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THE INFLUENCE OF ARBITRATOR BACKGROUND AND REPRESENTATION ON ARBITRATION OUTCOMES

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ABSTRACT

We study the role of arbitrator background in securities arbitration. We find that several aspects of arbitrator background are correlated with arbitration outcomes. Specifically, industry experience, prior experience as a regulator, and status as a professional or retired arbitrator are correlated with statistically significant differences in arbitration awards. 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 possible arbitrator bias. On the one hand, they suggest that the party selection process is relatively effective in screening for 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.

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1. INTRODUCTION

Mandatory arbitration has been the norm for broker-customer disputes since the late 1980s when the Supreme Court upheld mandatory arbitration provisions in broker-customer agreements.[1] Mandatory arbitration has been a standard term in such agreements ever since, and the overwhelming majority of broker-customer disputes, even those involving substantial sums, are resolved through arbitration.[2]

Broker-customer arbitration takes place largely behind the closed doors of the Financial Industry Regulatory Association (FINRA), an industry self-regulatory organization.[3] The FINRA arbitration process has been the subject of ongoing controversy, as critics have debated the extent to which the arbitration process is fair to customers.[4] This debate is impeded by the limited transparency of arbitration cases. Although FINRA releases the written decisions issued by arbitration panels, it does not disclose the details of the claims filed or background information on the arbitrators who issue these decisions.[5] Moreover, under FINRA's arbitration rules, arbitrators only need

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

[2] 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).

[3] FINRA 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. FINRA handles arbitration of both broker-customer disputes and disputes between FINRA member firms and their employees, which are subject to a different set of arbitration procedures. See FINRA, Arbitration and Mediation, http://www.finra.org/ArbitrationAndMediation/Arbitration/Rules/CodeofArbitrationProcedure/ (last visited 9/10/13) (stating that "The Code of Arbitration Procedure for Industry Disputes (Industry Code) governs arbitrations between or among industry parties"). This article only analyzes arbitration that result from disputes between brokers and their customers.

[4] See, e.g., Stephen J. Choi, Jill E. Fisch, and A. C. Pritchard, Attorneys as Arbitrators, 39 J. Legal Stud. 109, 110-11 (2010) (summarizing criticisms of FINRA's arbitration process).

[5] In addition, limited public information is available about many arbitrators, unlike judges, whose backgrounds are generally a matter of public record. Thus our study, which is in the vein of a substantial body of legal scholarship about judicial decision-making, see, e.g., Diane P. Wood, When to Hold, When to Fold, and When to Reshuffle: The Art of Decisionmaking on a Multi-Member Court, 100 CALIF. L. REV. 1445 (2012), .is distinctive in that we do not have access to similar information about either the arbitrators who issue the decisions or the cases that they are deciding.

to disclose minimal information in their awards.[6] An explanation of the reasons for the award is not required unless such an explanation is jointly requested by all the parties.[7] .

This lack of transparency is combined with a distinctive party selection regime. In FINRA arbitrations, FINRA generates a list of potential arbitrators for each case from its roster, and the parties then select their arbitrators from this list. . Historically, FINRA arbitration panels have consisted of two public arbitrators and one non-public or industry arbitrator. The industry arbitrator is typically a current or former broker-dealer, and his or her role was to provide expertise about industry practice. The public arbitrators or "neutrals" were supposed to be free from ties to the brokerage industry. The definition of who qualifies as a public arbitrator has been a source of controversy, as some commentators have criticized FINRA's criteria for independence as insufficiently rigorous. In response, FINRA has imposed increasingly stringent limits on the category of public arbitrators, which we discuss below.

FINRA's reforms in response to the critics of the arbitration process suggest that arbitrator background may play an important role in the outcome of arbitration cases. At the same time, the extent to which the party selection process mitigates these effects is unclear, raising the question: Does the selection of arbitrators have an effect on arbitration outcomes?

To explore this question, we analyze a dataset of randomly selected arbitration awards from 1998 to 2000. During that period the limitations on who qualified to serve as a public arbitrator were less restrictive than today. Because our study focuses on a period of time when individuals could more easily qualify as public arbitrators, we are

[6] Code of Customer Arbitration, Rule 12904 (e). Awards (designating information required in an arbitration award).
[7] Rule 12904(g) Explained Decisions.

able to study the effect of arbitrator characteristics that, in some cases, FINRA now treats as disqualifying. We hand collect data on background characteristics of the arbitrators who issued the awards in our sample, focusing on whether those arbitrators had prior securities experience, served as professional arbitrators, were retired, or had previously served either as a regulator or a compliance officer. We explore whether the presence of arbitrators with these characteristics on a panel affects the size of the arbitration award and, if so, whether the impact is affected by whether the parties are represented by counsel.

We proceed as follows. In Part 2, we lay out the legal status of arbitration and FINRA arbitration procedures. We also survey prior literature. 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

Since the late 1980s, the Supreme Court has taken a consistent position endorsing arbitration as an alternative system of dispute resolution, reading congressional adoption of the Federal Arbitration Act as reflecting a "federal policy favoring arbitration."[8] Specifically, the Court held in 1987, in *Shearson/American Express v. McMahon* that arbitral forums were fully capable of resolving securities fraud disputes.[9] Two years later, in *Rodrigues de Quijas v. Shearson/American Express, Inc.*, the Supreme Court

[8] Shearson/American Express v. McMahon, 482 U.S. 220, 226 (1987) (quoting *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24 (1983)).

[9] 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.

explicitly overruled its prior decision in *Wilko v. Swan* and held that pre-dispute arbitration agreements were valid for claims arising under the Securities Act of 1933.[10] Subsequently, the Supreme Court has repeatedly emphasized its approval of arbitration as an alternative to litigation, stating that arbitration offers "lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes."[11] The Court has held that arbitration can be used to resolve claims that would otherwise be brought as part of a class action.[12] Most recently, the Supreme Court held that arbitration agreements containing class action waivers must be enforced by the courts even if the cost of pursuing an individual claim would be prohibitively expensive.[13]

The Supreme Court's expansive reading of the FAA has 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 misapplied applicable law.[14] Although in the past courts granted motions to vacate arbitration awards in which the arbitrators were found to have manifestly disregarded the law, the Supreme Court's most recent interpretation of "manifest disregard" suggest that this language may just be a "judicial gloss" on the explicit grounds for vacatur set out in the FAA.[15] Lower courts have read this Supreme

[10] 490 U.S. 477 (1989).
[11] Stolt-Nielsen S.A. v. AnimalFeeds International Corp., 130 S. Ct. 1758, 1776 (2010).
[12] AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2010).
[13] American Express v. Italian Colors Restaurant, -- S. Ct. --, 2013 WL 3064410 (2013). The extent to which brokers may require their customers to waive their rights to participate in class action litigation, since FINRA arbitrators do not have the power to adjudicate disputes on a class basis, is currently the subject of litigation between FINRA and Charles Schwab. See Tess Stynes & Caitlin Nish, FINRA Panel: Regulators Can't Block Schwab Arbitration Agreement, Wall St. J., Feb. 22, 2013, http://online.wsj.com/article/SB10001424127887323549204578319933909503430.html (describing preliminary decision by FINRA hearing panel in favor of Schwab). FINRA has appealled the decision.
[14] See, e.g., United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29, 38 (1987).
[15] 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

Court precedent as holding that the statutory grounds for vacating or modifying an arbitration award are exclusive.[16]

These legal standards limit the extent to which courts can review arbitration procedures for bias. Under § 10(a) of the FAA, a court can vacate a decision if it finds "evident partiality" or "other misbehavior" of the arbitrators.[17] Courts have interpreted evident partiality as involving a relationship with an arbitrator, a lawyer or a party[18] rather than an arbitrator's predisposition or general views about the law or the industry.[19] Relevant here, courts have rejected the argument that an arbitrator's position or experience within the industry is sufficient to meet the legal standard of bias,[20] even if that position might present the appearance of bias.[21] Moreover, to the extent that the arbitrators disclose any potential biases or conflicts, or relationships that create the potential for bias, courts have held such disclosure insulates the award from subsequent

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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*, 130 S. Ct. 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, (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")

[16] 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).

[17] *STMicroelectronics*, 648 F.3d at 74.

[18] *STMicroelectronics*, 648 F.3d at 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).

[19] See, e.g., Repub. Party of Minn. v. White, 536 U.S. 765, 777 (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 ….").

[20] 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").

[21] *STMicroelectronics*. 648 F.3d at 74-77 See also Owen-Williams v. BB&T Inv. Servs., 717 F. Supp. 2d 1 (D.D.C. 2010) (citations omitted) ("'It is well established that a mere appearance of bias is insufficient to demonstrate evident partiality."").

challenge because a party can respond to the disclosure by striking the arbitrator or seeking his or her removal from the panel.[22]

2.2. FINRA Procedures

Arbitrators in FINRA customer arbitrations are chosen through a party selection system. In 1998-2000, the time period from which our sample is chosen, customer claims for more than $50,000 were resolved by three-arbitrator panels consisting of two public and one industry arbitrator.[23]

FINRA does not impose limits on the background or professional ties of industry or non-public arbitrators, and they generally include current and former brokers, bankers and other professionals in the securities industry.[24] On the other hand, public arbitrators, also known as neutrals, are supposed to lack substantial industry ties. At the time of our study, FINRA imposed, through its definition of public arbitrator, relatively minimal restrictions. The definition excluded individuals who had within the past three years been associated with a broker-dealer, who were registered or associated with a commodities dealer, as well as persons retired from such positions and employees of banks and other financial institutions that effect securities and commodities transactions. In addition, the rules excluded attorneys, accountants and other professionals who, within the prior two years had devoted twenty percent or more of their professional work to clients engaged in the foregoing business activities. Thus, at the time of our study, the pool of public arbitrators contained many individuals with non-trivial ties to the securities industry.

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[22] 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.").

[23] FINRA has now raised this limit to $100,000. FINRA Regulatory Notice 09-13 (2009).

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

Subsequently FINRA amended the definition of a public arbitrator several times to reduce these ties by imposing additional grounds for disqualification. In 2004, for example, the National Association of Securities Dealers (NASD) (now FINRA)[25] increased from three to five years the amount of time necessary after leaving the securities industry to transition from a non-public to public arbitrator; clarified that “retired” broker dealers included anyone who spent a substantial part of his or her career in the industry, prohibited anyone who had been associated with the industry for at least twenty years from ever becoming a public arbitrator, regardless of how long ago the association ended, excluded attorneys, accountants, or other professionals whose firms have derived ten percent or more of their annual revenue in the previous two years from clients involved in securities-related activities, regardless of whether the excluded individual represented such clients, and provided that investment advisers may not serve as public arbitrators. FINRA also extended the industry exclusions to the spouse and immediate family members of an industry member.[26]

In 2007, FINRA revised the definition of public arbitrator to exclude persons who were employed by or served as an officer or director of, a company in a control relationship with a broker-dealer as well as the spouses and immediate family members of such persons. FINRA also clarified that persons registered through a broker-dealer could not be public arbitrators even if they were employed by a non-broker-dealer (such as a bank). In 2008, FINRA modified the professional disqualification rule to add a

[25] 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.

[26] SEC, Exchange Act Rel. 34-49573, Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations (April 16, 2004).

dollar limit in addition to the 10% limit. Under the amendments, an attorney, accountant, or other professional was prohibited from serving as a public arbitrator if the individual`s firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to certain industry entities relating to customer disputes concerning an investment account or transaction.[27] Most recently, FINRA amended the definition of public arbitrator to exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators and to require such individuals to wait for two years after ending their affiliations before being permitted to serve as public arbitrators.[28]

Since November 1998,[29] 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).[30] During the time period involved in our study, the NASD provided the parties in each case with two separate lists, one consisting of sixteen public arbitrators and the other consisting of eight industry arbitrators. The lists were generated by an NASD computer program using a rotational method, although the computer eliminated arbitrators with obvious conflicts of interest.[31] Along with the lists, the parties were also provided with background information on each

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[27] SEC, Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator, Sec. Exch. Act. Rel. No. 54792 (March 19, 2008).

[28] SEC, Release No. 34-69297; Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to Amend the Customer and Industry Codes of Arbitration Procedure to Revise the Public Arbitrator Definition (Apr. 4, 2013) New rule is effective July 1, 2013.

[29] Prior to 1998, arbitrators were appointed by the NASD staff. See www.sacarbitration.com/pdf/Arbitrator%20Service%2000-05.pdf

[30] 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. See https://www.finra.org/Newsroom/NewsReleases/1998/P010433

[31] The NASD shifted from a rotational method to a random selection method in 2005. See www.sec.gov/rules/sro/nasd/34-51083.pdf

arbitrator, including a copy of that arbitrator's Arbitrator Disclosure Report.[32] NASD rules then allowed parties to strike, without cause, prospective panelists and required the parties to rank numerically the remaining arbitrators until they reached agreement on a panel.[33] Importantly, list selection operated, at the time of our study, on a free strike basis, in which the parties were not limited in the number of prospective arbitrators they could strike. As a result, it was possible for the selection process to result in an incomplete panel. If this happened, the NASD would appoint an additional arbitrator selected randomly by computer, and the parties were not given the option of striking this additional arbitrator.

FINRA subsequently changed this procedure in three significant ways.[34] First at the time of our study, the public arbitrator ranked most highly by all the parties was appointed as chair of the panel. In 2006, FINRA adopted specific qualifications for panel chairs.[35] To implement the qualification requirements, the list section system was modified to generate three separate lists of eight potential arbitrators: a chair qualified list, another public list and a non-public list.[36] Then, in 2007, FINRA instituted limits on party strikes – limiting the parties to four strikes from each list of eight potential arbitrators.[37] This change had the effect of reducing but not eliminating the possibility of an incomplete panel because some arbitrators were unable to serve or subsequently

[32] See *STMicroelectronics*, 648 F.3d at 72 (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.

[33] FINRA has subsequently modified the list selection system several times.

[34] http://www.metrocorpcounsel.com/articles/8629/how-changes-nasd-code-arbitration-procedure-may-affect-customer-arbitrations

[35] To be "chair-qualified" an arbitrator was required to have a law degree or experience on at least three prior cases, as well as otherwise meeting the definition of a public arbitrator.

[36] http://www.law360.com/articles/17126/sec-ok-s-updates-to-nasd-arbitration-code

[37] SEC, Exchange Act Release No. 55158 (January 24, 2007), 7).

challenged for cause. To address this concern, in 2010, FINRA amended the selection system to expand the list of potential arbitrators from eight to ten.[38]

Debate continues over whether arbitrators should have experience in the securities industry. 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.[39] 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 dispute to be arbitrated arose."[40] On the other hand, an arbitrator's connections to the industry – those same connections that may furnish expertise – may also lead to claims of arbitrator bias. Of particular concern is the possibility that arbitrators with industry ties will be predisposed against claimants. Moreover, some commenters worry that the industry member's greater expertise will give their views undue weight with the public members of the panel. As noted above, FINRA has increased the restrictiveness of the definition of public arbitrator on several occasions to address these concerns. In addition, FINRA recently responded to these concerns by offering the option of all-public panels in customer arbitrations.[41]

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[38] SEC, Exchange Act Rel. No. 34-62480 (July 9, 2010) Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change Relating to Amending the Codes of Arbitration Procedure to Increase the Number of Arbitrators on Lists Generated by the Neutral List Selection System

[39] See 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 (2010) (defending expertise of FINRA arbitrators).

[40] International Produce v. A/S Rosshavet, 638 F.2d 548 (2d Cir. 1981).

[41] See *STMicroelectronics*, 648 F.3d at 77 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-

2.3. Prior Literature

The literature evaluating the relative merits of arbitration versus litigation is extensive. The fairness of arbitration, 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.[42] In addition, a few articles specifically study the FINRA arbitration process.[43] Among the challenges faced by these studies is the absence of a baseline. Arbitration decisions rarely report details of the underlying claim, providing researchers with little basis for assessing case merits. As a result, the studies rely largely on survey data examining the extent to which arbitration participants report satisfaction with the system.[44]

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.[45] Schultz finds a declining trend in the frequency with which customers prevail.[46]

These trends 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

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public panel in all cases). See also rule change in April 2013 simplifying the procedure for selecting an all public panel.

[42] Choi et al., supra note _ at 119 (summarizing the literature).

[43] Id. at 116-118.

[44] 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).

[45] Jiro E. Kondo, The Self-Regulation of Enforcement: Evidence from Investor-Broker Disputes at the NASD. (Working paper. Northwestern University, Kellogg School of Management 2009).

[46] Lawrence S. Schultz,. Storm Clouds in Arbitration, in Securities Arbitration 2008: Evolving and Improving (David E. Robbins, ed.. New York: Practising Law Institute 2008).

[47] Alexander J.S. Colvin, An Empirical Study of Employment Arbitration: Case Outcomes and Processes, 8 J. Emp. Leg. Stud. 1 (2011) (reporting strong evidence of repeat player advantage in employment arbitration).

potential arbitrators effectively and the ability to discipline arbitrators who rule against defendants by refusing to select them in subsequent 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 in our empirical analysis.

Congress has considered statutory changes to restrict pre-dispute arbitration clauses. 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.[50] 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.[51] To date, the SEC has not exercised this authority.

3. HYPOTHESES

Our hypotheses relate to a variety of characteristics that arbitrators bring with them to the arbitration process. They are based on the prior literature, conversations with a number of lawyers experienced in securities arbitration, our own anecdotal experience testifying as expert witnesses in arbitration cases, and our own conjectures based on the disclosures provided to the parties pursuant to the arbitrator selection process.

[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] Alon Klement &Zvika Neeman, 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] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2d Sess. 2010).
[51] 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).

As discussed in Section 2, FINRA procedures during our sample period allowed arbitrators with certain connections to the securities industry to serve as public arbitrators. Individuals who would be treated as industry arbitrators under current rules were then 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. On the other hand, the arbitrator disclosure forms required the disclosure of industry experience; with that information in hand, parties could strike them from the list. As noted above, 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 addition, many arbitrators' professional backgrounds revealed substantial industry experience, but not specific ties to the brokerage industry. Examples include academics, regulators, attorneys engaged in transactional securities work, and attorneys who primarily represented investors. These other sources of securities experience are unlikely to be correlated with significant industry bias. Indeed, to the extent that these arbitrators represent investors in other proceedings, their predisposition may be pro-customer rather than pro-industry.

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 reflect greater securities experience. Nonetheless, we postulate that experience in the securities industry is more likely to make the arbitrator more sympathetic to the industry.

H1: Arbitrators with connections to the securities industry will make smaller awards.

Some research has questioned the effect of arbitrator incentives, in particular the desire to be selected as an arbitrator in future cases. Klement and Neeman, for example, hypothesize that arbitrators tailor their awards to influence the perception of future parties. If arbitrators care about their selection in future cases, this may skew arbitration awards in favor of industry parties who are repeat players in securities arbitration. This effect is likely to be greatest for professional arbitrators – those who devote substantially all of their time to serving as arbitrators. 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 of being selected in future cases.

H2: Professional arbitrators will make smaller awards.

Another category of public arbitrators who may be anxious to be selected as arbitrators are retired people. In addition to having a lower opportunity cost for their time, 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.

H3: Retired arbitrators will make smaller awards.

We are also interested in 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.

H4: Arbitrators with prior experience as regulators will make larger awards.

Compliance officers play a quasi-regulatory role within brokerage firms, so we conjecture that service as a compliance officer might have an effect similar to past experience as a regulator.

H5: Arbitrators who are compliance officers will make larger rewards.

One overarching hypothesis is that the effects conjectured in the hypotheses above will be reduced or eliminated if the parties are represented by counsel. Unlike litigation in which the parties have little or no ability to determine the judge to whom their cases are assigned, parties in securities arbitration are able to exercise substantial control over the makeup of the arbitration panel through the party selection process. Importantly, the information that we study regarding the possibility of bias is all disclosed to the parties at the time that they are selecting the arbitrators. We postulate that attorneys experienced in securities arbitration will have a sense of how these characteristics are likely to affect their client's case and will select arbitrators accordingly.

H6: The effects of these characteristics in H1-H5 will be reduced if the claimant/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[52] with a three-person panel, thus excluding awards made by 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 panel chair.[53]

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>>

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[52] A substantial percentage of arbitration claims are settled or resolved on the papers without a live hearing.

[53] Because of FINRA's selection procedures at the time of our study, the chairs are almost all public arbitrators. In some cases, for reasons that we are unable to ascertain, decisions in our sample reported that the panel was chaired by an industry arbitrator. 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.[54] 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 an objective fact, and one that is verifiable by the broker or brokerage firm respondent, claimants' discretion with respect to the amount of compensation claimed is limited.

A number of additional factors may affect the Compensation Ratio. To control for these factors, our models include variables relating to 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 the Appendix.

<<Insert Table 2 About Here>>

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,

[54] 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.

including claims relating to "know your customer," NYSE Rule 405,[55] and NASD Rule 2310 issues,[56] 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 the respondents have settled.[57] 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 a partial settlement for an unreported amount, and the award (if any) against the remaining non-settling respondents was reported and 0

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[55] 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.

[56] 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."

[57] 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.

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, although 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. Moreover, arbitrators may perceive a large award against an individual broker or small firm as posing a risk of insolvency. The mean Claimed Compensation for our sample is $291,000, 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.[58] A large brokerage firm

[58] Securities Industry Association 1998.

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. 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 pressed their claim for punitive damages during the hearing.

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.[59] Arbitrators may, at their discretion, choose to expunge the arbitration claim from the CRD records for a broker involved in arbitration. 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.

To measure of the complexity of the arbitration, we include in our opinion controls the number of hearings in the arbitration (Number of Hearings) and the length of the arbitration opinion (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).

[59] 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).

In Hypothesis H6 we postulate that the presence of an attorney may have an effect on panel selection, which may in turn, relate to arbitration outcomes. To assess this possibility, we include in certain models 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 otherwise. In addition, better representation may lead directly to better outcomes. Indeed, representation may 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. Claimants were represented by counsel in 87% of the cases; respondents 82%.

4.3. Industry Experience

Our first test attempts to disaggregate the effects of experience and expertise 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. It is important to note that, at the time of our study, both the Chair and the panel would have been drawn from the same list of public arbitrators, but the Chair would have been ranked more highly by the parties.

<<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, 20% 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:

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

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.

The potential for bias presented by affiliation with the securities industry seems rather obvious, but the results in Model 1 suggest that it may not affect outcomes. Nonetheless, given the role that the parties play in arbitrator selection, it is difficult to understand why a claimant would ever allow an arbitrator with connections to the industry to serve as a public arbitrator on a panel. One reason may be that the claimant is not fully using the benefits of the party selection process. Claimants, after all, are likely to be one shot players, and the party selection process differs from many other types of dispute resolution. The use of claimants' counsel, who can add experience in party selection may be valuable here, and 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 variables for Claimant Attorney, Respondent Attorney, and interaction variables for Securities Experience Chair * Claimant Attorney and Securities Experience Panel * 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 2 of Table 4.

The results strongly support the hypothesis that unrepresented claimants see lower 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 2 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 * Claimant Attorney, when summed with Securities Experience Panel, captures the effect of this characteristic on claimants who have representation. The coefficient for the interaction variable is positive and significant and the sum of the two is not significantly different from zero (as reported in the F-test in the legend). 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.[60]

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

[60] 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 2 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 2, but only Profession Securities-Banker Chair is significant (at the 1% level). The interaction terms with Claimant Attorney are positive, similar with Model 2 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.

essentially eliminated, however, when claimants are represented by counsel. What about less obvious conflicts of interest? Do they influence awards? If so, is that influence ameliorated by the presence of counsel?

As indicated above, some commentators argue that arbitrators are motivated by a desire to be selected in future cases. They hypothesize that such arbitrators will tend to make lower awards in an effort to be more attractive to respondents, who are typically repeat players. Our second test examines whether these 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 his or her 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. Professional arbitrators constitute 35% of the chairs, arguably the most influential position, and 25% of the other public arbitrators.

<<Insert Table 5 About Here>>

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

$$\text{Compensation Ratio}_i = \alpha + ß_{1i}\text{Professional\_Arbitrator\_Chair}_i + ß_{2i}\text{Professional\_Arbitrator\_Panel}_i + + \sum ß_{ji}\text{ Subject Matter}_{ji} + \sum ß_{ki}\text{Opinion Controls}_{ki} + \sum ß_{li}\text{State Controls}_{li} + \text{Year Effects} + \varepsilon_i$$

Model 1 of Table 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 re-estimate the model above adding variables for Claimant Attorney, Respondent Attorney, as well as interaction variables for Claimant Attorney and the two Professional Arbitrator variables. We present the results of this regression in Table 6, Model 2. The coefficient for Professional Arbitrator Panel is negative in this model and larger in magnitude, albeit insignificant, which we attribute to the relatively small number of observations in this category. The coefficient for the sum of the interaction variable and Professional Arbitrator Panel is also negative and marginally significant. This suggests that attorneys do not completely ameliorate the potential conflict of interest created by an arbitrator's potential desire to trim awards to encourage future selection.

4.5. Retired Arbitrators

Retired arbitrators may face similar incentives as professional arbitrators. To the extent that an arbitrator is retired, he may face fewer demands on his time. The arbitrator's honorarium, albeit modest, may be more significant to an arbitrator who is retired. As a result, retired arbitrators, like professional arbitrators, may be motivated to make lower awards to enhance their future prospects of selection by broker-dealers. 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. Of course, some of the arbitrators in our sample continued to work full time after the age of 65, but many did not, even if they had not retired completely. 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>>

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 arbitrators on awards, we estimate the following equation for each award using ordinary least squares and robust standard errors clustered by arbitrator:

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

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 five percent level, while the coefficient for Retired Arbitrator Panel is positive, albeit insignificant. Examining the interaction between retired arbitrators and the presence of a claimant attorney in Model 2, 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 sum of Retired Arbitrator Chair and the interaction variable is negative and significant at the five percent level. As with profession arbitrators, this suggests that attorneys do not completely ameliorate the potential conflict of interest created by a retired arbitrator's potential desire to trim awards to encourage future selection. Our findings suggest that the incentives of professional and retired arbitrators represent a more subtle type of bias that may not be fully reflected in the party selection process, even with the aid of counsel.

4.6. Regulatory Experience

Our next set of tests looks at the effect of an arbitrator's experience as a regulator on their awards. To assess the possibility that experience as a regulator will incline an arbitrator to give more credence to claims of broker-dealer misconduct, we create an indicator variable equal to 1 if the arbitrator has experience as a federal or state prosecutor, a federal or state securities regulator, or a prior affiliation with a self-regulatory organization, and 0 otherwise.

In our earlier tests, we focused only on public arbitrators. For this set of tests, we expand our scrutiny to include the industry arbitrator. We postulate that industry arbitrators with a regulatory background 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 of arbitrators.

<<Insert Table 9 About Here>>

Regulatory experience is relatively common among the arbitrators in our sample, especially for industry arbitrators. Among the chairs, 16% had regulatory experience, while 10% of the other public arbitrators had such experience. For industry arbitrators, 11% had prior regulatory experience.

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:

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

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. Only the latter is significant, however, 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, our hypothesis is that regulatory experience will lead arbitrators to be harder on respondents. Accordingly, we want to see if the presence of an attorney for the respondent mitigates the tendency of public arbitrators with regulatory experience to give larger awards.[61] In Model 2 of Table 10 we add variables for Claimant Attorney, Respondent Attorney, and 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 * Respondent Attorney. Similarly, the coefficient for Regulator Panel is insignificant in

[61] 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.

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

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 in Models 3 and 4 of Table 10. We see in Model 3 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 * Respondent Attorney, similar to Model 2 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 * 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 their clients. We present the results of this regression in Model 4 of Table 10. We see that the coefficient for Regulator Industry is negative in this estimation, albeit not significant at conventional significance levels. The coefficient for the sum of this variable and the variable interacting Regulator Industry with Claimant Attorney is positive, but also insignificant. These finding suggest that prior experience as a regulator among industry arbitrators does not have a significant effect on awards. Although our data does not allow us to ascertain the reason for this finding, it is possible that regulators have a reduced tolerance for weak cases or, alternatively, that industry ties outweigh regulator effects.

4.7. Compliance officers

For our final set of tests, we wanted to see if employment as a compliance officer with a broker-dealer would have an effect on arbitration awards. We posit that compliance officers, like former regulators, may have more familiarity with broker misconduct and therefore may be inclined to make higher awards. Table 11 shows the incidence of experience as a compliance officer in our sample.

<<Insert Table 11 About Here>>

The incidence of experience as a compliance officer is relatively low for the public arbitrators in our sample (3% for chairs and 4% for the public panel member), but quite common among the industry arbitrators (44%). Because individuals largely self-select into the pool of available arbitrators, 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 actual and potential industry participants, however, we can only speculate in this regard.

Given the prevalence of compliance officers among the industry arbitrators, we focus our tests on them. We estimate the following equation for each award using ordinary least squares and robust standard errors clustered by arbitrator:

$$\text{Compensation Ratio}_i = \alpha + \text{ß}_{1i}\text{Compliance Industry}_i + \sum \text{ß}_{ji}\text{ Subject Matter}_{ji} + \sum \text{ß}_{ki}\text{Opinion Controls}_{ki} + \sum \text{ß}_{li}\text{State Controls}_{li} + \text{Year Effects} + \varepsilon_i$$

We present the results in Table 12.

<<Insert Table 12 About Here>>

The coefficient for the Compliance Industry variable is insignificant in Model 1. In Model 2, we add Claimant Attorney, Respondent Attorney, as well as an interaction variable for Claimant Attorney and the Compliance Industry variable. The coefficient for Compliance Industry, which represents the effect that such arbitrators have on awards when the claimant is not represented by counsel, is negative, with a relatively large magnitude, but it just misses significance at conventional significance levels (10.3%). The sum of the coefficient of this variable and the interaction variable is positive, but also insignificant. These results are only suggestive that the presence of counsel may make a difference. As with regulators, our findings may be based, in part, on the uncertain effect that a compliance background may have on the manner in which an arbitrator approaches a customer dispute.

5. CONCLUSION

In an ideal dispute resolution system, 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, like other systems of adjudication, cannot achieve that ideal of impartiality. FINRA has recognized the importance of an arbitrator's background in its increasingly stringent qualification requirements. This paper sheds empirical light on whether those changes are likely to affect case outcomes.

In this study we examine the relationship between an arbitrator's background, representation by counsel, and the outcome in securities arbitration. For the public arbitrators, we find that industry experience is correlated with statistically significant decreases in arbitration awards for claimants who are not represented by counsel. We find mixed results with respect to counsel's influence in our other tests. We find that professional arbitrators who are not the panel chair correlate with a statistically significant decrease in awards, and this effect is not eliminated by the presence of counsel for the claimant. Similarly, public chairs who are retired correlate with a statistically significant decrease in awards, and this effect is also not eliminated by the presence of counsel for the claimant. Our findings, although limited, suggest that characteristics such as retirement or professional arbitrator may create biases that are less visible to counsel than industry experience.

Looking at prior regulatory experience, we find some evidence that public arbitrators with regulatory experience are inclined toward larger awards if they do not serve as the panel chair. This effect is mitigated somewhat, but not eliminated, by the presence of an attorney for the respondent. Finally, we find some marginally significant evidence that there is a difference in awards if the industry arbitrator has experience as a compliance officer, depending on whether the claimant is represented by counsel.

Our findings suggest that FINRA may have been justified in imposing increasingly stringent limitations on the category of public arbitrators. Prior restrictions and reliance on disclosure did leave room for arbitrator backgrounds to influence outcomes. The effect was most likely to be felt by unrepresented parties; the presence of counsel mitigated, but did not eliminate the effect of arbitrator background.

Supporters of arbitration often highlight its streamlined proceedings and low costs compared to litigation as an advantage for small claimants.[62] These procedural advantages may offer claimants access to dispute resolution that they could not realistically obtain in courts, which undercuts FINRA's advice to potential claimants that

[62] Barbara Black, How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act, 13 U. Penn J. Bus. L. 1, 103 (2010) (warning that eliminating mandatory arbitration of customer disputes is likely to have a negative impact on retail investors).

they do not need to retain an attorney. Our findings suggest that, even with streamlined procedures, claimants who lack attorneys may face an uphill battle. Moreover, our findings advocate that the effectiveness of party selection depends in part on access to counsel experienced in the selection procedure. At the same time, however, our findings suggest that counsel may not be fully effective in screening for more subtle forms of bias such as an arbitrator's desire to be selected in future cases.

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.

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)
Securities Experience Chair	-0.413	-1.309
	(-0.46)	(-0.45)
Securities Experience Panel	-0.374	-4.558**
	(-0.52)	(-2.71)
Claimant Attorney		-0.346
		(-0.39)
Respondent Attorney		-1.689
		(-1.51)
Securities Experience Chair * Claimant Attorney		1.056
		(0.34)
Securities Experience Panel * Claimant Attorney		4.989*
		(2.60)
Constant	-1.658	0.120
	(-1.16)	(0.06)
N	186	186
Adj. R^2	0.310	0.341
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. F-test for Securities Experience Chair + Securities Experience Chair * Claimant Attorney = 0.7866. F-test for Securities Experience Panel + Securities Experience Panel * Claimant Attorney =0.54754.

+ 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)
Professional Arbitrator Chair	0.349	-0.863
	(0.64)	(-0.55)
Professional Arbitrator Panel	-1.194*	-1.487
	(-2.05)	(-0.89)
Claimant Attorney		0.731
		(0.69)
Respondent Attorney		-2.296*
		(-2.48)
Professional Arbitrator Chair * Claimant Attorney		1.541
		(0.93)
Professional Arbitrator Panel * Claimant Attorney		0.413
		(0.23)
Constant	-2.382+	-0.930
	(-1.84)	(-0.50)
N	239	239
Adj. R^2	0.298	0.322
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. F-test for Professional Arbitrator Chair + Professional Arbitrator Chair * Claimant Attorney = 0.2439. F-test for Professional Arbitrator Panel + Professional Arbitrator Panel * Claimant Attorney = 0.0890

+ 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 7. Retired Arbitrators

	N	Fraction Retired
Chair	295	0.325
Panel	295	0.522

Table 8. Retired Arbitrator Regressions

	(1)	(2)
Retired Chair	-0.983*	0.139
	(-1.97)	(0.10)
Retired Panel	0.456	0.231
	(0.98)	(0.19)
Claimant Attorney		1.680
		(1.60)
Respondent Attorney		-1.563+
		(-1.69)
Retired Chair * Claimant Attorney		-1.244
		(-0.87)
Retired Panel * Claimant Attorney		0.277
		(0.21)
Constant	-2.820*	-2.770
	(-2.45)	(-1.60)
N	266	266
Adj. R^2	0.293	0.304
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. F-test for Retired Chair + Retired Chair * Claimant Attorney = 0.0398. F-test for Retired Panel + Retired Panel * Claimant Attorney = 0.3126.

+ 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 9. Regulatory Experience for Public and Industry Arbitrators

	N	Fraction Regulators
Chair	295	0.156
Panel	278	0.097
Industry	262	0.107

Table 10. Regulatory Experience Regressions

	(1)	(2)	(3)	(4)
Regulator Chair	0.875	-0.251		
	(1.15)	(-0.12)		
Regulator Panel	2.549**	3.156		
	(3.23)	(1.21)		
Regulator Industry			-0.037	-1.122
			(-0.05)	(-0.81)
Claimant Attorney		1.065		0.918
		(1.35)		(0.98)
Respondent Attorney		-1.816		-0.768
		(-1.55)		(-0.81)
Regulator Chair * Respondent Attorney		1.388		
		(0.64)		
Regulator Panel * Respondent Attorney		-0.853		
		(-0.31)		
Regular Industry * Claimant Attorney				1.609
				(0.92)
Constant	-1.684	-0.930	-3.510**	-3.644*
	(-1.27)	(-0.44)	(-2.95)	(-2.16)
N	190	190	239	239
Adj. R^2	0.337	0.342	0.219	0.222
Subject Matter Controls	Yes	Yes	Yes	Yes
Opinion Controls	Yes	Yes	Yes	Yes
State Controls	Yes	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. F-test for Regulator Chair + Regulator Chair * Respondent Attorney = 0.1699. F-test for Regulator Panel + Regulator Panel * Respondent Attorney = 0.0047. F-test for Regulator Industry + Regulator Industry * Claimant Attorney = 0.6268

$^+$ 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 11. Compliance Experience for Public and Industry Arbitrators

	N	Fraction Regulators
Chair	290	0.031
Panel	275	0.040
Industry	259	0.436

Table 12. Compliance Experience Industry Arbitrator Regressions

	(1)	(2)
Compliance Industry	0.0220	-2.157
	(0.04)	(-1.64)
Claimant Attorney		-0.067
		(-0.06)
Respondent Attorney		-0.831
		(-0.90)
Compliance Industry * Claimant Attorney		2.473^{+}
		(1.71)
Constant	-3.701**	-2.760
	(-3.12)	(-1.45)
N	236	236
Adj. R^2	0.245	0.251
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. F-test for Compliance Industry + Compliance Industry * Claimant Attorney = 0.5569.

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

* Coefficient significant at the 5% level or less.

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