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## INFORMATION NOTE

### Securities arbitration in the United States

#### Summary

- *In the United States (US), securities disputes are primarily channelled into arbitration or submitted to mediation, principally at a forum provided by the Financial Industry Regulatory Authority (FINRA).*
- *FINRA is a self-regulatory organization (SRO) in the securities industry, regulating about 4 700 member securities firms. It was created in 2007 through the consolidation of the National Association of Securities Dealers (NASD) and some operations of the New York Stock Exchange (NYSE).*
- *The Securities Exchange Act of 1934 requires broker-dealers to register with, and submit to the rules of, a SRO as a condition of doing business with the US public. This is significant with respect to arbitration because the SRO rules require a broker-dealer to arbitrate if the customer so chooses.*
- *FINRA is led by a board of 23 Governors, handling virtually all mediation and arbitration claims involving (a) investor against broker-dealer, (b) broker-dealer against broker-dealer, and (c) broker-dealer against its employee(s).*
- *FINRA is funded primarily by member fees. It also derives its income from the dispute resolution fees payable by both disputing parties to an arbitration claim.*
- *FINRA's arbitration hearings are conducted in a litigation-like manner with opening statements, followed by submittals of evidence by the claimant and the respondent, arguments against the evidence and closing arguments. Alternatively, disputing parties can initiate mediation before filing a formal claim for arbitration, or at any stage of a pending arbitration.*
- *Awards made by the arbitration panel are final and binding on all parties. Where an arbitration claim is determined in favour of the claimant, the award may include compensatory and punitive damages, and/or interest and cost awards.*

- *Although arbitrators receive an honorarium from FINRA, they are not employees of FINRA and work on a case-by-case basis. The inclusion of public arbitrators in the arbitration panel should inject a greater degree of independence into FINRA's arbitration procedure.*
- *Securities arbitrations by SROs are overseen by Congress and the Securities and Exchange Commission. For FINRA, it has further established the National Arbitration and Mediation Committee to oversee its dispute resolution process. In addition, it is subject to the obligation to meet information accessibility by the public.*
- *A recent study found that a sizeable percentage of customers expressed a negative impression of the arbitration process conducted at NASD and NYSE, particularly regarding the fairness and outcomes of SRO arbitrations.*

## **1. Background**

1.1 Shortly after the collapse of Lehman Brothers in September 2008, the Financial Secretary requested the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) to submit reports on their observations, lessons learned and issues identified during the process of investigating the received complaints regarding the Lehman Brothers Minibonds. The Financial Secretary received the said reports from HKMA and SFC at end-2008, with both suggesting the need to consider the establishment of a dispute resolution scheme for the financial industry in Hong Kong. In response, the Financial Services and the Treasury Bureau announced on 9 February 2010 to conduct a three-month consultation to solicit public views on the establishment of a financial dispute resolution centre in Hong Kong.

1.2 The purpose of this information note is to provide the Panel on Financial Affairs (Panel) with background information on the development of the securities arbitration scheme in the United States (US), thereby facilitating the Panel's deliberation on the establishment of a financial dispute resolution centre in Hong Kong.

1.3 In the US, the financial regulators, such as the Federal Reserve and the Securities and Exchange Commission (SEC), have not established any dispute resolution mechanism as an out-of-court alternative for resolving customer complaints<sup>1</sup>. Instead, they would investigate the consumer complaints received, and prosecute the financial services providers under complaint for any fraud and/or other wrongful acts found.

1.4 Against the above background, individual customers in the US have made use of the mediation and arbitration schemes provided by independent organizations as an informal mechanism for settling their financial disputes. The financial market sector in which arbitration is most frequently employed for resolving customer disputes is the securities industry<sup>2</sup>. Within the securities industry, self-regulatory organizations (SROs) have established their own mediation and arbitration forums to act as an alternative to the courts for resolving customer disputes<sup>3</sup>.

## **2. Development of securities arbitration in the United States**

2.1 In the US, the development of securities arbitration can be traced back to 1872, when the New York Stock Exchange (NYSE) began to require investors to sign standard customer agreements stating that they would arbitrate, rather than litigate, any future disputes. In subsequent years, many other exchanges and securities firms followed the lead of NYSE to subject their customers to pre-dispute arbitration agreements. These agreements were typically enforced by the courts, particularly after the passage of the *Federal Arbitration Act* in 1925 to require courts enforcing arbitration agreements in the same manner as other contracts.

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<sup>1</sup> For example, the Federal Reserve states that it is unable to resolve contract disputes or undocumented factual disputes between a customer and a bank. Likewise, SEC declares that it cannot act as a judge or an arbitrator and force a financial service provider to resolve customer complaints. See *Federal Reserve* (2010) and *Securities and Exchange Commission* (2010).

<sup>2</sup> See Cirielli (2003).

<sup>3</sup> In the US, federal securities legislation provides for the delegation of SEC's supervisory power to SROs in the securities sector. While operating under the supervision of SEC, these SROs possess broad authority to impose governance standards, set rules, and undertake enforcement and disciplinary proceedings with respect to their members.

2.2 In 1953, the US Supreme Court in *Wilko v. Swan* faced the choice between the *Federal Arbitration Act's* mandate to arbitrate, and the provisions in the *Securities Act of 1933* intended to protect the customer interest<sup>4</sup>. *Wilko v. Swan* was a case in which an investor sued his brokerage firm under Section 12(2) of the *Securities Act of 1933*, alleging that he had been fraudulently induced to buy 1 600 shares of a particular company. In response, the brokerage firm asked the court to suspend litigation until arbitration was carried out, pursuant to the arbitration clause contained in the margin agreements signed by the investor before the financial dispute.

2.3 After expressing some mistrust of arbitration, the US Supreme Court in *Wilko v. Swan* determined that a pre-dispute arbitration agreement was unenforceable when an investor brought a fraud claim under Section 12(2) of the *Securities Act of 1933*<sup>5</sup>. After the ruling of *Wilko v. Swan*, many federal courts refused to compel arbitration for customers' claims arising under the federal securities legislation, notwithstanding the presence of pre-dispute arbitration agreements.

2.4 The US Supreme Court's attitude towards commercial arbitration changed gradually in the ensuing years, culminating in a reconsideration of its position in the late 1980s. In 1987, the Supreme Court in *Shearson/American Express Inc. v. McMahon* expressed its confidence in the arbitration procedures overseen by SEC and questioned the mistrust of arbitration that constituted the basis for the ruling of *Wilko v. Swan*.

2.5 In 1989, the US Supreme Court went further in *Rodriguez de Quijas v. Shearson/American Express Inc.* to overrule the earlier judgment on *Wilko v. Swan* and uphold the enforceability of pre-dispute arbitration agreements to settle customer claims arising under the *Securities Act of 1933*. Since then, securities firms have generally included pre-dispute arbitration clauses in their standard customer agreements, binding their customers to arbitrate for future disputes. At present, securities disputes are primarily channelled into arbitration or submitted to mediation, principally at a forum provided by the Financial Industry Regulatory Authority (FINRA).

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<sup>4</sup> The *Securities Act of 1933* contains provisions regulating the primary market (i.e. direct sales from issuers), and prohibiting deceit, misrepresentations and other frauds in the sale of securities.

<sup>5</sup> According to Zoltowski (2008), in *Wilko v. Swan*, "the Supreme Court held that a pre-dispute agreement to arbitrate a claim under the Securities Act of 1933 was not enforceable despite the [*Federal Arbitration Act*] because it violated public policy. The Court felt that since there were risks that arbitrators would misapply law, which the judiciary would not be able to overturn under the [*Federal Arbitration Act*], allowing securities arbitration would in effect allow claimants to waive provisions of the Securities Act [of 1933]. Securities Act [of 1933] section 14 prohibits waiving any provision of the Act."

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### 3. Operation of the Financial Industry Regulatory Authority

3.1 As a SRO in the securities industry, FINRA regulates about 4 700 member securities firms. It was created on 30 July 2007 through the consolidation of the National Association of Securities Dealers (NASD<sup>6</sup>) and the member regulation, enforcement and arbitration functions of NYSE. FINRA oversees virtually every aspect of the US securities business, including:

- (a) formulating and enforcing rules governing the activities of securities firms and brokers and, when necessary, taking action against those that do not comply;
- (b) registering securities firms and brokers;
- (c) educating the investing public; and
- (d) administering the largest forum in the US specifically designed to resolve securities disputes.

#### Jurisdictions of the Financial Industry Regulatory Authority

3.2 In the US, almost all broker-dealers are registered with FINRA, making it the largest SRO in the country<sup>7</sup>. At end-December 2009, FINRA oversaw 4 720 brokerage firms, 166 893 branch offices and 633 280 registered securities representatives.

3.3 In addition, FINRA operates the largest dispute resolution forum in the US, handling virtually all mediation and arbitration claims involving (a) investor against broker-dealer, (b) broker-dealer against broker-dealer, and (c) broker-dealer against its employee(s) (e.g. employment disputes, compensation, discrimination, and wrongful termination).

3.4 FINRA also provides dispute resolution services for several national securities exchanges through contracted agreements. These exchanges submit themselves to FINRA's rules and procedures for handling mediation and arbitration claims filed against their non-FINRA exchange members.

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<sup>6</sup> NASD was a national securities association registered with SEC pursuant to Section 15A of the *Securities Exchange Act of 1934*. The purpose of the organization was to provide self-regulation of the over-the-counter securities market.

<sup>7</sup> Essentially, a broker is a firm or an individual acting as an intermediary between buyers and sellers of securities, usually charging a commission for these services. A dealer is a firm or an individual engaged in the business of buying and selling securities for its own account, either directly or through a broker.

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### Legislative framework

3.5 The *Securities Exchange Act of 1934* requires broker-dealers to register with SEC, and where applicable, with a SRO. The *Act* defines the term "SRO" as any registered securities associations, national securities exchanges, the Municipal Securities Rulemaking Board<sup>8</sup> and registered clearing agencies. Only one securities association – FINRA – is registered under the *Securities Exchange Act of 1934*.

3.6 The *Securities Exchange Act of 1934* further requires broker-dealers to comply with the SRO rules. This is significant with respect to arbitration because the SRO rules require a broker-dealer to arbitrate if the customer so chooses. In other words, a broker-dealer must submit to arbitration upon customer request in order to engage in the securities business.

3.7 Under Section 6 of the *Securities Exchange Act of 1934*, SROs must have rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of free trade ... and in general to protect investors and the public interest." As such, FINRA maintains and administers a Code of Arbitration Procedure for Customer Disputes (Arbitration Code) to set out the procedure whereby arbitrations are initiated and conducted for resolving securities disputes.

### Organization structure

3.8 FINRA is led by a board of 23 Governors entrusted with setting the overall strategic direction and policy of the organization. The membership of the board comprises:

- (a) 10 Industry Governors from the securities industry<sup>9</sup>;
- (b) 11 Public Governors appointed from outside the securities industry;

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<sup>8</sup> The Municipal Securities Rulemaking Board makes rules regulating dealers who deal in municipal bonds, municipal notes and other municipal securities.

<sup>9</sup> These 10 Industry Governors consist of (a) a Floor Member Governor, (b) an Independent Dealer/Insurance Affiliate Governor, (c) an Investment Company Affiliate Governor, (d) three Small Firm Governors, (e) one Mid-Size Firm Governor, and (f) three Large Firm Governors.

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- (c) the Chief Executive Officer of FINRA<sup>10</sup>; and
  - (d) the Chief Executive Officer of NYSE Regulation, Inc<sup>11</sup>.

3.9 FINRA has also established a subsidiary – FINRA Dispute Resolution – to provide mediation and arbitration services for resolving financial disputes between and among investors, securities firms and registered representatives.

#### *Funding arrangement*

3.10 FINRA is funded primarily by member fees. The largest proportion of funding is sourced from regulatory fees paid by FINRA's member firms<sup>12</sup>, which accounted for US\$453 million (HK\$3.5 billion<sup>13</sup>) or 58% of FINRA's total operating revenue in 2008.

3.11 FINRA also derives its income from user fees, contract services fees and transparency services fees<sup>14</sup>, which respectively accounted for 20%, 9% and 6% of FINRA's total operating revenue in 2008. Over the same period, FINRA received 5% of its total operating revenue from dispute resolution fees earned from the mediation and arbitration services.

## **4. Securities mediation and arbitration procedures**

4.1 FINRA's dispute resolution forum features the establishment of two pillars – mediation and arbitration – to act as an out-of-court alternative for resolving securities disputes.

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<sup>10</sup> While serving as the governing body of FINRA, the board of Governors appoints the Chief Executive Officer to manage the day-to-day operation of the organization.

<sup>11</sup> NYSE Regulation, Inc. is a not-for-profit corporation responsible for enforcing marketplace rules and federal securities laws of NYSE.

<sup>12</sup> Regulatory fees comprise (a) transaction-based fee charged for sale of a covered security, and (b) assessments based on a member firm's level of revenue earned in the prior year, the number of registered industry representatives and the number of branches established.

<sup>13</sup> Based on the average exchange rate of HK\$7.752 per US Dollar in 2009.

<sup>14</sup> User fees include FINRA registration fees, fees for qualification examinations, fees associated with FINRA-sponsored educational programmes and conferences, processing of membership applications and charges related to the review of advertisement and corporate financing filings. Contract services fees represent income earned from providing regulatory services to NASDAQ, Amex and other exchanges, whereas transparency services fees represent amounts charged for member firms using FINRA's market data reporting and display facilities.

### Mediation procedure

4.2 FINRA administers a securities mediation forum to facilitate negotiations between disputing parties and help them find a mutually acceptable resolution. Disputing parties can initiate mediation before filing a formal claim for arbitration, or at any stage of a pending arbitration. In the latter case, they can choose to have the mediation run separately from, but concurrently with, the pending arbitration. Alternatively, they can put the arbitration on hold to avoid potentially unnecessary arbitration costs if the mediation is successful.

4.3 Mediation with FINRA is a voluntary service and no parties involved in a securities dispute may be compelled to mediate. Any party interested in initiating mediation can alert FINRA Dispute Resolution of the intent to mediate, and the latter will contact the other party regarding the mediation request. Once all relevant parties have agreed to mediate, they must sign a written agreement – Submission Agreement – which indicates that they agree to submit to the mediation process<sup>15</sup>. They will then select the mediator of their choice to assist them in clarifying issues, addressing questions and reaching an agreement.

4.4 Should the disputing parties reach a mutually acceptable resolution, they (or their attorneys) will prepare a document detailing all the terms of the settlement. Once signed, the settlement agreement is final and binding on both parties. If the mediator cannot assist the disputing parties in reaching a settlement, the arbitration will continue its course where the mediation arose out of a pending arbitration case. When the disputing parties have filed solely for mediation, the claimant will need to file a separate claim requesting arbitration with FINRA Dispute Resolution.

### Arbitration procedure

4.5 In the US, the SRO rules require broker-dealers to arbitrate securities disputes at the demand of the customers. Reciprocally, customers are not required to choose arbitration over litigation. In other words, the SRO rules give customers the choice of which forum to settle their securities disputes with the broker-dealers concerned. In practice, securities firms may pre-empt such customers' choice through including pre-dispute arbitration clauses in the standard customer agreements or new account agreements which customers must sign in order to open an account.

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<sup>15</sup> Each party to a case submitted to FINRA Dispute Resolution for mediation is required to pay a filing fee. In addition, the mediator's fees and expenses are apportioned equally among the parties unless they agree otherwise.

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4.6 Once a customer is compelled to arbitrate a claim, the process involved – with increased formalities and legalities – resembles litigation with slight variation<sup>16</sup>. As discussed below, arbitration hearings are conducted in a litigation-like manner with opening statements, followed by submittals of evidence by the claimant and the respondent, arguments against the evidence and closing arguments.

#### *Initiating an arbitration claim*

4.7 The arbitration process is initiated by an investor, or a "claimant", filing a Statement of Claim with the Director of FINRA Dispute Resolution<sup>17</sup>. The Statement of Claim does not have to be in a particular format, but it typically includes the relevant facts, the basis for the claim and the damages and other relief requested by the claimant. Relevant documents may also be attached to the Statement of Claim to support the claim.

4.8 The Statement of Claim must be accompanied by a signed Submission Agreement, stating that the claimant agrees to submit the dispute to arbitration and abide by the procedural rules of the arbitration forum and the decision of the arbitrators. Along with the Statement of Claim and Submission Agreement, the claimant must also include a cheque for the filing fee and hearing session deposit.

4.9 Both sides to an arbitration claim are required to pay fees. Claimants must pay a filing fee when filing the Statement of Claim. The filing fee payable depends on the amount of damages the claimant is seeking, ranging from US\$50 (HK\$388) to US\$1,800 (HK\$13,954). In addition to the administrative filing fee, FINRA Dispute Resolution also charges fees for each hearing session that takes place with the arbitrators. The total hearing fee depends on the number of hearing sessions conducted. The arbitration panel will decide which parties are ultimately responsible for the hearing fees and other expenses in the determination made after the close of hearing.

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<sup>16</sup> See Alpert (2008).

<sup>17</sup> Any requests for securities arbitration must be subject to FINRA's general regulatory jurisdiction and a six-year time limit. The latter states that a claim is not eligible for arbitration if six years have elapsed from the occurrence of the event giving rise to the claim.

*Notification of the case to the respondent concerned*

4.10 When FINRA Dispute Resolution receives the required documents and fees from the claimant, it will serve the Statement of Claim on the respondent. The respondent must file a response within 45 days from the day it receives the Statement of Claim. In the response, the respondent should outline the defence it plans to argue and specify the relevant facts and available evidence to support the defence.

*Selection of arbitrators*

4.11 Shortly after the respondent files the response, FINRA Dispute Resolution will send a letter to both parties stating that the dispute is ready for selection of arbitrator(s) to hear the claim. Accompanying the letter will be a list containing the names of potential arbitrators generated by FINRA's computer system on a random basis from the rosters of arbitrators. Both parties are allowed to remove, or strike, some of the arbitrators on the list and rank the remaining names in order of their preference. From the ranked list prepared by each side, the arbitrator(s) with the highest combined ranking will be appointed to hear the claim.

4.12 FINRA Dispute Resolution maintains a list of individuals who have applied, and qualified, to be arbitrators. These arbitrators are not employed by FINRA and they are volunteers whom FINRA will compensate for their service. FINRA divides arbitrators into two categories: those with a substantial part of their careers involving the securities industry (non-public arbitrators<sup>18</sup>) and those not (public arbitrators).

4.13 The number of arbitrators on a case depends on the amount of damages the claimant is seeking. If the claimant is seeking US\$25,000 (HK\$193,800) or less in damages, FINRA's simplified arbitration process applies. The claim will be heard by a public arbitrator who is qualified to be a chairperson (known as Chair-qualified arbitrator). He or she renders the determination based on the written submissions of both parties without conducting a hearing.

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<sup>18</sup> According to FINRA, a non-public arbitrator can be a person who is currently working in the securities industry, or who has worked in the industry in the past five years. Alternatively, he or she can be a retired person who spent a substantial amount of his or her career in the securities industry. Non-public arbitrators also include lawyers, accountants or other professionals who have devoted 20% of their work to the securities industry over the past two years.

4.14 If the amount of a claim is more than US\$25,000 (HK\$193,800) and up to US\$100,000 (HK\$775,200), then one Chair-qualified public arbitrator will hear the case unless the parties agree in writing to three arbitrators. In the case of a three-member panel, it will be made up of: (a) one Chair-qualified public arbitrator, (b) one public arbitrator, and (c) one non-public arbitrator<sup>19</sup>.

4.15 For an arbitration claim of more than US\$100,000 (HK\$775,200), unspecified, or not requesting monetary damages, the case automatically goes to a three-member panel unless the parties agree in writing to one arbitrator. The three-member panel will consist of two public arbitrators (with one being a Chair-qualified public arbitrator) and one non-public arbitrator.

#### *Pre-hearing conference*

4.16 Once the parties select their arbitrators, the arbitration panel will hold an initial pre-hearing conference with the party representatives to decide procedural matters and set the hearing dates.

#### *Hearing*

4.17 At the hearing, each party is given the opportunity to make an opening statement, briefly describing their case and what they will try to prove to the arbitration panel. After the opening statement, the claimant presents his or her evidence and may call witnesses to testify on his or her behalf. After the claimant's witnesses have testified on "direct examination" (questioning by the claimant's attorney), they will be cross-examined by the respondent's attorney.

4.18 When all the claimant's witnesses have testified, it is the respondent's turn to present its case and call witnesses. The claimant, or his or her attorney, can cross examine any respondent's witnesses who have testified. Once both parties have offered their witnesses and evidence, they will present closing arguments to sum up the evidence and set out why the arbitration panel should rule in their favour.

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<sup>19</sup> According to Shorter (2005), "[h]istorically, the rationale for having a non-public arbitrator was that such a person would provide valuable insight into the inner workings of brokerage firms".

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### *Post-hearing*

4.19 After the hearing, the arbitration panel will decide on the outcome of the claim based on the principles of equity (fairness) and justice, rather than by a strict application of legal rules to the facts. A customer prevails if a majority of the arbitrators on a three-member panel, or the single member of a one-member panel, decide to direct the respondent to award the claimant some or all of the claims against it.

4.20 The arbitration panel typically makes a final decision within 30 days after the close of the hearing. The decision, called an "award", must be in writing, but the arbitration panel is not required to write opinions or provide explanations or reasons for its decision. The award indicates which party has prevailed and the amount, if any, that the successful party is entitled to receive as damages. It also decides whether to assess any costs and forum fees against any party, and how to allocate those costs and fees among the parties.

4.21 Awards made in securities arbitration are final and binding on all parties. They are usually not subject to review by the courts unless they can be shown that fraud, corruption or other misconducts occurred in rendering the awards. Other grounds for setting aside an award include partiality by an arbitrator or certain specific technical errors. In addition, an award may also be vacated when an arbitrator manifestly disregards the law.

### *Awards by the arbitrators*

4.22 Where a claim is determined in favour of the claimant, the award made by the arbitration panel may include one or more of the following:

#### Compensatory damages

4.23 The arbitration panel can award compensatory damages to compensate for the claimant's actual dollar loss and any other damages. The amount to be awarded is based on the figure stated by the claimant in the Statement of Claim as what he or she considers to be actual damages incurred.

#### Punitive damages

4.24 The arbitration panel may consider punitive damages as a remedy. Generally, punitive damages consist of compensation in excess of actual damages and are awarded to punish the respondent and deter future wrongdoing.

### Interest award

4.25 An interest award provides for the amount payable under the compensatory damages to bear interest at a given rate from the date specified in the award.

### Cost award

4.26 A cost award is an amount the arbitration panel considers to be fair to cover some or all the costs reasonably incurred by the claimant in respect of the claim for securities arbitration. The cost award against the respondent may include the filing fee, hearing session fee, and/or attorney fee incurred by the claimant.

### *Enforcement of the award*

4.27 Customers could complaint to FINRA if they cannot receive the damages and/or other relief within 30 days of receipt of the award. Under the by-laws of FINRA, the registration of a FINRA member can be suspended or cancelled if the member does not comply with an arbitration award, unless the member has made a timely move to vacate or modify the award.

## **5. Dispute resolution statistics**

5.1 According to the latest dispute resolution statistics, FINRA Dispute Resolution achieved the following results for its mediation and arbitration forums in 2009:

- (a) the mediation forum closed about 680 cases with 82% of them reaching a settlement;
- (b) the arbitration forum closed about 4 600 cases with 25% of them settled by the arbitration panel through formal determination. Another 54% of the cases were settled informally by disputing parties themselves (47% by direct settlement and 7% via mediation); and
- (c) arbitrators awarded damages in about 45% of the cases brought by customers.

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## 6. Independence of the securities arbitration procedure

6.1 Although arbitrators receive an honorarium from FINRA, they are not employees of FINRA and work on a case-by-case basis. Such an arrangement should help ease arbitrators' concern over the termination of their employment when making a determination against the securities industry. Likewise, a decision against a FINRA member firm will not preclude an arbitrator from being placed on FINRA's computer generated list of potential arbitrators for any particular arbitration panel. This independence should help pre-empt any incentive of FINRA's arbitrators to rule in favour of one party or another. In addition, the inclusion of public arbitrators in the arbitration panel should inject a greater degree of independence into FINRA's arbitration proceedings<sup>20</sup>.

6.2 FINRA's Arbitration Code and the *Federal Arbitration Act* contain provisions further governing the independence of arbitrators at the selection and appointment phase and throughout the case to the end of the hearing.

### *Selection of arbitrators*

6.3 In arbitration, FINRA is required under the Arbitration Code to furnish both sides with a list of potential arbitrators from which they could select for hearing their case. Along with the list, FINRA will send the parties Arbitrator Disclosure Reports<sup>21</sup> that disclose the education and employment history, past arbitration awards and other background information for each of the arbitrators on the list. The parties could make use of the information so provided to strike the names from the arbitrator list that pose a potential conflict of interest with the witnesses, issues or products in the case.

### *Appointment of arbitrators*

6.4 Before appointing arbitrators to an arbitration panel, Rule 12408 of the Arbitration Code requires the Director of FINRA Dispute Resolution to notify the arbitrators of the nature of the dispute and the identity of the parties to the arbitration claim. Each potential arbitrator must disclose to the Director any circumstances which might preclude him or her from rendering an objective and impartial determination in the proceeding.

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<sup>20</sup> See Securities Industry and Financial Markets Association (2008).

<sup>21</sup> FINRA requires arbitrator applicants to submit biographical profile forms and the personal information contained herewith will be entered into FINRA's database. Such information will be provided to the relevant parties in the form of an Arbitrator Disclosure Report during the arbitrator selection process.

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6.5 The Director of FINRA Dispute Resolution will inform the parties to the arbitration claim of any information disclosed to him or her under Rule 12408. If the parties have identified a possible source of bias from a potential arbitrator, they could either (a) request for the arbitrator to recuse himself or herself, or (b) challenge the arbitrator for cause and ask the Director to remove that arbitrator.

### *Hearing*

6.6 If a conflict of interest arises during the course of a hearing, the arbitrator concerned must disclose it so that a decision can be made as to whether (a) he or she should be voluntarily removed from the case, or (b) the matter should be referred to the Director or the President of FINRA Dispute Resolution for action<sup>22</sup>.

### *Post-award*

6.7 If a party learns of an arbitrator's bias after an adverse award has been rendered, the party can move to vacate the award under the *Federal Arbitration Act* on the grounds that "there was evident partiality or corruption in the arbitrators, or either of them"<sup>23</sup>.

## **7. Oversight of the securities arbitration procedure**

7.1 In the US, securities arbitrations by SROs are subject to extensive oversight by the Congress's investigative arm, the Government Accountability Office (formerly known as the General Accounting Office). For example, in 1992, the General Accounting Office conducted a comprehensive evaluation of the arbitration process sponsored by SROs in the securities industry. The review found that there was no indication of a pro-industry bias in decisions at industry-sponsored forums.

7.2 Public oversight of the securities arbitration is not limited to the legislative branch of the government. SEC also actively oversees the arbitration process conducted by SROs. For FINRA, it is further subject to scrutiny by the National Arbitration and Mediation Committee (NAMC) and obligation to meet information accessibility by the public.

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<sup>22</sup> FINRA Dispute Resolution is headed by the President, who is assisted by the Director of Dispute Resolution in charge of the dispute resolution programmes run by FINRA's four regional offices.

<sup>23</sup> See Section 10(a)(2) of *Title 9, United States Code*.

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### Securities and Exchanges Commission

7.3 Each SRO, including FINRA, is required to file with SEC any proposed rules or changes to its rules that affect the securities arbitration process. SEC will approve a rule change only if it finds the change to be consistent with the requirements of the *Securities Exchange Act of 1934* and the rules and regulations thereunder. In fact, SEC has the power to "abrogate, add to, and delete from" any SRO rules<sup>24</sup>, including arbitration rules, to ensure that securities arbitration adequately protects the statutory rights guaranteed under the federal securities legislation.

7.4 SEC's oversight of securities arbitration extends beyond the rulemaking arena. For instance, SEC engages in frequent reviews of SRO arbitration facilities 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<sup>25</sup>". For example, in 1998, SEC encouraged SROs to use "plain English" in disclosure documents and other materials used by customers. In addition, SEC commissioned a study in 2002 to review the adequacy of the securities arbitration process. Such proactive efforts aim to ensure that the rules governing securities arbitration provide consumers with a fair, efficient and impartial forum.

### National Arbitration and Mediation Committee

7.5 FINRA's board of Governors has established NAMC to oversee the securities mediation and arbitration services currently run by FINRA Dispute Resolution. NAMC includes representatives from the public, the securities industry, and the arbitrators and mediators serving in FINRA's Dispute Resolution<sup>26</sup>.

7.6 According to Rule 12102 of the Arbitration Code, NAMC has "the authority to recommend rules, regulations, procedures and amendments relating to arbitration, mediation and other dispute resolution matters to the Board" and "has such other power and authority as is necessary to carry out the purposes of the Code". NAMC is also charged with the responsibility for the recruitment, qualification training, and evaluation of arbitrators and mediators, and the review of existing rules, regulations and procedures that govern FINRA's mediation and arbitration processes.

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<sup>24</sup> See Section 78s(c) of *Title 15, United States Code*.

<sup>25</sup> See Securities and Exchange Commission (1998).

<sup>26</sup> According to the Arbitration Code, NAMC shall consist of between 10 and 25 members. In addition, at least 50% of NAMC's membership shall be non-industry members.

### Information accessibility by the public

7.7 FINRA provides the public with information on understanding and navigating its arbitration process. In particular, it provides numerous resources on its website for parties considering filing a claim or already in arbitration, which include "Dispute Resolution Statistics", "Code of Arbitration Procedure", "Overview of Arbitration and Mediation", "Arbitration Awards Online" and "Investor Complaint Program brochure".

## **8. Review of the securities arbitration scheme**

8.1 For the past two decades, arbitrations in forums sponsored by SROs have been the primary mechanism for resolving disputes among investors, brokerage firms and brokers. Despite this crucial role, the securities arbitration process has attracted criticisms on several fronts, including:

- (a) virtually mandatory nature of the process – almost every broker-dealer includes in the customer agreements a pre-dispute arbitration provision that obliges investors to submit all disputes that they may have with the firm and/or its associates to mandatory arbitration;
- (b) inclusion of one non-public arbitrator in every three-member panel and the resulting appearance of bias and impropriety to the investing public<sup>27</sup>; and
- (c) lack of transparency in arbitrators' decisions – the arbitration panel is not required to provide any explanation or justification for its decision.

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<sup>27</sup> In response, FINRA launched a voluntary pilot programme in October 2008 allowing some investors making arbitration claims to choose a panel made up of three public arbitrators, instead of two public arbitrators and one non-public arbitrator.

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8.2 In 2002, SEC commissioned Professor Perino of St. John's University to conduct a study on the operation of arbitrator disclosure requirements at NASD and NYSE. Professor Perino found no evidence of favourism toward either industry members or consumers. He also concluded that "there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations<sup>28</sup>." Nevertheless, he recommended that SROs should sponsor additional independent studies to further evaluate the impartiality of the SRO arbitration process. In response, the Securities Industry Conference on Arbitration (SICA) entered into an agreement with Pace University in 2005 to conduct the recommended study<sup>29</sup>.

### The Pace University study

8.3 The Pace University study was conducted by Professors Jill Gross and Barbara Black with the objective of assessing customers' perception of:

- (a) the competence of arbitrators to resolve investors' disputes with their broker-dealers;
- (b) the fairness of SRO arbitrations as compared with their perception of fairness in securities litigation in similar disputes;
- (c) the fairness of the outcomes of arbitrations; and
- (d) the fairness of the SRO arbitration process.

8.4 Pace University successfully mailed an eight-page survey to nearly 24 000 participants in the NASD and NYSE arbitrations filed between 1 January 2002 and 31 December 2006 and closed during 2005-2006. A total of 3 087 responses (representing a 13% response rate) were received and processed. On 6 February 2008, Pace University presented the survey results to SICA in a report entitled "Perceptions of Fairness of Securities Arbitration: an Empirical Study".

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<sup>28</sup> See Perino (2002).

<sup>29</sup> With the support of SEC, SICA was established in 1977 with representatives from SROs, the securities industry and the public. The creation of SICA at that time was to create a Uniform Arbitration Code to harmonize the rules of the various SRO arbitration forums then in existence. Since its inception in 1977, SICA has played an important role in the development of procedures for arbitration offered by various SROs.

### *Major findings*

8.5 The major findings of the Pace University study indicate the following customers' view on securities arbitration:

#### Arbitrators' attentiveness and competence

8.6 Based on the experience of their most recent dispute, a majority of customers surveyed gave positive assessments of the arbitrators' attentiveness at the hearing and their competence. 73.6% of customers agreed with the positive statement that "at the hearing, the arbitration panel listened to the parties, their representatives and their witnesses". Meanwhile, 54.5% of customers agreed with the positive statement that "the arbitration panel appeared competent to resolve the dispute".

#### Comparison between arbitration and litigation processes

8.7 When asked about the fairness of securities arbitration as compared to their most recent experience in a civil court case, 75.6% of customers surveyed indicated that arbitration was "very unfair" or "somewhat unfair".

#### Fairness of the outcomes of arbitrations

8.8 Customers expressed strong dissatisfaction with the outcome of their most recent securities arbitration case. In the survey, 70.8% of customers disagreed with the positive statement that "I am satisfied with the outcome", and only 22.2% of customers agreed with that statement.

#### Impartiality of the arbitration panel

8.9 A sizeable percentage of customers surveyed opined that the arbitration panel was biased. Some 40.6% of customers disagreed with the positive statement that "the arbitration panel was impartial" based on their most recent securities arbitration case.

Fairness of securities arbitration based on customers' recent experience

8.10 Customers surveyed expressed a negative impression of the overall arbitration process based on their most recent experience. About 62.6% of customers disagreed with the positive statement that "as a whole, I feel the arbitration process was fair", while 27.8% of customers agreed with the statement.

Fairness of securities arbitration based on customers' general impression

8.11 When directed to respond based on their overall impressions of the fairness of the securities arbitration process, 61.3% of customers surveyed disagreed with the positive statement that "arbitration was fair for all parties".

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