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ARBITRATION IN THE SECURITIES INDUSTRY: TOO MUCH OF A GOOD THING?*

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I. PREFACE

The study upon which this article is based was conducted in response to the explosive growth of the use of arbitration in the securities industry as a means of resolving broker/customer disputes. The study was designed to investigate whether the use that is being made of arbitration is efficient and, if inefficiencies were found, what procedures might be employed to screen out inefficient use.

This article was completed prior to the Supreme Court's recent resolution of the *Dean Witter Reynolds, Inc. v. Byrd* case.¹ In light of that decision, it now appears likely that the concerns raised in the article will become even more significant.

In the past three decades, customers who were involved in disputes with their brokers arising out of alleged violations of the federal securities acts could circumvent pre-dispute contractual commitments made with their brokers to bring their conflicts to arbitration by invoking the principles enunciated in the *Wilko v. Swan* decision.² In that watershed case, the U.S. Supreme Court ruled that the customer protections provided by the 1933 Securities Act, including the ability to seek judicial enforcement of these protections, cannot be overridden by pre-dispute contracts committing customers to resolve conflicts in arbitration. The reasoning in *Wilko* was also applied to disputes arising under the 1934 Securities Exchange Act.³ Customers often

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1. *Dean Witter Reynolds Inc. v. Byrd*, 105 S. Ct. 1238 (1985).

2. *Wilko v. Swan*, 346 U.S. 427 (1953).

3. *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Laupheimer v. McDonnell & Co.*, 500 F.2d 21 (2d Cir. 1974); Reader

prefer litigation over arbitration because of the perceived advantages of avoiding an industry arbitration panel, utilizing discovery rules provided in litigation, and obtaining in litigation an award of attorney fees. *Wilko* gave customers the right to bring their disputes to litigation, even if the customer had bound itself prior to the dispute to arbitration so long as a federal securities act cause of action was at issue.

In order to insure that the *Wilko* rule would provide the perceived benefits of litigation to a particular dispute with a broker, plaintiff customers would frequently include claims of federal securities acts violations along with claims that were based solely upon state common law. When these mixed claims were brought to litigation, several circuits permitted the state claims to be afforded the same advantages afforded the federal securities acts claims and thus to be adjudicated.⁴ This practice came to be known as "intertwining."

What *Dean Witter Reynolds* has done quite simply is to put an end to the intertwining doctrine. Thus, customer/broker disputes involving both state claims as well as federal securities acts claims will, after *Dean Witter Reynolds*, be bi-furcated. The number of cases that will be affected is unclear. It is certain, however, that this decision will substantially increase the number of matters to be resolved by an arbitration system which has already recently experienced dramatic growth.

In addition, a concurring opinion by Justice White in the *Dean Witter Reynolds* case raised the specter that the *Wilko* rule will no longer be mechanically applied to issues arising under the 1934 Securities Exchange Act.⁵ Since most customer broker disputes arise under the 1934 Act, Justice White's reservations regarding *Wilko* suggest the possibility of an even further expanded arbitration case load.

These increases, both actual and potential, in the matters going to arbitration, add further importance to the questions raised in the study. Is efficient use presently being made of the arbitration system? Are there mechanisms available to provide increased efficiencies? This article will explore these questions.

v. Hirsch & Co., 197 F. Supp. 111 (S.D.N.Y. 1961).

4. *Belke v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 693 F.2d 1023 (11th Cir. 1982); *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981); *C. F. Dickinson v. Heinold Securities, Inc.*, 661 F.2d 638 (7th Cir. 1981).

5. Justice White noted several distinctions between the claim brought in *Wilko* as opposed to claims brought under the 1934 Act. Most significantly, the *Wilko* case was based upon an *express* remedy provided by Section 12(2) of the 1933 Act. 15 U.S.C.S. §77o(2) (1984). Cases brought under the 1934 Act rely upon an *implied* remedy, not expressly found in the 1934 Act, but rather interpreted to arise under Section 10(b). 15 U.S.C.S. §78j(b) (1984).

II. STUDY GOALS

Any enumeration of the advantages of arbitration as a mechanism of dispute resolution should include a reference to its cost effectiveness and expediency. Arbitration of customer/broker disputes in the securities industry is typically perceived as possessing these advantages for both the customer and the broker.⁶ One could also posit that, on a macro level, an arbitration system is advantageous to the securities industry since it is perceived as redressing wrongs and thus promotes customer (investor) confidence in the fairness of the securities industry.⁷

As with other dispute resolution systems, there are direct costs associated with providing the desirable benefits of cost-effectiveness, expediency and investor confidence. In the securities industry, the costs of providing for and participating in the dispute resolution mechanism are absorbed by the self-regulatory organizations (the exchanges and the National Association of Securities Dealers) which organized the arbitration system and the parties (the brokers and the customers) who seek resolution of their disputes within the arbitration system. Ultimately, the costs absorbed by the self-regulatory organizations (SRO's) are passed on to member firms who either absorb the costs or pass them on to their customers.

As the costs for operating the securities industry's dispute resolution system rise, the affected parties—the SRO's, the member firms, and the investing public or its representatives—may begin to explore whether the same benefits associated with the present arbitration system can be achieved at a lesser cost. One approach to reducing the costs of arbitration is to investigate the possibility that unnecessary use is being made of the arbitration mechanism. Is the arbitration mechanism being utilized by disputants who might be capable of resolving their disputes by means which are less costly than arbitration, but

6. In encouraging the process that ultimately led to the adoption of a Uniform Code of Arbitration by the national securities exchanges and the National Association of Securities Dealers, the Securities and Exchange Commission (the "Commission") spoke of investors' needs for resolving claims "quickly" and with "minimum expense to both the industry and the investor." Securities Exchange Act Rel. No. 12974 (November 15, 1976). On another occasion, the Commission identified its motivation in stimulating the adoption of Uniform Code of Arbitration as evolving from a "concern that there be more effective, efficient, and economical dispute resolution procedures available to individual investors." Securities Exchange Act Rel. No. 13470 (April 26, 1977).

7. The Commission's Office of Consumer Affairs, pursuant to a Commission directive, prepared a report in 1976 discussing the need for revisions to the then current industry dispute resolution system and making suggestions for accomplishing these revisions. The report that the Office prepared was the basis for the Commission's support for the creation and adoption of the Uniform Code of Arbitration for the securities industry. The summary of the report anticipated that the proposed system would "encourage the individual investor to participate in the securities markets." Securities Exchange Act Rel. No. 12974 (November 15, 1976).

which provide equally satisfactory results? That is, is arbitration being used inefficiently?⁸

Arbitration might be used inefficiently for numerous reasons. In some instances, arbitration might be used because a less expensive resolution mechanism is not offered or is not readily available. At other times, it may be because the party engaging the arbitration mechanism is unaware that his dispute could be resolved more efficiently. If arbitration is being used inefficiently, it may be possible to institutionalize methods to screen out the inefficient use of arbitration while still inviting its efficient use.

What follows is a description of a study that was conducted to determine the extent to which inefficient use is being made of the arbitration process offered by the securities industry. After a discussion of the finding of the study, this paper will offer several proposals to avoid inefficient use of the arbitration mechanism while still providing parties with a cost-effective dispute resolution system that promotes confidence in the fairness of the securities industry.

III. TIMELINESS

The need to investigate potential inefficient use of arbitration in the securities industry is particularly relevant today. The use of arbitration as a mechanism to resolve broker/customer disputes has risen dramatically in recent years. In 1983,⁹ the NASD received 552 new regular¹⁰ claims, 23 percent more than the new regular claims received in 1982. From 1981 to 1982, the growth in these new cases for the NASD was 60 percent, and from 1980 to 1981 it was 52 percent. For the New York Stock Exchange, the comparable figures for growth was 28.5 percent from 1982 to 1983 (when new regular cases received went from 449 to 577), 22 percent from 1981 to 1982, and 55.5 percent from 1980 to 1981. Not all new cases ultimately end up before an

8. For purposes of further discussion in this paper, using arbitration for resolving disputes which disputes may be as readily resolved by less expensive methods (which also instill investor confidence in the securities industry) shall be considered an "inefficient" use of arbitration. Clearly there might be concerns external to the resolution of actual disputes (e.g., regulatory concerns, member-firm relation concerns among others) which would favor a resolution mechanism such as arbitration. These concerns are outside of the scope of this study.

9. The statistical information that follows regarding the growth in the use of arbitration was made available to the author by the Director of Arbitration of the New York Stock Exchange. It includes information that was prepared for a 1984 meeting of the Securities Industry Conference on Arbitration.

10. Regular claims will be distinguished from small claims of less than \$2500 which pursuant to the Uniform Code of Arbitration Procedure need not require a hearing and may be decided by a single arbitrator on the basis of written submissions of the claimant and respondent. See NASD Code of Arbitration Procedure (adopted effective November 1, 1968, amended effective July 21, 1980) Section 13 [Hereinafter CAP].

arbitration panel because significant numbers of cases are settled prior to hearing and others are withdrawn. However, the number of cases adjudicated by arbitrators is similarly rising. Arbitrators for the New York Stock Exchange rendered 331 awards in 1983, compared with only 154 in 1980; a 115 percent increase within a four-year period.

The costs associated with conducting an arbitration hearing vary with the amount claimed, the location of the hearing, the use or non-use of attorney representatives, and other factors. Broadly speaking, there are a number of categories of expenses which will have an impact on the overall expense of each arbitration. First, the administrative time expended by staff attorneys and support staff of the respective SRO in arranging for the hearing, conducting the hearing, preparing the documentation of the award, and responding to inquiries by the parties to the arbitration. Hearings are conducted by between three and five arbitrators.¹¹ Each arbitrator is partially compensated with a small honorarium from the respective SRO; that portion of his or her time which is not compensated by the honorarium is donated as a public service. If the parties are represented by attorneys, the attorneys' fees become a cost of conducting an arbitration. Finally, the lost business time of the parties is included in the cost of conducting an arbitration.

IV. METHODOLOGY

The goals of the study were to examine the nature of the use that is being made of the arbitration system. Much of the information sought was objective in nature, including: the dollar amount of the claim, whether the representation was *pro se*, the facts giving rise to the claim, and the number of communications of the parties prior to the filing of claim and prior to the hearing. The study also sought more subjective information in order to evaluate the legitimacy of the legal theory, the sufficiency of the complaint and the response in providing an adequate explanation of the parties' arguments, and whether other mechanisms might have provided a satisfactory resolution of the dispute if they had been available.

For much of the subjective information and even for a portion of the objective information,¹² a personal assessment of facts needed to be rendered by

11. The number of arbitrators at a hearing depends upon the dollar amount of the claim in dispute. Small claims of \$2500 or less may be heard by a single arbitrator but not more than three arbitrators. Although a hearing is not required for small claims of under \$2500, the arbitrator assigned to such claims may request a hearing. CAP §13. Claims of between \$2500 and \$100,000 may be heard by a panel of between three and five arbitrators. Claims of over \$100,000 require a panel of five arbitrators. CAP §19.

12. Some of the "objective" information required a subjective evaluation. As an example, since claimants do not necessarily specify the legal theory under which they are proceeding, an assessment had to be made by the interviewee regarding the nature of the theory of claimant's case.

someone familiar with specific arbitrated matters. Probably every individual who is familiar with a particular arbitration matter would have his or her own criteria to evaluate the subjective and even some of the objective questions for which information was sought. Of the possible candidates to evaluate an arbitration, the staff attorney of the SRO that conducted the arbitration¹³ typically has a relatively neutral perception. There is no a priori reason for the staff attorney to share potential biases of either claimant or respondent and the breadth of experience of the staff attorney would typically provide him with a broad spectrum of experience against which to evaluate the facts of a particular arbitrated matter.¹⁴

Since the questions of this study were presented orally, I attempted to provide the staff attorneys with similar criteria by which to evaluate the questions and offer answers. Questions were frequently rephrased or explained in depth when it appeared that there was uncertainty about the evaluation or when the criteria employed seemed to be dissimilar to the criteria employed by other respondents.

Staff attorneys were asked to refamiliarize themselves with the files of the five¹⁵ most recent broker/customer disputes which had gone to hearing for which they had been responsible and for which an award had been rendered. They were informed in advance of the nature of the information sought. A total of eleven attorneys at two SRO's (the New York Stock Exchange and the National Association of Securities Dealers) were interviewed in person or by phone. Responses for fifteen categories of objective and evaluative information was sought. When a subjective evaluation was required, the staff-attorney was sometimes given a spectrum of five answers ranging from a strong negative to a strong positive from which to respond; other times, a straight "yes" or

13. Each case which is received into arbitration by an SRO, is ushered through the arbitration proceedings by a staff attorney. The staff attorney is also usually the only party who is familiar with the case from its inception to its conclusion. The staff attorney receives all communication directed to the SRO and all documentation relevant to the hearing. The staff attorney officiates at the hearing, frequently provides informal procedural advice to the arbitrators and ultimately prepares the award that is agreed upon by the arbitrators. The staff attorney also fields any post-hearing problems.

14. Other individuals who might be familiar with particular arbitration matters would include parties to such arbitrations, attorneys representing such parties as well as the arbitrators. The parties and their attorneys would seemingly have an investment in perceiving the arbitration in a manner consonant with their respective positions. The arbitrators also have an investment in perceiving the arbitration in a manner that reflects favorably upon the role the arbitrator played. The staff attorney does not appear to be subjected to these built-in biases.

15. The staff attorneys were asked to employ no selection factors other than choosing the five most recent matters for which an award had been made. Since the interviews were conducted during the summer of 1984, most of the cases reported upon went to hearing in the first half of 1984.

"no" evaluation was sought. Information was collected both in the form of specific responses to the questions posed as well as in the form of anecdotes and general impressions.¹⁶ Responses were gathered regarding forty-one matters which had gone to hearing and for which an award had been determined.

The number of cases for which information was gathered is probably not large enough to insure statistical accuracy of the results. The statistics are presented for their possible suggestive value; they should be broadly indicative of the direction in which a larger sample would lean. The anecdotal information gathered identifies perceptions and provides insights valuable to a study of an arbitration system.

V. FINDINGS

Some general observations may be made of the characteristics of the cases studied. The observations summarize the information gathered regarding (i) the nature of the dispute; (ii) the parties' presentation of their positions; (iii) the conduct of the hearing; (iv) awards made; and (v) broker operational problems.

(1) Of the forty-one cases brought, twenty-one cases were based at least in part on a contract claim, nineteen on a breach of fiduciary duty, and nine on a fraud claim. The total is greater than forty-one because some cases had more than one theory of recovery.

(2) Twenty cases were for claims of less than \$10,000. An additional eighteen cases were for claims between \$10,000 and \$99,000. Two claims were for amounts of greater than \$100,000, and the claim of one case was unspecified.

(3) Eighteen of the forty-one claimants, or forty-four percent, brought their claim in a *pro se* capacity.¹⁷ Only 12 of the respondents or twenty-nine percent, were not represented by attorneys. In a total of twenty-three of the cases, at least one party was *pro se* represented.

(4) Of the twenty cases where the claims were less than \$10,000, twelve of the claimants were *pro se*. However, of the twenty cases in which the claims were greater than \$10,000, only five of the claimants were *pro se*. In other

16. Some questions typically evoked extended response. For example, one question was intended to determine whether the staff attorney believed a particular matter should have gone to hearing. Usually, the question was asked as follows, "Did the parties really have to go to arbitration? Are there means that might not have been available, but, if available and if utilized, would have made a hearing unnecessary?" Frequently a question of this sort stimulated a request from the interviewee for further explanation and, at times, prompted an expression of dispute resolution philosophy which would provide insights beyond those provided by the specifically requested information.

17. Two additional claimants were *pro se*, but since they also were attorneys, they were not included in the *pro se* category.

words, claimants were more than twice as likely to be bringing the claims in a *pro se* capacity if the dollar amount of their claims was under \$10,000 than if it was over \$10,000. From the information gathered, it was impossible to determine whether claimants are more likely to seek the services of an attorney because the large dollar amount of their claim, or if claimants are stimulated to seek higher awards only after they retain the services of an attorney.

(5) Questions were asked of the interviewees to ascertain the instances in which the parties attempted to communicate with one another prior to the filing of the complaint and/or prior to the hearing. Unfortunately, there is often no occasion to note inter-party communication efforts in the arbitration record. At times, the record notes a failure, or alleged failure, of the respondent to make a good faith reply to a customer's complaint. In eleven cases, the respondent was characterized as having either not replied, replied in a perfunctory manner, replied without a good faith investigation, or replied in an unproductive hostile manner. Totally discounting the cases for which the record is unclear about the respondent's reply, in over one quarter of the cases the respondent's reply was not characterized in a manner suggesting a good faith effort at communication with the claimant.

(6) Twenty-one of the forty-one cases were evaluated as being conducted in a somewhat informal manner. The interviewees were advised that the question regarding "informality" was seeking an evaluation of (i) whether the arbitration was conducted in a manner which followed court room procedure and (ii) whether the parties presented their own cases or were assisted in their presentation by the arbitrators.

In all but three instances (three out of twenty-three), if one of the parties was *pro se* represented, the hearing was conducted in a manner evaluated either as very informal or fairly informal. Contrariwise, in all but one instance (one out of eighteen) if both parties were either attorney represented or were themselves attorneys, the hearing was conducted in a manner that was evaluated as being either very formal, fairly formal, or average formal. These two observations indicate that arbitration hearings with one or more *pro se* parties are conducted more informally than arbitrator hearings in which both parties are represented by attorneys or are themselves attorneys.

(7) Five complaints were perceived as either fairly insufficient or very insufficient as a basis for establishing the nature of the complaint and seven responses were perceived as fairly or very insufficient as a basis for establishing the nature of the response. In all but three instances, the claimant's evidence presentation was perceived as sufficient to establish a case and in all but six instances, the respondents presentation of evidence was perceived as sufficient.

(8) In sixteen of the forty-one cases, one or more of the parties or their representatives were perceived as being either fairly hostile or very hostile at the hearing.

(9) In eighteen of the forty-one cases, there was no monetary award. In sixteen instances, the claim was dismissed, in one instance the claimant was

collaterally estopped, and in one instance, the claimant won but received no award. Of the twenty-two instances where monetary awards were provided, four of the awards amounted to ten percent or less of the claim amount, three of the awards were for between ten percent and forty percent of the claim amount, ten of the awards were for between forty percent and sixty percent of the claim amount, one award was for between sixty percent and ninety-nine of the claim amount, and four awards were for the entire claim amount. In fifty-five percent of the cases in which a monetary award was provided, the award was close (within ten percent) to being half of the amount claimed.

(10) In twelve instances, broker operational problems which did not rise to a level requiring disciplinary action, but which did help create the customer's perceived problem and with which the brokerage firm was not necessarily aware were identified by the interviewee.

In addition to the information summarized above relating primarily to the nature of the complaint and the conduct of the arbitration procedure the interviewees were asked evaluative questions regarding the validity of the claim and the propriety of utilizing arbitration to resolve it. The responses to these evaluative questions are summarized below. Although some of the information sought in these instances was quite subjective, many of the interviewees have had a broad range of experience upon which to base such evaluations. An evaluation that a matter might have been handled more efficiently by means other than an arbitration hearing would not have been made in the abstract; but, rather within the context of other arbitration experiences. Other information sought, however, was less subjective. If a claimant failed to mitigate damages, but still sought full compensation for harm suffered, it was not an extremely subjective determination that the claimant's case was not well founded in law.

(1) In eight matters the claimant's case was evaluated as not possessing arguments based upon a valid legal theory. In an additional four instances, an evaluation was made that a portion of claimant's case was not based upon a valid legal theory. This would include situations such as where a plaintiff had a legitimate cause of action, but proposed a damage remedy which could not be provided at law. For example, the dollar amount of some claims, included a request for punitive damages even though arbitrators are not often permitted to award punitive damages.¹⁸

18. "[P]unitive damages may not be awarded by the arbitrator, even if the parties have agreed upon giving the arbitrator the authority to do so." M. DOMKE, DOMKE ON COMMERCIAL ARBITRATION 445 (Rev. Ed. M. Wilner 1984) [hereinafter cited as DOMKE ON COMMERCIAL ARBITRATION]. Domke cites as authority for his proposition, *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976).

However, some courts have permitted the awarding of punitive damages. In the instance of a labor law arbitration, a federal district court in Wisconsin permitted punitive damages when an agreement "contain[ed] no specific provision on the subject of

(2) In twelve of the forty-one matters, the staff attorney indicated that he or she believed that means other than arbitration, were they available, might have been used to more efficiently resolve the dispute. In an additional four matters, the interviewee believed that some of the matters brought to arbitration might have even more efficiently resolved in part were means other than arbitrations available. In nine of those twelve instances, the staff attorney suggested that additional communication between the parties might have resolved the issue prior to the hearing. The suggestion was often made that one party was unaware on another's position and that additional communications could have given the parties insights which would have stimulated settlement. In three of the twelve instances, either the claimant's or respondent's position could have been made clearer in either written communications or the actual complaint or response. In four instances, the staff attorney believed that had a party been more familiar with the law, the issue would not have been arbitrated. In one instance¹⁹, the claimant was characterized as having gone to arbitration to settle his claims because he had not prepared his case. However, this case involved a claimant's failure to mitigate damages, suggesting that the interviewee perceived this matter as a further instance of a party using arbitration because of a lack of familiarity with the law.

(3) In twelve instances the staff attorney described a fact pattern which could be characterized as a good faith disagreement on the facts or the law. In ten additional instances, the attorneys believed the parties went to arbitration because one or both parties were being intransigent or were stonewalling.²⁰ The terms "intransigence" and "stonewalling", were frequently used by the interviewees. In other instances, I supplied these terms to summarize a fact pattern described by the interviewee in which one or more of the parties ignored the legitimacy of his or her position and rather insisted upon proceeding to arbitration.

In two instances, the staff attorney believed a matter went to arbitration because of the adversarial character of the attorney who had been retained by one of the parties. In an additional case, the staff attorney believed a matter went to hearing because the attorney was attempting to compensate for an earlier error in representing the client.

remedies." *Sheetmetal Workers Int'l Association v. Helgesteel Corp.*, 335 F. Supp. 812, 815 (C.D. Wisc. 1971).

19. The total number of explanations exceeds the total number of instances in which arbitration was judged as not necessary in whole or part because, in some instances, two different reasons explain the interviewee's evaluation.

20. A pattern of stonewalling was considered by the interviewees to be an explanation both as to why a matter needed to go to arbitration as well as why arbitration could be avoided. Assumedly, in the first instance, it was felt that the party could not be persuaded to discontinue stonewalling. In the second instance, an evaluation was assumedly made that perhaps the party could be dissuaded from stonewalling in order to avoid having the matter going to arbitration.

In one instance, the claimant was evaluated as wanting more than what his or her case was worth. This evaluation could suggest either a good faith belief in one's position or intransigence; therefore, it was not included in either category.

Finally, one claimant was evaluated as too hostile to settle without an arbitration. Again, because this too could be categorized as either intransigence or as a good faith belief in one's position, it was not included in either category.

(4) The following summary can be derived: In a total of twenty-four cases, the staff attorney evaluated one or both of the parties as either lacking knowledge about the relevant law, needing more communication with the opposing party, acting intransigently, or being unprepared.

(5) In four of forty-one cases, the staff attorney perceived the award granted as in some way "unreasonable." Unreasonableness was measured by the size of the award compared to the merits and presentation of the claimants case and the harm the claimant allegedly experienced.

VI. CONCERNS IDENTIFIED

In twelve of the forty-one cases which were arbitrated, the dispute between the parties can perhaps be characterized as a "good faith dispute." A good faith dispute would include a basic disagreement as to the facts or the law which required the interposition of a neutral third party for resolution.

In twenty-three cases, the behavior of the parties can be categorized as "other-than-good-faith behavior" and the disputes as "other-than-good-faith disputes." They are designated "other-than-good-faith disputes" because the genesis of the dispute is perceived as something other than a bona fide disagreement regarding facts or law not because the parties are somehow not in contention. "Other-than-good-faith-disputes" include disputes that persist because one or both of the parties did not have an accurate understanding of the relevant law; one or both of the parties refrained from engaging in other than perfunctory communication with the opposing party or the respondent refrained from conducting a good faith investigation of the problem leading to the dispute; or one or both of the parties was committed to intransigence regardless of the validity of his position.

If there were mechanisms available to counter other-than-good-faith behavior, then the number of matters actually going to hearing might be considerably reduced. The countering mechanism or mechanisms would have to respond to different behavior in each one of the above categories. In controversies where parties engaged the arbitration system in part because they were unfamiliar with the law, the mechanism to counter the other-than-good-faith behavior would have to educate parties as to the law. In controversies in which the respondent refused to investigate the behavior of its employees or engage in other than perfunctory communication with the opposing party, the countering mechanism would have to foster self-investigation and

meaningful communication. For parties who go to arbitration partially because of intransigence or stubbornness, a behavior countering mechanism would have to encourage settlement efforts or at least negotiations, but this behavior is probably the most difficult to alter. All three categories of other-than-good-faith behavior, however, could be susceptible to certain efforts at alteration.

VII. MECHANISMS TO COUNTER OTHER-THAN-GOOD-FAITH BEHAVIOR

The proposed mechanisms are designed to respond to a number of the problems that were identified during the interviews. They are intended as suggestions for further discussion. While the proposals might resolve some problems, they may create new ones. Hopefully, this article will generate further discussions about what other alternatives are available and/or how the below proposals might be refined.

A. *Invalid Legal Theories*

In twelve instances (29% of the cases studied) all or a portion of claimant's case was based upon what the staff attorney perceived to be an invalid legal theory. In six of those cases (50% of the time) the claimant was either represented by a lawyer or was himself an attorney. Thus, failure to base a case on a valid legal claim is not limited to *pro se* actions.

In these cases, if the claimants or their attorneys were informed, prior to the arbitration hearing, that their claim does not appear to be based upon a valid legal theory, then some percentage of such claimants might well desist in proceeding further in the arbitration process. A second percentage might aggressively seek a settlement. A third portion, however, might want to proceed regardless of the legitimacy of the legal claim. This third group might want to proceed for a number of reasons. Some might doubt the advice or believe that a panel of arbitrators might have a different view regarding the validity of the claim. Others might understand that arbitrators are not strictly bound by legal precedents in their deliberations.²¹ Finally, some might want to proceed merely to compel the respondent to incur the expense or inconvenience of defending himself. In fact a number of interviewees provided anecdotal information describing claimants who engaged the arbitration mechanism as a means of "punishing" the respondent broker.

It would be impossible to predict what percentage of the claimants would not proceed further with the arbitration process if they learned that their claims were probably devoid of a valid legal theory. However, merely dissuading claimants from proceeding to arbitration would not be an effective counter to the other-than-good-faith behavior of bringing invalid legal claims to hearing unless the countering procedure allowed the claimant to maintain confidence in the dispute resolution system as a whole. The claimant would have to

21. DOMKE ON COMMERCIAL ARBITRATION, *supra* note 18, at 391.

trust the advice given, have confidence in the impartiality of the source, and understand that arbitration would still be available if that path were chosen. It might be advisable to include with any evaluation suggesting a lack of validity of legal theory disclaimers regarding the lack of universality of the evaluation and the fact that arbitrators are not strictly bound by legal precedent. Further, claimants might be advised that some claimants have received monetary awards in spite of an evaluation that their claim was without legal merit.

Advice could be given regarding specific operations of the securities industry. The case samples suggest that claimants are frequently unaware of how execution reports are generated. Anecdotal information indicated that some claimants did not understand how a stop order operates. Other accounts described a lack of familiarity with the "pink sheets." It is possible that a number of disputes would dissipate if information regarding these industry practices was provided to parties (typically the claimant).

The hard question obviously is how and by whom is the claimant to be advised about the validity of the underlying legal theory of his or her case. At some point after the filing of submissions and before a hearing date is set, a party in the role of a neutral attorney-advisor could be introduced into the arbitration process. This role might well be assumed by the staff-attorney who presently shepherds the cases to arbitration and who, on occasion, already fills the attorney-advisor role.²² To some extent this role would require a redefinition of the staff attorney's position in regard to both the SRO and to the parties to the arbitration. Alternatively, an attorney-advisor might be added to staff by the SRO, perhaps outside of the specific structure of the arbitration office, to review arbitration cases which are destined for hearings. In either instance the attorney-advisor service could be provided by the SRO.

One concern with interjecting an attorney-advisor into the arbitration process might be the difficulty in determining *a priori* which parties require such advice and which do not. An attorney-advisor's services could be offered to all parties who request such assistance. Alternatively, such a service could be interjected as an automatic review procedure for all controversies after the completion of the parties' written submissions. If the review procedure were automatic for all controversies, it might well be conducted by the staff-attor-

22. Anecdotal information gathered from a number of staff attorneys suggests that they at times already play the role of attorney-advisor. One staff attorney provided an account of a case that had arisen in part as a result of a prospective claimant's lack of familiarity with stop orders. The attorney-advisor provided the prospective claimant with a pamphlet explaining stop orders and suggested that the customer read the pamphlet. The attorney advised the customer that if he wanted to still file a claim after reading the pamphlet, he should do so. The attorney reported that after reading the pamphlet, the customer was so "satisfied" that he offered to take the attorney out to lunch.

Another staff attorney indicated that she frequently has to explain terms and procedures to *pro se* claimants. Thus, in some situations and to some extent, she already conducts herself as an attorney advisor.

ney responsible for the particular matter.

The review procedure could also be expanded to include more than just an analysis of the legitimacy of the legal theory of the case or an explanation of specific securities industry operations. A total of twelve of the written submissions by claimants and respondents were perceived by the staff-attorneys as insufficient for purposes of enabling a reader to determine the nature of either the complaint or the response. Lack of clear submissions frequently leads to lengthy arbitration hearings, less effective hearings, and perhaps fewer settlements prior to hearing. Part of the attorney-advisor's role might be to provide claimants and respondents with an outline of how to prepare a submission (e.g., statement of issue, summary of facts, implication of facts for issue, etc.). The attorney-advisor might review the submissions for adequacy of information. As with the review for legal sufficiency, any advice would be in the form of a suggestion and the party would be advised that a decision to ignore the advice would not affect the party's ability to proceed with the arbitration.

Another concern regarding the introduction of an attorney-advisor function is that it might suggest an appearance of SRO partiality in a situation where it is essential for the SRO to be perceived by both parties as completely unbiased. Concerns were raised during the study by some interviewees regarding the appearance created by an SRO—whose members are all securities industry firms—advising a customer/claimant (who seeks to utilize the SRO's dispute resolution facilities) that his claim lacks legal substance. Many SRO staff attorneys feared that some claimants would take such advice as other than neutral and that SRO member-firms might find it difficult to accept SRO personnel advising customers on how best to present a claim against a member firm.

These concerns are at least in part exaggerated. In essence, the SRO is already providing assistance to parties in the presentation of their cases. In the vast majority (20 of 23) of matters in which one or more parties was *pro se*, arbitrators conducted the hearing in a manner that was characterized as less formal than if none of the parties were *pro se* (where only one of eighteen hearings was characterized as informal).²³ This informality typically includes lending assistance to the *pro se* party(ies). The propriety of such assistance has not been questioned and the arbitrators are still perceived of as neutral and not as agents of the SRO's or the member-firms. Possibly, a similar perception either presently exists or could be created about the role of the staff attorney. Hopefully, this kind of neutral role could also be created for an attorney-advisor if that position is separated from the staff attorney's function.

Finally, there are potential concerns with the conflict created by an attorney-advisor giving advice to opposing parties in an arbitration proceeding. However, the general rule of professional operation is that if the attorney be-

23. One staff attorney who appeared to oppose the concept of an attorney advisor indicated that as a general procedure, he advises arbitrators to lend assistance to *pro se* parties.

lieves he can competently advise both parties and discloses his dual role to each, acceptance of the services after disclosure extinguishes the potential impropriety. Both the recently adopted Model Rules of Professional Conduct²⁴ and the Code of Professional Responsibility²⁵ deem it acceptable for attorneys to advise clients in conflict situations so long as the clients knowingly consent to such representation and the attorney does not believe his dual relationship adversely affects either party.²⁶

In summary, the introduction of an attorney-advisor to the pre-hearing procedures of the arbitration process may well provide a mechanism for dissuading parties without valid legal claims from proceeding to an arbitration hearing while still preserving confidence in the arbitration system. In addition, an attorney-advisor might assist in assuring that party submissions convey adequate information to opposing parties regarding the nature of claimants' and respondents' positions. The development of an attorney-advisor position, however, may require alterations in our present perception of the SRO's role in the preparation of the arbitration matter.

B. *Communication Failures and Failures to Conduct Good Faith Investigations*

In evaluating the efforts of the parties to the arbitration to communicate with one another, in eleven instances, the interviewees characterized the respondents' communications with the claimant and the respondent's investigation of the facts giving rise to the controversy as not in good faith, perfunctory, hostile, non-existent, or otherwise inadequate. The interviewees indicated that, in ten of the forty-one cases sampled, the failure of the parties to communicate or to communicate in good faith at least in part compelled the arbitration. The failure to communicate was typically the fault of the respondent rather than the claimant.²⁷

Failure to communicate and other-than-good-faith behavior appears to discourage settlement and provokes hostility. In ten of the fourteen instances in which claimant or claimant's attorney appeared hostile at the hearing, there was either no recorded history of communication by the respondent to the claimant (four cases) or the communication was inadequate or hostile (six cases). A broker who engages in meaningful communication with the claimant demonstrates a certain amount of concern for his customer's problems. In

24. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7.

25. See Model Code of Professional Responsibility DR 5-105(c).

26. For a discussion of the potential conflicts of attorneys serving dual roles in dispute resolution processes and resolutions to these conflicts, see, J. FOLBERG, A. TAYLOR, *MEDIATION, A COMPREHENSIVE GUIDE TO RESOLVING CONFLICTS WITHOUT LITIGATION* Chapter 10, at 244-290 (1984).

27. Anecdotal information gathered from three interviewees described instances in which brokerage firms appeared to have decided not to participate in pre-hearing interaction with the claimant.

some situations, this demonstration of concern, even with no concomitant offer of settlement might satisfy a claimant's desire for attention to his problem.

Good faith communication by the respondent might convince a claimant that his claim is without merit, thereby promoting settlement. In other instances, a good faith examination of the facts leading up to the controversy might reveal to a respondent that a claimant's concerns are meritorious. Whether as a means to defuse claimant's outrage or to encourage settlement, good faith analysis of the problem and communication of such analysis would seem to be a sensible method of reducing the number of arbitration hearings.

One approach to insuring good faith analysis and communication by brokers would be the adoption of an SRO rule requiring brokerage firms subject to an arbitration claim to conduct a good faith examination of the facts leading to the filing and to convey the results to the claimants. Although it would be difficult, if not impossible, to determine in advance what would constitute a good faith examination, such a rule would establish an expectation that a manager would do more than merely ask the registered representative (broker) who had contact with the customer if he agreed with the customer's complaint. The manager would be expected to piece together the relevant facts. Where appropriate, telephone logs, execution records, account statements, cross-reference cards, compliance records, research reports and other records should be examined. After the facts have been examined, the brokerage firm manager should discuss both the facts and the relevant customs and practices of the industry with the claimant.

The notion of requiring a good faith examination is not particularly innovative nor impractical. In an analogous situation, credit card issuers are required pursuant to Truth in Lending Regulations to respond to written notification of billing errors with a

written explanation or clarification to the customer, after having conducted a reasonable investigation, setting forth, to the extent applicable, the reasons why the creditor believes the amount(s) was correctly shown on the periodic statement and, if the customer so requests, furnishing copies of documentary evidence of the customer's indebtedness with respect to the alleged billing error(s).²⁸

Failure of a credit card issuer to adequately investigate could lead to forfeiture of part of the disputed error.²⁹

The specifics of a good faith investigation rule would obviously be the subject of considerable debate. The spirit of such a rule, however would be to encourage resolution of customer complaints by means short of an arbitration hearing.

28. 12 CFR 226.13(F) (commonly referred to as Regulation Z).

29. Section 161(e) of the Fair Credit Billing Act, 15 USC § 1666.

C. *Intransigence*

Perhaps the most difficult other-than-good-faith behavior to eliminate is party intransigence. In ten of the forty-one case samples, one or more of the parties was viewed either as intransigent or as stonewalling the other party. Intransigence frequently cannot be distinguished from the other identified categories of other-than-good-faith behavior. Identifying intransigence as other-than-good-faith behavior does not suggest that arbitration cannot or should not be used to resolve disputes arising out of or maintained by such behavior. The characterization merely implies that the dispute is not generated by a bona fide disagreement over facts or law. The cause of disputes arising from or maintained by intransigence is the unwillingness of at least one party to objectively examine and construct reasonable conclusions from available factual or legal information. Intransigence gives rise to a dispute that does indeed require an outside party for resolution, but the dispute is not generated by a bona fide disagreement regarding facts or law. In these instances arbitration becomes a substitute for the party's(ies)' self-evaluation of the merits of the controversy. If the intransigent party(ies) could be persuaded to conduct an objective examination of the available facts and law and to construct reasonable conclusions, then the need to arbitrate the dispute might dissipate. The obvious question is how does one compel good faith examinations of information and the construction of reasonable conclusions?

The use of a mediation mechanism is frequently cited as a means to persuade the parties to conduct an objective evaluation of facts and law, draw reasonable conclusions, and consider settlement. In fact, when the Securities Exchange Commission's Office of Consumer Affairs made its initial proposals for a dispute resolution system, it suggested that participation by the parties in "nonbinding, informal mediation" be a "condition precedent to formal arbitration."³⁰

The term "mediation" means different things to different people. The seminal article on mediation by Professor Lon Fuller³¹ describes mediation as the interposition of a neutral third party, who reasons with the parties. The mediator has no authority to compel settlements or grant awards, rather, the parties re-examine their attitudes and alter their positions in order to ultimately achieve a settlement which each side can find acceptable through discussions with the mediator.

Traditionally, mediation is employed primarily where the parties are in a continuing relationship, such as an employer/employee relationship, in which each is dependent upon one another. Consequently, each is motivated to find a satisfactory solution to their common dispute so that the relationship may sur-

30. Securities Exchange Act Rel. No. 12974 (November 15, 1976).

31. Fuller, *Mediation—Its Forms and Functions*, 44 SO. CAL. L. REV. 305 (1971).

vive.³² The parties have a built-in motivation for redirecting their attitudes toward one another.

In securities industry disputes, there generally is no continuing relationship; therefore, traditional mediation would be largely impractical. The broker and customer have typically terminated their business relationship and there is no motivation to resolve their conflicts in order to preserve interpersonal harmony. Generally, each party to a securities industry arbitration dispute is seeking to "win" the dispute at the sake of his or her opponent's losing the dispute.³³ Securities industry disputes are not analogous to labor/management disputes, marital disputes or landlord/tenant for which there generally is considerable motivation for mutually satisfying settlements and for which traditional mediation is a viable dispute resolution mechanism.

In addition, traditional mediation would probably require an expenditure of resources at least as great as would arbitration. Even with this expenditure of resources, there would be no guarantee of a resolution of the dispute as is guaranteed in arbitration. In traditional mediation, the parties typically would first meet separately with the mediator and then jointly.³⁴ Although there might be a decrease in use of attorneys in mediation, the claimant, respondent, and SRO staff would probably spend more time in the dispute resolution proceedings than they would spend in arbitration.

Although traditional mediation might be an impractical means of responding to party intransigence in the arbitration process, there are conciliation elements of the mediation process that could be utilized within the present arbitration procedure to help discourage party intransigence and encourage settlements.

The proposal made above to advise parties when their claims are not based upon valid legal theories would in essence incorporate a mediation conciliation method. The attorney-advisor (or staff attorney) who advises the party of his or her invalid legal claim would be functioning in part as a mediator. The advice presented to the party would be presented with the hope of

32. *Id.* at 310. ("The two parties are locked in a relationship that is virtually one of 'bilateral monopoly;' each is dependent for its very existence on some collaboration with the other."); Eisenberg, *Private Ordering Through Negotiation: Dispute-Settlement and Rulemaking*, 89 HARV. L. REV. 637, 649 (1976) ("In cases where the disputants place a premium on the continuance of an ongoing relationship, the element of reconciliation is likely to provide each disputant with an incentive to give some weight to his opponent's good faith claim or defense . . .").

33. For mediation to work, "[t]he parties need commitment to non-adversarial resolution, and willingness not to have a winner or a loser. Mutual satisfaction is the goal of the mediation session." Meacham, *Internal, External and Public-Agency; The Use of Mediation to Resolve Employment Discrimination Complaints* (1983) (An unpublished paper prepared for the First National Conference on Resolving EEO Disputes Without Litigation on file with the National Institute for Dispute Resolution, Washington, D.C.).

34. Fuller, *supra* note 31, at 322-23.

moving that party closer to settlement by encouraging a re-evaluation of his or her own position in light of the new understanding of the appropriate legal precedent.

Additional elements of mediation, deliberately designed to bring the parties together and to discourage intransigence, could be institutionally incorporated in the present arbitration system. Anecdotal accounts provided by several staff attorneys indicate that there are at present situations in which the staff attorneys urge the parties jointly to reconsider their positions and to attempt to settle their disputes prior to the arbitration hearing. One staff attorney indicated that he urges a settlement prior to a hearing only when he is working on cases in which both parties are represented by attorneys. Another staff attorney suggested that he is willing to "knock heads" to some extent when the dispute is not a customer/broker dispute but rather a dispute between two member brokerage firms.

When dealing exclusively with lawyers or brokers, it seems that some staff attorneys are willing to urge settlement without fear of being perceived as partial, but when dealing with customers, staff attorneys are reluctant to advise the customer to reach a settlement. This reluctance appears to arise out of a concern of appearing impartial. The staff attorney's concern with appearing impartial varies considerably depending on the background and expectations of the parties with whom he is dealing. The staff attorney expects that attorneys representing parties in disputes anticipate and are familiar with settlement pressure. Similarly, brokers in dispute are perceived as being familiar with the need to reach settlement and are not expected to view settlement pressure as partial advice.

Party expectations make settlement advice acceptable in some fact situations (broker/broker disputes and negotiations with attorney representatives), but not in other instances (broker/customer disputes where negotiations are not conducted with attorneys). Perhaps party expectations can be institutionally altered. If both customers and brokers were advised at the time of filing of submissions that it is the responsibility of the staff attorney to urge settlements prior to hearings, such settlement advice might not carry with it a risk of appearing partial. As part of the pre-hearing procedures, staff attorneys could arrange for conference telephone calls between parties to explore the opportunities for settlement and to attempt to counter party intransigence. At present, there appears to be no institutionalized procedures that jointly assist the parties in settlement efforts after filing of submissions and prior to hearings. Concerns with the appearance of partiality should not override legitimate efforts to reconcile disputes by mechanisms other than formal hearings.

If staff attorney involvement in pre-hearing conciliation efforts in order to discourage intransigence and encourage settlement is accepted, then the specific conciliation efforts the staff attorney might employ must be determined. The staff attorney might informally gather facts by telephone conversations. As suggested above, the staff attorney might arrange conference calls to discuss settlement. The staff attorney might even offer an opinion as to how the

matter might be resolved if it goes to arbitration.³⁵ The formation of such opinion could be assisted by the preparation of statistical data regarding the typical size and distribution of awards. If the dispute is not resolved in the informal discussions, the parties would not be permitted to use any settlement offers as evidence during the arbitration. There could be considerable flexibility employed in integrating conciliation efforts with the present activities of the staff attorney. The major hurdle facing the SRO's would be to decide to institutionalize staff-attorney conciliation efforts.

Finally, it must be recognized that a certain amount of party intransigence will always be a part of any dispute resolution system. Parties at times engage the arbitration systems in order to harrass broker/respondents and occasionally respondents perceive stonewalling as a way to discourage customer/claimants. For these parties, perhaps no amount of conciliation efforts will promote good faith examination of the merits of their cases. These parties seek to engage the arbitration process; this engagement is satisfying in and of itself either because it allows them to punish their opposing party or because it provides them with a day in court.

D. Broker Operational Problems Not Rising to the Level of Disciplinary Violations

The proposals made above are each designed to reduce the arbitration case load by screening out other-than-good-faith disputes. Another approach to reducing the arbitration case load is to reduce matters that are brought to arbitration by eliminating brokerage firm behavior which might generate disputes.

In twelve matters in the case sample, brokerage firm operational problems, which did not necessarily rise to the level of disciplinary problems and of which the brokerage firm was not necessarily aware, were identified. These operational problems included a registered representative's lack of awareness of suitability obligations, confusing sales literature, and delays in crediting accounts.

Presently, the arbitration system does not provide a mechanism for the arbitrators to report to the respondent brokerage firm on operational deficiencies which might become apparent in the course of a hearing. Without information regarding such deficiencies, the brokerage firm might well continue to conduct its operations in the manner giving rise to the dispute.

35. This approach of providing the parties with an advisory opinion as to how a matter would be resolved were it to go to arbitration was employed with seemingly considerable success in a labor grievance mediation experiment conducted in the coal industry by two Northwestern University professors. Of 153 matters submitted to mediation in this experiment, only 17 matters went on to arbitration. Goldberg and Brett, *An Experiment in the Mediation of Grievances* (1982) (An unpublished paper on file with the National Institute for Dispute Resolution, Washington, D.C.).

To benefit from the insights of the arbitrators, the SRO's might adopt a procedure that would request oral comments from the arbitrators regarding potential brokerage firm operational problems identified during the hearing. These comments would be kept entirely separate from the arbitration award. They would be transmitted to the brokerage firm as a method of improving brokerage firm operations. They would not be available to claimants as a basis for potential appeals. Further consideration would have to be given to how to respond to arbitration reports which identified operational problems which did rise to the level of disciplinary violations.

VIII. CONCLUSION

Arbitration in the securities industry provides an efficient and expeditious method of dispute resolution which instills confidence in the securities industry's dispute resolution process and in the securities industry itself. However, as the number of matters going to arbitration, along with the corresponding costs in providing the service, are increasing, questions arise regarding whether some portion of the matters going to arbitration might be resolved by means other than arbitration while still preserving confidence in the securities industry dispute resolution process.

In this study, a small case sample of controversies that were arbitrated by the two SRO's with the largest arbitration staffs was examined. In a significant number of matters, it was perceived that controversies were going to arbitration in whole or in part because of reasons that could be characterized as arising from other-than-good-faith disputes regarding either facts or law. In some instances disputes went to arbitration because parties were unfamiliar with the controlling law. In other instances, arbitration was engaged because parties failed to communicate with one another in good faith or to examine the fact situation generating the disputes. Finally, arbitration was sometimes utilized because of party intransigence, i.e., party unwillingness to examine the merits of one's case. For discussion purposes, these three categories of disputes were identified as "other-than-good-faith disputes."

After identifying controversies arising from other-than-good-faith disputes, this paper raised several suggestions for resolving these controversies for discussion. The suggestions are intended as a means of generating further thought and further discussion and not as final proposals. These suggestions included: (i) integration of an attorney-advisor role in the pre-hearing procedures to advise parties as to invalid legal theories and to encourage preparation of informative submissions; (ii) adoption of SRO rules requiring broker-respondents to institute reasonable investigations of facts which are the subject of arbitration disputes and to engage in good faith communications with the claimant to describe the results of such investigations; (iii) integration of conciliation efforts into the present pre-hearing procedures so that some institutionalized actions might be made to resolve disputes once papers are filed but before the hearing is held; and (iv) creating of a confidential reporting mecha-

nism of broker firm operational problems which come to light during arbitration hearings in order to help reduce future disputes.

In addition to the issues raised in this study, further investigations might be conducted regarding other alternatives for resolving securities industry disputes. Many complaints are lodged with brokerage firms and with SRO's which never result in arbitration filings. Are those customers satisfied by the complaint processing procedures or do they get discouraged? If it is the former, then what can we learn from those complaint processing procedures that might help resolve disputes that do go to arbitration? If it is the latter explanation, is that discouragement healthy for the industry? Does the cost to the industry resulting from the discouragement of customers on pursuit of claims exceed the cost to the industry that would result if such claims went to arbitration? Further, many controversies for which arbitration papers are filed are resolved before the hearing. There is little information available regarding what factors prompted settlements in these situations. Again, further investigations might provide useful ideas on how to assist parties in resolving other controversies when the parties are not able to settle the dispute on their own.

The securities industry has provided its customers with an effective and well regarded dispute resolution system. As this system is given increasingly greater use, it becomes of increasingly greater interest to examine means of further improving the present mechanisms.