Re: Has NASD Dispute Resolution, which is **NOT** a sponsor of this email, informed you that….? (Part X)

> "Nobody makes a greater mistake than he who did nothing because he could only do a little."
>
> --- Edmund Burke (1727 – 1797)

I. Arbitrators and the Law
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III. "Does one plus one equal two?" (Encore, Encore)
IV. Discovery
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The following are some of the email comments received from arbitrators (**A**) and some of my replies (**LG**). Both may have been edited. From time to time, I had some afterthoughts on the subject (**LG [Supplement]**). On other occasions, ideas, which are not in direct response to an arbitrator's comment, are presented for your consideration, use and/or comment (**LG [Idea]**).

A summary of prior publications, others materials and associated links may be found at http://www.LGEsquire.com/LG_Links.html .

I. Arbitrators and the Law

A: I have been a NASD arbitrator for … (more than 14 years). My legal practice … (includes) securities law compliance. I am finding your e-mail blasts provocative and interesting.

Two questions bother me:

1. What state's law applies in an arbitration in California relating to a California customer?

2. Do the brokers' typical arbitration agreements include a choice of law clause?

I am also bothered by claimants' counsels invoking *Twomey* and *Duffy*. To me, the notion that a broker is a fiduciary is only the beginning of the analysis. And it may be an analysis that requires legal research after the hearing. Moreover, I don't think that it is an analysis that a panel member who is not a lawyer can make.

This leads me to a comment on arbitrator selection, it seems to me that a lawyer is needed on every arbitration panel. For panel selection purposes this requires the establishment of two pools: A general pool and a lawyers' pool. I would advocate the lawyers' being in both pools if this procedure were ever adopted.

Keep up the good work. Sincerely yours,

LG: The purpose of the emails is not to answer such specific questions, but to alert arbitrators that there are such issues looming just below the surface and that, in an attempt to do justice, those issues should not be ignored. However, the short answer to the first part is that one has to look at the specific facts, e.g., the terms of the agreement,

where the parties reside, where the transactions occurred, then apply a conflict of laws analysis. There is also the issue of procedural laws and substantive laws.

Proposed Rule Change SR-NASD-98-74 dealt with whether securities dealers could include choice of laws clauses in customer agreements. You might start your search by viewing "The General Comments on the Proposed Rule Change" at: http://www.sec.gov/rules/sro/nasd/34-50713.pdf. Search the pdf for the word "choice" and you will find about 12 items.

LG (Supplement): The ability of arbitrators to deal with legal issues and the necessity of legal training were explicitly covered by the Ruder Task Force Report to the NASD. The NASD has ignored/rejected those recommendations. At a minimum, customer/securities broker-dealer arbitration agreements should disclose that the NASD does not encourage or training panelists to employ the law in the decision-making process. In my opinion, with some training, non-attorneys would be able to understand the fiduciary duty principles in *Twomey and Duffy*.

My feeling is that only attorneys with "active" licenses should be permitted to serve as Chairpersons. I have served on panels with non-attorney Chairpersons. The low quality of their procedural decisions was an embarrassment. Sometimes, discovery decisions have to be revisited before the entire panel. Decisions on whether evidence should be admitted during hearings are sometimes masked with the statement, "We'll let it into evidence and attach a proper weight." Other times, there is no ruling on objections, but the attorneys for the parties continue without insisting on a ruling. Occasionally, it is necessary to go into executive session in order to educate the Chairperson. Some will simply turn to the attorney(s) on the panel and ask, "What do I do, now, Coach?"

A: Regarding the use of law, Federal courts are pretty clear that an arbitrator's award will not be overturned even if the law is not followed, as long as it is fair. Some cases go so far as to say that the arbitrator must be fair and is not bound to follow the law. (Sorry, it is late in the evening and I am not in my office, otherwise I'd look up the cites here.) Most state courts have followed the Fed's lead, and many states have statutes requiring a party seeking to overturn an award to show fraud or oppression. Interestingly, a study of 1500 arbitration cases in New Jersey in the mid 80's by the Rand Institute for Civil Justice concluded that arbitration awards are more likely to be in compliance with existing law than jury verdicts or court judgments. Does that mean arbitration or the law is fair, or both?

Although I am a lawyer, I do not think one has to be an attorney to be an effective arbitrator. Clear and logical thinking, neutrality and fairness together with common sense are far more important. That is not an argument that the law can be ignored, of course. I usually inform counsel at the preliminary hearing that we will not be able to do any research after the hearing, and if there are any cases or statutes they particularly want us to review, they should provide photocopies. Again, keep up the good work….

LG: Your comments raise many questions. Are more recent than 1980s data available? For what purpose was the "study" conducted? Why was the "study" limited to New Jersey cases? In which arbitration forums did the "arbitration awards" originate? What criteria were employed to determine that **"**arbitration awards are more likely to be in compliance with existing law than jury verdicts or court judgments"?

It may be somewhat Clintonesque, but some terms may need defining, e.g. "effective," "clear and logical," "fairness," "common sense." What standard would insure that all arbitrators have the same understandings? If it is "not an argument that the law can be ignored," what is the proper role of the law in the decision-making process?

What is the basis for informing counsel that you "will not be able to do any research after the hearing"? (I assume that you are referring to legal research.) Does that mean that you will be able to do research at any time before the end of the hearing? Do you consider knowing applicable law and calling it to the attention of counsel as doing legal research? What type of and how much legal research do you feel you are permitted to engage? What is the basis for your response?

A: You might be interested in the recent decision of the Maine Supreme Judicial Court in *Barrett v. McDonald Investments*, 2005 ME 43 (March 29, 2005), available on the Court's web site at: http://www.courts.state.me.us/opinions/2005%20documents/05me43ba.htm. The Court affirmed the denial of a motion to … compel arbitration…. The agreement required arbitration before NYSE, NASD or other SROs. Of principal interest is a concurring opinion by Justice Alexander which expresses a very dim view of mandatory arbitration programs of SROs, and comes to the conclusion that standard arbitration clauses in broker-customer agreements, are contracts of adhesion and often procedurally and substantively unconscionable. … [O]ne key element of his argument is that SRO arbitrators are advised that they need not follow the law. He opines that this invites the "wholesale flouting of federal laws and state laws designed to protect investors and provide them with judicially enforceable remedies against fraud and abuse...", pp. 12-13. Anyway, this ties in somewhat with your point about the need for training in the law for arbitrators and a duty to determine and follow the law as a key part of preserving the integrity of a fair and equitable arbitration process for securities disputes.

LG: … I read the opinion and the Montana case to which it refers. I feel that the basic impediment to change is the SEC. The 9th Circuit has held that SRO sponsored arbitration cannot be unconscionable as a matter of law as the SEC oversight assures that the arbitration procedures are not inadequate. It is necessary to demonstrate to Congress, citing arbitration practices/procedures, that the SEC's oversight, if any, provides no assurance of adequate procedures. Claimants' attorneys might take the approach that disclosures relating to arbitration are the equivalent of fraud by omission, e.g., failure to disclose that arbitrators are not trained in the law, discouraged from employing substantive law in the decision-making process, and not evaluated as to their competence.

LG (Supplement): I recently wrote to the SEC to make those points and am awaiting a response. A copy of my letter ("Severe Problems with NASD Arbitration and Questionable SEC Oversight") is located at: http://www.LGEsquire.com/050422_SEC_Nazareth.pdf .

II. Last Minute Settlements

A: Thanks for continuing the incredible work. I learn more from your e mails than from "The Neutral Corner." … I hope I do not seem reactionary, but I think I may represent a minority view.

I too am frustrated when a two or three week hearing settles just before the arbitration is scheduled. No one likes holes in our calendars, and it costs all of us some money. On the other hand, it would contravene an important public policy to create financial disincentives to settlement. We are supposed to encourage parties to settle, remember? If a case does settle on the eve of the hearing NASD will pay you a hundred bucks. Some see it as recognition of the inconvenience, others as an insult. If you want more, you need to ask yourself why you are arbitrating with NASD or the other exchanges.

First, securities arbitration with the SROs is no way to make a living. People can't seriously be in it for the money. At one time in the not-too-distant past, ADR was seen as having a public service, pro bono aspect to it. We were supposed to deliver a simple, low cost, efficient, fair, neutral and fast service in our delivery of justice. Arbitration, to a certain extent was a peer process, designed first and foremost to see that justice was done. My, how far we have come. If people want to be punished regardless of the outcome of their cases, they can opt for civil litigation. Neutrals in an ADR process need to keep the philosophical basis for that process in mind as part of their ethical obligations, in my opinion.

Very few people make a living at arbitration outside of labor arbitrators and more recently, retired judges. (Yes, there are always exceptions.) If you arbitrate with JAMS or AAA you can post your cancellation policies with your fees, giving advance notice. Interestingly enough, cancellation policies primarily designed to make the arbitrator whole without regard to the case settling or going to hearing creates a disincentive to select that arbitrator.

I think parties should be encouraged to settle, and encouraged to mediate before arbitration take place, although some may see mediation as another way to deprive arbitrators of their fees. Settlements are part and parcel of the ADR process, and we need to accept that for the system to work. That means we won't be sitting in windowless hotel conference rooms struggling with important issues for peanuts on about half our assigned NASD cases. That's life, and to charge parties seems to be punishing them for doing what is best for themselves. It is THEIR case, not the arbitrators'.

III. <u>"Does one plus one equal two?" (Encore, Encore)</u>

A: I told myself after my last letter to you, that enough is enough simply because you and I would never come to an understanding in regards to NASD arbitration. But after reading your letter of April 7, I just can't help myself.

To start with, I refer you to the sentence "The law informs one whether the presented evidence may be considered in the decision making process and how the facts are to be considered". Pretend for just a moment that you are not an attorney and you are not hung up on case law. Now pretend you are suing someone for MONEY. Not that someone held a gun to your head or held your wife hostage, or took money out of bank account, just in your opinion, the respondent mishandled your brokerage account.

You state the law will determine what evidence you can submit. The respondent submits all kinds of rulings by various judges or juries. But do you know if any of any of

the case law fits your personal situation. As an example, was the party in the same age bracket as you. Same sex. Same education. Same experience in investing. Same financial position. Same relationship with the broker. The same questions might be asked about the broker including how many times has he been named in a law suit. How then would you feel as a claimant if some of your facts or questions were thrown out unless the case law that was quoted fit your profile

Before I get into my final gripe, you use the terms "law" and "case law" in your letters. What is the difference?

Now my final gripe. Two more quotes from your letter. (l) “However, since you never look at the parties' briefs, you will never know whether case law might assist" And (2) "However, when you disregard the attorney's briefs on the law, feel that case law is, in effect, useless and fail to make full disclosure to the parties of your approach toward the law, much quality is lost" Wow! I could write a book rebutting these two sentences. But I will try to be brief.

(1) I (we) Always carefully read the statement of claim, the response, and all the motions, but do not bother with all the case law for the reasons stated below.

(2) When both parties submit case law, I find that each side uses the cases to prove their importantly, not once in my 20 some hearings has ANY attorney with all their boxes and boxes of papers they bring to a hearing, referred to case law in any shape or form.

It has been very interesting and educational corresponding with you, but please take me off your mailing list. I have lots of irons in the file and don't have the time to digest all the things you send. Sincerely

LG (Supplement):

Does case law fit “your personal situation”? First, it is necessary to read and understand the case. Cases involving fiduciary duty may apply regardless of the sexes of the parties, their education, their experience in investing and their financial position. Cases involving privileges, e.g. marital, patient-client and attorney-client communications, could be set forth to attempt to bar certain evidence.

Very basically, the law is either: statutory, e.g. an act of Congress, enacted by a state legislature and might be contained in the state’s Securities Law, Civil Code, Code of Civil Procedure; or, case law, where the courts have interpreted the statutory law and/or filled in gaps not covered by legislatures.

NASD arbitrators are only required to affirm that they have read the Statement of Claim and Statement of Answer. Thus, attorneys, who wish to have some assurance that the panel reads their position(s) on the law, should set forth those positions in their pleadings. Attorneys might not refer to the law in oral argument as they (incorrectly) assume that the arbitrators read the papers containing the cases references, understood their arguments and had no questions.

IV. <u>Discovery</u>

A: An article in the New York Times entitled, “All That Missing E-Mail … It’s Baaack” reminds me of an arbitration situation. The article said, “All Wall Street firms play hardball when clients bring arbitration cases. … The firm often stonewalls routine requests for documents and stalls even when arbitration panelists order the materials to be

produced." During a hearing, I asked for and my chairperson agreed to order a firm to produce certain documents. Day after day, the firm produced excuses rather than the ordered documents. The documents were eventually produced. After the hearing, I was orally informed by the NASD that an unidentified person had complained about the panel's document request. The NASD claimed that the request for the U-4 or U-5 allegedly gave the appearance of bias. I was told that it is "highly unusual" for a panel to order, on its own initiative, the production of documents. I responded that the panel had a duty to seek the truth and had the authority (Rule 10322) to make the request. I complained that the NASD was second-guessing a panel's procedural decision and was attempting to intimidate me so that I would not make further legitimate document production requests of member firms. The NASD denied the latter claim.

A: My firm represented a claimant in a churning, etc. case. We asked for copies of order tickets. The response was that they had been lost or destroyed and, after diligent search, could not be located. At the hearing, I called the salesman's secretary as a witness. She said that all the requested order tickets were stored in the office's basement. The order tickets were produced. An analysis of the order tickets showed a pattern of bunching (without account numbers) large orders in the early morning and allocations to specific accounts at the end of the day. My client's account was continually allocated the trades that already had built-in losses.

V. Securities Industry Arbitrators and "Arbitrator's Judicial Notice"

LG (Idea): Since 1988, customers of stock brokerage firms have been required to resolve disputes with those firms before arbitration panels provided by securities industry organizations. Approximately, 90% of the claims are resolved before the NASD. NASD arbitration rules require that one person from the securities industry sit on each three person arbitration panel.

In recent testimony before Congress, the Securities Industry Association attempted to justify the rule by stating: "This … (provides) a level of expertise that would not otherwise be available to the panel… [I]n light of the ever-growing complexity of the financial products that are often the subject of arbitrations … and the technical issues that sometimes arise … SIA believes that the presence of one arbitrator who is more familiar with these products and their appropriate and/or inappropriate use greatly increases the chances for the fairest resolution of claims. … An arbitrator with experience in the business is in the best position to evaluate, and to help co-arbitrators evaluate, that testimony. In addition, arbitrators who have had some experience in the securities industry are more likely to be well-versed in the supervisory and compliance structure of brokerage firms, the duties and obligations of brokers and other financial professionals, and the regulatory framework under which these individuals and firms are required to operate." (Testimony of Marc E. Lackritz President, Securities Industry Association before the Committee on Financial Services U.S. House of Representatives March 17, 2005, p. 6-7.)

The argument is disingenuous. The underlying assumption is that every securities industry arbitration panelist has more expertise and objectivity than any expert witness who might testify on behalf of a party and any non-securities industry co-panelist.

Further, the justification ignores the problem that the parties do not know of or have an opportunity to rebut any information that the securities industry arbitrator could privately present to his/her co-panelists.

On October 1, 1992, I complained to the NASD of what I described as "arbitrator's judicial notice." I explained what true judicial notice is and how it was being subverted in NASD arbitration. I wrote, in part: "If the trial court resorts to any source of information not received in open court … such information and its source shall be made a part of the record in the action and the court shall afford each party reasonable opportunity to meet such information before judicial notice of the matter may be taken. The aforesaid procedure has been established so that a court may not decide cases based upon secretly obtained information of which the adversaries are unaware and thereby unable to respond. …. I have … personally observed (that) … the securities industry representative, during the deliberations, will, for the first time, inform the other arbitrators of crucial information which he/she claims existed within the securities industry at the relevant period…. In each situation, the hearing, for all practical purposes, has been closed so that neither the expert witnesses nor the parties can be asked to comment upon the information. The aforesaid approach to 'arbitrator's judicial notice' is nothing but a blatant attempt to sway the panel's decision based upon what can be and sometimes is false and/or misleading information…." The NASD never responded to my letter.

It is time to remove this securities industry arbitrator vestige that has long outlived any initial usefulness and creates the appearance of bias. For those within the securities industry, who would resist the suggestion, there is an effective alternative.

The NASD has recently testified before Congress, "Transparency is a cardinal value of the federal securities laws. … NASD believes that transparency should be a hallmark of securities arbitration as well." (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, p. 3.) The NASD could require securities industry arbitrators to inform the parties of the details of the supposed "more likely to be well-versed" information that they currently whisper into the ears of their co-panelists. Further, NASD rules could provide the parties with an adequate opportunity to rebut the accuracy of that "secretly obtained information."

The NASD has created a further conundrum. It claims securities industry arbitrators provide valuable knowledge of the securities industry to their co-panelists. On the other hand, arbitrators, who use their legal backgrounds to decide issues, are considered biased (due to legal knowledge acquired outside of the hearing room) and are advised to solicit and grant motions to recuse themselves. However, an arbitrator's knowledge of the law is objectively verifiable by reading the cited law or cases, while a securities industry arbitrator's supposed knowledge of the securities industry is not. Further, the NASD deems training in securities industry products to be helpful, while it offers no training in legal issues.

My continuing thanks to those who have contributed to Parts I through X and/or shared their ideas/information. Please continue to forward these emails to your colleagues and associates and share your arbitration ideas and experiences with your fellow readers.

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