United States Senate

Committee on the Judiciary

Subcommittee on the Constitution

Hearing on S. 1782

THE ARBITRATION FAIRNESS ACT OF 2007

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

My name is Laurence Schultz. I have been representing public investors in claims against brokerage firms for more than 20 years. I am President of the Public Investors Arbitration Bar Association. PIABA is honored to present its position in support of the proposed Arbitration Fairness Act of 2007, S. 1782.

INTRODUCTION

PIABA was organized in 1990. We are a national bar association with approximately 470 members who represent investors throughout the nation in arbitration disputes against members of the securities industry. Our members have represented tens of thousands of investors in arbitration and have arbitrated many thousands of cases against the brokerage industry. The vast majority of our clients seek to recover lost savings and retirement funds. Many are retirees with no independent ability to replace their losses.

PIABA is dedicated to arbitration as an alternative method of dispute resolution for investors, provided the system is voluntary, provides neutral arbitrators and is fairly administered with neutral rules and procedures. To this end our members have worked with major arbitration forums in developing their arbitration rules and initiated many proposed rule and procedural changes designed to bring neutrality and fairness to the arbitration system. Some of these efforts have resulted in improvements in the arbitration system. None of these improvements alters the undeniable fact that the current investor arbitration system is neither voluntary nor unbiased. Nor is it fair to investors. Yet the industry has succeeded in forcing investors into mandatory arbitration as a condition of doing business with the brokerage industry.

PIABA supports investor choice. Arbitration of securities disputes, if held before a fair and impartial panel, can be attractive to investors. However, the choice to submit to arbitration must be made *after* the dispute has arisen in order to be considered truly voluntary. What we have now is a situation where mandatory arbitration clauses are foisted on consumers before any dispute even arises. These pre-dispute arbitration clauses are routinely enforced by the courts without regard to fairness or neutrality. This was not always the case.

THE HISTORICAL EROSION OF INVESTOR CHOICE

Just twenty years ago, many investors had the right to choose between court and arbitration after a dispute arose. The blanket imposition of mandatory arbitration on investors dates back to the Supreme Court's decision in *Shearson/American Express, Inc. v McMahon*[1] in 1987. Prior to the *McMahon* decision, various brokerage firms included mandatory arbitration clauses in their documentation, mostly in margin or

[1] 482 U.S. 220, 107 S.Ct. 2332 (1987).

option account agreements. But courts had often held these mandatory arbitration provisions unenforceable, and the SEC had adopted a rule prohibiting their use in claims arising under the federal securities laws.[2] In *McMahon* the Supreme Court reversed 34 years of established legal precedent and held that brokerage firms could enforce mandatory arbitration clauses against their clients even in cases involving federal statutes.

When *McMahon* was decided, the SEC found in a survey of brokerage firms that "96% of the margin accounts, 95% of the options accounts and 39% of the cash accounts" were subject to predispute arbitration clauses.[3] The survey also indicated that there was a movement toward putting these agreements in cash accounts. SEC Chairman Ruder testified to Congress,

> "I expressed vocally and vociferously my opposition to that trend. I believed then, and I believe now, that customer choice is an exceedingly important aspect of this industry and the movement apparently to push these clauses on the public so that they couldn't trade at all without them was in my mind simply terrible."[4]

In response, the investment firms gave assurances to the SEC that they did not intend to impose arbitration clauses in cash accounts and thus deprive American

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[2] Exchange Act Rule 15c2-2, "Disclosure Regarding Recourse to the Courts Notwithstanding Arbitration Clauses in Broker-Dealer Customer Agreements."

[3] Letter from SEC Chairman David Ruder to New York Stock Exchange, July 8, 1988, in ARBITRATION REFORM: HEARINGS BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE OF THE COMMITTEE ON ENERGY AND COMMERCE, HOUSE OF REPRESENTATIVES, 100TH CONGRESS, 2ND SESSION, ON MARCH 31, JUNE 9, AND JULY 12, 1988 (U.S. G.P.O., 1989), at p. 510. Similarly, James Buck, Sr. V.P. of the New York Stock Exchange, testified in that same hearing, "Most firms do not require arbitration agreements for cash accounts. Only in the case of margin accounts where the customer is borrowing money do you find overwhelming use of these clauses." *Id.* at p. 533.

[4] *Id.*, p. 512, Testimony of July 12, 1988. Chairman Ruder also testified to Congress on June 1, 1988, "I fail to see why one should deny access to the securities market to those people who are unwilling to waive their disputes in advance. I think it's unfair." See *id.*, p. 524.

consumers of any choice.[5] Based on those assurances, the SEC backed away from legislation prohibiting pre-dispute mandatory arbitration clauses.

Today the situation is much different. Virtually every brokerage firm in America includes a mandatory arbitration provision in its account documentation for every type of account, including cash accounts. Even consumers who open a self-directed cash account at major discount brokerage firms like Charles Schwab, Fidelity, and Vanguard Brokerage Services must accept the mandatory arbitration provision. The provisions are almost always non-negotiable. The result is that if Americans want to buy a stock or a bond or seek to participate in the capital markets in America, they must give up their constitutional right to a jury trial before an independent and impartial judiciary and, instead, submit to mandatory arbitration.[6]

The number and types of American consumers who invest have also changed since the days before *McMahon*. The number of households who own stocks "has increased more than three-fold since the early 1980s."[7] Half of all U.S. households own shares of stock or stock mutual funds. Capital markets are not just for the wealthy, but hold the retirement hopes and financial security for consumers from all walks of life. And those ordinary Americans are increasingly older; indeed, seniors are the fastest growing segment of investing consumers.[8] They are also the most vulnerable to abuse by financial advisors and to unjust and unfair outcomes in mandatory arbitration.

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[5] *Id.*, pp. 474 ("many industry members will not require pre-dispute arbitration clauses in cash account agreements"), 514-516.

[6] Most investors, when they open their accounts, are not aware that mandatory arbitration is being imposed on them as a condition of investing. Customers are told by brokers that these new account documents are routine and must be signed in order to have an account with the firm.

[7] Investment Company Institute & Securities Industry Association, Equity Ownership in America, 2005 (Nov. 2005), Chapter 1, http://www.ici.org/pdf/rpt_05_equity_owners.pdf.

[8] *See id.*, Chapter 2.

Mandatory securities arbitration today must be conducted in a system run by the dispute resolution arm of the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization formed by the recent merger of the regulatory divisions of the New York Stock Exchange and the National Association of Securities Dealers.

Requiring arbitration before a single industry forum is a dramatic change from the arbitration alternatives in place when *McMahon* was decided. At the time of *McMahon* there were at least ten different arbitration forums. Most stock exchanges provided arbitration alternatives. Many arbitration clauses, and the rules of the American Stock Exchange, gave investors the option of avoiding arbitrating in an arbitration forum associated with the securities industry by allowing arbitration before the American Arbitration Association. So while investors may have had to arbitrate in response to *McMahon*, they could still choose among various arbitration forums. Different forums had different rules, different policies, different administrators and most important, different pools of arbitrators. These options were important in attempting to obtain fair process and just outcomes for investors.

Now all these options are effectively gone for ordinary investors. Over the last decade, we have seen a consolidation of the American securities markets, which recently culminated in the merger of the New York Stock Exchange and the National Association of Securities Dealers. Investors with pre-dispute arbitration clauses (virtually all investors) are forced into the only game left in town. The only available arbitration system is run by an association whose membership is made up of brokerage firms. FINRA now has a virtual monopoly on investor dispute resolution. There is no meaningful competition among arbitration forums. There is no alternative other than arbitration. The Arbitration Fairness Act of 2007 will remedy this situation by giving

investing consumers a meaningful choice and restoring their right of access to the third branch of government – the courts.

Investor choice is the best option.

THE PLAYING FIELD IS TILTED AGAINST THE INVESTOR

As stated above, PIABA supports voluntary, arbitration, before a fair and unbiased panel of arbitrators pursuant to an agreement entered into after a dispute has arisen. A hallmark of the American judicial system is that both parties have a right to have their claims heard before a tribunal that is neutral, independent and unbiased. Unfortunately, investors can have no confidence that this is the case under the current, mandated system.

Investors who are required to arbitrate their disputes before FINRA appointed panels are often shocked to learn that FINRA rules require that one member of each three-member panel be from the securities industry. These individuals are often employed by brokerage firms as branch office managers or compliance officials, or even as attorneys who represent brokerage firms against investors in arbitrations. The mandatory participation of an industry representative on the arbitration panel creates an *appearance* of impropriety and bias. A consumer bringing a complaint is faced with a panel that appears to be a stacked deck. Bias or impropriety is perceived by the investor before the first word is spoken. By contrast, an investor plaintiff in a jury trial is entitled to exercise a challenge to a potential juror with a background in the securities industry. The very participation of an industry arbitrator undermines the credibility of the forum.

The brokerage industry insists that an industry arbitrator is needed on every three-person panel so that someone on the panel will have knowledge of the securities industry, effectively providing an "expert" on the panel. If this rationale ever had any basis in fact, it has disappeared over the years. As arbitration has become mandatory, and is now the "only game in town," it has become more sophisticated. Cases are typically presented by lawyers and last several days. Lawyers for both sides commonly use retained expert witnesses to present evidence of industry practices, rules and procedures. Requiring another "expert" on the panel provides no value to the process, and cannot be justified particularly in view of the resulting appearance of bias.

Unfortunately for investors, the so-called "expertise," which the industry arbitrators bring to the table is often no more than bias. The industry panelist is pre-disposed to condone industry practices that have become institutionalized, and apply those standards rather than the practices mandated by FINRA, the SEC, or even securities laws passed by Congress or the states. The temptation is always very strong for industry arbitrators to condone inappropriate practices which have become the norm.

Examples of industry-wide abuses which have become routine practice throughout the brokerage industry, include:

1. Retirement seminar fraud;
2. Recommendations to retail customers based on research tainted by investment banking conflicts of interest;
3. Unsuitable sales of high-commission variable annuities, particularly to elderly investors;
4. Ignoring mutual fund break points; and
5. Improper sales of mutual fund B shares.

How can a branch manager or compliance officer serving as an arbitrator be expected to award an investor damages for these kinds of cases, when the arbitrator has the same conduct going on within his own firm, and perhaps his own office? To

make matters worse, in sharp contrast to jury *voir dire* in court, FINRA arbitrators cannot be compelled to answer questions concerning their potential biases. Thus, an investor is simply in the dark as to what kinds of industry-wide wrongdoing the industry panelist or his/her firm may have engaged in previously, and how this could affect the outcome of the case.

Even today, as brokerage-sponsored hedge funds collapse and losses are sustained in bond funds filled with sub-prime paper, will industry arbitrators -- whose own firms may be involved in similarly deceptive practices – regard such conduct as deserving of damages? Or will they instead perceive these practices as the way business is done in the real world? And if the industry arbitrator finds the conduct unworthy of condemnation, it stands to reason that he or she will share his view with the other arbitrators, who often consider the industry arbitrator to be the FINRA – approved source of industry expertise. Thus, the non-industry arbitrators may be persuaded that what ought to be treated as an industry-wide scandal is simply business as usual.

A further source for conflict on the part of the industry arbitrator arises out of the increasing wave of mergers and consolidations in the securities industry. Today's Piper Jaffray broker may be a UBS Financial broker the next week. Yesterday's A.G. Edwards branch manager is today's Wachovia branch manager. That same manager may need to compete with another Wachovia branch manager for appointment to the manager's position. How severely can he be expected to sanction a firm that may be considering him for employment in the not-too-distant future? Perhaps this revolving door at the major firms helps to explain why, according to one survey of FINRA

arbitration, investors have a much tougher time recovering their losses from the large brokerage firms than the smaller ones.[9]

There are other disparities between the impartiality of the court system and the systemic bias that results from mandatory arbitration. For example, investor advocates have long complained that FINRA permits arbitrators with financial ties to the securities industry (*i.e.,* attorneys whose firms perform work for a securities firm) to serve as public arbitrators. While FINRA has acknowledged this issue and is making progress on it, the rules still permit arbitrators with certain ties to the industry to serve as non-industry arbitrators. For example, attorneys who represent brokerage firms and therefore may be biased in their favor are allowed to serve as public arbitrators. In any courtroom, an investor would be entitled to remove this person from a jury for cause. In FINRA arbitration there is no such right.

In short, the current arbitration forum to which every investor must resort is systemically biased. Many of the individuals involved may have only the best of intentions; yet it is impossible to deny that there is an appearance of bias. No investor pursuing an arbitration claim against a brokerage firm can help but question the impartiality of an arbitrator who works for the brokerage industry, or an attorney who has brokerage firm clients.

PIABA believes that many of these systemic problems would be resolved quite rapidly if investors could choose between court and arbitration. In such an event the administrators of industry arbitration would have every incentive to make their forum attractive to investors.

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[9] *See* Edward . O'Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes – A Statistical Analysis of How Investors Fare* 17 (2007), http://www.slcg.com/pdf/news/Mandatory %20Arbitration%20Study.pdf, pp. 10, 15-16. While PIABA did not participate in this study, its findings are consistent with the experiences of our members.

FINRA'S ARBITRATION RESULTS DEMONSTRATE UNFAIRNESS

For the year 2006, FINRA reported that 58% of the arbitrations decided were dismissals of investor claims. It is noteworthy that investors were assessed fees and costs by arbitrators in the vast majority of those decisions. FINRA characterizes the remaining 42% of the decisions as customer "wins" irrespective of the amounts awarded. Thus, FINRA regards an award of as little as $1 as a customer "win". In some "win" cases the amount awarded to the investor was actually exceeded by administrative fees and costs assessed to the investor by the arbitrators. The 42% "win" rate is the lowest on record for FINRA arbitrations and is a decline from win rates of 61% as recently as 1999. The consistent decline of the "win" rate has been an alarming trend in FINRA arbitrations, and is further indication of a bias in the system.[10]

The study performed by Daniel Solin and Edward O'Neal, Ph.D. drew similar conclusions, and further concluded that investors pursuing claims against large FINRA-member firms tended to fare far worse than those pursuing claims against smaller firms.[11]

Nor is the declining success rate for public customers limited in its impact to those cases which go to hearing. Faced with these kinds of results in an arbitration system to which they must submit, investors are forced to accept unfavorable settlements which actually compound the impact of the unfairness to investors. In fact, a standard tactic of mediators retained through FINRA trying to reach a settlement before cases go to hearing is to urge investors to settle for far less than their actual losses by

[10] The Securities Industry Conference on Arbitration, formed with the cooperation of the Securities and Exchange Commission, is conducting a neutral survey concerning fairness of the arbitration process. Parties and counsel on both sides have received SICA questionnaires. PIABA welcomes and looks forward to the results of the SICA survey.

[11] *See* footnote 10.

showing them statistics demonstrating that even when customers win at FINRA they only recover a fraction of their damages.

INVESTORS ARE DENIED THEIR LEGAL RIGHTS

As a general proposition, arbitration awards are final and binding on the parties, and are not subject to correction for errors of law or fact. Motions for vacatur of arbitration awards can be based on just few narrow grounds, such as corruption, fraud and arbitrator misconduct.[12] Such motions are granted only in the rarest of circumstances.

Even more disturbing is the concern that arbitrators are subject to little or no oversight. Courts have repeatedly held that the fact that arbitrators may have made legal errors is no basis for vacating their awards. Although the securities arbitration claims often require consideration of complicated legal issues there is no requirement that arbitrators be lawyers. In fact, the limited training that FINRA provides to arbitrators does not cover basic issues of substantive law such as state investor protection statutes. SRO arbitrators show a general aversion to applying any statutory remedies the way the state legislatures intended. State securities laws and consumer fraud statutes are routinely ignored. Arbitrators speaking at conferences have stated that they and their colleagues think that statutory remedies are "draconian." A recent study of NASD arbitration awards in Florida revealed that where arbitrators found liability to a standard equal to or greater than the requirements for liability under Florida's state

[12] *See* the Federal Arbitration Act, 9 U.S.C. § 10.

securities act, they failed to award the statutory remedy in nearly 48% of the applicable cases![13]

In court, a judge is a trained and experienced attorney who is duty-bound to apply the law. And the judge's legal rulings are subject to review by appellate judges, who are equally duty-bound to follow the law. By contrast, legal rulings are made in arbitrations by panelists who may not even be attorneys, and those rulings are not subject to any meaningful review. As a result, consumers who have lost their life's savings get one shot at an arbitration panel, with no confidence that the law will be followed, and will have no recourse even if the legal rulings are clearly wrong.

The framers of the Constitution preserved the right to a jury trial for a reason. To an investor who has lost everything, no proceeding will ever be as important as his/her case to get the money back. There is no room for error in such a case. The expediency of resolving disputes by arbitration, while laudable, should not be forced upon such an investor. An investor should be able to choose to arbitrate a dispute after the dispute has arisen. Otherwise, the investor must be permitted to go to court, where constitutional rights will be protected.

THE INDUSTRY'S ABUSE OF ARBITRATION DISCOVERY RULES

Perhaps the best example of brokerage industry abuses that have been a continuing part of the FINRA mandatory arbitration process has been in the area of arbitration discovery. Prominent brokerage firms defending against investor claims have repeatedly ignored the arbitration discovery rules to the detriment of investors

[13] Mark A. Tepper, *SRO Arbitration: Is It Fair To Investors?*, 13(4) PIABA B.J. 51 (Winter 2006). The disregard of legislative remedies was substantially higher in three-person panels containing an industry arbitrator than in cases decided by a sole public arbitrator.

trying to recover their losses. Unfortunately there has been little significant consequence to the offending firms.

Arbitration discovery is limited in that it does not provide for depositions or interrogatories. This is consistent with the purpose of arbitration, which is to provide a streamlined dispute resolution process. However, discovery of documents is an essential part of the rules. Obviously if brokerage firms are allowed to conceal unfavorable documents, investors will often be unable to successfully prove their claims.

Investor advocates have long complained that arbitrators were allowing the brokerage industry to abuse and even ignore document production obligations under the FINRA arbitration rules. These complaints were not without substance. Caught red-handed in several cases, in 2004 Merrill Lynch, Morgan Stanley and Citigroup were fined $250,000 each by FINRA for not producing documents in violation of discovery rules.

Unfortunately, these fines were nominal. The 20 cases cited by FINRA in its disciplinary proceeding represented only a fraction of those investors whose cases were prejudiced. Investors who were damaged by the discovery abuse recovered nothing from the sanctions and, because the fines were smaller than the gains from the brokerage firms' misconduct. There was no meaningful deterrence. The self regulatory system had failed.

The absence of deterrence was resoundingly clear in the case of Morgan Stanley. During this very period, and at least until March of 2005, Morgan Stanley refused to produce e-mails in thousands of arbitrations claiming the e-mails had been destroyed in the terrorist attacks of September 11, 2001. Finally, in September 2007 FINRA announced that Morgan Stanley's statements to the arbitration panels about the

destruction of these e-mails were false. Morgan Stanley cynically used 9/11 as a ruse to withhold documents from thousands of investors.

Morgan Stanley's 9/11 arbitration fraud continued for at least three and a half years and involved thousands of investors, many of whom lost their cases, were awarded reduced amounts or accepted reduced settlements. Morgan Stanley totally undermined the integrity of the arbitration process. For this, Morgan Stanley was fined just $12.5 million, of which just $9.5 million was set aside for the thousands of investors who were damaged by the fraud. The sum of $12.5 million is meaningless to Morgan Stanley. It represents just .025% of Morgan Stanley's 2006 revenues of over $50 billion. And the sum of $9.5 million spread among thousands of investors cannot begin to compensate them for the resulting damages.

More important, the fine does nothing to repair the damage done to the arbitration process, which no one with any modicum of integrity can claim was fair to Morgan Stanley investors. Had Morgan Stanley been required to resolve some of its clients' claims in court, rather than arbitration, there can be little doubt that this ongoing fraud would have been exposed earlier. Indeed, given the *in terrorem* effect of court sanctions and the contempt power, one would expect that Morgan Stanley would never have tried to get away with such an audacious scheme. If investor choice were still the law, this systematic fraud on the investing public (Morgan Stanley's own customers) would likely have been averted.

INDUSTRY'S AND REGULATORS' CONTENTION THAT ARBITRATION IS FAIR

Representatives of the securities industry, and a few regulatory authorities, contend that arbitration is fair and therefore should remain mandatory. This specious reasoning is perhaps one of the best arguments to bar mandatory arbitration.

If the securities industry and these regulators truly believe the current system is fair as it is presently constituted, they should have no concern over making it voluntary. To the contrary, if it is indeed as fair as their claims would suggest, the arbitration system should not only survive, but it should continue to attract the majority of investor claims on a voluntary basis.

Unfortunately, the securities industry has engaged in a concerted campaign to conceal the true state of affairs in the existing system of mandatory arbitration of investor disputes. For example, in October 2007, the Securities Industry and Financial Markets Association ("SIFMA") issued a purported "white paper" on securities arbitration that referred to arbitration as the "success story of an investor protection focused institution."[14]

Notwithstanding the fact that this entire paper was prepared by employees of the securities industry and/or outside counsel who serve the securities industry (without any apparent involvement of either public investors or any other neutral participants in the arbitration forum), SIFMA still had to smudge their own statistical analyses in order to support their thesis. For example, in order to support the primary contention in the paper, that the "Total Percentage of Claimants Who Recover Damages or Other Relief in Arbitration or By Settlement is Favorable," SIFMA had to include thousands of cases where brokerage firms themselves were the "Claimant."

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[14] http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

THE SHROUD OF SECRECY

Another problem which plagues the arbitration process is excessive secrecy .The public, the press, and other investors with claims similar to those being heard, have no right to attend arbitration hearings. They would not be barred from the courtroom. It is difficult to see who, other than
brokerage firms, benefits from this secrecy. Arbitration hearings are even off limits to securities regulators. This is anomalous and unfortunate because in addition to the SEC's role in overseeing the arbitration process, one of the original rationales for allowing private suits under provisions
of the federal securities laws was to act as a "necessary supplement to Commission action."[15] Arbitration secrecy denies both the SEC and state regulators direct evidence of securities violations that has a direct and often devastating impact on the investing public and American capital markets.

Arbitration secrecy promotes a divide and conquer mentality, and the brokerage firms take advantage of that tactic. They try to prevent shared discovery in multiple victim cases. They also (a) conceal documents in one case after those same documents have already been produced in other arbitrations; (b) tell different stories to different arbitration panels; and (c) repeat arguments to a second panel when the same argument has been rejected by a different panel (in court, "judicial estoppel" would stop that tactic). By hiding documents, preventing access to witnesses, tailoring stories, and fomenting inconsistent results, they successfully avoid full responsibility for their misconduct. And the hapless consumer often goes home with nothing, or with a paltry incomprehensible "award."

[15] *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

CONCLUSION

In fairness to America's 90 million savers and investors, mandatory securities arbitration must be ended. Forcing investors into mandatory arbitration as a condition of buying and selling securities is fundamentally unfair. Only Congress can provide the necessary remedy, and that remedy is consumer choice. The Arbitration Fairness Act of 2007 provides that remedy. PIABA is pleased to support the bill.

We thank you for the opportunity to be heard on this important issue.

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