

**Securities
Arbitration in the
Market Meltdown
Era:**

**Achieving Fairness in
Perception and Reality**

Volume One

Chair

David E. Robbins

Practising Law Institute

CORPORATE LAW AND PRACTICE
Course Handbook Series
Number B-1754

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COMPULSORY ARBITRATION:
ITS IMPACT ON THE EFFICIENCY
OF MARKETS

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I. INTRODUCTION

In a recent paper entitled "Mandatory Arbitration of Securities Disputes-A Statistical Analysis of How Claimants Fare," Edward S. O'Neal and Daniel R. Solin have written, from a *quantitative* perspective, about the deterioration of investor returns in compulsory arbitration as a mechanism for resolving customer disputes in the securities industry.¹ Aided by Alan Greenspan's recent memoir,² this article will examine its *qualitative* failings and comment on various concepts including property rights, the rule of law, regulatory agency capture, path dependence, the role of lawyers and other topics related to compulsory pre-dispute arbitration.

One of the central goals of this article is a serious critique of arbitration as it has been practiced in the securities industry since the 1987 Supreme Court decision in Shearson/American Express v. McMahon.³ We will examine the role of lawyers in defending property rights and how reform in the area of both the courts and arbitration procedures would counteract the effects of agency capture and the limitations of compulsory arbitration. As this article explains, allowing lawyers to more effectively defend the property rights of investors would enhance the long-term health and efficiency of the American securities markets to the benefit of both the securities markets themselves and their investors.

More than 20 years have passed since the Shearson decision, and we seek here to stimulate further discussion between both those who practice before industry forums such as PIABA members, as well as among members of the securities industry. By gathering diverse input it should be possible to achieve a balanced approach to influence U.S. policy makers to produce necessary change without giving up the beneficial aspects of the present system. The public policy question of compulsory pre-dispute arbitration lies beyond normal party politics; meaningful reform should involve efforts to produce necessary change while avoiding exclusive appeal to one camp or ideology. Instead, the emphasis should be on fundamental fairness and improving market efficiency.

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1. Edward S. O'Neal and Daniel R. Solin, Mandatory Arbitration of Securities Disputes-A Statistical Analysis of How Claimants Fare (2007), <http://www.smartestinvestmentbook.com> or <http://www.sleg.com/pdf/workingpapers/Mandatory%20Arbitration%20Study.pdf>.
 2. Alan Greenspan, The Age of Turbulence - Adventures in a New World (2007).
 3. 482 U.S.220 (1987).

II. PROPERTY RIGHTS, THE RULE OF LAW AND COMPULSORY ARBITRATION

While it is true, as Chairman Greenspan observes, that "Few developing countries protect the property rights of even their own citizens as we do the property rights of foreigners,"⁴ the U.S. system of protecting the property rights of investors in its own capital markets is seriously deficient.⁵ This is surprising given the central role of the markets in capital formation, which is the engine of economic growth in the United States and—by extension—the world. Proceeding from the myth that investors "voluntarily" elect compulsory pre-dispute arbitration, both the Congress and the Supreme Court have allowed a system of compulsory pre-dispute arbitration to first develop and then flourish in the United States without serious public debate.

As almost all FINRA member firms have compulsory pre-dispute arbitration clauses in their customer agreements, and most will not waive such clauses even upon customer request, there is little that even a determined investor can do to avoid the reach of forced arbitration.⁶

Such clauses, however attractive they may have appeared for a time to both industry firms and investors, are increasingly unwise and unsustainable for the long term. While compulsory arbitration makes sense for both investors and the industry for smaller claims in which costs will consume the total award, such practices otherwise fundamentally undermine the rule of law and the protection the law provides to property rights which, as Chairman Greenspan observes repeatedly in Chapters 12 to 17 of his book, govern the economic growth of a nation.

The following list includes some of the more important ways in which arbitration as currently practiced in the securities industry operates that are *contrary to a respect for the right to property*.

1. **NASAA Speaks Out** - With the arbitration forums having been created by the industry without participation by individual investors,

4. Page 388.

5. Chairman Greenspan is on record as generally against increased regulation in the markets. Our thesis is that compulsory arbitration and thus the limiting of individual's property rights is a form of increased regulation that benefits the industry at the expense of market efficiency.

6. See Tanya Solov, Director, Illinois Securities Department, Illinois Secretary of State, testimony on behalf of the North American Securities Administrators Association before the United States Senate Committee on the Judiciary Constitution Subcommittee, (12/12/2007).

or investor organizations such as PIABA, the process is a creature of the securities industry and beholden to it, or so it would appear to investors required to use it. Anecdotal observation is that while there is often a broker or Branch Office Manager on an arbitration panel, there is almost never an average investor. The rule of law requires at least the appearance of impartiality and, while the various industry forums have never been implicated in major scandal, their origin and current constitution invites suspicion by those required to use them. The North American Securities Administrators Association (NASAA) has endorsed the Feingold Senate bill that would legislate a requirement of choice for the investor. As these state regulators are both knowledgeable about the industry and serve as proxies for the intent of the citizens of their states, private investors have already expressed their unhappiness with such compulsory arbitration.⁷

2. **No Evolving Precedent** - Arbitration of customer disputes and its lack of publicly available, reasoned decisions lead to a lack of development of securities law and a body of decisions which constitute precedent, the basis of our legal system. The financial industry evolves quickly while the laws governing it have been frozen in time. Accordingly, both industry firms and individual investors will increasingly be unable to assess either the justness of their cause or the potential value of their claims. Cases are argued in arbitration in terms of case law and legal precepts established decades ago. As time passes, and participants employ newer investment vehicles through market innovations, the path to a proper arbitration decision will become less and less clear without the development of a body of appropriate case law. An already-existing example of this occurs in electronic trading, where concepts such as suitability are subject only to a slim body of SEC-promulgated regulatory precepts untested in any observable actions. Such disparities will grow with time. The rule of law requires a body of precedent to guide its application or, increasingly, it will not be a meaningful way to protect property rights of all market participants on both the sell and buy side (i.e. both securities firms and investors).

7. See Jill I. Gross and Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration* (2008), <http://ssrn.com/abstract=1118430>.

3. **Inherently Biased Arbitrators** - The selection of arbitrators occurs in a manner that largely precludes the possibility of a full spectrum of allowable decisions under law. A hallmark of the current FINRA arbitration procedure is the practice of making available copies to both parties of previous awards in which the arbitrator has participated, and then allowing arbitrators to be selected in a voting process. Accordingly, a large body of arbitrators "know" that they cannot award punitive damages, attorney's fees or, often, even a large award where they are otherwise appropriate without risking the appearance of having a customer bias that will cause attorneys representing industry clients to rank them lower for future panels. This tends to produce an industry bias in panels and constitutes a breach of the respect for rights to property. It is particularly unfortunate in those instances where it leaves rogue firms or rogue brokers relatively unpunished by even the standards of the most-staunch industry advocate.
4. **Bush League Decision Making** - The decision-making-by-amateurs aspect in which arbitrators – no matter how skilled they may be in securities knowledge – who appear to lack the legal or forensic skills routinely applied to decision making in the court room also undermines the arbitration system. Further, such decisions lack the possibility of appellate review, which has a prophylactic effect upon the conduct of a trial or arbitration. While arbitration as guided by a skilled chairperson is often a model of effective dispute resolution, it can and frequently does reveal amateurishness on the part of the chair or one or more members of a panel. The rule of law requires more than knowledge of the industry regulated. If it did not, we might still be turning to all manner of industry organizations for dispute resolution services as was once the case when, in the middle ages, such dispute resolution was the exclusive province of the medieval guilds. The long list of qualifications required to become an arbitrator and the financial hurdle imposed upon such individuals is a far cry from a 'jury of peers' chosen in a court of law from rolls of voters. Yet, it is the results of people taken from voter rolls that arbitration panels should replicate if arbitration results are to be seen to be as fair as jury trials.

This is only a sampling of the reasons why those compelled to arbitrate may in practice experience a diminution in the protection of their property rights. No better example of the loss of property rights through a failure of the rule of law exists than in that body of judicial decisions holding that arbitration decisions do not even have

to be legally correct. In this regard, the standard for review on a motion to vacate when trying to overturn an arbitration award is almost an insurmountable hurdle which has recently been added to by the decision of a Supreme Court holding that even manifest disregard for the law is not a stand-alone basis for overturning an arbitration award.⁸

From this perspective it is also possible to see the fallacy of seeking to justify compulsory pre-dispute arbitration on the basis that the average of awards in arbitration equals the average awarded in comparable court cases. We doubt this proposition is correct factually but even if true it is misguided.⁹ As Chairman Greenspan points out,¹⁰ a lack of legal certainty undermines the rule of law. Fairness in both the reality and appearance of awards is required if property rights are to be respected.

The force of these arguments may initially lack persuasion to industry members who look on the many benefits of arbitration for them alone – smaller awards, usual confidentiality of both discovery and arbitration results, relative lack of exposure to punitive awards or attorney's fees though provided for by law. – until the day when the lack of legal certainty and the inability to subsequently overturn even huge wrongful awards against industry members drives home the point relative to the benefits of the rule of law. Presumably as a hedge against this possibility, arbitration agreements routinely preclude bringing class actions in arbitration although the logic supporting compulsory pre-dispute arbitration dictates that it should apply to them as well – the agreements of all class members are equally “voluntary”.

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8. Hall Street Associates, L.L.C. v. Mattel, Inc., 128 S. Ct. 1396 (2008). This recent Supreme Court decision indicates that “manifest disregard” of the law as a basis of judicial review is simply a shorthand for the well-known basis appearing in the Federal Arbitration Act (FAA), 9 U.S.C. Sections 10 and 11, and not the basis for expanded review. Alternately, if an expanded basis for review under Wilko v. Swan, 346 U.S. 427, 74 S. Ct. 182, 98 L. Ed. 168 based on manifest disregard did once exist, it is now overturned. While the court intriguingly suggests that “the FAA is not the only way into court for parties wanting review of arbitration awards”, the authors have seen little previous sympathy by the court for numerous petitioners who have sought such routes including various state law or common law approaches “where judicial review of (a) different scope is arguable.”
 9. O’Neal and Solin, *id.* As indicated previously, the decline in the size of arbitration awards documented by these authors has almost surely resulted in average arbitration awards falling below what might have been achieved in a courtroom setting.
 10. Page 332.

III. PATH DEPENDENCE, CAVEAT EMPTOR, REGULATORY AGENCY CAPTURE AND THE APPROPRIATE ROLE OF THE LAWYER IN THE DEFENSE OF PROPERTY RIGHTS AND THE RULE OF LAW

What investor protection exists today has been achieved against a background of *caveat emptor* (buyer beware). As such, our legal framework and regulatory structure exhibit path dependence which implicitly requires the attorney, in seeking to vindicate the rights of his client, in the eyes of both the industry and the public, to defend his position in the process and the actions he has taken. As costly as prior litigation may once have been to the securities industry, the attorney plays an essential role in the vindication of property rights through seeking to enforce the rule of law. If Chairman Greenspan is right in his thesis that it has been the rule of law that has facilitated the great growth in the American economy, then surely this would not have occurred without the participation of the lawyer.¹¹

While regulation and regulators have their role, regulation and regulatory agencies have too often been subject to "agency capture" and do not in general represent a resource to which the individual investor can turn for detection and rectification of fraud.¹² Self regulation can suffer from the same limitations and in an amplified fashion. Agency capture is a concept first developed in economics and since embraced in regulatory legal decisions. To summarize the concept, agencies formed to protect consumers and smaller interests who have less of a voice in

11. See particularly chapters 12 to 17 of Greenspan's book.

12. Greenspan at 375. A counter example occurs in the futures industry where the Commodity Futures Trading Commission (CFTC) administers reparations procedures as part of a three-way dispute resolution process allowing the disgruntled investor to select from among reparations, arbitration before the National Futures Association (or the American Arbitration Association) and Federal Court. The reparations process is conducted by a CFTC administrative law judge. However, the Wall Street Journal reported on December 13, 2000 that one administrative law judge, Bruce Levine, had never ruled in favor of an investor in eight years at the CFTC. While the presumptive bias against investors was moderated by initiation of settlement procedures between parties by Judge Levine's clerk who one author (RWC) personally observed produce an excellent settlement for a deserving claimant, the failure of the CFTC to take action relative to an administrative law judge who failed to rule for an investor in nearly 180 cases is deeply disturbing. "Agency capture" is a term that hardly does justice in this situation and would appear to underlie a much more deeply-rooted bias against futures investors within the commission that must go beyond mere appearance.

public policy are often ultimately 'captured' by the industry the agency was designed to regulate. The reason this occurs is that, once the initial focus upon the wrongs that led to the creation of the agency has become history, the greater resources of the industry (and thus its influence on the regulatory agency) allow the industry to control and manipulate the very agency designed to regulate it and safeguard the public. Many argue that the S.E.C. and FINRA are captured agencies.¹³

The history of our financial markets is one of *caveat emptor*. Every attack on this principle has been met with shrill warnings that changes to the status quo will endanger the efficiency of markets and, thus, our privileged way of life that derives from our economic system.¹⁴ Reality is the exact opposite. With each measure of increased accountability and transparency has come a commensurate increase in market efficiency. History is our teacher on that score.

For example, the first request by a stock exchange for information regarding earnings, assets and liabilities was rejected by corporate management in 1825 as a threat to competition within the securities

13. Two recent articles in The New York Times provide excellent examples of agency capture at the S.E.C., which is directly related to the current financial meltdown in America. In the first, an action in 2004 of the five members of the Securities and Exchange Commission led to what has been called the most serious financial crisis since the 1930s is detailed. Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. Times, Oct. 2, 2008. In approving an exemption favored by the five big investment banks including Goldman Sachs which at the time was led by Henry M. Paulson, Jr. who later became US Treasury Secretary and now leads the US recovery effort, the Commission set the stage for subsequent disaster. The exemption changed the so-called "net capital rule" and allowed the banks to "unshackle billions of dollars held in reserve as a cushion against losses in their investments". *Id.* It contributed directly to excessive leveraging in mortgage-backed securities and other instruments including credit derivatives which later was responsible for the demise of Bear Stearns and Lehman Brothers, and crippled Merrill Lynch and Morgan Stanley. In the second article, the inspector general of the Commission is reported as having concluded that the Commission should "consider disciplining its director of enforcement and two supervisors" in connection with the firing of an agency lawyer for trying to interview influential Wall Street insider John J. Mack who later became the chief executive officer of Morgan Stanley. The inspector general is reported as having found evidence that "raised serious questions about the impartiality and fairness" of an investigation into possible illicit trading at a giant hedge fund. The inspector general's 191 page report adds further support to accusations of widespread S.E.C. "failing to aggressively regulate financial institutions at the heart of the subprime mortgage crisis." Walt Bogdanich, *Impartiality of S.E.C. Is Questioned*, N.Y. Times, Oct. 7, 2008.

14. B. Mark Smith, Toward Rational Exuberance: The Evolution of the Modern Stock Market (2001).

industry. Until 1869, a company could issue shares at will without disclosing the total number issued. The Securities and Exchange Act of 1934 abolished stock pools, insider trading and deliberate disinformation, all designed to fraudulently manipulate stock prices. This legislation was met with a boycott of the capital markets wherein underwriters refused to issue new stocks.

The President of the New York Stock Exchange – an individual later imprisoned for his acts – proclaimed that “the nation’s securities markets would dry up”.¹⁵ This position had been clearly articulated years earlier by *Barron’s Financial Weekly*, which argued that short term manipulation of stock prices was not a concern to long term investors. Even the creation of the Federal Reserve in 1914 was met with concern by market participants as interference by outsiders.

We now know that these grudging changes toward respect for individual property rights and transparency have increased market efficiency. For example, market participants justify price to earnings ratio expansion over the history of the markets to increased safety within the markets, safety created by these very reforms that were so stridently opposed.

Studies show that the individual’s efforts to protect his or her own property rights lead to a greater degree of market efficiency. “Uncertainties that stem from the arbitrary enforcement of the body of prevailing rules are reflected in higher risk and cost of capital which, in turn, inhibit economic growth.”¹⁶ Indeed, the rise of America as a haven for investors and flight capital from other countries exists only because of our respect for and enforcement of property rights.¹⁷

15. Opposition continued for four years after the creation of the S.E.C. until one of its chief protagonists, N.Y.S.E. President Richard Whitney, filed for bankruptcy and was indicted for fraud. B. Mark Smith, *id.*

16. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, What Works in Securities Law, *The Journal of Finance* Vol. 61 (2006). (Authors examine 49 countries and “find little evidence that public enforcement benefits stock markets, but strong evidence that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock markets.” *Id.*)

17. “Market transactions are inhibited if we cannot trust the reliability of counterparties’ information. The ability to rely on the word of a stranger is integral to any sophisticated economy. ...To be sure, the history of business is strewn with Fisks, Goulds, and numerous others treading on, or over, the edge of legality. But they were a distinct minority. If the situation had been otherwise, the United States at the end of the nineteenth century would never have been poised to displace Great Britain as the world’s leading economy.” Alan Greenspan, speech at the 2004 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia, April 16, 2004.

Financial markets are too dynamic to be effectively regulated to avoid all future crises. Regulation usually is sufficient only to prevent future crisis of the same type being specifically targeted for regulation, and even that is not certain. Regulation cannot anticipate and reliably deal with future innovations that might threaten the economic system.

For every threat created to the economic system, there are third parties who are at risk. Empowering these third parties to protect themselves by respecting their property rights via litigation should be part of any system designed to help to avoid future economic dislocations. So long as third parties are not restricted in their ability to adapt to threats to their property, they are able to be more vigilant of financial innovation, and thereby strengthen and promote it.

For example, in the current sub-prime mortgage crisis where lending institutions acted as if mortgagee credit worthiness was no longer an issue, investment banks were comfortable bundling suspect mortgages into securities because the recourse of the private investors was limited by rules against aiding and abetting liability, by compulsory arbitration and by the total lack of ability to fix personal responsibility on the actions of individual investment bank personnel. This is also illustrated by the analyst scandal associated with the last stock market crash of 2000 where, under the system of securities law enforcement now in place, relatively few investors ever received compensation for the conduct of Jack Grubman at Citibank/Salomon Smith Barney and Henry Blodgett at Merrill Lynch. Indeed, Blodgett remains active in the industry. Arbitration was no remedy.

How can the great players in the securities industry be expected to obey the law when, because of compulsory arbitration and other favorable laws that serve to regulate markets for the advantage of the industry, they have largely been exempted from it? Often it is the small investor bringing his claim in a court of law that serves as the early warning system of wide-spread wrong-doing.

Current economic problems are typical of those problems of the past. The solution is reflected in the history of the markets. Increased transparency, sensible regulation and the ability of the individual investor to enforce his or her property rights in a court of law are important parts of any solution to preventing future economic problems.

IV. THE FUTURE

The role of the lawyer in the defense of property rights and the rule of law remain essential, and our discussion on compulsory arbitration and

its limitations is seen to be a discussion about the nature of the forums available to the lawyer in seeking to vindicate the property rights of clients. Once these rights were enforced through a court system, and it was in part a failure of that court system that put the securities industry on the path of compulsory arbitration.¹⁸ Had improvements in the courts been undertaken (including, say, a Federal Small Claims Court with simplified and quicker procedures where there was diversity and amounts between \$75,000 and perhaps \$2,000,000 in dispute), the compulsory pre-dispute arbitration system of today might never have come into existence. But accepting that it may be desirable to live with a truly voluntary arbitration system in the future, what can be said about attainable improvements?

Contrary to earlier critical comments, if conducted properly, arbitration of securities disputes does have a number of distinct advantages that exist for both the investor and the securities firm.

1. **Expeditious** - It is relatively quick, and is becoming quicker now that the cases generated by the market decline of 2000 - 2002 have largely passed through the system. And if FINRA gets its way to provide for a single arbitrator for cases up to \$100,000, that will speed up the process.
2. **Less Expensive** - It is usually inexpensive or at least less expensive than going to court, particularly when the complexity of the dispute requires no more than a limited number of days of arbitration.¹⁹
3. **Confidential** - It permits a greater degree of confidentiality for both clients and firms who do not wish client losses and other confidential records (including asset records and tax returns) to become public.

However, these advantages are largely mitigated by the disadvantages created in the current arbitration system. A major failure of the arbitration system arises because of its compulsory nature and the way in which it has choked off the development of securities law with its consequent erosion of the rule of law generally. While we do not wish to indicate what system would better replace it, we do look with favor on

18. As part of their decision-making process in *Shearson* the justices of the Supreme Court apparently considered the impact of the workload on the Federal Courts. See Dissent of Justice Blackmun, *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987).

19. O'Neal and Solin, *id.* Panel fees ultimately act as a brake on the cost effectiveness of FINRA arbitration.

the CFTC system, in which the client is offered a pre-dispute *choice* between arbitration and going to the courts as one alternative.²⁰

While we are mindful that the choice between arbitration and court was available before Shearson and that few investors selected arbitration, we feel that the circumstances are different today and that steps exist which the industry might take that would result in many more investors selecting arbitration *if given a free choice*. Group behavior is path dependent and the existence of a number of well-honed arbitration mechanisms and a skilled body of arbitration practitioners (that exist within PIABA and the Compliance and Legal Division of the SIFMA) would help assure the continuity of arbitration for years to come, particularly given the benefits of speed, cost and confidentiality. As a further benefit, any such free choice system would still have some investors selecting the court approach, which would allow for independent case law development.

One proposal for increased fairness in arbitration would be if arbitration panels were instructed that violations of a Notice to Members (NTM) provides a basis for strict liability and that once determined to exist, damages are appropriate. Today, the industry is fond of noting in its Answers to Statement of Claims that violations of NTMs are not a basis for relief. NTMs regarding suitability are of limited usefulness if, at arbitration hearings, industry lawyers are free to argue that NTMs have no import and that, say, Modern Portfolio Theory is just a theory and not for everyone in spite of instruction from regulators on the point. This last sentiment, which is often heard at arbitration where lack of proper diversification is an issue, is particularly unfortunate since the foundation of investing is Modern Portfolio Theory which was developed in 1952 by Dr. Harry Markowitz, for which he won the Nobel Prize. Modern Portfolio Theory is not new, and it is widely accepted as accurate.

To strengthen the appeal of arbitration in a truly-voluntary environment, the current system should be strengthened by establishing a pool of funds to assure that those who successfully prosecute their claims to an award would be paid irrespective of the financial viability of the firm against which an award is made. By giving arbitration such a distinct advantage over litigation—where litigants often see victory unmatched with corresponding compensation—the securities industry could take a significant step toward increasing the attractiveness of its

20. The choice is actually three-way as the client may also select Reparations, as discussed in an earlier footnote.

forum.²¹ Alternatives include requiring firms to carry appropriate insurance (that covers intentional wrongdoing by officers and employees and not just negligence), and/or to have higher minimum capital reserves. Firms with fraudulent intent who are subject to repeated claims should be squeezed out of business as quickly as possible.

In addition, reform in arbitrator selection procedures—to remove selection bias—is needed. This should be matched by further efforts to improve the quality of arbitration pools in order to improve the attractiveness of arbitration. The latter has been an industry focus in recent years and is much needed. We see no solution to the problems of arbitrator selection mentioned earlier than the random selection of arbitrators from a pool of truly neutral individuals operating without allegiance to the industry. Some have suggested that public arbitrators for arbitration panels be selected from voter rolls, much as current grand jury pools are constituted. They certainly need to be paid better, and compensated for study time so that they come to the hearing prepared.

Along with these more obvious changes, arbitration forums should experiment with other potential reforms to generate further improvements. Now that the various securities arbitration forums are no longer choked with cases, experiments should be made in such areas as reasoned awards and partial appeal rights in cases where one party or another feels at the outset that such procedures are necessary. Lastly, the investor and his attorney need to be brought into the rule-making process for arbitration.

So the task before us should entail a dual approach which embodies the right of the investor to freely select, or freely reject, arbitration in an atmosphere that provides for quick, efficient dispute resolution by arbitration with as much potential certainty as such a forum can provide — all with the objective of enforcing property rights in an effective manner. By such action, an improved dispute resolution system for the Twenty-First Century will result. It will benefit the investor and the industry alike and, by maximizing the growth potential of the securities industry through further development of the rule of law, it will improve the American economy as a whole.

Making arbitration a choice will serve to pressure FINRA to evolve still further. By creating an incentive to make arbitration more desirable to the public investor, it will spur innovation that satisfies the interests of

21. See U.S. General Accounting Office, Rep. No. 66D-00-115, Securities Arbitration: Actions Needed to Address Problems of Unpaid Awards (2000).

the small investor, the employees of the securities industry and the industry as a whole.

V. MARKET EFFICIENCY

Ultimately, the goal of the markets is to deploy capital efficiently. It is this efficiency that drives the economic engine of capitalism. Regulations designed to benefit the industry and insulate it from liability do not create free markets. Rather, regulated markets with an industry bias cause the inefficient deployment of capital. When individuals cannot vindicate their property rights through efficient and fair dispute resolution, it is the market itself that ultimately loses efficiency. An *inefficient* industry pays the price in terms of lower gains. This is a clear lesson of history.

Every dollar lost or inefficiently deployed due to poor investment advice, irrational exuberance or through fraud is a dollar that is unavailable for sound investment in our economic system. Such wasted capital is a form of nutrient that is not being placed on the plant that could grow in our economic garden and mature into a fruit-bearing tree, but rather, it is a nutrient that is being wasted. If so much money had not been poorly deployed in the analyst debacle of the late 1990s and the subprime markets situation today, our economy would not now be headed to potential recession, or worse.

The inability of investors to effectively enforce property rights through some more efficient mechanism, whether it be through litigation, arbitration, binding mediation through a truly neutral third party or administrative law judge, leads to market inefficiency, which is detrimental to the health of our economic system. In the short run, market inefficiencies benefit only those few who encourage them while in the long run they are harmful to the American economy, as Chairman Greenspan so perceptively notes.

NOTES



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