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United States General Accounting Office
Washington, D.C. 20548

November 9, 2000

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Dear Mr. Dingell:

Subject: Procedures for Updating Arbitrator Disclosure Information

This report responds to your March 23, 2000, request that we evaluate the effectiveness of the National Association of Securities Dealers' (NASD) subsidiary, NASD Dispute Resolution, Inc. (NASD-DR), procedures for updating biographical information that its arbitrators submit.[1] You specifically cited an incident in which NASD-DR staff did not enter updated information on the employment status of one arbitrator into its arbitrator disclosure information database. This resulted in the parties in arbitration not receiving the updated information until after their case had begun. You expressed concern about whether NASD-DR had implemented a procedure to ensure prompt updating of this database that would prevent recurrences of this type of incident.

Results in Brief

Late in 1998, NASD-DR began to improve the way it handles the background information updates that its arbitrators submit. It assigned responsibility for entering this information into its arbitrator disclosure information database to specific staff members in each of its offices, required that the data be entered within 3 days of receipt, and conducted random spot-checks of the data entered. Although these changes reduced the potential for untimely or inaccurate data entry, they could not ensure that all data submitted by about 7,000 arbitrators to any of NASD-DR's offices by mail, telephone, or e-mail would be entered in a timely and accurate manner. To further reduce the potential for error, NASD-DR plans, beginning late in 2000, to (1) introduce a form that will allow arbitrators to submit update information electronically and (2) centralize processing of the information in its Department of Neutral Management, the unit responsible for administering arbitrator training and selection activities. Since NASD-DR has made improvements and plans to initiate additional improvements to its procedures for updating arbitrator disclosure information, we are not making any further recommendations at this time.

[1] In July 2000, NASD-DR became operational as a subsidiary of NASD. NASD-DR administers NASD arbitration, mediation, and other alternative dispute resolution services.

Background

The securities industry uses arbitration to resolve disputes between industry members, their employees, and individual investors. Securities self-regulatory organizations (SRO) administer arbitration programs under the Securities and Exchange Commission's (SEC) oversight. The largest SRO arbitration program is that of NASD-DR, which administered about 92 percent of investor-initiated securities arbitration cases in 1998. NASD-DR has a pool of about 7,000 eligible arbitrators.

How Arbitrators Are Selected

In selecting individuals for placement on its arbitrator roster, NASD-DR relies on background information that prospective arbitrators provide. This information is initially entered into the NASD-DR arbitrator information database when arbitrators become enrolled into the program and is to be updated for any new information. NASD-DR uses the background information to classify arbitrators as "nonpublic" or "public."[2] The parties in a dispute also use this information in deciding whether to accept arbitrators to be assigned to their case. NASD-DR arbitrator disclosure reports include information on education and training, employment, past arbitration experience, financial disclosure, and conflict of interest. The reports also include a narrative section, written by the arbitrators, describing their professional duties and responsibilities.

We recently reported on changes that NASD-DR made to its procedure for selection of arbitrators.[3] NASD-DR officials told us that one of their most significant rule changes has been for the parties in arbitration to select arbitrators from a list. Under the previous rules, NASD-DR staff provided the parties with the names of three arbitrators. The parties had one peremptory challenge and unlimited challenges for cause to eliminate particular arbitrators. The new rules provide for a list selection process that gives the parties a greater role in choosing who will decide their cases. The new process, called the Neutral List Selection System (NLSS), was implemented late in 1998 as a result of a recommendation by the Arbitration Policy Task Force.[4] The task force noted that for this process to be effective, the parties must be provided adequate arbitrator disclosure information in order to make informed judgments in selecting arbitrators.

Under NLSS, NASD-DR supplies a list of up to 15 names that are selected by computerized rotation of the arbitrator roster. The parties can strike anyone from the list and rank the

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[2] Nonpublic arbitrators typically have significant professional contacts with the securities industry, and are able to bring their knowledge of the industry to the dispute resolution process. Public arbitrators do not have close ties to the securities industry, and have developed their professional expertise outside the industry. Both types of arbitrators are expected to be neutral in particular cases. Cases involving investors and certain employment disputes have panels with a majority of or solely of public arbitrators. Some intra-industry cases have panels composed of solely nonpublic arbitrators. For full definitions of nonpublic and public arbitrators see the NASD Code of Arbitration Procedure, Section 10308.

[3] Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards (GAO/GGD-00-115, June 15, 2000).

[4] Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc., January 1996.

remaining arbitrators according to their preferences. If the parties cannot agree, they are assigned the next available arbitrator with the correct classification—public or nonpublic--on the computerized roster to fill any remaining vacancies. NASD-DR also revised the roster of arbitrators and eliminated names for various reasons, such as unsatisfactory evaluations in previous arbitration cases, failure to complete new training requirements, lack of interest, or conflicts of interest that would prevent them from serving as independent arbitrators. NASD-DR officials told us that revising the roster is an ongoing effort that NASD-DR performs as a routine matter.

Objectives, Scope, and Methodology

Our objectives were to determine whether NASD-DR had implemented procedures to ensure prompt updating of its arbitrator information database. We interviewed officials of NASD-DR to obtain information on current and planned procedures for updating arbitrator disclosure information and reviewed related documents, including internal audit reports on the updating of arbitrator information. Because NASD-DR's internal audit work already indicated the occurrence of errors and omissions, we did not consider independently auditing the data entry function. We obtained comments from NASD-DR and SEC on a draft of this report and these comments are discussed near the end of the report.

We conducted our work in Washington, D.C., and New York, NY, during July through October 2000, in accordance with generally accepted government auditing standards.

NASD-DR Has Taken Steps to Obtain Updated Arbitrator Information

NASD-DR has taken actions to help ensure that arbitrators submit updated background information. After arbitrators become enrolled in the program, NASD-DR officials told us NASD-DR repeatedly reminds arbitrators of the obligation to update background information. For example, NASD-DR's arbitrator training materials note that each time arbitrators are appointed to a case, they are to review their disclosure reports for accuracy and update them as necessary. Other NASD-DR materials provided to arbitrators–the Arbitrator's Reference Guide, the Code of Arbitration Procedure, and the Arbitrator's Manual–also contain discussions of required disclosures and the obligation to update background information. In addition, NASD-DR officials stated that in the NASD-DR newsletter–called The Neutral Corner, which it sends to all arbitrators free of charge–NASD-DR regularly places reminders about their duty to provide updated disclosure information.

NASD-DR has also used other measures to further ensure that arbitrator background information is up to date. In 1992, and again at the end of 1998, NASD-DR surveyed its pool of arbitrators to review and verify the accuracy of information on their backgrounds. In addition, NASD-DR officials said that NASD-DR staff checks the background information for possible conflicts of interest before sending the information to the parties in arbitration for their review. When arbitrators are appointed to a case, NASD-DR also requires them to sign an oath or affirmation indicating that the background information is accurate.

NASD-DR Has Improved Its Arbitrator Information Update Procedures and Plans Additional Improvements

Before 1998, NASD-DR had no distinct procedures for entering arbitrator update information into its database and checking to ensure that the entries were made in a timely and accurate manner. According to NASD-DR officials, arbitrator information sent to a specified staff member in any of its four regional offices by mail, e-mail, or via telephone could be entered by the staff member or the staff member's secretary. Information that was mailed to NASD-DR but not addressed to a specified staff member was to be forwarded to the group responsible for administering the arbitrator selection process, where it would be entered by a staff member. No specified staff member, however, was responsible for reviewing the inputted information to ensure that all information was accurately and completely entered. Such a procedure, in which any staff member could enter information and no one was responsible for checking the entries, made it difficult to ensure that all information was entered in a timely and accurate manner.

With implementation of NLSS and in response to an SEC inspection, NASD-DR adopted procedures to better ensure that arbitrator update entries are made in a timely and accurate manner. According to NASD-DR officials, NASD-DR has reviewed arbitrator update information practices in all of its offices and identified individual staff members in each office who are responsible for making the update entries. The officials stated that they have instituted a requirement that the staff members responsible for entering the update information must do so within 3 business days from receipt of the information.

To monitor these requirements, the officials stated that NASD-DR regional directors, starting in December 1998, were to conduct quarterly audits of the update process. To verify that the updates were made, the regional directors were to randomly audit 10 percent of all updated disclosure reports. Each regional director was to file a written report of the audit with the Director of Neutral Management—the official responsible for managing NLSS. However, the NASD-DR officials noted that with 7,000 arbitrators, these random spot checks still might not always have ensured that all updated information is entered. Audit reports that we reviewed for the last three quarters indicated that the auditors found typographical errors and omissions in arbitrator disclosure reports in some of the regions, and corrective actions were taken. The reports did not provide data on the extent to which errors occurred.

To better enable NASD-DR to monitor the receipt and entry of arbitrator update information, the officials said they are planning an e-mail reporting form for arbitrators to use to submit this information. They said that this form is intended to provide a more distinct and auditable process by which NASD-DR could document receipt of the information and establish internal control checks to ensure that the updated information is entered into its database. The officials said they expected that use of the e-mail form would be implemented in late 2000. Arbitrators using the form would be able to submit update information electronically or print the form, fill in the updated information and FAX or mail it to NASD-DR. Because some arbitrators may be reluctant or unable to access the form or submit data electronically, NASD-DR may still have to provide them the traditional letter or telephone methods to supply information updates. In these cases NASD-DR regional staff who receive the information

would record the information on the form and forward it to the Department of Neutral Management.

In addition, to better manage the data entry process, NASD-DR plans to centralize the arbitrator roster maintenance function in the Department of Neutral Management, located in its New York City office. NASD-DR officials said that the department would be solely responsible for updating and revising arbitrator records. The officials said this would make the process easier to control and reduce the possibility of errors.

Conclusions

The steps NASD-DR has taken to improve its procedures for entering arbitrator update information appear reasonable to reduce the opportunity for errors and improved the promptness of data entry. The additional changes that NASD-DR plans to implement late in 2000 could make the update process easier to control and further reduce the possibility of errors. NASD-DR's regular audits of the update process provide it a means for evaluating the success of the changes in reducing the potential for data entry errors and better ensuring that the parties in arbitration are provided accurate and up to date information. Since NASD-DR has made improvements and plans to initiate additional improvements to its procedures for updating arbitrator disclosure information, we are not making any further recommendations at this time.

Agency Comments and Our Evaluation

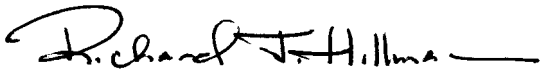
NASD Dispute Resolution, Inc. and SEC provided written comments on a draft of this report, which are reprinted in appendixes I and II. NASD-DR agreed with the contents of this report and provided additional information on initiatives it has taken or plans to take to improve the dispute resolution process. In particular, with regard to procedures for updating arbitrator disclosure information, NASD-DR also plans to redesign its computer system. The new system will be implemented over the next few years and, among other things, will enable arbitrators to access and update their own records in NASD-DR's system.

SEC also agreed with the contents of this report. It suggested a technical change to the draft, which we made. SEC stated that the steps taken or soon to be taken by NASD-DR to enter updated arbitrator information into its systems reasonably address this issue. SEC also commented that SEC staff intends to monitor NASD-DR's implementation of the new procedures later this year as part of a routine inspection.

As agreed with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will provide copies to Representative Tom Bliley, Chairman, House Committee on Commerce; Representative Michael G. Oxley, Chairman, and Representative Edolphus Towns, Ranking Minority Member, Subcommittee on Finance and Hazardous Materials, House Committee on Commerce; the Honorable Arthur Levitt, Chairman, SEC; Mr. Frank Zarb, Chairman, NASD; and other interested parties. We will also make copies available to others upon request.

Please call me or Michael A. Burnett, Assistant Director, at (202) 512-8678 if you or your staff have any questions concerning this report. David Tarosky also contributed to this report.

Sincerely yours,



Richard J. Hillman
Director, Financial Markets and
Community Investment

Comments from NASD Dispute Resolution Inc.

Linda D. Fienberg

President
NASD
Dispute Resolution

Chief Hearing Officer and
Executive Vice President
NASD Regulation

October 24, 2000

Mr. Richard J. Hillman
Director, Financial Markets and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Hillman:

NASD, Inc. (NASD), and its subsidiary corporation, NASD Dispute Resolution, Inc. (Dispute Resolution), appreciate the opportunity to comment on the GAO Report entitled: Procedures for Updating Arbitrator Disclosure Information (GAO Report or Report). On behalf of the NASD, I would like to thank the GAO staff members for the courteous manner in which they conducted this review of our securities arbitration program. In addition, the opportunity afforded the Dispute Resolution staff to discuss your findings during the course of this review resulted in our development of several important initiatives responsive to the Report, as described below. Pursuant to your invitation for comments, this letter contains our formal response to the GAO Report.

NASD Dispute Resolution routinely works with the National Arbitration and Mediation Committee (NAMC),[1] to improve the dispute resolution process. The GAO Report cited numerous improvements instituted by NASD Dispute Resolution to monitor the receipt and entry of arbitrator update information. In recent years, NASD Dispute Resolution instituted numerous changes responsive to recommendations contained in prior GAO reports such as:

- Establishing formal arbitrator qualification standards,
- Creating a training requirement in 1993 and a testing requirement in 1998 for new arbitrators,[2]
- Periodically collecting questionnaires from all members of the arbitration roster to verify the accuracy of their background and experience,

[1] The NAMC, the NASD Dispute Resolution Board's Standing Committee, has a majority representation of public (that is, non-industry) members.
[2] The arbitrator training program and materials have been revised and updated several times since 1993.

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- Instituting the Neutral List Selection System (NLSS), in November of 1998, which gives the parties more control in the selection of their panel, and

- Creating the Director of Neutral Management position with central responsibility for all neutral qualification and maintenance issues.

In 1999, the staff updated the records of over 6,500 arbitrators based on the arbitrators' responses to a November 1998 questionnaire. Arbitrators who failed to respond to the questionnaire were subsequently dropped from the roster. Dispute Resolution senior staff members conduct regular audits to ensure that the staff inputs important updates provided by arbitrators in a timely manner.

NASD Dispute Resolution Initiatives

As indicated above, NASD Dispute Resolution has long recognized the importance of updating its arbitrator records in a timely and accurate manner. We believe that when parties consider an arbitrator for possible service, they have a fundamental right to arbitrator information that is up-to-date, correct, and relevant. To address this issue further, NASD Dispute Resolution will take the following actions to supplement its existing efforts:

1. *Centralization of the Roster Maintenance Function*: Beginning in November 2000, the Department of Neutral Management (DNM), located in New York City, will be solely responsible for updating and revising arbitrator records. We believe this will make the process easier to control and reduce the possibility of errors.

2. *Online Update Form*: By November 15, 2000, arbitrators will be able to update their records online via NASD Dispute Resolution's Web site. An easy, step-by-step form has been designed that will allow arbitrators to update their information and to submit it electronically to the DNM.[3] Regional staff will notify the DNM of necessary updates by completing and forwarding this form electronically.

3. *Arbitrator Disclosure Reports*: Beginning November 1, 2000, arbitrators serving on three-person panels will receive a copy of the disclosure reports of their fellow arbitrators. This practice will help arbitrators have a better understanding of the expertise and background of the people with whom they are serving and, we hope, will also encourage panel members to consider the disclosures made by other arbitrators and to make similar disclosures themselves.

4. *Redesign of the Computer System:* NASD Dispute Resolution has begun an ambitious project to redesign its legacy computer system. The new system, (Matrics[4]), will be implemented in phases over the next few years and will feature a web-based gateway for parties, counsel, arbitrators, mediators, and staff. Among other things, the new system will enable neutrals to access and update their own records on our system.

[3] Arbitrators may also print the form, complete it by hand, and fax or mail it to the Department of Neutral Management.
[4] Matrics is an acronym for Mediation and Arbitration Tracking and Retrieval Interactive Case System.

Mr. Richard J. Hillman
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Conclusion

NASD Dispute Resolution appreciates the importance of providing to parties complete and accurate information about the arbitrators in our forum. Our plans to provide arbitrators with the means to update their records electronically should ease the process for neutrals and enable the Dispute Resolution staff to monitor changes. Dispute Resolution staff believes that centralizing the record update and maintenance functions will improve our capabilities and create methods of measuring the efficacy of those changes. Finally, our system redesign efforts signal a continuing commitment to dedicate significant resources to address these matters on an ongoing basis.

Again, thank you for the opportunity to respond to the GAO Report and to work with your staff to help fashion responsive initiatives. If you have any questions or require further information, please contact me at (202) 728-8407.

Very truly yours,

Linda D. Fienberg
President
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cc: Michael A. Burnett
Robert Glauber
Richard G. Ketchum
Robert Love
Mary L. Schapiro
Frank G. Zarb

Comments From the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

October 24, 2000

Richard J. Hillman
Director
Financial Markets
and Community Investment
United States General Accounting Office
441 G Street, NW
Room 2A30
Washington, DC 20548

Dear Mr. Hillman:

Thank you for the opportunity to review the General Accounting Office's (GAO) draft report entitled Procedures for Updating Arbitrator Disclosure Information. In your report, you evaluate the effectiveness of procedures used by the National Association of Securities Dealers' (NASD) subsidiary, NASD Dispute Resolution, Inc. (NASD-DR), to update biographical information submitted by arbitrators.

The Commission staff had shared the concern voiced by Congressman John D. Dingell that there might be a problem in NASD-DR's procedures for incorporating updated information on arbitrators into its records based on a complaint regarding one arbitrator appointed to an NASD-DR case. In that case, the arbitrator had submitted updated information that was not placed into NASD-DR records or provided to the parties.

We are pleased to learn in your draft report that GAO's work is consistent with the staff's own review of this issue since that complaint was made – that there is no systemic problem regarding the update of biographical information. We agree that the steps taken or soon to be taken by NASD-DR to enter updated arbitrator information into its systems reasonably address this issue. The Commission's inspection staff has advised me that it intends to monitor the implementation of the revised procedures planned for later this year as part of its routine inspection cycle.

We shared a technical comment on the draft directly with your staff, and otherwise have no comments on the report. Thank you again.

Sincerely,

Catherine McGuire
Chief Counsel

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