United States House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises

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

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

INTRODUCTION

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

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

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

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

SPECIFIC ISSUES OF CONCERN

1. Elimination of the Mandatory Industry Arbitrator

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

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

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

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

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

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

Perhaps most compelling is the experience of the past few years. Revelation of cases involving industry-wide wrongful conduct highlights the importance of taking away the mandatory industry arbitrator. The mutual fund scandal is a telling example. The industry had common, institutionalized practices of undisclosed fees, which motivated the brokers to sell certain types of mutual funds to customers, whether they were in the best interests of the customer or not. Having a branch manager from one of the other firms engaging in this practice sitting on an arbitration panel is not fair. The use of industry arbitrators tends to give rise to institutionalization of wrongful and fraudulent practices that become industry wide.

Another telling example arises in cases involving the wrongful sale of fee laden variable annuities[2] to retirees. The NASD, SEC and numerous financial writers have condemned the over-sale of variable annuities. Yet, the investor is often forced to have his claim for unsuitable sale of variable annuities heard by an arbitrator whose employer is reaping massive profits from sales of variable annuities to the same types of clients.

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

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

2. <u>Overly Broad Definition of Who May Serve As "Public" Arbitrators</u>

Compounding the problems created by the mandatory presence of "non-public" arbitrators on three-member arbitration panels is what has historically been the SROs overly-broad definitions of who may serve as "public" arbitrators. "Public" arbitrators can - by virtue of their ties to the securities, insurance and financial services industry - have a more negative effect on a customer's rights in arbitration than the mandated "non-public" arbitrator addressed above. This problem continues to grow as various sectors of the financial services industry continue to consolidate their operations in the admitted quest for "capturing assets" and offering the consumer “one-stop shopping.” The arbitration rules of the SROs regarding who qualifies as a “public” arbitrator for the purposes of customer-member arbitrations have simply not kept pace with this reality.

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

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

3. <u>Industry Abuses of the Arbitration Discovery Process</u>

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

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

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

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

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

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

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

4. Unpaid Arbitration Awards

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

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been "grossly negligent" in turning over requested documents, destroying e-mails and representing to the court that everything required to be produced had been produced, when in fact, it hadn't. *See* "Morgan Stanley Loses Early Round in Case Filed by Perelman," Susanne Craig, *Wall Street Journal*, Page C1, March 9, 2005. The article also noted that MSDW and two other firms had been fined by the NASD for failing to turn over documents in almost two requirements and no mandatory bonding or insurance requirements, entities whose entire reason for existing is to fleece unsuspecting investors take as much money as they can and then simply cease to exist.[4]

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

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

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

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

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

5. <u>Expediting Reform of Arbitration at the New York Stock Exchange</u>

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

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

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

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

CONCLUSION

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

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out as advisors and guardians of an investor's money for less than the cost of a new car.