



**REPORT TO THE SECURITIES AND EXCHANGE COMMISSION
REGARDING ARBITRATOR **CONFLICT DISCLOSURE**
REQUIREMENTS IN NASD AND NYSE SECURITIES
ARBITRATIONS**

Michael A. Perino
Visiting Professor
Columbia Law School

Associate Professor
St. John's University School of Law


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BACKGROUND AND PURPOSE



The NASD, through its subsidiary NASD Dispute Resolution, Inc. (“NASD-DR”),¹ and the New York Stock Exchange (the “NYSE”) are the leading providers of arbitration services for the securities industry. These self-regulatory organizations (“SROs”) have adopted detailed procedures for conducting the arbitrations they sponsor. The SEC, as part of its oversight of the SROs, reviews the procedural fairness of SRO arbitration rules through its review and approval of proposed SRO rule changes. The SEC also inspects the SRO arbitration programs on a regular basis. The SROs’ arbitration rules require arbitrators to disclose potential conflicts and give parties the ability to strike or challenge arbitrators based on those disclosures.

In September 2001, the California legislature passed amendments to the California Code of Civil Procedure to change disclosure rules in contractual arbitrations conducted in the state. The legislation permits parties to disqualify arbitrators based on disclosure of a broad array of information and requires courts to vacate arbitral awards if the arbitrator failed to make a required disclosure. The legislation also delegates authority to the Judicial Council of California to adopt mandatory ethics standards for individuals serving as neutral arbitrators, including rules for the disclosure of potential conflicts.²

Pursuant to this statutory mandate, the Judicial Council adopted Division VI of the Appendix to the California Rules of Court, entitled *Ethics Standards for Neutral Arbitrators in Contractual Arbitration* (the “California Ethics Standards” or the “Standards”), most of which became effective on July 1, 2002. The California Ethics Standards conflict with current SRO arbitration rules; they generally impose more detailed disclosure obligations on arbitrators than current SRO rules.

¹ Pursuant to a restructuring in July 2000, NASD created NASD-DR to oversee its arbitration and mediation programs. NASD-DR took over operations of these programs from NASD Regulation, Inc, which was also a wholly owned subsidiary of NASD.

² CALIF. CODE OF CIV. PROC. 1281.85. The Judicial Council of California is the policy-making arm of the California courts and is charged with, among other responsibilities, promulgating rules of court administration, practice, and procedure.

Before the California Ethics Standards were adopted, NASD-DR and the NYSE contacted California officials seeking to exempt SRO arbitrations from the Standards. The Commission staff also contacted members of the California legislature to express its view that SRO arbitration programs were subject to pervasive federal regulation and therefore should be exempt from the California Ethics Standards. Neither the Judicial Council nor the legislature, however, chose to create an SRO exemption.



As a result, on July 22, 2002, NASD-DR and the NYSE filed suit in the United States District Court for the Northern District of California seeking a declaratory judgment that the California Ethics Standards cannot be applied to them or their arbitrators. The Commission filed an *amicus curiae* brief in the action in support of the position that the comprehensive scheme of federal securities regulation preempts the Standards. The Commission also announced that it had asked me to assess the adequacy of current NASD and NYSE disclosure requirements. This Report reflects the results of that assessment.



SCOPE OF REVIEW

To evaluate current conflict disclosure rules and the potential impact of adopting the California Ethics Standards, I examined the NASD Code of Arbitration Procedure (the “NASD Code”) and NYSE Arbitration Rules (the “NYSE Rules”), various materials prepared by the Securities Industry Conference on Arbitration (“SICA”), SRO rulemaking proposals, and other SEC releases. I reviewed the relevant California legislation, the California Ethics Standards, comments submitted with respect to the Standards, and the pleadings in the litigation challenging application of those Standards to SRO-sponsored arbitrations. I also reviewed empirical and other academic literature on arbitrations, in securities and other contexts.


In addition, I conducted extensive interviews with representatives of the SROs. I also contacted lawyers experienced in securities arbitrations, members of the Securities Industry Association, representatives of the Public Investors Arbitration Bar Association, arbitrators, and academics familiar with securities arbitrations to obtain their views on whether current disclosure rules are adequate. I provided the SROs with a draft of this Report for their comments.




EXECUTIVE SUMMARY OF REPORT AND RECOMMENDATIONS




Securities arbitrations are the primary dispute resolution mechanism for disputes involving customers and broker-dealers. The benefits of arbitration are well known. It provides a streamlined, expeditious, and final mechanism for resolving disputes through the use of **experts in the matters at issue**. To attain these benefits and to foster confidence in the integrity of the process, **investors, the public, the judiciary, and legislatures must believe that arbitrators are fair and impartial**. Conflict disclosure rules are a crucial component in creating a system that is in fact fair and that investors perceive to be fair.



Are current SRO conflict disclosure rules adequate to achieve these goals? **This Report concludes that there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations**. To be sure, some critics, particularly lawyers that represent investors, continue to suggest that SRO-arbitrations have a distinct pro-industry bias. But, **available data on arbitration outcomes do not suggest that industry members fare better than investors**. Investors generally appear to believe that arbitrators are fair and impartial. A miniscule percentage of arbitral awards are vacated on the basis of arbitrator bias. There is thus little evidence that an overhaul of current conflict disclosure rules is needed.



Moreover, this Report concludes that adopting the California Ethics Standards is likely to yield very few benefits for investors for two reasons. Any lingering perceptions of pro-industry bias appear to stem from rules governing panel composition, not from the presence of undisclosed arbitrator conflicts. And, although current SRO rules represent a very different **drafting philosophy** from the Standards, both call for many of the same kinds of disclosures.



At the same time, adopting the California Ethics Standards may impose significant costs and may have significant **unintended consequences** that may reduce investors' perceptions of the fairness of SRO arbitrations. Current SRO conflict standards are consistent with model disclosure standards and judicial opinions analyzing arbitrator disclosure requirements. Changing current rules to define potential conflicts more broadly may deter well-qualified arbitrators from serving or may disqualify those with significant expertise from hearing a

case. The net result may well be less accurate case resolutions and more judicial challenges to arbitral awards.



Other aspects of the Standards appear to misconceive the relationship between the SROs and industry members. The Standards require disclosure of any fees or assessments industry members pay to the SRO and would permit the parties to disqualify an arbitrator on the basis of those disclosures. While such an approach may be appropriate to reveal biases involving some for-profit arbitration providers, they make little sense for securities arbitrators, who have no financial interest in the SROs. Indeed, since all industry members pay fees and assessments to the SROs, adopting this rule could effectively preclude all SRO arbitrations if the parties exercise their statutory challenges to the fullest possible extent.

While the current SRO conflict disclosure requirements generally appear adequate, some minor enhancements to disclosure and other related rules may provide additional assurance to investors that arbitrators are in fact neutral and impartial. For this reason, the Report makes the following four recommendations:

1. **Amend Arbitration Rules to Emphasize that All Conflict Disclosures Are Mandatory.** SRO rules specify that arbitrators *should* disclose certain matters and should take reasonable efforts to update their disclosures. While NASD-DR and the NYSE appear to treat these disclosures as mandatory, they should amend these provisions to formalize that arbitrators *shall* disclose the required information and *shall* take reasonable efforts to update their disclosures. *See* pages 12-14.
2. **Re-examine the Definitions of Public and Non-Public Arbitrators.** Critics of SRO arbitrations consistently point to the presence of industry arbitrators on arbitration panels and the classification of arbitrators as public or non-public as the primary sources of potential pro-industry bias. No classification rule could ever precisely define public and non-public arbitrators; there will always be classification questions at the margin about which reasonable people will differ. Nonetheless, this Report recommends that the SROs should evaluate current rules to determine whether it is advisable to broaden their definitions of industry arbitrators. Specifically, the Report recommends that in addition to proposals already under consideration:

- NASD-DR and the NYSE should consider whether it is appropriate to expand the definition of “immediate family member” to include spouses, parents, and children, regardless of whether the children are declared as dependents or are members of the arbitrator’s household.
- NASD-DR should consider whether it is appropriate formally to adopt the NYSE’s position that close questions with respect to classification or challenges for cause should be resolved in favor of customers.



This Report is only recommending that the SROs evaluate the advisability of these changes. Definitive recommendations are inappropriate at this time because I have insufficient data on the effect that these changes may have on the depth of the arbitrator pool or on any additional administrative costs that such amendments would entail. *See* pages 16-19.

3. **Provide Greater Transparency with Respect to Challenges for Cause by Including the Cause Standard in the Rules.** Both the NASD-DR and the NYSE follow the same standard for granting for cause challenges to arbitrators. The standard, however, does not appear in their respective arbitration procedures. Including the standard in the rules should provide greater transparency with respect to challenges and greater party confidence that all challenges will be granted or denied on the same basis. *See* pages 19-23.



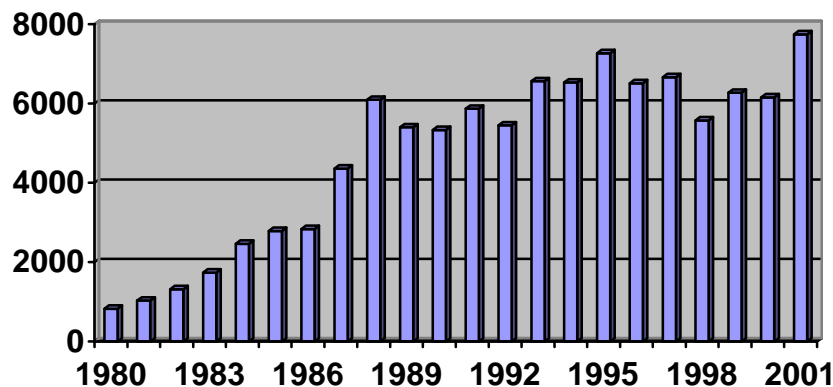
4. **Sponsor Independent Research to Evaluate Fairness of SRO Arbitrations.** Given the unquestioned significance of securities arbitrations, it is crucial that the SROs resolve any lingering concerns about pro-industry bias. To date, available empirical evidence, particularly with respect to investor perceptions of the arbitration process, is fairly limited and only suggests that there are no substantial systemic problems in SRO arbitrations. As a result, this Report recommends that the SROs sponsor additional independent studies to further evaluate the impartiality of the SRO arbitration process. *See* pages 30-37.

After reviewing a draft of this Report, the NYSE represented that it would propose amendments to the SICA Uniform Code of Arbitration and subsequently to the NYSE Rules to implement Recommendations 1 and 3. The NYSE also represented that it would present for consideration at the next SICA meeting Recommendations 2 and 4. The NASD stated that it intended to recommend to SICA and propose to NASD’s board that it follow each of the Report’s recommendations.

OVERVIEW OF SRO ARBITRATIONS

Arbitrations are the primary dispute resolution vehicle in the securities industry and date back to at least 1872.³ SRO rules require broker-dealers to submit disputes with customers to arbitration.⁴ Customer arbitrations are generally the result of pre-dispute arbitration agreements, which broker-dealers typically include in customer contracts. Most of these contracts require use of an SRO arbitration forum. In 1987, the United States Supreme Court upheld pre-dispute arbitration agreements as consistent with the strong public policy in favor of arbitration.⁵ As Figure 1 demonstrates, the number of arbitrations

Figure 1
Annual SRO Arbitration Filings (1980-2001)



³ See J. KIRKLAND GRANT, SECURITIES ARBITRATION FOR BROKERS, ATTORNEYS, AND INVESTORS 94-95 (1994). In 1872, the NYSE instituted an arbitration program to resolve disputes between members of the Exchange and public customers. See REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (Jan. 1996), reprinted in [1995-1996 TR. BINDER] FED. SEC. L. REP. (CCH) ¶ 85,735, at 87,433 [hereinafter the “RUDER REPORT”].

⁴ NASD CODE 10301(a) & 10101(c); see NASD CODE IM-10100(a) (for consequences to firms for failure to arbitrate). SRO arbitrations may also involve disputes among members, associated persons, or registered clearing agencies.

⁵ See Federal Arbitration Act, 9 U.S.C. § 2; *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1 (1983).

has grown substantially with the widespread use of these agreements and as more individual investors have engaged in securities transactions.⁶

Resolving disputes through arbitration has potential benefits for both industry members and customers.⁷ Arbitration is generally less expensive and faster than litigation.⁸ Claims that are too small to pursue cost-effectively in litigation are viable when arbitration is available. While arbitration has grown more “litigious,” in recent years,⁹ thereby eroding some of its transaction costs savings, the participants also benefit from expert decision-makers who appear, on average, to yield quick and accurate decisions.¹⁰ There are limited grounds for courts to overturn arbitration awards, thereby providing a greater degree of finality than litigation. Arbitrators are not bound by precise legal standards, which may benefit investors, particularly as federal securities remedies have become more restrictive.¹¹

⁶ The data for Figure 1 comes from SICA.



⁷ Society may also benefit to the extent that an extensive securities arbitration system conserves scarce judicial resources. See John C. Coffee, Jr., *Commentary on Joel Seligman, The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 376, 379 (1996).

⁸ GRANT, *supra* note 3, at 96-97.


⁹ RUDER REPORT, *supra* note 3, at 87,433; Bruce M. Selya, *Arbitration Unbound: The Legacy of McMahon*, 62 BROOK. L. REV. 1433, 1445-48 (1996).

¹⁰ See *Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145, 150 (1968) (White, J., concurring) (“It is often because they are men of affairs, not apart from but of the marketplace, that they are effective in their adjudicatory function.”); Deborah R. Hensler, *Science in the Court: Is There a Role for Alternative Dispute Resolution?*, LAW & CONTEMP. PROBS., Summer 1991, at 171, 186 (“Arbitrations’ chief benefit to many disputants may be that it reduces the uncertainty of outcomes by substituting expert decisionmakers for lay juries.”); Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEG. STUD. 1, 5 (1995).

¹¹ See Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1035-40 (2002); Marc I. Steinberg, *Securities Arbitration: Better for Investors than the Courts*, 62 BROOK. L. REV. 1503 (1996). Arbitrators may not completely ignore the law; most courts hold that they may overturn SRO arbitration awards based on “manifest disregard of the law.” See, e.g., *Halligan v. Piper Jaffray, Inc.*, 148 F.3d 197 (2d Cir. 1998); *Montes v. Shearson Lehman Brothers, Inc.*, 128 F.3d 1456 (11th Cir. 1997); see also *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 942 (1995) (recognizing manifest disregard standard in dicta). Other courts, however, have expressed reservations about the validity of this ground, which is not one specified in the Federal Arbitration Act. See *George Watts & Son, Inc. v. Tiffany & Co.*, 248 F.3d 577 (7th Cir. 2001).



To be sure, critics of securities arbitration contend that industry members prefer arbitration because SRO-sponsored arbitrations tend to yield pro-industry outcomes. While it is theoretically possible for an arbitration forum to develop such a bias, two factors—regulatory oversight and economic self-interest—appear, at least in theory, to provide a significant check on any such tendencies. The SROs are the primary regulators of securities broker-dealers and have a statutory mandate to provide a fair dispute resolution forum.¹² The SEC exercises substantial oversight of the SROs. The SEC approves arbitration rules before they become effective.¹³ Proposed rules are published in the *Federal Register* and are subject to public comment.¹⁴ Section 19 of the Exchange Act requires the SEC to approve SRO rules only if they are consistent with the requirements of the federal securities laws.¹⁵ The Commission retains the power to amend or abrogate SRO rules “as [it] deems necessary or appropriate to insure the fair administration of the [SRO.]”¹⁶



The Commission oversees SRO arbitrations through its inspection process, which is intended to “identify areas where procedures should be strengthened, and to encourage remedial steps either through changes in administration or through the development of rule changes.”¹⁷ The SEC staff stated that it reviews whether the SROs are complying with their own rules and whether the SROs can enhance their rules and procedures. In this regard, the SEC staff evaluates SRO administration and processing of arbitration cases and the management of the arbitration pool, including the selection, training, rotation, and evaluation of arbitrators. The SEC’s staff has consistently worked with the SROs and others to develop procedural protections to guard the integrity of SRO arbitrations. At the same time, the United States General Accounting Office (the “GAO”) has conducted a number of independent

¹² See 15 U.S.C. §§ 78f(b) & 78o-3(b).

¹³ 15 U.S.C. § 78s(b)(1). For a description of some SRO rulemaking initiatives and SEC oversight see Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327, 335-39 (1996).

¹⁴ 15 U.S.C. § 78s(b).

¹⁵ 15 U.S.C. § 78s(b)(2).

¹⁶ 15 U.S.C. § 78s(c); see *McMahon*, 482 U.S. at 233-34 (noting that the Commission has “expansive power to ensure the adequacy of the arbitration procedures employed by the SROs... including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.”).

¹⁷ See SEC Rel. No. 34-40109, 63 FED. REG. 35299, 35303 n.53 (June 29, 1998).



reviews of the adequacy of SRO procedures and evaluations of the overall fairness of the system.¹⁸



This oversight system provides an important independent review of the fairness of SRO arbitration procedures. But, the securities industry also has a rational self-interest in providing a fair dispute resolution system. The SROs recognize that because arbitration is mandatory for most customer disputes, public perceptions of the fairness of the arbitration process are crucial to its success.¹⁹ Systemic procedural inequities would likely increase the costs of the arbitration system as more dissatisfied parties attempted to overturn arbitration awards. The presence of systemic conflicts or other procedural inequities might invite closer judicial scrutiny of arbitration awards, yielding more successful challenges and therefore less finality.²⁰

This combination of oversight and rational self-interest has made the SROs quite responsive to groups that have advocated revisions to the SROs' arbitration procedures. Indeed, the SROs have regularly revised their procedures over the last fifteen years. The SROs formed SICA (a cooperative venture consisting of representatives of the SROs, the Securities Industry Association, and members of the public) to establish a Uniform Arbitration Code and to otherwise monitor and revise securities arbitration procedures.²¹

¹⁸ See, e.g., GAO, PROCEDURES FOR UPDATING ARBITRATOR DISCLOSURE INFORMATION, Rep. No. GAO-01-162R (Nov. 9, 2000) [hereinafter UPDATING ARBITRATOR DISCLOSURE]; GAO, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS, Rep. No. GAO/GGD-00-115 (June 2000) [hereinafter PROBLEM OF UNPAID AWARDS]; GAO, SECURITIES ARBITRATION: HOW INVESTORS FARE, Rep. No. GAO/GGD-92-74 (May 1992) [hereinafter HOW INVESTORS FARE].

¹⁹ See SICA, THE ARBITRATOR'S MANUAL 3 (January 2001) ("Since arbitration is the primary means of resolving disputes in the securities industry, the public perception of its fairness is of paramount importance.").

²⁰ See *Penn v. Ryan's Family Steak Houses, Inc.*, 269 F.3d 753, 758 (7th Cir. 2001); *Cole v. Burns Int'l Security Servs., Inc.*, 105 F.3d 1465, 1482-83 (D.C. Cir. 1997); Christopher R. Drahozal, "Unfair" Arbitration Clauses, 2001 U. ILL. L. REV. 695, 697-98; Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOK. L. REV. 1335, 1353 (1996) ("if the adhering party can demonstrate that the proposed arbitration rules or processes are not impartial—that they favor the stronger party—the arbitration might be enjoined"); see also Carrie Menkel-Meadow, *Do the "Haves" Come Out Ahead in Alternative Judicial Systems?: Repeat Players in ADR*, 15 OHIO ST. J. ON DISP. RESOL. 19, 52 (1999) (noting that securities and other industries favor arbitration "so much that they are willing to undertake potentially substantial internal reforms to avoid judicial nullification").

²¹ See X LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4577-78 (rev'd 3d ed. 1996).



NASD established a standing committee of its board, the National Arbitration and Mediation Committee (the “NAMC”), to recommend improvements to its dispute resolution systems.²² Lawyers representing investors have formed their own association, the Public Investor Arbitration Bar Association (“PIABA”). PIABA advocates the interests of public investors, proposes changes to arbitration procedures, and serves as a clearinghouse for information on SRO arbitrations and arbitrators.



The SROs have sponsored independent evaluations of their arbitration procedures as well. For example, in 1994 the NASD appointed an Arbitration Policy Task Force chaired by former SEC Chairman David S. Ruder to evaluate the need for securities arbitration reform. The resulting task force report, commonly referred to as the Ruder Report, served as the basis for substantial changes intended to enhance the fairness of the arbitration system,²³ particularly with respect to the selection of arbitrators.

SRO PROCEDURES FOR DISCLOSURE OF ARBITRATOR CONFLICTS

This Report assumes familiarity with SRO arbitrations. The following description therefore focuses only on the procedural protections with respect to arbitrator conflicts. There are three primary components: (1) obtaining and updating arbitrator background information; (2) arbitrators’ disclosure obligations and conflict training; and (3) selecting the arbitration panel.

Although the NASD and NYSE base their rules on the Uniform Code, their procedures differ with respect to the classification and selection of arbitrators and challenges for cause. This overview emphasizes NASD-DR procedures because it is the forum for about 90% of securities arbitrations.²⁴ Unless otherwise noted, there are no significant differences between NYSE and NASD procedures.

²² NASD CODE 10102. The NAMC is composed of a majority of non-securities industry members.

²³ See *supra* note 3.

²⁴ According to data compiled by SICA, in 2000 and 2001, NASD-DR was the forum for 89.75% of all securities arbitrations. Collectively, NASD-DR and the NYSE handled about 99% of all SRO-administered securities arbitrations in those two years.

Obtaining and Updating Arbitrator Background Information

NASD-DR and the NYSE respectively maintain pools of approximately 6,700 and 2,400 eligible arbitrators.²⁵ Conflict disclosure begins when arbitrator applicants submit biographical profile forms to the SRO.²⁶ Those forms require that applicants provide detailed information on their business and employment histories, education, training, conflicts, associations with industry members, and other matters.²⁷ The NASD-DR application also includes a narrative Background Information Statement in which the applicant is asked to provide “accurate, current, complete, and comprehensive” statements, including information on “industry members that you have represented or by whom you have been employed.” Attorneys and accountants are further directed to provide specific details about their practices. Copies of the NASD-DR and NYSE arbitrator applications appear in Appendix A.

Arbitrator information is entered into the SROs’ databases and is disclosed to parties when panels are selected. Arbitrators must update this biographical information on a regular basis.²⁸ NASD-DR sends frequent reminders to arbitrators about the importance of this obligation,²⁹ especially after they are notified regarding possible service as an arbitrator.³⁰ As described more fully below, NASD-DR requires arbitrators in each case to affirm that they have reviewed their disclosure report and that it is accurate, and to complete a disclosure checklist attached to the oath. NASD-DR provides each arbitrator on a panel with the co-panelists’ biographical profiles in order to facilitate peer reviews for accuracy. NYSE also requires arbitrators to update their profiles each time they are appointed to a case.



²⁵ Gary Tidwell, Kevin Foster & Michael Hummel, *Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations* 3 (1999). NASD-DR has eliminated individuals from its pool of arbitrators for, among other reasons, disabling conflicts of interest. See UPDATING ARBITRATOR DISCLOSURE, *supra* note 18, at 3.

²⁶ THE ARBITRATOR’S MANUAL, *supra* note 19, at 4.

²⁷ UPDATING ARBITRATOR DISCLOSURE, *supra* note 18, at 2.

²⁸ THE ARBITRATOR’S MANUAL, *supra* note 19, at 4.

²⁹ UPDATING ARBITRATOR DISCLOSURE, *supra* note 18, at 3. Among other things, NASD-DR emphasizes arbitrator training and disclosure responsibilities in its newsletter for neutrals, *The Neutral Corner*.

³⁰ THE ARBITRATOR’S MANUAL, *supra* note 19, at 4.

Since 1992, NASD-DR has twice surveyed its roster of arbitrators to ensure the accuracy of the background materials on file. In 1998, NASD-DR took steps to regularize its processes for updating its database to ensure that information is entered accurately and on a timely basis. NASD-DR randomly audits updated disclosure reports each quarter to verify that updates were correctly entered.³¹ Since November 2000, arbitrators have been able to update their disclosure information via the Internet. The GAO concluded in 2000 that “[t]he steps NASD-DR has taken to improve its procedures for entering arbitrator update information appear reasonable to reduce the opportunity for errors and improved the promptness of the data entry.”³² The SEC Staff also reached the conclusion that “there is no systemic problem regarding the update of biographical information.”³³

Arbitrators’ Disclosure Obligations and Conflict Training

Rule 10312(a) of the NASD Code and Rule 610(a) of the NYSE Rules impose a broad conflict disclosure obligation on arbitrators. Each arbitrator is required to disclose to the Director of Arbitration “any circumstances which might preclude such arbitrator from rendering an objective and impartial determination.” Specifically, the Rules mandate that arbitrators disclose:

- (1) Any direct or indirect financial or personal interest in the outcome of the arbitration;
- (2) Any existing or past financial, business, professional, family, social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. Persons requested to serve as arbitrators should disclose any such relationships or circumstances that they have with any party or its counsel, or with any individual whom they have been told will be a witness. They should also disclose any such relationship or circumstances involving

³¹ UPDATING ARBITRATOR DISCLOSURE, *supra* note 18, at 4.

³² UPDATING ARBITRATOR DISCLOSURE, *supra* note 18, at 5.

³³ UPDATING ARBITRATOR DISCLOSURE, *supra* note 18, at 10.

members of their families or their current employers, partners, or business associates.³⁴

Arbitrators have a continuing disclosure obligation throughout the arbitration and should make reasonable efforts to inform themselves of potential conflicts.³⁵

This standard is modeled closely on the American Bar Association and the American Arbitration Association Code of Ethics for Arbitrators in Commercial Disputes (the “ABA/AAA Code”).³⁶ It was developed with substantial input from the SEC, SICA, securities industry members, and members of the public. Like other SRO arbitration rules, the SEC approved the initial conflict disclosure rule and all subsequent amendments.³⁷

Nonetheless, there is one potentially problematic aspect of the standard. Although it is within a mandatory provision, the rule uses permissive language to describe some arbitrator conflict disclosure obligations. It states that arbitrators “should” disclose the information requested, not that they “shall” disclose the information. Likewise, the standard states that arbitrators should update their disclosures. Representatives of the SROs informed me that this permissive language was taken directly from the ABA/AAA Code and that in practice the SROs treat the disclosures as mandatory.

³⁴ NASD CODE 10312(a). Rule 610(a) is substantially similar, except it omits reference to “other relationships or circumstances.” NYSE RULES 610(a)(2).

³⁵ NASD CODE 10312(b) & (c); NYSE RULES 610(b) & (c).

³⁶ SRO arbitrators are required to comply with all ethical obligations of the ABA/AAA Code.

³⁷ SEC Rel. No. 34-26805, 54 FED. REG. 21144 (May 16, 1989).

Recommendation One

Amend Arbitration Rules to Emphasize that All Conflict Disclosures Are Mandatory. Section 10312 of the NASD Code currently specifies that arbitrators *should* disclose certain matters and should take reasonable efforts to update their disclosures. NYSE Arbitration Rule 610 contains substantially the same language. While NASD-DR and the NYSE appear to treat these disclosures as mandatory, they should amend these provisions to formalize that arbitrators *shall* disclose the required information and *shall* take reasonable efforts to update their disclosures.

The *Arbitrator's Manual* provides arbitrators with additional disclosure guidelines. It admonishes arbitrators that public perceptions of the fairness of SRO arbitrations are “of paramount importance” and that the “key to an effective arbitration system is having capable, fair, and impartial arbitrators who hear and decide cases conscientiously.”³⁸ Arbitrators “must be fair and impartial and must also appear to be fair and impartial.”³⁹ The *Manual* emphasizes that any doubts about disclosure should be resolved in favor of disclosure and that “it is in the best interests of the individual arbitrator and of the entire arbitration process that arbitrators ‘bend over backwards’ to avoid any appearance of bias.”⁴⁰

The *Manual* then specifies a non-exclusive list of nine examples of disabling conflicts involving four general areas: (1) opinion or bias;⁴¹ (2) business or personal relationships;⁴² (3) previous or current involvement;⁴³ and (4) financial interest.⁴⁴

³⁸ ARBITRATOR'S MANUAL, *supra* note 19, at 3.

³⁹ ARBITRATOR'S MANUAL, *supra* note 19, at 3.

⁴⁰ ARBITRATOR'S MANUAL, *supra* note 19, at 5.

⁴¹ The *Manual* provides two examples of a disabling opinion or bias:

- (1) Arbitrator has a firm opinion or belief as to the subject of an action for which she/he is an arbitrator.
- (2) Arbitrator has a personal bias toward a party.

⁴² The *Manual* provides three examples of a disabling business or personal relationship:

In addition to case-specific conflicts, SICA has established temporary and permanent arbitrator disqualification criteria. For example, arbitrators that misstate or fail to disclose material information are subject to permanent disqualification. The complete list of temporary and permanent disqualification criteria appears in the NASD Arbitrator Application in Appendix A.



Since 1993, new arbitrators must undergo training. A substantial portion of the training involves conflict disclosure obligations.⁴⁵ Since 1998, NASD-DR arbitrators must pass an examination on arbitration procedures,⁴⁶ including whether they understand and can apply the conflict rules.

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- (1) Arbitrator is or was related by blood or marriage to any party, its attorneys, or witnesses.
 - (2) Arbitrator is or was guardian or ward, conservator or conservatee, employer or employee, principal or agent, or debtor or creditor of either a party or an officer of a corporation which is a party. Arbitrator is the parent, spouse, or child of one who is related as above described.
 - (3) Arbitrator is or was a member of any party's family, a business partner, vendor, customer, or client of any party, a surety or guarantor of the obligations of any party, is currently a creditor or shareholder of any corporate party, or has any business relationship with any party.

⁴³ The *Manual* provides three examples of a disabling previous or current involvement:

- (1) Arbitrator is adverse to a party, its attorneys, or witnesses, or has complained against or been accused by any of them in another action, instituted or resolved during the past five (5) years.
- (2) Arbitrator or any member, shareholder, or associate of, or of counsel to his or her law firm has been in the relation of attorney and client with, or adverse to, any party within three (3) years of the filing of the arbitration claim.
- (3) The arbitrator is currently a party to or the subject of a complaint, arbitration, or litigation involving a securities investment.

⁴⁴ The *Manual* provides one example of a disabling financial interest:

Arbitrator knows that she/he has, individually or as a fiduciary, or her/his spouse or minor child residing in her/his household has a financial interest in the subject matter in controversy or in a party to the arbitration proceeding, or any other interest that could be substantially affected by the outcome of the arbitration proceedings.

⁴⁵ One NYSE representative informed me that he usually tells arbitrators in these sessions that "if it crosses your mind, disclose it."

⁴⁶ PROBLEM OF UNPAID AWARDS, *supra* note 18, at 19.

Selecting the Arbitration Panel

NASD-DR and the NYSE use different procedures to select arbitration panels. With respect to panel composition, however, both attempt to ensure that the majority of arbitrators in customer cases are unaffiliated with the securities industry (so-called “public arbitrators”), although there are some classification differences between the SROs.

Arbitrators are not employees of the SROs. They receive a relatively small honorarium of \$200 for each hearing session they attend. The chair of the panel receives an additional \$75 per day.⁴⁷ These rates appear to be substantially below the market rates for arbitrators in other commercial arbitration programs.⁴⁸

Panel Composition

In all public customer cases, either the majority of arbitrators on a three-person panel or the single arbitrator on a one-person panel will be public.⁴⁹ Non-public arbitrators are those that have close professional ties to the securities industry. Obviously, writing bright line rules that distinguish between public and industry arbitrators is difficult. At the margins, how an individual is classified is a judgment call on which reasonable people can and do differ. These difficulties led the Arbitration Policy Task Force to consider recommending that NASD eliminate arbitrator classifications. Ultimately, however, it chose not to do so, in part because its other panel selection recommendations provided substantial protection against potentially partial arbitrators.⁵⁰ Industry arbitrators are also, of course, subject to the same conflict disclosure requirements as public arbitrators.

NASD-DR currently classifies arbitrators as non-public if they work in the securities industry, are retired from the industry, or worked in the industry

⁴⁷ The honorarium for a case not requiring a hearing is \$125. NASD CODE IM-10104.

⁴⁸ See George H. Friedman, *The Level Playing Field*, 11 SECURITIES ARBITRATION COMMENTATOR 1, 3 (July 2001) (noting that compensation for arbitrators in non-SRO settings ranges from \$750 to \$1,000 per arbitrator per day).

⁴⁹ See NASD CODE 10308(b)(1).

⁵⁰ RUDER REPORT, *supra* note 3, at 87,472.

within the last three years.⁵¹ “Non-public” arbitrators include attorneys, accountants, or other professionals that devoted 20% or more of their professional work in the last two years to clients in the securities industry.⁵² The NYSE definition of non-public arbitrator is broader in several respects. First, the NYSE requires five (instead of three) years in a new profession before reclassifying a non-public arbitrator as a public arbitrator. Second, NYSE includes persons associated with “registered investment advisers,” a category of securities professional not specifically listed in the NASD-DR rules. Third, for retired individuals the NYSE rule clarifies that the individual is a non-public arbitrator if he or she “spent a substantial part of his or her business career” in the industry.⁵³

The NAMC has, however, recently approved a number of changes that would, if adopted, substantially harmonize the NASD-DR and the NYSE approaches. Specifically, the NAMC has approved proposals to adopt the same five-year transitioning period the NYSE employs and to eliminate investment advisers as public arbitrators. In addition, the NAMC approved a SICA proposal that precludes an individual from ever being classified as a public arbitrator if he or she spent 20 or more years in the industry, no matter how long the individual has been out of the industry. The NASD’s Board of Directors is scheduled to consider these changes on November 20, 2002.

Public arbitrators do not have close personal or professional relationships with the industry. NASD-DR provides that public arbitrators are arbitrators who do not conduct activities that would qualify them as non-public arbitrators or have a spouse or immediate family member that conducts such activities.⁵⁴ The NYSE has substantially the same definition. The primary difference is that the immediate family member definition under the NASD Code includes individuals that share a home with, receive substantial financial support from, or are declared as dependents for federal income tax purposes by someone who would be classified as a non-public arbitrator.⁵⁵ The NYSE only includes spouses and members of the household.⁵⁶

⁵¹ NASD CODE 10308(a)(4)(A) & (B).

⁵² NASD CODE 10308(a)(4)(C).

⁵³ NYSE RULES 607(a)(2).

⁵⁴ NASD CODE 10308(a)(5).

⁵⁵ NASD CODE 10308(a)(5)(B).

⁵⁶ NYSE RULES 607(a)(3).

To “insure continued investor confidence in the arbitration process,” the NYSE also includes Guidelines for Classification of Arbitrators in its Rules. The Guidelines specify, “any close question on arbitrator classification or on challenges for cause shall be decided in favor of public customers.”⁵⁷ The Guidelines specify, among other things, that:

- Attorneys, accountants, or other professionals who routinely represent the securities industry must be non-public arbitrators
- Attorneys, accountants, or other professionals may be classified as public arbitrators if their firms have close industry ties, but challenges for cause based on such ties will be honored
- Individuals who spent a substantial part of their careers in the securities industry are non-public arbitrators⁵⁸
- Arbitrators that spent minor portions of their careers in the industry must still disclose all past affiliations “and challenges for cause based upon such past affiliations shall be sustained”
- Close family relationships with broker-dealers must be disclosed and challenges for cause based on those relationships shall be honored
- Spouses of securities industry personnel may not serve as arbitrators.

⁵⁷ NYSE RULES, GUIDELINES FOR ARBITRATORS ¶ 7.

⁵⁸ The NYSE Director of Arbitration informed me that he interprets the “substantial” standard to classify as industry arbitrators anyone who spent more than one-third of his or her career in the securities industry.

Recommendation Two

Re-examine the Definitions of Public and Non-Public Arbitrators.

Critics of SRO arbitrations consistently point to the presence of industry arbitrators on arbitration panels and the classification of arbitrators as public or non-public as the primary sources of potential pro-industry bias. No classification rule could ever precisely define public and non-public arbitrators; there will always be classification questions at the margin about which reasonable people will differ. Nonetheless, this Report recommends that the SROs should evaluate current rules to determine whether it is advisable to broaden their definitions of industry arbitrators. Specifically, the Report recommends that in addition to the proposals already under consideration:

- NASD-DR and the NYSE should consider whether it is appropriate to expand the definition of “immediate family member” to include spouses, parents, and children, regardless of whether the children are declared as dependents or are members of the arbitrator’s household.
- NASD-DR should consider whether it is appropriate formally to adopt the NYSE’s position that close questions with respect to classification or challenges for cause should be resolved in favor of customers.

This Report is only recommending that the SROs evaluate the advisability of these changes. Definitive recommendations are inappropriate at this time because I have insufficient data on the effect that these changes may have on the depth of the arbitrator pool or on any additional administrative costs that such amendments would entail.

Panel Selection: NASD-DR Arbitrations

In 1998, NASD significantly altered its system for selecting arbitration panels when it adopted the computerized Neutral List Selection System (the “NLSS”). NLSS was based on the recommendations of the Arbitration Policy Task Force and was intended to address structural bias criticisms by giving all

parties greater participation in selecting the arbitration panels that would hear their case.⁵⁹ There was, to be sure, little if any evidence that the previous selection system caused arbitrators to render pro-industry decisions. Still, by opening the selection system up to greater participation by customers and industry members, NASD-DR seems to have substantially alleviated concerns that arbitrators had incentives to skew decisions in favor of industry members. Moreover, by moving to a rotational system in which a computer simply selects the next available arbitrator on the list, NASD-DR addressed criticism that it may have created an appearance of partiality because it used a relatively small number of arbitrators too frequently.⁶⁰

Under NLSS, after a claim is filed the NASD-DR staff prepares a computer-generated list of public and non-public arbitrators.⁶¹ Arbitrators are chosen on a rotating basis within a geographic area, with the NLSS automatically excluding arbitrators based on party conflicts.⁶² NASD-DR staff reviews the list and excludes arbitrators for conflicts that are not coded into the NLSS.⁶³ Staff members are required to document why arbitrators are removed from an NLSS-generated list. NASD-DR Regional Directors and the Director of Neutral Management review those reports monthly.

The NASD-DR staff forwards the lists to all parties⁶⁴ along with an Arbitrator Disclosure Report, which includes information on the arbitrators' areas of expertise, training, experience, employment history for at least the last ten years, conflicts, and publicly available awards.⁶⁵ The parties may request

⁵⁹ Previously, the staff provided the parties with the names of three arbitrators it had selected based on, among other things, expertise in the matters at issue and a conflict check. Parties were given background information on the arbitrators and had a single peremptory challenge and unlimited challenges for cause. Some commentators suggested that the "attempt to select suitable panel members results in bias and inappropriate prejudgments by the arbitration staff." See RUDER REPORT, *supra* note 3, at 87,470.

⁶⁰ HOW INVESTORS FARE, *supra* note 18, at 57-58.

⁶¹ NASD CODE 10308(b)(4)(A). To the extent possible, the lists contain twice the number of public arbitrators as non-public arbitrators. NASD CODE 10308(b)(3).

⁶² NASD CODE 10308(b)(4)(A).

⁶³ This review includes, where applicable, a review of the Central Registration Depository Record for each potential arbitrator.

⁶⁴ NASD CODE 10308(b)(5).

⁶⁵ The awards are available for free on the NASD-DR web site. Previously, NASD-DR provided only the last five awards (or all awards in last twelve months). Through a contract with *The Securities Arbitration Commentator* (SAC), NASD-DR now provides parties with the

additional information about the listed arbitrators, and the Director is required to forward any responses to the parties.⁶⁶ The parties are entitled to an unlimited number of strikes. After striking any arbitrators, the parties separately rank the remaining public and non-public arbitrators.⁶⁷ These rankings are sent to the Director who enters them into NLSS to create separate consolidated rankings. The ranking excludes arbitrators stricken by any party.⁶⁸

The NASD-DR staff then contacts arbitrators and provides them with basic information about the case, including the names of the parties, lawyers, and potential witnesses. The arbitrator must determine whether any conflicts exist. Materials distributed to arbitrators emphasize that:

All arbitrators in securities controversies must qualify as impartial, neutral arbitrators. If the arbitrator does not believe that a conflict exists, but rather some association with the parties, counsel, and/or witnesses may be questioned, the arbitrator must disclose the association. When in doubt, disclosure should be the rule.⁶⁹

When appointed, an NASD-DR arbitrator must sign an oath or affirmation that he or she is:

not an employer of, employed by, or related by blood or marriage to any of the parties or witnesses whose names have been disclosed to me; that I have no direct or indirect interest in this matter; I know of no existing or past financial, business, professional, family or social relationship which would impair me from performing my duties; and that I will decide the controversy in a fair manner and render a just award.

Arbitrators must affirm that they do not satisfy the temporary or permanent disqualification criteria, that they have reviewed and completed an Arbitrator Disclosure Checklist (which requires arbitrators to evaluate 18 potential

means to search for free an extensive online database of previous arbitrator awards maintained jointly by SAC and CCH, Inc.

⁶⁶ NASD CODE 10308(b)(6).

⁶⁷ NASD CODE 10308(c).

⁶⁸ NASD CODE 10308(c)(3).

⁶⁹ THE ARBITRATOR'S MANUAL, *supra* note 19, at 4-5.

conflicts), and that they have reviewed and updated their Arbitrator Disclosure Report. Copies of the Oath and the Checklist appear in Appendix B.

The director appoints the panel based on the final rankings, subject to arbitrator disqualification or unavailability.⁷⁰ If the initial lists contain insufficient names to fill a panel, the NASD-DR staff extends the list by having the NLSS computer select additional arbitrators. Parties obtain the same conflict disclosure as for arbitrators on the initial list; however, parties are only entitled to challenge arbitrators for cause on the extended list. The NASD Code does not provide a specific standard for granting challenges for cause. *The Arbitrator's Manual*, however, specifies that challenges:

will be granted where it is reasonable to infer an absence of impartiality, the presence of bias, or the existence of some interest on the part of the arbitrator in the outcome of the arbitration as it affects one of the parties. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.⁷¹

The Director has final discretion to grant for cause challenges. If the Director denies a challenge, the party may file a recusal motion with the arbitrator or it may seek a court order vacating any arbitral award.⁷²

⁷⁰ NASD CODE 10308(c)(4)(A).

⁷¹ THE ARBITRATOR'S MANUAL, *supra* note 19, at 7.

⁷² The Federal Arbitration Act does not give courts authority to remove arbitrators for bias or impartiality prior to any award. *Gulf Guaranty Life Ins. Co. v. Connecticut Gen. Life Ins. Co.*, 304 F.3d 476, 490-91 (5th Cir. 2002); *Aviall, Inc. v. Ryder System, Inc.*, 110 F.3d 892, 895 (2d Cir. 1997).

Recommendation Three

Provide Greater Transparency with Respect to Challenges for Cause by Including the Cause Standard in the Rules. Both the NASD-DR and the NYSE follow the same standard for granting for cause challenges to arbitrators. The standard, however, does not appear in their respective arbitration procedures. Including the standard in the rules should provide greater transparency with respect to challenges and greater party confidence that all challenges will be granted or denied on the same basis.

After selection of the panel and before the first hearing or pre-hearing conference, either the Director or any party may object to the continued service of an arbitrator. The Director determines whether the arbitrator should be disqualified based on the conflict information the arbitrator discloses pursuant to Rule 10312, although the parties may unanimously agree to permit the arbitrator to continue to serve.⁷³ After the first hearing or pre-hearing conference, the Director may only remove an arbitrator based on conflict information that was required to be disclosed and that was not previously disclosed to the parties when the arbitrator was selected.⁷⁴ The Director fills vacancies from the consolidated rankings or by appointment if no ranked arbitrators remain.⁷⁵ Parties obtain the same disclosure and may make the same challenges to arbitrators appointed to fill vacancies.⁷⁶

Some evidence suggests that NASD-DR improved public perceptions of the fairness of arbitrations when it adopted NLSS. In preparing this Report, I spoke with a number of experienced securities arbitration lawyers. Claimants' lawyers in particular informed me that NLSS has substantially improved the arbitrator selection process because it gives parties greater control over arbitrator selection. In a survey of SRO arbitration participants, NASD-DR found that claimants and their representatives prefer NLSS to the previous system. In the sample, 58% of claimants said that NLSS was better than staff selection, as opposed to only 16% who said it was worse. By contrast,

⁷³ NASD CODE 10308(d)(1).

⁷⁴ NASD CODE 10308(d)(2).

⁷⁵ NASD CODE 10308(d)(3).

⁷⁶ NASD CODE 10308(d)(3).

respondents or their representatives were more evenly divided; 48% thought NLSS was better than staff selection while 44% thought it was worse.⁷⁷ While these results were based on a relatively small sample (n=61), they suggest that the shift to NLSS improved public perceptions of fairness.

Panel Selection: NYSE Arbitrations

The NYSE staff selects the panel in most arbitrations.⁷⁸ Its database eliminates arbitrators based on facial conflicts (such as current or previous affiliation with a party). The NYSE staff also considers whether arbitrators have expertise in the subject matter of the case and performs an additional conflict check. The staff then contacts the arbitrators and provides basic case information, including the names of potential witnesses, parties, and lawyers. Arbitrators must update their profiles when they are appointed to a case.

The parties receive the names, profiles, employment histories, and the arbitrators' last three awards; other awards are available on request or from the NYSE website. The parties may request additional information on the arbitrators. If the arbitrator does not respond to these requests, the Director will grant a for cause challenge to that arbitrator.

The parties have one peremptory challenge and unlimited challenges for cause. The NYSE uses the same basic standard for reviewing for cause challenges as NASD-DR; however, it supplements this standard with the additional criteria contained in its Guidelines for Classifying Arbitrators and emphasizes that close calls on conflicts will be decided in the customer's favor. If the Director declines to grant a for cause challenge, the party may ask the arbitrator to recuse himself or it may seek a court order vacating the arbitration panel's decision. The Director informed me that in most cases if he declines to grant a challenge the arbitrator will recuse himself upon motion of a party. The Director has the power to fill any vacancies created, subject to the power of the parties to challenge any replacement arbitrator.⁷⁹ The Director of Arbitration

⁷⁷ See NASD Regulation, *The Neutral List Selection System ("NLSS"): Highlights of the West Point Analysis 1-2* (March 2000).

⁷⁸ NYSE RULES 607(a). The parties may unanimously agree to another method for selecting arbitrators. NYSE RULES: VOLUNTARY SUPP. PROCEDURES FOR SELECTING ARBITRATORS (A).

⁷⁹ NYSE RULES 611.

does not have the power to remove an arbitrator after the first hearing has commenced.

Since August 2000, parties in NYSE arbitrations have been able to opt for a pilot program that provides two list selection options—random list selection and enhanced list selection.⁸⁰ Under random list selection, the Director randomly generates lists of securities industry and public arbitrators.⁸¹ The staff reviews the names for potential conflicts. The parties receive the same arbitrator disclosure information as under the NYSE’s standard procedure.⁸² The parties are entitled to strike any or all of the names on the lists.⁸³ Each party ranks the remaining arbitrators and the NYSE selects arbitrators based on the parties’ mutual preferences.⁸⁴

The enhanced list disclosure system combines aspects of the random list selection process and the standard selection process. The Director of Arbitration provides the parties with six public and three securities industry arbitrators that the staff has chosen based on their qualifications and experience. The parties are entitled to three peremptory and unlimited

⁸⁰ In July 1998, the NYSE began an informal pilot program to determine parties’ interest in alternative arbitrator selection methods. In August 2000, the NYSE formalized a two-year pilot program. The NYSE recently extended the program for two years. *See* SEC Rel. No. 46372, 67 FED. REG. 54521 (Aug. 22, 2002).

⁸¹ NYSE RULES: VOLUNTARY SUPP. PROCEDURES FOR SELECTING ARBITRATORS (B) 2(i)(2). Typically, parties receive the names of 10 public and 5 securities industry arbitrators. *See* SEC Rel. No. 46372, 67 FED. REG. 54521, 54522 (Aug. 22, 2002).

⁸² NYSE RULES: VOLUNTARY SUPP. PROCEDURES FOR SELECTING ARBITRATORS (B) 2(i)(3).

⁸³ NYSE RULES: VOLUNTARY SUPP. PROCEDURES FOR SELECTING ARBITRATORS (B) 2(iii)(1). If a potential arbitrator is stricken for cause, the NYSE randomly selects a replacement arbitrator. *Id.* at (B) 3(b).

⁸⁴ NYSE RULES: VOLUNTARY SUPP. PROCEDURES FOR SELECTING ARBITRATORS (B) 2(iii). If the remaining names are insufficient, the NYSE will send the parties a second randomly generated list of three names for each vacancy on the panel. The parties have one peremptory challenge for each vacancy and unlimited challenges for cause. The parties rank the remaining arbitrators and the NYSE selects arbitrators based on mutual preferences. If there remain insufficient names, the Director will randomly appoint arbitrators. *Id.* at (B) 2(iv)

challenges for cause. The parties then rank the remaining arbitrators and the Director makes appointments based on the parties' mutual preferences.⁸⁵

In the last two years, about 15% of the parties chose one of the list selection options. The NYSE has commented that the modest acceptance rate for these alternatives suggests that they should remain optional. A possible explanation for this low rate is that in customer cases parties that prefer list selection may always file cases with NASD-DR.

THE CALIFORNIA ETHICS STANDARDS

In September 2001, California enacted S.B. 475 to address, among other things, disclosure of arbitrator conflicts of interest. "Neutral arbitrators"⁸⁶ are required to disclose all matters that could cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial.⁸⁷ The statute amended section 1281.9 of the California Code of Civil Procedure (the "Civil Procedure Code") to require arbitrators to disclose in writing within ten days of his or her proposed appointment: (i) any ground specified for disqualification of judges; (ii) detailed information concerning arbitrations during the previous five years that involve parties or lawyers in the current arbitration, including the names of all parties and lawyers and the results of each arbitration; (iii) any attorney-client relationship the arbitrator has or had with any party or lawyer; and (iv) any professional or significant personal relationship the arbitrator, his or her spouse, or minor child living in the household has or had with any party or lawyer.⁸⁸

⁸⁵ NYSE RULES: VOLUNTARY SUPP. PROCEDURES FOR SELECTING ARBITRATORS (C). If the lists are insufficient, the Director appoints the remaining arbitrators, subject to a single peremptory challenge and unlimited challenges for cause. *Id.*

⁸⁶ A "neutral arbitrator" is "an arbitrator who is (1) selected jointly by the parties or by the arbitrators selected by the parties or (2) appointed by the court when the parties . . . fail to select an arbitrator who was to be selected jointly by them." CIV. PRO. CODE § 1280(d). It is unclear whether SRO arbitrators fit within this definition because as a technical matter the SROs appoint the arbitrators. The California Ethics Standards define arbitrator more broadly and do cover SRO arbitrators. *See* Standard 2(a)(1)(C).

⁸⁷ CIV. PRO. CODE § 1281.9(a).

⁸⁸ *Id.*

If the arbitrator fails to comply with section 1281.9 or if he or she makes a specified disclosure, then any party may disqualify the arbitrator.⁸⁹ Courts are required to vacate arbitral awards if an arbitrator fails to disclose a ground for disqualification of which he or she was aware or fails to disqualify himself or herself upon receipt of a party's disqualification demand.⁹⁰

S.B. 475 also amended section 1281.85 of the Civil Procedure Code to delegate authority to the Judicial Council to adopt mandatory ethics standards for individuals serving as neutral arbitrators in contractual arbitrations held in the state. Pursuant to this mandate, the Judicial Council adopted the California Ethics Standards, most of which became effective on July 1, 2002. Standard 7 contains the new arbitrator disclosure requirements. A copy of the California Ethics Standards appears in Appendix C.

In addition to re-iterating the broad disclosure obligation of section 1281.9, Standard 7(b) articulates thirteen separate disclosure obligations for arbitrators.

- **Standard 7(b)(1)** requires the arbitrator to disclose whether the “arbitrator or a member of the arbitrator’s extended family is a party, a party’s spouse or domestic partner, or an officer, director, or trustee of a party.”⁹¹
- **Standard 7(b)(2)** requires the arbitrator to disclose whether the “arbitrator, a member of the arbitrator’s extended family, or the arbitrator’s former spouse is,” a lawyer in the arbitration, the spouse or domestic partner of a lawyer in the arbitration, or “[c]urrently associated in the private practice of law with a lawyer in the arbitration.”

⁸⁹ CIV. PRO. CODE § 1281.91. In SRO arbitrations the Director of Arbitration rules on challenges for cause.

⁹⁰ CIV. PRO. CODE § 1286.2(a)(6). Although section 1286.2 is written as a mandatory provision, S.B. 475 states that it was the legislature’s intent to codify existing law, “which provides that an arbitration award *may* be vacated when a neutral arbitrator fails to disclose a matter that might cause a reasonable person to question the ability of the arbitrator to conduct the arbitration proceeding impartially.” S.B. 475, § 8 (emphasis added).

⁹¹ The arbitrator’s “extended family” includes the arbitrator’s immediate family (spouse, domestic partner, and minor child living in the household) and “the parents, grandparents, great-grandparents, children, grandchildren, great-grandchildren, siblings, uncles, aunts, nephews, or nieces of the arbitrator or the arbitrator’s spouse or domestic partner ... or the spouse of such person.” Standard 7(n).

- **Standard 7(b)(3)** requires the arbitrator to disclose whether the arbitrator or a member of the arbitrator’s immediate family “has had a significant personal relationship with any party or a lawyer for a party.”⁹²
- **Standards 7(b)(4) and 7(b)(5)** require arbitrators to disclose whether they have in the preceding five years served as a “neutral arbitrator [or other dispute resolution neutral] in another arbitration involving a party to the current arbitration or a lawyer for a party.”⁹³
- **Standard 7(b)(6)** requires arbitrators to disclose any attorney-client relationship between the arbitrator and any party or lawyer within the previous two years.
- **Standard 7(b)(7)** requires disclosure of “[a]ny other professional relationship the arbitrator or a member of the arbitrator’s immediate family has or has had with a party or a lawyer for a party.”
- **Standards 7(b)(8) and 7(b)(9)** requires the arbitrator to disclose whether the “arbitrator or a member of the arbitrator’s immediate family has a financial interest in a party” or “in the subject matter of the arbitration.”
- **Standard 7(b)(10)** requires the arbitrator to disclose whether the “arbitrator or a member of the arbitrator’s immediate family has an interest that could be substantially affected by the outcome of the arbitration.”
- **Standard 7(b)(11)** requires the arbitrator to disclose whether the “arbitrator or a member of the arbitrator’s extended family has personal knowledge of disputed evidentiary facts relevant to the arbitration.”
- **Standard 7(b)(12)** requires disclosure in customer cases of information concerning the relationship between the SRO and the arbitrator and disclosure of any professional or financial relationship between the SRO and any party or any lawyer in the arbitration.⁹⁴ Standard 7(b)(12)(A) requires, among other things, arbitrators to disclose

⁹² The Standards define “significant personal relationship” to include a “close personal friendship,” but do not specify what else might qualify. *See* Standard 2(q).

⁹³ A “lawyer for a party” includes anyone associated with the law firm representing the party. *See* Standard 2(l).

⁹⁴ *See* Standard 2(d) (defining consumer arbitrations to include customer disputes involving pre-dispute arbitration agreements drafted by non-consumer parties that consumer parties are required to accept). The effective date for Standard 7(b)(12) is January 1, 2003.

whether the provider organization has a financial interest⁹⁵ in a party or whether a party is a member of the provider organization.⁹⁶ The arbitrator must disclose whether the SRO is providing or previously has provided dispute resolution services to a party⁹⁷ or whether the SRO has entered into a relationship under which it expects to provide dispute resolution services to a party in the future.⁹⁸ If the arbitrator makes any of these disclosures, it must also disclose information about the SRO's procedures⁹⁹ and other arbitrations.¹⁰⁰

- **Section 7(b)(13)** requires the arbitrator to disclose “the arbitrator’s membership in any organization that practices invidious discrimination on the basis of race, sex, religion, national origin, or sexual orientation.”

As with the statutory disclosure requirements, any disclosure or failure to disclose under the Standards results in mandatory disqualification on the motion of any party or vacatur.¹⁰¹

⁹⁵ Financial interest, with some exceptions, “means ownership of more than a 1 percent legal or equitable interest in a party, or a legal or equitable interest in a party of a fair market value in excess of one thousand five hundred dollars (\$ 1,500), or a relationship as director, advisor or other active participant in the affairs of a party.” CIV. PRO. CODE § 170.5(b).

⁹⁶ Standard 7(b)(12)(A)(i) & (ii).

⁹⁷ Standard 7(b)(12)(A)(v). Arbitrators are required to disclose information on cases in the previous two years, but not cases concluded before July 1, 2002. Standard 7(b)(12)(C).

⁹⁸ Standard 7(b)(12)(A)(iv).

⁹⁹ Standard 7(b)(12)(B). Specifically, arbitrators must disclose: (i) any financial relationship or affiliation they have with the SRO; (ii) the SRO’s process and criteria for recruiting, screening, and training arbitrators; (iii) the SRO’s process for identifying and selecting potential arbitrators for specific cases; and (iv) any role the SRO plays in ruling on disqualification motions. *Id.*

¹⁰⁰ The arbitrator must disclose “the number of pending and prior cases involving each party or lawyer in the arbitration” and “the date of decision, the prevailing party, the names of the parties’ attorneys, and the amount of monetary damages awarded, if any, in each such prior case.” Standard 7(b)(12)(D).

¹⁰¹ CIV. PRO. CODE § 1281.9(a)(2) (requiring arbitrators to disclose “[a]ny matters required to be disclosed by the ethics standards for neutral arbitrators”).

ANALYSIS OF THE CURRENT CONFLICTS DISCLOSURE REGIME

Eliminating conflicts and increasing public confidence in procedural fairness are important goals that any dispute resolution system should strive to achieve. But as the SEC has recognized, reducing potential conflicts or the appearance of partiality entails costs as well.¹⁰² Proposed changes must “balance the need to strengthen investor confidence in the [SRO’s] arbitration system with the need to maintain arbitration as a form of dispute resolution that provides for the equitable and efficient administration of justice.”¹⁰³ Moreover, significant unintended consequences often accompany regulatory shifts.¹⁰⁴ For this reason, arguments for imposing additional procedural requirements should begin by identifying whether there are actual problems in existing procedures.

There is little if any evidence of actual problems with respect to the rules currently employed for disclosure of arbitrator conflicts of interest. Available empirical evidence on outcomes in SRO arbitrations suggests that current procedures provide a fair system to address customer disputes. Survey evidence suggests that those who have participated in SRO arbitrations generally perceive SRO arbitrators to act fairly and impartially. There is also little evidence from judicial review of arbitration awards of patterns of systemic non-disclosure of conflicts.

Arbitration Outcomes

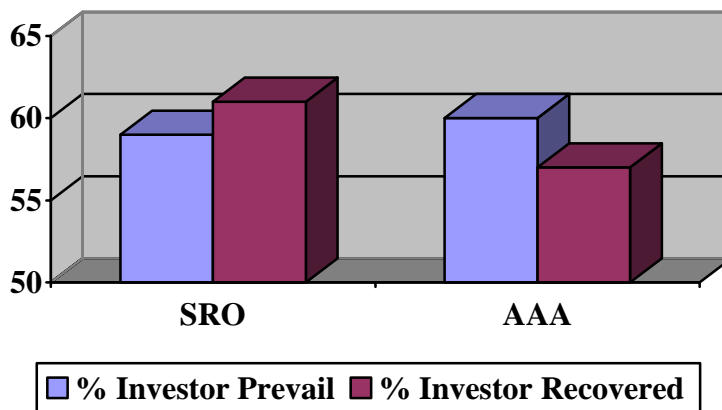
Evidence on outcomes in SRO arbitrations does not directly address whether undisclosed arbitrator conflicts present a substantial problem in SRO arbitrations. Nor does such data address whether any individual cases were correctly decided and free of bias or partiality. But, the traditional criticism of

¹⁰² See HOW INVESTORS FARE, *supra* note 18, at 61 (noting SEC’s concern that imposing additional qualification and training requirements on arbitrators “risk increasing significantly the costs of securities arbitration and reducing the pool of qualified arbitrators without materially improving the general quality of the arbitrator pool or increasing assurances of the independence or capability of individual arbitrators.”).

¹⁰³ SEC Rel. No. 30153, 57 FED. REG. 1292 (Jan. 6, 1992).

¹⁰⁴ See Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. ____ (forthcoming).

Figure 2
Investor Outcomes in SRO vs. AAA Arbitrations



SRO arbitrations is that arbitrators tend to possess subtle biases in favor of industry members. It seems reasonable then to start any search for pervasive biases with data on actual outcomes in arbitrations.

The most comprehensive study of investor outcomes in securities arbitrations is the GAO’s 1992 report, *Securities Arbitration: How Investors Fare*.¹⁰⁵ That report examined results in arbitrations over an eighteen-month period from January 1989 to June 1990 and found no evidence of a systemic pro-industry bias.



For example, some critics suggest that investors tend to fare worse in SRO-sponsored arbitrations versus arbitrations in non-SRO forums. As shown in Figure 2, the GAO found no statistically significant difference between the results in industry-sponsored arbitrations versus arbitrations at AAA.¹⁰⁶ In the SRO arbitrations, the arbitrators found for investors in about 59% of the cases versus 60% of AAA cases. In cases in which investors prevailed, they recovered on average about 61% of the damages they claimed in SRO arbitrations versus 57% in AAA arbitrations. In addition, about 44% of SRO cases and 33% of AAA cases settled.¹⁰⁷



¹⁰⁵ See *supra* note 18.

¹⁰⁶ HOW INVESTORS FARE, *supra* note 18, at 38-39. The GAO was unable to evaluate arbitration versus litigation results because of the limited number of litigated cases. *Id.* at 6.

¹⁰⁷ *Id.* at 48.

The GAO updated these findings in 2000.¹⁰⁸ It found that in the period 1992-1998 both the percentage of investor favorable outcomes and the proportion of awards to amounts claimed declined over the previous study period.¹⁰⁹ The GAO Report suggested, however, that an increase in settled claims during the second study period,¹¹⁰ rather than the rise of a pro-industry bias, might explain these apparent declines to the extent that the settlements substantially altered the mix of cases that went to a final arbitration decision. In other words, industry members may have settled more of the stronger cases, leaving more of the weaker cases for resolution through arbitration decisions. Although the GAO did not analyze arbitration settlements, it did report, “the declining win rate could indicate little or no change in the fairness of the arbitration process.”¹¹¹

Indeed, if one examines SICA’s data on arbitration outcomes over the period from 1980 through 2001 (represented in Figure 3), one finds some annual variation, but little if any evidence of systemic advantages for industry members and no evidence of any trends in favor of one party or another.¹¹² From 1980 to 2001, SRO arbitrators decided 31,001 public customer cases. Of that total, 16,294 (52.56%) resulted in customer awards. In the three years

¹⁰⁸ PROBLEM OF UNPAID AWARDS, *supra* note 18.

¹⁰⁹ In its initial study, investors won about 59% of the time. The annual win rate in the later study ranged from 49% to 57%. From 1992 to 1996, the rate averaged 51%, but climbed to 56% in 1997 and 57% in 1998. *Id.* at 23-24.

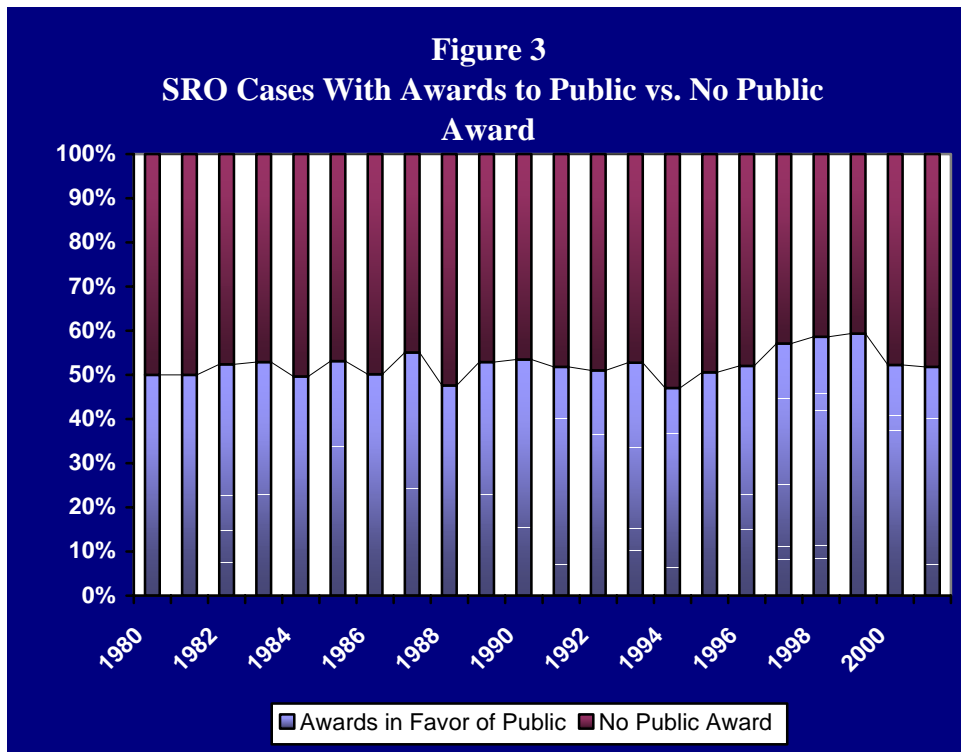
Awards during the second study period ranged from 46% to 57% of the amount claimed, averaging about 51% from 1992 to 1998. By contrast, in the first study period awards averaged 61% of the amount claimed. *Id.*

¹¹⁰ Less than 50% of claims settled from 1989 to 1992, while settlements ranged from 50% to 60% of the cases from 1993 to 1998. *Id.* at 7.

¹¹¹ *Id.* at 5.

¹¹² SICA, ELEVENTH REPORT 125 (2001). Data on 2001 is from the NYSE.

since the GAO last looked at SRO arbitration outcomes, customers won



awards in 54.18% of the cases.

In 2000, the GAO could not reach a conclusion on the fairness of the process based on the same analysis of case outcomes it had used in the 1992 study. Very few cases were handled outside the SRO forums, and so the GAO had insufficient data to compare SRO arbitration outcomes to AAA or litigation outcomes.¹¹³ The GAO suggested that there were fewer cases at non-SRO forums because more pre-dispute arbitration agreements required arbitration in an SRO forum.¹¹⁴ Critics of SRO arbitrations suggest that giving investors the opportunity to select non-industry forums would help maintain the integrity of securities arbitration.¹¹⁵ But it is not entirely clear that if given such a choice investors would select non-SRO forums. In January 2000, SICA

¹¹³ *Id.* at 7.

¹¹⁴ *Id.* at 31.

¹¹⁵ Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327, 344-46 (1996).

initiated a two-year pilot program whereby investors could elect to arbitrate their claims in selected non-SRO forums. Of the 277 cases eligible for the program, only eight were submitted. Among the reasons participants gave for not selecting the alternative forums was the lower cost of SRO arbitrations, a preference for more familiar SRO procedures, and the possibility of delays in non-SRO forums.¹¹⁶ If SRO arbitrations were significantly biased in favor of the industry, it is reasonable to predict that the suggested speed and cost advantages would not be compelling.

In sum, the available evidence on arbitration outcomes does not suggest that arbitrators tend to have pro-industry biases.

Survey Data on Perceptions of the Fairness of SRO Arbitrations

The most recent and comprehensive study of investor perceptions of the fairness of SRO arbitrations and the impartiality of SRO arbitrators reveals a substantial level of satisfaction among parties and representatives.¹¹⁷ The study reviewed the evaluations submitted in NASD arbitrations over a fifteen-month period between December 1, 1997 and April 1, 1999.

Two limitations of the study suggest that its findings must be interpreted with caution. First, few arbitration participants completed the surveys; the authors concluded that the evaluation response rate was only between 10%-20%. Second, these responses may reflect selection bias problems. The authors performed some tests to detect possible problems and found none, but it is still possible that individuals that were more satisfied with the fairness of the process or that achieved favorable outcomes were more likely to complete the surveys.

Despite these limitations, the authors concluded that participants in NASD-sponsored arbitrations overwhelmingly believed that their cases were handled fairly and without bias.¹¹⁸ Two aspects of the survey are particularly

¹¹⁶ See SICA, *Final Report Securities Industry Conference on Arbitration Pilot Program for Non-SRO Sponsored Arbitration Alternative* (2002).

¹¹⁷ Gary Tidwell, *supra* note 25. Mr. Tidwell was the Director of Neutral Training and Development for NASD Regulation at the time this study was prepared.

¹¹⁸ *Id.* at 3.

relevant. First, as shown in Table 1 an overwhelming majority (93.49%) strongly agreed or agreed that their cases were handled fairly and without bias. Only 3.8% of respondents strongly disagreed with this statement.¹¹⁹

Table 1
Overall Evaluation of Whether Claim Was Handled Fairly and Without Bias¹²⁰

	Frequency	Percent	Cumulative
Strongly Agree	573	57.36%	57.36%
Agree	361	36.14%	93.49%
Disagree	27	2.70%	96.20%
Strongly Disagree	38	3.80%	100.00%
Total	999	100.00%	

The California Ethics Standards are primarily concerned with public perceptions of the fairness of arbitration proceedings. The data suggest that claimants (who tend to be customers) have a stronger opinion of the fairness of arbitration proceedings than respondents. Table 2 demonstrates that a significantly higher percentage of claimants or attorneys representing claimants (61%) strongly agreed that their case had been handled fairly and without bias, as opposed to only 53% of respondents or those representing respondents.¹²¹



¹¹⁹ In 2001, NASD-DR conducted a follow-up study. While the response rate remained low (34%) and the sample size (n=61) was small, the results were generally consistent. Eighty-five percent of the survey respondents strongly agreed (62%) or agreed (23%) that their cases were handled fairly and without bias. Twelve percent disagreed, while none strongly disagreed. The remaining 2% were neutral. NASD-DR, *Customer Satisfaction Survey Results 1* (May 2001).

¹²⁰ Source: Gary Tidwell, *supra* note 25, at 20.

¹²¹ The p-value for the chi-square analysis of these responses is 0.003, which reflects a statistically significant difference in the way that claimants and respondents answered these questions. *Id.* at 17.

Table 2
Respondents' and Claimants' Evaluation of Whether Claim Was Handled Fairly and Without Bias¹²²

	Strongly Agree	Agree	Disagree	Strongly Disagree	Total
Respondent	245 52.92%	196 42.33%	9 1.94%	13 2.81%	463 100.00%
Claimant	321 61.03%	165 31.37%	18 3.42%	22 4.18%	526 100.00%
Total	566 57.23%	361 36.50%	27 2.73%	35 3.54%	989 100.00%

Arbitration participants were also asked to evaluate whether the arbitrators displayed fairness and the appearance of fairness. As the data in Table 3 demonstrate, 91.67% of the respondents rated the arbitrators as either excellent or good. The percentage of respondents and claimants rating the arbitrators as excellent was virtually identical (76.86% v. 76.74%).¹²³

Table 3
Overall Evaluation of Whether Arbitrator Displayed Fairness and Appearance of Fairness¹²⁴

	Frequency	Percent	Cumulative
Excellent	774	76.71%	76.71%
Good	151	14.97%	91.67%
Fair	48	4.76%	96.43%
Poor	36	3.57%	100.00%
Total	1009	100.00%	



Thus, the available data indicate that arbitration participants believe that their arbitrations were fair and impartial.

¹²² Source: Gary Tidwell, *supra* note 25, at 20. The upper number is the frequency of the response. The lower number is the percentage of the response.

¹²³ *Id.* at 38. In evaluating the structural bias claim, it would have been useful if the study evaluated whether claimants tended to give lower evaluations to non-public arbitrators, but the study does not break down the data in this manner.

¹²⁴ Source: Gary Tidwell, *supra* note 25, at 38.

Judicial Review of Arbitration Awards for Bias

One final piece of evidence concerning the adequacy of current arbitrator disclosure and disqualification rules is the low rate of judicial challenges to SRO arbitration awards on the basis of arbitrator bias. Richard Ryder of *Securities Arbitration Commentator* has performed the most comprehensive analysis of judicial challenges to arbitration awards.¹²⁵ Mr. Ryder reviewed 297 judicial challenges to arbitration awards decided from 1988 through 1999. Given the thousands of SRO arbitration decisions over the same time period, the paucity of opinions demonstrates a low level of judicial challenges. It is unclear, however, whether there are relatively few challenges because participants are generally satisfied with the arbitration process and outcomes or whether few parties undertake challenges because of the limited bases that exist for overturning arbitral awards.


Thirty decisions (or about 10% of the decisions studied) involved attempts to vacate awards based on arbitrator bias under section 10(a)(2) of the Federal Arbitration Act. Of those, only three decisions (10% of the challenges based on bias) were successful. By contrast, the overall vacatur rate was 22.6%. All three decisions occurred before NASD-DR adopted the NLSS to encourage more party participation in the selection of arbitrators. These data suggest that courts have found few conflict problems in the arbitral awards they have reviewed.

Recommendation Four


Sponsor Independent Research to Evaluate Fairness of SRO Arbitrations. Given the unquestioned significance of securities arbitrations, it is crucial that the SROs resolve any lingering concerns about pro-industry bias. To date, available empirical evidence, particularly with respect to investor perceptions of the arbitration process, is fairly limited and only suggests that there are no substantial systemic problems in SRO arbitrations. As a result, this Report recommends that the SROs sponsor additional independent studies to further evaluate the impartiality of the SRO arbitration process.

¹²⁵ Richard P. Ryder, *Securities Arbitration 2000 in SECURITIES ARBITRATION TODAY'S TRENDS, PREDICTIONS FOR TOMORROW 2000*, 1196 PLI/Corp 1141 (2000).

THE EXPECTED BENEFITS AND COSTS OF ADOPTING THE CALIFORNIA ETHICS STANDARDS




While available empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair, some investor representatives still insist that they reflect a pro-industry bias. If we assume for purposes of analysis that this perception is common, then we should evaluate the benefits and costs of attempting to address it by adopting some or all of the California Ethics Standards. It is obviously difficult to predict with any degree of certainty how adopting new conflict disclosure rules will affect investor perceptions of fairness, but it appears that adopting the Standards will reap a very small benefit while imposing substantial costs on SRO arbitrations.




The Benefits of Adopting the California Ethics Standards

Would investors benefit if the SROs adopted the California Ethics Standards? Adopting the Standards may prevent some biased arbitrators from serving on arbitration panels and might marginally improve perceptions of fairness. But two factors suggest that any improvement in these areas is likely to be quite small.



First, adopting new disclosure standards may do little to alter lingering perceptions that SRO arbitrations have a pro-industry bias because those perceptions do not appear to stem from current disclosure rules. In preparing this Report, I interviewed PIABA representatives and other investor lawyers. Virtually every investor lawyer I spoke to complained of a pro-industry bias in SRO arbitrations. The lawyers interviewed, however, did not attribute the presence of bias to problems with conflict disclosure rules. These lawyers generally identified few or no problems with current conflict disclosure rules. Most said it was unusual for arbitrators not to disclose fairly their backgrounds. Those with anecdotes of non-disclosure problems generally stated that the undisclosed information should have been disclosed under current rules.



Instead, those suggesting a pro-industry bias typically attributed that bias to the presence of non-public arbitrators on the panels. Most believed that the non-public arbitrators were invariably biased against investors. They also

tended to express the view that inherent bias resulted from the fact that securities arbitrations are administered by SROs. While these interviews do not amount to a scientific survey, individuals familiar with SRO arbitrations inform me that the views are representative. Whatever the merits of these views, they suggest that adopting the California Ethics Standards will do little to alleviate any perception of pro-industry bias.



Second, current SRO disclosure rules arguably cover a significant portion of the disclosures required under the California Ethics Standards. The key difference between these two disclosure obligations is one of drafting philosophy—the SROs have adopted a broad disclosure standard while California has chosen to articulate numerous precise rules that describe the required disclosures. Reasonable people can differ over which approach is likely to be more effective, but the simple fact is that for the most relevant conflict information the approaches are functionally equivalent.

For example, Standards 7(b)(8) and 7(b)(9) require the arbitrator to disclose any financial interest in a party or in the subject matter of the arbitration. Standard 7(b)(10) requires the arbitrator to disclose whether the “arbitrator or a member of the arbitrator’s immediate family has an interest that could be substantially affected by the outcome of the arbitration.” The SROs require arbitrators to disclose the same information. Arbitrators must disclose any “direct or indirect financial ... interest in the outcome of the arbitration” and any “existing or past financial, business ... or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias.”¹²⁶ Under current practice (and by rule if this Report’s recommendation is adopted), arbitrators must disclose “any such relationships or circumstances involving members of their families...”¹²⁷


The same is true with respect to family, business, professional, and personal relationships with anyone involved in the arbitration. Under California Ethics Standard 7(b)(1), the arbitrator must disclose whether the “arbitrator or a member of the arbitrator’s extended family is a party, a party’s spouse or domestic partner, or an officer, director, or trustee of a party.” Under Standard 7(b)(2), the arbitrator must disclose whether the “arbitrator, a member of the arbitrator’s extended family, or the arbitrator’s former spouse is,” among other things, “currently associated in the private practice of law


¹²⁶ NASD CODE 10312; *see* NYSE RULES 610(a).

¹²⁷ *Id.*

with a lawyer in the arbitration.” Standard 7(b)(3) requires the arbitrator to disclose whether he or she “has had a significant personal relationship with any party or a lawyer for a party.” Standard 7(b)(6) requires arbitrators to disclose any attorney-client relationship between the arbitrator and any party or lawyer within the previous two years. Standard 7(b)(7) requires disclosure of “[a]ny other professional relationship the arbitrator or a member of the arbitrator’s immediate family has or has had with a party or a lawyer for a party.”

These disclosures are comparable to what is already required under SRO rules. SRO arbitrators are required to disclose any “existing or past ... business, professional, family, social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias.”¹²⁸ Under current practice (and by rule if this Report’s recommendation is adopted), arbitrators are required to disclose “any such relationships or circumstances” that they have with any party, lawyer or known witness in the arbitration. They must also disclose “any such relationship or circumstances involving members of their families...” The *Arbitrator’s Manual* provides, as an example of a disabling personal relationship, the fact that the arbitrator “is or was related by blood or marriage to any party, its attorneys, or witnesses.”¹²⁹

 Moreover, parties in SRO arbitrations currently have the ability to request additional information about arbitrators and the Director is required to forward these responses to the parties.¹³⁰ Thus, if parties are dissatisfied with the extent of disclosure available to them, either in an individual case or more generally, the parties may seek to supplement the arbitrators’ responses. It is my understanding that some lawyers regularly send the equivalent of interrogatories to potential arbitrators to obtain what they believe to be relevant information. NASD-DR immediately forwards these requests to the arbitrators and asks the arbitrators immediately to respond or indicate that they will not provide the requested information. As a result, the parties will typically obtain responses before they are required to strike potential arbitrators. In addition, after the panel is appointed, the parties will obtain the arbitrators’ updated conflict disclosures. If these disclosures reveal a conflict, then the party may challenge the arbitrator for cause.




¹²⁸ NASD CODE 10312(a)(2); *see* NYSE RULES 610(a)(2).

¹²⁹ ARBITRATOR’S MANUAL, *supra* note 19, at 8.

¹³⁰ NASD CODE 10308(b)(6).

As a result, because conflict disclosure rules do not appear to be the primary source of perceptions of pro-industry bias and because current rules cover much of what is required to be disclosed in California, there appears to be little expected benefit from adopting the California Ethics Standards.

The Costs of Adopting the California Ethics Standards



It often can be difficult to make the case against more expansive disclosure obligations. The more information individuals have, the more informed their decision-making can be, whether it involves buying or selling securities or selecting the arbitrators that will hear their dispute. But as the Supreme Court has recognized producing information is costly.¹³¹ Some kinds of information are at best only marginally significant to the decision-making process. Providing decision-makers with a welter of information may not yield better decisions if important information is buried amidst irrelevant details. If the production costs are imposed on individuals (like arbitrators) that have little to gain from disclosure, we may well deter many individuals from participating in the underlying activity. The California Ethics Standards appear to implicate precisely these kinds of information production costs.

The California Ethics Standards Are Inconsistent With Model Arbitrator Disclosure Standards and the Federal Arbitration Act

The SRO conflict disclosure requirements are modeled closely on Canon II of the ABA/AAA Code.¹³² The ABA/AAA Code provides that “arbitrators should disclose the existence of any interests or relationships that are likely to affect their impartiality or that might reasonably create an appearance that they are biased against one party or favorable to another.”¹³³ SRO arbitrators similarly must disclose any circumstances that might preclude the arbitrator from rendering an objective and impartial determination or any matters that “might reasonably create an appearance of partiality or bias.”

¹³¹ See *Commonwealth Coating Corp. v. Continental Casualty Co.*, 393 U.S. 145, 151-52 (1968); cf. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976).

¹³² All SRO arbitrators agree to comply with the ABA/AAA Code. An ABA Task Force is currently considering amendments to Canon II. To the extent that those amendments are eventually adopted, the SROs may need to re-evaluate their conflict disclosure rules.

¹³³ ABA/AAA CODE OF ETHICS, CANON II (Introductory Note) (emphasis added).

When the SEC approved this standard in 1989, it found that the rule should enhance investor confidence in the selection of arbitrators and provide the necessary guidance to arbitrators concerning relationships that may create conflicts and that therefore must be disclosed.¹³⁴

By contrast, California Ethics Standard 7(b) has a far broader basic disclosure obligation because it requires the arbitrator to disclose “any matters that *could* cause a person aware of the facts to reasonably *entertain a doubt* that the proposed arbitrator would be able to be impartial.” This standard appears to be substantially the same as the standard used for judges.¹³⁵ But, arbitrators are not judges, and two crucial differences appear to make this conflict disclosure standard inappropriate for them.

First, arbitrators traditionally have expertise in the subject matter of the cases they handle. Indeed, this is one of the key benefits of arbitration because expertise theoretically allows arbitrators to render more accurate rulings on complex, technical, and often arcane questions.¹³⁶ Such expertise typically comes from working in or with the industry.¹³⁷ As a result, imposing too broad a disclosure and disqualification standard may make it difficult for anyone with any connections to or experience in the industry to serve on an arbitration panel. Application of the California Ethics Standards would likely pose the most substantial difficulties for non-public arbitrators and could lead to significant unintended consequences. If interpreted broadly, the standard may well lead to less informed arbitrator decisions and therefore to more errors. The end result may well be less confidence in the arbitration process, not more.

It is for precisely this reason that many courts recognize that arbitrator expertise is generally inconsistent with the kind of impartiality we expect from full-time judges:

Familiarity with a discipline often comes at the expense of complete impartiality. Some commercial fields are quite narrow, and a given expert may be expected to have formed strong views on certain topics, published articles in the field and

¹³⁴ SEC Rel. No. 26805, 54 FED. REG. 21144 (May 16, 1989).

¹³⁵ See CIV. PRO. CODE § 170.1(a)(6)(C).

¹³⁶ See GRANT, *supra* note 3, at 103.

¹³⁷ See *Andros Compania Maritima, S.A. v. Marc Rich & Co., A.G.*, 579 F.2d 691, 700 (2d Cir. 1978).

so forth. Moreover, specific areas tend to breed tightly-knit professional communities. Key members are known to one another, and in fact may work with, or for, one another, from time to time. As this Court has noted, “expertise in an industry is accompanied by exposure, in ways large and small, to those engaged in it....”¹³⁸

Indeed, in some industry arbitrations these kinds of connections are nearly inevitable.¹³⁹



Second, unlike judges, arbitrators often have occupations or business interests apart from their roles as arbitrators. This fact has led the SROs to adopt the pragmatic view Justice White expressed in his concurring opinion in *Commonwealth Coating Corp. v. Continental Casualty Co.*¹⁴⁰ Like Justice White, the SROs recognize that arbitrators should “err on the side of disclosure.”¹⁴¹ Still:

an arbitrator’s business relationships may be diverse indeed, involving more or less remote commercial connections with great numbers of people. He cannot be expected to provide the parties with his complete and unexpurgated business biography.¹⁴²

If the arbitrator discloses material relationships with the parties or if undisclosed relationships were “trivial,” Justice White saw “no reason automatically to disqualify the best informed and most capable potential arbitrators.”¹⁴³

¹³⁸ *Morelite Construction Corp. v. New York City Dist. Council Carpenters Benefit Funds*, 748 F.2d 79, 83 (2d Cir. 1984) (quoting *Andros Compania Maritima*, 579 F.2d at 701); see also *Sphere Drake Ins. Ltd. v. All American Life Ins. Co.*, 2002 U.S. App. LEXIS 21100, at *5 (7th Cir. Oct. 9, 2002).

¹³⁹ See *Cook Industries, Inc. v. C. Itoh & Co. (America) Inc.*, 449 F.2d 106, 107 (2d. Cir. 1971).

¹⁴⁰ 393 U.S. 145 (1968).

¹⁴¹ *Id.* at 152; see *ARBITRATOR’S MANUAL*, *supra* note 19, at 5 (“When in doubt, disclosure should be the rule.”).

¹⁴² 393 U.S. at 151.

¹⁴³ *Id.* at 150.

Subsequent courts have followed this balanced approach. Federal courts consistently hold that standards for disqualifying arbitrators are less stringent than those for federal judges.¹⁴⁴ A simple appearance of possible bias is insufficient to overturn an arbitral award.¹⁴⁵ Instead, courts generally require a substantial conflict such that “a reasonable person would *have* to conclude that an arbitrator was partial to one party to the arbitration.”¹⁴⁶ The California Ethics Standards, which require disclosure, disqualification, and vacatur anytime a person *could reasonably entertain a doubt* about the partiality of an arbitrator, are much broader and seem closer to the kind of simple appearance of possible bias standard that federal courts routinely reject.¹⁴⁷

The California Ethics Standards Appear Burdensome and May Deter Qualified Arbitrators From Serving



While the California Ethics Standards and the SRO rules clearly require disclosure of similar kinds of information, they are not co-extensive. Standard 7(b) requires disclosures that current rules do not. This Report concludes that the SROs should not amend their rules to require these additional disclosures.

Some terms used in the Standards are defined so broadly that they appear to require disclosure of a wide variety of relatively minor relationships that would not typically call into question the arbitrator’s impartiality. Some Standards require disclosure of not only the arbitrator’s relationships but those of his or her “extended family,” which includes, among others, grandparents, great-grandparents, nephews, or nieces “of the arbitrator or the arbitrator’s

¹⁴⁴ See *Sphere Drake Ins. Ltd.*, 2002 U.S. App. LEXIS 21100, at *8; *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 679-80 (7th Cir.), *cert. denied*, 464 U.S. 1009 (1983).

¹⁴⁵ See, e.g., *Peoples’ Security Life Ins. Co. v. Monumental Life Ins. Co.*, 991 F.2d 141, 146 (4th Cir. 1993) (“It is well established that a mere appearance of bias is insufficient to demonstrate evident partiality.”); *Merit*, 714 F.2d at 681 (“circumstances must be powerfully suggestive of bias”).

¹⁴⁶ See *Morelite Construction Corp.*, 748 F.2d at 84 (emphasis added); see also *Apperson v. Fleet Carrier Corp.*, 879 F.2d 1344, 1358 (6th Cir. 1989), *cert. denied*, 495 U.S. 947 (1990).

¹⁴⁷ Mandatory vacatur under the California Ethics Standards is also inconsistent with one of arbitration’s primary benefits—finality. Such a standard may encourage any party that loses in arbitration (particularly well-financed members of the securities industry) to search for any conflict to use as a pretext for vacating an award. See *Commonwealth Coatings*, 393 U.S. at 151 (White, J., concurring); *Andros Compania Maritima*, 579 F.2d at 702. The end result may well be to increase the cost and complexity of arbitrations, to increase the time they take to resolve, and to impair substantially their traditional finality advantages.

spouse or domestic partner ... or the spouse of such person.”¹⁴⁸ Likewise, the Standards define a “lawyer for a party” to include anyone associated with the law firm representing the party.¹⁴⁹ Among other situations, an arbitrator could be subject to disqualification because her spouse used to serve on a bar committee with an associate of a party’s lawyer, even if the associate is uninvolved in the case.¹⁵⁰

Similarly, under Standard 7(b)(6)(A) arbitrators must disclose whether a “party or an officer, a director, or a trustee of a party is or, within the preceding two years, was a client of the arbitrator in the arbitrator’s private practice of law or a client of a lawyer with whom the arbitrator is or was associated in the private practice of law.” This Standard would seemingly permit, for example, a party to disqualify an arbitrator if a former client of the arbitrator’s former law firm was a party to the arbitration.

Other conflicts are particularly problematic given the nature of SRO arbitrations and the realities of modern law firm practice. For example, Standard 7(b)(4) requires arbitrators to disclose whether they have in the preceding five years served as a “neutral arbitrator in another arbitration involving a party to the current arbitration or a lawyer for a party.” Because SRO arbitrations frequently involve broker-dealers, arbitrators will often have heard previous cases involving one of the parties. Similarly, some law firms handle a large number of securities arbitrations, thereby creating the potential for additional conflicts.¹⁵¹

To be sure, many parties will not choose to disqualify arbitrators based on these tenuous potential conflicts. Nonetheless, these Standards still impose a duty on arbitrators to collect, maintain, and update a broad array of information. Given the relatively small honoraria in SRO arbitrations, many well-qualified arbitrators may simply choose not to serve under these

¹⁴⁸ Standard 2(n).

¹⁴⁹ Standard 2(l).

¹⁵⁰ See Standard 7(b)(7) (requiring disclosure of “[a]ny other professional relationship the arbitrator or a member of the arbitrator’s immediate family has or has had with a party or a lawyer for a party.”).

¹⁵¹ See *University Commons-Urbana, Ltd. v. Universal Constructors, Inc.*, 2002 U.S. App. LEXIS 18820, at *21-22 (11th Cir. Sept. 13, 2002) (counsel’s and arbitrator’s previous participation in arbitrations does not demonstrate bias absent showing of an ongoing business relationship).



circumstances. Indeed, in preparing this Report I spoke to several experienced arbitrators who said that they would not serve as arbitrators if the Standards applied. This result should not be surprising. Courts and commentators have long recognized that there is a tension between broad conflict disclosure rules and the willingness of qualified arbitrators to serve. As the Introductory Note to the ABA/AAA Code warns:

These provisions of the code are intended to be applied realistically so that the burden of detailed disclosure does not become so great that it is impractical for persons in the business world to be arbitrators, thereby depriving parties of the services of those who might be best informed and qualified to decide particular types of cases.¹⁵²

This same “realistic” approach is reflected in the standard the SROs use in ruling on challenges for cause. Such challenges are granted when it “is reasonable to infer an absence of impartiality, the presence of bias, or the existence of some interest on the part of the arbitrator in the outcome of the arbitration as it affects one of the parties. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.”¹⁵³ Federal courts use the same standard for bias challenges under the Federal Arbitration Act.¹⁵⁴

The California Ethics Standards May Significantly Undermine the SROs’ Ability to Hear Arbitrations

Standard 7(b)(12) is perhaps the most problematic provision of the California Ethics Standards. It requires disclosure in customer cases of information concerning the relationship between the SRO and the arbitrator and of any professional or financial relationship between the SRO and any party or any lawyer in the arbitration. For example, Standard 7(b)(12)(A) requires, among other things, arbitrators to disclose whether the provider organization has a financial interest in a party or whether a party is a member

¹⁵² ABA/AAA CODE OF ETHICS, CANON II (Introductory Note).

¹⁵³ THE ARBITRATOR’S MANUAL, *supra* note 19, at 7.

¹⁵⁴ *Middlesex Mutual Ins. Co. v. Levine*, 675 F.2d 1197, 1202 (11th Cir. 1982); *Tamari v. Bache Halsey Stuart, Inc.*, 619 F.2d 1196 (7th Cir.), *cert. denied*, 449 U.S. 873 (1980); *United States Wrestling Federation v. Wrestling Division of the AAU, Inc.*, 605 F.2d 313, 318 (7th Cir. 1979) (*quoting* *Lucke v. Spiegel*, 131 Ill.App.2d 532, 536, 266 N.E.2d 504, 508 (1970)).

of the provider organization.¹⁵⁵ The arbitrator must disclose whether the SRO has provided dispute resolution services to a party or whether the SRO has entered into a relationship under which it expects to provide dispute resolution services to a party in the future.¹⁵⁶ If the arbitrator makes any of these disclosures, it must also disclose information about the SRO's procedures¹⁵⁷ and other arbitrations.¹⁵⁸

These provisions could effectively eliminate SRO-sponsored arbitrations in California. All SRO customer arbitrations involve at least one party that is a member of the provider organization and those members are required to pay fees to the SROs. Pre-dispute arbitration agreements require the parties to submit their dispute to an SRO sponsored arbitration, which means that there is an agreement under which the provider organization expects to provide dispute resolution services in the future. In other words, these conflicts will exist in all SRO-sponsored arbitrations and could serve as a basis for disqualifying all arbitrators.

Even if parties do not exercise all possible challenges, the provision would appear to impose substantial administrative burdens on arbitrators and the SROs. Arbitrators will be required to maintain and update an extensive set of records in order to make disclosures under the California Ethics Standards. Arbitrators may rely on information the SRO provides,¹⁵⁹ but that simply shifts the burden from the arbitrator to the SRO. Given the volume of SRO-sponsored arbitrations, these burdens are likely to be significant.

¹⁵⁵ Standard 7(b)(12)(A)(i) & (ii).

¹⁵⁶ Standard 7(b)(12)(A)(iv).

¹⁵⁷ Standard 7(b)(12)(B). Specifically, arbitrators must disclose: (i) any financial relationship or affiliation they have with the SRO; (ii) the SRO's process and criteria for recruiting, screening, and training arbitrators; (iii) the SRO's process for identifying and selecting potential arbitrators for specific cases; and (iv) any role the SRO plays in ruling on disqualification motions. *Id.*

¹⁵⁸ The arbitrator must disclose "the number of pending and prior cases involving each party or lawyer in the arbitration" and "the date of decision, the prevailing party, the names of the parties' attorneys, and the amount of monetary damages awarded, if any, in each such prior case." Standard 7(b)(12)(D).

¹⁵⁹ Standard 7(b)(12)(F).

CONCLUSION

This Report concludes that there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations. Available empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair. At the same time, there is likely very little benefit from adopting the California Ethics Standards, in part because current SRO rules require many of the same disclosures as the Standards.

Adopting other aspects of the California Ethics Standards could impose significant costs and have significant unintended consequences that may actually reduce investors' perceptions of the fairness of SRO arbitrations. Adding new disclosure obligations may deter well-qualified arbitrators from serving or may disqualify those with significant expertise from hearing a case. The net result may well be less accurate case resolutions and more judicial challenges to arbitral awards. Other aspects of the standards, like requiring disclosure of any fees or assessments industry members pay to the SRO and permitting parties to disqualify an arbitrator on the basis of those disclosures, seem particularly ill-suited to SRO arbitrations because securities arbitrators have no financial interest in the SROs. Since all industry members pay fees and assessments to the SROs, adopting this rule could effectively preclude all SRO arbitrations if the parties exercise all their statutory challenges.

While the current SRO conflict disclosure requirements generally appear adequate, making some of the modifications discussed above may provide additional assurance to investors that arbitrators are in fact neutral and impartial.