



*The Efficacy of Securities Arbitration
And Proposals for Change*

A White Paper from the
Financial Services Institute, Inc.
and
The Financial Markets Practice Group of
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Section One

INTRODUCTION

Over the last eighteen months, we have experienced a “perfect storm” in the financial markets: a housing market liquidity crisis, the collapse of housing market derivative securities, a credit freeze, business failures, Ponzi scheme revelations, investor panic, and ensuing steep financial market declines. As is usually the case, the recent events catalyzed into lawsuits and arbitrations by investors seeking to recover their losses. In 2009, FINRA Dispute Resolution statistics showed that 7,137 arbitration claims had been filed through early December, nearly double the number of arbitrations filed for the entire year of 2007.^{1,2}

Proposed “consumer protection” legislation is another byproduct of the market collapse. On June 17, 2009, the Obama Administration released its plan for reforming the financial services industry’s regulatory structure in the form of a white paper entitled “Financial Regulatory Reform - A New Foundation: Building Financial Supervision and Regulation” (White Paper).³ Shortly after the release of the White Paper, the Treasury Department proposed legislation entitled the “Investor Protection Act of 2009”.⁴ The investor protection components of the *Wall Street Reform and Consumer Protection Act of 2009* (H.R. 4173), passed by the House of Representatives on December 11, 2009, are largely based upon the Treasury Department’s IPA.⁵

On November 10, 2009, Senator Christopher Dodd (D-CT), Chair of the Senate Banking, Housing and Urban Affairs Committee, released a discussion draft of the *Restoring American Financial Stability*

¹ See FINRA Dispute Resolution Statistics, available at www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm (Last visited Feb. 18, 2010) (hereinafter “FINRA Statistics”).

² See Robyn Goldwyn Blumenthal, *Investors Win More Broker Cases*, MINNEAPOLIS STAR TRIBUNE, D5 (Nov. 1, 2009) (predicting 7,500 arbitrations by the end of 2009 due to the market declines of 2007 and 2008).

³ Financial Regulatory Reform - A New Foundation: Building Financial Supervision and Regulation. , available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

⁴ Investor Protection Act of 2009 – Treasury Proposal, available at <http://www.treas.gov/press/releases/docs/tg205071009.pdf>.

⁵ The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009), available at http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/111_hr_finsrv_4173_full.pdf.

Act of 2009.⁶ On March 15, 2010, Senator Dodd released a revised version of the discussion draft titled *Restoring American Financial Stability Act of 2010* (RAFSA).⁷ On March 22, 2010, the Senate Committee on Banking, Housing, and Urban Affairs approved the bill via a party line vote of 13 to 10. The bill would introduce a number of reforms in the financial services industry, create new means for investor-protection oversight, and may increase regulatory enforcement procedures. Section 921 of the of RAFSA would authorize the SEC to create rules related to the use of pre-dispute arbitration in the securities industry.⁸

Another piece of legislation, the *Arbitration Fairness Act of 2009*⁹ seeks to drastically undercut long-standing federal policies favoring arbitration. For example, the bill seeks to curtail the use of pre-dispute arbitration agreements in “consumer” contracts, such as those used by securities broker-dealers in customer agreements. If passed into law, the bill would likely eliminate arbitration as the principal means of dispute resolution in the securities industry, leaving litigation in federal or state courts as the primary, if not only, means for resolution of customer disputes.

This White Paper provides a short history of the role of arbitration in the securities industry, including discussion of United States Supreme Court decisions that paved the way for use of pre-dispute arbitration agreements. The Paper addresses attempts by some members of Congress to “legislatively overrule” those decisions. Finally, the results of a survey of FSI member firms conducted in January 2010, entitled *Effectiveness and Fairness of FINRA Arbitration* (hereinafter “FSI Survey”), are analyzed in the context of the Congressional debate.¹⁰

⁶ Discussion Draft, Restoring American Financial Stability Act of 2009, November 10, 2009, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=943242e1-ca66-411c-89e2-8954eb3fc085.

⁷ Discussion Draft, Restoring American Financial Stability Act of 2010, March 15, 2010, available at http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf

⁸ *Id. at Section 921.*

⁹ Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong. (2009). In December 2007, Congress heard testimony regarding a similar bill, entitled “the Arbitration Fairness Act of 2007,” which would have enacted changes similar to the currently proposed Arbitration Fairness Act. The 2007 bill died in Committee. The 2009 bill, however, reportedly is expected to advance through Congress.

¹⁰ A copy of the survey form is attached to this Paper as Appendix A.

FSI member firms responses to the FSI Survey show that member firms' experiences with arbitration are not colored by the problems that Congress perceives with arbitration. Briefly, members' responses revealed these trends:

- FINRA arbitrations are more cost-effective than litigation in terms of total cost and cost to conduct pre-hearing discovery.
- FINRA arbitrations are generally resolved more quickly than litigation.
- The perceived benefits of FINRA arbitration diminish when the number of claimants or respondents increases, or when a large demand for monetary relief is made.
- Arbitrators should provide written decisions that include factual findings and legal conclusions in support of their awards to ensure transparency and consistency of results.

Section Two

REVIEW OF THE HISTORY OF SECURITIES ARBITRATION AND CURRENT STATUS OF FINRA DISPUTES AND CONGRESSIONAL ACTION

Although arbitration and other forms of alternative dispute resolution were not universally utilized to resolve securities disputes prior to 1987, the United States Supreme Court's decision that year in *Shearson/American Express, Inc. v. McMahon*¹¹ marked a paradigm shift in the use of pre-dispute arbitration agreements in the securities industry. In *McMahon*, the Court addressed the federal policies embodied in the Federal Arbitration Act (hereinafter "FAA").¹² It concluded that those policies have equal force in securities disputes brought under the Securities Exchange Act of 1934 (hereinafter "'34 Act") as in other commercial disputes subject to arbitration:

The Arbitration Act thus establishes a "federal policy favoring arbitration," . . . , requiring that "we rigorously enforce agreements to arbitrate." . . . [T]his duty to enforce arbitration agreements is not diminished when a party bound by an agreement raises a claim founded on statutory rights. As we observed in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, "we are well past the time when judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals" should inhibit enforcement of the Act " 'in controversies based on statutes.'"¹³

In *McMahon*, the plaintiffs argued that they should not be compelled to arbitrate their '34 Act claims because a plaintiff's statutory rights, as opposed to a right arising out of a contract, ought to be judged in federal court, and not relegated to private arbitration.¹⁴ The *McMahon* Court rejected the plaintiffs' arguments, holding that oversight by the Securities and Exchange Commission (hereinafter

¹¹ 482 U.S. 220 (1987).

¹² 9 U.S.C. §§ 1-14.

¹³ *Id.* at 226 (citing *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24 (1983) and *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985)).

¹⁴ *Id.* at 227 (citing, 34 Act § 29(a)).

“SEC”) of arbitration procedures established by the New York Stock Exchange, American Stock Exchange, and National Association of Securities Dealers (hereinafter “NASD” n/k/a the Financial Industry Regulatory Authority (hereinafter “FINRA”)), of which the SEC had expressly approved, was enough to “ensure that arbitration is adequate to vindicate [federal statutory] rights.”¹⁵

Two years later, in *Rodriguez de Quijas v. Shearson/American Exp., Inc.*, the Supreme Court extended its *McMahon* holding to claims brought under the Securities Act of 1933 (hereinafter “’33 Act”).¹⁶ Following *McMahon* and *Rodriguez*, a claim falling within the ambit of the ‘33 Act and the ‘34 Act—essentially any claim involving the sale of securities—presumptively was subject to mandatory, binding arbitration. This led to the near-universal inclusion of mandatory arbitration clauses in contracts between securities broker-dealers and their customers. FINRA also adopted Rule 3110(f), which set certain disclosure requirements for mandatory pre-dispute arbitration clauses in customer account agreements.

The Court’s decisions in *McMahon* and *Rodriguez* also marked a concomitant increase in arbitration filings. For example, in the year after *McMahon* was decided, the number of arbitration cases filed with the NASD nearly doubled, jumping from 1,587 filings in 1986 to 2,886 filings in 1987.¹⁷ The number of arbitrations has steadily grown thereafter.

FINRA’s statistics on arbitration filings reveal a strong relationship between market declines and the number of arbitration filings made after such declines. SIFMA’s *White Paper on Arbitration in the Securities Industry*, published in October 2007 acknowledges this trend with respect to the burst of the “dot.com” bubble in the early 2000’s.¹⁸ As one would expect, the number of filings steadily increased from 5,558 in the year 2000 to an all-time high of 8,945 in 2003; a sixty-two percent increase in only three years. Conversely, from 2003 through 2005 the number of arbitration filings sharply decreased, indicating that new filings of “dot.com” cases were dwindling.

¹⁵ *Id.* at 236, 238.

¹⁶ 490 U.S. 477, 483 (1989).

¹⁷ Gary Tidwell, Maj. Kevin Foster, and Maj. Michael Hummel, *Party Evaluation of Arbitrators: An Analysis of Data Collected From NASD Regulation Arbitrations*, at 7 (August 5, 1999) available at www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arb_med/p009528.pdf (citing data from the NASD’s Office of Dispute Resolution from 1980 through mid-1999) (hereinafter “Tidwell Study”).

¹⁸ SIFMA, *White Paper on Arbitration in the Securities Industry: The Success Story of an Investor Protection Focused Institution that has Delivered Timely, Cost-Effective, and Fair Results for Over 30 Years* (October 2004) (hereinafter “SIFMA Study”).

The recent market downswing fits this pattern, as well. In 2007, before the recent sub-prime securities meltdown, just 3,238 new arbitrations were filed with FINRA Dispute Resolution (about one-third of the 2003 amount).¹⁹ But, as of early December 2009 (reflecting the latest 2009 statistics currently available), 7,137 new arbitrations had been filed—a forty-five percent increase over the total number of filings in 2007.²⁰ This number does not reflect additional filings made by year-end 2009.²¹

In the midst of the current financial crisis, and with constituent investors and consumer advocates clamoring for action, certain Members of Congress have expressed a less favorable view of pre-dispute arbitration agreements than the Supreme Court two decades earlier in *McMahon* and *Rodriguez*. According to this view, the Supreme Court undermined the beneficial purposes of arbitration in permitting “statutory” claims by “consumers” to be subject to arbitration agreements.²² This line of thinking postulates that, with respect to employment, consumer, and franchise disputes, the Supreme Court has misinterpreted Congressional intent underlying the FAA:

- Supreme Court decisions have changed the meaning of the FAA to include “disputes between parties of greatly disparate economic power” and “corporations are requiring millions of consumers . . . to give up their right to have disputes resolved by a judge or jury”²³
- Consumers have “no meaningful option whether to submit their claims to arbitration.” People do not understand the fine print that “strips them of rights,” and are “not even aware that they have given up their rights.”²⁴
- Mandatory arbitration undermines the development of the law absent judicial review of arbitration decisions.²⁵
- Mandatory arbitration is not transparent due, in part, to the absence of written decisions from arbitrators.²⁶

¹⁹ Tidwell Study, *supra* note 17, at 7.

²⁰ FINRA Statistics, *supra* note 1.

²¹ FINRA Statistics, *supra* note 1.

²² H.R. 1020, *supra* note 9.

²³ *Id.* at § 2(2).

²⁴ *Id.* at § 2(3).

²⁵ *Id.* at § 2(4).

- Arbitration clauses “tilt” against individuals, “strip individuals of substantive statutory rights, ban class actions, and force people to arbitrate their claims hundreds of miles from their homes.”²⁷

These proposed Congressional “findings” are not consistent with recent studies about the effectiveness and fairness of securities arbitrations. For example, SIFMA reviewed current arbitration policies, data, and other studies and reached several conclusions in stark contrast to the above. Specifically, SIFMA reached six key conclusions about arbitration of securities disputes:

- 1) Arbitration is faster and cheaper than traditional litigation;
- 2) Arbitration is more accessible for investors than courts;
- 3) Investors regularly recover awards in arbitration either by settlement or award;
- 4) Arbitration is fair, and participants perceive that it is fair;
- 5) Regulatory oversight by FINRA and the SEC ensures that the arbitration process is fair; and
- 6) Pre-dispute arbitration clauses are fair to investors and serve the public interest.²⁸

In 2009, the House Judiciary Committee heard testimony on the Arbitration Fairness Act of 2009. Stephen J. Ware, a Professor of Law at the University of Kansas, gave testimony in opposition to the bill.²⁹ Professor Ware testified that empirical research conducted on the outcome and process costs of contractual arbitration versus litigation confirm the observations made by FSI member firms in the FSI Survey.³⁰ When comparing the process costs (*i.e.*, legal fees spent on pre-trial matters, discovery, motion practice, trial, and appeal) of litigation versus arbitration, arbitration was generally less expensive.³¹ When considering the outcomes (*i.e.*, who wins, and how much is won) overall, Professor

²⁶ *Id.* at § 2(5).

²⁷ *Id.* at § 2(6).

²⁸ SIFMA Study, *supra* note 18, at 3-5.

²⁹ Testimony of Stephen J. Ware on Mandatory Binding Arbitration, 2009 WL 2942430 (Sept. 15, 2009).

³⁰ *Id.*

³¹ *Id.*

Ware concluded that consumers “fare as well in arbitration as in litigation. . . . In short, empirical studies do not support the notion that consumer and employment arbitration is unfair.”³²

FSI Survey respondents largely share the views expressed in the SIFMA Study and by Professor Ware’s testimony, and eschew the views expressed by proponents of the Arbitration Fairness Act of 2009. Additionally, FSI Survey respondents express a more nuanced view that a better system may lie somewhere between a view espousing FINRA arbitration for every consumer dispute, no matter how big or complicated, and the efforts of some in Congress to do away with mandatory arbitration altogether. Countering the view that arbitration is lopsided against the consumer, trends show that, at least with respect to securities arbitrations before FINRA, investors are starting to prevail at a higher rate than they were three years ago.³³

³² *Id.*

³³ See Blumenthal, *supra* note 2.

Section Three

RESULTS OF THE FSI SURVEY

A. Methodology and Collection of Responses

In January 2010, FSI contacted its independent broker-dealer members and invited them to complete a thirty-three question survey about various topics related to the fairness and effectiveness of the FINRA securities arbitration process.³⁴ The survey items were grouped into five categories: (1) Cost and Effectiveness of Arbitration (eleven questions); (2) Pre-hearing Procedures and Discovery (six questions); (3) Hearing and Awards (six questions); (4) Other Considerations (four questions); and (5) Current Developments or Changes to Arbitration (six questions). Participants completing the survey were asked to agree or disagree with various items on a five-point Likert scale. Possible responses were: (1) strongly agree; (2) agree; (3) neutral; (4) disagree; or (5) strongly disagree. Survey participants were only permitted one response per statement.

B. Analysis of FSI Survey Responses

1. Cost and Effectiveness of Arbitration

Overall, FSI members' responses are generally consistent with prior research in this area, which found that the cost of arbitration is generally less than the cost of litigation, and that arbitrations are generally resolved faster than court cases.^{35,36} In fact, the overwhelming majority of FSI Survey respondents—seventy-five percent—strongly agreed or agreed that FINRA arbitration is an effective way to resolve disputes with customers.³⁷ Moreover, the majority of FSI Survey respondents strongly

³⁴ Of FSI's 119 broker-dealer members at the time the survey was conducted, forty-one at least partially completed the FSI Survey, a thirty-five percent response rate. Thirty-three members completed the entire FSI Survey, for a total response rate of twenty-eight percent.

³⁵ See Appendix B, Figs. 1-3.

³⁶ See SIFMA Study, *supra* note 18, at 25 and Appx. B; see also U.S. District Courts—Median Time Intervals From Filing to Disposition of Civil Cases, available at www.uscourts.gov/caseload2009/tables/C05Mar09.pdf (Last visited Feb. 11, 2010) (hereinafter "Federal Judicial Statistics").

³⁷ Appendix B at Fig. 4.

agreed or agreed that parties should continue to use FINRA Dispute Resolution rather than another arbitration forum to resolve disputes.³⁸

The cost of alternative dispute resolution is suggested as one of the reasons that parties should engage in arbitration, if given the choice.³⁹ FSI Survey respondents largely agreed that arbitrations cost less than litigation.⁴⁰ Sixty-nine percent of FSI Survey respondents either strongly agreed or agreed that arbitration costs less; in contrast, only nine percent said arbitration is more expensive.⁴¹ Given the ever-increasing costs of e-discovery,⁴² the FSI Survey also asked FSI Survey respondents to agree or disagree that discovery was also less expensive in arbitration.⁴³ The overwhelming majority of FSI Survey respondents—seventy-five percent—confirmed that discovery in arbitrations is less expensive than discovery in litigation.⁴⁴

With respect to the expedience of litigation, current data from the United States Federal Judiciary indicates that on average 33.1 months pass from when a case commences until it is tried.⁴⁵ FINRA Dispute Resolution Statistics show that the “Turnaround Time” for a case that goes to hearing is approximately 11.5 months from filing to award—roughly a third of the time that it takes for a case to go to trial in the federal courts.⁴⁶

FSI Survey responses are consistent with statistics from the federal courts and from FINRA. Sixty-three percent of the FSI Survey respondents strongly agreed or agreed that FINRA arbitrations are

³⁸ See Appendix B at Fig. 5.

³⁹ SIFMA Study, *supra* note 18; Ware Testimony, *supra* note 29.

⁴⁰ Appendix B at Fig. 1; *see also* SIFMA Study, *supra* note 18.

⁴¹ Appendix B at Fig. 1.

⁴² Thomas Y. Allman, *Managing E-Discovery After the 2006 and 2008 Amendments: The Second Wave*, 804 PLI/Lit 129 (2009) (“[E]xcessive discovery costs remain of major concern. The Supreme Court noted . . . that the threat of excessive electronic discovery expense could push cost-conscious defendants to settle even anemic cases before reaching those proceedings.”), quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 559 (2007) (inner quotation marks omitted).

⁴³ Appendix B at Fig. 2.

⁴⁴ *Id.*

⁴⁵ Federal Judicial Statistics, *supra* note 36.

⁴⁶ FINRA Statistics, *supra* note 1.

resolved faster than litigation.⁴⁷ Only six percent of FSI Survey respondents disagreed with that statement.⁴⁸

Of course, the raw speed at which a dispute is considered on the merits is not the only factor to consider in determining overall fairness of arbitration versus litigation. In arbitration, parties largely give up pre-trial procedures that may effectively dispose of claims prior to a hearing on the merits (*e.g.*, court-ordered mediation or settlement conference, motion to dismiss, or motion for summary judgment). The statistics bear this out. Twenty-four percent of arbitration cases filed with FINRA went to hearing in 2008—one out of four cases.⁴⁹ In contrast, only 2.4% of cases, less than three out of one hundred, pending in federal courts in 2009 were resolved through trial.⁵⁰ Thus, the majority of FINRA cases, and the vast majority of federal cases, are resolved prior to hearing or trial, either by settlement or some other pre-hearing or pre-trial process.⁵¹

When asked if FINRA arbitrations are more likely to settle than litigated disputes, the majority of FSI Survey respondents responded “neutral,” while only thirty-seven percent agreed that arbitrations were more likely to settle than litigated disputes.⁵² FINRA indicates that approximately fifty-four percent of arbitrations are settled either through direct settlement negotiations or via mediation.⁵³ While recognizing that statistics for settled cases are not readily available from the Federal Judicial Statistics, it is clear that pre-trial processes (*e.g.*, default judgment, involuntary dismissal, summary judgment, and voluntary dismissal through settlement) dispose of the bulk of federal court actions because less than three percent of federal cases go to trial.

One question on the FSI Survey asked members to respond to the statement “Arbitration is more effective overall to resolve smaller, less complex claims.”⁵⁴ The majority of FSI Survey respondents strongly agreed or agreed with that statement.⁵⁵ Sixteen percent disagreed, and no FSI Survey

⁴⁷ Appendix B at Fig. 3.

⁴⁸ *Id.*

⁴⁹ FINRA Statistics, *supra* note 1.

⁵⁰ Federal Judicial Statistics, *supra* note 36.

⁵¹ FINRA Statistics, *supra* note 1; Federal Judicial Statistics, *supra* note 36.

⁵² Appendix B at Fig. 6.

⁵³ FINRA Statistics, *supra* note 1.

⁵⁴ Appendix B at Fig. 5.

⁵⁵ *Id.*

respondent strongly disagreed.⁵⁶ FSI Survey respondents that strongly agreed or agreed with that statement were asked three follow-up questions related to a single arbitration or related cases:⁵⁷

- 1) Provide the number of claimants that would tip the balance in favor of litigation;⁵⁸
- 2) Provide the number of respondents that would tip the balance in favor of litigation;⁵⁹ and
- 3) Provide a claimed dollar amount that would tip the balance in favor of arbitration.⁶⁰

The majority of FSI Survey respondents stated that the presence of as few as three to five claimants or respondents is sufficient to warrant litigating in court instead of arbitration.^{61,62} As to the amount in controversy that would favor litigation over arbitration, responses were more varied. The amount in controversy that would dictate litigation over arbitration ranged from a low of \$30,000 (which is only \$5,000 greater than the cut-off between a single arbitrator and a voluntary three-arbitrator panel under FINRA Rules)⁶³ to a high of \$1,000,000, which garnered three votes.⁶⁴

Overall, responses to the follow-up questions reveal that FSI members would likely prefer to have larger cases—in terms of the number of parties involved or the amount of damages claimed—litigated instead of arbitrated. Although FINRA does not have limitations on the number of claimants, respondents, or damages allowed in a single arbitration (or collection of related cases), FINRA does prohibit claimants from bringing purported class actions in arbitration.⁶⁵

⁵⁶ *Id.*

⁵⁷ See Appendix A.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ Appendix B at Fig. 7a.

⁶² Appendix B at Fig. 7b.

⁶³ FINRA Rule 12204(a) states that “If the amount of a claim is more than \$25,000 but not more than \$100,000, exclusive of interest and expenses, the panel will consist of one arbitrator unless the parties agree in writing to three arbitrators.”

⁶⁴ Appendix B at Fig. 7c.

⁶⁵ FINRA Rule 12204(a).

2. Pre-hearing and Discovery

Overall, FSI Survey respondents were satisfied with arbitrators' responsiveness in scheduling deadlines and setting hearing schedules. One area of concern, however, is whether the parties' substantive and due process rights were adequately preserved in the arbitration forum, as opposed to litigation. Forty-four percent of FSI Survey respondents either disagreed or strongly disagreed with the view that arbitration preserved substantive and due process rights.⁶⁶

With regard to motion practice, few FSI Survey respondents disagreed that arbitrators' decisions on motions were guided by the parties' obligations under the law.⁶⁷ With respect to motions to dismiss, sixty-five percent of FSI Survey respondents believe that they should be able to move to dismiss claims that a court would not recognize as a valid cause of action.⁶⁸

Despite FSI Survey respondents' preference to have motions to dismiss available, last year FINRA curtailed the ability to have a statement of claim dismissed before the case in chief is finished, and specifically discouraged such practices.⁶⁹ Under new rules, specific procedures limit motions to dismiss, requiring them to be filed separately from a party's answer, and sixty days before a scheduled hearing.⁷⁰ Full panels must decide the motion, only after a pre-hearing conference, and only if the panel finds that (a) the non-moving party signed a settlement agreement or release, or (b) the moving party was not associated with the account, security, or conduct in question.⁷¹ Decisions must be unanimous and in writing.⁷² A denied motion means the movant is assessed the hearing fees.⁷³ The new FINRA rules create a significant disincentive to a pre-hearing motion to dismiss that is not present in federal court actions, where motions for summary judgment are deemed an integral part of the Federal Rules of Civil Procedure.

⁶⁶ Appendix B at Fig. 8.

⁶⁷ Appendix B at Fig. 9.

⁶⁸ Appendix B at Fig. 10.

⁶⁹ FINRA Rule 12504(a)(1).

⁷⁰ FINRA Rule 12504(a)(2), (3).

⁷¹ FINRA Rule 12504(a)(6).

⁷² FINRA Rule 12504(a)(4),(7).

⁷³ FINRA Rule 12504(a)(9)-(11). Moreover, a finding that a motion is frivolous means the movant must pay the non-movants' "reasonable costs and attorneys' fees," or, if made in bad faith, face sanctions. *Id.*

FSI Survey Respondents generally believed that FINRA discovery procedures allowed parties to obtain all necessary information prior to hearing.⁷⁴

One area of concern for FSI Survey respondents was related to sanctions for misconduct in the discovery process.⁷⁵ FINRA authorizes arbitrators to sanction parties for failing to cooperate in discovery, non-compliance with FINRA's discovery rules or a panel discovery order, or frivolous objections to requests for production of documents or information.⁷⁶ Sanctions may be monetary, or the arbitrators may dismiss claims or strike defenses if prior warnings or sanctions are not effective.⁷⁷ In such cases, sixty-nine percent of FSI Survey respondents strongly agreed or agreed that arbitrators should provide the parties with written explanations of sanctions awards; only twelve percent disagreed.⁷⁸

3. Arbitrators, Hearings, and Awards

The identity and experiences of FINRA arbitrators is an important area of concern for participants in the arbitration process. According to an August 2009 *Forbes* article on FINRA arbitrators, FINRA's arbitrator roster included almost 6,100 individuals.⁷⁹ FINRA uses detailed procedures to select potential arbitrators from a pool of applicants; requires applicants to disclose their biography, employment, and associations with the financial industry to avoid creating conflicts of interest; and mandates training before applicants may hear cases.⁸⁰

FSI Survey respondents largely agreed (fifty-three percent) that the arbitrators who heard their cases were competent to deal with securities disputes, and only nineteen percent disagreed that the

⁷⁴ Appendix B at Fig. 11.

⁷⁵ Appendix B at Fig. 12.

⁷⁶ FINRA Rule 12511. *See also* FINRA, Notice to Parties – Discovery Rules and Procedures (last updated Jan. 6, 2010) (available at [www.finra.org/Arbitration Mediation/Parties/ArbitrationProcess/NoticestoParties/P009517](http://www.finra.org/Arbitration%20Mediation/Parties/ArbitrationProcess/NoticestoParties/P009517)) (“The purpose of this Notice is to remind all parties—claimants and respondents—that failure to comply with the forum’s discovery rules and procedures can result in sanctions, including dismissal of claims, defense or proceedings.”)

⁷⁷ FINRA Rule 12511.

⁷⁸ Appendix B at Fig. 12.

⁷⁹ Seth E. Lipner, *Who Are These “Arbitrators” Anyway?* *Forbes.com*, available at www.forbes.com/2009/08/24/commentary-arbitration-lipner-intelligent-investing-finra.html (Aug. 24, 2009).

⁸⁰ *See* SIFMA Study, *supra* note 18, at 16-20.

arbitrators were competent.⁸¹ FSI Survey respondents strongly agreed (twenty-five percent) or agreed (forty-six percent) that arbitrators should show some level of familiarity with parties' obligations under securities laws and rules. Despite the belief that arbitrators are competent and should be knowledgeable about the securities laws, FSI Survey respondents found that arbitration panels tended to decide cases based on equitable principles (fifty-nine percent) rather than focusing on the applicable securities laws and rules.⁸² Either way, FSI Survey respondents believed that outcomes in arbitrations were less predictable than outcomes in litigated cases.⁸³

When it came to the award itself, the vast majority of FSI Survey respondents agreed that the arbitrators' awards should include written reasoning.⁸⁴ Thirty-one percent strongly agreed with that statement; forty-one percent agreed.⁸⁵ The desire for reasoning in awards is likely related to FSI Survey respondents' beliefs that arbitrators favor equity over enforcement of the applicable laws and rules and the perceived lack of predictability with arbitration outcomes.⁸⁶ Apparently, the lack of predictability is a factor FSI Survey respondents are willing to sacrifice in favor of speed and lower cost, but FSI Survey respondents nevertheless express a desire to have arbitrators explain why they are reaching their results.

FSI Survey respondents expressed views in accord with one of the proposed findings expressed by proponents of the Arbitration Fairness Act of 2009 (*i.e.*, that arbitration proceedings lacked transparency because arbitrators are not required to provide written reasons for an award).⁸⁷ Parties to FINRA arbitrations have the option to receive a written, reasoned award, as long as the parties make a joint request and pay the chairperson an honorarium of \$400, but that is seldom done.⁸⁸

Responses were mixed to the question of whether arbitration awards should receive broader judicial review.⁸⁹ Forty-one percent agreed that broader judicial review was warranted, thirty-seven

⁸¹ Appendix B at Fig. 13.

⁸² Appendix B at Fig. 15.

⁸³ Appendix B at Fig. 16.

⁸⁴ Appendix B at Fig. 14.

⁸⁵ *Id.*

⁸⁶ Appendix 13 at Figs. 15 and 16.

⁸⁷ See H.R. 1020, *supra* note 9, § 2(5).

⁸⁸ FINRA Rule 12904(g).

⁸⁹ Appendix B at Fig. 17.

percent disagreed, and twenty-two percent were neutral.⁹⁰ When asked if the lack of judicial review has stunted the development of securities law, many FSI Survey respondents agreed that securities law would be more developed if the arbitrated disputes had been judicially resolved.⁹¹

Consistent with research in other studies, FSI Survey respondents do not detect any pro-industry bias in the decision-making process or in arbitration awards.⁹² For example, in response to the statement that the presence of an industry member on a three-arbitrator panel increased “pro-industry bias,” thirty-four percent of FSI Survey respondents strongly disagreed and forty-four percent disagreed.⁹³

In contrast with the view that FINRA arbitrations are industry-biased and rigged against the investor, when asked whether awards favored broker-dealers at the expense of investors, ninety-one percent of FSI Survey respondents strongly disagreed or disagreed that broker-dealers were favored over investors.⁹⁴ No FSI Survey respondent agreed with that statement.⁹⁵

4. Current Developments or Changes to Arbitration

FSI Survey respondents were not in favor of current initiatives by some in Congress to undo the status of pre-dispute arbitration agreements.⁹⁶ FSI Survey respondents agreed that prohibiting pre-dispute arbitration agreements would lead to more costly litigation, and would not serve the interests of the capital markets.⁹⁷ Responses to this question produced the highest percentage of “strongly agree” responses—fifty-three percent—when compared to the other questions in the survey.⁹⁸ Twenty-five percent of FSI Survey respondents agreed that prohibiting pre-dispute arbitration agreements

⁹⁰ *Id.*

⁹¹ Appendix B at Fig. 18.

⁹² Appendix B at Fig. 19.

⁹³ Appendix B at Fig. 20.

⁹⁴ Appendix B at Fig. 19.

⁹⁵ *Id.*

⁹⁶ Appendix B at Fig. 21.

⁹⁷ Appendix B at Fig. 22.

⁹⁸ *Id.*

would increase the costs for resolving customer disputes.⁹⁹ A small percentage of FSI Survey respondents disagreed (nine percent), but no one strongly disagreed with that statement.¹⁰⁰

Similarly, FSI Survey respondents agreed that Congress should not disturb the FINRA arbitration system by prohibiting pre-dispute arbitration agreements.¹⁰¹ In separate items, participants responded that FINRA arbitration need not be overhauled¹⁰² and that FINRA was not too involved in the arbitration process.¹⁰³ In fact, many participants agreed that FINRA arbitration should be expanded to include other types of financial products.¹⁰⁴

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Appendix B at Fig. 21.

¹⁰² Appendix B at Fig. 23.

¹⁰³ Appendix B at Fig. 24.

¹⁰⁴ Appendix B at Fig. 25.

Section Four

CONCLUSION

The key findings from the FSI Survey may be summarized as follows:

- FINRA arbitration is cost-effective. The costs for conducting discovery are less in arbitration than in litigation, and in the aggregate, the total amount of money spent on arbitration is less than it would be in litigated cases.
- When comparing FINRA arbitrations to litigated cases that go to a final hearing or trial, FINRA arbitrations generally reach the merits hearing more quickly than court trials, which saves the participants time and money.
- FINRA arbitration is not appropriate for all types of claims and cases. FINRA has already precluded class actions from arbitration, but FSI members also perceived that the benefit of FINRA arbitration is lost when the arbitration includes several claimants or respondents, or if a large monetary award is at stake.
- Finally, some transparency in FINRA arbitrations would be preferred over efficiency and cost-savings. For example, FSI member firms generally would prefer arbitrators to provide written decisions that include factual findings and legal conclusions in support of their awards to ensure transparency and consistency of results.

Overall, FSI Survey respondents confirmed recent research finding that arbitrations are cost-effective, efficient ways to resolve disputes, and fair to all parties involved. Such results are at odds with proposed Congressional findings that arbitration is unfair and skewed to favor large corporations instead of individuals. According to the research, both broker-dealers and investors perceive arbitration as a fair and less expensive way for parties to resolve disputes.¹⁰⁵

One area where the FSI Survey and proposed Congressional findings are in accord relates to the content of an arbitration award. Both FSI Survey respondents and Congressional proponents of FAA reform prefer that arbitrators provide written explanations for awards. Congress states that the absence of such findings in arbitration awards has contributed to a lack of transparency. For FSI members,

¹⁰⁵ SIMFA Study, *supra* note 18.

written awards would serve an instructional and remedial function. Written explanations would provide guidance to broker-dealers and associated persons about how to prevent and correct practices leading to monetary awards, and confirm the legitimacy of practices that do not. Without a written rationale for a decision, parties are merely left to guess and any potential educational value from the award may be lost.

Although FSI Survey respondents generally concluded that arbitration is effective and fair, many suggested that change would be appropriate in cases involving a large number of parties and/or high monetary demands. While arbitration is cost-effective and efficient for resolving smaller, less complex disputes, larger disputes may be better suited for resolution in the judicial system. If this were to occur, the body of securities law might also continue its evolution, which would further help guide the resolution of disputes and the securities industry itself.

FINANCIAL SERVICES INSTITUTE¹⁰⁶

BRIGGS AND MORGAN, P.A.¹⁰⁷

¹⁰⁶ Briggs and Morgan acknowledges the work of Matthew Schwartz (matt.schwartz@financialservices.org), and David Bellaire (david.bellaire@financialservices.org).

¹⁰⁷ FSI acknowledges the work of Margaret Goetze (mgoetze@briggs.com), Julie Firestone (jfirestone@briggs.com), David Rosedahl (drosedahl@briggs.com), Kent Schoen (kschoen@briggs.com), Jessica Stomski (jstomski@briggs.com), Daniel Supalla (dsupalla@briggs.com), Frank Taylor (ftaylor@briggs.com), Steven Wilson (swilson@briggs.com).

FSI: Effectiveness and Fairness of FINRA Arbitration

Introduction

Effectiveness and Fairness of FINRA Arbitration

This survey is intended to evaluate the views of FSI members about the effectiveness and fairness of the arbitration of customer claims. Conducted by the Briggs and Morgan law firm, a law firm sponsor of FSI, the survey is designed to identify whether FSI members believe the securities arbitration process is conducted simply, fairly, economically and without bias by arbitrators.

Responses will be used to prepare a white paper on FINRA arbitration that will be available to FSI members. Your responses will be kept anonymous and confidential and will never be used in any way to permit identification of your firm.

Preliminary Information

1. Background Information

Person Completing

Survey:

Title:

Address:

Address 2:

City/Town:

State:

ZIP/Postal Code:

Email Address:

Phone Number:

2. Firm Information

Firm Name:

Number of registered persons
at your firm:

Number of arbitrated
customer disputes:

Number of cases filed in
courts in 2009:

3. May we contact you regarding your responses to this survey?

Yes

No

4. Preferred Method of Communication

Telephone

Email

FSI: Effectiveness and Fairness of FINRA Arbitration

Cost and Effectiveness of Arbitration

This survey consists of 33 questions, which you will rate on a 5-point scale. The options are (1) strongly agree, (2) agree, (3) neutral, (4) disagree, and (5) strongly disagree.

Please select the option that matches closest with your firm's experiences in arbitrating customer disputes.

5. The costs associated with a FINRA arbitration are less than the costs associated with litigation.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

6. The costs associated with conducting discovery in a FINRA arbitration are less than the costs associated with conducting discovery in litigation.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

7. FINRA arbitration resolves disputes faster than litigation.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

8. Disputes commenced in FINRA arbitration are more likely to settle than litigated disputes.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

9. FINRA arbitration is an effective way to resolve disputes with customers.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

10. Arbitration is more effective overall to resolve smaller, less complex claims.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Responses	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

FSI: Effectiveness and Fairness of FINRA Arbitration

11. If you Agreed with Question 10, please answer the following: approximately what number of CLAIMANTS in a single case or in a collection of related cases would tip the balance in favor of litigation over arbitration?

12. If you Agreed with Question 10, please answer the following: approximately what number of RESPONDENTS in a single case or in a collection of related cases would tip the balance in favor of litigation over arbitration?

13. If you Agreed with Question 10, please answer the following: approximately what CLAIMED DOLLAR AMOUNT in a single case or in a collection of related cases would tip the balance in favor of litigation over arbitration?

14. Parties should be free to select a different arbitration forum other than FINRA to resolve disputes.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

15. Comments regarding the cost and effectiveness of arbitration:

FSI: Effectiveness and Fairness of FINRA Arbitration

Pre-Hearing Procedures and Discovery

16. The FINRA arbitration discovery process enables the parties to obtain the information needed for a hearing.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

17. Arbitrators should not be permitted to sanction parties for discovery-related conduct unless a written order explaining the sanctions is issued.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

18. Arbitrator's decisions on pre-hearing motions were guided by the parties' obligations under applicable laws or rules.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

19. Parties should be permitted to bring motions to dismiss claims that a court would not otherwise recognize as a valid cause of action.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

20. FINRA arbitration provides parties with all of the substantive and due process rights to which they would be entitled in litigation.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

21. Arbitration panels are responsive to my needs in scheduling deadlines and setting the arbitration hearing dates.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

22. Comments on pre-hearing and discovery processes in arbitration:

	5
	6

FSI: Effectiveness and Fairness of FINRA Arbitration

Hearing and Awards

23. FINRA arbitrators are competent to resolve securities disputes.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

24. Parties should be able to obtain broader judicial review of FINRA arbitration awards.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

25. Parties in FINRA arbitration are more likely than parties in court to have their disputes resolved by a decision-maker on a full factual record.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

26. FINRA arbitrations offer results that are more predictable than court decisions.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

27. FINRA arbitration awards should include the arbitrators' reasoning.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

28. Arbitrators' awards favor broker-dealers at the expense of investors.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

29. Comments regarding arbitration hearings or awards:

	5
	6

FSI: Effectiveness and Fairness of FINRA Arbitration

Other Considerations

30. Arbitrators must demonstrate they are knowledgeable about parties' obligations under applicable securities laws or rules before they may sit on FINRA panels.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

31. Arbitrators favor equity over ensuring compliance with applicable securities laws and rules.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

32. Arbitration has not allowed securities law to develop as it would if disputes were resolved in courts.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

33. The presence of a non-public or "industry" arbitrator on a three-member panel increases the risk of pro-industry bias into the decision-making process.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

FSI: Effectiveness and Fairness of FINRA Arbitration

Current Developments or Changes to Arbitration

34. Prohibiting pre-dispute arbitration agreements would produce more protracted, costly litigation; a result that would not serve the best interests of investors or the U.S. capital markets.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

35. Congress should not disturb the FINRA arbitration system using legislation that would prohibit pre-dispute arbitration agreements.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

36. FINRA arbitration should be expanded to include all types of retail financial products.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

37. FINRA arbitration must be completely overhauled.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

38. FINRA is too involved with the arbitration process.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

39. I would prefer to arbitrate a dispute with a broker-dealer, rather than go to court.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Response	j	j	j	j	j

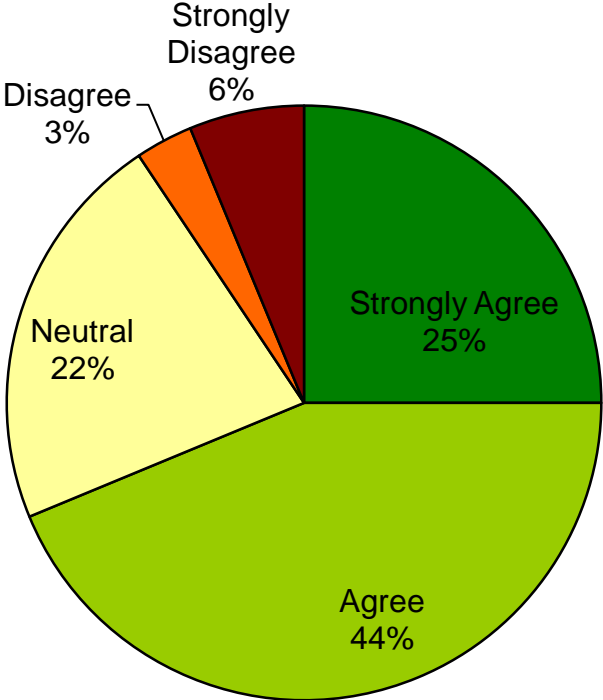
40. Comments regarding current developments or changes to arbitration:

Comments

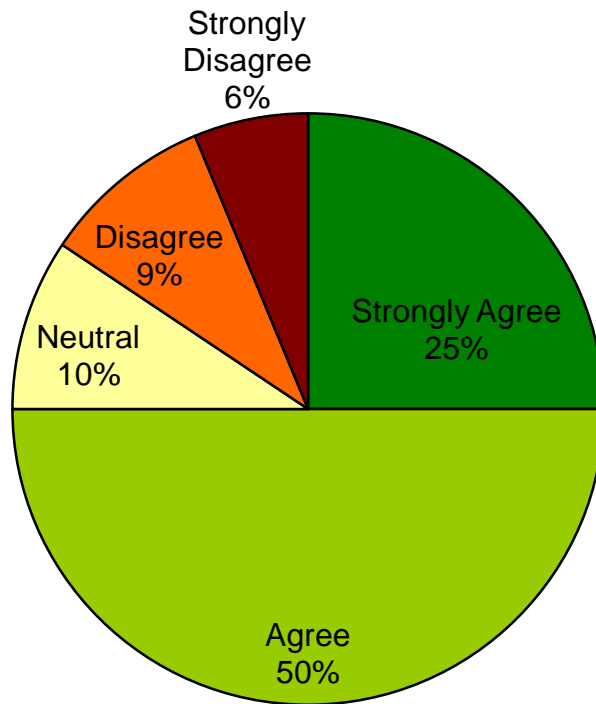
41. Please provide any comments regarding this survey.



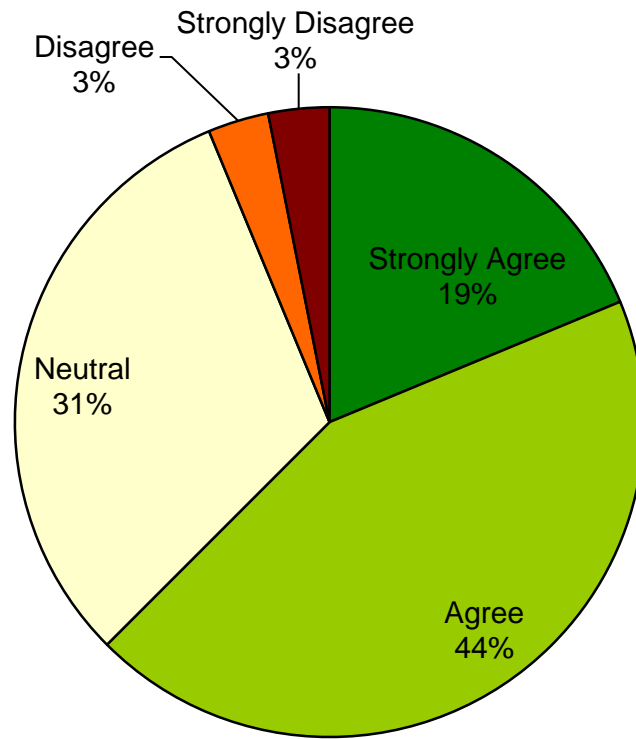
The costs associated with a FINRA arbitration are less than the costs associated with litigation.



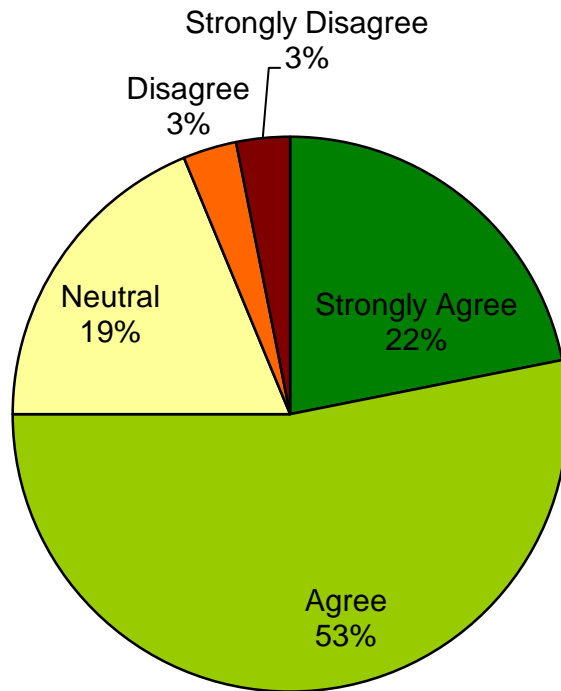
The costs associated with conducting discovery in a FINRA arbitration are less than the costs associated with conducting discovery in litigation.



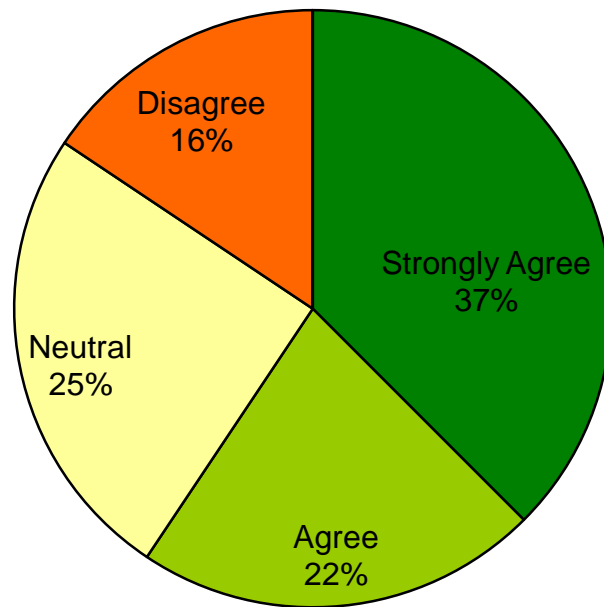
FINRA arbitration resolves disputes faster than litigation.



FINRA arbitration is an effective way to resolve disputes with customers.



Arbitration is more effective overall to resolve smaller, less complex claims.



Disputes commenced in FINRA arbitration are more likely to settle than litigated disputes.

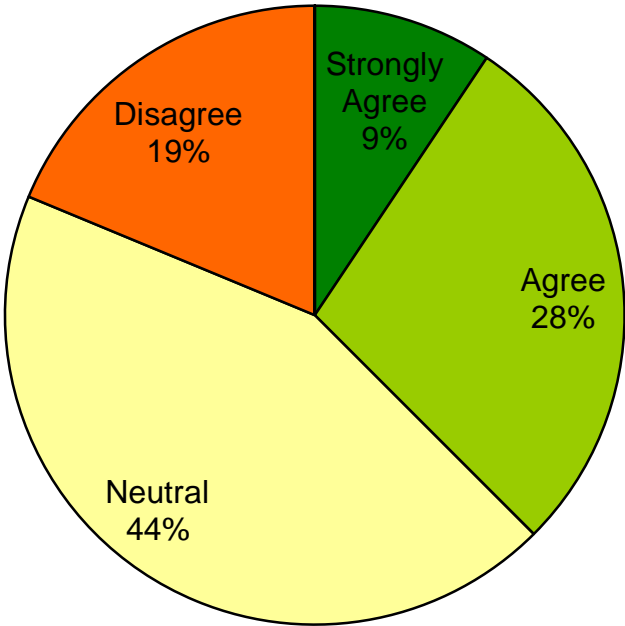


Figure 7a: If you Agreed with Question 10, please answer the following: approximately what number of CLAIMANTS in a single case or in a collection of related cases would tip the balance in favor of litigation over arbitration?

Response	Number of Respondents
3	4
4	1
5	5
>10	1
few	1
unknown	1
varies	1

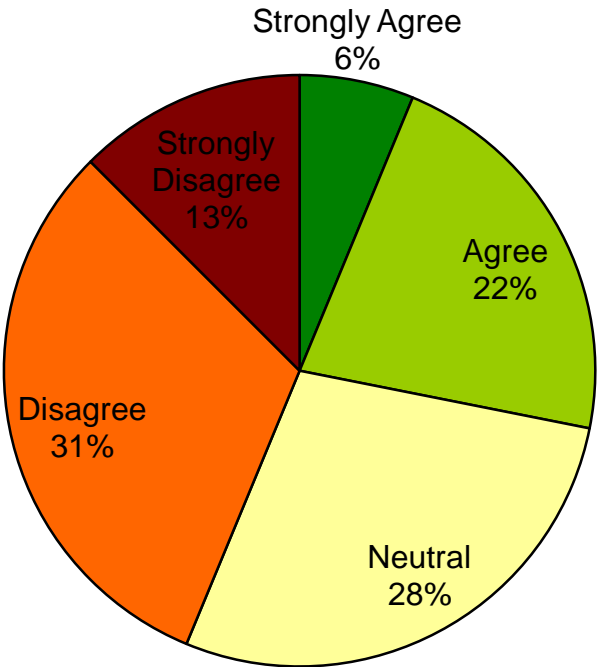
Figure 7b: If you Agreed with Question 10, please answer the following: approximately what number of RESPONDENTS in a single case or in a collection of related cases would tip the balance in favor of litigation over arbitration?

Response	Number of Respondents
2	1
3	6
>3	1
I don't think that there is a black-letter line, but the inefficiencies of litigation are disproportionately egregious in smaller, less complex cases.	1
varies	1
unknown	1

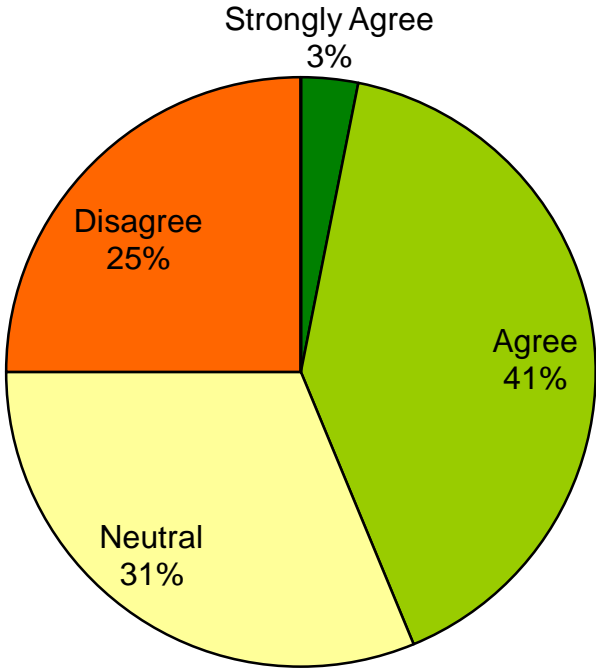
Figure 7c: If you Agreed with Question 10, please answer the following: approximately what CLAIMED DOLLAR AMOUNT in a single case or in a collection of related cases would tip the balance in favor of litigation over arbitration?

Response	Number of Respondents
\$30,000	1
\$100,000	1
\$150,000	1
\$250,000	1
\$250,000 plus	1
\$500,000	1
\$1 Million	3
unknown	1
varies	1
The more claimed, the more I want arbitration.	1
I don't think that there is a black-letter line, but the inefficiencies of litigation are disproportionately egregious in smaller, less complex cases.	1

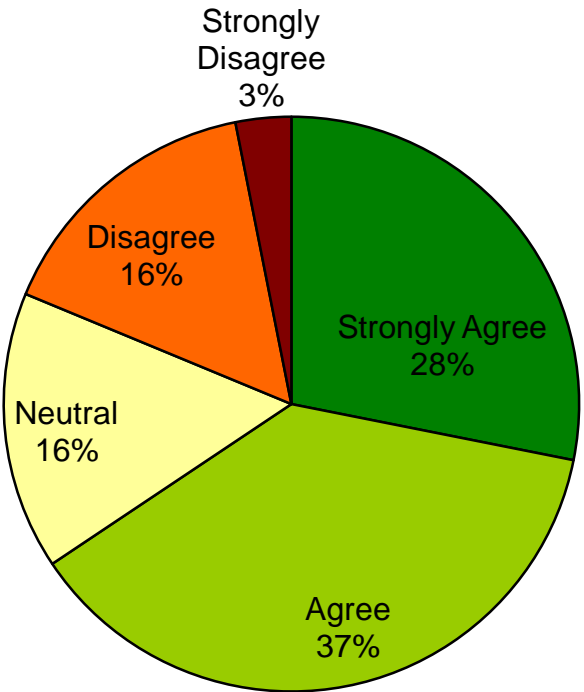
FINRA arbitration provides parties with all of the substantive and due process rights to which they would be entitled in litigation.



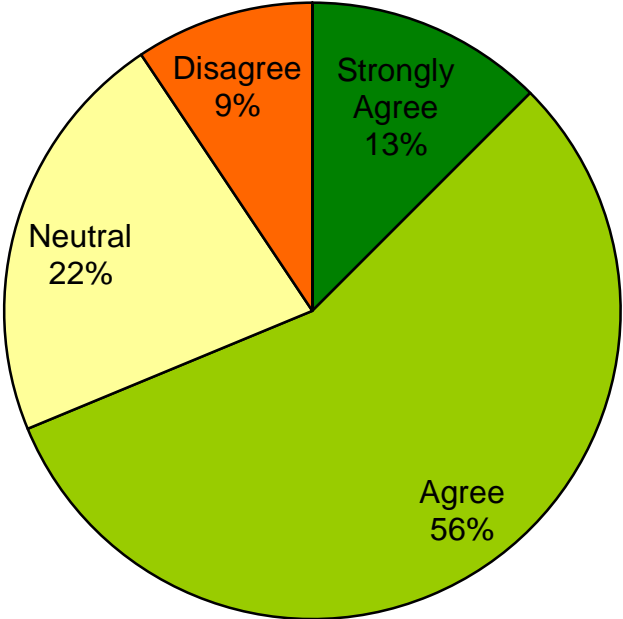
Arbitrator's decisions on pre-hearing motions were guided by the parties' obligations under applicable laws or rules.



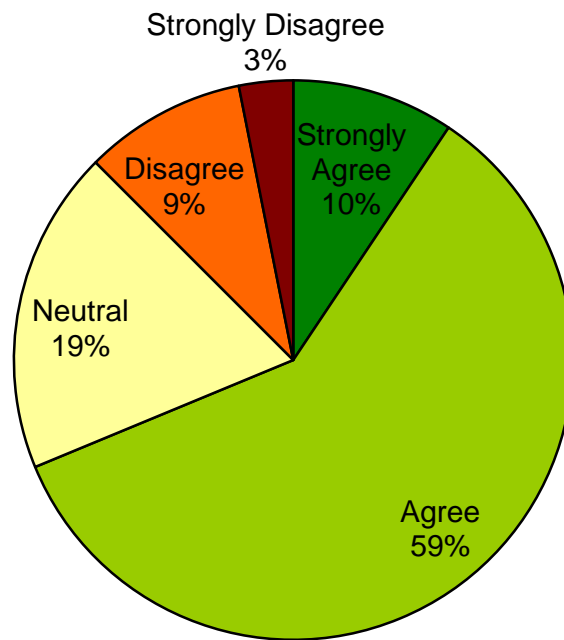
Parties should be permitted to bring motions to dismiss claims that a court would not otherwise recognize as a valid cause of action.



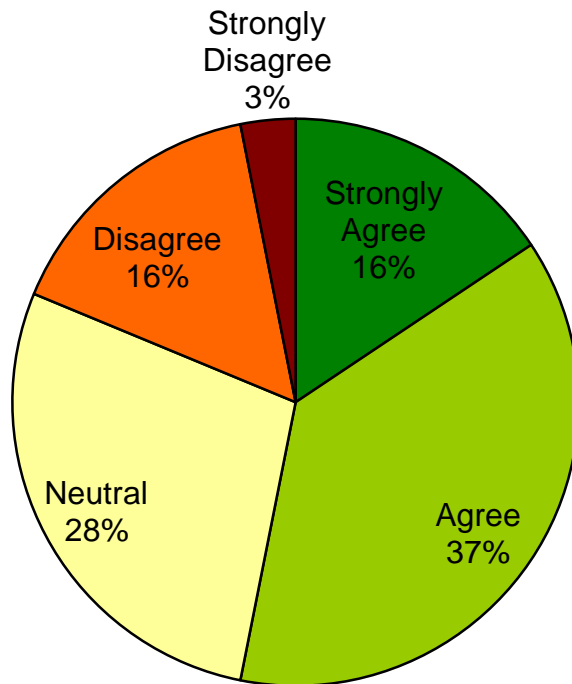
The FINRA arbitration discovery process enables the parties to obtain the information needed for a hearing.



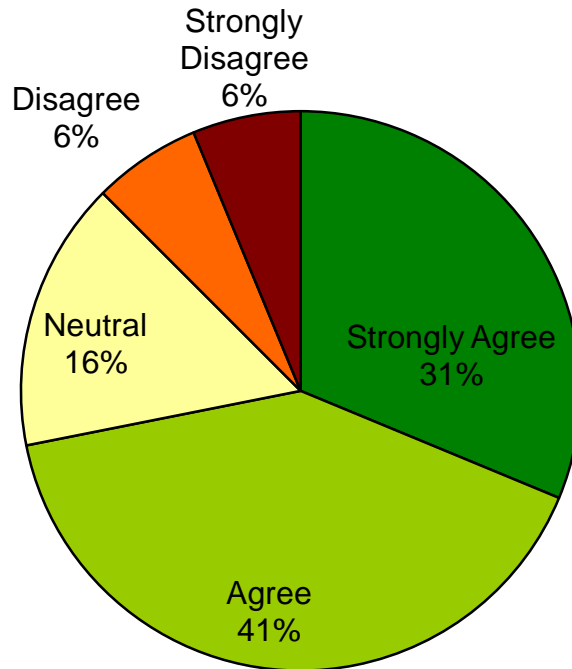
Arbitrators should not be permitted to sanction parties for discovery-related conduct unless a written order explaining the sanctions is issued.



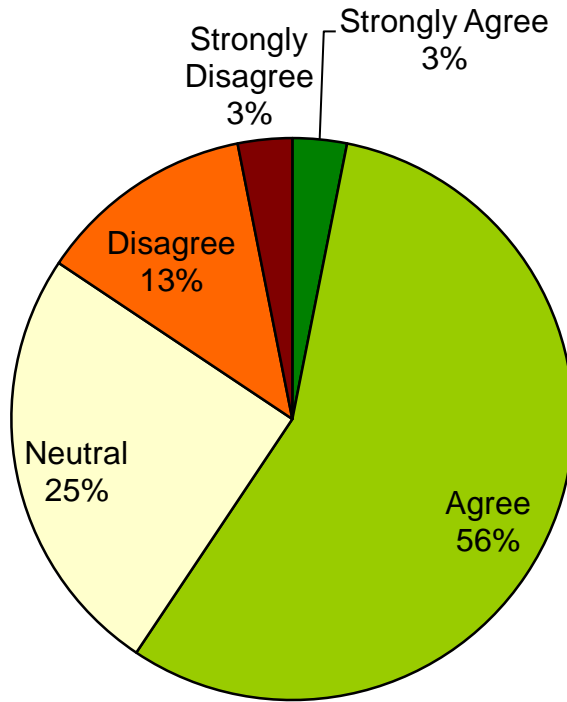
FINRA arbitrators are competent to resolve securities disputes.



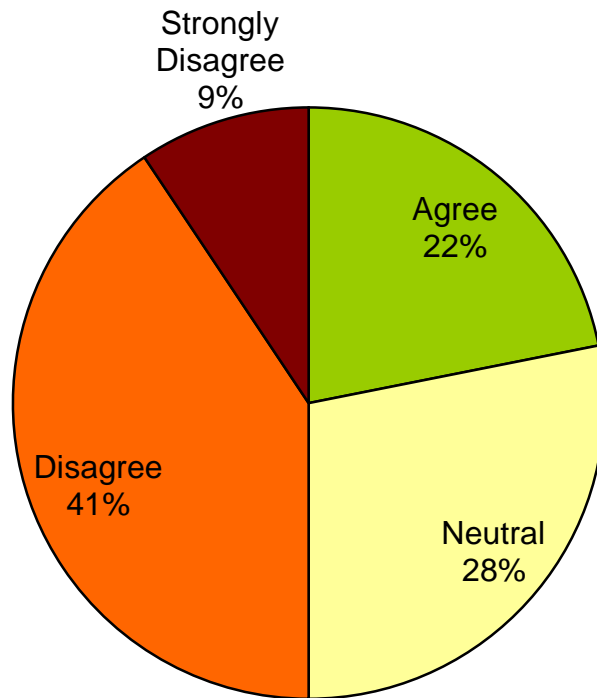
FINRA arbitration awards should include the arbitrators' reasoning.



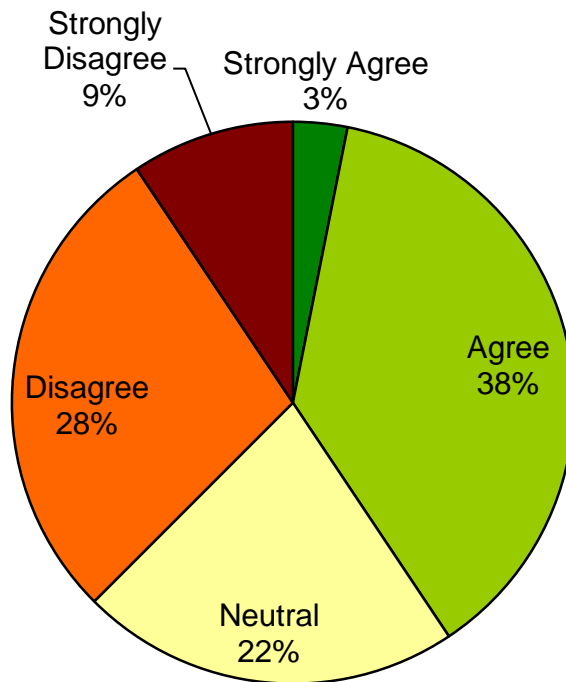
Arbitrators favor equity over ensuring compliance with applicable securities laws and rules.



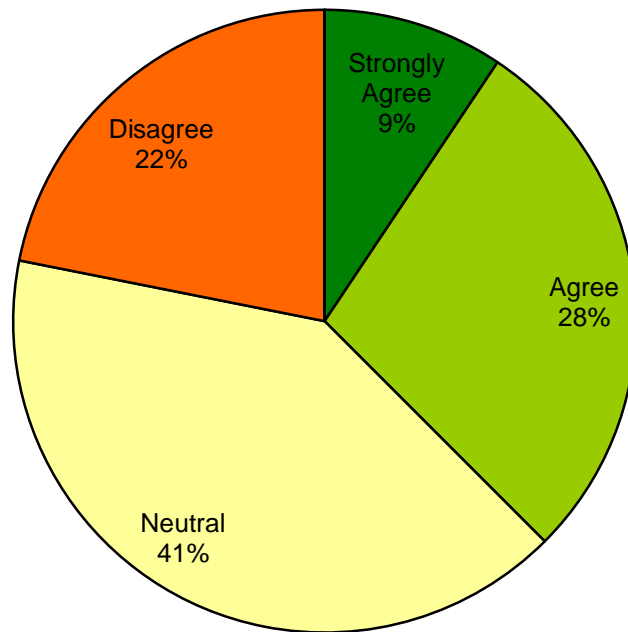
FINRA arbitrations offer results that are more predictable than court decisions.



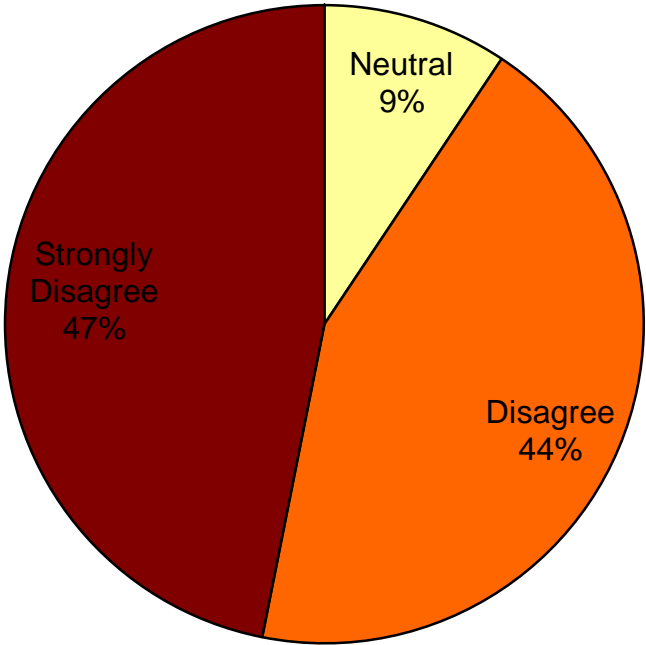
Parties should be able to obtain broader judicial review of FINRA arbitration awards.



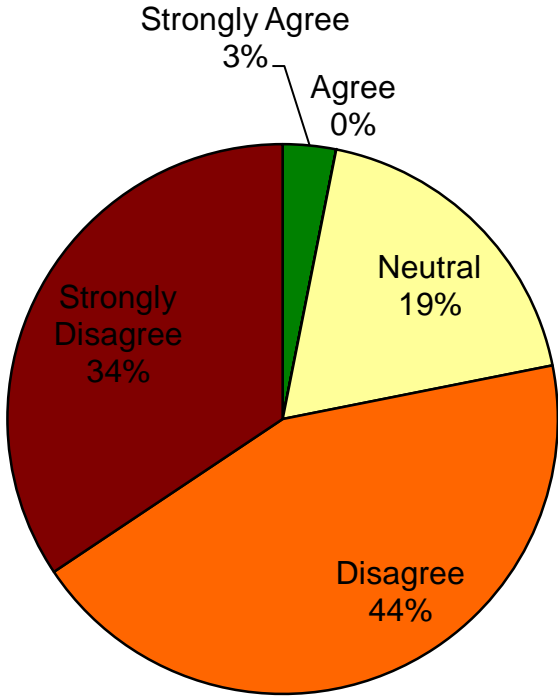
Arbitration has not allowed securities law to develop as it would if disputes were resolved in courts.



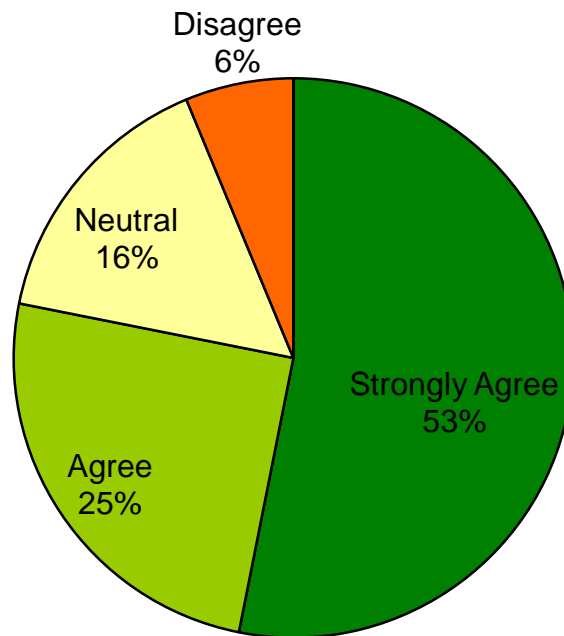
Arbitrators' awards favor broker-dealers at the expense of investors.



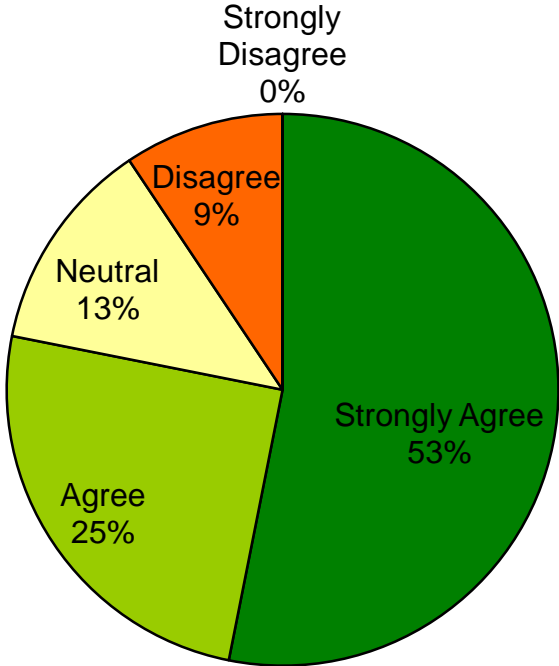
The presence of a non-public or "industry" arbitrator on a three-member panel increases the risk of pro-industry bias into the decision-making process.



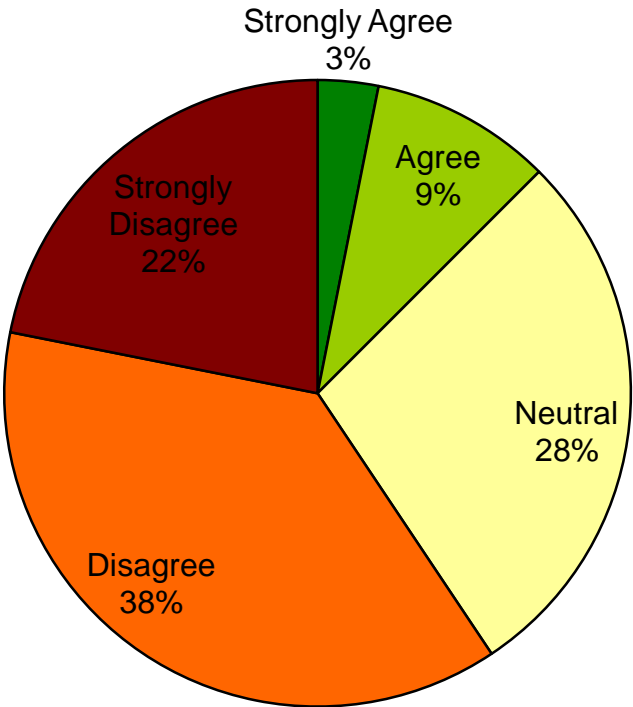
Congress should not disturb the FINRA arbitration system using legislation that would prohibit pre-dispute arbitration agreements.



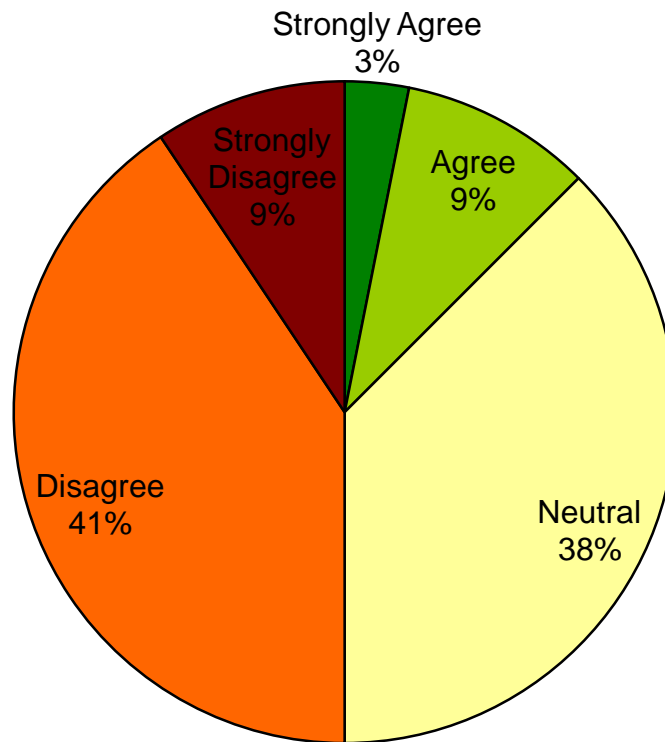
Prohibiting pre-dispute arbitration agreements would produce more protracted, costly litigation; a result that would not serve the best interests of investors or the U.S. capital markets.



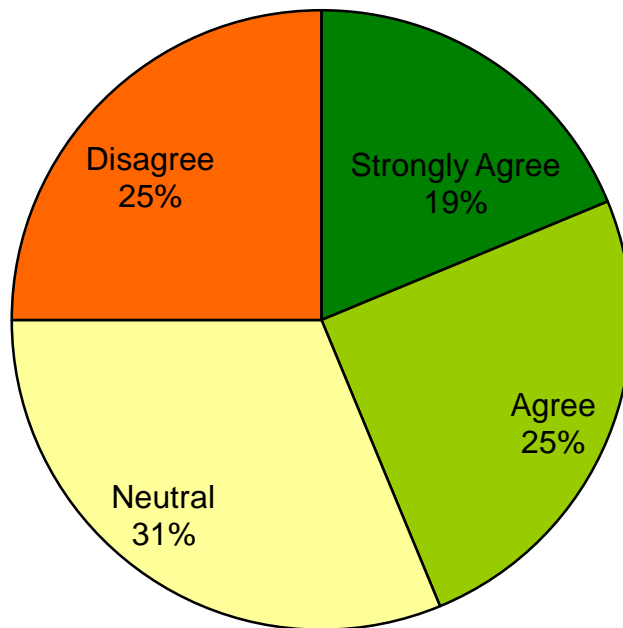
FINRA arbitration must be completely overhauled.



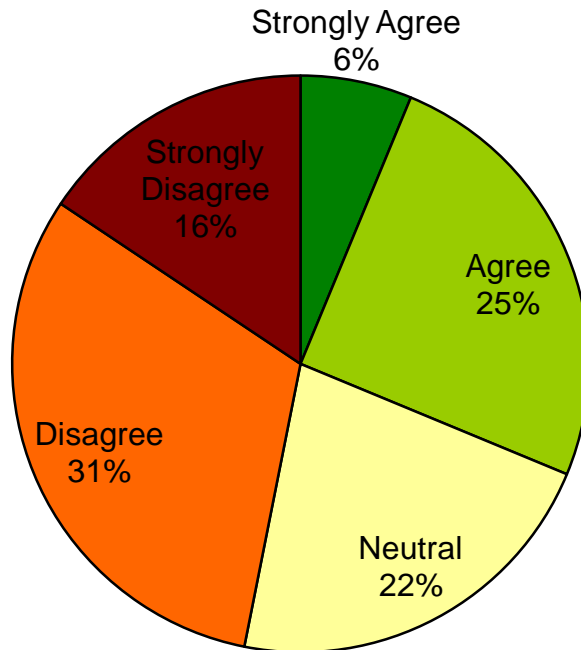
FINRA is too involved with the arbitration process.



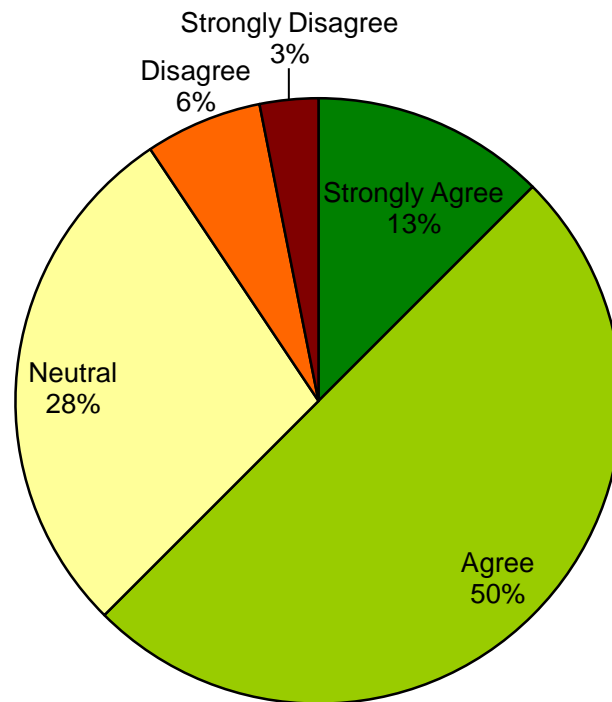
FINRA arbitration should be expanded to include all types of retail financial products.



Parties should be free to select a different arbitration forum other than FINRA to resolve disputes.



Arbitration panels are responsive to my needs in scheduling deadlines and setting the arbitration hearing dates.



I would prefer to arbitrate a dispute with a broker-dealer, rather than go to court.

