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June 18, 2007

Nancy M. Morris, Esquire
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Ms. Morris:

This is a request for rulemaking pursuant to Rule 192(a), SEC Rules of Practice.

I. <u>The Rule Being Requested</u>

As the Petitioner, I request that the SEC create a rule which would prohibit broker-dealers from requiring investors to accept mandatory arbitration clauses.

II. <u>The Support For This Petition</u>

In support of this Petition, I am enclosing the following documents:

1. Letter dated May 4, 2004 from Senators Patrick Leahy, Chairman of the Senate Judiciary Committee and Senator Russell D. Feingold, a member of the Senate Judiciary Committee; and
2. Two copies of a Study entitled: *Mandatory Arbitration of Securities Disputes. A Statistical Analysis of How Claimants Fare* (the "Study"), which I co-authored with Edward S. O'Neal, Ph.D.

I incorporate into this Petition the views of Senators Leahy and Feingold, to which I subscribe.

The mandatory arbitration process, run by the NASD and the NYSE, clearly does not have the *perception* of fairness. The Study indicates that the *reality* of the process is consistent with this perception.

The Study raises very troubling issues about the fairness of the mandatory arbitration process. These issues include the following:

- Claimant win rates have steadily declined since 1999
- Claimant win rates are lower against larger brokerage firms
- Awards as a percent of amount claimed in claimant victories have steadily declined since 1998
- The larger the case, the lower the award as a percent of the amount claimed
- The amount an investor can expect to recover going into arbitration has declined from a high of 38% in 1998 to a low of 22% in 2004
- The amount an investor can expect to recover going into arbitration against a large firm in a large case (over $250,000) is 12%.

As stated in the Study, at p. 19:

> As a practical matter, given the low expected recovery percentages, especially for large cases against large firms, and the significant cost to pursue these claims, very careful consideration is required before the decision is made to pursue claims under the mandatory arbitration process.

The mandatory arbitration system, imposed on investors who have no choice other that to submit to it, is totally inconsistent with the statutory obligation of the SEC to insure that rules governing mandatory arbitration are "in the public interest." *See,* 15 U.S.C. §78s-(b)(1) (2000).

The data in the Study clearly demonstrates that this system is *contrary* to the public interest.

III. <u>The Interest of Petitioner in this Petition</u>

I am a securities arbitration attorney who represents investors in major cases against large brokerage firms. I have seen up close and very personally the devastating consequences to investors who are revictimized by this unfair process.

IV. Conclusion

I adopt fully the following language from the letter of Senators Leahy and Feingold referred to above:

> There can be no doubt that investors would be better off with a choice between the court remedy provided by Congress and SRO arbitration than they are currently with no option but SRO arbitration.

Anything less will undermine further the confidence of the investing public in our financial system.

Thank you for your consideration of this important request.

Sincerely yours,

Daniel R. Solin

United States Senate

COMMITTEE ON THE JUDICIARY
WASHINGTON, DC 20510–6275

May 4, 2007

The Honorable Christopher Cox
Chairman
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox:

We write regarding the prevalence of mandatory arbitration clauses in securities brokerage contracts. While arbitration can offer investors a valuable alternative to the courts as a means of resolving disputes, the increasing trend of stronger parties to a contract forcing weaker parties to waive their rights to judicial process is reason for serious concern. Although the Securities and Exchange Commission ("SEC") has done a good job regulating some other aspects of securities arbitration, we are troubled that the SEC has not adequately addressed the problem of mandatory arbitration clauses.

When Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, it provided investors with an enhanced judicial remedy intended to serve as the foundation for vigorous private enforcement of the Acts' new comprehensive protections. The threat of public prosecution by individual investor-litigants gave teeth to the enforcement of securities laws, and Congress intended that this special judicial remedy be widely available to investors. Because securities firms today almost uniformly present prospective customers with contracts that include "take-it-or-leave-it" mandatory arbitration clauses, most investors are no longer able to invoke the courts to assert their rights either under the Acts or state laws. Accordingly, we request that the SEC, in fulfillment of its statutory duty to protect individual investors, promulgate a rule that will prohibit broker-dealers from requiring investors to accept mandatory arbitration clauses.

In its 2000 *Report on Securities Arbitration* (GAO/GGD-00-115), the General Accounting Office noted that the number of securities cases processed in the courts was "too small to make meaningful comparisons" to those processed through arbitration and later explained that all nine of the largest twelve brokerage firms that replied to its survey "require individual investors to agree to resolve their disputes through SRO-sponsored arbitration as a condition of opening most types of accounts." *Id.* at 5, 30. Since then, this situation has only worsened. On its own website, the SEC tacitly recognizes that the judicial remedy has been virtually extinguished for investors when it states: "[I]f you have a brokerage account, you probably signed an agreement that requires you to settle any disputes with your broker through arbitration rather than the courts." Where investors face a stark choice between signing a mandatory arbitration agreement and forgoing investment-related services, we cannot say honestly that arbitration has been voluntarily selected. Instead, we must admit that arbitration has been imposed on investors—regardless of their wishes—by the brokers, which hold much greater bargaining power. In the SEC Office of Inspector General's ("OIG") 1999 audit titled *Oversight of Self-Regulatory Arbitration*, the OIG conceded that "to the extent investors are unable to open accounts without signing mandatory arbitration agreements, they perceive that their participation in securities arbitration is involuntary." *Id.* at 4.

Thus far, the SEC has not responded to this specific problem with regulations. Instead, the Commission has declined to act beyond imposing stricter disclosure requirements, explaining that so long as the terms of any contract were fully disclosed, further regulation was unnecessary. *Id.* at 5. This policy may have been sufficient in the past when investors could, through their own initiative, identify and select brokers that did not include mandatory arbitration clauses in their standard contracts. With the prevalence of such clauses in today's brokerage contracts, however, the Commission must step in on behalf of the individual investors and restore their ability to choose judicial process.

The SEC's mission is, first and foremost, to protect investors, and simply relying on investors' ability to exercise informed choice when no choice is actually offered is clearly insufficient. Arbitration can be a fair and efficient way to settle disputes, but only when it is entered into knowingly and voluntarily by both parties to the dispute. We call on the Commission to consider the best mechanisms to address this problem, giving particular attention to the following alternatives: (1) a rule banning all pre-dispute mandatory arbitration clauses; or (2) if pre-dispute agreements are to be allowed, a rule requiring broker-dealers to provide their customers with a "check-the-box" choice between traditional judicial process and Self-Regulatory Organization ("SRO") arbitration.

Two Supreme Court cases from the 1980s, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), paved the way for the expansive judicial enforcement of mandatory arbitration clauses under the Securities Acts. In both cases, the assumptions and rationale underlying the Supreme Court's rulings are clear: that arbitration increases rather than limits options and that the SEC will actively monitor arbitration to ensure it offers adequate investor protections. Promulgation of either of the aforementioned rules would be consistent with the Supreme Court's rulings on this issue.

First, arbitration agreements were presumed by the Court to "advance the objective of allowing buyers of securities a *broader* right to *select* the forum for resolving disputes." *Rodriguez de Quijas* at 483 (emphasis added). This rationale that arbitration is valid on the grounds that it broadens the choices for claimants to select their forum is echoed in decisions upholding arbitration agreements in other contexts. *See, e.g., Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 29 (1991). When the Supreme Court decided *McMahon* and *Rodriguez de Quijas*, it was not standard practice across the brokerage industry to include mandatory arbitration clauses in customer contracts, and many investors were free to select among brokers on the basis of whether they did or did not permit judicial process. That mandatory arbitration clauses are now an industry norm—and thus a de facto requirement imposed upon investors—is a significant shift from one of the presumptions essential to the Court's decisions. The SEC should act to require that brokers allow investors to have an actual choice between the courts and arbitration, thereby restoring the element of voluntariness assumed by the Court.

Second, the SEC was presumed by the Court to be exercising its "authority to oversee and to regulate those arbitration procedures." *Rodriguez de Quijas* at 483. As noted in *McMahon*, the Commission has "expansive power" to regulate in this area. *Id.* at 233. Thus, issuing an appropriate rule is consistent with the second presumption of the Court as well. In an amicus brief filed by the SEC in the 2002 case, *NASD Dispute Resolution, Inc. and New York Stock Exchange, Inc., v. Judicial Council of California, et al*, the Commission correctly asserted that it "has full supervisory authority over the rules adopted by SROs, including the power to mandate the adoption of additional rules." Indeed, this power has been both contemplated and exercised with regard to mandatory arbitration clauses in the past. *See, e.g.*, Current Rule 10301(d) of NASD Code of Arbitration. It is the SEC's charge to protect the interests of the American investor and to regulate in furtherance of this duty. Promulgation of a rule concerning mandatory arbitration is clearly within the power of the Commission and is consistent with its charter.

Investors must have the opportunity to meaningfully weigh arbitration's benefits against a set of significant trade-offs. Notwithstanding the SEC's efforts to ameliorate some of the most troubling aspects of arbitration, agreeing to arbitration is still a waiver of constitutional rights that are protected in the judicial system. For instance, arbitration (1) lacks the formal court-supervised discovery process often necessary to learn facts and gain documents; (2) does not require that arbitrators follow the rules of evidence laid out for state and federal courts; (3) imposes no obligation on arbitrators to provide factual or legal discussion of the decision in a written opinion; and (4) severely limits judicial review. Arbitration is structured to create a more streamlined proceeding in order to provide faster and less expensive decisions, though at the cost of reduced legal certainty.

The appeal of arbitration and mediation for disputes that are relatively straightforward or that involve modest damages will ensure that such alternative dispute resolution processes can continue to be the primary means for resolving disputes even after implementation of a rule that is more protective of investors. At the same time, restoring investors' access to the courts would enable some investors to assert their rights more effectively than in arbitration. Thus, an investor who requires significant discovery to show that she was the victim of coordinated misconduct by a firm will be much better able to substantiate this kind of complex claim with the more extensive discovery procedures of state or federal court. Although citizens are permitted to waive certain constitutional rights, it is important to remember that implicit in the constitutional foundation of our civil justice system is the basic principle that individuals should not be coerced or mislead into waiving such fundamental rights.

SEC promulgation of either of the mandatory arbitration rules suggested above would not indicate any disapproval of arbitration, nor would it lessen the benefits that arbitration can bring to the securities field. Rather, by insisting on the element of voluntary participation in the arbitration process, the SEC would strengthen the validity of arbitration as a forum for resolving disputes. According to the SEC's Office of Inspector General, "virtually all of the officials" surveyed by OIG during the audit believed that even if the SEC were to eliminate mandatory arbitration agreements altogether, the more sweeping of the two proposals we have made, such regulation would not result in a significant decrease in the number of disputes handled through arbitration. *Oversight of Self-Regulatory Arbitration* at 4. The OIG continued that if—instead of being bound by mandatory arbitration agreements—investors were given the *choice*, those investors "would perceive the securities arbitration process more favorably." *Id.*

We believe we should encourage arbitration and mediation in cases where they can be helpful. Should the SEC act as suggested in this letter, the quality of the securities arbitration process will be improved. As the SEC's Division of Market Regulation stated when it recommended in 1988 that brokers be prohibited from requiring mandatory arbitration clauses, reintroducing the element of competition between SROs and the courts for the investor dispute resolution business "should increase incentives to SROs and their members to ensure that the arbitration forum remains fair and efficient." *Id.* at 5. Arbitration will remain as a vital option for investors; at the same time, in those circumstances where an investor with a complex or particularly sensitive claim might be better protected by traditional judicial process, the SEC will have ensured that that protection is available.

One of the most important pillars of our justice system, enshrined in the Seventh Amendment, is the right to take a dispute to court. Crowded court dockets and the expense of litigation lead many litigants in civil cases appropriately to seek alternative ways to resolve their disputes. It may well be that arbitration is the best way of resolving many of these matters and that most investors, when given the choice, will select arbitration. It is vital, however, for the SEC to ensure that American investors are given a meaningful opportunity to make the choice between arbitration and traditional judicial process. There can be no doubt that investors would be better off with a choice between the court remedy provided by Congress and SRO arbitration than they are currently with no option but SRO arbitration.

Thank you for your attention to this important matter. We look forward to your response.

Sincerely,

RUSSELL D. FEINGOLD
United States Senator

PATRICK LEAHY
Chairman

Mandatory Arbitration of Securities Disputes

—

A Statistical Analysis of How Claimants Fare

by Edward S. O'Neal, Ph.D. and Daniel R. Solin[1]

Introduction and Overview

In 1987, a sharply divided[2] United States Supreme Court decided *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987). In its decision the court held that the mandatory arbitration provisions in agreements between investors and brokerage firms are enforceable.

Securities firms are required to be members of self-regulatory organizations. The largest of these organizations is the National Association of Securities Dealers (NASD). Virtually all NASD members require investors dealing with them to agree to resolve disputes by arbitration.[3]

The NASD is required to obtain approval from the Securities and Exchange Commission when it changes its procedural rules.[4] However, it is very clear that rules governing mandatory arbitration must be "in the public interest".[5]

In recent years, a debate has raged over the fairness of the mandatory arbitration system. The conflicting views of the industry and investor advocates were foreseen by Justice Blackmun in his dissenting opinion in *McMahon*. He wrote:

> "Furthermore, there remains the danger that, at worst, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the market professional. The Uniform Code provides some safeguards

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[1] This study was funded by the authors. Edward S. O'Neal, Ph.D, is a principal with Securities Litigation and Consulting Group, Inc. (SLCG), a financial economics consulting firm, www.slcg.com. This work was completed while he was on the faculty at the Babcock Graduate School of Management at Wake Forest University.

Daniel R. Solin is a securities arbitration attorney representing investors. He is also a Registered Investment Advisor and Senior Vice President of Index Funds Advisors, Inc., www.ifa.com.

[2] Justice O'Connor authored the majority opinion. Chief Justice Rehnquist and Justices White, Scalia, and Powell joined the majority. Justice Blackmun wrote a dissenting opinion, which Justices Brennan and Marshall joined. Justice Stevens wrote a separate dissenting opinion.

[3] The NASD rules require the submission of all disputes with investors to arbitration. NASD CODE OF ARBITRATION PROCEDURE, §§ 10301(a), 10101(c).

[4] See 15 U.S.C. §78s-(b)(1) (2000).

[5] See 15 U.S.C. §78o-3(a) (2000).

> but despite them, and indeed because of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public. It is generally recognized that the codes do not define who falls into the category "not from the securities industry".

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> "The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be some truth to the investors' belief that the securities industry has an advantage in a forum under its own control. See *N. Y. Times*, Mar. 29, 1987, section 3, p. 8, col. 1 (statement of Sheldon H. Elsen, Chairman, American Bar Association Task Force on Securities Arbitration: "The houses basically like the present system because they own the stacked deck"). (footnotes omitted) *Shearson/American Express v. McMahon*, 482 U.S. 220, 260-261 (U.S. 1987)

The issues in the ongoing debate continue to include (i) the requirement that one of the three arbitrators be affiliated with the securities industry[6] and (ii) the fact that the arbitration process is administered by the NASD instead of by an entity unaffiliated with the securities industry.[7]

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[6] See NASD CODE OF ARBITRATION PROCEDURE Rule 10308 (b)(1)(B) ("If the amount of a claim is more than $50,000, the Director shall appoint an arbitration panel composed of **one non-public** arbitrator and two public arbitrators, unless the parties agree to a different panel composition") (emphasis supplied). The Rules of the New York Stock Exchange are identical in this regard. See NYSE Rule 607(a). The control over the selection of arbitrators who are on the panel, and the ability to classify them as "public" or "non-public," as well as other broad authority invested in the Director of Arbitration of the NASD, gives the NASD vast authority to influence the outcome of investor disputes submitted to it. See NASD CODE OF ARBITRATION PROCEDURE Rules 10103, 10308, 10310, 10311, 10312, 10313 and 10319.

[7] The securities industry believes that the requirement of an industry affiliated arbitrator is helpful to investors since that arbitrator has the specialized knowledge to discern misconduct by a broker. The contrary view is that the presence of an industry arbitrator affects the perception of fairness of the proceeding. See, *Arbitration Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce,* 100th Cong., 2d Sess. 265 (1988) (statement of James C. Meyer, Pres., N. Am. Sec. Adm'rs Ass'n), at p. 6 ("[s]ecurities industry professionals contend that arbitrators are unbiased and oftentimes harsher on their colleagues than others might be in arbitration proceedings. That may or may not be true. But even if it is, the perception of fairness is as important as the reality of fairness.").

In addition, there is concern that the fact that the major brokerage firms are "repeat players" in the process, gives them an unfair advantage. Arbitrators who wish to continue to be appointed to panels may be influenced by the fact that issuing a large award against one of these firms could cause them to be stricken from serving on future panels.[8]

In contrast, a number of studies and articles have concluded that there is no pro-investor bias in the mandatory arbitration proceedings.[9]

On March 17, 2005, industry representatives, academics and investor advocates presented sharply conflicting views on this subject before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.[10]

The industry representatives extolled the virtues of mandatory arbitration. The investor advocates decried its bias.[11]

William Galvin, the Secretary of the Commonwealth of Massachusetts and Chief Securities Regulator in Massachusetts, testified as follows:

> "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

[8] See Carrie Menkel-Meadow, *Do the "Haves" Come Out Ahead in Alternative Judicial Systems? Repeat Players in ADR,* 15 Ohio St. J. on Disp. Res. 19, 50-52 (1999); Richard A. Voytas, Jr., *Empirical Evidence of Worsening Conditions for the Investor in Securities Arbitration,* 12 Securities Arbitration Commentator 7 (2002), as cited in 21 Ohio St. J. on Disp. Resol. 329, 381.

[9] See, U.S. Gen. Accounting Office, Rep. No. GGD-92-74, *Securities Arbitration: How Investors Fare;* U.S. Gen. Accounting Office, Rep. No. GGD- 00-115, *Securities Arbitration: Actions Needed to Address Problems of Unpaid Awards* (2000); Michael A. Perino, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations* (Nov. 4, 2002) http://www.sec.gov/pdf/arbconflict.pdf; *Securities Mediation: Dispute Resolution for the Individual Investor*, 21 Ohio St. J. on Disp. Resol. 329, 381, fn. 50.

[10] The transcript of these hearings can be found at: http://financialservices.house.gov/media/pdf/109-11.pdf.

[11] Daniel R. Solin, co-author of this report, testified at these hearings. His testimony may be found at: http://financialservices.house.gov/media/pdf/109-11.pdf, at pp. 111-121. Mr. Solin set forth similar views in two books he has authored: *Does Your Broker Owe You Money?* (Perigee Books, 2006) and *The Smartest Investment Book You'll Ever Read* (Perigee Books, 2006). See also, www.smartestinvestmentbook.com.

> 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.[12]

The NASD provides extensive data on the outcome of mandatory arbitration proceedings on its statistics page.[13] According to the NASD, for calendar year 2006, Claimants prevailed in 425 of 1,011 cases (42%) and received an average of 42% of the amount claimed.[14]

It has become well accepted to justify the fairness of the mandatory arbitration system by setting forth the total "win" percentage of claimants and the percent of the amount claimed that claimants are awarded. The following quote from an article by a well known proponent of the fairness of the mandatory arbitration process is illustrative:

> "In 2002, the Securities and Exchange Commission sponsored a study by Professor Michael Perino regarding the operation of arbitrator disclosure requirements in securities arbitration. Among other things, Professor Perino sought empirical data on the experience of investors in securities arbitration, and determined that the most comprehensive study of investor outcomes was the GAO's 1992 report, *Securities Arbitration: How Investors Fare,* which examined results in arbitration over an eighteen-month period between 1989 and 1990. The report found "no evidence of a systematic pro-industry bias" in arbitrations sponsored by the NASD, NYSE, and other SROs when compared to arbitrations conducted by the AAA. Among other things, the GAO noted, in SRO arbitrations, panels found for investors in about 59% of arbitrations versus 60% of AAA-sponsored arbitrations, and prevailing investors received average awards of about 61% of the damages, as opposed to awards averaging 57% of amounts claimed in AAA proceedings. Constantine N. Katsoris, *ROADMAP TO SECURITIES ADR,* 11 Fordham J. Corp. & Fin. L. 413, 441.[15]

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[12] http://financialservices.house.gov/media/pdf/109-11.pdf, pp 6-8 at 7.

[13] http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm.

[14] http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm.

[15] Professor Katsoris testified before the House Subcommittee. His testimony can be found at: http://financialservices.house.gov/media/pdf/109-11.pdf, pp 47-49, at 49 ("In conclusion, I can express to you that since the mandate of *McMahon,* the system has, on balance, worked well").

We believe that win rates and percent of amount claimed that was awarded is an inaccurate and misleading basis for determining the fairness of the mandatory arbitration system. Our analysis considers the amount awarded and the size of both the claim made and the firm against whom the claim is made. We believe this approach presents a far more accurate basis with which to assess the fairness of this process.[16]

General Description of the Data[17]

We collected data on NASD and NYSE arbitrations that occurred between January 1995 and December 2004. We attempted to collect every arbitration decision that was handed down in either forum.

The NASD would not provide us with copies of its awards. We were able to obtain these awards from the LEXIS database and, in the context of litigation with the NASD[18], obtained its permission to use these awards for non-commercial purposes only.[19] The NYSE would not provide us with copies of its arbitration awards and required us to go to its library and physically copy every award.

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16 Justice Blackmun, dissenting in *McMahon*, held the same view. ("The amici in support of petitioners and some commentators argue that the statistics concerning the results of arbitration show that the process is not weighted in favor of the securities industry. ... Such statistics, however, do not indicate the damages received by customers in relation to the damages to which they believed they were entitled. It is possible for an investor to "prevail" in arbitration while recovering a sum considerably less than the damages he actually incurred.") *Shearson/American Express v. McMahon, supra,* at pp 220, 261.

17 The NASD database of awards was downloaded from LexisNexis with the permission of LexisNexis. Lexis requested that we provide the following link to its bookstore: www.lexis.nexis.com/bookstore.

Arbitration award information © 2007 National Association of Securities Dealers, Inc. Used with permission from the NASD.

While the NASD claims a copyright interest in the arbitration awards issued by the panels it appoints to decide these disputes, this issue is far from settled. The NASD is not the author of these awards and authorship has generally been held to be a requirement for any claim of copyright. See 1-5 Nimmer on Copyright §5.01. See also, the language of the Intellectual Property Clause: "To promote the progress of science and useful arts, by securing for limited time to authors and inventors the exclusive right to their respective writings and discoveries." U.S. Const., art. I, § 8 cl. 8 (Emphasis supplied); *Medforms, Inc. v. Healthcare Mgmt. Solutions, Inc.*, 290 F. 3d 98, 107 (2d Cir., 2002).

18 *Solin v. NASD,* 2005 U.S. Dist. LEXIS 39757 (D.N.Y. 2005).

19 Rule 10330(f) of the NASD CODE OF ARBITRATION PROCEDURE states that "[A]ll awards and their contents shall be made publicly available."

While every arbitration decision is slightly different, there are certain data items that are generally included. We collected the data shown in Table 1 from each of the arbitration decisions.

The final sample consisted of 13,810 cases. 90% of the cases were in the NASD's forum and the remaining 10% were NYSE cases. Each year of our sample has at least 700 cases with a high of just over 2000 cases in 2004. Figure 1 shows the distribution of cases in our sample by the year of the arbitration decision. There is a general but uneven increase in the number of cases in the last half of our sample period. This

Table 1

Variable	Description (if needed)
Forum	NASD or NYSE
Date of Award	Date award was announced
Date of Filing	Date case was filed
Dispute Type	Was the case brought against a firm, an associated person of the firm, or both the firm and associated person
Brokerage Defend	A dummy variable that is 1 if the case was defended, 0 if it was not
Hearing	A dummy variable that is 1 if the case went to a hearing, 0 if it did not
Number Pre-hearing Sessions	
Number Hearing Sessions	
Hearing City	
Hearing State	
Reason for Claim	Many claims allege more than 1 reason for the claim. We designate dummy variables for each of the following reasons: suitability, misrepresentation, failure to supervise, breach of fiduciary duty, negligence, omission of facts, breach of contract, churning, failure to execute a trade, dispute over trade, margin dispute, commission dispute, unauthorized trading, selling away, online trading, fraud, delayed pay for settlement
Nature of Damages Requested	We designate dummy variables to code the following types of damages requested: interest, attorney fees, return of commissions, well managed account damages, rescission
Counter Claim Alleged	A dummy variable that is 1 if the respondent files a counterclaim, 0 if not
Number of Arbitrators	
Name of Arbitrators	
Name of Chairperson	
Arbitrator Dissented	A dummy variable that is 1 if an arbitrator dissented, 0 if not
Name of Dissenting Arbitrator	
Name of Brokerage Firm Involved	
Name of Associated Person Involved	

increase is likely driven by the bear market and resulting investor losses in the 2000 to 2002 period.

Twenty-eight percent of the awards in our sample did not designate a city or state in which the arbitration took place. Of the remaining 72%, the Northeast region of the country was most highly represented and the Midwest was the least represented. Figure 2 shows the number of cases that were heard in the four regions of the country during our sample period.

There is a very large range of requested damages in our sample. For our subsequent empirical analysis, we divide our sample into five categories by requested damages.

Figure 1

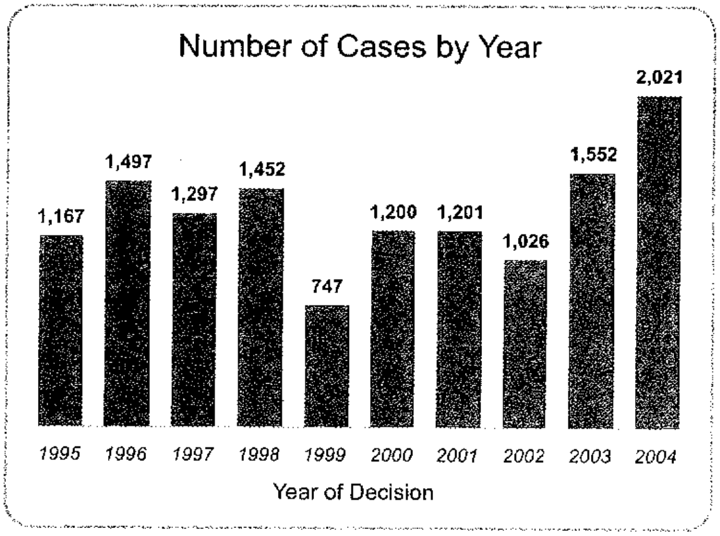


Figure 2

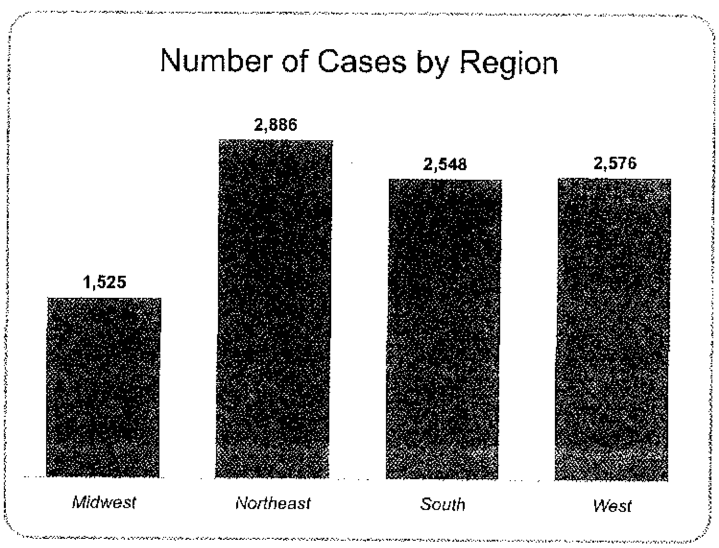


Figure 3 shows the representation in our sample by requested damages amount.

One of the variables in our sample is the name of the brokerage or investment advisory firm against which the case was filed. In order to better explore this variable, we categorized brokerage firms based on their size. For this analysis, we consulted the *Securities Industry Yearbook* (2002) and categorized all of the firms in our sample based on the total number of broker-dealer registered representatives.

We designated four categories: the largest 3 brokerage firms, the next 7 firms, the next 10 firms, and all of the remaining firms. We use the 2002 yearbook (which is based on 2001 data) because in our sample the median case based on award date is in 2001. Brokerage firms over our sample period underwent numerous mergers and acquisitions. We handled these corporate events by treating all cases against an ultimately acquired or merged firm as being cases against the acquirer. We also tracked name changes through the sample period and used a single uniform identifier for firms that changed names at some point in our sample period. Figure 4 shows the number of cases in our sample filed against our categories of brokerage firms.

Figure

3

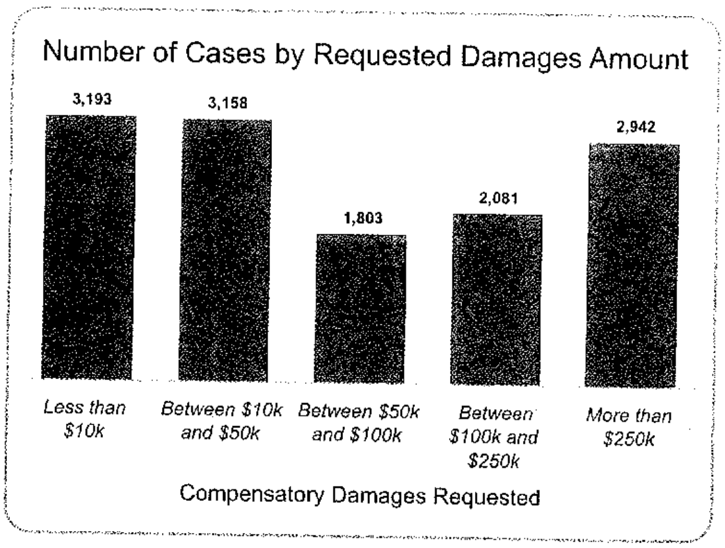
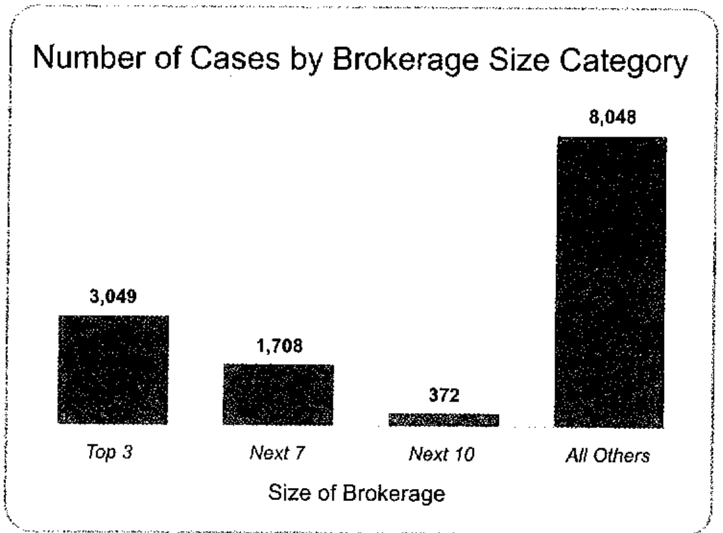


Figure 4



Win Rates and Award Percentages

As set forth above, previous empirical analysis of the investor arbitration process has focused on the frequency with which investors win and the amounts that are awarded when an investor wins. Typical studies tabulate both raw win rates and awards as a percentage of the amount specified in the original claim. Consistent with previous empirical studies, we categorize the arbitrations in our sample as a win for the claimant if any amount is awarded to the claimant.[20]

Figure 5 shows the win rates in each of the ten years covered by our sample. The win rates increase generally from 48% in 1995 to 59% in 1999. The year 2000 began a multi-year decline in win rates which culminates in a low of 44% in 2004. The overall win rate in the entire sample period for claimants is 51%.

Win rates are different depending on the size of the brokerage firm involved. Figure 6 shows the win rates for the four different size categories of brokerage firms. The win rate against the top 3 brokerage firms averaged 39% in our sample. Win rates against brokers in the 4-10 category and in the 11-20 category are 43%. For firms outside of the top 20 based on number of registered representatives, the win rate was 57%. Cases against smaller firms are more likely to result in an award to claimants.

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[20] Although classifying as an investor victory any case with a monetary award has been typical in previous studies, our subsequent analysis demonstrates the problems with such a simplistic categorization.

Win rates alone do not give an accurate picture of how investors or brokers fare in the arbitration process. In a $100,000 claim, a win with an award of $5,000 is far different than a win with an award of $100,000. However, both are counted as wins when win rates are analyzed.

Previous researchers have also quantified the average amount of the awards as a percentage of the amount stated in the claim. The GAO June 2000 report[21] found the percentage awarded in cases won by claimants to be about 50%. This percentage is consistent with previous studies.

Figure 5

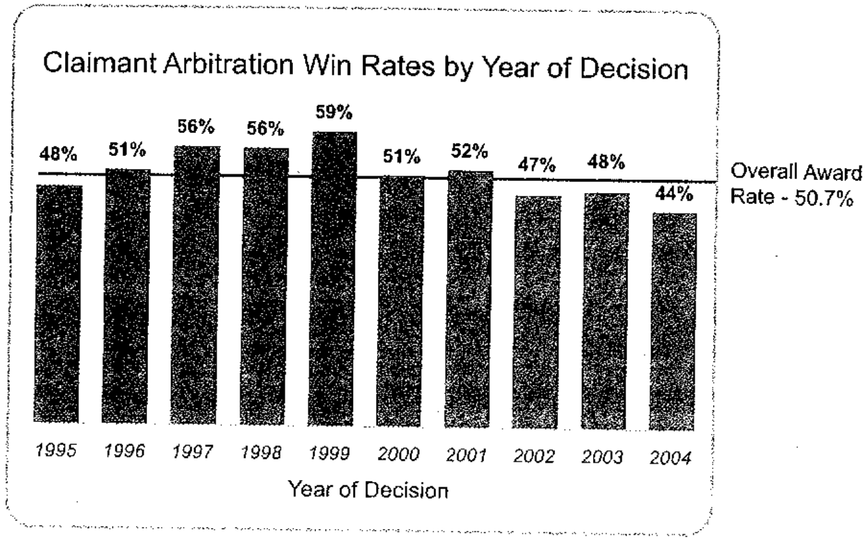
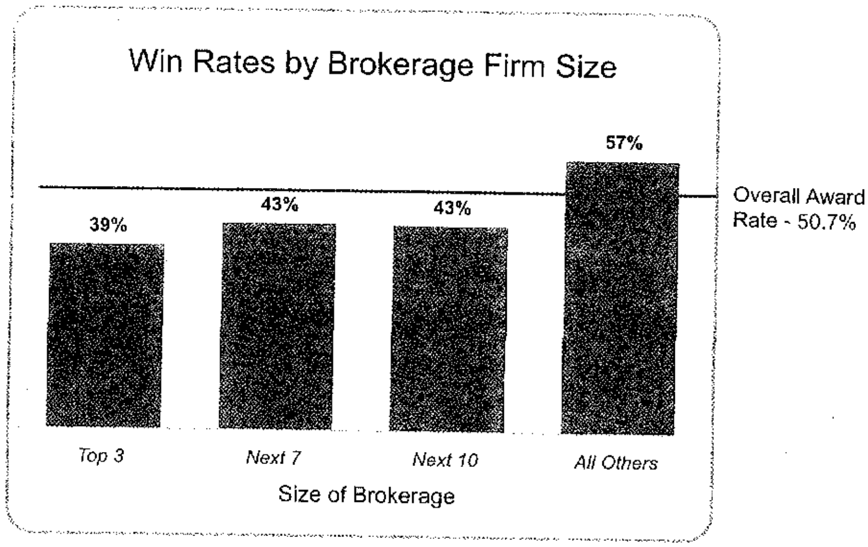


Figure 6



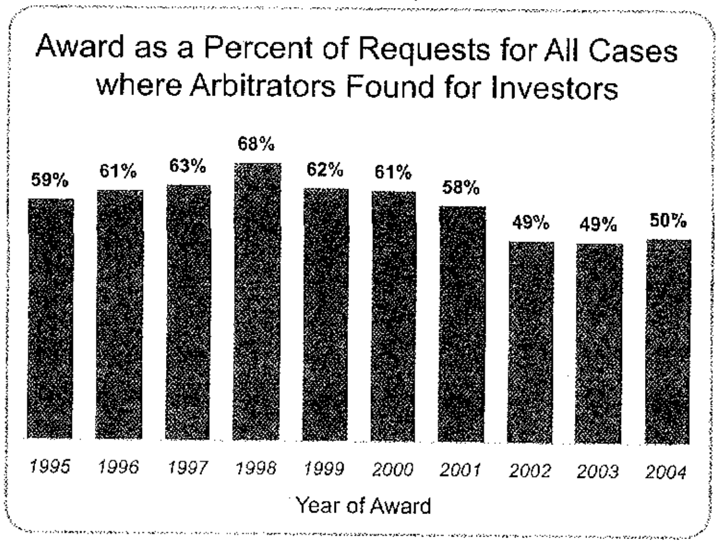
[21] *Securities Arbitration: Actions Needed to Address the Problem of Unpaid Awards* (GAO/GGD-00-115, June 15, 2000)

Figure 7 shows the percentages won in cases in which investors were granted an award. Importantly, this includes only the cases where there was an award and does not include cases that resulted in no award to investors. The award percentages reached a high in 1998 of 68% and have steadily declined in the later years of the sample to stabilize at approximately 50% in the 2002-2004 time period. Note that this decline in the award percentage roughly corresponds to the decline in win rates over the same period. Toward the end of the sample period, investors were winning less frequently and, when they did win, they were being awarded a smaller percentage of their claim.

The amount that investors can expect to recover in a win varies dramatically with the size of the requested damages. Using the five categories of damage requests, we calculate the average amount that an investor recovers, given that the arbitration results in a non-zero award, and present the results in Figure 8. There is a clear monotonic decline in the award percentage.

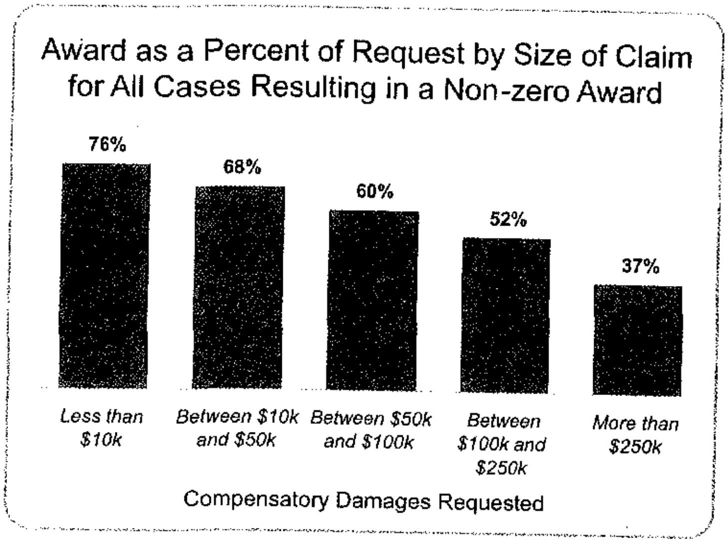
There are multiple potential explanations for this result. It may be that large claims with significant merit are more often settled. The risk of taking small claims to arbitration is low from the brokerage firm's standpoint. Or it may be that larger claims are really smaller claims with trumped-up damages numbers from aggressive claimant's counsel. A third explanation is that arbitrators are hesitant to grant large monetary awards regardless of the alleged level of damages in the case. There may be other explanations as well. Regardless of the explanation, if an investor finds himself in an arbitration proceeding, the percentage of claim he can expect in a win is a declining function of the amount requested in the case.

Figure 7



Figure

8



Clearly win rates in isolation or award percentages in isolation do not provide a complete assessment of the outcomes in the arbitration process. We propose that a better measure for assessing the arbitration process combines the win rates and the award percentages. We call this measure the Expected Recovery Percentage, and it is simply the product of the win rate and the amount awarded as shown in equation (1) below:

Equation

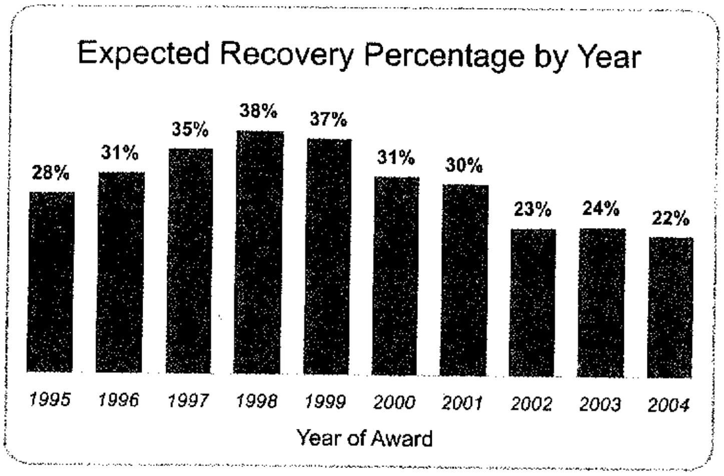
1

$$\text{Expected Recovery \%} = (\text{Win rate})*(\text{Award \%})$$

If we assume that investors win half the time and they receive, on average, half of the claimed amount when they do win, the expected recovery percentage is (.5)*(.5) which is .25 or 25%. This number is very informative for potential claimants and respondents. It means that going into the arbitration, the expected amount to be awarded is 25% of the amount claimed. It takes into account the fact that half the time claimants lose and are awarded nothing. The other half of the time they win and are awarded an amount that averages half of the claim.

We calculate the expected recovery percentage on a year-by-year basis for our sample and present the results in Figure 9. Consistent with Figures 5 and 7 that show both win rates and award percentages declining since the late 1990s, expected recovery percentage also declines. The high in our sample period is 38% in 1998. The low is

Figure 9



22% in 2004. As a percentage of the amount claimed, investors in arbitration were being awarded 22 cents on the dollar in 2004 vs. 38 cents on the dollar in 1998. The decline in expected recovery percentage is steeper than either the decline in win rates or award percentages because the expected recovery percentage is the product of the two individually declining variables.

One driving factor in the decline of expected recovery percentage over time is that award requests in dollars have increased in the 2000s while awards have remained fairly constant. Figure 10 shows the average real dollar amount of the requests and awards expressed in 1995 dollars (adjusted for inflation). Award requests increased significantly over the entire period while average awards remained fairly constant. In 1998 the average award was $56,000 while in 2004 it was $59,000. This 6% increase in real awards is dwarfed by the difference in award requests which rose over 300% from $168,000 in 1998 to $540,000 in 2004.

The rise in award requests was likely driven by a combination of the technology bear market which began in 2000 and lasted through 2002 and the analyst fraud scandal, which led to the $ 1.4 billion "global settlement" between 10 of the largest Wall Street firms, the SEC, the Self Regulatory Organizations and all fifty states.[22] Figure 11 shows the real award requests and the growth of $100 invested in the NASDAQ Composite index in 1995. The increase in award requests took off in 2001, a year after the initial drop in the NASDAQ index. The level of award requests stays high though the rest of

[22] See Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement,* 11 Conn. Ins. L.J. 107, 117-21 (2004).

Figure
10

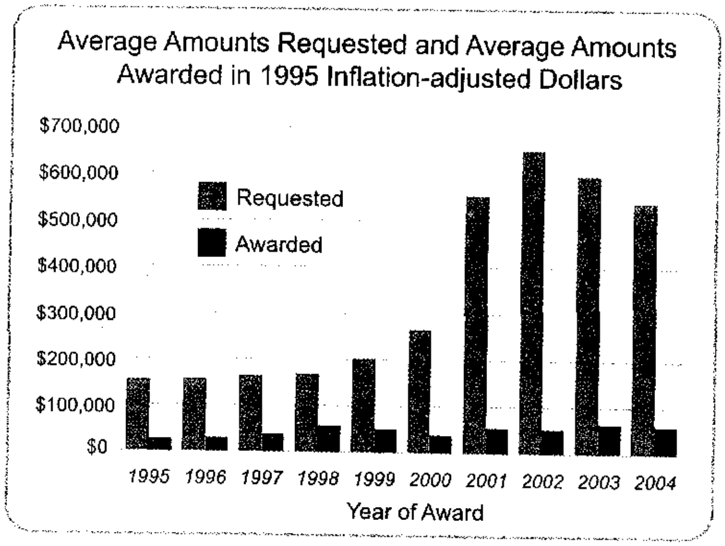
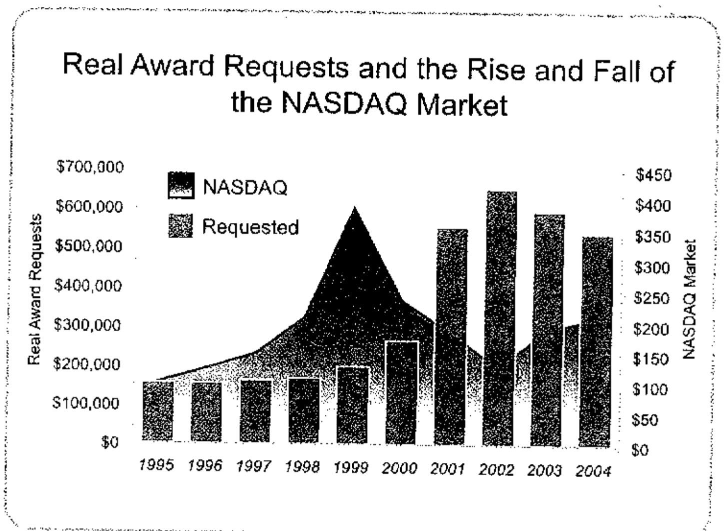


Figure
11



our sample period, presumably reflecting the continued filing of cases as the NASDAQ market languished in 2001 and 2002.

Figure 12 shows the expected recovery percentage as a function of the size of the claim. This figure shows that the recovery percentage is fairly consistent across all smaller claims but dips significantly for claims over $250,000. Expected recovery percentage also is related to the size of the brokerage firm against which the case is brought. Figure 13 shows that cases against smaller firms result in a larger expected recovery percentage than against the top 20 brokerage firms. No significant difference in recovery percentage exists among firms in the top 3, next 7 or next 10 as defined by number of registered representatives.

Figure 12

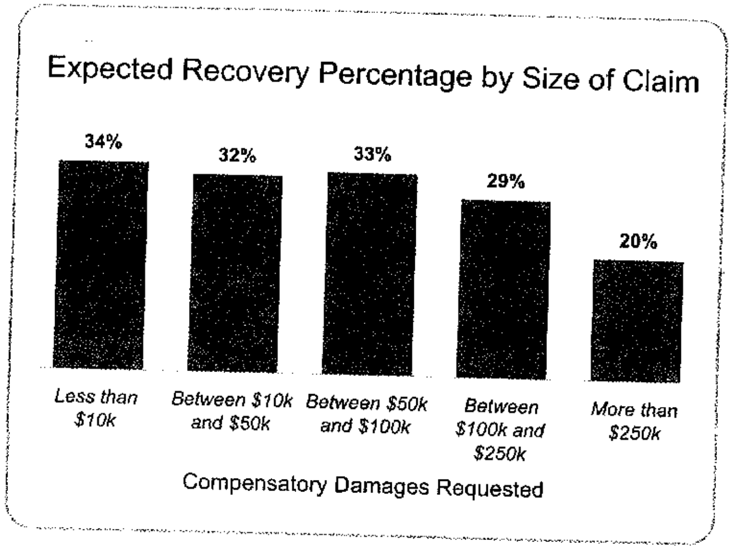
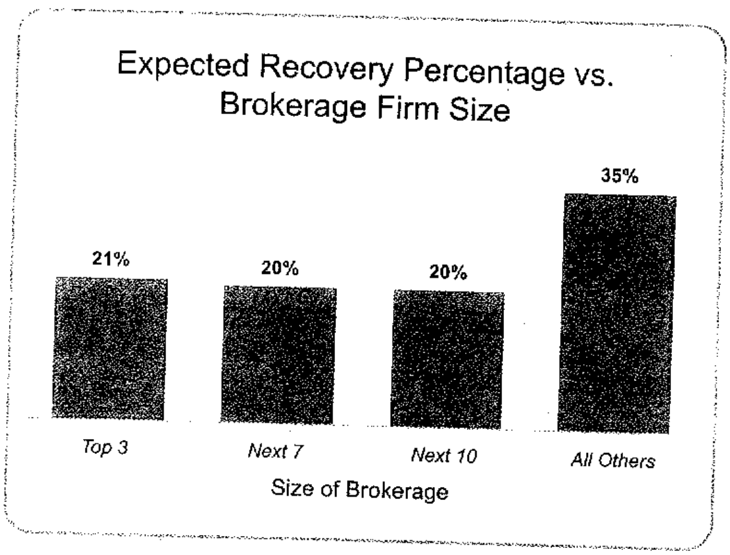


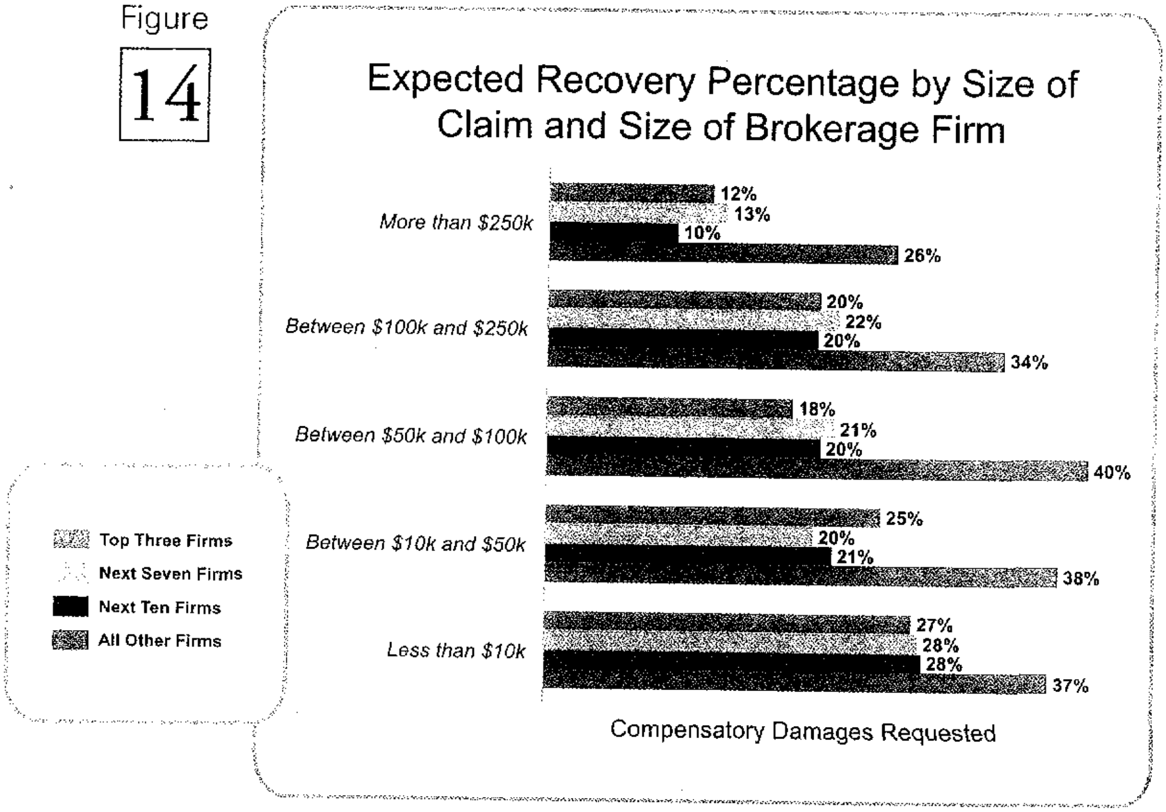
Figure 13



The preceding analysis documents that cases with large claims and arbitrations brought against top 20 brokerage firms result in lower expected recovery amounts. Figure 14 presents recovery percentages broken down both by the size of the brokerage firm and the size of the claim. The preceding findings are clearly evident in this graph. The greater recovery percentage in claims against small firms persists across all claims regardless of the size of the claim. Claims against top 20 brokerage firms exhibit expected recovery percentages that decline significantly as the size of the claim increases. Claimants in arbitrations against top 20 brokers face an expected recovery percentage that is approximately 28% in claims under $10,000. The expected recovery percentage plunges to approximately 12% in claims over $250,000.[23]

Recall from figure 4 that most of the claims in our ten-year sample period are against firms or entities that are outside of the top 20. Although previous studies do not categorize claims based on size of the brokerage firm, it is likely that those studies, drawing from the same sample period, are also dominated by small firms. Since cases against small firms appear to be decided more favorably for claimants, we must be careful to realize that numbers drawn from broad studies of the arbitration process are influenced significantly by such claims. Even more importantly, it is likely that a significant number of these claims against smaller firms are unpaid. The GAO found that approximately half of all arbitrated awards go unpaid. Further, they find that the larger the award, the lower the probability of being paid.[24]

Figure 14



[23] Some might argue that there are many cases that are not appropriately handled or vetted by claimant attorneys and that the existence of such cases in our database depresses the average expected recovery rate. However, we analyzed cases over $250,000 against the top 20 brokerage firms where Claimant's were represented by members of the current Board of Directors of the Public Investors Arbitration Bar Association ("PIABA"), www.piaba.org. PIABA is a national bar association whose member attorneys are dedicated to the representation of investors in disputes with the securities industry. The Expected Recovery Percentage in these cases was 13.6%, which is not statistically different from 12%.

[24] See GAO/GGD-00-115 *Actions Needed to Address Problem of Unpaid Awards,* Chapter 4.

Conclusions and Extensions

Our analysis uncovers a number of potentially troublesome facts about the investor arbitration system:

- Claimant win rates have steadily declined since 1999
- Claimant win rates are lower against larger brokerage firms
- Awards as a percent of amount claimed in claimant victories have steadily declined since 1998
- The larger the case, the lower the award as a percent of the amount claimed
- The average amount an investor can expect to recover going into arbitration has declined from a high of 38% in 1998 to a low of 20% in 2004
- The average amount an investor can expect to recover going into arbitration against a large firm in a large case (over $250,000) is 12%

There may well be innocent explanations for fact that the chances of an investor recovering significant damages from a major brokerage firm are statistically small in mandatory arbitration. However, our data clearly indicates a decline in both the overall "win" rate and the expected recovery percentage against major brokerage firms, at a time when the misconduct of these firms reached its apex with the analyst fraud scandal.

This data gives credence to Commissioner Galvin's testimony about the system really being a "... damage containment and control program masquerading as a juridical proceeding", intended to protect the major brokerage firms from significant damages. Whether for good reason or otherwise, the mandatory arbitration system is achieving this result.

In addition, this diminished expected recovery percentage must be viewed in the context of the cost to the investor to achieve this relatively modest award. In our sample of 13,810 cases, there were 3,956 where arbitration panels awarded claimants nothing but assessed forum fees to claimants. In these cases the average forums fees were $2,742 (in these same cases average forum fees against respondents were $2,693). An additional 51 cases had positive awards for claimants which were less than the forum fees assessed against them. In our analysis and that of previous researchers, these cases are considered "wins" for claimants. Clearly such an outcome is not a victory for claimants. Interestingly, of these 51 cases, 7 were cases in which panels awarded $1 for claimants. For these 7 cases, average forum fees assessed were $4,896 against claimants and $4,987 against respondents. On a percentage basis in our overall sample, forum fees average 2.7% of the amount awarded to claimants.[25]

In addition to forum fees, claimants may face travel and lodging costs if the arbitration is held out of their home town. Although we do not have information on what these costs may be, we do have information on the number of hearing sessions for the cases in our sample. Each hearing session is a half day and there are typically 2 hearing sessions per day. The average case in our sample has 3.6 hearing sessions which would equate to roughly two days in hearings. As might be expected, the number of hearing sessions increases with the size of the claim. Cases over $250,000 average 8 hearing sessions. The US General Services Administration publishes per diem rates for lodging and meals. In 2006, the average per diem rate for all cities in the contiguous United States was $139. It is worth noting, however, that hearings are typically held in larger cities where costs of lodging and meals are likely higher than average. Claimants (and respondents) would also face travel costs to and from the city in which the hearings occurred.

Finally, there are legal costs for attorneys and experts. Claimant attorneys often work on a contingency basis. The typical contingency fee is 1/3 of the amount awarded before fees. Although claimants may not hire expert witnesses, it is often the case that respondents do. If there is a perceived disadvantage to a lack of an expert, then claims may be compromised without an opposing expert testifying on behalf of the claimant. Realistically, large cases likely require claimants to hire an expert, if for no other reason than to counter respondents' experts.

Although we do not have numerical estimates for fees other than forum fees, it is interesting to estimate how the fees would ultimately affect the amounts that claimants receive on average by participating in the arbitration process. For example, assume an investor is bringing a $500,000 claim against a top 20 brokerage firm. Our previous analysis suggests that claimants in a case over $250,000 can expect to recover approximately 12%. That amount in a $500,000 claim is $60,000. If the claimant attorney takes 1/3 before fees, the claimant is left with $40,000. In our sample, average

[25] This figure represents the sum of all forum fees divided by the sum of all awards.

forum fees for large cases are $4,000 per case. Once these fees are paid, the claimant has $36,000. In a large case such as in this example, it is almost certain that claimant will hire an expert witness. The cost of an expert may range from $5,000 to as much as $25,000 depending on the type of case. If we assume that claimant hires an expert witness and pays $10,000 for the expert's services, this reduces the claimant's take to $26,000. The claimant also spent an average of 4 days out of town (average of 8 hearing sessions per case on large cases) and incurred the associated travel, lodging and meal costs. If we assume conservatively that the hearing was in the claimant's hometown, requiring zero travel costs, the claimant netted $26,000 on a $500,000 case. The award is 5.2% of the original $500,000 claim.

As a practical matter, given the low expected recovery percentages, especially for large cases against large firms, and the significant cost to pursue these claims, very careful consideration is required before the decision is made to pursue claims under the mandatory arbitration process.

Critics of studies that look at arbitration outcomes point to the fact that many, if not the majority, of claims brought against securities firms are settled rather than taken all the way through arbitration. The typical criticism suggests that more meritorious cases are settled while those with less merit proceed through to arbitration. Therefore attempts to assess the fairness of mandatory arbitration are biased by only considering those cases that end up being arbitrated. Such criticism is clearly anecdotal. Because settlement agreements are confidential, there is no way to analyze the typical or average settlement outcome. However, even settlement terms would be influenced by the perception of an unfair arbitration process.

Brokerage firms and claimants negotiate settlements against the backdrop of probable arbitration outcomes. Settlement offers from both sides will be influenced by what they expect an arbitration panel to decide. In an environment where expected recovery rates are low, respondents would tend to offer less and claimants would tend to accept less in settlement. This outcome would likely occur even if arbitration recovery rates were low expressly because the claims that reached arbitration had little merit. Claimants in arbitration have absolutely no idea about the merits of settled claims relative to arbitrated claims and so must assume a priori that they are similar in merit.[26]

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[26] Claimant attorneys may have some prior experience with cases and have some knowledge about the relative merits of cases. However, their experience is much less extensive than large brokerage firms that have arbitrated and/or settled hundreds of claims.

Importantly, respondents, who are typically repeat participants in the process, may have a better feel for the merits of settled versus arbitrated claims. Settled claims against their own firm are effectively "inside information" about securities litigation that may give them an edge in assessing how or whether to settle a case.

Clearly the outcome of settled cases and arbitrated cases are closely related. Since the only publicly available data is on arbitrated cases, that data will influence how claimants and respondents approach settlement. If one party appears to have an unfair advantage in arbitration, that same party will likely fare better in settlement. It is not possible to make the statement that claims that settle have more merit - the fact that they settle and the terms of the settlement are closely linked to expected outcomes in arbitration.

Claimants' risk-aversion will also influence whether a case settles or proceeds to arbitration. The advantage to settlement is to receive an assured payout rather than face an uncertain payout that results from arbitration. The more averse to risk the claimant, the lower amount he will take in settlement. This compounds any perceived unfairness in the arbitration process.

Consider an example where an investor has a $100,000 claim. Although merit is a subjective judgment, assume for the example that the brokerage firm also agrees that the investor has been wronged and the fair amount of damages is $100,000. Further assume that the investor has never endured the arbitration process and the investor's only knowledge of arbitration outcomes is the statistical data which suggests that investors win half the time and when they do, they garner 50% of their claimed damages. How will such a case be approached in settlement negotiations? The claimant would believe from the data that his expected recovery in arbitration is 25%. However, there is a high degree of uncertainty. It might be greater or less than 25% (which would, in this example, be $25,000). A risk-neutral claimant would accept a settlement offer of $25,000 or more, but would not accept an offer of less than $25,000. A risk-averse claimant would accept $25,000, but would also accept something less than $25,000. The brokerage firm knows the same statistics about arbitrated claims and would therefore not likely offer even $25,000. Such a case will likely settle for something less than $25,000 even if both parties agree that the case is worth $100,000. This example is not unlike any other settlement example that could occur in cases that would go to a jury trial. However, the difference is in the perceived fairness of what will happen if the case does not settle. The only information the claimant has is that he must arbitrate his claim if it does not settle and that such arbitrations result in a highly uncertain recovery rate that averages 25% of the claim. If jury-tried securities cases resulted in higher expected recovery rates, settlements would be at higher amounts and would likely occur more often.

The more risk-averse the claimant, the lower amount he will accept in settlement.[27] It is also likely that, all other things being equal, risk-averse investors are more likely to have cases against financial services firms. Approximately 35% of the cases in our sample involve the issue of suitability (in many claims there are a number of causes listed in the claim statement). Although there may be cases involving investments that are not suitable because they are too conservative for investors, it is far more likely that claims with significant damages arise from investment strategies that are too aggressive for investors. Therefore the sub-sample of all investors that find themselves in arbitrations against financial services firms is likely more risk-averse than the universe of all investors. This heightened risk aversion for claimants in general decreases the amount the average claimant will accept in settlement.

It will be up to the courts to determine whether it is consistent with public policy to require all investors to submit to this mandatory process, and to forego their Seventh Amendment right to a jury trial,[28] as a condition to engaging in a securities transaction.[29]

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[27] In the preceding example, very risk-averse investors would accept much less than $25,000.

[28] USCS Const. Amend. 7

[29] If a Court were to determine that the mandatory arbitration process is systemically unfair to investors, there is ample precedent permitting it to refuse to enforce the arbitration clause. *Walker et al v. Ryan's Family Steak Houses, Inc.*, 400 F.3d 370, 385-88 (6th Cir. 2005) (bias exists where the "arbitration-selection process itself is fundamentally unfair"); *McMullen v. Meijer, Inc.*, 355 F.3d 485, 494 (6th Cir. 2004) ("When the process used to select the arbitrator is fundamentally unfair, as in this case, the arbitral forum is not an effective substitute for a judicial forum, and there is no need to present separate evidence of bias or corruption in the particular arbitrator selected"); *Hooters of America, Inc. v. Phillips*, 173 F. 3d 933, 938 (4th Cir. 1999) (arbitration system where party who drafted arbitration agreement is a "a sham system … crafted to ensure a biased decision-maker").