Arbitration Tilting More Against Investors: Jane Bryant Quinn

By Jane Bryant Quinn

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Bloomberg - Let's say you had $50,000 in auction- rate securities that your broker said were as safe as money- market funds. The market collapsed and you sold at an 80 percent haircut. At your arbitration hearing, one of the three panel members works at a firm that also sold auction rates deceptively. How fair will the hearing be? Will the industry let this conflict of interest stand?

The flood of auction-rate claims against brokerage firms points up, again, how badly the deck is stacked against you in securities-industry arbitration. For claims exceeding $50,000, your three-member panel of judges must include an industry representative, plus two ``public'' members who also can have industry ties.

The industry rep is there to explain the industry's point of view to the other panelists -- effectively, a Wall Street mouthpiece, sympathetic to the very products and practices you're complaining about. As an ``expert,'' his or her opinion carries extra weight.

For years, the lawyers representing customers have pressed to get rid of this fifth-columnist on arbitration panels. The industry always stonewalled.

Then, in 2007, a bill called the Arbitration Fairness Act appeared in Congress, containing a clause requiring all three panelists to be from the public. Coincidentally -- I'm sure -- the Financial Industry Regulatory Authority (FINRA), which runs securities arbitrations, decided to hedge its position.

Last week, FINRA announced a two-year pilot project, allowing as many as 420 cases to be heard by an all-public panel. Customers' lawyers welcomed the pilot, tepidly, as a baby step in the direction of fairness.

The Boot

Then, fairness got the boot.

Last May, the Public Investors Arbitration Bar Association wrote to FINRA about the problem of conflicted panelists on the auction-rate cases. PIABA President Laurence Schultz, of Driggers, Schultz & Herbst in Troy, Michigan, asked that potential panelists be excluded from the hearings if they worked for firms that originated or sold auction-rate securities. After private talks, PIABA expected a yes.

FINRA said no, in a letter that Linda Fienberg, president of FINRA Dispute Resolution, sent to Schultz last week. Arbitrators will simply be required to make additional disclosures if, after Jan. 1, 2005, they worked for firms that sold auction-rate securities, sold them themselves or supervised anyone who did.

It will then be up to the lawyers (or to the customers, if they're representing

themselves) to decide whether to take those arbitrators as panelists. ``The steam is coming out of my ears,'' says Philip Aidikoff of Aidikoff, Uhl & Bakhtiari in Beverly Hills, California.

Staying Involved

To understand the steam -- and why FINRA is still being pressed to change its mind -- you need to know how arbitration panels are chosen. The parties to the dispute get three lists of eight names, chosen randomly by computer from the arbitrator pool. There's one list of industry panelists and two for the two public members. Each side strikes as many as four names on each list, for any reason at all, then ranks the rest in order of preference. FINRA names the panel, choosing the arbitrators most acceptable to both sides.

By keeping the people involved with auction-rate securities in the panelist pool, FINRA forces customers' lawyers to use up their challenges to get rid of them. If four challenges aren't enough, they're stuck.

They will also use up challenges that might have been needed for other reasons, such as bouncing an arbitrator whose awards consistently skew in favor of the industry. Arbitrators can also be challenged for cause -- meaning direct and definite bias or interest in the outcome -- though that's hard to show.

Everyone's Involved

What makes this especially unfair is that arbitration issues have changed, says Brian Smiley of Smiley Bishop & Porter LLP in Atlanta. ``The cases used to be about isolated broker misconduct,'' he says. ``Now we're seeing institutional misconduct -- the perversion of Wall Street research during the tech bubble, selling fraudulent and unsuitable variable annuities, abuses in the securitization of subprime products and, lately, auction-rate securities.'' All the big firms are involved.

Say that you have an auction-rate case against UBS AG and get stuck with a Merrill Lynch & Co. branch manager as your required industry panelist. How can that Merrill manager bring in a large award, or indeed any award? His own firm is up against the same charges. He might worry that if he finds for you, it could cost him his promotion or even his job.

Whatever the reason, the win rate for consumers has been spiraling down. They won 53 percent of their arbitrated cases in 2001 but only 36 percent in 2007, according to the Securities Arbitration Commentator in Maplewood, New Jersey, which tracks awards. (So far this year, they're running at 47 percent, says SAC Managing Editor Richard Ryder.)

Paltry Returns

Even with wins, you don't get much money back. In a study of arbitration covering 1995 through 2004, attorneys Daniel Solin and Edward O'Neal, of the Securities Litigation & Consulting Group in Fairfax, Virginia, combined win rates with awards to create an ``expected recovery rate.'' It peaked in 1998, at 38 cents on the dollar, falling to 22 cents in 2004.

More cases settle than go to arbitration, but those low recovery rates ``knock down the settlement offers you get,'' says attorney Theodore Eppenstein of New York.

When trying to remove Wall Street's thumb on the scale during arbitration, ``you're up against some of the best funded lobbying in the country,'' Aidikoff says. ``Where are the people who speak for individual investors?'' Where, indeed.