2014

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Stephen Choi
NYU Law School

Jill E. Fisch
University of Pennsylvania Carey Law School

Adam C. Pritchard
University of Michigan - Ann Arbor

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Stephen J. Choi, Jill E. Fisch, & A.C. Pritchard[*]

ABSTRACT

We study the role of arbitrator background in securities arbitration. We find that arbitrator background is correlated with arbitration outcomes. Specifically, industry experience, prior experience as a regulator, and status as a professional arbitrator are correlated with statistically significant differences in arbitration awards. We find that the impact of these characteristics is affected by whether the arbitrator in question serves as the panel chair and by whether the parties to the arbitration are represented by counsel.

Our findings offer some preliminary insights into the debate over arbitrator bias. On the one hand, they suggest that the party selection process is relatively effective in screening for potential bias. FINRA has imposed increasingly more rigorous qualification requirements, specifically with respect to the independence of public arbitrators, but our study suggests that these requirements are unlikely to affect outcomes in most cases. On the other hand, party selection appears to be most effective when the parties are represented by counsel. Our findings highlight the importance of legal representation in the arbitration process.

[*] STEPHEN J. CHOI is the Murray and Kathleen Bring Professor of Law, New York University, JILL E. FISCH is the Perry Golkin Professor of Law, University of Pennsylvania, and A.C. PRITCHARD is the Frances and George Skestos Professor of Law, University of Michigan. The authors thank numerous individuals who assisted us in collecting the background information on arbitrators for our analysis.

1. INTRODUCTION

On January 10, 2012, the Carlyle Group filed a registration statement with the SEC in connection with an initial public offering of limited partnership interests. The form S-1 disclosed that the partnership agreement would contain provisions requiring investors to resolve any disputes through individual arbitration rather than litigation. Carlyle's filing generated a substantial and largely critical media response, with critics arguing that Carlyle's actions were designed to strip shareholders of important rights.[1] The SEC had previously refused to allow companies to issue publicly traded securities if they required arbitration to resolve shareholder disputes but, in the last two decades, courts and commentators have become more receptive to arbitration as a substitute for litigation. In addition to claiming that litigation is "spinning out of control," defenders of arbitration argue that it is cheaper, faster, and eliminates the lawyer-driven abuses associated with the class action.

Carlyle retreated from its effort to test the legality of mandatory arbitration for shareholder suits. In the context of broker-customer disputes, however, mandatory arbitration has long been the norm. In the late 1980s, the Supreme Court upheld mandatory arbitration provisions in brokerage customer agreements,[2] and mandatory arbitration has been a standard term in such agreements ever since. As a result, the

[1] See, e.g., Carlyle Curbing Shareholder Rights Irritates Lawmakers Who See Precedent
By Miles Weiss - Jan 26, 2012 (quoting U.S. Senator Richard Blumenthal as stating that "The SEC should reject this effort to circumvent shareholder rights because it will be an extraordinary and enduring precedent").

[2] Shearson/American Express v. McMahon, 482 U.S. 220 (1987); Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

overwhelming majority of broker-customer disputes, even those involving substantial sums, are resolved through arbitration.[3]

Brokerage customer arbitration takes place largely behind the closed doors of the Financial Industry Regulatory Association (FINRA).[4] Unlike judicial proceedings, FINRA arbitrations are not open to the public. Although FINRA releases the written decisions issued after arbitration hearings, it does not disclose the details of the claims filed or background information on the arbitrators who issue these decisions. Moreover, FINRA arbitration rules require the arbitrators to announce only bare-bones information in their awards.[5] Notably, an explanation of the reasons for the arbitrators' decision is not required unless such an explanation is jointly requested by all the parties.[6] The result is a process with limited transparency.

The absence of detailed case-specific information creates challenges for empirical research, making evaluation of arbitration's effectiveness in protecting investors' rights exceedingly difficult. Nonetheless, as commentators debate the relative merits of arbitration versus litigation, the need for tools to assess the arbitration process becomes apparent. Significant issues remain, including the selection of arbitrators and structuring of arbitration panels to limit the potential for bias, and improving the reliability of arbitration awards.

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[3] See, e.g., STMicroelectronics, N.V. v. Credit Suisse Sec. (USA) LLC, 648 F.3d 68 (2d Cir. 2011) (upholding trial court's confirmation of $400 million arbitration award).

[4] "FINRA is a private corporation that succeeded the National Association of Securities Dealers and the enforcement divisions of the New York Stock Exchange as the self-regulatory organization for the securities industry." Wachovia Securities LLC v. Brand, __ F.3d __ (4th Cir. 2012). FINRA handles arbitration of both broker-customer disputes and disputes between FINRA member firms and their employees. This article only analyzes arbitration that result from disputes between brokers and their customers.

[5] Code of Customer Arbitration, Rule 12904 (e). Awards (designating information required in an arbitration award).

[6] Rule 12904(g) Explained Decisions.

FINRA has been particularly sensitive to concerns about potential arbitrator bias. Over the past eight years, FINRA has changed the arbitrator selection process, enhanced the independence requirements for public arbitrators, and increased the opportunity for customers to bring their disputes before all-public panels.

Further refinements to that process require a better understanding of the effects of arbitrator and case-specific differences on arbitration outcomes. This project examines one such difference – arbitrator background – as well as the effect that legal representation has on that difference. To explore the role of arbitrator background in securities arbitration, we analyze a dataset of randomly selected arbitration awards from 1998 to 2000. We hand collect data on particular arbitrator background characteristics – people who serve as professional arbitrators, people with prior securities experience, prior regulators and retired arbitrators. We explore whether the presence of arbitrators with these characteristics affects the size of arbitration awards and the extent to which the impact is affected by whether the arbitrator with these characteristics serves as the panel chair. We also examine the extent to which the impact is affected by legal representation of the parties.

We proceed as follows. We lay out the background on the arbitrability of securities claims, FINRA arbitration procedures and survey prior literature in Part 2. Part 3 sets forth our hypotheses. Part 4 describes our sample and variables, and reports the results of our empirical tests. Part 5 concludes.

2. BACKGROUND

2.1. Legal Status of Customer Arbitration

At one time, the Supreme Court was suspicious of contracts that required customers to submit disputes to arbitration. In *Wilko v. Swan*,[7] the Supreme Court held that suits under the Securities Act of 1933 were not subject to mandatory arbitration. As the Court later explained, *Wilko* "reflect[ed] a general suspicion of the desirability of arbitration and the competence of arbitral tribunals."[8] Many lower courts, applying similar reasoning, extended *Wilko* to other securities claims, including litigation pursuant to § 10(b) of the Securities Exchange Act.[9]

In the late 1980s, the Supreme Court reversed its position. In *Shearson/American Express v. McMahon*, the Court held that the Federal Arbitration Act reflected a "federal policy favoring arbitration."[10] Specifically, the Court held that arbitral forums were fully capable of resolving securities fraud disputes[11] and that the "the mistrust of arbitration that formed the basis for the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time."[12] Two years later, in *Rodrigues de Quijas v. Shearson/American Express, Inc*., the Supreme Court explicitly overruled *Wilko* and held that pre-dispute arbitration agreement would be upheld, even with respect to claims arising under the Securities Act of 1933.[13] Subsequently, the Supreme Court has emphasized its approval of arbitration as an alternative to litigation,

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[7] 346 U.S. 427 (1953).
[8] Shearson/American Express v. McMahon, 482 U.S. 220 (1987).
[9] See, e.g., Allegaert v. Perot, 548 F.2d 432 (CA2), cert. denied, 432 U.S. 910 (1977).
[10] Shearson/American Express v. McMahon, 482 U.S. at 226, quoting *Moses H. Cone Memorial Hospital v. Mercury Construction Corp*., 460 U.S. 1, 24 (1983).
[11] The Court based its holding, in part, on the fact that "the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights." 482 U.S. at 233-34. The extent to which the SEC has exercised that authority to oversee the fairness of customer arbitration procedures is unclear.
[12] 482 U.S. at 233.
[13] 490 U.S. 477 (1989).

stating that arbitration produces “lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes.”[14]

The Supreme Court’s expansive reading of the FAA and its approval of alternative dispute resolution have resulted in a deferential approach to judicial review of arbitration awards. Under the Court’s interpretation of the FAA, courts are not permitted to overturn arbitration awards on the basis that the arbitrators misinterpreted or applied applicable law.[15] Although traditionally the courts have granted motions to vacate arbitration awards in which the arbitrators were found to have manifestly disregarded the law, the Supreme Court’s most recent decisions on the doctrine of “manifest disregard” suggest that this language is merely a “judicial gloss” on the explicit statutory grounds for vacatur set out in the FAA.[16] Lower courts have read this Supreme Court precedent as holding that the statutory grounds for vacating or modifying an arbitration award are exclusive.[17]

These legal standards limit the extent to which courts can exercise effective oversight over the potential for bias in arbitration procedures. Under § 10(a) of the FAA, a court can vacate a decision on the basis of “evident partiality” or “other misbehavior”

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[14] 559 U.S., at ___, 130 S. Ct. 1758, 1776). See also Hall Street Assocs. v. Mattel, Inc., 552 U.S. 576, 581 (2008) (stating that the FAA reflects a “comprehensive scheme to replace judicial hostility to arbitration with a national policy favoring it.”). The Court recently held that California’s prohibition of class action waivers was preempted by the Federal Arbitration Act. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2010).

[15] See, e.g., United Paperworkers Int’l Union v. Misco, Inc., 484 U.S. 29, 38 (1987).

[16] The primary such authority is contained in FAA § 10(a)(3) which allows courts to vacate arbitration awards only "where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the
controversy; or of any other misbehavior by which the rights arbitral proceedings is itself desirable, reducing the cost and increasing the speed of dispute resolution." See Stolt-Nielsen at n. 3 (“We do not decide whether “‘manifest disregard’” survives our decision in Hall Street Associates, L.L.C. v. Mattel, Inc., 552 U.S. 576, 585, 128 S. Ct. 1396, 170 L. Ed. 2d 254 (2008), as an independent ground for review or as a judicial gloss on the enumerated grounds for vacatur set forth at 9 U.S.C. § 10”)

[17] See, e.g., Citigroup Global Mkts., Inc. v. Bacon, 562 F.3d 349, 358 (5th Cir. 2009); Frazier v. CitiFinancial Corp., 604 F.3d 1313, 1323-24 (11th Cir. 2010) (holding that the common law standards for vacatur are, therefore, no longer valid).

of the arbitrators.[18] Courts have interpreted evident partiality as involving a relationship with an arbitrator, a lawyer or a party[19] rather than an arbitrator's predisposition or general views about the law or the industry.[20] In addition, courts have rejected the argument that an arbitrator's position or experience within the industry is sufficient to meet the legal standard of bias,[21] even if that position might present the appearance of bias.[22] Moreover, to the extent that the arbitrators disclose any potential biases or conflicts, or relationships that create the potential for bias, such disclosure insulates the award from subsequent challenge in that a party can respond to the disclosure by striking the arbitrator or seeking his or her removal from the panel.[23]

2.2 FINRA Procedures

Arbitrators in FINRA customer arbitrations are chosen through a party selection system. In 1999-2000, the time period from which our sample is chosen, customer claims for more than $50,000 were resolved by a three-arbitrator panels.[24] FINRA rules specified that the panels were to consist of two "public" arbitrators and one "industry" arbitrator. FINRA does not impose limits on the background of industry arbitrators, and they generally include current and former brokers, bankers and other professionals in the

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[18] Cite statute and STMicroelectronics.
[19] STMicroelectronics at 74. See Positive Software Solutions, Inc. v. New Century Mortg. Corp., 476 F.3d 278 (analyzing nature of relationships that might require vacatur of arbitration award for partiality).
[20] See, e.g., Repub. Party of Minn. v. White, 536 U.S. 765, 777, 122 S. Ct. 2528, 153 L. Ed. 2d 694 (2002) ("A judge's lack of predisposition regarding the relevant legal issues in a case has never been thought a necessary component of equal justice ….").
[21] See also Positive Software Solutions, Inc. v. New Century Mortg. Corp., 476 F.3d 278 (noting that "the best lawyers and professionals . . . normally have the longest lists of potential connections to disclose").
[22] STMicroelectronics. See also Owen-Williams v. BB&T Inv. Servs., 717 F. Supp. 2d 1 (DDC 2010) (citations omitted) ("'It is well established that a mere appearance of bias is insufficient to demonstrate evident partiality.'").
[23] See, e.g., Cortina v. Citigroup Global Mkts., Inc., 2011 U.S. Dist. LEXIS 92954, 17-18 (S.D. Cal. Aug. 19, 2011) ("Because the arbitrator disclosed prior to the hearing the facts Petitioner contends give the impression of bias, his request to vacate the award based on non-disclosure is denied.").
[24] FINRA has now raised this limit to $100,000. FINRA Regulatory Notice 09-13 (2009).

securities industry.[25] Public arbitrators, also known as "neutrals" are supposed to lack substantial industry ties, and FINRA rules disqualify various professionals from serving as public arbitrators on the basis of ties that include current and former employment relationships, a close relative who works in the securities industry, and, for lawyers, substantial representation of industry clients.[26]

Since November 1998, arbitrators for FINRA arbitrations have been chosen through a list selection system administered by the Director of Dispute Resolution, termed the Neutral List Selection System (or NLSS).[27] During most of the time period involved in our study, the National Association of Securities Dealers (NASD)[28] provided the parties in each case with two separate lists, one consisting of public arbitrators and the other consisting of non-public arbitrators, in a roughly two-to-one ratio.[29] The lists were generated by an NASD computer program using a rotational method, although the computer eliminated arbitrators with obvious conflicts of interest. Along with the lists, the parties were also provided with background information on each arbitrator, including

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[25] FINRA Rule 10308. Selection of Arbitrators, (4) "non-public arbitrator"

[26] FINRA Rule 10308. Selection of Arbitrators, (5) "public arbitrator." See also SEC, Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator, Sec. Exch. Act. Rel. No. 54792 (March 19, 2008).

[27] The NASD's Neutral List Selection System (NLSS) went into effect on November 17, 1998. The NLSS was proposed by the NASD Arbitration Policy Task Force as part of its 1996 Securities Arbitration Reform Report and modeled after the list selection system used by the American Arbitration Association. The report recommended that panels for larger cases continue to be composed of one industry member and two public arbitrators. The report recommended improving the quality of arbitrators by increased arbitrator compensation, better training, expanding the arbitrator pool and requiring arbitrator evaluation of co-panelists. The report also made some highly controversial recommendations concerning the availability of punitive damages in arbitration awards.

[28] The NASD was the predecessor to FINRA. Prior to the merger, approximately 90% of securities arbitrations were handled by the NASD; the remainder were arbitrated through the New York Stock Exchange arbitration program.

[29] Under FINRA's current selection procedure, FINRA provides the parties in a customer dispute with three sets of names. One set is a list of potential public arbitrators, the second is a list of industry arbitrators, and the third is a list of chair-eligible arbitrators.

a copy of that arbitrator's Arbitrator Disclosure Report.[30] FINRA rules then allowed parties to strike, without cause, prospective panelists until they reached agreement on a panel.

The position of panel chair has received particular attention. The chair exercises greater control over the arbitration process than the other panelists, often being the one to decide motions, discovery issues, evidentiary questions, etc.[31] FINRA itself has stated that "chairpersons . . . play a vital role in the administration of cases."[32] At the time of our study, arbitration chairs were merely required to qualify as public arbitrators.[33] FINRA has subsequently tightened its requirements for an arbitrator to qualify to serve as a panel chair.[34]

An ongoing issue in FINRA arbitrations concerns the appropriate extent to which arbitrators should have securities industry background. On the one hand, more knowledgeable arbitrators are likely to produce more accurate awards. Broker-customer disputes frequently involve technical issues in which familiarity with industry practices is valuable. Securities expertise enables an arbitrator to understand the nature of the claims better.[35] As some courts have noted, "[t]he most sought-after" arbitrators "are those who are prominent and experienced members of the specific business community in which the

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[30] See STMicroelectronics (describing selection process and disclosure Arbitrator Disclosure Reports). Parties were allowed to request additional information on the arbitrators, and the NASD director was required to forward that request to the arbitrators, although the arbitrators were not required to respond.

[31] See Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 Thereto To Amend NASD Arbitration Rules for Customer Disputes, Sec. Exch. Act Rel. No. 51856 (June 15, 2005), 70 FR 36442, 36445 (June 23, 2005).

[32] Id.

[33] Choi, Fisch & Pritchard, supra at _ (explaining that FINRA would designate as chair the public arbitrator that received the higher combined ranking from the parties).

[34] Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 Thereto To Amend NASD Arbitration Rules for Customer Disputes, Sec. Exch. Act Rel. No. 51856 (June 15, 2005), 70 FR 36442, 36445 (June 23, 2005).

[35] See Bondi (defending expertise of FINRA arbitrators).

dispute to be arbitrated arose."[36] On the other hand, an arbitrator's connections to the industry – those same connections that may furnish expertise – may also lead to claims that the arbitrator is biased.[37] Of particular concern is the possibility that arbitrators with industry ties will be predisposed against claimants. FINRA has recently responded to these concerns by offering parties in customer arbitrations the option of all-public panels.[38]

2.2. Prior Literature

The literature evaluating the relative merits of arbitration versus litigation is extensive. Many commentators argue that arbitration provides faster dispute resolution at a lower cost than litigation. Some commentators have specifically advocated substitution of arbitration for litigation in an increasing range of securities disputes, along the lines of the Carlyle proposal.[39]

The extent to which arbitration raises fairness considerations, particularly in cases between a retail investor or consumer and a business defendant, has been widely debated. Several empirical studies have examined arbitration results in the consumer and employment context.[40] In addition, a few articles specifically study the FINRA arbitration process.[41] Among the challenges faced by these studies is the absence of a

[36] International Produce v. A/S Rosshavet, 638 F.2d 548 (2d Cir. 1981).
[37] FINRA has imposed increasing restrictions on the extent to which public arbitrators can have ties to the securities industry.
[38] See STMicroelectronics at n.5 (describing concerns about pro-industry bias and FINRA's response of offering all-public panels). Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes (offering customers the option to choose an all-public panel in all cases).
[39] See, e.g., Bradley J. Bondi, Facilitating Economic Recovery & Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation, 33 Harv. J. L. & Pub. Pol'y 607, 630-31 (2010).
[40] Cite to our prior paper (summarizing the literature).
[41] Id.

baseline. Arbitration decisions rarely report details of the underlying claim, providing researchers with little basis for assessing case merits.[42] As a result, the studies rely largely on survey data examining the extent to which arbitration participants report satisfaction with the system.[43]

Two recent studies report a trend toward less favorable decisions for claimants. Kondo finds that, since the adoption of the party selection by FINRA, selection of pro-industry arbitrators has increased, and selection of arbitrators based on their expertise has declined.[44] Schultz finds a declining trend in the frequency with which customers prevail.[45] On the other hand, Choi and Eisenberg find that arbitrators award punitive damages in a non-trivial percentage of cases, and that such awards appear to be correlated both with compensatory damages and more serious allegations of misconduct.[46]

To the extent that a trend against claimants exists, it may be due to the advantage that brokerage firms have, as repeat players, in securities arbitrations.[47] This advantage includes both the ability to screen potential arbitrators effectively and the ability to discipline arbitrators who rule against defendants by refusing to select them in subsequent

[42] Arbitrators are not required by FINRA rules to provide an explanation of the basis for their award unless such an explanation is requested by all the parties. SEC Order Approving Proposed Rule Change To Require Arbitrators To Provide an Explained Decision, Securities Act Release No. 59358, 74 Fed. Reg. 6928 (Feb. 11, 2009). Notably, arbitrators adhere to the conventional silence even in large cases involving institutional claimants. See, e.g., ST Microelectronics v. Credit Suisse, 2009 FINRA Arb. LEXIS 112 (omitting any explanation of the basis for $431 million award, the largest in the history of FINRA arbitration).

[43] See, e.g., Jill Gross & Barbara Black, When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration, 2008 J. Disp. Resol. 349 (2008).

[44] Kondo, Jiro E. 2009. The Self-Regulation of Enforcement: Evidence from Investor-Broker Disputes at the NASD. Working paper. Northwestern University, Kellogg School of Management, Evanston, Ill. http://www.kellogg.northwestern.edu/faculty/kondo/public/k1_paper_f09.pdf.

[45] Schultz, Lawrence S. 2008. Storm Clouds in Arbitration. Pp. 351-93 in Securities Arbitration 2008: Evolving and Improving, edited by David E. Robbins. New York: Practising Law Institute.

[46] Choi and Eisenberg, 39 J. Legal Stud. 497

[47] Colvin, 8 J. Emp. Leg. Stud. 1 (2011) (reporting strong evidence of repeat player advantage in employment arbitration) .

cases.[48] Klement and Neeman model the potential that arbitrators will bias their decisions in a private party selection system in order to increase the likelihood that they will be selected in the future.[49] We explore this possibility below.

Congress has considered statutory changes to restrict the use of pre-dispute arbitration clauses. In the proposed Arbitration Fairness Act of 2009, Congress considered banning pre-dispute agreements to arbitrate various types of customer and employment disputes.[50] Although the language was unclear, some commentators suggested that it would have covered customer securities claims.[51] More recently, the Dodd-Frank Act of 2010 authorizes (but does not require) the Securities and Exchange Commission to limit or prohibit agreements requiring customers of any broker or dealer to arbitrate future disputes arising under federal securities laws.[52] Some commentators have warned that such action would harm retail investors because of the limited private judicial remedies provided by federal law in broker-customer disputes.[53]

3. HYPOTHESES

H1: Arbitrators with connections to the securities industry will make smaller awards. This effect will disappear if the claimant is represented by counsel.

H2: Professional arbitrators will make smaller awards. This effect will disappear if the claimant represented by counsel.

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[48] Public Citizen, The Arbitration Trap: How Credit Card Companies Ensnare Consumers (Sept. 2007), available at http://www.citizen.org/publications/publicationredirect.cfm?ID=7545.
[49] Klement, Alon and Neeman, Zvika, Private Selection and Arbitrator Impartiality (March 31, 2011). Available at SSRN: http://ssrn.com/abstract=1800026 or http://dx.doi.org/10.2139/ssrn.1800026
[50] Arbitration Fairness Act of 2009, S. 931, 111th Cong. (2009); H.R. 1020, 111th Cong. (2009).
[51] See Bondi at 634.
[52] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2d Sess. 2010).
[53] See Barbara Black, How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act, 13 Univ. Penn. J. Bus. L. 101 (2010).

H3: Retired arbitrators will make smaller awards. This effect will disappear if the claimant represented by counsel.

H4: Arbitrators with prior experience as regulators will make larger awards. This effect will disappear if the respondent is represented by counsel.

4. EMPIRICAL TESTS

4.1 Description of Dataset

We obtained NASD arbitration awards from the FINRA arbitration awards online site and from the LEXIS database. To generate a random set of arbitrators, we randomly selected 417 arbitration awards involving investor claimants for the years 1998 to 2000. We limited our sample to arbitration decisions that followed a hearing[54] and to those that involve three-person panels as opposed to a single arbitrator. We only look at arbitrations where the chair and one panel arbitrator are public arbitrators and the other panel arbitrator is an industry arbitrator. The decisions identify the members of the panel as well as indicating the arbitrator who serves as the chair of the panel.[55]

We then collected data on the background of each of the arbitrators in our sample from the arbitrator disclosure reports that we were able to obtain, which we supplemented with information from public sources such as the internet. We were able to obtain background data on approximately two-thirds of the arbitrators appearing in our arbitration sample. Table 1 reports the number of arbitration awards in our sample by year.

<<Insert Table 1 About Here>>

[54] A substantial percentage of arbitration claims are settled or resolved on the papers without a live hearing.
[55] Because of FINRA's selection procedures at the time of our study, the chairs are almost all public arbitrators. We excluded arbitrations with non-public chairs from the sample.

4.2 Variable Description

The dependent variable for our tests is the Compensation Ratio, defined as the compensatory award (or settlement if reported) divided by the requested compensation amount.[56] One potential weakness in this measure is that the claimant decides how much to request as compensation, which creates room for exaggeration. Claimants may request punitive or exemplary damages as well as damages for pain and suffering. However, these are listed separately in the arbitration award which allows us to exclude them from our measure of the compensatory damages. The compensatory damages will typically turn on the number of securities involved in a particular transaction multiplied by the losses the investor-claimant incurred on the securities. Because information on the quantity of securities traded (as well as the increase or decline in share price) is also available to the broker or brokerage firm respondent, claimants' discretion with respect to the amount sought as compensation is limited by the arbitration process.

A number of factors may affect the Compensation Ratio. To control for these factors, our models include a number of variables relating to representation, the subject matter of the dispute, selection of the dispute for arbitrator resolution, award, and state in which the arbitration occurred. A list of the variable definitions is provided in Table A1.

<<Insert Table 2 About Here>>

To control for the strength of the presentation of the case, we add indicator variables coded as 1 if the claimant is represented by counsel (Claimant Attorney) or the respondent is represented by counsel (Respondent Attorney), respectively, and 0

[56] We use Compensation Ratio rather than the absolute level of compensation awarded as our dependent variable because we lack data on the actual damages suffered by the claimants. Using the ratio rather than the raw figure mitigates the omitted variable problem.

otherwise. Better representation may lead to better outcomes. These variables may also correlate with case strength – claimants with strong cases are more likely to be able to attract an attorney to work on a contingency fee basis, while respondents with no defenses may not bother to hire counsel. In addition, the presence of an attorney may have an effect on panel selection, a topic which we explore further in our empirical tests below. Claimants were represented by counsel in 87% of the cases; respondents 82%.

Subject matter controls include indicator variables for six common areas of arbitration. Suitability is defined to equal 1 if the arbitration involved a suitability claim, including claims relating to "know your customer," NYSE Rule 405,[57] and NASD Rule 2310 issues,[58] and 0 otherwise. Other subject matter indicator variables include Churning (a churning, excessive trading, or excessive commission claim), Unauthorized Trades, Failure to Execute (a failure to buy or sell as directed), Misrepresentation, and Conversion (a claim of theft, conversion, unauthorized withdrawals, or self-dealing). The base category consists of claims involving a non-specified breach of contract or violation of fiduciary duty. Table 2 reports on the frequency of the subject matter claims in our arbitration sample. Misrepresentation (72%) and suitability (47%) claims are the most common.

We also include controls to address selection effects. Table 2 reports on the settlements in our sample. The vast majority of settlements are unreported; our sample includes a small number of settlements that are reported – typically because only some of

[57] NYSE Rule 405, the "know your customer" rule, requires member firms to use "due diligence to learn the essential facts relative to every customer [and] every order." NYSE Rule 405.

[58] NASD Rule 2310, the "suitability requirement," states that "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

the respondents have settled.[59] In those cases, the reported decision may or may not report the settlement terms. The variable Reported Settlement is defined to equal 1 where the arbitration resulted in a full or partial settlement and the settlement amount was reported as part of the arbitration award (and included therefore in the Compensation Ratio variable) and 0 otherwise. Unreported Partial Settlement is defined to equal 1 where the arbitration resulted in an unreported partial settlement and the award (if any) against the remaining non-settling respondents was reported and 0 otherwise. We expect that awards in the case of an Unreported Partial Settlement should be lower due to the settlement by a subset of the respondents. On the other hand, the partial settlement may correlate with the strength of the case.

Table 2 also provides summary statistics on our opinion controls. Opinion controls focus on characteristics of the claim that may affect the Compensation Ratio. Claimed Compensation is included because the absolute level of compensation requested may affect the Compensation Ratio awarded. Arbitrators may be less willing to grant a higher Compensation Ratio for larger Claimed Compensation amounts, all other things being equal, simply because they are reluctant to award large sums.[60] Large claims are more likely to be inflated by the claimant than small ones. Moreover, arbitrators may perceive a large award against an individual broker or small firm as posing a risk of insolvency. A Compensation Ratio of 20% for a $100,000 claim produces only a $20,000 award – the same Compensation Ratio for a claim of $100 million is likely to be more difficult to obtain. The mean Claimed Compensation for our sample is $291,000,

[59] The strength of cases that settle may be different from those that do not settle. Moreover, the claimants who settle are arguably more risk averse than those that do not, which may affect their investment decisions as well.

[60] We should note that this concern appears to be mitigated in more recent arbitrations. See newspaper article talking about the increasing size of arbitration awards.

but the median is a much more modest $90,000. The Compensation Ratio is less skewed, with a mean award of 38% of the claim and a median of 22%. To account for possible non-linearity in the relationship between Compensation Ratio and Claimed Compensation, we also include a squared term for Claimed Compensation.

We include a control variable for arbitrator experience, Inexperienced, set to one if the award is from the first year that the arbitrator appeared in the dataset, and zero otherwise. Arbitrators new to the job may be reluctant to make large awards because it may reduce their chances for future selection by brokerage firms and their attorneys – the repeat players in securities arbitrations.

As an additional control, we include Top Accused Brokerage set to 1 if any of the respondents was one of the top 10 brokerage firms as of 1998 (Securities Industry Association 1998). A large brokerage firm may have repeat player advantages and greater resources in defending those complaints, leading to lower awards.

Several opinion controls deal with the strength of the case; stronger cases should result in a higher Compensation Ratio. Unfortunately, we have no direct measure of the strength of the claimant's case, so we rely on three proxies. First, Respondent Failed to Appear is defined to equal 1 if the any of the respondents failed to appear at the arbitration hearing and 0 otherwise. Respondents may not appear if their case is weak; alternatively, failing to appear itself may lead the arbitrators to view the respondents' case as less meritorious. In most cases a default award will be entered against the non-responding party; query how successful claimants are in collecting on such awards. At least one respondent failed to appear in 23% of the awards in our sample.

Second, we use a request of punitive damages by the claimant (Claimed Punitive Damages) as a proxy for a relatively strong case. Although punitive damages can be (and are) claimed in connection with each of the claim types in our classification, we hypothesize that claimants request punitive damages in cases involving more egregious wrongdoing or where they have hard evidence of fraud or other culpable misconduct. Many awards request an unspecified amount of punitive damages. This measure may be relatively noisy, as some lawyers will request punitive damages in every case, while others never do. We defined Claimed Punitive Damages as equal to 1, however, only when the claimant has made the punitive damages claim with some specificity. Two situations fall within this definition: (a) where we observe the claimant requests a positive dollar amount of punitive damages – fixing in the arbitrator's minds a precise amount of punitive damages and (b) where we observe the actual award of punitive damages, indicating that the claimant took actions during the arbitration hearings to press their claim for punitive damages.

Third, our last proxy for the strength of the case, Claimed CRD Expungement, is equal to 1 if the respondents requested that the Central Registration Depository (CRD) record of any of the respondent-brokers be expunged and 0 otherwise. FINRA maintains CRD records for active brokers reflecting customer complaints and disciplinary proceedings.[61] Arbitrators may, at their discretion, choose to expunge the arbitration claim from the CRD records for a broker involved in arbitration; expungement has the effect of erasing the record of the claim from the broker's CRD file.

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[61] See, e.g., Protect Your Money: Check Out Brokers and Investment Advisers, Securities & Exchange Commission, http://www.sec.gov/investor/brokers.htm (describing CRD database).

Although NASD rules adopted in 2004 provide that arbitrators may only grant expungement requests under specific conditions,[62] a recent PIABA study found that expungement remains common (Public Investors Arbitration Bar Association 2007).[63] We treat a respondent as requesting CRD expungement: (a) where we observe the respondent requesting the expungement in the award summary and (b) where we observe the actual award of CRD expungement, indicating that the respondent actively pursued expungement during the arbitration hearings. We treat a request for CRD expungement as an indication that the respondents' case was stronger relative to the claimants' case. We consider this proxy to be the noisiest of the three case strength proxies in light of the consistent criticisms leveled at arbitration panels for awarding expungement without an adequate basis.

We include in our opinion controls the number of hearings in the arbitration as a measure of the complexity of the arbitration (Number of Hearings). We also include the length of the arbitration opinion as another measure of case complexity (Opinion Length). Finally, our models include state controls for the state in which the arbitration hearing took place, which we treat as exogenous to the variables in our dataset. We include indicator variables for the three states with the most arbitrations (New York, California, Florida).

4.3. Industry Experience

[62] In 1999, the NASD temporarily halted expungement by arbitrators after complaints were raised. In 2004, it adopted new rules providing that arbitrators could expunge a broker's record only if "arbitration panel found that an investor's allegations had been factually impossible or false, or that the accused broker had not been individually involved in the matter." FINRA Rule 2130.

[63] The *New York Times* reported that, in 2005, FINRA expunged 907 customer complaints from brokers' records, or 13% (Browning 2005).

As discussed in Section 2, FINRA procedures during our sample period allowed arbitrators with connections to the securities industry to serve as public arbitrators. Individuals who might, under current rules, have been treated as industry arbitrators were treated as public arbitrators either because their work for the securities industry fell below a certain minimum threshold of their overall business, or because they had retired from the industry and more than three years had elapsed since their retirement. Of course, their service as public arbitrator was limited because the arbitrator disclosure forms required the disclosure of industry experience and parties could, on the basis of that experience, strike them from the list. FINRA's definition of public arbitrator has subsequently been tightened to make it harder for persons associated at any time with the securities industry to serve as public arbitrators.

In contrast, many arbitrators' professional backgrounds revealed substantial industry experience that did not reflect ties to the brokerage industry. Examples include attorneys engaged in transactional securities work, attorneys who primarily represented investors, academics and regulators. These other sources of securities experience are unlikely to be correlated with significant industry bias. Indeed, to the extent that these arbitrators engage in work on behalf of investors, their predisposition may be pro-customer rather than pro-industry.[64]

Because securities experience can lead arbitrators to be predisposed toward either the industry or the investor-claimants but may, at the same time, lead an arbitrator to a more sophisticated understanding of the issues involved in the case, it is difficult to determine the significance of differences in arbitration awards issued by panels that

[64] See, e.g., STMicroelectronics (evaluating argument that arbitrator, because of his substantial expert and consultant work on behalf of claimants was likely to be biased against Credit Suisse).

reflect greater securities experience. Our first test attempts to disaggregate these effects by focusing on industry connections.

We create an indicator variable, Securities Experience, which is set equal to 1 if the arbitrator was primarily employed in the securities industry during the course of his or her career, or if the individual has done work for firms in the securities industry in the five years prior to the arbitration, regardless of the amount; if not, the variable equals zero. Table 3 reports the incidence of securities experience among the public arbitrators in our sample. We classify the arbitrators according to their position on the panel, distinguishing the public arbitrators selected to be the arbitration Chair from those serving in the second Panel position.

<<Insert Table 3 About Here>>

The incidence of connections to the securities industry is surprisingly high. Recall that the connections are disclosed on the arbitrator's disclosure form and arbitrators can be struck for any reason. Nonetheless, twenty percent of the arbitrators serving as chairs had some connection to the industry, along with 19% of the arbitrators serving in the panel position.

To test the importance of the public arbitrators' connections to the securities industry, we estimate the following equation for each award using ordinary least squares and robust standard errors clustered by arbitrator:

$$\text{Compensation Ratio}_i = \alpha + ß_{1i}\text{Securities\_Industry\_Chair}_i + \\ + ß_{2i}\text{Securities\_Industry\_Panel}_i + ß_{3i}\text{Claimant Attorney}_i \\ + ß4_i\text{Respondent Attorney}_i + \sum ß_{ji}\text{ Subject Matter}_{ji} + \sum ß_{ki}\text{Opinion Controls}_{ki} + \sum ß_{li}\text{State Controls}_{li} + \text{Year Effects} + \varepsilon_i$$

Model 1 of Table 4 reports our results (using an ordinary least squares model with errors clustered by individual arbitrator).

<<Insert Table 4 About Here>>

We find that the coefficients for Securities Industry Chair and Securities Industry Panel, are both negative, but neither is significant. This finding does not support the hypothesis that panels with public arbitrators who have connections to the securities industry tend to provide lower awards. In Model 2, we examine arbitrations in which both public arbitrators have connections to the industry. Not surprisingly, the coefficient for Securities Experience Both is negative, but insignificant, presumably due to the small number of observations.

The conflict of interest presented by affiliation with the securities industry seems rather obvious, but the results in Model 1 suggest that it may not have much on influence on outcomes. Nonetheless, given the role that the parties play in arbitrator selection, when would a claimant ever allow an arbitrator affiliated with the industry to serve as a public arbitrator on their panel? We hypothesize that counsel may play an important role in the process by which panels are selected. To assess this possibility, we estimate the model again, this time adding interaction variables for Securities Experience Chair x Claimant Attorney and Securities Experience Panel x Claimant Attorney. The interaction variables allow us to assess separately the effect of connection to the securities industry on claimants who are represented by counsel and those who are unrepresented. We present the results in Model 3 of Table 4.[65]

[65] The small number of observations did not allow us estimate a model interacting Securities Experience Both with Claimant Attorney. The same problem precluded us from estimating a similar model in the analyses presented below.

The results strongly support the hypothesis that unrepresented claimants face the greatest reduction in awards when public arbitrators have connections to the securities industry. The Securities Experience Panel coefficient captures the effect of this characteristic on claimants who are unrepresented. It is negative in Model 3 with considerably greater magnitude than in Model 1. Moreover, the coefficient estimate is significant at the one percent level. The coefficient for the interaction variable Securities Experience Panel x Claimant Attorney, when summed with Securities Experience Panel, captures the effect of this characteristic on claimants who have representation. This coefficient is positive and significant and the sum of the two is not significantly different from zero. This finding suggests that lawyers play an important role in screening out even obvious conflicts of interest. Conversely, unrepresented claimants appear to be at a disadvantage in protecting themselves against conflicts of interest.[66]

4.4. Professional Arbitrators

The results presented in Table 4 suggest that arbitrators with connections to the securities industry tend to make lower awards. The effect of that conflict of interest is essentially eliminated, however, when claimants are represented by counsel. What about

[66] We also looked at whether the Chair or Panel arbitrator was working in a securities firm or as a banker at the time of the arbitration (Profession Securities-Banker). We re-estimated Model 3 of Table 4 replacing Securities Experience Chair and Securities Experience Panel and their interaction terms with corresponding variables for Profession Securities-Banker Chair and Profession Securities-Banker Panel. Unreported, the coefficient on Profession Securities-Banker Chair and Profession Securities-Banker Panel are negative, similar with Model 3, but only Profession Securities-Banker Chair is significant (at the 1% level). The interaction terms with Claimant Attorney are positive, similar with Model 3 of Table 4, but not significantly different from zero. The sum of Profession Securities-Banker Chair and the Profession Securities-Banker Chair x Claimant Attorney is negative and significant at the 10% level. The sum of Profession Securities-Banker Panel and the Profession Securities-Banker Panel x Claimant Attorney is not significantly different from zero. While a Claimant Attorney can mitigate the impact of an arbitrator (this time the Chair) that works in the securities industry or as a banker, the overall effect as indicated by the sum of Profession Securities-Banker Chair and the Profession Securities-Banker Chair x Claimant Attorney is negative.

less obvious conflicts of interest? Do they influence awards? If so, is that influence ameliorated by the presence of counsel?

Some research has questioned the effect of arbitrator incentives, in particular, the desire to be selected as an arbitrator in future cases. Kerment and Neeman, for example, hypothesize that arbitrators consider the perception of future parties in determining their awards. If arbitrators care about their selection in future cases, this effect is likely to be greatest for professional arbitrators – those who devote substantially all of their time to serving as arbitrators. In contrast, arbitrators whose primary vocation is not dispute resolution and who serve as arbitrators only occasionally are less likely to be influenced by the concern that their decisions will affect their likelihood in future cases.

The effect of these incentives may skew arbitration awards in favor of industry parties. In particular, arbitrators may rationally view securities firms (but not investors) as repeat players in securities arbitration. If an arbitrator wishes to appear attractive to securities firms, he or she may vote for lower awards in an effort to generate future work. This effect is potentially important in that a substantial percentage of our pool of arbitrators consists of professional arbitrators. They constitute 35% of the chairs, arguably the most influential position, and 25% of the other public arbitrators.

We therefore design our second test to examine whether professional arbitrators behave differently from other arbitrators. To assess this possibility, we create an indicator variable, Professional Arbitrator, coded to equal one if the arbitrator devotes substantially all of their professional time to arbitration and mediation or is described as self-employed, and zero otherwise. Table 5 reports the incidence of professional arbitrators among the public arbitrators in our sample.

<<Insert Table 5 About Here>>

We estimate the following equation for each award using ordinary least squares and robust standard errors clustered by arbitrator:

$$\begin{aligned}\text{Compensation Ratio}_i = \alpha &+ ß_{1i}\text{Professional\_Arbitrator\_Chair}_i \\ &+ ß_{2i}\text{Professional\_Arbitrator\_Panel}_i + ß_{3i}\text{Claimant Attorney}_i \\ &+ ß4_i\text{Respondent Attorney}_i + \textstyle\sum ß_{ji}\text{ Subject Matter}_{ji} + \\ &\textstyle\sum ß_{ki}\text{Opinion Controls}_{ki} + \sum ß_{li}\text{State Controls}_{li} + \text{ Year Effects } + \varepsilon_i\end{aligned}$$

Model 1 of Table 6 reports our results.

<<Insert Table 6 About Here>>

The coefficient for Professional Arbitrator Chair is positive, but insignificant. Recall that the parties generally must agree on this position. The coefficient for Professional Arbitrator Panel, however, is negative and significant at the five percent level. These results suggest that professional arbitrators are inclined to make smaller awards, but only when they are serving as the second public arbitrator, not the chair. These differing results based on the position of the professional arbitrator suggest that this potential conflict of interest is a more subtle one. How does the effect interact with the presence of an attorney for the claimant?

To assess this possibility, we reestimate the model above adding interaction variables for Claimant Attorney and the two Professional Arbitrator variables. We present the results of this regression in Model 2 to Table 6. The coefficient for Professional Arbitrator Panel is negative in this model and larger in magnitude, albeit insignificant. The coefficient for the interaction variable is positive, although also insignificant. These results are consistent with attorneys ameliorating the potential conflict of interest created by an arbitrator’s potential desire to trim awards to encourage future selection, but the separation is less clear than with the connections to the securities industry.

4.5. Retired Arbitrators

Another category of public arbitrators who may be anxious to be selected as arbitrators would be individuals who have retired from full-time work. In addition to having a lower opportunity cost for their time, anecdotal evidence from our conversations with retired arbitrators suggested that serving as an arbitrator was an interesting diversion that got them out of the house. A willingness to serve would give retired arbitrators an incentive similar to that of professional arbitrators to curry favor with brokerage firms, the repeat players in this process. Alternatively, some attorneys suggested to us that older arbitrators may be more conservative, and therefore reluctant to make large awards. Both of these factors suggest that older arbitrators would tend to make lower awards. Retired and older arbitrators make up a significant portion of the public arbitrators in our sample. Retired chairs make up nearly a third of the sample, and over half of the arbitrators occupying the second public arbitrator position.

To assess the effect of retired arbitrators on the level of awards, we create an indicator variable set equal to one if the arbitrator was retired at the time of the arbitration, or over the age of 65, and zero otherwise. Obviously, some of the arbitrators in our sample were continuing to work after age of 65, but our investigation suggested that many of the arbitrators above age 65 were not working full time at that point, even if they were not fully retired. Arbitrators who were only working part time presumably had time available to take on more arbitration work. Insofar as our coding treats some arbitrators who are working full time as retired, it should bias against any significant finding.

<<Insert Table 7 About Here>>

We estimate the following equation for each award using ordinary least squares and robust standard errors clustered by arbitrator:

$$\text{Compensation Ratio}_i = \alpha + ß_{1i}\text{Retired\_Chair}_i + ß_{2i}\text{Retired\_Panel}_i + ß_{3i}\text{Claimant Attorney}_i + ß4_i\text{Respondent Attorney}_i + \sum ß_{ji}\text{ Subject Matter}_{ji} + \sum ß_{ki}\text{Opinion Controls}_{ki} + \sum ß_{li}\text{State Controls}_{li} + \text{Year Effects} + \varepsilon_i$$

We present the results in Table 8.

<<Insert Table 8 About Here>>

For retired arbitrators, the chair position appears to be relevant. The coefficient for Retired Arbitrator Chair is negative and significant at the ten percent level, while the coefficient for Retired Arbitrator Panel is insignificant. When we focus in Model 2 on arbitrations for which both public arbitrators are retired, the coefficient for that variable is negative and significant at the ten percent level. Examining the interaction between retired arbitrators and the presence of a claimant attorney, the coefficient for Retired Arbitrator Chair is positive in this specification, albeit insignificant, suggesting that claimants who are not represented by counsel do not face any disadvantage when there is a retired chair. The coefficient for the interaction variable is negative, but it is insignificant and the sum of the two coefficients is also insignificant, so we cannot conclude that the presence of a Claimant Attorney leads to a lower recovery for claimants when a retired arbitrator serves as chair. As with professional arbitrators, this more subtle conflict leads to more ambiguous results.

4.6. Regulatory Experience

Our final set of tests looks at the effect of an arbitrator's experience as a regulator on their awards. Our hypothesis is that arbitrators with prior government experience are likely to give more credence to claims of broker misconduct and/or see greater need to deter such misconduct through larger awards. To assess this possibility, we create an indicator variable equal to 1 if the arbitrator has experience as a federal or state prosecutor, federal or state securities regulator, a prior affiliation with a self-regulatory organization, or employment as a compliance officer with a broker-dealer, and 0 otherwise. We include compliance officers within our definition of regulator on the theory that they play a quasi-regulatory role within brokerage firms.

In our earlier tests, we focused only on public arbitrators. For this set of tests, we expand our scrutiny to also include the industry arbitrator. We postulate that industry arbitrators with a regulatory background or who have played a compliance role within their firm may have a lower tolerance for "bad apples" within the industry. Table 9 shows the incidence of experience as a regulator among our three groups.

<<Insert Table 9 About Here>>

Regulatory experience is relatively common among the arbitrators in our sample, especially for industry arbitrators. Among the chairs, 17% had regulatory experience, while 13% of the other public arbitrators had such experience. These numbers are far outstripped by industry arbitrators: nearly half of that group had either regulatory or compliance experience. Individuals are largely self-selected into the pool of available arbitrators, so it is possible that industry members with regulatory or compliance experience are more interested in the arbitration process. Without knowing the breakdown for the overall pool of potential industry participants, however, we can only speculate in this regard.

To test the effect of regulatory experience among arbitrators on the level of awards, we estimate the following equation for each award using ordinary least squares and robust standard errors clustered by arbitrator:

$$\text{Compensation Ratio}_i = \alpha + ß_{1i}\text{Regulator\_Chair}_i + ß_{2i}\text{Regulator\_Panel}_i + ß_{3i}\text{Claimant Attorney}_i + ß4_i\text{Respondent Attorney}_i + \sum ß_{ji}\text{ Subject Matter}_{ji} + \sum ß_{ki}\text{Opinion Controls}_{ki} + \sum ß_{li}\text{State Controls}_{li} + \text{Year Effects} + \varepsilon_i$$

We present the results in Table 10.

<<Insert Table 10 About Here>>

Consistent with our hypothesis, we find in Model 1 that the coefficients for Regulator Chair and Regulator Panel are both positive, although only the latter is significant (at the ten percent level). We see in Model 2 that when both public arbitrators have regulatory experience, the effect is considerably more pronounced, with a much larger positive coefficient, which is significant at the one percent level.

In our prior analyses, we assessed the interaction of the presence of an attorney for the claimant with the arbitrator background characteristic of interest. For this set of regressions, however, we are interested to see if the presence of an attorney for the respondent mitigates the tendency of public arbitrators with regulatory experience to give larger awards.[67] In Model 3 of Table 10 we add interaction variables for Respondent Attorney and the Regulator Chair and Regulator Panel indicator variables. The coefficient for Regulator Chair is insignificant in this model, as is the sum of that variable and Regulator Chair x Respondent Attorney. Similarly, the coefficient for Regulator

[67] Importantly, as discussed above, the presence of a plaintiffs' attorney may be a proxy for case quality; the presence of a respondent attorney is less likely to correlate with case quality.

Panel is insignificant in this model, as is the sum of that variable and Regulator Panel x Respondent Attorney. Thus, we do not find substantial evidence that the presence of an attorney for the respondent mitigates this effect.[68]

We also assess the effect of industry arbitrators with regulatory experience, substituting Regulator Industry for the two public arbitrator variables used in the model above. We present the results in Table 11.

<<Insert Table 11 About Here>>

We see in Model 1 that the coefficient for Regulator Industry is positive, but small in magnitude and insignificant. Given the small magnitude of the coefficient, we decided to re-estimate the model two different ways. First, we estimated the model with an interaction variable, Regulator Industry x Respondent Attorney, similar to Model 3 in Table 10. Both Regulator Industry and the interaction variable were insignificant in this model, which we have not tabulated. We then re-estimated the model with an interaction variable, Regulator Industry x Claimant Attorney. Our rationale for doing so was that claimant attorneys may play a role in identifying industry arbitrators who were more likely to be generous to claimants. We present the results of this regression in Model 2 of Table 11. We see that the coefficient for Regulator Industry is negative in this estimation and significant at the five percent level. The coefficient for the variable interacting Regulator Industry with Claimant Attorney is positive, also significant at the five percent level. The sum of the two is not significantly different from zero. These finding suggest

[68] We re-estimated the models of Table 10 with replacing Regulator Industry with an indicator variable equal to 1 if the arbitrator has experience as a federal or state prosecutor, federal or state securities regulator, or a prior affiliation with a self-regulatory organization and 0 otherwise (excluding compliance officers). Unreported we get the same qualitative results as in Table 10.

that industry arbitrators tend to make lower awards only when claimants are not represented by counsel.

5. CONCLUSION

In an ideal world, the background of an arbitrator would not influence the outcome in arbitration. Each arbitrator would set aside his or her prior experiences and biases and rule impartially. The reality, however, is that securities arbitration is not an ideal world. FINRA has recognized the importance of an arbitrator's background in its increasingly stringent qualification requirements.

In this study we examine the relationship between an arbitrator's background and the outcome in securities arbitration. For the public arbitrators, we find that industry experience and status as a professional arbitrator are correlated with statistically significant decreases in arbitration awards. This decrease, however, is tempered when claimant is represented by counsel. We also find that prior experience as a regulator for the public arbitrators is correlated with a statistically significant increase in arbitration awards. We do not find substantial evidence that the presence of an attorney for the respondent mitigates this effect. Turning to the industry arbitrator, we find that industry arbitrators with regulatory experience correlate with a statistically significant decrease in arbitration awards. This effect, however, is mitigated when the claimants have an attorney.

Our findings have important implications for how FINRA regulates arbitrator background into the future. Our most consistent finding is that representation by counsel can reduce or eliminate the effect of arbitration background on arbitration outcomes. Supporters of arbitration often highlight its streamlined proceedings and lower costs compared to litigation as an advantage for small claimants. Our findings suggest that, even with streamlined procedures, claimants who lack attorneys are disadvantaged.

APPENDIX: VARIABLE DEFINITIONS

Variable	Definition
Compensation Ratio	The total amount of compensation award divided by the claimed compensation amount.
Subject Matter Controls	
Suitability	Indicator variable equal to 1 if the arbitration involved a suitability claim, including claims involving "know your customer," NYSE Rule 405, and NASD Rule 2310 issues, and 0 otherwise.
Churning	Indicator variable equal to 1 if the arbitration involved a churning, excessive trading, or excessive commission claim and 0 otherwise.
Unauthorized Trades	Indicator variable equal to 1 if the arbitration involved an unauthorized trading claim and 0 otherwise.
Failure to Execute	Indicator variable equal to 1 if the arbitration involved a claim that the broker or brokerage firm failed to execute a transaction, failed to monitor an account properly, improperly executed a transaction, or engaged in activities that resulted in errors in a customer account and 0 otherwise.
Misrepresentation	Indicator variable equal to 1 if the arbitration involved misrepresentation, fraud, failure to disclose, Rule 10b-5, common law fraud, or deceptive sales tactic claim and 0 otherwise.
Conversion	Indicator variable equal to 1 if the arbitration involved a theft, conversion, unauthorized withdrawals, or self-dealing claim and 0 otherwise.
Reported Settlement	Indicator variable equal to 1 if the arbitration resulted in a full or partial settlement and the settlement amount was reported and 0 otherwise.
Unreported Partial Settlement	Indicator variable equal to 1 if the arbitration resulted in a partial settlement and the settlement amount was not reported (but the award for the non-settling respondents was reported) and 0 otherwise.

Opinion Controls

Claimed Compensation	Amount of claimed compensation in dollars by the arbitration claimants.
Inexperienced	Indicator variable equal to 1 if the award is from the first year the arbitrator appears in the dataset and 0 otherwise.
Top Accused Brokerage	Indicator Variable equal to 1 if any of the responedents was one of the top 10 brokerage firms of 1998.
Respondent Failed to Appear	Indicator variable equal to 1 if the any of the respondents failed to appear at the arbitration hearing and 0 otherwise.
Claimed Punitive Damages	Indicator variable equal to 1 if punitive damages were imposed on any of the respondents in the arbitration award and 0 otherwise.
Claimed CRD Expungement	Indicator variable equal to 1 if the CRD records of any of the respondent-brokers was expunged and 0 otherwise.
Number of Hearings	Number of hearings for the arbitration.
Opinion Length	Number of pages in the award opinion.

Arbitrator Background

Securities Experience	Indicator variable equal to 1 if the arbitrator's primary career experience was in the securities industry or the arbitrator had worked for a securities firm within the last five years, and 0 otherwise.
Professional Arbitrator	Indicator variable equal to 1 if the arbitrator primarily works as arbitrator or is self-employed and 0 otherwise.
Retired	Indicator variable equal to 1 if the arbitrator is retired or over age 65 at the time of arbitration and 0 otherwise.
Regulator	Indicator variable equal to 1 if the arbitrator has experience as a federal or state prosecutor, federal or state securities regulator, experience with a self-regulatory organization, or a compliance officer with a broker-dealer, and 0 otherwise.

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Table 1. Arbitrations by Year

Year	**Freq.**	**Percent**
1998	149	35.7
1999	134	32.1
2000	134	32.1
Total	417	100.0

Table 2. Summary Statistics

Variable	N	Mean	Median	Standard Deviation
Award ($ Thousands)	405	58.0	15.8	125.8
Compensation Ratio	405	0.379	0.222	0.407
Claimant Attorney	405	0.867	1.000	0.340
Respondent Attorney	405	0.822	1.000	0.383
Suitability	405	0.469	0.000	0.500
Churning	405	0.205	0.000	0.404
Unauthorized Trades	405	0.328	0.000	0.470
Failure to Execute	405	0.170	0.000	0.376
Misrepresentation	405	0.724	1.000	0.448
Conversion	405	0.037	0.000	0.189
Reported Settlement	405	0.005	0.000	0.070
Unreported Partial Settlement	405	0.049	0.000	0.217
Claimed Compensation ($ millions)	382	0.291	0.090	0.849
Inexperienced	405	0.111	0.000	0.315
Top Accused Brokerage	405	0.094	0.000	0.292
Respondent Failed to Appear	405	0.225	0.000	0.418
Claimed Punitive Damages	405	0.309	0.000	0.463
Claimed CRD Expungement	405	0.148	0.000	0.356
Number of Hearings	405	5.447	4.000	4.228
Opinion Length	405	4.630	4.000	1.150
New York	405	0.146	0.000	0.353
California	405	0.235	0.000	0.424
Florida	405	0.111	0.000	0.315

Table 3. Industry Experience for Public Arbitrators

	N	Fraction with Securities Experience
Chair	290	0.200
Panel	275	0.193

Table 4. Industry Experience Regressions

	(1)	(2)	(3)
Securities Experience Chair	-0.412		-1.309
	(-0.46)		(-0.45)
Securities Experience Panel	-0.553		-4.558**
	(-0.81)		(-2.71)
Securities Experience Both		-5.463	
		(-1.25)	
Claimant Attorney	0.929	1.006	-0.346
	(1.18)	(1.23)	(-0.39)
Respondent Attorney	-2.031^{+}	-1.922^{+}	-1.689
	(-1.77)	(-1.72)	(-1.51)
Securities Experience Chair * Claimant Attorney			1.056
			(0.34)
Securities Experience Panel * Claimant Attorney			4.989*
			(2.60)
Constant	-0.500	-0.767	0.120
	(-0.24)	(-0.38)	(0.06)
N	186	186	186
Adj. R^2	0.324	0.327	0.341
Subject Matter Controls	Yes	Yes	Yes
Opinion Controls	Yes	Yes	Yes
State Controls	Yes	Yes	Yes

Note. Dependent variable for OLS regressions is the log odds of the compensation ratio. Variable definitions are in the Appendix. t-statistics are in parentheses.

$^{+}$ Coefficient significant at the 10% level or less.

* Coefficient significant at the 5% level or less.

** Coefficient significant at less than the 1% level.

Table 5. Professional Arbitrators

	N	Fraction Professional Arbitrators
Chair	344	0.346
Panel	305	0.246

Table 6. Professional Arbitrator Regressions

	(1)	(2)	(3)
Professional Arbitrator Chair	0.437		-0.863
	(0.81)		(-0.55)
Professional Arbitrator Panel	-1.191*		-1.487
	(-2.09)		(-0.89)
Professional Arbitrator Both		-1.254+	
		(-1.81)	
Claimant Attorney	1.414+	1.329+	0.731
	(1.84)	(1.73)	(0.69)
Respondent Attorney	-2.189*	-2.129*	-2.296*
	(-2.44)	(-2.39)	(-2.48)
Professional Arbitrator Chair * Claimant Attorney			1.541
			(0.93)
Professional Arbitrator Panel * Claimant Attorney			0.413
			(0.23)
Constant	-1.619	-1.123	-0.930
	(-0.93)	(-0.66)	(-0.50)
N	239	239	239
Adj. R^2	0.323	0.320	0.322
Subject Matter Controls	Yes	Yes	Yes
Opinion Controls	Yes	Yes	Yes
State Controls	Yes	Yes	Yes

Note. Dependent variable for OLS regressions is the log odds of the compensation ratio. Variable definitions are in the Appendix. t-statistics are in parentheses.

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** Coefficient significant at less than the 1% level.

Table 7. Retired Arbitrators

	N	Fraction Retired
Chair	295	0.325
Panel	295	0.522

Table 8. Retired Arbitrator Regressions

	(1)	(2)	(3)
Retired Chair	-0.931^{+}		0.139
	(-1.87)		(0.10)
Retired Panel	0.457		0.231
	(0.98)		(0.19)
Retired Both		-0.985^{+}	
		(-1.76)	
Claimant Attorney	1.429^{*}	1.608^{*}	1.680
	(2.07)	(2.33)	(1.60)
Respondent Attorney	-1.530^{+}	-1.331	-1.563^{+}
	(-1.67)	(-1.42)	(-1.69)
Retired Chair * Claimant Attorney			-1.244
			(-0.87)
Retired Panel * Claimant Attorney			0.277
			(0.21)
Constant	-2.655	-2.613	-2.770
	(-1.63)	(-1.60)	(-1.60)
N	266	266	266
Adj. R^2	0.307	0.305	0.304
Subject Matter Controls	Yes	Yes	Yes
Opinion Controls	Yes	Yes	Yes
State Controls	Yes	Yes	Yes

Note. Dependent variable for OLS regressions is the log odds of the compensation ratio. Variable definitions are in the Appendix. t-statistics are in parentheses.

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** Coefficient significant at less than the 1% level.

Table 9. Regulatory Experience for Public and Industry Arbitrators

	N	Fraction Regulators
Chair	290	0.166
Panel	275	0.131
Industry	257	0.463

Table 10. Regulatory Experience Public Arbitrator Regressions

	(1)	(2)	(3)
Regulator Chair	1.071		0.666
	(1.32)		(0.28)
Regulator Panel	1.364^{+}		1.435
	(1.69)		(0.58)
Regulator Both		6.110**	
		(2.90)	
Claimant Attorney	0.998	0.930	1.007
	(1.24)	(1.17)	(1.23)
Respondent Attorney	-2.014^{+}	-1.973^{+}	-2.024
	(-1.80)	(-1.78)	(-1.65)
Regulator Chair * Respondent Attorney			0.439
			(0.17)
Regulator Panel * Respondent Attorney			-0.097
			(-0.04)
Constant	-0.875	-0.349	-0.930
	(-0.45)	(-0.17)	(-0.44)
N	186	186	186
Adj. R^2	0.335	0.333	0.327
Subject Matter Controls	Yes	Yes	Yes
Opinion Controls	Yes	Yes	Yes
State Controls	Yes	Yes	Yes

Note. Dependent variable for OLS regressions is the log odds of the compensation ratio. Variable definitions are in the Appendix. t-statistics are in parentheses.

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** Coefficient significant at less than the 1% level.

Table 11. Regulatory Experience Industry Arbitrator Regressions

	(1)	(2)
Regulator Industry	0.091	-2.690*
	(0.19)	(-2.04)
Claimant Attorney	0.899	-0.684
	(1.14)	(-0.59)
Respondent Attorney	-0.469	-0.712
	(-0.51)	(-0.77)
Regulator Industry x Claimant Attorney		3.235*
		(2.25)
Constant	-4.184*	-2.793
	(-2.47)	(-1.48)
N	234	234
Adj. R^2	0.235	0.249
Subject Matter Controls	Yes	Yes
Opinion Controls	Yes	Yes
State Controls	Yes	Yes

Note. Dependent variable for OLS regressions is the log odds of the compensation ratio. Variable definitions are in the Appendix. t-statistics are in parentheses.

+ Coefficient significant at the 10% level or less.

* Coefficient significant at the 5% level or less.

** Coefficient significant at less than the 1% level.