

When Arbitrators Are Their Own Judges
By GRETCHEN MORGENSON

WHEN Harley C. McDonald, a retired lawyer for a Nebraska construction company, lost 80 percent of his \$60 million stock market nest egg, he lost faith in the brokerage industry.

And now, after having filed a complaint contending that his broker had neglected his investments, he's losing faith in the arbitration system that is supposed to address grievances.

Whether Mr. McDonald's broker is at fault is undetermined; an arbitration panel will decide that. But what is certain --- at least in the eyes of Mr. McDonald, his wife, his lawyer and investor advocates --- is that the arbitration process is flawed.

"There's no justice here," said Mr. McDonald's wife, Carol. "You don't have any way to get due process."

The source of Mrs. McDonald's ire is the process used to determine the members of the arbitration panel. Given that there are just three members and that they act as judge and jury, each individual holds great sway.

The problem is that the potential arbitrators are trusted to volunteer their own possible conflicts of interest. But, as Mr. and Mrs. McDonald found, that is not always the case.

For investor advocates, the potential for conflicts among arbitrators ranks high on the list of arbitration problems. They say that requiring arbitrators to volunteer their conflicts with little policing of those disclosures is an honor system that can lead to abuse.

In the McDonalds' case, a potential conflict of interest was not disclosed by the nominated arbitrator. Instead, it came out after the McDonalds' lawyer, Lawrence L. Klayman of Klayman & Toskes in Boca Raton, Fla., challenged the arbitrator.

Securities arbitration panels are supposed to offer a way to resolve disputes fairly, faster and more cheaply than the overtaxed court system. A three-member panel hears the case; one person represents the brokerage industry, and the other two are public representatives.

Arbitration became practically ubiquitous in 1987, after the Supreme Court ruled in a case known as Shearson/American Express v. McMahon that account forms signed by customers requiring that disputes be resolved in arbitration were enforceable contracts. Wall Street firms soon required clients to sign such documents.

The process is overseen by the Financial Industry Regulatory Authority, a nongovernment agency formed through the combination of the former arbitration units of the NASD and the New York Stock Exchange. Previously, those units operated separately.

Last year, according to the authority, 7,212 cases were decided in arbitration, down from a peak in 2004 of 9,209. Forty-two percent of cases in 2006 resulted in monetary awards for the customer. Five years earlier, that figure was 54 percent.

The stakes in the arbitration were high for the McDonalds, as they often are for investors who bring securities claims against their brokers.

Filed in September 2005, the McDonalds' claim contended that their broker failed to diversify their \$60 million portfolio, which held just two volatile telecommunications companies. The couple lost \$48.6 million as a result, they contend.

The shares were a part of Mr. McDonald's earnings over almost 30 years at Peter Kiewit Sons, a privately held construction services company in Omaha. As general counsel for the company's construction division, Mr. McDonald earned compensation that included shares in the company. When he retired in 1993, those shares were worth about \$6 million. Five years later, some of that stake had become stock of public companies, Level 3 Communications and WorldCom.

MR. McDONALD explained that both he and his wife were unsophisticated investors who had never had a brokerage account.

When he retired, Mr. McDonald put his shares in a safe deposit box at FirstTier Bank of Omaha. After FirstTier was acquired by U.S. Bancorp in 1999, the couple opened a brokerage account at the firm. Their broker soon moved to Piper Jaffray, a regional firm based in Minneapolis, taking the McDonalds' account with him.

"Both Carol and I were called in, and we said we don't know anything about the stock market," Mr. McDonald, who is 66, said. "They assured us they had experts in the two stocks we held, and they would be able to monitor them and advise us what to do."

He said the brokers gave them little guidance, offering no advice except to send research reports that recommended the purchase of Level 3 shares. By June 2000, the couple's holdings in the two stocks were valued at \$66 million. They owned no other stocks.

The couple sold some of their shares --- worth about \$5 million --- between 1999 and 2001. But by the end of 2001 their portfolio, ravaged by the downturn in technology and telecommunications stocks, had dwindled to \$7.3 million. In the summer of 2002, WorldCom declared bankruptcy.

Research analysts at Piper Jaffray, like many brokerage firms during this period, had maintained bullish opinions on telecommunications and technology stocks, including Level 3, well after the tech stock bubble burst. For example, according to the complaint, the firm did not downgrade Level 3 from "strong buy" until April 19, 2001, when it moved it down a notch, to "buy." But that was after the shares had fallen to \$13.06 from a peak of almost \$50 that previous January.

The couple sold another \$7 million in stock between 2001 and 2004, but in September 2005 they filed a complaint against their broker. Piper Jaffray denied the McDonalds' allegations, arguing that a broker does not have a duty to provide advice to customers about stockholdings that he did not personally recommend. The firm's lawyers also moved to dismiss the case on the grounds that the McDonalds should have filed it a year earlier.

But the case progressed, and an arbitration panel was convened in January 2006. Because of scheduling conflicts on both sides, the hearing was not scheduled to begin until last month. When arbitration panels are convened, lawyers representing both parties can choose from a list of potential panelists. There are 6,773 potential panelists in the pool overseen by the financial regulatory authority.

According to the arbitrators' manual, panelists are asked to disclose any relationships that involve family members, current or former employers, partners or business associates. In a so-called arbitrator disclosure report, potential panelists list their background, education and training and other information, like lawsuits filed against them. Armed with this information, lawyers for both plaintiff and defendant can assess arbitrators' fitness for a case.

During the arbitrator selection process, lawyers for both sides are allowed to strike people from the list of candidates. If all are struck, the lawyers must accept the regulatory authority's choices for the panel. At that point, lawyers for both sides can challenge a panelist only for possible biases, misclassification, conflicts or undisclosed material information.

The chairman appointed to the McDonald's panel was Mark F. Marshall, a lawyer at Davenport, Evans, Hurwitz & Smith a 35-lawyer firm in Sioux Falls, S.D. As an arbitrator, he represented the public, not the brokerage industry.

Last month, just four days before the first hearing was scheduled, the McDonalds' lawyer, Mr. Klayman, learned that Mr. Marshall's firm represented Piper Jaffray in a 1999 lawsuit, and that in 2002 and 2006, his firm provided legal services to Piper relating to public offerings it helped underwrite. In a letter to regulators on July 12, Mr. Klayman challenged Mr. Marshall's selection as an arbitrator.

The next day, according to documents filed with the regulatory authority, Piper Jaffray's counsel reported that it had uncovered further ties between it and Davenport Evans, Mr. Marshall's law firm:

Davenport had represented the brokerage firm in 2003 in a case involving three Piper Jaffray brokers. Mr. Marshall did not represent Piper, but Mr. Klayman challenged his selection again, and on July 16, Mr. Marshall was removed from the panel by the authority.

A new chairman will be chosen in the coming weeks. The hearing has not yet been rescheduled.

Mr. McDonald said he was surprised to learn that his panel's chairman could have decided a significant case involving a brokerage firm that had ties to his employer. "I can't

imagine an attorney with a law firm making a decision adverse to one of the firm's major clients," he said.

Mr. Marshall did not return two phone calls seeking comment.

Mr. Klayman said that he thought it should not be up to the lawyers representing brokerage firm customers to track down undisclosed conflicts among arbitrators. Lawyers for brokerage firms in these cases should be required, he said, to investigate potential conflicts among the arbitrators selected for a panel.

"Our goal is to find somebody who is unbiased and who has disclosed all their conflicts," Mr. Klayman said. "Investors, I believe, are entitled to a fair shot at justice."

He suggests that the rules be modified to require defense counsel to investigate ties among its firm, its client and arbitrators assigned to a case and report them to the regulators.

"The system needs to be overhauled," he said. "Now we have evidence that possibly mandates change."

OFFICIALS at the Financial Industry Regulatory Authority said the arbitrator selection system has extensive checks and balances that make it work well for both parties in any dispute. Linda D. Fienberg, president of the authority's dispute resolution program, said in a statement that new applicants undergo extensive background checks by an outside vendor and that applicants who intentionally misstate facts or fail to disclose material information are disqualified. Each time they are appointed to a case, she said, arbitrators must sign an oath attesting to the truthfulness and completeness of their disclosures.

"Even in the rare cases when an arbitrator with an apparent conflict ends up on an arbitrator list," Ms. Fienberg said, "the error is discovered and Finra moves quickly to rectify the problem --- by removing the arbitrator and providing new arbitrator choices to the parties."

At least one firm already does appear to scrutinize arbitrators chosen to oversee cases in which it is involved. Mr. Klayman noted that in a recent case involving Wells Fargo Investments, the firm's lawyers notified Klayman & Toskes before arbitrator selection that one potential panelist should not be a candidate in the case as she is a Wells Fargo employee. The firm also said the arbitrator should not be listed as representing the public because she works for Wells Fargo, a fact that was not mentioned on her arbitrator disclosure report.

"Wells Fargo's outside counsel should be commended for their honesty and forthrightness," Mr. Klayman said.

Questions about how closely regulators monitor arbitrator disclosure forms arose in another case involving Wells Fargo. One of the 24 arbitrator candidates on the list prepared by Finra had disclosed that he was a senior regional manager for Wells Fargo Private Client Services in Omaha. Indeed, he had overseen the branch office that was at issue.

An official from the regulatory authority said that Finra's inclusion of that manager as a potential panelist was a clerical error that was corrected without doing any harm to the parties.

Cynthia J. Swan, senior counsel at Wells Fargo & Company, said:

"According to the rules, the NASD, now Finra, employs a screening mechanism for its arbitrator lists but, in our experience, it sometimes misses people associated with either the claimant or the respondent."

But they don't necessarily serve on panels, she said, because the lawyers for either party identify the conflicts or the arbitrators themselves point them out.

Steven D. Toskes, a partner at Klayman & Toskes, said: "Everybody should want the process to be fair to everybody. That's all we ask, and that's all the McDonalds are asking."
