalidate claimant's charge of churning, I was looking for NASD to tell me what THEIR definition of churning was. If it was the same as respondent's attorney had stated, then I would have accepted his defense. If not, then I would have rejected it. ... (Capitalized emphasis in original.)

**LG:** ... If the respondent had stated the same defense, but said that it was a legal definition, quoted the same statements from cases and given you copies of the cases to verify his/her quotations, would that have influenced your decision?

**A:** Not really - I don't have the legal background to review legal documentation and fully understand it and how it does (not) apply to a case at hand. Come to think of it, perhaps I have just stumbled into your original complaint - that the non-lawyers involved in arbitration don't have the legal background to fully understand, and thereby apply the law.

**D. Some Arbitrators Employ Their Own Version of the Principle of “Contributory Negligence”**

**A:** In many (most?) cases the concept of contributory negligence is in the picture, even though I don't immediately recall hearing that phrase in the cases I've been on. From your comments I gather that doesn't make you very comfortable. It kind of works for me in arriving at "fair and equitable". (Emphasis added.)

**LG:** ... A translation might be, “The respondent was negligent, but the law allows the amount of damage he/she/it caused to be reduced if the

claimant was also negligent.” Generally, it might also be referred to as “comparative fault.” It is a principle used to distribute fault and reduce damages awarded. However, the operative word is “negligence.” The concept of “contributory negligence” does not allow damages to be reduced when the claimant asserts other causes of action. ... In cases of breach of contract or torts other than negligence, e.g., fraud, breach of fiduciary duty, the concept of contributory negligence does not apply. In those situations, “contributory negligence” is a bogus defense.

**E. Some Arbitrators Just Try to Look Fair**

**A:** I generally agree that the training is more on how to look fair and do not talk to the parties in the rest room, than how to approach decision making, balance conflicting stories, apply the law, which law to apply, authority of SEC, NASD, Exchange Rules and state law, etc.

It is obvious that the NASD’s failure to educate arbitrators as to applicable law is having an impact upon the quality of justice available in arbitration proceedings. This should be most concerning as the NASD has substantially increased the number of arbitrators since 1993, when it ceased providing education in substantive law.

**V. NASD Needs an Effective Means to Evaluate Arbitrator Competence**

The Ruder Task Force Report (1996) recommended that the NASD implement an effective means to assess the competence of its arbitrators. The NASD has failed and, thus, refused to do so. The Report to the Securities And Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations by Michael A. Perino (2002) (“Perino Report”) confirms that the NASD’s attempts are in need of vast improvement.

**A. The Ruder Task Force Report Recommended that the NASD Implement an Effective Arbitrator Evaluation Procedure**

The Ruder Task Force Report recommended that the NASD implement an effective evaluation procedure concerning arbitrator competence. The Ruder Task Force Report stated, in part:

Many securities arbitration participants expressed concerns about the selection, quality, and training of arbitrators. ....

[T]he information garnered from these various evaluations (provided by the parties and their legal counsel) is very limited. As a result, the NASD is missing an important element of feedback about the quality of individual arbitrators.... This lack of information limits the NASD's ability to address specific concerns about individual arbitrators and to make improvements to the process based on participant concerns.

....

Evaluations of arbitrators by participants in the arbitration process are a vital source of information. They are used by the NASD staff to develop training programs, counsel arbitrators about deficiencies or problems, and to determine if certain arbitrators should continue to be selected.

....

[W]e reluctantly recommend that arbitrators should be required to evaluate the co-panelists before they are asked to serve again and before they receive their honoraria for their participation in the case.

Ms. Linda D. Fienberg, Esquire, was the "Task Force Reporter" of Ruder Task Force Report. Subsequently, she became President of NASD Dispute Resolution. The NASD has not implemented the aforesaid recommendations.

## **B. NASD Has No Effective Arbitrator Evaluation Procedure**

The NASD is essentially flying blind as to the quality and competence of its arbitrators. Until the mid-1990s, NASD Staff would attend each arbitration hearing session. Thereafter, Staff has little contact with arbitrators and does not attend hearing sessions. However, I have informed the NASD of the attitudes of various NASD arbitrators (without disclosing the identities of the arbitrators), which has been caused by the NASD's lack of arbitrator training and effective evaluation. (See, III.E.1, above.)

### **1. NASD Procedure Discourages Use of "Peer Evaluation" Questionnaire**

The NASD has engendered a "why bother" attitude among its arbitrators. The NASD employs a "Peer Evaluation" questionnaire "as an essential part of the NASD Dispute Resolution's continuing effort to ensure that arbitrators are qualified." However, few people want to be and/or want to be considered as informants. Even so, the NASD discourages use of the forms. It does not even acknowledge receipt when such form is submitted. It does not inform complainants as to what occurs, if anything, to the perpetrator. The NASD does not publish information as to the supposed effectiveness of its Peer Evaluation process, e.g. number of questionnaires submitted; types of complaints; and, actions, if any, taken by the NASD in response to complaints.



The NASD provides no guideline as to whether an arbitrator should use the Peer Evaluation form to report very revealing specific comments or actions by co-panelists. Some examples of actual events are as follows: A Chairperson (attorney) stated that he is not paid enough to take the time to learn applicable law and do an analysis to apply it to the facts under consideration. A co-panelist stated that a customer knew the allegedly omitted fact, because the customer was so wealthy. A co-panelist stated that he would never award punitive damages, but during a prior arbitration, represented to the parties that he was not adverse to awarding punitive damages. Co-panelists (attorneys) repeatedly fraternized with counsel outside the presence of all others despite repeatedly being advised that such conduct was improper. A Chairperson (attorney) stated, in substance, that he is unaware that a principal is legally responsible for the acts of its agent. A Chairperson's pre-hearing discovery rulings demonstrated incompetence. A Chairperson (attorney) tentatively ruled that numerous claimants be excluded from a hearing, as they might hear each other's testimony. ["(A)ll parties to the arbitration and their counsel shall be entitled to attend all hearings." NASD Code of Arbitration, Rule 10317.] Chairperson (attorney) engaged in repeated acts of verbal abuse against co-panelist. Which, if any, of the above are reportable events?

## **2. SEC Study Found that Few Bother to Submit "Peer Review" Questionnaire**

The latest publicly available report on evaluations provided by parties to an arbitration stated, "[F]ew arbitration participants completed the surveys .... The evaluation response rate was only between 10% to 20%. ... [T]hese responses may reflect selection bias problems ... [I]t is ... possible that individuals that ... achieved favorable outcomes were more likely to complete the surveys." ("Perino Report" at p. 34.)

## **VI. Recently Adopted NASD Rule 3110(f) Misleads the Investing Public To Believe that Arbitrators Employ Substantive Law in Their Decision-Making Process**

The NASD recently adopted Rule 3110(f), which states, in part:

Requirements When Using Predispute Arbitration Agreements With Customers. (1) Any predispute arbitration clause shall be highlighted and shall be immediately preceded by the following disclosure language ... which shall be highlighted: ... (D) The arbitrators' award is not required to include ... legal reasoning.... (Emphasis added.)

The NASD described the purpose of the change to Rule 3110(f) as: “To ensure that customers are advised about what they are agreeing to when they sign predispute arbitration agreements... including notice that by agreeing to arbitrate their disputes, customers may be waiving certain rights that would be available in court.” (NASD-SR-98-74 11/19/99) The NASD recognized, “Customers' perceptions of unfairness are heightened by the fact that, in order to open an account, they are forced to agree to SRO-sponsored arbitration.” (NASD-SR-98-74, 11/22/04)

In view of the information herein, one could easily conclude that recent NASD Manual amendment causes member firms to convey the false and misleading impression to public customers that arbitrators are required to and/or do employ legal reasoning to reach their decisions. The Rule fails to state that the NASD: (1) does not provide its arbitrators with training in substantive law; (2) has effectively discouraged use of the law in the arbitration decision-making process; and, (3) has not implemented an effective means to evaluate arbitrator competence.

The NASD professes that the “NASD believes that transparency should be a hallmark of securities arbitration...” (Testimony of Linda D. Fienberg, President, NASD Dispute Resolution Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Committee on Financial Services, United States House of Representatives, March 17, 2005) However, the mandated disclosures in NASD Rule 3110(f) leave much to be desired.

## **VII. Questionable SEC Oversight**

The SEC is tasked with oversight of the NASD arbitration process. Further, the SEC is obviously aware of the comments and recommendation contained in the GAO Report, Ruder Task Force Report and the Perino Report.

In response to my recent FOIA request<sup>2/</sup> to the SEC concerning its oversight of NASD arbitration from 1996 as to fairness of the arbitration process, training of arbitrators and evaluation of arbitrators, the SEC claimed an exemption with respect to “approximately 62 boxes” of documents. Assuming standard packing boxes, the SEC has generated approximately 310,000 pages of documents or over 30,000 pages per year.

The SEC, through proper oversight, should be aware that the NASD: (1) does not provide its arbitrators with training in substantive law; (2) has effectively discouraged use of the law in the arbitration decision-making process; and, (3) has not implemented an effective means to evaluate arbitrator competence. If so, the SEC condones such practices as it has allowed those practices to continue for multiple years. On the other

hand, if the SEC is not aware that those practices exist within NASD arbitration, its extensive oversight leaves much to be desired.

### **VIII. Conclusion**

Justice will not be served unless and until the NASD establishes and promulgates policies concerning the use applicable law in the arbitration decision-making process and takes effective measures to educate and evaluate its arbitrators as to their knowledge of applicable law. The NASD recognizes that parties to arbitration proceedings may view arbitrators “much as a judge would be viewed in a court of law.” However, without adequate knowledge of the applicable law, the arbitrators act as jurors who function without guidance from a judge or approved jury instructions. (Further, unlike jurors, the arbitrators are not even sworn to follow the law.)

The NASD has recently professed to Congress that the “NASD believes that transparency should be a hallmark of securities arbitration...” The NASD stated that the purpose of a recent arbitration agreement disclosure oriented rule changes was “To ensure that customers are advised about what they are agreeing to when they sign predispute arbitration agreements...” However, the NASD’s operational history indicates otherwise.

The GAO Report, the Ruder Task Force Report and the Perino Report long-ago specified the problems that need to be solved and have made curative recommendations. The NASD has ignored those problems. The result is the overall quality of justice provided by NASD sponsored arbitrations is suspect. In spite of its oversight mandate, the SEC acts with indifference. Public investors suffer.

The quality of justice or lack thereof dispensed in NASD arbitrated disputes and the quality related SEC oversight should be made clear to the investing public. In its current form, the NASD arbitration process and purported SEC oversight thereof constitutes a sham upon the investing public.

Hopefully, in executing its oversight function, the SEC will formally investigate the aforesaid allegations, recognize their veracity and cause the NASD to implement long overdue changes.

Ms. Annette L. Nazareth  
April 22, 2005  
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Please communicate with the undersigned in the event that further information is desired.

Very truly yours,

LES GREENBERG

LG:ms

cc: The Honorable Richard H. Baker  
The Honorable Barney Frank  
Mr. William H. Donaldson, Chairman  
Ms. Cynthia A. Glassman, Commissioner  
Mr. Harvey J. Goldschmid, Commissioner  
Mr. Paul S. Atkins, Commissioner  
Mr. Roel C. Campos, Commissioner

ec: Ms. Katherine England, Assistant Director, Division of Market Regulation, SEC

<sup>1/</sup> “Special Arbitrator Qualifications for Employment Discrimination Disputes ... (b) Single Arbitrators or Chairs of Three-Person Panels ... (C) substantial familiarity with employment law; and (D) ten or more years of legal experience....” NASD Code of Arbitration Procedure, Rule 10211.] (Emphasis added.) [“Temporary Injunctive Orders; Requests for Permanent Injunctive Relief ... (3) Selection of Arbitrators and Chairperson. (A)(i) In cases in which all of the members of the arbitration panel are non-public ... At least three of the arbitrators listed shall be lawyers with experience litigating cases involving injunctive relief. (B)(i) In cases in which the panel of arbitrators consists of a majority of public arbitrators ... At least a majority of the arbitrators listed shall be public arbitrators, and at least four of the arbitrators listed shall be lawyers with experience litigating cases involving injunctive relief. ... (4) Applicable Legal Standard. The legal standard for granting or denying a request for permanent injunctive relief is that of the state where the events upon which the request is based occurred, or as specified in an enforceable choice of law agreement between the parties.” NASD Code of Arbitration Procedure, Rule 10335. (Emphasis added.)

<sup>2/</sup> On March 10, 2005, pursuant to the provisions of the Freedom of Information Act (“FOIA”), I requested that the SEC (File No. 05–04212) provide documents described as follows:

[A]ll writings, e.g., reports of findings of inspections, letters, emails, audits, reports, notes of oral communications and/or interviews, notices, that evidence that the Securities and Exchange Commission, including its staff, (collectively "SEC") from January 1, 1996 to the date hereof has exercised oversight over NASD Dispute Regulation (and/or any predecessor organization)(collectively "NASD") arbitration with respect to:

- (a) the degree of fairness to the respective parties of arbitrator awards rendered in NASD arbitration proceedings;
- (b) the adequacy of training, other than with respect to procedural matters, provided by the NASD to its arbitrators;
- (c) the adequacy of the process by which the NASD evaluates the competence of NASD arbitrators after the respective arbitrators have first been assigned to their first case; and,
- (d) the NASD's implementation of recommendations contained in the Report of the Arbitration Policy Task Force To The Board of Governors National Association of Securities Dealers, Inc. (January 1996) with respect to arbitrator training in the substantive law and methods for arbitrator evaluations.

On April 19, 2005, the SEC provided its "final response" by stating, in part:

After consulting with other Commission staff, we have determined to withhold documents (approximately 62 boxes) that may be responsive to your request under 5 U.S.C. § 552(b)(8), 17 CFR § 200.80(b)(8), since they constitute an examination, operating, or condition reports prepared by, on behalf of, or for the use of the Commission or any agency responsible for the regulation or supervision of financial institutions. (Emphasis added.)