

THE SECURITIES ARBITRATION SYSTEM

HEARING

BEFORE THE
SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED NINTH CONGRESS

FIRST SESSION

MARCH 17, 2005

Printed for the use of the Committee on Financial Services

Serial No. 109-11



U.S. GOVERNMENT PRINTING OFFICE

24-398 PDF

WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
RICHARD H. BAKER, Louisiana
DEBORAH PRYCE, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chair*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, Jr., North Carolina
JUDY BIGGERT, Illinois
CHRISTOPHER SHAYS, Connecticut
VITO FOSSELLA, New York
GARY G. MILLER, California
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona
JIM GERLACH, Pennsylvania
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
MICHAEL G. FITZPATRICK, Pennsylvania
GEOFF DAVIS, Kentucky
PATRICK T. McHENRY, North Carolina

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELAZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, Jr., Tennessee
RUBEN HINOJOSA, Texas
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
CAROLYN McCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
ARTUR DAVIS, Alabama
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
DEBBIE WASSERMAN SCHULTZ, Florida
GWEN MOORE, Wisconsin
BERNARD SANDERS, Vermont

Robert U. Foster, III, *Staff Director*

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED
ENTERPRISES

RICHARD H. BAKER, Louisiana, *Chairman*

JIM RYUN, Kansas, <i>Vice Chair</i>	PAUL E. KANJORSKI, Pennsylvania
CHRISTOPHER SHAYS, Connecticut	GARY L. ACKERMAN, New York
PAUL E. GILLMOR, Ohio	DARLENE HOOLEY, Oregon
SPENCER BACHUS, Alabama	BRAD SHERMAN, California
MICHAEL N. CASTLE, Delaware	GREGORY W. MEEKS, New York
PETER T. KING, New York	DENNIS MOORE, Kansas
FRANK D. LUCAS, Oklahoma	MICHAEL E. CAPUANO, Massachusetts
DONALD A. MANZULLO, Illinois	HAROLD E. FORD, Jr., Tennessee
EDWARD R. ROYCE, California	RUBÉN HINOJOSA, Texas
SUE W. KELLY, New York	JOSEPH CROWLEY, New York
ROBERT W. NEY, Ohio	STEVE ISRAEL, New York
VITO FOSSELLA, New York,	WM. LACY CLAY, Missouri
JUDY BIGGERT, Illinois	CAROLYN MCCARTHY, New York
GARY G. MILLER, California	JOE BACA, California
MARK R. KENNEDY, Minnesota	JIM MATHESON, Utah
PATRICK J. TIBERI, Ohio	STEPHEN F. LYNCH, Massachusetts
J. GRESHAM BARRETT, South Carolina	BRAD MILLER, North Carolina
GINNY BROWN-WAITE, Florida	DAVID SCOTT, Georgia
TOM FEENEY, Florida	NYDIA M. VELÁZQUEZ, New York
JIM GERLACH, Pennsylvania	MELVIN L. WATT, North Carolina
KATHERINE HARRIS, Florida	ARTUR DAVIS, Alabama
JEB HENSARLING, Texas	MELISSA L. BEAN, Illinois
RICK RENZI, Arizona	DEBBIE WASSERMAN SCHULTZ, Florida
GEOFF DAVIS, Kentucky	BARNEY FRANK, Massachusetts
MICHAEL G. FITZPATRICK, Pennsylvania	
MICHAEL G. OXLEY, Ohio	

CONTENTS

	Page
Hearing held on:	
March 17, 2005	1
Appendix:	
March 17, 2005	27

WITNESSES

THURSDAY, MARCH 17, 2005

Fienberg, Linda D., President, Nasd Dispute Resolution, Inc.	4
Galvin, Hon. William Francis, Secretary of the Commonwealth of Massachusetts	6
Katsoris, Constantine, Wilkinson Professor of Law, Fordham University School of Law	13
Kupersmith, Karen, director of Arbitration, New York Stock Exchange, Inc. ...	12
Lackritz, Marc E., President, Securities Industry Association	15
Perino, Michael, Professor of Law, St. John's University School of Law	8
Shockman, Rosemary, President, Public Investors Arbitration Bar Association	10
Solin, Daniel R., Esquire	17

APPENDIX

Prepared statements:	
Gillmor, Hon. Paul E.	28
Kanjorski, Hon. Paul E.	29
Fienberg, Linda D.	31
Galvin, Hon. William Francis	41
Katsoris, Constantine	47
Kupersmith, Karen	50
Lackritz, Marc E.	65
Perino, Michael	80
Shockman, Rosemary	103
Solin, Daniel R.	111

THE SECURITIES ARBITRATION SYSTEM

Thursday, March 17, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:00 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ryun, Kanjorski, Frank, Clay, and Scott.

Mr. BAKER. I would like to call this meeting of the Capital Markets Subcommittee to order.

The committee meets today for the purpose of reviewing the current securities arbitration system, which has been in place and in effect for some number of years, which enables those who feel wronged in the treatment of their investment practices may seek out remuneration or appropriate remedy by engaging in the services of arbitration systems.

Three out of every four investors who have sought arbitration remedy before the NASD have been awarded compensation. In a 1997-1999 survey, 93 percent of the NASD arbitrants believe their claims were handled appropriately and without bias. There have been diligent efforts to improve on the payment methodologies, from the amount of unpaid awards in 2001 of 31 percent, down to the recently achieved number of 14 percent for the first half of 2004. Regrettably, the unpaid awards usually are attributable to brokers who are no longer in business.

I do believe the system offers a timely, efficient and low-cost remedy for those who seek redress, but it certainly is consistent with the committee's overview of market-sector-by-market-sector to engage in this hearing today, ask stakeholders and participants to give us their perspectives, and each of you brings to the committee a unique perspective on enhancement, remedies, criticisms, compliments, of the current methodology and we certainly will welcome your comments.

By way of explanation, every individual's comments will be made part of the official record. We will recognize you in regular order for the customary 5 minutes of comment. I am certain that as the committee proceeds, members will come in and out. I am advised that in about 45 minutes to 1 hour, we will expect a series of votes which will interrupt the proceedings, but it is our intent to return immediately thereafter to conclude the hearing.

Also by way of announcement, because of prior obligations before this hearing was actually scheduled, Mr. Ryun will at the appropriate time assume the chair.

With that, I would like to recognize the ranking member, Mr. Frank, for his statement.

Mr. FRANK. Mr. Chairman, thank you for calling this hearing. I did request that the Secretary of the Commonwealth of Massachusetts, my former legislative colleague and former legislative colleague of about half the Massachusetts delegation, William Galvin, who has been a very diligent advocate of the rights of individual investors in regard to this and in many other areas. He is the one who called this subject to my attention and thought it was worth this sort of an examination. I agree with him and I am glad to do that.

I also welcome Mr. Daniel Solin who has written on this, who is another Massachusetts person.

I thank you for convening this balanced panel. I think there were some very important issues raised as to how this process goes forward. This is very much our obligation. We are not at a crisis point here, but we are often legitimately criticized for waiting until we get to crisis points. I think that some concerns have been raised; The Wall Street Journal today has a page one article which raises some genuine issues that need to be addressed. I hope some of the representatives of industry will address some of them as to who is or is not a public arbitrator and what qualifies you to be a public arbitrator.

I think what we have found is to the extent that we are able to have hearings such as this and to legislate, we are helping the financial system. To the extent that we address concerns or grievances of individual investors or institutional investors in the large have, and give people some sense that we are trying to improve that, we enhance the attractiveness of investing. This is not an attack, even for those who are critical of the system. It is not an attack on the American financial system. It is an effort to continue to improve it and thereby, among other things, enhance its attractiveness to people.

So this is a relatively new subject for the committee. I want to congratulate Secretary Galvin for the initiative he has taken in bringing this issue forward. Once, as it often happens, people learn that there is going to be this kind of a hearing, other people come forward with comments. I think this is the beginning of a process which I hope will result in some improvements.

Thank you.

Mr. BAKER. I thank the gentleman for his statement.

Mr. Ryun?

Mr. RYUN. Thank you, Mr. Chairman, for scheduling this important hearing.

Arbitration has long been a primary dispute resolution process for the securities industry in the United States. By providing a faster and cheaper method of resolving disputes between investors and brokers than would the court proceedings, the arbitration process has been largely successful. The success of the arbitration process depends heavily on the ability to provide a fair and unbiased

proceeding. It is especially critical to ensure the arbitrators selected are unbiased.

To accomplish this goal, panels are made up of three arbitrators, two that are public and one that is industry. While the actual process for selecting arbitrator varies from forum to forum, I believe that this is generally done in an equitable fashion. I look forward to hearing the comments from our witnesses on the various techniques used to ensure the fairness. All in all, I believe that arbitration has served the industry well.

Clearly, each member of this panel should remain interested in continuing to improve the system by making it even more equitable and efficient. The results of the disputes through means other than a court proceeding saves time and money for all parties involved. There is strong evidence that the system already operates in an equitable manner, but we are here today to hear testimony from those who know the industry best and who can provide us with valuable insight on where improvements could and possibly should be saved.

I encourage my colleagues on this committee, as well as witnesses, to come to this dispute, if you will, with an attitude of helping to make a great system even better. I believe we have an outstanding panel of witnesses. I believe that this hearing is going to give us an opportunity to look at the state of the industry. I will be especially interested to hear comments about recent improvements in the arbitration selection process, as well as the positive trends that result in fewer unpaid rewards.

Again, I thank the esteemed panel for coming, for your time, for agreeing to be here, and I welcome each of you. I look forward to your testimony.

Mr. BAKER. I thank the gentleman.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet today to discuss the issue of securities arbitration. I just left the hearing on steroids in the Reform Committee. I was going to suggest we could end up making this a lot sexier if we put a testing device in for all financial service people. It may get us the attention the other hearing gets.

I greatly appreciate the courtesy that you have extended to Congressman Frank, the ranking Democrat on the Financial Services Committee, in agreeing to convene this hearing. Securities arbitration is an important issue and deserves careful examination. The securities industry has long relied on arbitration to resolve disputes. As I understand the New York Stock Exchange has used arbitration throughout most of its history. In addition, more than 125 years ago, the big board expanded its arbitration program to include investor complaints.

For many decades, investors had the option of pursuing claims against brokers through either litigation or arbitration. In 1987, a U.S. Supreme Court ruling determined that brokerage firms could compel customers to agree to arbitrate claims in an industry-sponsored forum as a condition of opening a brokerage account. In such agreements, customers would forfeit their right to pursue individual claims in court.

Since the Supreme Court ruling, the use of mandatory arbitration agreements has grown. In my view, there is nothing inherently wrong with arbitration per se. It can prove to be a more efficient and less expensive dispute resolution mechanism than court litigation. However, for arbitration to work well and to foster investor trust, it must be fair.

We have before us a panel with a demonstrated breadth and depth of knowledge on arbitration issues. They will be able to help us understand how arbitration works and whether there is a need for statutory, regulatory or procedural reforms. I look forward to learning of their insights, as I approach these matters with an open mind.

As we proceed today, I nevertheless hope that we will explore a number of issues. For example some have questioned the mandatory nature of securities arbitration. We should therefore examine whether investors should once again be offered a choice. We should also discuss the inclusion of an industry-related arbitrator on arbitration panels, and the process of selecting arbitrators. In particular, we should focus on the disclosure of potential conflicts.

One other issue that we are certain to review today concerns the transparency of arbitrators's decisions. In the past, arbitrators have not had to justify their decisions with written rulings. As a result, a customer often had little understanding of how the arbitration panel reached its decision in a case. To address this concern, the NASD recently proposed giving the participants in arbitration proceedings the option, prior to the first hearing, to request written explanations of decisions for an additional fee. The adoption of this proposed reform will help to better transparency and may increase investor satisfaction with and confidence in the fairness of the arbitration proceedings.

In closing, Mr. Chairman, I commend you for convening this proactive hearing to examine the securities arbitration process. I look forward to receiving the testimony of our distinguished panel.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 29 in the appendix.]

Mr. RYUN. [Presiding.] Thank you very much.

Since it does not appear that we have any questions within the financial industry with regard to steroids, we are going to move ahead.

I would like to begin by introducing our first panelist, Ms. Linda Fienberg, president of NASD Dispute Resolution.

We look forward to your testimony and welcome you. Thank you for coming.

**STATEMENT OF LINDA D. FIENBERG, PRESIDENT, NASD
DISPUTE RESOLUTION, INC.**

Ms. FIENBERG. Thank you very much, Chairman Ryun, for inviting us to participate, and thank you to the members of the committee and subcommittee.

My name is Linda Fienberg and I am president of NASD Dispute Resolution. I am very grateful for the opportunity to testify about our arbitration system. NASD is a private sector regulator of the securities industry. Our foremost mission is to protect investors

and to ensure market integrity. By federal law, any individual or firm that sells securities to the public must be regulated by NASD.

As part of our investor protection mission, NASD operates the world's largest forum to help investors, firms and individual brokers settle disputes through arbitration or mediation. In 2004, we administered more than 9,000 arbitrations. Roughly three of every four investors who brought claims received compensation either in settlements or awards.

Over the last decade, we have made significant improvements to ensure that investors get a fair, expeditious and affordable resolution of their disputes. Important steps have included party selection of arbitrators; tightening the definition of who can serve as a public arbitrator; increasing the number of arbitration hearing sites so that there is one in every state, we will have 68 sites by the end of this month; and sponsoring our expanded mediation program.

NASD believes that transparency should be the hallmark of securities arbitration. Each step of the process should be clear for investors. Transparency starts when investors open a brokerage account. In most cases, investors sign an agreement with their brokerage firm to settle any disputes through arbitration rather than litigation. This is a matter of contract between the investor and the firm, an arrangement the Supreme Court has held permissible under the federal securities laws. It is not an NASD requirement, but NASD does require firms present plain English agreements that explain to investors the process and the differences between arbitration and litigation.

To further transparency, during the arbitration selection process, parties receive arbitrator disclosures and information on past awards to help them choose their three-member panel. NASD allows parties to strike arbitrators they do not want and to rank the remaining ones in order of preference. And NASD awards are publicly available on our Web site.

An important step that NASD has taken to improve transparency is a rule proposal that we recently sent to the SEC that will give investors the power to require arbitrators to explain in writing the basis of their decisions. We believe this will increase investor confidence in the fairness of the process.

NASD also ensures the integrity of the process by taking all steps in our power to ensure that investors get the money from their awards, mediations or settlements. Our rules require NASD firms and brokers to pay awards within 30 days or face removal from the industry. Recent NASD initiatives have resulted in a steady decline in the percentage of unpaid awards to about 14 percent to 15 percent, but we are not satisfied with this. Even one unpaid award is one too many.

The essential quality of arbitration is fairness. Therefore, the quality of the arbitrators is critical. We maintain a roster of about 7,000 arbitrators. They are not NASD employees. We are committed to have arbitrators who have the experience to evaluate disputes fairly. Thus, we review their performance on strictly neutral criteria. To assure the quality of the arbitration, all new applicants must undergo background checks, training and testing. And we continue to train existing arbitrators to make sure the roster is

filled with highly qualified individuals. NASD rules require that arbitrators disclose all conflicts of interest. We remove from the roster those who do not comply.

Mr. Chairman, let me briefly discuss an issue that has been a subject of some debate. Each arbitration panel consists of three individuals, two who are classified as public and one who is classified as non-public who has ties to the industry. Some critics have charged that non-public arbitrators are biased toward the industry. Let me be clear: the overwhelming number of awards is unanimous, and our review of them shows absolutely no abuse or pattern of non-public arbitrators favoring industry parties.

In conclusion, NASD is committed to review of its arbitration program to promote transparency for investors, to improve quality, and to ensure the integrity of that process. We look forward to working with Congress on this and other issues.

Mr. Chairman, again thank you for the opportunity to testify. I would be happy to answer any questions.

[The prepared statement of Linda D. Fienberg can be found on page 31 in the appendix.]

Mr. RYUN. Ms. Fienberg, thank you very much for your testimony.

Next, we have the Honorable William Galvin, Secretary of the Commonwealth of Massachusetts.

**STATEMENT OF WILLIAM FRANCIS GALVIN, SECRETARY OF
THE COMMONWEALTH OF MASSACHUSETTS**

Mr. GALVIN. Thank you, Chairman Ryun and Ranking Member Frank and all the members of the subcommittee.

I am Bill Galvin, Secretary of the Commonwealth and chief securities regulator in Massachusetts. Thank you for the opportunity to be here today to testify about arbitration in the securities industry from the point of view of investors on Main Street. I can speak to the concerns of small investors because they call or visit my office in Massachusetts all the time. Small investors, let's not forget, are the lifeblood of our securities markets. Without their faith and trust and their hard-earned money, our markets could not function.

Unfortunately, in recent years their faith has been badly shaken. They have watched as giant companies, some with household names, were looted and run into the ground by corrupt management. They have seen respected Wall Street firms hype technology stocks using corrupt research reports, research that we now know were designed not to paint a true picture of the company or its prospects, but to curry favor with a client in order to win lucrative investment banking business.

Corporate scandals and the collapse of the high-tech bubble have hurt countless Main Street investors. That is bad enough. What is worse in my opinion is the rigged system we now have to help harmed investors seek a measure of justice. Every year, thousands of investors file complaints against their brokers. If these disputes are not settled, they end up in mandatory arbitration, a system that I believe is fundamentally flawed and stacked against the individual investors.

The sad thing is, industry-sponsored arbitration is the only game in town. When an investor opens a brokerage account, in almost all

cases he or she must sign away their right to a day in court should a dispute arise. Instead, they agree to have their claim heard by a panel of three arbitrators, picked from a list compiled by the NASD or the NYSE, the so-called “industry self-regulators.”

The term “arbitration” as it is used in this proceeding is really a misnomer. Most often, the process is not about two evenly matched parties to a dispute seeking the middle ground and a resolution of their conflict from knowledgeable, independent and unbiased fact-finders. Rather, what we have here in America today is an industry-sponsored damage containment and control program, masquerading as a juridical proceeding.

Of the three arbitrators on the panel, there is one with ties to the securities industry and two supposedly without ties to the industry. I believe the truth about the independence of these other arbitrators will reveal a troubling pattern. I invite your review. Is it a fair process? The industry would say yes, but let’s think about it for a minute. The NASD, the industry umbrella group, or the NYSE, gets to decide who is qualified to be an arbitrator and who is not. They and only they select the pool of arbitrators. There is no state in this union that gives to one party to litigation the unilateral right to choose the finders of fact or jury that will decide their case.

Would anyone seriously suggest that we apply this approach to any other industry? For instance, would anyone here seriously suggest that in all future disputes between automobile manufacturers and their customers relating to defects, that those who purchase an automobile can only bring their complaints and claims before a panel selected by GM, Ford or Chrysler? I do not think so. Are not the financial futures of our citizens entitled to at least as much protection as their cars?

As further proof of this rigged system, I offer one example that I happen to be personally familiar with. John J. Mark is a former NASD arbitrator from Massachusetts. Mr. Mark was an arbitrator with the Commonwealth of Massachusetts for many years and an adjunct professor at Harvard University and Boston University. As far as I know, he is a man of impeccable credentials and yet he was dropped from the NASD pool of arbitrators. Why? As he told a meeting of state securities regulators last summer, “The word on the street is, if you rule against the brokerage houses, you will be removed from the list.”

To be sure, lately the NASD has been working on this arbitration process. About 9 months ago, for example, they fined three large Wall Street firms, Merrill Lynch, Morgan Stanley, and Smith Barney, \$250,000 each for failing to produce documents in some 20 arbitration cases between 2002 and 2004. That was an overdue step in the right direction. Foot-dragging by Wall Street firms involved in disputes with investors must be punished, but these fines are so small in light of the overall totality of the problem that they hardly operate as a deterrent to further stonewalling. Automatic default and treble damages on claims would be a far more effective remedy. More recently, the NASD, after deliberation, has passed another milestone. Arbitrators may be required to put their decisions in writing for a fee.

But no fine or other regulatory tinkering will address the more fundamental flaw of the so-called arbitration process, namely that it is run by the industry and for the industry. The system is unfair. Consider the statistics. While the NASD asserts that in more than half the cases, arbitration panels award money to investors, the number of so-called investor victories does not tell the true stories of how investors fare in arbitration.

The NASD cites cases where the arbitrators make any cash award as a victory for the investor, but in fact many of those awards are for only a fraction of the amount claimed. Under this method of reckoning, a claimant who has \$5 million in losses, but was awarded just \$5 in restitution, has received an arbitration award. This is a pyrrhic victory at best.

The arbitration system should be reformed to put the investors' interest on the same level as those of Wall Street. How can we do that? Given that investors by law today have no choice but arbitration, we need to make the system more fair. The best way to do that is to take it out of the hands of the industry. Put someone besides the self-regulators in charge. That is the best solution. In the short term, we need to increase the oversight of the arbitration process. The FCC, state securities regulators and perhaps even Congress need to take a hard look at arbitration.

State securities regulators have begun this process by creating a task force to look at the issues involving arbitration. These issues include how arbitrators are selected, trends in arbitration awards, and how cumbersome and expensive the system is for investors. This is not a small thing. We have almost 100 million investors in this country. In recent years, we have made reforms to make sure that Main Street investors get a better shake in the marketplace. We now need to focus on reforming the dispute resolution system. It is the right thing to do, the right thing for investors, and the right thing for our markets. It is time to act.

Again, I am grateful for the chance to be here today to share some of my thoughts, and I look forward to your questions. Thank you.

[The prepared statement of Hon. William Francis Galvin can be found on page 41 in the appendix.]

Mr. RYUN. Mr. Galvin, thank you very much for your testimony.

I want to encourage the panelists to stay with the 5-minute time limit.

We are next going to hear from Mr. Michael Perino, professor of law from St. John's University School of Law. Thank you.

**STATEMENT OF MICHAEL PERINO, PROFESSOR OF LAW, ST.
JOHN'S UNIVERSITY SCHOOL OF LAW**

Mr. PERINO. Thank you. Mr. Chairman and members of the committee, thank you for the invitation to appear before you today.

As you all are well aware, the fairness and adequacy of securities arbitration is crucially important because arbitration is the primary dispute resolution mechanism for customer-broker disputes. To be successful, the system must not only be fair and impartial, but investors, the public, the judiciary and Congress must believe that it is fair and impartial.

Does securities arbitration satisfy that standard? This subcommittee will no doubt hear stories of problems in individual cases and calls for substantial overhauls of the current system, but a rational regulatory policy cannot be based on mere anecdote. Sweeping changes can have significant unintended consequences and additional procedural requirements can impose significant cost. As the SEC has noted, proposed changes “must balance the need to strengthen investor confidence in the arbitration system with the need to maintain arbitration as a form of dispute resolution that provides for the equitable and efficient administration of justice.”

Those seeking to revamp the securities arbitration system thus should have the burden of identifying through thorough and well-documented empirical evidence that actual problems in fact exist. In my mind, a compelling case for substantial change has yet to be made. In 2002, the SEC asked me to review the adequacy of arbitrator conflict disclosure requirements in securities arbitrations. In putting together that study, I examined the available empirical evidence in detail, which I discuss at length in my written statement. I am not going to repeat that material here. Of course, I am happy to answer any questions you might have about it.

At bottom, the available empirical evidence on outcomes in SRO arbitrations and on investors’ perceptions of the arbitration process suggests that the current system addresses customer disputes fairly and impartially. There are, I believe, good reasons why the data do not show a pro-industry bias. The NASD and the New York Stock Exchange are likely subject to more regulation and greater oversight than any other arbitration forum.

The NASD and the New York Stock Exchange are not mere trade organizations, as some have characterized them, but self-regulatory organizations that have a statutory mandate to provide a fair dispute resolution forum. The SEC exercises oversight over the SROs, approves all arbitration rules before they become effective, and oversees SRO arbitrations through its inspection process.

Congress also plays an important role. In addition to holding hearings such as this, members have frequently requested the GAO to study the securities arbitration system. Although the GAO has recommended changes from time to time, it has never found that SRO-sponsored arbitrations were biased in favor of securities industry members.

The securities industry also has a rational self-interest in providing a fair dispute resolution system. The acceptability of arbitral awards is strongly correlated with the parties’s perceptions of whether fair and unbiased procedures were used to reach an outcome. Systemic procedural inequities would likely increase the costs of the arbitration system. More dissatisfied parties would attempt to overturn arbitration awards and judges would be more likely to grant those requests. If the securities industry wants to reap the cost savings associated with arbitrations, they must also inhibit any pro-industry biases from developing.

Let me be clear about one final point. Nothing I have said here or in my written statement should be taken to mean that we can safely ignore securities arbitrations. In my report to the SEC, I wrote that given the unquestioned significance of securities arbitra-

tions, it is crucial that the SROs resolve any lingering concerns about pro-industry bias. Accordingly, I recommended that the SROs sponsor additional independent studies to further evaluate the impartiality of the arbitration process. It is my understanding that such a study is about to commence. If that or other studies reveal systemic problems, then those problems should and must be addressed. But until persuasive evidence of such a problem exists, it would be imprudent to substantially alter a system that appears to serve investors well.

Thank you.

[The prepared statement of Michael Perino can be found on page 80 in the appendix.]

Mr. RYUN. Mr. Perino, thank you very much.

Our next panelist is Ms. Rosemary Shockman, president of Public Investors Arbitration Bar Association.

Welcome.

STATEMENT OF ROSEMARY SHOCKMAN, PRESIDENT, PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

Ms. SHOCKMAN. Thank you, Mr. Chairman, Ranking Member Frank. My name is Rosemary Shockman. I have been representing public investors in cases against securities broker-dealers for 23 years. I am president of the Public Investors Arbitration Bar Association. PIABA is an international bar association of more than 750 lawyers representing investors in securities arbitrations. We are dedicated to creating a level playing field for public investors in securities arbitration.

Let me begin with what we believe is the most important issue to help level the playing field for aggrieved investors: the elimination of the mandatory industry arbitrator on panels hearing cases. As was pointed out earlier, the cases are heard by three-member panels. One of the panelists is required to be a member of the securities industry. The remaining two are to be public, although many times they have also spent part of their careers in the securities industry.

Problem number one with the industry arbitrator is my clients come in to me, they see the industry gets to have one member on the panel and they do not think it looks fair to them. They think it has an appearance of impropriety. Problem number two with the industry arbitrator, and I think to practitioners this is a greater problem, we have been faced, and we have seen in the last few years these broad securities problems such as the mutual fund problems that went across the industry, and the problems now that we are seeing with variable annuity sales.

The NASD, the SEC, and NYSE have all come out commenting about the over-sale of variable annuities on suitable sale to retired investors, a half-trillion sold in the last 3 years. Yet our clients when they bring these cases are forced to have their cases heard with a panel member whose very firm is selling the same variable annuities and using the same practices. That is a reason to end the industry arbitrator.

The industry tells us that an industry arbitrator is needed so that someone on the panel will have knowledge of the securities industry, sort of an expert witness. Long ago, that might have been

true. Securities arbitration has become so much more sophisticated. Both parties are represented by lawyers, and typically have expert witnesses. We do not really need to have an expert witness on the panel anymore. Congress should urge the SEC to move forward to adopt rules eliminating the requirement of an industry arbitrator.

Compounding the problem of the industry arbitrator is the existence of public arbitrators who are just too close to looking like an industry arbitrator. Instances where public arbitrators have worked for years in the securities industry, maybe 10, 15 years, where lawyers have worked for long periods of time representing broker-dealers, it does start to look to the public investor having his or her case heard that this panel is stacked against them.

Last summer, I had a case in which not only did I have an industry arbitrator, but two of the people on the public panel presented to me for selection had gone from being industry arbitrators to public arbitrators the week before. So there are some problems here that definitely need to be worked with with respect to who is a public arbitrator.

Discovery abuses, I do commend the NASD for their efforts to put forth fines and so on, but here is a packet of just recent discovery abuses with Morgan Stanley Dean Witter. It is still out there. It is a problem. They look at it as a cost of doing business.

Unpaid arbitration awards, there has been an improvement, but part of what is not reflected in those numbers is clients who do not get lawyers because the lawyers know that they cannot collect at the end of the day. So while the NASD has made strides in collecting against people who can pay, we still have a problem with small broker-dealers who simply go out of business and there is no where to collect. I recently had the experience of a widowed mother-in-law of a prominent Member of this Congress, who came to me with a very good case. She had been defrauded, but there was nowhere to collect the money in the end. This was a broker-dealer heading out of business.

Public investors are shocked to hear that they have to have car insurance, that the net capital requirements are so small for broker-dealers. Why isn't there some sort of protection in an industry where people are handling their life savings?

Problems at the New York Stock Exchange. Practitioners who brought cases there for years are no longer bringing cases because of delays in getting arbitrators appointed and in getting hearings set, just extraordinary delays. I do want to commend Karen Kupersmith and Dan Beta of the Exchange for meeting with us and working with us in efforts to try to improve that situation. It still exists. Work needs to be done there.

Thank you, and if we can provide any further information, we would be happy to do so.

[The prepared statement of Rosemary Shockman can be found on page 103 in the appendix.]

Mr. RYUN. Thank you for your testimony.

Our next panelist is Ms. Karen Kupersmith, director of Arbitration, New York Stock Exchange.

Welcome.

**STATEMENT OF KAREN KUPERSMITH, DIRECTOR OF
ARBITRATION, NEW YORK STOCK EXCHANGE, INC.**

Ms. KUPERSMITH. Thank you very much, Mr. Chairman, Congressman Frank and everyone else for permitting me to come here today to testify on behalf of the New York Stock Exchange. I am Karen Kupersmith. I am the director of Arbitration at the New York Stock Exchange. I started working there in 1983, first as a staff arbitration attorney and then a senior counsel, a manager and finally I was appointed director of Arbitration in April, 2004.

There have been many changes at the New York Stock Exchange since I have been there, but one factor has remained constant, a factor that I have personally observed and that is the firm commitment of the New York Stock Exchange to providing the most fair and neutral forum possible for the public investor.

Arbitration has always been thought of and found to be efficient, faster than court, and also far more economical than litigation proceedings. At the New York Stock Exchange, in fact, in 2004 all cases were closed in less than 15.45 months. In court, that number is considerably higher, often 2 1/2 years to perhaps even 5 years.

The New York Stock Exchange is very committed to providing this level playing field and has taken many initiatives to show this commitment. The most recent of these is a recent rule filing with the SEC, the purpose of that filing being to make permanent a variation of a pilot program that allows for alternate ways of appointing arbitrators. This particular rule filing will now give, once approved, the public investor the right to select the method of arbitrator appointment, either computerized list selection or what we call the traditional staff method of appointment.

At the base of every arbitration program are the arbitrators themselves. They are the individuals who hear the cases and they are the most important part of the system. The New York Stock Exchange is doing everything possible to recruit new arbitrators into its pool to enlarge that pool. Currently, our 12 staff attorneys are reaching out to all the current arbitrators that we have and asking them, do you know of somebody who might be interested, who would be a good candidate to be an arbitrator? It is very important to us to have people from diverse backgrounds to represent the diverse backgrounds of the public investors sitting before them.

I always say, were my mother to be involved in a securities arbitration and have a complaint against a brokerage house, I would want someone on that panel with a background similar to hers.

We train our arbitrators carefully and continually. There is an ongoing requirement that all NYSE arbitrators attend training at least once every 4 years. This training focuses on disclosures and how important it is that everything be disclosed. Any family, personal, professional, social or other type of relation, any type of financial or personal interest that the arbitrator might have in the outcome of the proceeding must be disclosed.

To help that, we have just started an online portal system so our arbitrators can actually go online and input information themselves to maintain their profiles in the most current fashion possible. We also focus on the fact that arbitrators in deciding cases must decide the cases on the facts and the testimony before them in that par-

ticular matter, and should not have any preconceptions when they start the hearing and throughout the course of a proceeding.

We are always reviewing the process of arbitration to make it better. Relationships change and so have the corporate relationships changed, many as a result of the financial modernization legislation, some of which I understand came out of this committee. Corporate relationships are far more complicated and complex now, so that entities which once had nothing to do with the securities industry now may find themselves owning broker-dealers. The New York Stock Exchange is in the process of reviewing current classifications to make sure that all classifications of arbitrators as either public or securities arbitrators is correct, and is correct as regards these new relationships that have developed.

I thank you very much for permitting me to be here to testify today, and I am glad to answer any questions. Thank you.

[The prepared statement of Karen Kupersmith can be found on page 50 in the appendix.]

Mr. RYUN. Ms. Kupersmith, thank you very much for your testimony.

Let me sort of give you an update on what is happening. The Chair has ruled that I am going to, out of respect for all of you and your time, I am going to go ahead and miss this particular vote because we have time for a lot of other discussion on the floor. I want to listen as much as we can to what the panel has to say and keep things moving along, if we may.

Next, we have Mr. Constantine "Gus" Katsoris, Wilkinson Professor of Law, Fordham University School of Law.

Welcome. We look forward to your testimony.

**STATEMENT OF CONSTANTINE KATSORIS, WILKINSON
PROFESSOR OF LAW, FORDHAM UNIVERSITY SCHOOL OF LAW**

Mr. KATSORIS. Thank you, Mr. Chairman.

I have participated in the resolution of securities disputes for over 35 years as an arbitrator, a mediator, an arbitrator trainer, a public member of the Securities Industry Conference on Arbitration, also known as SICA, and an adviser to the Fordham Law School Arbitration Clinic.

I could not begin to share all of my experiences in the 5 minutes allotted me, so I will save my opinions for my responses to questions from the panel. I would, however, like to tell you how I first got involved in this area. Before joining the faculty at Fordham Law School over 40 years ago, I was a full-time litigator at a major Wall Street law firm. After a few years of teaching and loving every minute of it, I realized that I missed litigation.

Thus, in 1967, I became an arbitrator at the NASD and shortly thereafter at the New York Stock Exchange, where I have served in many, many, many cases. In 1977 when SICA was first created, I was selected as one of its public members where I have served ever since. In addition, about 8 years ago at the suggestion of then-SEC Chairman Arthur Levitt, I helped establish the Securities Arbitration Clinic at Fordham to represent injured investors who could not obtain an attorney and thus would find it difficult to pursue their claims. I am proud to say it is the most popular clinic at Fordham and is the first such clinic in the country to obtain puni-

tive damages in an SRO arbitration. There are presently about one dozen such law school clinics operating today, and collectively they constitute a growing force in this area.

Arbitration in the 1960s when I first began was like the horse and buggy days. There was virtually no pre-hearing discovery or exchange of information. Not too many people complained, however, because basically the system was voluntary as far as the public was concerned. In the 1970s, however, the SEC was not satisfied with handling of small claims and its office of consumer affairs issued a report recommending the creation of a non-SRO entity for the handling of such claims. In response to this report, SICA was created with an initial mandate to establish a procedure for handling small customer claims.

Facilitating the processing of small claims, however, did not address the broader issue, namely the basic balkanization of the various SRO arbitration programs. In other words, each SRO had its own set of rules. Some were written, some existed solely on the basis of custom and usage, all of which complicated the task of the practitioner in choosing a forum.

Thus, SICA's next assignment was to establish a uniform code of arbitration, which was basically applicable to all SRO cases, large as well as small. Nevertheless, SRO arbitrations were still basically voluntary because of the then-prevailing conventional wisdom that 1934 Act federal securities claims were not subject to previous arbitration agreements and thus could still go to court.

As confidence grew in the new code, SRO arbitrations more than tripled from 830 in 1980 to over 2,800 in 1986. Yet SRO arbitration was still in its infancy until the McMahon case in 1987, which virtually transformed the process from a voluntary procedure to a mandatory one by holding that 1934 Act claims were arbitral pursuant to pre-dispute arbitration agreements.

After the McMahon case, the landscape changed overnight. Not only did the number of arbitrations more than double to over 6,000 in the year after McMahon than the year before, but equally significant was the influx of the larger and more complicated cases that previously were being filed in court. At this point, the task of ensuring the fairness of SRO arbitrations largely fell upon SICA, which incidentally had been favorably mentioned in the McMahon case as evidence of the changing landscape.

SICA's independence was essential to the process, and that independence was ensured at the outset because its public members were beholden to no one. Thereafter, the public members got to pick their own successors. Moreover, the SEC with its oversight authority over the SROs and as gatekeeper of the 19(b) process, attends SICA meetings. Indeed, the efforts to ensure a level playing field are outlined in SICA's 12 reports issued to the SEC over the years, which describe with great transparency the evolution in SRO arbitrations. I have a few of those reports here which I will gladly give at the end.

It is not only the affirmative rules that SICA enacted into the code of arbitration that is important, but it is also the actions that SICA took in preventing from seeing the light of day some provisions that could have been injurious to the public. For example, a rigid cap on punitive damages where no such rule existed in court.

Another example, an offer of a ward rule that could have limited the damages sought by claimants. And there were others.

Since the adoption of the uniform code, over 100,000 arbitrations have been filed at the various SROs. Has justice been achieved in every one of those 100,000 cases? Certainly not, but I do not know of any dispute resolution system that has an unblemished record in this regard, and that includes our own court system. Admittedly, sometimes awards are excessive, sometimes they are inadequate, but that is true no matter what resolution system we use.

Are there improvements that can still be made to the SRO process? Of course there are, and the process is ongoing and never-ending as new problems and situations arise. For example, when it became obvious that third party subpoenas were being used in an abusive manner, SICA just a few months ago required a 10-day notice period before such subpoenas became effective. Another example, when a problem arose as to the administrative appointment of arbitrators to fill vacancies, SICA just this very week, last Tuesday, granted a peremptory challenge to each side as to such appointments.

My principal concern going forward is we do not backslide into a system of balkanization that existed before SICA, where practitioners had to contend with the diverse rules of procedures of the various states, various courts, and the various SROs throughout the country, each of which spoke in a different language, reminiscent of the biblical Tower of Babel. We saw an example of that when the State of California recently sought to impose its own rules as to the qualification of arbitrators in SRO proceedings.

In conclusion, I can express to you that since the mandate of McMahon, the system has on balance worked well. We must be ever vigilant, however, that the playing field remains level and is not tilted one way or the other.

Thank you, Mr. Chairman.

[The prepared statement of Constantine Katsoris can be found on page 47 in the appendix.]

Mr. RYUN. Thank you very much for your testimony.

Our next panelist is Mr. Marc Lackritz, president of the Securities Industry Association.

Thank you for being here.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you very much, Mr. Chairman and members of the committee. We commend you for holding this hearing today and welcome the opportunity to discuss the current arbitration system, as well as suggestions for improvement.

Mr. Chairman, public trust is critical to the success of our capital markets, the securities industry, and any dispute resolution mechanism used by our customers. SRO-sponsored securities arbitration is a system that works well. It is a fair and efficient means of resolving disputes between customers and brokerage firms. We know this from the weight of both anecdotal evidence and empirical data. Independent organizations such as the General Accounting Office, the Securities Industry Conference on Arbitration, and noted aca-

demetic experts, some of whom are here today, have all consistently documented the success of securities arbitration.

Studies conducted over the past 20 years have consistently shown that investors receive awards in more than half of all cases brought in arbitration. Even this data understates investor success since investors collect money in more than three-quarters of the cases that they bring to arbitration, taking into account cases that are settled by the parties.

Arbitration continues to be a far more efficient and cost-effective dispute resolution mechanism than traditional court-based litigation. Studies have consistently shown that on average, disputes are resolved much faster and at a lower cost to customers in the SRO-sponsored arbitration than in comparable court cases. Successful claimants get the relief they want more quickly. The significant reduction in time spent litigating means less disruption in the parties' business and lives and less money spent on lawyers.

Faster resolution also makes arbitration fair, since there is less difficulty with witnesses' inability to recall age-old facts and less trouble locating witnesses and documents. That is why an independent analysis in 2000 found that 93 percent of all parties to securities arbitration consider the system to be fair. Aggrieved customers get what they really want: their day in court.

Unlike in court cases, claimants in arbitration are not held to technical pleading standards. Unlike in court cases, pre-trial discovery in arbitration is focused and limited and rarely includes expensive and time consuming taking of depositions. Unlike in court cases, the hearings themselves are not intimidating technical proceedings bound strictly by the rules of evidence, but are designed to be flexible and allow the arbitrators to reach the most equitable and just conclusions.

The more streamlined process of arbitration, as compared with many procedural and financial obstacles that must be overcome by a plaintiff in a court case, means that nearly every case brought in arbitration other than those that are settled goes to a full merits hearing.

So the system works, but it will continue to be superior to court-based litigation only if we guard against what I would call creeping litigiousness that is at the gates. Some of the changes that have been proposed, for example requiring written explanations of awards by arbitration panels, expanding pretrial discovery, broadening the scope of parties' rights to appeal from arbitrators' decisions, would undermine what has made arbitration an attractive alternative: a streamlined, efficient and less-costly means of resolving disputes. I urge the committee and the Congress to be very reluctant to endorse this type of change to securities arbitration.

Two criticisms leveled at securities arbitration are the inclusion of a so-called industry arbitrator on panels and the mandatory nature of arbitration. Both criticisms miss the mark. Arbitration panels in most fields, not just securities, include those with experience in that field. This is a positive development for everyone by providing a level of expertise that would not otherwise be available to the panel.

The ever-growing complexity of financial products and services and the technical issues that sometimes arise, as well as the dis-

putes among expert witnesses on both sides that often occur, make it desirable that one of the three arbitrators be well-versed in the regulatory framework under which brokers and other financial professionals operate. The painstaking and transparent selection process for arbitrators also protects against any possible pro-industry bias.

Criticism of the mandatory nature of securities arbitration is also misplaced. Agreeing to arbitrate rather than court-based litigation, is a choice of forum, not of rights. In fact, arbitration can and does impose extraordinary sanctions with respect to securities firms such as referring conduct uncovered in the proceeding to regulatory authorities or suspending an industry member's license for failing to pay an arbitration award promptly. Moreover, agreeing in advance to arbitrate all disputes is a neutral event that prevents one party when a dispute arises from blocking access to arbitration because it sees an advantage to dragging the dispute out in court.

The current system of SRO-sponsored arbitration, like any system of justice devised by humans, is not perfect. The NASD, the New York Stock Exchange and the securities industry continue to work hard to take into account the concerns and issues raised by all participants and to adjust the process as needed. The facts show that disputes continue to be resolved more expeditiously, efficiently and fairly than they would be in our already-overburdened court system.

Thank you for holding this hearing, Mr. Chairman, and for inviting me to testify. I would be pleased to answer any questions.

[The prepared statement of Marc E. Lackritz can be found on page 65 in the appendix.]

Mr. RYUN. Mr. Lackritz, thank you very much.

Our final panelist today is Mr. Daniel Solin, investor, attorney and author. In fact, one of his books is very intriguing, "Does Your Broker Owe You Money?"

We welcome your testimony.

STATEMENT OF DANIEL SOLIN, ESQUIRE

Mr. SOLIN. Thank you very much, Mr. Chairman.

Thank you, especially, Congressman Frank, for convening these hearings. It is a terribly important issue for the millions of investors who have been the victims of misconduct by their brokers and whose only recourse is the industry-sponsored arbitration system.

While it is of course true that these investors sign a document in which they agree to mandatory arbitration, make no mistake about the reality of what that situation really is. I have been representing investors for a number of years. I have tried many cases before these tribunals. I have never met a single investor who knew that when he signed his or her account opening statements, they were consenting to mandatory arbitration, much less understood the nature of the mandatory arbitration they were consenting to.

The issue, Mr. Chairman, has nothing to do with the merits of arbitration or the merits of the court system. The issue properly framed is whether investors in this country are entitled to a dispute resolution system which has both the appearance and the reality of fairness. The current system does not have the appearance

of fairness. As Commissioner Galvin and Rosemary Shockman so eloquently stated, it is run by the industry. This makes no more sense than if Congress mandated that all investor disputes should be run by PIABA as the administrative arm. No one would regard that as fair or reasonable and no investor would perceive that as fair or reasonable.

Second, as somebody who sits and looks in the eyes of these tribunals, let me tell you that having an industry member on that tribunal is a devastating blow to the perceived, if not the actual, fairness of these proceedings. The ostensible purpose for having this industry arbitrator is because of his supposed expertise. If that is true, you can imagine the influence that that person has which is far beyond his one vote.

The fact that in a number of cases, the industry arbitrator joins in acquiescing to a favorable verdict for the investor does not mean that that industry arbitrator did not do his or her best to ensure that that result did not occur. It does not mean that that industry arbitrator did not accomplish his or her goal of limiting the amount of damages that that tribunal would award.

The impartiality, as Commissioner Galvin and Rosemary Shockman stated, of the public arbitrators is highly suspect. The only study I have found is a 1994 study by the General Accounting Office which said that 89 percent of the panelists at that time were white men over the age of 60. There are very, very few members of those panels, of the 6,000 or 7,000, who are around today. Certainly in 1994, there were very few of them who were people of color, who were younger people. This tends to be a very conservative industry-oriented group.

The NASD and the NYSE have broad discretion in appointing these people and it is not true, in all candor, that we as advocates play a meaningful role in this process. Very often in my cases, a week or 2 weeks before the actual hearing, for some reason, the arbitrators that we ranked highly drop out and the NASD and the NYSE then have the right without any discretion whatsoever to appoint whoever they want. We have no role in that process.

Finally, and this is a very significant point, psychologically let me tell you that it is a valuable perk for people to sit on these tribunals. They love sitting in judgment. This is part of their life. Many of them are retired. This is a very important part of who they are. And these people know that if they issue a big award against the brokerage industry, they are not going to be re-appointed to sit on panels. It becomes a self-selecting group.

There is no evidence that this system is fair. The evidence that Mr. Perino is talking about and that the industry representatives are talking about is very flawed statistical evidence, as I indicate in my report. We are in the process of doing an exhaustive analysis that I hope will shed some light on it, but it is very difficult to prove that a whole system is unfair.

What should be done here is very clear. We should have a system of arbitration run by a completely impartial tribunal, like the American Arbitration Association or any private dispute regulation group. We should not have an industry judging itself. All we are asking for as representatives of investors is that there be a totally impartial administration and that the three people sitting there are

completely impartial, unaffiliated with anyone, which is exactly what Ms. Kupersmith's mother would want if she did have a claim against her broker. She would not want a panel that is one-third biased any more than she would want a jury that is one-third biased or a judge who says one-third of my mind is made up before we start.

I thank you again, Mr. Chairman. I thank you again, Congressman Frank, for the opportunity to share my views with you.

[The prepared statement of Daniel R. Solin can be found on page 111 in the appendix.]

Mr. RYUN. Thank you very much.

I want to thank all the panelists for coming. I know you have tremendous insight into what this process is all about. The discussion has been good today about arbitration process and how to make it more transparent. Specifically, it is important that the investors are well informed and it is very clearly understood what this process is all about.

With that in mind, I want to inquire a little about the process of ensuring that investors understand what they are doing when they sign a pre-dispute arbitration agreement. Specifically, what is done to make sure that each investor knows that the signing of the agreement effectively waives their right to sue? I will be interested in any comments anyone has to make on that.

Mr. KATSORIS. At SICA, we had passed a rule that the arbitration clause be highlighted in the agreement that the customer signs at the beginning. SICA had passed an additional rule that that clause be separately initialed by the customer so there would be no doubt that the customer saw that arbitration clause. Unfortunately, no SRO has passed it. I would recommend that they rethink that and adopt the SICA rule which is still on the books that they separately initial that arbitration clause. That would defuse the argument that somebody did not see it, and perhaps solve that problem for the future.

Mr. RYUN. Mr. Solin?

Mr. SOLIN. Thank you, Mr. Chairman. Picture what happens when an investor in this country goes to open up his account. He is confronted with a slew of account opening statements. More often, the broker already has his trust or he would not be there. He is entrusting him usually with his or her life savings. These arbitration clauses are not negotiated the way any normal bilateral agreement between two equals would be negotiated.

As a practical matter, if the investor does not sign whatever is in those papers, they have nowhere to go if they want to invest in this country. The issue is not, I would respectfully suggest, do investors know that there is a mandatory arbitration clause. The issue is whether all investors in this country should be required to sign a mandatory arbitration clause that consigns them to resolve all of their disputes by an industry organization.

Mr. RYUN. Let me address this a little bit differently, if I may. I would like to go to Linda Fienberg from NASD. You testified the presence of an industry arbitrator on the panel does not influence the outcome of the arbitration in favor of the broker. I think it is an important point that merits further discussion and I would like to have any further comments you would like to make.

Ms. FIENBERG. Thank you, Chairman Ryun.

We are, first and foremost of course, a regulator of the securities industry. As a result, we are very concerned not only about the quality of the forum, but also about its fairness and the appearance of fairness. Therefore, we have reviewed our award data to be sure that there is no bias in the process because of the industry arbitrator. Here is what we found. About 98 percent of awards are unanimous. In 2004 for example, there were a little over 1,100 cases in which the customer prevailed. In only 32 of those cases was there a dissent: 21 times by public arbitrators and only 11 times by non-public arbitrators, reflecting the two-and-one composition of panels.

Looking at the flip side, we reviewed the awards of the entire roster of arbitrators who had signed at least eight awards. We found the same thing. Of 1,226 arbitrators with eight or more awards, only 41 ruled for the industry 75 percent or more of the time; 28 of the 41 were public arbitrators; only 13 were industry. Of the 1,226, 209 decided in favor of investors 75 percent or more of the time. Of the 209, 67 were industry arbitrators or 32 percent, and 142 were public arbitrators.

In addition, we are satisfied by the many surveys that have been taken by the GAO, by the SEC examinations and audits, by the most recent one done by Professor Perino under the auspices of the SEC, that there is no unfairness in the forum and our surveys reflect that the actual participants in the forum, the investors in the forum, do not believe that they have gotten an unfair shake at the end of the day.

Mr. RYUN. I am going to give Mr. Frank an opportunity. I know we are about to move into final passage and I would like him to have an opportunity to ask some questions as well.

Mr. FRANK. Thank you, Mr. Ryun. I just want to reassure the panel, and I know you have come a long way, and there are only a couple of us. It is a Thursday afternoon. It was not the optimal time, but there are 10 people sitting up here behind us, staff members, and getting information to them is the best way to get information across. So you are not testifying vainly and I think you are adding significantly because of the presence of the people who do a lot of the thinking around here, to the basic knowledge.

Mr. Lackritz, one question, you really believe that this is really good for the investor, right, the system?

Mr. LACKRITZ. Yes, I do.

Mr. FRANK. Do you think the investors are so stupid that they would not know that if you did not force it on them? I mean, why don't you make it voluntary? You answered the objections partially. There is an objection to having it case-by-case whether or not you go to arbitration. And I know the Chairman asked a very good question which is, well, shouldn't we know about it in advance.

But the question you have to put is, what good would it do the investor to know about it? It is a contract of adhesion, so you know about it. So what are you going to do? Go out and sign with nobody? So why shouldn't it be that the investor is asked, and you can say this if you know, arbitration would be a lot better for you, and here is the record, than going to court? Do you want to sign this clause or not? Why not make it voluntary with the investor?

Mr. LACKRITZ. First of all, I do believe this process is good for investors.

Mr. FRANK. I know that, but we only have 5 minutes. Don't repeat.

Mr. LACKRITZ. I think that rather than larding up opening an account with a lot of due process requirements—

Mr. FRANK. Excuse me. Answer my question, Marc, come on. You know that we have a limited amount of time. Don't do a Greenspan on me and filibuster.

[Laughter.]

The question is this: Why do you not give the investor the choice to go into the arbitration system or not? Why would that not be better?

Mr. LACKRITZ. Because number one, it is a solution in search of a problem. Number two, I think that the mandatory structure in fact provides a regulatory oversight mechanism that provides far more scrutiny and makes the process far better.

Mr. FRANK. Let me ask NASD, if in fact we had a system where investors could decide to go into the arbitration or not, would that impeded your ability to oversee the system for those that agreed to it?

Ms. FIENBERG. I actually believe if given—

Mr. FRANK. That is a straightforward question.

Ms. FIENBERG. I am going to answer. I believe that most investors would still—

Mr. FRANK. That is not what I asked you. Please, you are all very intelligent people, a simple question. The suggestion was it has to be made mandatory for everybody to provide regulatory oversight. Would you be capable of administering regulatory oversight if it was optional for whether or not there was arbitration in every case?

Ms. FIENBERG. We could still have our regulatory oversight over those cases that came into arbitration.

Mr. FRANK. Good. That was the question. Thank you for the answer. Look, you can repeat yourselves, but the point is this. You are giving answers that are not fully responsive. I think you make a very good case for arbitration. I would like to see it somewhat changed, but I do not understand you think the investors who you generally think are wise people, we are often told, you know, honor their choices and not infringe on them. But let me put it this way, if individual investors, according to you, I think, and others, are smart enough to take half of their Social Security accounts and decide how to run the rest of their lives with it, why aren't they smart enough to decide whether they want to go into a mandatory arbitration system?

Mr. LACKRITZ. You raise a philosophical question in terms of how much freedom do you want to give people. If in fact people have a choice, when you know one system is better than the other, do you want to bar them from in fact picking a system that is going to be worse for them or not. So it gets back to paternalism. I completely agree with—

Mr. FRANK. Okay, so your argument is that you know, and you have certainly more experience in this than the investors, because you know that this system is better for them, you do not want

them to be able to make the bad choice. You may hear that argument in the Social Security context, by the way, made by some people on the other side. But you have not made a case to me as to why it has to be mandatory. Certainly, it would work sometimes. I understand the argument for mandatory if you need a critical mass of participants, but I think you would have that anyway.

The other question now is with regard to the industry member. Why couldn't there be industry members providing expertise without a vote? I mean, we have that all the time. Look, expertise about votes? I just started out by mentioning there are 10 people sitting up here who will know at any given time more about these subjects than any of us because they do not have to march in parades. They have a certain advantage in terms of their time allocation. So they do not vote, but they know a great deal and have a great deal of input. Why is it necessary, and let me ask any of the panelists, to give that person a vote to get the benefit of his or her expertise? Yes, sir.

Mr. KATSORIS. I have heard this debate many, many times about the industry against the public. I was on SICA when——

Mr. FRANK. Excuse me, sir. I just asked a simple question. Why is it necessary?

Mr. KATSORIS. I will try to develop a——

Mr. FRANK. No, you are not. Why is it necessary to give that person a vote to get the benefit of his or her expertise?

Mr. KATSORIS. I do not mind if you dismantle the whole present process of industry participation.

Mr. FRANK. That is not what I asked you, sir. If you do not want to answer the question I asked, it is voluntary. This is not arbitration. There is no contract of adhesion. I would like anyone who wanted to to ask the question, why is it not possible to get the expertise, because I think there is an argument for the expertise. Why is it not possible to get that expertise without giving that person a vote? Mr. Solin?

Mr. SOLIN. Mr. Frank, that is exactly what happens in every arbitration I have been in. It is not necessary, is the answer to your question, because each side calls expert witnesses who provide all the expertise that the panel needs.

Mr. FRANK. Okay, I figured that, because somebody suggested to me, well, and maybe it was Mr. Lackritz who said, well, you know, you get conflicting experts and you need one to be the arbitrator, but I think that argument refutes itself. The fact is, this is not science. This is not something that is indisputable, although in today's political climate even science is not indisputable if you do not like it for religious reasons, but the notion that one expert somehow cuts through everyone else's expertise seems to me problematic.

Mr. Lackritz?

Mr. LACKRITZ. Yes, with all due respect, you are proceeding from an assumption that the industry involvement here is problematic.

Mr. FRANK. I am not. Excuse me, you lose me. I want to be cooperative here, but you lose me when you will not answer the question. I do not understand why you won't. The question is: Is there not a way to get expertise without giving that person a vote? I know you have said this to me before, well, you know, if there is

no crisis, you don't change it. We are often asked to make changes without there being a total crisis. But in any case, that is a question that is aside from your hurt feelings because I have even raised the issue that you are not perfect. The question is: Why is it not possible to get that expertise without giving the person a vote? That is not dispositive of whether or not the person ought to vote.

Ms. FIENBERG. If I may, we believe it is necessary in order to promote transparency. If this person were in the panel but did not have a vote, then people choosing this person would not have a track record as they do with all the awards from the industry and the public.

Also, in order to avoid impasses, in order to save money, you would still have to have three voting arbitrators. That means you would increase the delays because you would have four people's schedules to consider. It would be more costly because you would be paying four arbitrators instead of three, and of course I am not sure we would be able to get that person if they did not have the ability to have the same rights as the other three members of the panel.

Mr. FRANK. I am skeptical of that, but I appreciate your answer to the question. Let me close with this, Mr. Chairman, because you do stress again the importance of transparency. That is why you believe it is important to have the decisions, the reasons published. Mr. Lackritz suggests that this would be a degree of litigiousness that might significantly detract from the process. I am wondering if any member of the panel would like to comment on that. Let's start with you, and that is my message.

Mr. KATSORIS. I do not think that you need an industry arbitrator anymore. I think we have outlived that, which started originally 30 year ago or so. However, if you eliminate categories, you eliminate all categories, throw everybody into the pool, and depend upon peremptory challenges and challenges for cause like any other judicial system.

Mr. FRANK. I appreciate that. Let me ask, how do you deal with the argument that reducing the reasons to writing would somehow detract from the flexibility and superiority of arbitration over litigation?

Ms. SHOCKMAN. Thank you, Congressman. I think that the issue of reasoned awards, and PIABA believes the issue of reasoned awards is way down near the bottom of things that really need to be addressed. It is true that investors, after cases when they have lost those cases, and when they have won them and gotten some teeny-tiny fraction award, they want to know what happened.

Mr. FRANK. I am sorry. I apologize if I am unusually inarticulate today. I did not ask in general your opinion of doing them in writing. I was asking specifically whether reducing them to writing would be so burdensome that it would reduce the advantage of arbitration over the courts. That is a separate question.

Ms. SHOCKMAN. I do not think it would be so burdensome that it would reduce the advantage of arbitration.

Mr. FRANK. The general rule that I make, which is if I ask you a question and you do not like the answer that you would have to

give, do not answer it, but do not answer a different question, because I mean that is not the way I think so that is not helpful.

Does anybody else have a comment on whether this would be so burdensome?

Mr. KATSORIS. Congressman Frank, I wrote an article last week. I think I sent it to all the members of this panel: Beware of what you ask for, you might just get it. It has to deal with reasoned awards. I think most of the panel has it. I have another 10 copies here. I will leave them here. This is a debate between myself and a member of PIABA as to the pros and cons of reasoned awards.

Mr. FRANK. All right. I appreciate that. Once the staff has read it, they will tell me about it. I guess again I will try one more time, the argument that reducing things to writing would make it too burdensome. Does anybody want to comment on that?

Ms. FIENBERG. NASD does not believe it would add an extra burden. The awards, of course, are already in writing, but there is not an explanation in many of them as to why an investor won or lost. We get many complaints from investors, as Ms. Shockman indicated, if they have not prevailed, as to what happened, why did the panel turn down their claim.

We have structured this proposal so that investors get to choose whether to have this explained decision, so when they choose in advance whether they want it or not, they can factor in that it might be slightly longer until they get that award. We are prepared to provide sufficient staff so that it will not take longer or burden the process.

Mr. FRANK. Let me ask Mr. Perino, do you have any view on whether or not they should be written down, the reasons?

Mr. PERINO. I am hoping this answer is going to satisfy your responsiveness requirement. There is nothing inherent with writing them down in and of itself, but the more procedural and other requirements that you require in arbitration, if it is that—

Mr. FRANK. I agree. It is cumulative, but I have not heard a lot of other proposals. This one in terms of, if we only did that, would it be a qualitative difference?

Mr. PERINO. If the parties want a reasoned award, there is absolutely no reason not to give it to them. There is one potential downside with reasoned awards. Arbitrators sometimes reach decisions based on what they view as the equities of the situation as opposed to what the law actually requires. That may actually harm investors in some cases if a reasoned award is required.

Mr. FRANK. It is one thing, though, of course to give reasoned awards. That does not necessarily mean that there then has to be a compilation or that in any way it is considered to have precedential value. You could separate that out. Does the NASD proposal assume precedential value?

Ms. FIENBERG. No, absolutely not, Congressman Frank. This would not be precedential, just as they are not now. Even today, many arbitrators do in fact write explanations of their decisions and they are not precedential and they would not be if this new rule is approved by the SEC after public comment.

Mr. FRANK. Thank you, Mr. Chairman.

Mr. RYUN. Thank you very much to the panelists for coming. I appreciate your insight. Let me just make an observation. I know

there is room for improvement. I tend to think, though, unless something is completely broken, let's be careful in fixing it. If it is something that seems to move through in months as opposed to years, I would hate to add more expense and longevity to it.

So let me just say this in closing, since there are no other members for questions, we need to continue to have this dialogue and do things that would help improve the system. I want to thank you very much for being here.

This meeting stands adjourned.

[Whereupon, at 3:18 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 17, 2005

March 17, 2005

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored
Enterprises
Hearing entitled, "A Review of the Securities Arbitration System."

Thank you, Mr. Chairman, for calling this hearing today to review the securities arbitration system.

To be brief, I believe that today will provide our subcommittee with an excellent opportunity to learn more about our current structure along with any new developments, such as the figures showing a great amount of unpaid rewards in addition to the recent NASD rule requiring that arbitrators provide findings if requested by the affected parties.

Again, I thank the Chairman, look forward to the testimony of the well-balanced panel of witnesses, and yield back the remainder of my time.

**OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
A REVIEW OF THE SECURITIES ARBITRATION SYSTEM
THURSDAY, MARCH 17, 2005**

Mr. Chairman, we meet today to discuss the issue of securities arbitration. I greatly appreciate the courtesy that you have extended to Congressman Frank, the Ranking Democrat on the Financial Services Committee, in agreeing to convene this hearing. Securities arbitration is an important issue that deserves careful examination.

The securities industry has long relied on arbitration to resolve disputes. As I understand, the New York Stock Exchange has used arbitration throughout most of its history. In addition, more than 125 years ago, the Big Board expanded its arbitration program to include investor complaints.

For many decades, investors had the option of pursuing claims against brokers through either litigation or arbitration. In 1987, a U.S. Supreme Court ruling determined that brokerage firms could compel customers to agree to arbitrate claims in an industry-sponsored forum as a condition of opening a brokerage account. In such agreements, customers would forfeit their right to pursue individual claims in court.

Since the Supreme Court ruling, the use of mandatory arbitration agreements has grown. In my view, there is nothing inherently wrong with arbitration *per se*. It can prove to be a more efficient and less expensive dispute-resolution mechanism than courtroom litigation. However, for arbitration to work well and to foster investor trust, it must be fair.

We have before us a panel with a demonstrated breadth and depth of knowledge on arbitration issues. They will be able to help us understand how arbitration works and whether there is a need for statutory, regulatory, or procedural reforms. I look forward to learning of their insights, as I approach these matters with an open mind.

As we proceed today, I nevertheless hope that we will explore a number of issues. For example, some have questioned the mandatory nature of securities arbitration. We should therefore examine whether investors should once again be offered a choice. We should also discuss the inclusion of an industry-related arbitrator on arbitration panels, and the process for selecting arbitrators. In particular, we should focus on the disclosure of potential conflicts.

One other issue that we are certain to review today concerns the transparency of arbitrators' decisions. In the past, arbitrators have not had to justify their decisions with written rulings. As a result, a customer often had little understanding of how an arbitration panel reached its decision in a case.

To address this concern, the NASD recently proposed giving the participants in arbitration proceedings the option, prior to the first hearing, to request written explanations of decisions for an additional fee. The adoption of this proposed reform will help to better transparency and may increase investor satisfaction with and confidence in the fairness of arbitration proceedings.

-more-

In closing, Mr. Chairman, I commend you for convening this proactive hearing to examine the securities arbitration process. I also look forward to receiving the testimony of our distinguished experts.



Testimony

of

Linda D. Fienberg

President

NASD Dispute Resolution

Before the

**Subcommittee on Capital Markets, Insurance and Government
Sponsored Enterprises**

Committee on Financial Services

United States House of Representatives

March 17, 2005

Mr. Chairman and Members of the Subcommittee: NASD would like to thank the committee for the invitation to testify regarding securities arbitration. NASD operates the largest dispute resolution forum in the world to assist in the resolution of monetary and business disputes involving investors, securities firms, and individual brokers. NASD has operated the forum since 1968, providing a fair process through arbitration and mediation for investors to settle disputes with their brokers. And arbitration and mediation are faster and cheaper than litigation. NASD reviews its arbitration program continuously to identify ways to promote transparency to investors, improve the quality of arbitration, and ensure the integrity of the arbitration process.

Executive Summary

Over the last five years, NASD has administered over 33,000 arbitration cases through its dispute resolution forum. In 2004 alone, NASD administered over 9,000 arbitrations and 2,000 mediations throughout 56 hearing locations. In investor cases decided between 2000 and 2004, arbitrators awarded over \$660 million in damages. However, awards are only a portion of the overall picture. Approximately 60 percent of all claims are settled directly between the parties or through mediation. Arbitrators decide only about 30 percent of the claims. Over the past five years, of those claims decided, 55 percent resulted in an award in favor of the investor. The combination of settlements and awards reflect that roughly three out of every four investors who bring an arbitration claim are awarded some amount of compensation.

NASD strives continually to improve the transparency of the arbitration process for investors. For example, we have sent to the Securities and Exchange Commission (SEC) a proposed rule that will allow investors to require expanded written explanations of the arbitrators' decision. And, by the end of this month, we will have 68 hearing locations with at least one in every state. We are improving the quality of arbitration by providing new and continuing training to the arbitrators and by making sure the arbitration roster is filled with highly qualified individuals. NASD ensures the integrity of the arbitration process by doing all we can to see that investors get the money owed to them from arbitration awards, tightening the rules on arbitrator disclosure of conflicts of interest, and removing arbitrators from the roster when they fail to meet NASD procedural requirements.

NASD

Founded in 1936, NASD is the world's pre-eminent private sector securities regulator. In 1939, the SEC approved NASD's registration as a national securities association under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—more than 5,200 securities firms that operate more than 97,000 branch offices and employ more than 660,000 registered representatives.

Our rules regulate comprehensively every aspect of the brokerage business. Our market integrity and investor protection responsibilities include compliance examinations, rule writing, professional training, licensing and registration, dispute resolution, and investor education. NASD examines broker-dealers for compliance with NASD rules, MSRB rules, and the federal securities laws—and we discipline those who fail to comply. Last year, NASD filed a record number of new enforcement actions (1,410) and barred or suspended more individuals (830) from the securities industry than in any previous year. NASD, pursuant to a regulatory services agreement, monitors all trading on the NASDAQ Stock Market—more than 70 million orders, quotes and trades per day. NASD has a nationwide staff of more than 2,400 and is overseen by a Board of Governors, more than half of whom are not in the securities industry.

Introduction to Securities Arbitration

Arbitration is a means of determining whether the investors in the dispute are entitled to recover damages or equitable relief. In arbitration, an impartial person or panel hears all sides of the issues as presented by the parties, studies the evidence, and then decides how the matter should be resolved. Arbitration is final and binding, subject to review by a court only on a very limited basis as provided by the Federal Arbitration Act or applicable state arbitration laws. Courts will vacate decisions by arbitrators only if, for example, a party can demonstrate that an arbitrator failed to disclose a relationship with a party or failed to accept relevant evidence into the record. Arbitration allows parties to resolve disputes more quickly and cheaply than by going to court. In arbitration, arbitrators decide if wrongdoing occurred and how to correct it or compensate the injured party for it.

The SEC insures that the arbitration process and rules protect investors and the public interest, and that they are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Arbitration of securities disputes falls under the SEC's federally mandated oversight of the national securities exchanges and self-regulatory organizations (SROs), including NASD. The NASD arbitration rules, as with all substantive NASD rules, must be reviewed and approved by the SEC, subject to a statutorily mandated public review and comment period, before approval and implementation. NASD's arbitration program, like all other NASD activities, also is subject to continuing federal oversight beyond the rule approval process. This oversight includes regular inspections by the SEC.

NASD does not require investors to arbitrate any claim against any brokerage firm or broker. This is a matter of private contract between broker-dealers and their customers and has been held by the Supreme Court to be permissible under the federal securities laws. Most investors who have brokerage accounts have signed an agreement that requires them to settle any disputes with their broker through arbitration rather than the courts. NASD regulates the form and content of the arbitration agreement if firms choose to include arbitration clauses in their contracts. These requirements ensure that customers are aware that they are agreeing to arbitrate and understand the nature of the arbitration process. NASD also prohibits firms from restricting remedies in these

agreements that would be available to investors in court. In several instances, NASD has disciplined firms for attempting to restrict investor rights and remedies in these arbitration clauses.

NASD also offers parties the option of using its voluntary mediation program. Mediation is an informal non-binding approach in which an independent and trained neutral party—a mediator— facilitates negotiations between disputing parties, helping them to find their own mutually acceptable resolution. The resulting settlements often save the parties substantial time and expense. Also, mediations can be initiated before or at any stage of the arbitration process. NASD's mediation program results in settlements more than 80 percent of the time.

NASD administers three types of claims in the arbitration forum. The first and largest group (approximately 80 percent of the cases) involves customers against their broker-dealer and/or individual brokers. These typically involve allegations of unsuitable recommendations, breach of fiduciary duty, fraud, churning, and failure to supervise. The types of securities most often involved in these types of claims are: common stock, mutual funds, annuities, options, corporate bonds, limited partnerships, and certificates of deposit. The second type of claim we administer involves disputes between broker-dealers. These include trading disputes, allegations of raiding, or breach of contract. The third type involves disagreements between firms and their employees. These include contract disputes, compensation disagreements, discrimination claims, and wrongful termination claims, and represent less than five percent of our overall case filings. Nothing precludes employees from pursuing complaints with the Equal Employment Opportunity Commission, independent of their arbitration claims.

The vast majority of arbitration claims are resolved by means other than final award by the arbitrators. These means include direct settlement, mediation and withdrawal of claims. In 2004, arbitrators decided only 27 percent of the NASD administered arbitration cases.

Improving Transparency for Investors

Transparency is a cardinal value of the federal securities laws. Issuers of securities are required to make disclosure to prospective investors; publicly traded companies are required to make ongoing disclosure to shareholders; and broker-dealers are required to make disclosure to customers. NASD believes that transparency should be a hallmark of securities arbitration as well.

Unlike most arbitration programs, NASD makes its arbitration awards publicly available. In addition, during the arbitrator selection process, parties receive arbitrator disclosures and information on past awards rendered by that arbitrator to help them choose an unbiased panel and ensure their confidence in the process. Information on the awards is available free of charge on NASD's Web site.

An important step that NASD has taken involves the issuing of expanded written explanations in arbitration awards. The NASD Board of Governors recently proposed a rule change that will enable investors to require arbitration panels to explain the basis of their awards. NASD filed this rule proposal with the SEC for comment and approval on March 15. Under the proposed rule, customers will be able to request a written explanation before the arbitration panel holds its first hearing and, at the conclusion of the process, the panel will provide a written explanation describing the basis for that panel's award. We believe that this new option will increase investor confidence in the fairness of the NASD arbitration process.

Arbitrator Disclosure of Conflicts of Interest

Another way that NASD ensures transparency in the process is by requiring arbitrators to disclose relevant information about their education, employment history, and brokerage accounts, if any, plus potential conflicts of interest due to business, personal, or client relationships. The more information that investors have about arbitrators, the better the system works to make sure that arbitrators have no ties to the parties or others involved in the dispute. NASD rules require that arbitrators disclose all conflicts. As part of the arbitrator selection process, NASD provides an extensive background disclosure statement on each potential arbitrator to the parties to assist in the selection process. NASD also requires each arbitrator to execute an oath in each case on which that arbitrator serves. The oath contains an affirmation that the arbitrators have no direct or indirect interest in the matter and have no relationship with any party, counsel, or witness that would prevent them from deciding the controversy fairly. In addition, as part of the oath, NASD requires each arbitrator to complete and sign a 23-question disclosure checklist to assist the arbitrator in identifying potential relationships that might raise even the appearance of bias in the eyes of the parties.

In July 2002, the SEC retained Professor Michael Perino to assess the adequacy of NASD (and New York Stock Exchange) arbitrator disclosure requirements. The SEC released the Perino Report in November 2002. After reviewing the NASD procedures related to arbitrator disclosures, Professor Perino wrote: "This Report concludes that there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations." (Report to the Securities And Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations by Professor Michael A. Perino, November 4, 2002, page 48.)

Improving the Quality of Arbitration

The essential quality of arbitration is fairness. The decision reflects the best, unbiased judgment of an individual arbitrator or panel of arbitrators. The quality of the individual arbitrators, therefore, is a key determinant of the quality of the arbitration outcome. NASD is committed to utilizing arbitrators who have the experience and the temperament to evaluate investors' disputes fairly, and to reviewing those arbitrators' performance according to strictly neutral criteria.

The Arbitrators and Mediators

NASD maintains a roster of approximately 7,000 arbitrators and 1,000 mediators who are carefully selected from a broad cross-section of people. These arbitrators and mediators are not NASD employees.

Arbitrators are classified as “public” or “non-public.” In 2004, NASD amended its rules on who qualifies as a public arbitrator to exclude from that category individuals with even minor or indirect ties to the securities industry.

A subcommittee of NASD’s National Arbitration and Mediation Committee (NAMC) reviews and approves or disapproves all new applicants to the roster. The NAMC is a board-level advisory group composed of investor representatives, industry representatives, and arbitrators and mediators; a majority of the Committee is composed of non-industry members.

NASD continually assesses the fairness of its arbitration forum to ensure that the process is fair and transparent to investors. We ask the parties to complete a user survey at the conclusion of every case, providing valuable feedback on the fairness and quality of the process and the roster. NASD made this form available online via our Web site in December. We ask each arbitrator to complete a peer review survey as another means of gauging fairness and improving the process.

Ensuring the quality of the arbitrators who serve is of utmost importance to us. NASD conducts a background check of all applicants and constantly reviews the quality of the arbitration roster through the use of party, peer, and staff evaluations, and quarterly roster reviews conducted by the regional offices. Arbitrators joining NASD’s arbitration panel must complete in-person NASD-sponsored training, and must pass a written test. A rule filing pending at the SEC will require that persons serving as chairs of the panels complete additional NASD-sponsored chair training. We have also implemented new, online training for arbitrators and special training for panel chairpersons.

The first online course, designed to assist arbitrators serving as chairpersons, was rolled out in June 2003. NASD continues to develop subject-specific courses, which are offered online to arbitrators to further their understanding of NASD rules and procedures. We have also begun hosting a series of telephone workshops to aid arbitrators. Audio recordings of the workshops are also available on the NASD Web site. To date, over 5,000 arbitrators have listened to the 2004 phone-in workshops.

Neutral List Selection System

Parties choose arbitrators through the Neutral List Selection System (NLSS), which NASD implemented in November 1998. This system gives parties direct input into the arbitrator selection process and ensures that NASD staff does not control which arbitrators are selected.

Parties receive a list of arbitrators and, as noted, comprehensive arbitrator disclosure statements and information on past awards for each potential arbitrator to help them make informed decisions. Parties may strike arbitrators they do not want, and rank the others in order of preference. After the parties strike or rank the listed arbitrators, the panel is appointed based on parties' choices, resulting in three arbitrators (two public and one non-public) for cases involving claims of more than \$50,000 and one public arbitrator for smaller claims. If the panel cannot be completed through the list process because of too many party strikes or the inability of an arbitrator to accept an assignment, vacancies are filled by the computer-generated rotation system.

Arbitrator decisions have no impact on how NLSS lists arbitrators for service, or how NLSS appoints arbitrators when the parties return their lists of proposed arbitrators. We do provide access to award records to parties and counsel to assist them in selecting arbitrators for their case.

Removal of Arbitrators from the Roster

NASD also has procedures in place that govern the removal of an arbitrator from the roster. Triggering events for arbitrator removal include party, counsel, and peer complaints, and staff observations. For an arbitrator to be removed permanently from our roster, four senior Dispute Resolution staff, including the President of NASD Dispute Resolution, must all agree on the removal. At no time during this process do any of the decision makers review the arbitrator's awards to see whether the awards favor the investor or the industry.

As of January 2005, after the Dispute Resolution management signs a removal request form, two public members of the NAMC must approve the request. The two-member review team is comprised of the NAMC's Chairperson and the Chairperson of the roster subcommittee (both of whom are public). In the event that one of them has a conflict or is otherwise unavailable, another public member of the roster subcommittee reviews it. An arbitrator is permanently removed only if the vote of the NAMC review team is unanimous.

Ensuring the Integrity of the Arbitration Process

Not only must the individual arbitrators be experienced and unbiased, but the entire arbitration process from selection of arbitrators through the discovery process to the payment of awards must be characterized throughout by evenhandedness. NASD is committed to continuous review and improvement of the arbitration process to promote fairness.

The Discovery Process

NASD takes numerous steps to remind all parties of their obligations to cooperate in the voluntary exchange of documents and information during arbitration. In late 2003, we issued a notice to firms reminding them and brokers of their obligations to comply

with NASD discovery rules and procedures for production of documents and materials in arbitration claims. In that notice, we indicated that we will continue to monitor compliance and will refer any perceived abuses to the enforcement side of NASD for investigation and disciplinary review.

In 2004, NASD censured and fined three registered firms a total of \$750,000 for failing to comply with their discovery obligations in 20 arbitration cases between 2002 and 2004. In connection with these sanctions, NASD ordered the firms to implement written procedures designed to ensure that future discovery violations that lead to sanctions are elevated to senior officers for review and appropriate corrective action.

We are currently working on two additional initiatives to improve the discovery process. The first is the creation of a voluntary pilot program for the use of a special roster of trained Discovery Arbitrators, who would review and resolve discovery issues expeditiously. The second is an updating of the existing Discovery Guide Lists, which identify documents that each party should produce in an NASD arbitration.

Classification of Arbitrators

The Perino Report recommended several amendments to SRO arbitrator classification and disclosure rules that, according to the Report, might “provide additional assurance to investors that arbitrations are in fact neutral and fair.”

To implement Professor Perino’s recommendations, and with input from investor and industry representatives, and from the Securities Industry Conference on Arbitration (SICA) as to several other related changes to the definition of public and non-public arbitrators, NASD rolled out a comprehensive revision to the Code of Arbitration Procedure. The revisions were aimed at tightening up the definition of “public arbitrator.”

The new rule also excludes from the public arbitrator roster attorneys, accountants, and other professionals whose firms have derived 10 percent or more of their annual revenue in the previous two years from clients involved in securities-related activities-- even if the professional had no ties and did no work for the industry, and also provides that investment advisers may not serve as public arbitrators. It excludes from the public roster anyone whose immediate family member (“immediate family member” now includes include parents, stepparents, children and stepchildren, or anyone who is a member of the household) is affiliated with the securities industry. Finally, it clarifies related areas of the Code by strengthening the standards for disqualifying arbitrators and clarifying the arbitrator's duty to disclose and update potential conflict-of-interest information.

NASD is considering further amendments to the definition of public arbitrator that would remove from the public arbitrator roster any person who, while properly classified as public under the current SEC-approved rules, nevertheless works for a non-securities related entity that is in some way affiliated with a broker-dealer. For example,

a person might work for a real estate firm that is under common control with a broker-dealer, which could cause an investor to question the person's status as a public arbitrator. We are working out details of the proposal, and we expect to present it to our Board in April 2005.

Unpaid Awards

NASD arbitration rules provide for sanctions against broker-dealers or individual brokers who fail to comply with the procedural orders and awards of the arbitrators. This is especially important when it comes to helping investors collect arbitration awards. Once an investor has won an award, NASD takes steps to ensure the award is paid quickly. For example, our rules require NASD firms and individual brokers to pay arbitration awards within 30 days or face suspension or expulsion from the securities industry.

NASD's initiatives have resulted in a steady decline in the percentage of unpaid awards. In 1998, the Government Accountability Office (GAO) found that over 60 percent of investor arbitration awards went unpaid that year. As a direct result of the changes we have implemented, NASD has reduced that number to about 15 percent through the first half of 2004. These changes included requiring brokerage firms to certify compliance with awards within 30 days and asking investors to notify NASD if the awards have not been paid. Firms are also required to certify that their employees have paid their awards. NASD begins suspension proceedings if an award is not paid within 30 days from the date the award is served, unless the brokerage firm or individual broker files in court a petition to vacate the award, files for bankruptcy, or requests a hearing on the suspension proceedings.

While NASD believes that arbitration is the most effective means of resolving securities disputes, our rules prevent terminated firms from enforcing predispute arbitration agreements with customers. NASD has also established streamlined default proceedings. Investors can take advantage of this rule for cases in which the firm or broker that has been removed from the industry fails to respond to the arbitration claim. Thus, an investor bringing a claim against a defunct firm has a choice of opting out of the arbitration process, or submitting the dispute to a streamlined arbitration default process. Since the rule permitting investors to opt out of arbitration in these instances went into effect in June 2001, 94 percent of the over 800 investors given this option chose not to go to court, but to remain in the arbitration system.

GAO and NASD statistics reflect that in approximately 85 percent of the instances of unpaid awards, the party responsible for the damages was a broker-dealer firm or individual broker that had left the securities industry. NASD records with the Central Registration Depository (CRD) any failure to pay an award and has enhanced reporting requirements for civil and criminal complaints and for arbitration claims. These measures and other surveillance tools help prevent a firm or individual with an outstanding unpaid arbitration award from re-registering with NASD.

NASD is exploring additional measures to decrease the instances of unpaid awards such as increases in net capital requirements, increased surveillance of marginally capitalized firms with pending claims, and enhanced education for investors on how to recognize the risks that a firm may go out of business. We have also implemented systematic reviews of new arbitration claims for patterns of abuse of investors by firms or brokers.

Helping Investors with the Process

Through assistance in organization and training of the students, NASD supports several law school legal clinics that represent small investors who cannot afford to hire an attorney or whose losses are too small to retain an attorney. The clinics, located throughout New York State, Pennsylvania, California, and Illinois provide an essential service for investors while at the same time giving law students valuable experience. Under the supervision of experienced practitioners, the students provide services such as interviewing investors, reviewing client documents, investigating facts, analyzing cases for merit, negotiating settlements, and representing clients in mediations and arbitrations before the NYSE and NASD.

In March of 2005, the NASD Investor Education Foundation awarded more than \$1 million to 11 organizations for new educational programs and research projects. One of those grants was to Northwestern University's Bluhm Legal Clinic. Northwestern will use its grant to establish the Investor Protection Clinic, the first securities arbitration clinic in the Midwest. The new Clinic's aims are to provide legal representation for small investors and to develop a model securities arbitration clinic that can be replicated at other law schools throughout the nation.

Conclusion

NASD is committed to continuously reviewing its arbitration program to promote transparency to investors, improve the quality of arbitration, and ensure the integrity of the arbitration process. We look forward to working with Congress on this and other issues as we continue our mission of protecting investors and ensuring market integrity.

TESTIMONY OF WILLIAM FRANCIS GALVIN
Secretary of the Commonwealth of Massachusetts

Before the U.S. House
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises

A Review of the Securities Arbitration System

Thursday, March 17, 2005

Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, I am Bill Galvin, Secretary of the Commonwealth and Chief Securities Regulator in Massachusetts. Thank you for the opportunity to be here today to testify about arbitration in the securities industry — from the point of view of investors on Main Street.

I can speak to the concerns of small investors because they call or visit my office in Massachusetts all the time. Small investors, let's not forget, are the life blood of our securities markets. Without their faith and trust — and their hard-earned money — our markets couldn't function.

Unfortunately, in recent years their faith has been badly shaken. They've watched as giant companies, some with household names, were looted and run into the ground by corrupt management. They've seen respected Wall Street firms hype technology stocks using corrupt research reports — research that, we now know, was designed not to paint a true picture of the company or its prospects but to curry favor with a client in order to win lucrative investment banking business.

Corporate scandals and the collapse of the high-tech bubble have hurt countless Main Street investors. That's bad enough. What's worse in my opinion, is the rigged system we now have to help harmed investors seek a measure of justice.

Every year thousands of investors file complaints against their brokers. If these disputes aren't settled, they end up in mandatory arbitration, a system that I believe is fundamentally flawed and stacked against the individual investor. The sad thing is, industry-sponsored arbitration is the only game in town.

When an investor opens a brokerage account, in almost all cases he or she must sign away their right to a day in court should a dispute arise. Instead, they agree to have their claim heard by a panel of three arbitrators picked from a list compiled by the NASD, the so-called industry self-regulator.

The term “arbitration” as it is used in these proceedings is a misnomer. Most often, this process is not about two evenly matched parties to a dispute seeking the middle ground and a resolution to their conflict from knowledge, independence and unbiased fact finders, rather what we have in America today is an industry sponsored damage containment and control program masquerading as a juridical proceeding.

Of the three arbitrators on the panel, there is one with ties to the securities industry and two supposedly without ties to the industry. I believe the truth about the independence of these other arbitrators will reveal a troubling pattern and I invite your review.

Is it fair? The industry would say “yes.” But let’s think about it for a minute.

The NASD, the industry group, gets to decide who is qualified to be an arbitrator and who isn’t. They and only they — the NASD, that is — select the pool of arbitrators. There is no state in this union that gives to one party to litigation the unilateral right to choose the finding of fact or jury that will decide their case without regard to the other party’s choice. Would anyone seriously suggest that we apply this approach to any other industry?

For instance, would anyone here seriously suggest that in all future disputes between automobile manufacturers and their customers relating to defects that those who purchase an automobile can only bring their complaints and claims before a panel selected by GM, Ford or Chrysler? – I don’t think so.

Are not the financial futures of our citizens entitled to at least as much protection as in cars?

As further proof of this rigged system, I offer one example that I happen to be personally familiar with — John J. Mark, a former NASD arbitrator from Massachusetts.

Mark was an arbitrator with the Commonwealth of Massachusetts for many years, and an adjunct professor at Harvard and Boston University. As far as I know he's a man of impeccable credentials. And yet he was dropped from the NASD's pool of arbitrators.

Why? As he told a meeting of state securities regulators last summer, (and I quote): "the word on the street is if you rule against the (brokerage) houses, you will be removed from the list" (end quote).

To be sure, lately the NASD has been working on this arbitration process.

About nine months ago, for example, the NASD fined three large Wall Street firms — Merrill Lynch, Morgan Stanley and Smith Barney — \$250,000 each for failing to produce documents in some 20 arbitration cases between 2002 and 2004. That was an overdue step in the right direction. Foot-dragging by Wall Street firms involved in disputes with investors must be punished.

But these fines are so small, they hardly operate as a deterrent to further stonewalling. Automatic default and treble damages on claims would be a far more effective remedy.

More recently, the NASD after deliberation has passed another milestone. Arbitrators may be required to put their decision in writing — for a fee. But no fine or other regulatory tinkering will address the more fundamental flaw of the so-called arbitration process — namely, that it's run by the industry and for the industry.

The system is unfair.

Consider this statistic. While the NASD asserts that in more than half the cases arbitration panels award money to investors the number of so-called investor "victories" does not tell the true story of how investors really fare in arbitration.

The NASD cites cases where the arbitrators make any cash award as a “victory” for the investor. But in fact, many of those awards often are for only a fraction of the amount claimed. Under this method of reckoning, a claimant who had \$5 million losses but was awarded just \$5.00 in restitution has received an “arbitration award.” This is a pyrrhic victory, at best.

The arbitration system should be reformed to put investors’ interests on the same level as those of Wall Street.

How can we do that?

Given that investors, by law today, have no choice but arbitration, we need to make the system more fair. The best way to do that is to take it out of the hands of the industry — put someone besides the NASD in charge. That’s the best solution.

In the short-term, we need to increase oversight of the arbitration process. The S.E.C., state securities regulators — and perhaps even Congress — need to take a hard look at arbitration.

State securities regulators have begun this process by creating a task force to look at issues involving arbitration. These issues include how arbitrators are selected, trends in arbitration awards, and how cumbersome and expensive the system is for investors.

This is not a small thing.

We have almost 100 million investors in this country. In recent years we have made reforms to make sure Main Street investors get a better shake in the marketplace.

We now need to focus on reforming the dispute-resolution system. It's the right thing to do — right for investors and right for our markets. It's time to act.

Again, I am grateful for the chance to be here today to share some of my thoughts and I look forward to your questions.

Statement to Congressional Committee on Financial Services on March 17, 2005
By Constantine N. Katsoris, Wilkinson Professor of Law,
Fordham University School of Law.

- ** I am appearing before this Committee in my individual capacity and have not received any Federal grants or contracts related to the subject upon which you have invited me to discuss.
- ** I have participated in the resolution of securities disputes for over 35 years as an arbitrator, mediator, arbitrator trainer, Public Member of the Securities Industry Conference on Arbitration (SICA) and an advisor to the Fordham Law School Arbitration Clinic.
- ** I couldn't begin to share all of my experiences in the 5 minutes allotted me, so I will save my opinions for my responses to questions from the panel.
- ** I would, however, like to tell you how I first got involved in this area.
- ** Before joining the Faculty at Fordham Law School over 40 years ago I was a full time litigator at a major Wall Street Law Firm. After a few years of teaching – and loving every minute of it – I realized that I also missed litigation. Thus, in 1967 I became a arbitrator at the NASD and (shortly thereafter) at the NSYE where I have served in many, many, many cases.
- ** In 1977, when SICA was first created I was selected as one of it's Public Members, where I have served ever since.
- ** In addition, about eight years ago – at the suggestion of then SEC Chairman Arthur Levitt – I helped establish a Securities Arbitration Clinic at Fordham to represent injured investors who couldn't obtain an attorney and thus would find it difficult to pursue their claims. I am proud to say it is the most popular clinic at Fordham, and is the first such clinic in the country to obtain punitive damages in an SRO arbitration. There are presently about a dozen such law schools clinics operating today; and, collectively they constitute a growing force in this area.
- ** Arbitration in the 60s was like the horse and buggy days. There was virtually no pre-

discovery or exchange of information. Not too many people complained, however, because basically the system was voluntary as far as the public was concerned.

- ** In the 70s, however, the SEC was not satisfied with the handling of small claims, and its Office of Consumer Affairs issued a Report recommending the creation of a non SRO entity for the handling of such claims.
- ** In response to this Report, SICA was created with an initial mandate to establish a procedure for the handling of small customer claims. Facilitating the processing of small claims, however, did not address the broader issue, namely: the basic *Balkanization* of the various SRO arbitration programs. In other words, each SRO had its own set of rules (some were written, some existed solely on the basis of custom and usage) all of which complicated the task of the practitioner in choosing a forum.
- ** Thus, SICA's next assignment was to establish a Uniform Code of Arbitration which was basically applicable to all SRO cases, large as well as small. Nevertheless, SRO arbitrations were still basically voluntary because of the then prevailing conventional wisdom that *34 Act* Federal Securities claims were not subject to pre-dispute arbitration agreements; thus, you could still go to court.
- ** As confidence grew in the new Code, SRO arbitrations more than tripled from 830 in 1980 to over 2,800 in 1986. Yet, SRO arbitration was still in its infancy until the *McMahon* case in 1987 which virtually transformed the process from a voluntary procedure to a mandatory one by holding that *34 Act* claims were arbitrable pursuant to pre-dispute arbitration agreements.
- ** After the *McMahon* case, the landscape changed overnight. Not only did the number of arbitrations more than double to over 6,000 in the year after *McMahon* than the year before; but, equally significant was the influx of the larger and more complex cases that previously were being filed in court.
- ** At this point, the task of insuring the fairness of SRO arbitrations largely fell upon SICA which, incidentally, had been favorably mentioned in the *McMahon* case as evidence of the changing landscape. SICA's independence was essential to the process, and that independence was insured at the outset because its Public Members were beholden to no one; and, thereafter the Public Members got to pick their own successors.
- ** Moreover, the SEC – with its oversight authority over the SROs and as gatekeeper of the 19b process – attends SICA meetings. Indeed, the efforts to insure a *Level Playing Field*

are outlined in SICA's Twelve Reports issued to the SEC over the years, which describe, with great transparency, the evolution in SRO arbitration, for example:

- 1) Expanded document discovery and more extensive exchange of pre-hearing information to prevent trial by ambush;
- 2) To facilitate the discovery process, it established lists of documents that must be presumptively produced;
- 3) Tightened the rules for the qualification of arbitrators and the avoidance of conflicts;
- 4) Changed the method of arbitrator selection from SRO appointment to list selection by the parties;
- 5) Held hearings throughout the country regarding the questionable practice of non-attorney representation of claimants;
- 6) Established a Pilot Program whereunder claimants could opt-out of SRO arbitration in favor of another forum;
- 7) Encouraged the creation of Law School clinics to represent claimants who could not obtain representation; and, the list goes on and on.

** Since the adoption of the Uniform Code, over 100,000 arbitrations have been filed at the various SROs. Has justice been achieved in *every one* of those 100,000 cases? Certainly not; but, I don't know of *any* dispute resolution system that has an unblemished record in this regard – and that includes our own court system.

** Admittedly, sometimes awards are excessive and sometimes they are inadequate, but that will be true no matter which resolution system we use.

** Are there improvements that can still be made to the SRO arbitration process? Of course there are, and the process is ongoing and never-ending as new problems and situations arise.

** In conclusion, I can express to you that since the mandate of *McMahon*, the system has, on balance, worked well.

THANK YOU.

Testimony

New York Stock Exchange, Inc. 11 Wall Street New York, NY 10005 www.nyse.com



**Karen Kupersmith
Director of Arbitration
New York Stock Exchange, Inc.**

On

A Review of the Securities Arbitration System

**Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
United States House of Representatives**

March 17, 2005

Karen Kupersmith
Director of Arbitration
New York Stock Exchange, Inc.

On

A Review of the Securities Arbitration System

Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
United States House of Representatives

March 17, 2005

I. Introduction

Chairman Ryun, Ranking Member Frank, Ranking Member Kanjorski and Members of the Subcommittee. My name is Karen Kupersmith and I am the Director of Arbitration at the New York Stock Exchange (“NYSE” or the “Exchange”). I began working as a staff attorney in the Arbitration Department in 1983 and became Director in April 2004. The number of cases filed per year when I joined the NYSE was far less than the number filed today, the nature of the cases filed was not nearly as complex as today, and the hearings themselves usually were concluded in a day or less. Throughout the last decade, with the significant increase in case filings, case complexity, and hearing sessions required to conclude cases, I have personally observed that one factor has remained constant – the commitment of the NYSE to providing investors with the fairest method for resolving disputes with brokerage firms.

The NYSE has worked hard over the years to ensure a level playing field for investors in our arbitration forum. Some of the more significant factors ensuring that public investors receive the fairest method for resolving their disputes are summarized below and are discussed in more detail later in my testimony:

- Proposed rule amendment giving public investors choice of method of arbitrator selection
- Enhanced discovery procedures
- Ability of arbitrators to order sanctions/defense dismissal for non-compliance with arbitrator orders, including discovery orders
- Increase in staff to manage a larger caseload
- Staff attorney availability for pro se individuals
- Close calls regarding challenges for cause decided in favor of investors
- Recruitment of arbitrators from diverse backgrounds
- Expanded background information about arbitrators
- Mandatory disclosure requirements for arbitrators
- Arbitrator training requirements
- Arbitrator evaluations by staff, parties, and peers
- Development of on-line portal for arbitrators to input profile data
- Location of hearings based on investor's residence
- An in-person hearing for small claims at the investor's request
- Age and health calendar preferences
- Accessibility of awards and information on website
- Cooperation with PIABA

- Active role in SICA

II. Historical Background

Arbitration at the NYSE dates back to 1817. Throughout a nearly 200 year history, arbitration at the Exchange has served as an effective alternative forum to the courts, as documented by historians such as Henry Clews as early as the late eighteenth century (*Twenty-Eight Years in Wall Street*). Support for the use of arbitration was encouraged by the Securities and Exchange Commission (the “SEC”) shortly after its creation in 1935, when it stated in Release No. 34-131 that ... “the Exchange should encourage its members to offer customers a standard arbitration agreement.” In 1972 Judge Medina of the Second Circuit Court of Appeals described the arbitration clause of the NYSE Constitution as “the most significant of the measures taken to implement the self regulation contemplated by the 1934 Act” when he cited the NYSE Constitution (previously Article VIII, Section 1) and the provision for arbitration at the demand of the non-member (*Coenan v R.W Pressprich & Co.*, 453 F.2d 1209 (2d Cir. 1979)).

With the increased acceptance of arbitration, other self-regulatory organizations (“SROs”) began offering arbitration as an alternative method of dispute resolution. In 1976, the SEC stated that it would like to “...establish a new entity to administer a uniform system of dispute grievance procedure for the adjudication of small claims.” (see SEC Release Nos. 12528 and 12974). In response, in 1977, several SROs created a task force which eventually became known as the Securities Industry Conference on Arbitration (“SICA”). SICA is comprised of public members (representatives of the investor bar),

SROs, and a representative of the Securities Industry Association. SICA has worked since its inception to monitor and recommend changes to SRO arbitration as needed, and to develop informational material for investors explaining how the arbitration process works.

In 1987, the U.S. Supreme Court, in a landmark decision, *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987), (“*McMahon*”), upheld the validity of pre-dispute agreements to arbitrate. The court relied on what it considered the inherent safeguards in the securities arbitration process, as well as expressing confidence that substantive rights would be protected. Since 1987, the courts have relied on *McMahon*, holding that most securities industry disputes should be heard in arbitration as long as a pre-dispute agreement to arbitrate exists. Since *McMahon*, SICA has responded to the concerns of various organizations and interest groups about the fairness of the process, including focus on increased arbitrator disclosure requirements and more extensive discovery procedures, as discussed below. Many of SICA’s recommendations in this regard have been adopted by the SROs and have improved the system for investors.

III. The Benefits of Arbitration

Arbitration as an alternate method of dispute resolution has long been recognized as efficient, convenient, and quicker and less expensive than legal proceedings. These benefits have always been a significant reason for the success of securities industry arbitration. There are numerous benefits of arbitration that render it a more productive dispute resolution process for investors than litigation. Some of these benefits are further discussed below.

Privacy

Arbitrations, unlike legal proceedings, are private. This is often attractive for those investors who shun publicity and/or do not want their private financial affairs publicly disclosed.

Flexibility of the Process

Public investors with relatively small claims may find it difficult or impractical to retain an attorney. In this situation, or if they simply choose not to hire an attorney, they may still file a claim in arbitration without dealing with the daunting nature of legal proceedings. There is no requirement for a formal submission of pleadings similar to that required in court. Instead, an investor may file a statement of claim in simple letter format that explains what happened and what the investor seeks to recover. A NYSE staff attorney is assigned to a case from the time it is filed until the time it closes. This staff attorney is available to assist the investor with the arbitration rules at all stages of the proceeding, answer procedural questions, and otherwise explain the arbitration process.

The informal nature of arbitration proceedings is not as intimidating as is the formal nature of courtroom litigation. Should a public investor retain an attorney not experienced in the field of securities industry arbitration, that attorney will have the same access to arbitration staff attorneys to guide her/him through the process.

For those investors not able to retain an attorney, an increased number of law schools have begun securities industry arbitration clinics. These clinics are supervised by experienced attorneys and have the support of the SROs who participate both in round table discussions and in classroom instruction, the SEC, other governmental agencies, and attorneys in private practice. Law students under the careful watch of the clinics' attorneys interview the public investor, review the claims, and should a claim be accepted by the clinic, represent the public investor in the arbitration proceeding. In these instances, investors who would otherwise not have representation in a court of law would have representation in the arbitration forum.

Speed of Resolution

An important benefit of securities arbitration is the speed in which claims are resolved. Depending on the jurisdiction and the court in which filed, legal proceedings can take as long as 2 1/2 to 5 years to be resolved. At the NYSE, however, all public investor claims closed in 2004 were closed in less than 16 months. At the NYSE, any investor over 70 years of age or with health problems can receive a calendar preference, if requested, and have her/his claim heard in an expedited fashion, often within 6 months of filing.

Fairness

Arbitration is based on principles of equity – doing what is most fair and just in light of the facts and circumstances of the particular case. Public investors receive a direct benefit from these equitable principles. Should a panel of arbitrators find that the facts of a

particular case merit an award because it is equitable, an award can be made without the need to cite case precedents or any other justification.

Based on both the number of cases settled and the number of awards issued at the NYSE in their favor, public investors received monetary remuneration in 70.96 percent of the public investor cases closed in 2004, and, in 80.99 percent of the public investor cases closed in 2003. In those cases that settled, the investors often receive this remuneration long before they would receive any compensation from the filing of a claim in court.

IV. The Arbitrators

The arbitrators are at the core of the arbitration process. Arbitrators must be capable, fair, and impartial. The NYSE has a total of 1600 arbitrators, 961 of whom are classified as public arbitrators and 639 of whom are classified as securities arbitrators.

Securities arbitrators are those arbitrators associated with an Exchange member, broker/dealer, government securities dealer, municipal securities dealer or registered investment advisor, registered under the Commodity Exchange Act or a member of a registered futures exchange, or who have been associated with any of these within the past five years. Arbitrators who are retired from or who have spent a substantial part of their business career associated with any of the above entities remain classified as securities arbitrators. Attorneys, accountants, and other professionals who devote 20 percent or more time representing securities industry clients are also classified as securities arbitrators.

Arbitrator Selection

Arbitrators are currently selected to serve on a particular case based on one of three methods. Under all methods, the investor is always assured that a majority of the panel will be composed of public arbitrators, unless she/he chooses that a majority come from the securities industry. Under the first method, known as traditional staff appointment, the NYSE staff attorney selects three arbitrators to serve on a panel. The parties have one peremptory challenge, which is a challenge that allows them to reject an arbitrator for any reason, and unlimited challenges for cause. NYSE rules provide in the Guidelines for Classification of Arbitrators that if there is a close question regarding challenges for cause, the question "...shall be decided in favor of public customers."

The second and third methods, which have been in place for approximately five years under a pilot program approved by the SEC in 2000, currently require the agreement of all parties to the arbitration. Under the second method, referred to as "list selection," arbitrators are randomly selected by computer and the parties are given lists with the names of ten public and five securities arbitrators. The parties have unlimited peremptory challenges, and replacement names are provided for arbitrators challenged for cause. If a panel cannot be selected from the first set of lists, a second set of lists is generated with three names for each vacancy. The parties then have one peremptory challenge and unlimited challenges for cause. If a panel still cannot be appointed, the computer randomly selects one name at a time until a panel of arbitrators able to serve is appointed. Arbitrators are not pre-screened for availability; they are pre-screened only to make sure they have no brokerage accounts or securities affiliations with any of the named parties.

Under the third method, referred to as “enhanced selection,” six public and three securities arbitrators are selected by the staff attorneys. The parties have three peremptory challenges and unlimited challenges for cause. The arbitrators are pre-screened for availability, and conflicts with parties and their attorneys.

The NYSE has a proposed rule amendment pending with the SEC which would make permanent a variation of the pilot program. The proposed amendments would give the investor or non-member the absolute right to select the method of arbitrator appointment, i.e., list selection or traditional staff selection. Parties would still be able to agree on any other reasonable method of selection.

Arbitrator Qualifications

The NYSE is committed to maintaining the highest ethical and performance standards for arbitrators. Arbitrators must have a minimum of five years experience in their field or profession, must submit two letters of recommendation, and must take part in continuing securities industry arbitration training courses.

The process of recruiting arbitrators is an ongoing one. At present, the NYSE conducts hearings in 46 cities throughout the country and a pool of arbitrators exists in each city. Arbitrators are recruited from diverse backgrounds to reflect the diverse backgrounds of the public investors who appear before them.

Arbitrator Training

Arbitrators must be trained prior to serving on a panel. This training can be either at the New York Stock Exchange or at the NASD. Once an arbitrator has received the initial requisite training, the NYSE requires that arbitrators attend a training program at least once every four years. This requirement for subsequent training may be waived if the arbitrator has demonstrated proficiency as observed by a NYSE staff attorney.

Arbitrator training includes matters such as NYSE arbitration rules, new developments in arbitration, relevant cases, and related information. The training program focuses on the fact that arbitrators should make decisions based only on the facts and evidence presented in the case before them. The training also covers the continuing obligation to disclose all potential conflicts, including any financial or personal interest the arbitrator may have in the outcome of the arbitration, and, any past or present financial, professional, family, or social relationship the arbitrator may have with any of the parties and/or their attorneys. Arbitrators are instructed that if the question "Should I disclose it?" crosses their mind, they must disclose the information, regardless of how inconsequential the information may seem to them. The rule is: if in doubt, disclose.

Arbitrators taking part in these training programs are encouraged to exchange ideas and experiences. They discuss discovery and what documents should be ordered produced in relation to different fact patterns. They also discuss situations that have actually occurred during hearings and which have posed the greatest difficulties, in order to explore different ways in which such situations may be handled should they arise in the future.

This interchange often provides arbitrators with insights and knowledge into areas that are of the greatest concern to investors.

Evaluation of Arbitrators

In order to ensure high standards of conduct, performance, and quality, arbitrators are continually evaluated by their peers, the parties, and the staff attorneys. Complaints are carefully reviewed and followed up on with other panel members and/or the parties. If it is determined by the Director of Arbitration that an arbitrator should no longer be appointed to serve on panels, the arbitrator is removed from the active pool. Additionally, the Central Registration Depository ("CRD") database is checked each time that a securities arbitrator is appointed to a case. Any securities industry arbitrator with three or more reportable customer claims within the past five years, regardless of the outcome, is removed by the Director of Arbitration from the active pool.

V. Recent Improvements to Arbitration

The NYSE has taken many steps over the past decade to ensure that the public investor involved in an arbitration proceeding plays on a level field, and that cases continue to be administered as efficiently as possible. These steps include increased staffing, adoption of discovery procedures, expanded arbitrator disclosures, additional hearing locations, and more liberal granting of challenges for cause when asserted by an investor, as well as enhancements to the NYSE website.

The NYSE website is continually enhanced to include more information about dispute resolution and arbitration, and to provide greater transparency about the arbitration process. For example, NYSE Rules and a User's Guide to Arbitration are available on the website, as are all arbitration awards from 1991 to the present.

The NYSE Arbitration Department has more than doubled in size since the end of 2002, both in staff and in physical space. In addition to myself and my assistant, there are currently twelve attorneys, eight arbitration specialists (similar to paralegals), and twelve administrative personnel. The entire staff is available to assist the public investor with questions about the arbitration process and procedures at the NYSE. Written materials are also available to help public investors without an attorney and every effort is made to make pro se public investors comfortable with the process.

Public investors who file claims in amounts of \$25,000 or less may use the NYSE small claims procedure. This procedure allows the matter to be decided on the papers, without a hearing. However, should the public investor want a hearing, she/he will get one, regardless of the size of the claim.

The information that is given to the parties about arbitrators has been significantly expanded over the years. The NYSE realizes the importance of all parties receiving full disclosure about the background and experience of the individuals who may ultimately hear and decide their cases. If the parties request additional background information, it is provided. Additionally, the NYSE has recently created an on-line portal by which

arbitrators can review and input changes electronically to their profile. This will help ensure that information about potential arbitrators is current.

NYSE has adopted discovery procedures since *McMahon* that provide a framework including time periods for document/information requests and responses. When disputes arise over what documents should be produced, the disputes are resolved by a public arbitrator, unless the public investor requests a securities arbitrator. NYSE rules provide that issues involving discovery disputes are to be resolved on the papers by a public arbitrator. However, the arbitrator may elect to hold a hearing, telephonic or in-person, and/or refer the matter to the full panel. The SICA Arbitrator's Manual is available for guidance as to the types of documents frequently ordered produced and discusses various considerations that the arbitrator should balance in making decisions as to what should be produced.

NYSE arbitration rules provide that the arbitrators may obtain compliance with any orders they issue by imposing sanctions. The rules give the arbitrators the ability to dismiss a defense for continued failure to comply with orders of the panel.

Claims are filed at the NYSE by investors from all over the country. After a claim is filed, the NYSE generally sets the location for a hearing based on the investor's residence, so long as there is any connection to the residence and the events in question. For example, if a public investor lives in Nevada, requests a hearing in Nevada, but has an account with a brokerage firm in Michigan, the hearing location would be Nevada as long

as there is any connection with that venue such as the firm sending monthly statements to the investor's residence. In addition, if a public investor requests a hearing location other than one where the NYSE regularly conducts hearings, for reasons such as health and/or age, such requests are usually granted as long as the NYSE is able to appoint arbitrators willing to travel to the desired location, at the NYSE's expense.

VI. Conclusion

The NYSE has remained committed to providing public investors with the most neutral and fair forum for the resolution of securities industry disputes. As discussed above, the NYSE has taken many positive actions over the past decade affirming this commitment. These actions have been and will continue to be expanded as the NYSE continues to work with the SEC, PIABA, and SICA.

The NYSE is committed to the cooperative effort of all those involved in securities industry arbitration. It is through the combined expertise and experience of the various interest groups that the greatest benefit to the process can be achieved – the benefit of continually improving the process – which is the goal of the New York Stock Exchange.

Thank you for allowing me to testify today. I will be pleased to answer any questions.

Testimony of
Marc E. Lackritz
President, Securities Industry Association
before the
Committee on Financial Services
U.S. House of Representatives
March 17, 2005

Introduction and Summary

Mr. Chairman and members of the Committee:

I am Marc Lackritz, President of the Securities Industry Association.¹ SIA appreciates the opportunity to testify before the Committee today on how well the securities arbitration process is serving our investors.

Public trust is critical to the success of our capital markets, the securities industry, and any dispute resolution process used by our customers. When disputes arise between customers and securities firms, the process of resolving those disputes must be fair in fact, and also perceived to be fair. That is why SIA commends the Committee for holding this hearing, and welcomes the opportunity to discuss the current system of dispute resolution as well as suggestions to improve that system. SIA has been active over the years in efforts to improve the dispute resolution process, and we share the Committee's objective of examining securities arbitration with that goal in mind.

SRO-sponsored securities arbitration is a system that works. It is a fair and efficient means of resolving disputes between customers and brokerage firms -- fair both to customers and to individuals and firms in the securities industry. We know this from the weight of both anecdotal evidence and empirical data.

Arbitration continues to be a far more efficient and cost-effective dispute resolution mechanism than traditional court-based litigation. On average, disputes are resolved much faster and at far lower cost to customers in the SRO-sponsored arbitration fora than in comparable

court cases. This allows participants to put a dispute behind them and move on with their lives, without the often all-consuming, years-long battles of traditional litigation.

Aggrieved customers get what so many say is what they really want: their “day in court.” Unlike in court cases, claimants in arbitration are not held to technical pleading standards. Unlike in court cases, pretrial discovery in arbitration is focused and limited, and rarely includes expensive and time-consuming taking of depositions. Unlike in court cases, the hearings themselves are not intimidating, technical proceedings bound strictly by the rules of evidence, but are designed to be flexible and allow the arbitrators to reach the most equitable conclusion. The more streamlined process of arbitration, as compared with the many procedural and financial obstacles that must be overcome by a plaintiff in a court case, means that nearly every case brought in arbitration (other than those that are settled) goes to a full merits hearing.

So the system works. But it will continue to be superior to court-based litigation only if we guard against what I call the “creeping litigiousness” that is at the gates. Some of the changes that have been proposed, both formally and informally -- requiring written explanations of awards by arbitration panels, expanding pretrial discovery, broadening the scope of parties’ rights to appeal from arbitrators’ decisions – would undermine what has made arbitration an attractive alternative: the streamlined, efficient, and less costly means of resolving disputes. I urge the Committee and the Congress to be very reluctant to endorse this type of change to securities arbitration.

I address below a few of the issues in a little more detail.

Arbitration Offers Significant Benefits To Parties That Are Not Available In Court

SRO-sponsored securities arbitration allows parties to resolve disputes quickly, fairly and efficiently. As illustrated by the unbiased, third-party statistics below, arbitration offers significant benefits to *all* parties -- customers and securities firms alike -- that may not be achieved through litigation in the court system or in other forums.

SRO-Sponsored Arbitration Provides a Faster and More Efficient Method to Resolve Disputes

The hard data confirm that SRO-sponsored arbitration provides a faster and more efficient method for customers to resolve disputes. Specifically, new statistics published by the NASD show that for customer cases closed in 2004, the average turnaround time from filing to judgment was 17 months.² Conversely, recently compiled statistics for civil cases in the United States District Court for the Southern District of New York³ show that for the 12-month period ending September 30, 2004, the median time from filing to trial -- not final resolution, just trial -- was 26.8 months.⁴ The most obvious benefit of the speedy resolution is that successful plaintiffs obtain the relief they seek -- usually money -- more quickly, and all parties are able to resolve a dispute and move on to more constructive endeavors. In addition, the significant reduction in time to judgment benefits all parties involved in the process: if parties spend less time litigating, they spend less money.

Moreover, by providing parties with the early opportunity to have their case heard, arbitration avoids many of the problems typically associated with delay in the court system, such as a witness's inability to recall facts and difficulty locating witnesses and documents long after the events at issue. The more efficient process that exists in arbitration also lessens the

substantial disruption in the parties' businesses and lives that is often involved with protracted court proceedings. Such a waste of resources helps no one. Arbitration reduces that waste.

SRO-Sponsored Arbitration is Fair and Effective

Some critics of the SRO-sponsored arbitration fora complain that the NASD and New York Stock Exchange are controlled by the securities industry and deliver inequitable and unfair results to customers. These complaints are belied by the facts. For example, a report prepared by the Securities Industry Conference on Arbitration ("SICA") in 2001 found that, of the 31,001 public customer cases decided by SRO arbitrators between 1980 and 2001, 52.56 percent resulted in customer awards.⁵ Similarly, the most recent NASD statistics show that, of the 2,019 customer cases decided in 2004, 55 percent resulted in customer awards.⁶ This echoes the results of an earlier study by the GAO.⁷ In that study, the GAO analyzed results in arbitrations over an 18-month period from January 1989 to June 1990 and found that arbitration panels found for investors in 59 percent of cases in fora sponsored by the SROs versus 60 percent in arbitrations brought before the American Arbitration Association ("AAA"), an independent organization not associated with any SRO or securities industry group. When investors prevailed in SRO arbitrations, they recovered approximately 61 percent of their claimed damages versus approximately 57 percent in AAA arbitrations.⁸

But even these numbers understate customers' success in securities arbitrations. When critics complain that customers prevail in "only" half of the cases they bring, they ignore the fact that a large percentage of cases brought in SRO-sponsored fora result in favorable settlements for customers prior to a hearing. NASD statistics for 2004 show that approximately 54 percent of arbitrations that were closed that year were settled by the parties, or with the help of a mediator,

prior to a hearing.⁹ Likewise, recent NYSE statistics show that of the 1095 cases closed in 2004, 554 (or approximately 51 percent) were settled prior to a hearing.¹⁰ Taken together, these numbers mean that customers are collecting money in more than three-quarters of the cases that they bring in arbitration. That success rate is hardly indicative of a system biased against customers.

These studies, all conducted by unbiased third-parties, confirm that a claimant's chances in an SRO-sponsored arbitration forum are as good, if not better, than his or her chances in court or in another independent arbitral forum. That does not mean that customers will win every claim brought against a broker: one certainly would not expect that to be the case. But the statistics strongly support the anecdotal evidence that customers are given a fair shake.

Furthermore, studies have shown that claimants have a favorable view of the SRO arbitration process as it is currently structured. Specifically, between December 1997 and April 1999, the NASD surveyed participants in 2,037 cases that were closed with an arbitration award.¹¹ The results, which were analyzed independently by the U.S. Military Academy at West Point, revealed that approximately 93 percent of those surveyed agreed that the process was fair. In addition, although not specifically quantified, the NASD survey found that "[b]y and large . . . claimants viewed the process somewhat more favorably than respondents did."¹²

And experience shows that, when given a choice, customers have chosen SRO arbitration. In January 2000, a two-year pilot program was offered by SICA in which investors could choose to arbitrate their claims in certain non-SRO forums, like JAMS or the AAA. Of the 277 cases eligible for the program, only eight were submitted to one of the alternative programs.¹³ This is strong evidence that all participants – customers and industry-related – believe that SROs provide a fair forum for resolution of securities customers' complaints.

The Process of Arbitrator Selection and Panel Composition Is Fair

Another point of recent criticism has focused on the selection of arbitration panels and the inclusion in most customer cases of one so-called “industry” arbitrator. This criticism, too, misses the mark, and is unsupported by any empirical evidence of flaws in the process. The truth is that the arbitrator selection process and the inclusion of an independent industry arbitrator on three-member arbitration panels are both fair and beneficial to all of the parties. The notion of a systemic problem of conflicted arbitrators is fiction. As Professor Michael Perino concluded, in his 2002 Report commissioned by the SEC, “there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations. Available empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair.”¹⁴

Under the current structure in arbitrations before the NYSE and NASD, a three-member panel is required to include one arbitrator with some experience in or around the securities industry. The “industry” arbitrator cannot have any affiliation with the industry member involved in the proceeding and sits on the panel with two “public” arbitrators, who must have no affiliation with the securities industry. In addition, like the public arbitrators, the industry arbitrator must abide by the rules requiring him or her to disclose any circumstances that might preclude him or her from rendering an objective and impartial determination.¹⁵

First, it should be noted that arbitration panels -- in *any* field, not just securities -- typically include one or more arbitrators with experience in that field. This is usually considered a positive for all involved, providing a level of expertise that would not otherwise be available to the panel (and certainly would not be expected on a jury). The inclusion of *one* such arbitrator, particularly when balanced against the requirement that *two* of the arbitrators will have no

affiliation at all with the securities industry, does not create any pro-industry bias. Indeed, simple mathematics suggests just the opposite.

Second, in light of the ever-growing complexity of the financial products that are often the subject of arbitrations (such as options, annuities and structured products for high-net-worth individuals), and the technical issues that sometimes arise (for example, margin loan requirements), SIA believes that the presence of one arbitrator who is more familiar with these products and their appropriate and/or inappropriate use greatly increases the chances for the fairest resolution of claims.

So many cases today revolve around expert testimony from both sides on these topics. An arbitrator with experience in the business is in the best position to evaluate, and to help co-arbitrators evaluate, that testimony. In addition, arbitrators who have had some experience in the securities industry are more likely to be well-versed in the supervisory and compliance structure of brokerage firms, the duties and obligations of brokers and other financial professionals, and the regulatory framework under which these individuals and firms are required to operate. This knowledge benefits all parties, and does not bias the proceedings in favor of the securities industry.

Third, it is worth noting that there is *no* evidence suggesting that industry arbitrators have dissented from awards in favor of customers with any degree of frequency, nor that public arbitrators have dissented often from awards in favor of an industry member. The most typical result -- a unanimous award -- is a testament both to the collaborative and deliberative process that the mixed Panels undertake, and to the fairness of the conclusions they reach.

Moreover, the selection process used to choose the public and industry arbitrators is extremely equitable and transparent. Under the current system, each party is given a list of

public and industry arbitrators and is asked to rank them in order of preference. Each party is provided with extensive disclosures from the prospective arbitrators describing their background and listing all prior arbitration awards they have issued. These awards are publicly available on the Internet and by request from the SRO fora, thus making the potential arbitrators' backgrounds and history completely transparent. If a party wishes to do so, it can strike an arbitrator's name from the list and therefore will not be required to present its case to an arbitrator it does not favor. And if a party believes that a designated arbitrator is conflicted or otherwise inappropriate to hear a particular case, the rules provide for that arbitrator's removal "for cause."

There is simply no evidence of any systemic problem with arbitrator selection.

SRO-Sponsored Arbitration Provides Claimants with an Opportunity for a Hearing, Which They May Not Otherwise Obtain in Court

In addition to the efficiency and fairness benefits described above, parties who utilize arbitration are far more likely to have their claims aired in a full hearing, and decided on the merits, rather than won or lost on technicalities. This is in sharp contrast to court proceedings, where a significant percentage of claims are dismissed on pre-hearing motions to dismiss or for summary judgment.¹⁶ Many of these dismissals are on what may be described as technical, or procedural, grounds. This includes dismissals for pleading failures, jurisdictional deficiencies, and statutes of limitations bars.

A plaintiff in a court case may be faced with a daunting gauntlet of obstacles: a threshold motion attacking the sufficiency of pleading in a complaint; formal document requests with no presumption of anything being properly discoverable; written interrogatories; depositions of fact witnesses; discovery motions; written expert reports; depositions of expert witnesses; formal

requests for admissions; a pretrial motion for summary judgment; interlocutory appeals of any decisions rendered before a trial; motions to preclude or allow certain evidence at trial; and then, finally, for the few who make it that far, a trial followed by almost automatic appeals by the losing party. And, if a customer prevails in court after all of that, he may have to hurdle additional obstacles just to get that hard-earned judgment enforced.

That is the reality facing those who need to resort to the court system. In contrast, arbitration allows for a simple statement of claim, an answer, presumptive discovery, and then a full merits hearing. While pre-hearing motions are permitted in arbitration, they are vastly more limited than those in court. The costs to get to a hearing are a fraction of what they are in traditional litigation. As arbitration practitioners will readily acknowledge, many claims that would otherwise have been dismissed in court on legal grounds are nonetheless presented on the merits to arbitrators, allowing the claimants an opportunity which he or she may otherwise never have had – an opportunity to persuade arbitrators that fairness and equity dictate that relief should be granted, even if the technical aspects of the law may not be on their side. And, as reflected in the significant percentage of cases that settle before a hearing, customers are able to use the leverage of a speedy hearing in negotiating favorable resolutions of disputes through mediation or other settlement negotiations.

Mandatory Arbitration Benefits Small Investors

Some have questioned the “mandatory” nature of arbitration, the fact that many, if not most, securities firms include in their account agreements with their customers a contractual provision requiring that all disputes be resolved through binding arbitration. Some critics of the process ask “Why is it permissible for securities firms to force customers to give up some of their rights, and to deny their customers access to the courts without affording them any choice in the matter? Why can’t we let the parties choose to arbitrate, or not, *after* a dispute has arisen?”

Posing the question as an issue of a limitation on customers’ rights just distorts the issue. By agreeing to arbitration rather than court-based litigation, parties choose their forum, not their rights. Arbitrators are empowered to grant all relief that a court can grant, including in the appropriate case punitive damages and/or attorneys’ fees. In fact, arbitrators have an additional power with respect to the securities firms and their associated persons: they can, and do, initiate referrals to regulatory and disciplinary authorities if in the course of an arbitration hearing they become aware of conduct that in their view may constitute violations of SRO rules or the federal securities laws. And, unlike in court, if an industry member does not pay an award promptly, the regulators have the ability to suspend the member’s license. That protection for customers is *only* available in arbitration.

But the truth is that mandatory arbitration provides the greatest benefit to the customer with the small claim. If all parties to a dispute have to agree to arbitrate rather than litigate *after* the dispute arises, any party can block arbitration if he sees an advantage in doing so. And human nature being what it is (channeled through clever lawyers), when a dispute does arise between a customer and a securities firm, the deeper pocket may perceive some advantage in

proceeding through traditional, slow, expensive, court-based litigation and veto any attempt at arbitration.

The result of this may well be that aggrieved customers with relatively small claims will find themselves without any remedy at all, as their access to cost-efficient arbitration would be blocked, and their claims may be too small for an attorney to risk taking. With the possibility of facing the full panoply of defenses and discovery hurdles that I discussed earlier, customers who do manage to bring a claim in court may find themselves at a severe disadvantage to deeper-pocketed defendants.

Agreeing in advance to arbitrate *all* disputes is a neutral event. This pre-dispute agreement ensures that the benefits of arbitration will in fact be available to all parties if needed.

“Creeping Litigiousness” Should Be Stopped

If SRO-sponsored arbitration is going to continue to provide the fair, efficient and superior results that I have been describing, we must guard against the “creeping litigiousness” that is threatening to destroy the process. What I mean by this is the series of proposals to alter some of the basic rules and principles of arbitration in order to make it more like traditional litigation. I believe these proposals are misguided. Famed law scholar Grant Gilmore observed:

The values of a reasonably just society will reflect themselves in a reasonably just law. The better the society, the less law there will be. In Heaven there will be no law, and the lion will lie down with the lamb. The values of an unjust society will reflect themselves in an unjust law. The worse the society, the more law there will be. In Hell there will be nothing but law, and due process will be meticulously observed.¹⁷

Arbitration should not take on more of the characteristics of a court case. Already, the length of hearings and number of sessions to conclude arbitrations have steadily increased over the last several years. Arbitrations have grown increasingly complex and are gradually adopting

litigation-style procedural devices that reduce the efficiency and anticipated economy of the system. Arbitration hearings used to seldom last more than a few days. Today, it is not at all uncommon for hearings to stretch over ten, twenty, or more days over several months or even years. This trend must be reversed if arbitration is to continue to fulfill its promise of less expensive, expeditious, and *consumer-friendly* resolutions of disputes.

Along those lines, some of the changes to the arbitration process that recently have been proposed should be rejected. For example, the NASD's recently proposed rule change that would require arbitration panels, upon request of a customer, to provide written explanations of their awards¹⁸ would be counterproductive and contrary to the spirit of arbitration. By turning arbitrators into pseudo-judges, forced to write opinions that are subject to review, this rule would inevitably lead to more appeals from arbitration awards. Any explanation provided by an arbitration panel would be closely parsed by the losing party, in an effort to identify possible grounds for undermining the finality of the award. Although no doubt well-intended by people who believe written explanations will be helpful to customers, this new requirement will be anything but customer-friendly: it will undermine the chief benefit of arbitration by adding the opportunity for an additional layer of costs and legal maneuvering. The relative finality of arbitration decisions that exists today could be destroyed, which would be a detriment to investors and industry members alike.

Similarly, critics of the current system who have called for the expansion of pre-trial discovery are off the mark. The current system, which includes clear lists of presumptively discoverable material from both sides, works well. If parties in a particular case do not comply with their discovery obligations, arbitrators are empowered to deal with those violations. And the SROs have shown that they are ready and willing to act if they see more systemic problems

with member firms. But there is no reason to turn arbitration discovery into the war of attrition that is all too familiar to parties in court cases. It is the avoidance of full blown discovery in arbitration that permits the process to work for all, including customers with small claims.¹⁹

Conclusion

In conclusion, SIA believes strongly that the current system of SRO-sponsored arbitration not only works, it works well. Is it perfect? No, of course it is not, nor is any alternative system, currently in place or proposed, perfect. Inevitably, any system that processes thousands of cases a year will produce the occasional anomalous result. But the point is not to compare securities arbitration to utopia -- the only useful exercise is to compare arbitration with traditional, court-based litigation, and in that contest, arbitration wins hands-down for efficiency, user-friendliness, and fairness. The NASD, the New York Stock Exchange and the securities industry continue to work hard to take into account the concerns and issues raised by all participants, and to adjust the process as needed. The facts show that disputes continue to be resolved more expeditiously, efficiently, and fairly than they would be in our already overburdened court systems.

Thank you for holding this hearing and for inviting me to testify. I would be pleased to answer any questions.

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firm to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund

companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2004, the industry generated an estimated \$228 billion in domestic revenue and \$305 in global revenues.

² Obtained from the NASD's Web site at address: <http://www.nasd.com>, visited as of March 9, 2005.

³ The Southern District of New York was chosen because of the large number of securities-related cases filed in that court.

⁴ Obtained from the Federal Court Management Statistics Web site at address: <http://www.uscourts.gov/cgi-bin/cmsd2004.pl>, visited as of March 14, 2005. This data is also supported by studies conducted in the employment context. In particular, a recent study comparing timing factors involved in 125 employment discrimination cases filed in the United States District Court for the Southern District of New York with 186 arbitrations involving employment disputes in the securities industry showed that arbitration was significantly more efficient than litigation in the court system. Specifically, the study found that the median time from filing to judgment was 16.5 months for arbitration and 25 months for claims brought in court. See Michael Delikat & Morris M. Kleiner, Comparing Litigation and Arbitration of Employment Disputes: Do Plaintiffs Better Vindicate Their Rights in Litigation?, A.B.A. Lit. Section Conflict Mgmt., Vol. 6, Issue 3, Winter 2003. The results of this recent study are not at all surprising, since they mirror the results of a similar study conducted by SIA in 1998. In the 1998 study, SIA compared the results of employment discrimination claims brought before the New York Stock Exchange ("NYSE") and the NASD between February 24, 1992 and March 31, 1998, with those brought in the federal court in New York. The study showed that the average length of time between the filing of a claim in arbitration and the rendering of an award after hearing was 15.6 months for the NYSE and 17.8 months for the NASD. Conversely, resolution of similar claims in the court system took 27.5 months to resolve.

⁵ SICA, Eleventh Report 125 (2001).

⁶ Obtained from the NASD's Web site at address: <http://www.nasd.com>, visited as of March 9, 2005.

⁷ See GAO, Securities Arbitration: How Investors Fare, Rep. No. GAO/GGD-92-74 (May 1992).

⁸ A study of securities industry employment disputes, which compared various outcomes in employment discrimination cases filed in the Southern District of New York with similar cases brought in SRO arbitration for a, echoed these results. That study revealed that Claimants in arbitration prevailed 46 percent of the time, while plaintiffs who brought cases in court prevailed only 34 percent of the time. And arbitration outcomes generated a higher median monetary award for claimants in arbitration – \$100,000 – versus plaintiffs in court – \$95,554. Michael Delikat & Morris M. Kleiner, Comparing Litigation and Arbitration of Employment Disputes: Do Plaintiffs Better Vindicate Their Rights in Litigation?, A.B.A. Lit. Section Conflict Mgmt., Vol. 6, Issue 3, Winter 2003.

⁹ Obtained from the NASD's Web site at address: <http://www.nasd.com>, visited as of March 9, 2005.

¹⁰ Obtained from the NYSE's Web site at address: <http://www.nyse.com/pdfs/arbstats031105.pdf>, visited as of March 9, 2005.

¹¹ 4,174 surveys were distributed (one to each side), and responses were received from 414 participants (54 percent returned by claimants, 46 percent returned by respondents).

¹² George H. Friedman, Selected Developments at NASD Dispute Resolution, in Securities Arbitration 2000 Today's Trends, Predictions for Tomorrow 153 (David Robbins ed. 2000).

¹³ See SICA, Final Report Securities Industry Conference on Arbitration Pilot Program for Non-SRO Sponsored Arbitration Alternative (2002).

¹⁴ Michael A. Perino, Report to the Securities Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, Nov. 4, 2002, at 48.

¹⁵ See NYSE Arbitration Rules, Rule 610(a); NASD Code of Arbitration Procedure § 10312(a).

¹⁶ Theodore Eisenberg, Federal District Court Civil Cases (obtained from Web site at address: <http://teddy.law.cornell.edu:8090/questcv3.htm>, visited as of March 9, 2005).

¹⁷ G. GILMORE, THREE AGES OF AMERICAN LAW 111 (1977).

¹⁸ New Arbitration Rule Requires Award Explanations Upon Investor Request, NASD News Release, Jan. 27, 2005.

¹⁹ For example, an investor with a claim for \$50,000 would have great difficulty in finding an attorney to take her case if the specter of numerous depositions and detailed written discovery like what exists in court cases were to become part of arbitration. The costs associated with such discovery could quickly run into the tens of thousands of dollars, thus, again, defeating the purpose for which SRO-sponsored arbitration was created.

Is Securities Arbitration Fair for Investors?

Written Testimony of Professor Michael A. Perino

St. John's University School of Law

**Before the Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises of the Committee on Financial Services
United States House of Representatives**

March 17, 2005

BIOGRAPHICAL STATEMENT

Michael A. Perino is currently a Professor at St. John's University School of Law in New York. Professor Perino's primary areas of scholarly interest are securities regulation and litigation, corporations, and complex litigation. Professor Perino has also been the Justin W. D'Atri Visiting Professor of Law, Business and Society at Columbia Law School and a Lecturer and Co-Director of the Roberts Program in Law, Business, and Corporate Governance at Stanford Law School.

Professor Perino has authored numerous articles on securities regulation, securities fraud, and class action litigation. Congress relied on the empirical findings of his article *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 *Stanford Law Review* 273 (1998), in enacting the Securities Litigation Uniform Standards Act of 1998. He is the author of the leading treatise on the Private Securities Litigation Reform Act, *Securities Litigation After the Reform Act* (CCH 2000). He has testified in both the United States Senate and the House of Representatives and is frequently quoted in the media on securities and corporate matters. The SEC has retained Professor Perino to provide it with a report and recommendations on the adequacy of arbitrator conflict disclosure requirements in securities arbitration. Professor Perino was also one of the principal developers of Stanford Law School's Securities Class Action Clearinghouse, which was nominated by the Smithsonian Institution for the 1997 Computerworld-Smithsonian Award as one of the five most important applications of information technology created by an educational institution.

Professor Perino received his LL.M. degree from Columbia Law School, where he was valedictorian, a James Kent Scholar, and the recipient of the Walter Gellhorn Prize for outstanding proficiency in legal studies. He received his J.D. from Boston College Law School, where he was elected to the Order of the Coif.

A full curriculum vitae and a completed "Truth in Testimony" Disclosure Form are appended to this written testimony.

INTRODUCTION

Mr. Chairman and members of the Subcommittee, I am honored by the invitation to appear before you today and to participate in these hearings. I understand that these hearings are intended to review the current system of securities arbitration. As the members of the Subcommittee are well aware, the fairness and adequacy of the system are crucially important because arbitration is the primary dispute resolution mechanism for customer and broker-dealer disputes. Arbitration is potentially beneficial for both parties because it provides a streamlined, expeditious, and final mechanism for resolving disputes through the use of experts in the matters at issue. To attain these benefits and to foster confidence in the integrity of the process, the system must not only be fair and impartial, but investors, the public, the judiciary, and Congress must believe that it is fair and impartial.

I am particularly grateful for the opportunity to share my views with the Subcommittee because I have studied securities industry arbitration in detail, with particular emphasis on the procedures used for resolving customer disputes. In September 2002, the United States Securities and Exchange Commission (SEC) retained me to analyze and write a report and recommendations on the adequacy of arbitrator conflict disclosure requirements in National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) securities arbitrations.¹ My report concluded

¹ REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATIONS (Nov. 4, 2002) [hereinafter SEC REPORT]. A copy of the SEC Report is available on the SEC's website (<http://www.sec.gov/pdf/arbconflict.pdf>).

that there is little if any indication that undisclosed conflicts represent a significant problem in securities arbitrations sponsored by these self-regulatory organizations (SROs)² and that adding more stringent disclosure requirements might impose significant costs on the arbitration system while yielding few benefits for investors. In addition to this in-depth study of the securities arbitration system, in 2004 I helped to found the St. John's University School of Law Securities Arbitration Clinic, which uses our students, under the guidance of an experienced clinic director, to provide representation to small investors in securities arbitrations.

To aid the Subcommittee in its inquiry, I have organized my testimony as follows. Part I provides an overview of securities arbitration and describes how regulatory and legislative oversight as well as the SROs' rational self-interest tends to prevent the system from developing industry-favorable biases. Part II discusses the existing empirical evidence, which provides little if any support for the hypothesis that there are systemic problems in the securities arbitration system. Overall, I conclude that the available evidence does not suggest that the heavily regulated securities arbitration system has any apparent pro-industry bias. While it is important to continue to study and monitor the arbitration system, any substantial overhaul should be contingent upon the presentation of persuasive empirical evidence of systemic problems.

² SROs are statutorily created entities that are given primary responsibility for regulating broker-dealers. 15 U.S.C. §§ 78f, 78o-3 (2000); see Richard L. Stone & Michael A. Perino, *Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453.

I. AN OVERVIEW OF SECURITIES ARBITRATION

Arbitration is the primary dispute resolution vehicle in the securities industry and dates back to at least 1872.³ It is mandatory both for broker-dealers and for customers.⁴ Arbitrations involving customer complaints are generally the result of pre-dispute arbitration agreements, which broker-dealers typically include in customer contracts. Today, most of these contracts require use of an SRO arbitration forum. In 1987, the United States Supreme Court upheld pre-dispute arbitration agreements as consistent with the strong public policy in favor of arbitration.⁵ As Figure 1 demonstrates, the number of SRO-sponsored arbitrations has grown substantially with the widespread use of these agreements and as more individual investors have engaged in securities transactions.⁶

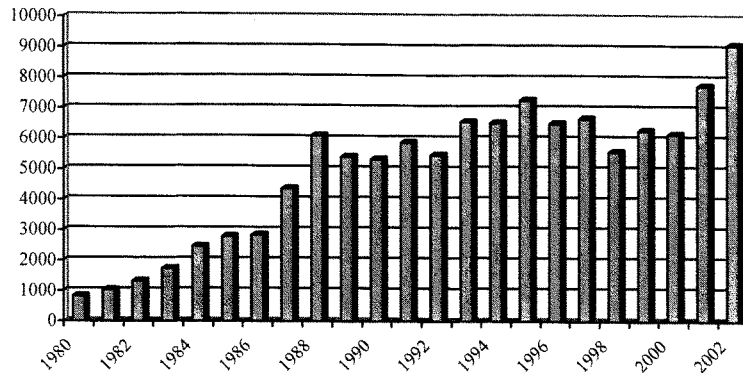
³ See J. KIRKLAND GRANT, *SECURITIES ARBITRATION FOR BROKERS, ATTORNEYS, AND INVESTORS* 94-95 (1994); REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (Jan. 1996), reprinted in [1995-1996 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,735, at 87,433.

⁴ SRO rules require broker-dealers to submit disputes with customers to arbitration. NASD CODE OF ARBITRATION §§ 10301(a), 10101(c); see NASD MANUAL IM-10100(a) (stating that failure to submit a dispute for arbitration as required by NASD Code of Arbitration may be deemed a violation of fair practice rules).

⁵ *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 242 (1987); see Federal Arbitration Act, 9 U.S.C. § 2 (2000); *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 480 (1989) (holding that pre-dispute agreement to arbitrate claims is enforceable); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 223-224 (1985) (holding that lower court erred in failing to grant motion to compel arbitration); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24 (1983) (stating that FAA establishes “liberal federal policy favoring arbitration agreements”).

⁶ The data for Figure 1 comes from the Securities Industry Conference on Arbitration (SICA).

Figure 1
Annual SRO Arbitration Filings (1980-2002)



Resolving securities disputes through arbitration provides potential benefits for both customers and industry members. Arbitration is generally less expensive and faster than litigation.⁷ Claims that are too small to pursue cost-effectively in litigation are viable when arbitration is available. While arbitration has grown more “litigious,” in recent years,⁸ thereby eroding some of its transaction costs savings, the participants also benefit from expert decision-makers who appear, on average, to yield quick and accurate decisions.⁹ There are limited grounds for courts to overturn arbitration awards, thereby

⁷ GRANT, *supra* note 3, at 96–97.

⁸ RUDER REPORT, *supra* note 3, at 87,433; Bruce M. Selya, *Arbitration Unbound: The Legacy of McMahon*, 62 BROOK. L. REV. 1433, 1445-48 (1996).

⁹ See *Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145, 150 (1968) (White, J., concurring) (“It is often because they are men of affairs, not apart from but of the marketplace, that they are effective in their adjudicatory function.”); Deborah R. Hensler, *Science in the Court: Is There a Role for Alternative Dispute Resolution?*, LAW & CONTEMP. PROBS., Summer 1991, at 171, 186 (“Arbitrations’ chief benefit to many disputants may be that it reduces the uncertainty of outcomes by substituting expert

providing a greater degree of finality than litigation. Arbitrators are not bound by precise legal or evidentiary standards, which may benefit investors, particularly as federal securities remedies have become more restrictive.¹⁰ Indeed, lawyers experienced in representing customers in securities arbitrations note that arbitration can be a better dispute resolution forum for investors because “innocent, unsophisticated investors generate sympathy from arbitrators, in the form of an award, for tragic, seemingly avoidable losses, despite the well-established law that suggests no liability by the broker.”¹¹ Recently, “arbitration panels seem to have reached beyond existing legal authorities to expand the rights and protections accorded to the investing public.”¹²

Critics of securities arbitration, however, contend that members of the securities industry prefer arbitration because SRO-sponsored arbitrations tend to yield pro-industry outcomes.¹³ While it is theoretically possible for an arbitration forum to develop just

decisionmakers for lay juries.”); Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEG. STUD. 1, 5 (1995).

¹⁰ See Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1040 (2002); Marc I. Steinberg, *Securities Arbitration: Better for Investors than the Courts*, 62 BROOK. L. REV. 1503 (1996). Arbitrators may not completely ignore the law; most courts hold that they may overturn SRO arbitration awards based on “manifest disregard of the law.” See, e.g., *Halligan v. Piper Jaffray, Inc.*, 148 F.3d 197 (2d Cir. 1998); *Montes v. Shearson Lehman Brothers, Inc.*, 128 F.3d 1456 (11th Cir. 1997); see also *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 942 (1995) (recognizing manifest disregard standard in dicta).

¹¹ Black & Gross, *supra* note 10, at 1040.

¹² Gretchen Morgenson, *Why Investors May Find Arbitrators on their Side*, N.Y. TIMES, Aug. 8, 2001, at Sec. 3, p. 1 (quoting securities regulation expert Lewis D. Lowenfels).

¹³ See, e.g., Black and Gross, *supra* note 10, at 993 (citing Seth Lipner, *Ideas Whose Time Has Come: The Single Arbitrator and Reasoned Awards*, SECURITIES ARBITRATION 2000, at 659, 661 (PLI Corporate Law & Practice Course, Handbook Series No. 659, 2000) (indicating suspicion of SRO forum independence and “belief that arbitration reduces investors’ substantive rights”); Marc I. Steinberg, SECURITIES REGULATION 884 (3d ed. 1998) (noting that many believe securities arbitration favors the securities industry). Not all commentators share these views. See, e.g., Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. &

such a bias,¹⁴ two factors—regulatory and legislative oversight and economic self-interest—appear to provide a significant check on any tendencies toward the development of systemic industry biases in SRO-sponsored securities arbitrations.¹⁵

The NASD and NYSE are likely subject to more regulation and greater oversight than any other arbitration forum. The SROs are the primary regulators of securities broker-dealers and have a statutory mandate to provide a fair dispute resolution forum.¹⁶ If they fail to do so, they run the risk of losing their SEC registrations.¹⁷ The SEC exercises substantial oversight of the SROs and approves all arbitration rules before they become effective.¹⁸ Proposed rules are published in the *Federal Register* and are subject to extensive public comment.¹⁹ Section 19 of the Securities Exchange Act requires the SEC to approve SRO rules only if they are consistent with the requirements of the federal securities laws.²⁰ This requires that any proposed rules promote just and equitable principles of trade and protect investors and the public interest.²¹ The Commission

MARY L. REV. 1055, 1121 (1999) (indicating empirical studies show no evidence of unfairness to investors); Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183 (1996).

¹⁴ There are examples of precisely this kind of apparently biased forum in non-securities contexts. See, e.g., *Hooters of America, Inc. v. Phillips*, 173 F.3d 933 (4th Cir. 1999).

¹⁵ As is discussed more fully in Section II, *infra*, the available empirical evidence on outcomes in customer-broker arbitration does not support the hypothesis that the securities arbitration system has a pro-industry bias.

¹⁶ See 15 U.S.C. §§ 78f(b), 78o-3(b) (2000).

¹⁷ *Id.*

¹⁸ 15 U.S.C. § 78s(b)(1) (2000).

¹⁹ 15 U.S.C. § 78s(b) (2000).

²⁰ 15 U.S.C. § 78s(b)(2) (2000).

²¹ 15 U.S.C. §§ 78f(b), 78o-3(b) (2000).

retains the power to amend or abrogate SRO rules “as [it] deems necessary or appropriate to insure the fair administration of the [SRO].”²²

The Commission oversees SRO arbitrations through its inspection process as well, which is intended to “identify areas where procedures should be strengthened, and to encourage remedial steps either through changes in administration or through the development of rule changes.”²³ The SEC staff reviews whether the SROs are complying with their own rules and whether the SROs can enhance their rules and procedures. In this regard, the SEC staff evaluates SRO administration and processing of arbitration cases and the management of the arbitration pool, including the selection, training, rotation, and evaluation of arbitrators. The SEC’s staff has consistently worked with the SROs and others to develop procedural protections to guard the integrity of SRO arbitrations. For example, in 1987 and 1988, the SEC raised concerns with the SROs about the need to revise arbitration procedures and about the use of pre-dispute arbitration clauses.²⁴ Those concerns prompted the SROs to revise substantially their procedures and to adopt new disclosure requirements for arbitration clauses.²⁵

Congress also plays an important and substantial oversight role with respect to securities arbitrations. In addition to holding hearings such as this, Members have

²² 15 U.S.C. § 78s(c) (2000); *see Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 233–34 (1987) (noting that the Commission has “expansive power to ensure the adequacy of the arbitration procedures employed by the SRO... including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights”).

²³ *See* SEC Rel. No. 34-40109, 63 FED. REG. 35299, 35303 n.53 (June 29, 1998).

²⁴ SEC Rel. No. 34-26805, 54 FED. REG. 21144 (May 16, 1989).

²⁵ *Id.*

frequently requested the United States Government Accountability Office (GAO) to evaluate various aspects of the securities arbitration system. The GAO has investigated investor outcomes in securities arbitrations,²⁶ whether problems exist with respect to unpaid arbitration awards,²⁷ whether arbitration provides an appropriate system for resolving employment discrimination claims,²⁸ whether problems exist with respect to updating arbitrator disclosure information,²⁹ and other matters.³⁰ Although the GAO has recommended changes from time to time, it has never found that SRO-sponsored arbitrations were biased in favor of securities industry members.

This regulatory and legislative oversight system provides an important independent review of the fairness of SRO arbitration procedures. The securities industry, however, also has a rational self-interest in providing a fair dispute resolution system. The SROs recognize that because arbitration is mandatory for most customer disputes, public perceptions of the fairness of the arbitration process are crucial to its

²⁶ GAO, SECURITIES ARBITRATION: HOW INVESTORS FARE, Rep. No. GAO/GGD-92-74 (May 1992) [hereinafter HOW INVESTORS FARE]; SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS, Rep. No. GAO/GGD-00-115, at 16, 30 (June 2000) [hereinafter PROBLEM OF UNPAID AWARDS].

²⁷ PROBLEM OF UNPAID AWARDS, *supra* note 26; GAO, EVALUATION OF STEPS TAKEN TO ADDRESS THE PROBLEM OF UNPAID ARBITRATION AWARDS, Rep. No. GAO-01-654R (April 27, 2001).

²⁸ See, e.g., GAO, EMPLOYMENT DISCRIMINATION: HOW REGISTERED REPRESENTATIVES FARE IN DISCRIMINATION DISPUTES, Rep. No. GAO/HEHS-94-17 (March 1994).

²⁹ See, e.g., GAO, PROCEDURES FOR UPDATING ARBITRATOR DISCLOSURE INFORMATION, Rep. No. GAO-01-162R (Nov. 9, 2000).

³⁰ GAO, FOLLOW-UP REPORT ON MATTERS RELATING TO SECURITIES ARBITRATION, Rep. No. GAO-03-162R (April 11, 2003) (evaluating, among other things, NASD procedures for removing arbitrators from cases and use of motions to dismiss and for summary judgment in arbitrations).

success.³¹ The acceptability of arbitral awards is strongly correlated with parties' perceptions of whether fair and unbiased procedures were used to reach an outcome.³² Systemic procedural inequities would likely increase the costs of the arbitration system as more dissatisfied parties attempted to overturn arbitration awards. The presence of systemic conflicts or other procedural inequities might cause legislators to seek to overhaul arbitration structures or might invite closer judicial scrutiny of arbitration awards, yielding more successful challenges and therefore less finality.³³

This combination of oversight and rational self-interest has made the SROs quite responsive to groups that have advocated for revisions of the SROs' arbitration procedures. Indeed, the SROs have regularly revised their procedures over the last fifteen years.³⁴ The SROs formed the Securities Industry Conference on Arbitration (SICA), a cooperative venture consisting of representatives of the SROs, the Securities Industry Association, and members of the public to establish a Uniform Arbitration Code

³¹ See SICA, THE ARBITRATOR'S MANUAL 3 (January 2001) ("Since arbitration is the primary means of resolving disputes in the securities industry, the public perception of its fairness is of paramount importance.").

³² TOM R. TYLER, WHY PEOPLE OBEY THE LAW 115-24 (1990); E. Allan Lind, et al., *Individual and Corporate Dispute Resolution: Using Procedural Fairness as a Decision Heuristic*, 38 ADMIN. SCI. Q. 224 (1993).

³³ See *Penn v. Ryan's Family Steak Houses, Inc.*, 269 F.3d 753, 758 (7th Cir. 2001); *Hooters of America, Inc. v. Phillips*, 173 F.3d 933, 941 (4th Cir. 1999); *Cole v. Burns Int'l Security Servs., Inc.*, 105 F.3d 1465, 1482-83 (D.C. Cir. 1997); Christopher R. Drahozal, "Unfair" Arbitration Clauses, 2001 U. ILL. L. REV. 695, 697-98; Carrie Menkel-Meadow, *Do the "Haves" Come Out Ahead in Alternative Judicial Systems?: Repeat Players in ADR*, 15 OHIO ST. J. ON DISP. RESOL. 19, 52 (1999) (noting that securities and other industries favor arbitration "so much that they are willing to undertake potentially substantial internal reforms to avoid judicial nullification").

³⁴ See Constantine N. Katsoris, *The Resolution of Securities Disputes*, 6 FORDHAM J. CORP. & FIN. L. 307 (2001); Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483 (1996).

and to otherwise monitor and revise securities arbitration procedures.³⁵ NASD established a standing committee of its board, the National Arbitration and Mediation Committee (NAMC), to recommend improvements to its dispute resolution systems.³⁶ The NAMC is composed of a majority of non-securities industry members. Lawyers representing investors have formed their own association, the Public Investor Arbitration Bar Association (PIABA). Among other functions, PIABA advocates the interests of public investors and serves as a clearinghouse for information on SRO arbitrations and arbitrators.

The SROs have sponsored independent evaluations of their arbitration procedures as well. For example, in 1994 the NASD appointed an Arbitration Policy Task Force chaired by former SEC Chairman David S. Ruder to evaluate the need for securities arbitration reform. The resulting task force report, commonly referred to as the Ruder Report, served as the basis for substantial changes intended to enhance the fairness of the arbitration system.³⁷

The SROs actions after the release of my report to the SEC on the adequacy of their arbitrator conflict disclosure requirements provides a more recent example of the SROs' responsiveness to proposed changes. In my report, I concluded that: "While the current SRO conflict disclosure requirements generally appear adequate, some minor enhancements to disclosure and other related rules may provide additional assurance to

³⁵ See X LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION 4577-78* (rev'd 3d ed. 1996); Constantine N. Katsoris, *The Level Playing Field*, 17 *FORDHAM URB. L.J.* 419 (1989).

³⁶ See SEC REPORT, *supra* note 1, at 10.

³⁷ See *supra* note 3.

investors that arbitrators are in fact neutral and impartial.”³⁸ In particular, my report made the following four recommendations: (1) amend arbitration rules to emphasize that all conflict disclosures are mandatory; (2) re-examine the definitions of public and non-public arbitrators; (3) provide greater transparency with respect to challenges for cause by including the cause standard in the arbitration rules; and (4) sponsor independent research to evaluate the fairness of SRO arbitrations.³⁹ The SROs promptly adopted these recommendations.⁴⁰ Indeed, the NASD went beyond those recommendations and further narrowed the definition of public arbitrator. NASD expressed a preference for an overly restrictive rather than overly permissive definition of public arbitrator because it wanted “to protect the integrity of the NASD forum[] and investors’ confidence in the integrity of the forum...”⁴¹

In sum, the SEC, Congress, and the SROs appear to have worked consistently and diligently to ensure SRO-sponsored securities arbitration provides a fair dispute resolution system.

II. AVAILABLE EVIDENCE DOES NOT SUPPORT THE EXISTENCE OF SYSTEMIC PROBLEMS IN THE SECURITIES ARBITRATION SYSTEM

Public confidence in the fairness of the securities arbitration system is crucial to its success. But, imposing additional procedural requirements on the system should not in any way be viewed as a costless way to achieve that goal. As I noted in my SEC

³⁸ SEC REPORT, *supra* note 1, at 4.

³⁹ SEC REPORT, *supra* note 1, at 4-5.

⁴⁰ SEC Rel. No. 34-49573, 69 FED. REG. 21871 (Apr. 22, 2004).

Report, for example, imposing additional arbitrator conflict disclosure rules “may deter well-qualified arbitrators from serving or may disqualify those with significant expertise from hearing a case. The net result may well be less accurate case resolutions and more judicial challenges to arbitral awards.”⁴² It is for this reason that the SEC has long taken the position that proposed changes must “balance the need to strengthen investor confidence in the [SROs’] arbitration system with the need to maintain arbitration as a form of dispute resolution that provides for the equitable and efficient administration of justice.”⁴³ In addition, significant unintended consequences often accompany regulatory shifts,⁴⁴ suggesting that such changes should not be undertaken based on sporadic anecdotal accounts of perceived problems in individual cases. Consequently, those seeking to revamp the securities arbitration system should have the burden of identifying through thorough and well-documented empirical evidence that actual problems in fact exist.

To date, there is little empirical evidence to suggest systemic problems in the securities arbitration system. While it remains important to study the system further, available empirical evidence on outcomes in SRO arbitrations and on investors’

⁴¹ 69 FED. REG. at 21872.

⁴² SEC REPORT, *supra* note 1, at 48, *see also* HOW INVESTORS FARE, *supra* note 26, at 61 (noting SEC’s concern that imposing additional qualification and training requirements on arbitrators “risks increasing significantly the costs of securities arbitration and reducing the pool of qualified arbitrators without materially improving the general quality of the arbitrator pool or increasing assurances of the independence or capability of individual arbitrators.”).

⁴³ SEC Rel. No. 30153, 57 FED. REG. 1292 (Jan. 6, 1992).

⁴⁴ *See, e.g.*, Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913.

perceptions of the arbitration process suggest that the current system addresses customer disputes fairly and impartially.

A. Arbitration Outcomes

The most comprehensive study of investor outcomes in securities arbitrations is the GAO's 1992 report, *Securities Arbitration: How Investors Fare*.⁴⁵ That report examined results in arbitrations over an eighteen-month period from January 1989 to June 1990 and found no evidence of a systemic pro-industry bias.

For example, some critics suggest that investors tend to fare worse in SRO-sponsored arbitrations versus arbitrations in non-SRO forums. As shown in Figure 2, the GAO found no statistically significant difference between the results in SRO-sponsored arbitrations versus securities arbitrations at the American Arbitration Association (AAA).⁴⁶ In SRO arbitrations, the arbitrators found for investors in about 59% of the cases versus 60% of AAA cases. In cases in which investors prevailed, they recovered on average about 61% of the damages they claimed in SRO arbitrations versus 57% in AAA arbitrations.⁴⁷ In addition, about 44% of SRO cases and 33% of AAA cases settled.⁴⁸

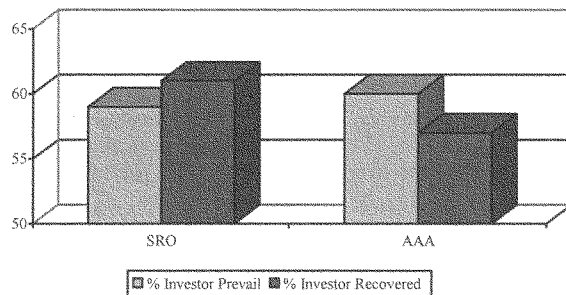
⁴⁵ See *supra* note 26.

⁴⁶ HOW INVESTORS FARE, *supra* note 26, at 38-39. The GAO was unable to evaluate arbitration versus litigation results because of the limited number of litigated cases. HOW INVESTORS FARE, *supra* note 26, at 6.

⁴⁷ HOW INVESTORS FARE, *supra* note 26. This finding is consistent with empirical studies from other arbitration contexts and with conventional views of arbitration that suggest that arbitrators tend to make compromise awards between the parties' positions. See David E. Bloom, *Empirical Models of Arbitrator Behavior Under Conventional Analysis*, 68 REV. ECON. & STATS. 578, 585 (1986); Henry S. Farber, *Splitting-the-Difference in Interest Arbitration*, 35 INDUS. & LAB. REL. REV. 70 (1981).

⁴⁸ HOW INVESTORS FARE, *supra* note 26, at 48.

Figure 2
Investor Outcomes in SRO vs. AAA Arbitrations
(January 1989-June 1990)



The GAO updated these findings in 2000.⁴⁹ It found that in the period 1992-1998 both the percentage of investor favorable outcomes and the proportion of awards to amounts claimed declined over the previous study period.⁵⁰ The GAO Report suggested, however, that an increase in settled claims during the second study period,⁵¹ rather than the rise of a pro-industry bias, might explain these apparent declines to the extent that the settlements substantially altered the mix of cases that went to a final arbitration decision. In other words, industry members may have settled more of the stronger cases, leaving more of the weaker cases for resolution through arbitration decisions. Although the GAO

⁴⁹ PROBLEM OF UNPAID AWARDS, *supra* note 26.

⁵⁰ In its initial study, investors won about 59% of the time. The annual win rate in the later study ranged from 49% to 57%. From 1992 to 1996, the rate averaged 51%, but climbed to 56% in 1997 and 57% in 1998. PROBLEM OF UNPAID AWARDS, *supra* note 26, at 23-24. Awards during the second study period ranged from 46% to 57% of the amount claimed, averaging about 51% from 1992 to 1998. By contrast, in the first study period awards averaged 61% of the amount claimed. PROBLEM OF UNPAID AWARDS, *supra* note 26.

⁵¹ Less than 50% of claims settled from 1989 to 1992, while settlements ranged from 50% to 60% of the cases from 1993 to 1998. PROBLEM OF UNPAID AWARDS, *supra* note 26, at 7.

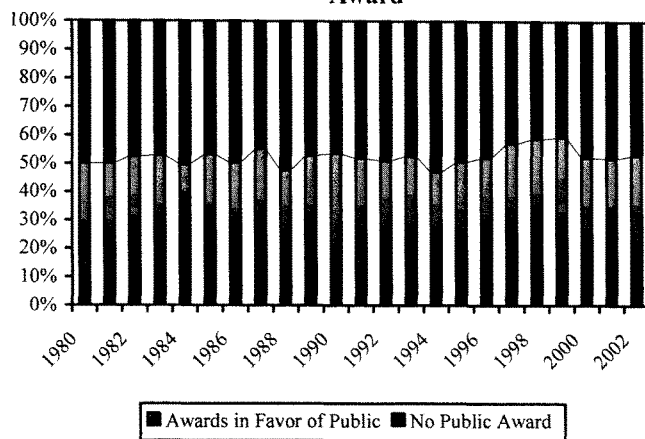
did not analyze arbitration settlements, it did report, “the declining win rate could indicate little or no change in the fairness of the arbitration process.”⁵²

Indeed, if one examines SICA’s data on arbitration outcomes over the period from 1980 through 2001 (represented in Figure 3), one finds some annual variation, but no evidence of systemic advantages for industry members. From 1980 to 2002, SRO arbitrators decided 32,732 public customer cases. Of that total, 17,211 (52.58%) resulted in customer awards. These findings are consistent with empirical studies involving other arbitration contexts in which repeat players are present. Most of the work in this area involves labor disputes in which employers and unions are the repeat players. Although the repeat players on the claimants’ side are different (plaintiff’s lawyers instead of unions) a similar pattern emerges—each side wins about half the time.⁵³

⁵² PROBLEM OF UNPAID AWARDS, *supra* note 26, at 5.

⁵³ See Lisa B. Bingham, *Employment Arbitration: The Repeat Player Effect*, 1 EMPL. RTS. & EMPLOY. POL’Y J. 189, 202 (1997) (reviewing studies).

Figure 3
SRO Cases With Awards to Public vs. No Public Award



In 2000, the GAO could not reach a conclusion on the fairness of the process based on the same analysis of case outcomes it had used in the 1992 study. Very few cases were handled outside the SRO forums, and so the GAO had insufficient data to compare SRO arbitration outcomes to AAA or litigation outcomes.⁵⁴ The GAO suggested that there were fewer cases at non-SRO forums because more pre-dispute arbitration agreements required arbitration in an SRO forum.⁵⁵ Critics of SRO arbitrations suggest that giving investors the opportunity to select non-industry forums would help maintain the integrity of securities arbitration.⁵⁶ But, it is not entirely clear

⁵⁴ PROBLEM OF UNPAID AWARDS, *supra* note 26, at 7.

⁵⁵ PROBLEM OF UNPAID AWARDS, *supra* note 26, at 31.

⁵⁶ Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327, 344-46 (1996).

that if given such a choice investors would select non-SRO forums. In January 2000, SICA initiated a two-year pilot program whereby investors could elect to arbitrate their claims in selected non-SRO forums. Of the 277 cases eligible for the program, only eight were submitted. Among the reasons participants gave for not selecting the alternative forums was the lower cost of SRO arbitrations, a preference for more familiar SRO procedures, and the possibility of delays in non-SRO forums.⁵⁷ If SRO arbitrations were significantly biased in favor of the industry, it is reasonable to predict that the suggested speed and cost advantages would not be compelling.

Of course, win rates are only part of the story—the amount recovered is important as well. Here too the GAO’s empirical evidence, which demonstrates that claimants recover 40 to 60 percent of the amounts claimed, is hardly unexpected. There is a widespread popular perception that arbitrators tend to split the difference,⁵⁸ a phenomenon that has been observed in a wide variety of arbitration contexts. In other words, recoveries in securities arbitration are similar to recoveries in other arbitrations and do not suggest any special pro-industry bias.⁵⁹

⁵⁷ See SICA, FINAL REPORT SECURITIES INDUSTRY CONFERENCE ON ARBITRATION PILOT PROGRAM FOR NON-SRO SPONSORED ARBITRATION ALTERNATIVE (2002).

⁵⁸ Bloom, *supra* note 47, at 578.

⁵⁹ In fact, claimants may do better in arbitration than they would in litigation. Although the cases are quite different in many obvious respects, it is worth noting that recoveries in securities fraud class actions tend to be substantially lower on a percentage basis than recoveries in securities arbitrations. One recent study found that the median settlement in recent securities class actions was 4.4% of the estimated damages. See Laura E. Simmons, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003* at 5 (2004) (available at http://www.cornerstone.com/fram_res.html) (studying cases filed after passage of Private Securities Litigation Reform Act).

In sum, the available evidence demonstrates that claimants in securities arbitration do at least as well as claimants in similar arbitration contexts. There is thus nothing in the outcomes data to suggest that the securities arbitration system has any apparent pro-industry bias.

B. Survey Data on Perceptions of the Fairness of SRO Arbitrations

The most recent and comprehensive study of investor perceptions of the fairness of SRO arbitrations reveals a substantial level of satisfaction among parties and representatives.⁶⁰ The study reviewed the evaluations submitted in NASD arbitrations over a fifteen-month period between December 1, 1997 and April 1, 1999.

Two limitations of the study suggest that its findings must be interpreted with caution. First, few arbitration participants completed the surveys; the authors concluded that the evaluation response rate was only between 10%-20%. Second, these responses may reflect selection bias problems. The authors performed some tests to detect possible problems and found none, but it is still possible that individuals that were more satisfied with the fairness of the process or that achieved favorable outcomes were more likely to complete the surveys.

Despite these limitations, the authors concluded that participants in NASD arbitrations overwhelmingly believed that their cases were handled fairly and without

⁶⁰ GARY TIDWELL, KEVIN FOSTER & MICHAEL HUMMEL, PARTY EVALUATION OF ARBITRATORS: AN ANALYSIS OF DATA COLLECTED FROM NASD REGULATION ARBITRATIONS (1999), *available at* http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_009528.pdf [hereinafter TIDWELL STUDY]. Mr. Tidwell was the Director of Neutral Training and Development for NASD Regulation at the time this study was prepared.

bias.⁶¹ Two aspects of the survey are particularly relevant. First, as shown in Table 1 an overwhelming majority (93.49%) strongly agreed or agreed that their cases were handled fairly and without bias. Only 3.8% of respondents strongly disagreed with this statement.⁶²

Table 1
Evaluation of Whether Claim Was Handled Fairly and Without Bias⁶³

	Frequency	Percent	Cumulative
Strongly Agree	573	57.36%	57.36%
Agree	361	36.14%	93.49%
Disagree	27	2.70%	96.20%
Strongly Disagree	38	3.80%	100.00%
Total	999	100.00%	

The data suggest that claimants (who tend to be customers) have a stronger opinion of the fairness of arbitration proceedings than respondents. Table 2 demonstrates that a significantly higher percentage of claimants or attorneys representing claimants (61%) strongly agreed that their case had been handled fairly and without bias, as opposed to only 53% of respondents or those representing respondents.⁶⁴

⁶¹ TIDWELL STUDY, *supra* note 60, at 3.

⁶² In 2001, NASD-DR conducted a follow-up study. While the response rate remained low (34%) and the sample size (n=61) was small, the results were generally consistent. Eighty-five percent of the survey respondents strongly agreed (62%) or agreed (23%) that their cases were handled fairly and without bias. Twelve percent disagreed, while none strongly disagreed. The remaining 2% were neutral. NASD-DR, *Customer Satisfaction Survey Results 1* (May 2001).

⁶³ TIDWELL STUDY, *supra* note 60, at 20.

⁶⁴ The p-value for the chi-square analysis of these responses is 0.003, which reflects a statistically significant difference in the way that claimants and respondents answered these questions. TIDWELL STUDY, *supra* note 60, at 17.

Table 2
Respondents' and Claimants' Evaluation of
Whether Claim Was Handled Fairly and Without Bias⁶⁵

	Strongly Agree	Agree	Disagree	Strongly Disagree	Total
Respondent	245 52.92%	196 42.33%	9 1.94%	13 2.81%	463 100.00%
Claimant	321 61.03%	165 31.37%	18 3.42%	22 4.18%	526 100.00%
Total	566 57.23%	361 36.50%	27 2.73%	35 3.54%	989 100.00%

Arbitration participants were also asked to evaluate whether the arbitrators displayed fairness and the appearance of fairness. As the data in Table 3 demonstrate, 91.67% of the respondents rated the arbitrators as either excellent or good. The percentage of respondents and claimants rating the arbitrators as excellent was virtually identical (76.86% v. 76.74%).⁶⁶ Thus, the available data indicate that arbitration participants believe that their arbitrations were fair and impartial.

⁶⁵ TIDWELL STUDY, *supra* note 60, at 20. The upper number is the frequency of the response. The lower number is the percentage of the response.

⁶⁶ TIDWELL STUDY, *supra* note 60, at 38. In evaluating the structural bias claim, it would have been useful if the study evaluated whether claimants tended to give lower evaluations to non-public arbitrators, but the study does not break down the data in this manner.

Table 3
Evaluation of Whether Arbitrator Displayed Fairness and Appearance of Fairness⁶⁷

	Frequency	Percent	Cumulative
Excellent	774	76.71%	76.71%
Good	151	14.97%	91.67%
Fair	48	4.76%	96.43%
Poor	36	3.57%	100.00%
Total	1009	100.00%	

CONCLUSION

The available evidence does not suggest that the heavily regulated securities arbitration system has any apparent pro-industry bias. This is not to say, however, that more work need not be done and that we can safely ignore securities arbitrations for the foreseeable future. In my SEC Report, I wrote that “[g]iven the unquestioned significance of securities arbitrations, it is crucial that the SROs resolve any lingering concerns about pro-industry bias.”⁶⁸ Due to the limited nature of existing evidence of investors’ perceptions of the arbitration process, I recommended that the SROs sponsor additional independent studies to further evaluate the impartiality of the SRO arbitration process. It is my understanding that such a study is about to commence and that its findings will be published before the end of the year. If that or other studies reveal systemic problems, then those problems should and must be addressed. But, until persuasive evidence of such problems exists, it would be imprudent to substantially alter a system that appears to serve investors well.

⁶⁷ TIDWELL STUDY, *supra* note 60, at 38.

⁶⁸ SEC REPORT, *supra* note 1, at 5.

United States House of Representatives

Committee on Financial Services
Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises

109th Congress -- First Session

**STATEMENT OF THE
PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION
IN CONNECTION WITH THE SUBCOMMITTEE'S
REVIEW OF THE SECURITIES ARBITRATION SYSTEM**

The PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION (PIABA) submits the following for consideration by the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, in its review of the securities arbitration process.

INTRODUCTION

PIABA is a non-profit, international bar association consisting of over 740 attorneys dedicated to the representation of investors in disputes with the securities industry. Formed in 1990, the mission of PIABA is to promote the interests of the public investor in securities and commodities arbitration by protecting public investors from abuses in the arbitration process, making securities and commodities arbitration as just and fair as systematically possible; and creating a level playing field for the public investor in securities and commodities arbitration. Since its founding, PIABA and its individual members have been on "the front lines" of every significant issue relating to the securities arbitration process and the development of law, regulations and rules impacting the process. By virtue of its longstanding commitment to and involvement in the securities arbitration process, PIABA is uniquely qualified to render insight

from the perspective of investors who, in most cases, are contractually bound to resolve their disputes through arbitration.

When investors open securities accounts, they are routinely required to sign arbitration agreements, as a condition to the broker-dealer accepting their accounts. Investors are then limited to bringing their claims in an *industry sponsored* forum. More than 90% of investor claims are currently brought before the National Association of Securities Dealers, with most remaining filed with the New York Stock Exchange.

The only chance of recovery for most investors who fall victim to wrongdoing on Wall Street is through the arbitration process. The securities arbitration process affects many thousands of citizens every year and deserves Congress' full attention if full public confidence is to be restored in the operation of America's capital markets and the notion of investor protection.

It is PIABA's hope that the committee will avoid the temptation to succumb to politically expedient, quick-fix, "sound bite" solutions in favor of serious consideration of the realities of the issues. We believe the most important issue to address is eliminating the mandatory industry arbitrator on panels hearing cases.

SPECIFIC ISSUES OF CONCERN

1. Elimination of the Mandatory Industry Arbitrator

Arbitration cases are heard by three-member panels.¹ One of the panelists is an industry arbitrator, a member of the securities industry. The remaining two panelists are public, although they also have sometimes spent part of their careers in the securities industry.

¹ Three-member panels are appointed to all NASD arbitrations in which the stated claim exceeds \$50,000. The threshold claim amount for appointment of 3-member panels at the NYSE is \$25,000.

From the outset of a case, the industry arbitrator presents an appearance of bias and impropriety to the investing public. Indeed, the industry arbitrators tend to sanction industry practices that have become institutionalized and apply the standard of their own practices, rather than the practices mandated by the NASD, the SEC, the NYSE and other regulatory bodies.

Historically, the arbitration rules and system were constructed by the securities industry with very little public participation, until 1992, when the claimants' bar became more visible and organized. Most of the current framework of rules and procedures was in place before arbitration was mandatory. Arbitration did not become mandatory until the late 1980's, after the United States Supreme Court decision in *Shearson/American Express v. McMahon*.

The entrenched rule providing for an industry arbitrator is vigorously defended by the industry, indicating, perhaps, how strongly the industry feels this arbitrator gives it an advantage in the arbitration process. The industry says an industry arbitrator is needed so that someone on the panel will have knowledge of the securities industry, an "expert witness" on the panel.

If this rationale ever had any basis in fact, it has evaporated over the years. Arbitration has become an increasingly sophisticated process. Where arbitration was once selected on a voluntary basis by investors seeking to handle simple disputes, which could be heard by panels in a day or two, the advent of mandatory arbitration moved all customer grievances to arbitration. Cases are typically presented by lawyers. They generally last for several days. The use of retained expert witnesses to present industry practices, procedures and rules to the panels is typical.

Perhaps most compelling is the experience of the past few years. Revelation of cases involving industry-wide wrongful conduct highlights the importance of taking away the mandatory industry arbitrator. The mutual fund scandal is a telling example. The industry had common, institutionalized practices of undisclosed fees, which motivated the brokers to sell

certain types of mutual funds to customers, whether they were in the best interests of the customer or not. Having a branch manager from one of the other firms engaging in this practice sitting on an arbitration panel is not fair. The use of industry arbitrators tends to give rise to institutionalization of wrongful and fraudulent practices that become industry wide.

Another telling example arises in cases involving the wrongful sale of fee laden variable annuities² to retirees. The NASD, SEC and numerous financial writers have condemned the over-sale of variable annuities. Yet, the investor is often forced to have his claim for unsuitable sale of variable annuities heard by an arbitrator whose employer is reaping massive profits from sales of variable annuities to the same types of clients.

There may be limited occasions when public investors would still wish to have the presence of an industry arbitrator. In those instances, of course, the public investor could always request the presence of a member of the industry.

We will point out other recurring problems with arbitration, but they all pale when compared to allowing the industry arbitrators to continue. Elimination of mandatory industry arbitrators would be the number one way to improve mandatory arbitration in customer cases.

2. Overly Broad Definition of Who May Serve As "Public" Arbitrators

Compounding the problems created by the mandatory presence of "non-public" arbitrators on three-member arbitration panels is what has historically been the SROs overly-broad definitions of who may serve as "public" arbitrators. "Public" arbitrators can - by virtue of their ties to the securities, insurance and financial services industry - have a more negative effect on a customer's rights in arbitration than the mandated "non-public" arbitrator addressed above. This problem continues to grow as various sectors of the financial services industry continue to consolidate their operations in the admitted quest for "capturing assets" and offering

the consumer "one-stop shopping." The arbitration rules of the SROs regarding who qualifies as a "public" arbitrator for the purposes of customer-member arbitrations have simply not kept pace with this reality.

Lifetime members of the insurance industry, including those employed by companies which designed and marketed variable annuities to the broker-dealer community for ultimate sale to the retail customer, may sit as "public" arbitrators. Persons who have spent several years working in the securities industry or attorneys defending broker-dealers against public customers in securities cases can become "public" arbitrators.

PIABA urges the committee to direct the SEC to undertake a comprehensive review of the definition of "public" arbitrator at both SROs and make appropriate changes to ensure that the concept of a "public" arbitrator comports with the realities of an ever-consolidating financial services industry. Public arbitrators should have no connection, past or present, to the financial services industry.

3. Industry Abuses of the Arbitration Discovery Process

Arbitration is meant to be, and has historically been, a relatively expeditious and inexpensive method of dispute resolution. When it operates as designed, there is much to commend arbitration as a preferable alternative to court in the resolution of customer-broker disputes.

SRO arbitration should have a streamlined discovery process. Unfortunately, brokerage firms have removed streamlining from the process, by evading and avoiding their discovery obligations in arbitration. They have managed to thwart the intention of the rules.³

² According to the National Association of Variable Annuities, just under half a trillion dollars in variable annuities were sold during 2000-2003. According to the NASD, claims involving variable annuity purchases rose from 182 in 2001 to 721 in 2003.

³ It appears that this behavior is not limited solely to arbitration. For example, it has been reported that, within the last 2 weeks, a state Circuit Court Judge in West Palm Beach, Florida found Morgan Stanley Dean Witter to have

In recognition of arbitrators' and the SROs' historic unwillingness to enforce rigorous compliance with their discovery obligations or to impose meaningful sanctions for failure to do so, the securities industry has chosen to play "fast and loose" with its discovery obligations in the arbitration process, apparently making the calculated decision that the few instances in which their behavior is sanctioned will be far outweighed by the exposure avoided by simply obstructing the discovery process.

Elimination of the routine use of confidentiality agreements would be a substantial step in the right direction. The industry now typically refuses to produce even compliance manuals, which are needed in virtually every case, without confidentiality agreements. The near elimination of confidentiality agreements would make documentary evidence more widely accessible to claimants, and would cast some light on the industry's desire to keep secret bad practices.

The only conceivable reason for this continued insistence on confidentiality is an attempt by members of the securities industry to make it more difficult for customers to obtain the documents relevant to the prosecution of their claim and to further ensure that it is more difficult for other wronged customers of the member firm at issue to bring subsequent claims against the firm. The securities industry is utilizing the arbitration process to limit its future exposure, and driving up the cost and time involved in the proceeding for the customer.

4. Unpaid Arbitration Awards

Millions of dollars in arbitration awards continue to go unpaid. Armed with the "SIPC" logo and enabled to transact business as broker dealers by virtue of ridiculously low net capital

been "grossly negligent" in turning over requested documents, destroying e-mails and representing to the court that everything required to be produced had been produced, when in fact, it hadn't. See "Morgan Stanley Loses Early Round in Case Filed by Perelman," Susanne Craig, *Wall Street Journal*, Page C1, March 9, 2005. The article also noted that MSDW and two other firms had been fined by the NASD for failing to turn over documents in almost two

requirements and no mandatory bonding or insurance requirements, entities whose entire reason for existing is to fleece unsuspecting investors take as much money as they can and then simply cease to exist.⁴

Statistics listing the dollar amount of unpaid awards do not capture the breadth of the problem. Abused investors often cannot find lawyers to represent them in cases against broker-dealers when the ability to collect is uncertain. Many investors are left with no avenue for recovery.

Investors who are able to procure legal representation to pursue a claim against an "empty pocket" are forced to walk away with absolutely no credible chance of ever recovering their losses, no matter how egregious the behavior of the firm may have been.

These types of issues are well addressed in other industries and areas. In many states, attorneys are required to have malpractice insurance. Car owners are required to have liability insurance.

Public investors are shocked to hear that these broker-dealers are not required to have insurance, and have very small net capital requirements.

It is time for Congress to take a far more serious look at SIPC reform, net capital requirements and insurance/bonding requirements than it has in the past.

5. Expediting Reform of Arbitration at the New York Stock Exchange

Every member of this committee is undoubtedly aware of press reports of the problems which permeated the New York Stock Exchange during the last 2 years of Richard Grasso's tenure as its chairman. The NYSE arbitration department was not spared those problems; in

dozen investor complaint cases. Unfortunately, the judge's reaction to MSDW's obstructionist behavior is something which almost never happens in arbitration, a fact of which the securities industry is acutely aware.

⁴ The great majority of NASD member firms are small firms, many of which are allowed to hold themselves

fact, it appears to have borne an undue share of the problems. Much ado has been made about the restructuring and reformation of the NYSE. PIABA has previously urged John Thain, the Exchange's current CEO, not to overlook reform of the NYSE arbitration department, which is often the last refuge of investors abused by NYSE member firms. PIABA is encouraged by and commends the steps which have thus far been taken by the NYSE to bring its arbitration department back to its previous position as a viable (and to some, preferable) alternative to the NASD. Unfortunately, many NYSE cases are still plagued by delayed appointments of arbitrators and failure to set hearings on a timely basis.

CONCLUSION

The Board of Directors of PIABA is most appreciative of the Committee's interest in a closer look at securities arbitration. We hope that Congress will direct the SEC's attention and serious consideration of all the issues we've raised here today. We are willing to assist this Committee and the SEC in any way we can.

Testimony of Daniel R. Solin

**U.S. House Subcommittee on Capital Markets, Insurance and
Government Sponsored Entities**

March 17, 2005

Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, thank you very much for the opportunity to share my experiences with you. I am an attorney representing investors who are victims of broker misconduct. My extensive first-hand experience inspired me to write a book entitled, "*Does Your Broker Owe You Money?*" to educate investors about the industry's mandatory arbitration system and to help them avoid becoming victims of broker misconduct. I am also in the process of completing a detailed statistical analysis of all awards issued by NASD and NYSE arbitration panels for the past ten years.

Mandatory arbitration in the securities industry is a system that takes away two fundamental rights of American citizens: access to the courtroom and trial by a jury of their peers. This is a system that has neither the appearance nor the reality of impartiality, since it requires that a victim of misconduct must submit his or her claim to a tribunal administered by the very industry that he or she is suing. Worse, the arbitration rules insist on a stacked jury: one of the three arbitrators deciding the case must be from within the industry, and the other two "public" arbitrators often have some past association with it.

The panel of potential arbitrators, which is carefully screened by the NASD and the NYSE, is a demographic that is hardly representative of the hapless investors who

appear before them. A 1994 study conducted by the U.S. General Accounting Office found that 97 percent of the arbitrators were white, 0.9 were black and 0.6 were Asian. The same study found that 89% were white men over the age of 60.

This lack of racial, gender, age and ethnic diversity stands in stark contrast to our jury system. Our laws require that juries be drawn from all demographics, representing a cross section of the communities in which they serve. The fact that the industry-administered tribunals are so homogeneous in their make-up leads to both the perception and the reality of a pro-industry bias.

The 1992 and 2000 Reports by the General Accounting Office on the fairness of the mandatory arbitration system shed little light on this issue and were very misleading. While the methodology in the Reports was accurate, the findings were fatally incomplete. The GAO Reports did not:

- Differentiate between cases where the arbitrators award only a small fraction of an investor's losses and those in which the investor is fully compensated for his or her losses. Instead, the GAO Reports treated both results as a "win";
- Analyze the records of arbitrators appointed by the SRO's to sit on panels, as contrasted with those selected by the respective parties. There is anecdotal evidence that appointed arbitrators are rewarded for their pro-industry awards by receiving more appointments to sit as panelists on additional cases;
- Analyze the record of any particular arbitrator; and
- Analyze or compute the likelihood of a Claimant prevailing on any particular type of claim or the likelihood of any particular arbitrator issuing an award in favor of a Claimant, in whole or in part.

My experience, the experience of many of my colleagues who represent investors before these tribunals, and the limited statistical analysis I have completed to date, all support my view that investors have an exceedingly small statistical possibility of

receiving any meaningful award from these tribunals, regardless of the merit of their claims.

The case of Mary Jane Schwartz provides a perfect example. Ms. Schwartz is a 62 year-old, divorced, retired nurse, living in Massachusetts. She had nearly her entire life savings – approximately \$1.3 million dollars – invested with her broker. Orally and in writing, Ms. Schwartz advised her broker that she wanted her investments to achieve capital preservation and income because she needed to live on that money for the rest of her life. She clearly stated that she did not want a risky portfolio. Ignoring Ms. Schwartz’s objectives and without disclosing the risks, the broker inappropriately invested as much as 98% of Ms. Schwartz’s portfolio in aggressive equity investments, including volatile technology stocks. The portfolio had no diversification. As a result of the broker’s completely unsuitable investment decisions, Ms. Schwartz lost more than \$915,000.

I represented Ms. Schwartz who pursued her claim for damages against the brokerage firm through mandatory arbitration, as she was required to do (NASD Dispute Resolution Arbitration Number 03-07760). After a week of hearings, the NASD panel technically found in favor of Ms. Schwartz, while in reality handing her a devastating loss. The NASD panel awarded Ms. Schwartz only \$4,994.77 and then assessed \$5,625.00 in NASD forum fees against her. While the NASD and the GAO Reports would count the Schwartz case as a “win” for her, Ms. Schwartz did not even recover the pathetically small amount of her award, because she ended up owing the NASD more money than she actually was awarded.

From the very beginning of her case, Ms. Schwartz never had a chance of getting justice at the NASD. The pool of potential arbitrators for her case, which had been screened and provided by the NASD, had an abysmal record of awards to aggrieved investors.

The 15 arbitrators in her pool had presided over 27 cases in which investors requested damages greater than \$100,000. Claimants “won” only 8 of those 27 cases. More telling is the fact that in those cases “won” by Claimants, the potential arbitrators in the Schwartz case awarded only 16.8% of the damages claimed by the prevailing Claimants. When you factor in the 19 cases that Claimants lost with the arbitrators in Ms. Schwartz’s NASD pool, Ms. Schwartz had a statistical probability of recovering only 7.1% of her damages.

Under the current securities industry mandatory arbitration system, the “deck is stacked” against investors. This appalling situation yields only one rational conclusion: The only appropriate course of action is to eliminate the role of the securities industry entirely from adjudicating disputes involving the misconduct of its members.

This could be easily accomplished by requiring that a completely impartial organization (like the American Arbitration Association or any number of private dispute organizations) administer securities arbitration cases and by requiring that these impartial organizations appoint a panel of arbitrators that is neutral, unbiased and totally unaffiliated with either party to the dispute. In addition, investors should be given the option of bringing their claims in court, before juries, as is their constitutional right.

The securities industry, whose blatant misconduct has caused trillions of dollars of losses to investors from all walks of life, is hardly worthy of the free pass that the cozy

mandatory arbitration system, administered by its brethren at the NASD and the NYSE, presently gives it. I entitled the chapter in my book on this subject: *Mandatory Arbitration—A National Disgrace*. I stand by that description of this shameful process.

I urge this Committee to give investors the right to a fair and impartial hearing by reforming this system without delay.

○