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On

A Review of the Securities Arbitration System

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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 or 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.