



Testimony

of

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NASD Dispute Resolution

Before the

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Sponsored Enterprises**

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

Executive Summary

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

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

NASD

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

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

Introduction to Securities Arbitration

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

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

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

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

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

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

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

Improving Transparency for Investors

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

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

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

Arbitrator Disclosure of Conflicts of Interest

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

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

Improving the Quality of Arbitration

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

The Arbitrators and Mediators

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

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

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

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

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

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

Neutral List Selection System

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

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

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

Removal of Arbitrators from the Roster

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

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

Ensuring the Integrity of the Arbitration Process

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

The Discovery Process

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

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

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

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

Classification of Arbitrators

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

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

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

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

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

Unpaid Awards

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

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

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

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

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

Helping Investors with the Process

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

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

Conclusion

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