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U.S. House of Representatives

Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

Washington, DC 20515

ROOM H2-316
HOUSE OFFICE BUILDING ANNEX NO. 2
PHONE (202) 226-2424

LAWRENCE R. SIDMAN
CHIEF COUNSEL AND STAFF DIRECTOR

March 28, 1988

MEMORANDUM

TO: TELECOMMUNICATIONS AND FINANCE MEMBERS AND STAFF

FROM: EDWARD J. MARKEY, CHAIRMAN

SUBJECT: Fairness and Effectiveness of the Current Arbitration Process in Broker-Dealer/Client Disputes.

SUMMARY

On Thursday, March 31, 1988, at 9:30 a.m., in room 2322 Rayburn House Office Building, the Subcommittee on Telecommunications and Finance will hold a hearing on the arbitration of broker-dealer/client disputes.

Witnesses will include:

Panel I

Mr. Stephen Brobeck, Executive Director for Consumers Federation of America

Theodore G. Eppenstein, Esquire, plaintiff's attorney experienced in securities arbitration; represented the McMahons in Shearson v. McMahon

Stephen L. Hammerman, Esquire, Executive Vice President, CAO and General Counsel, Merrill Lynch, Pierce, Fenner & Smith, Incorporated

Theodore A. Krebsbach, Esquire, First Vice President, Associate General Counsel, Shearson Lehman Brothers, Inc.; attorney representing Shearson/American Express during the McMahon Supreme Court decision

Panel II

Sheldon H. Elsen, Esquire, Co-Chairman of the American Bar Association Task force on Securities Arbitration

Professor Constantine N. Katsoris, Fordham University School of Law

Professor Norman S. Poser, Brooklyn Law School

Tower C. Snow, Jr., Esquire, Co-Chairman of the American Bar Association Task force on Securities Arbitration

The witnesses have been invited to testify before the Subcommittee to describe their views as to the fundamental fairness of the arbitration system and to comment on the voluntariness of arbitration agreements. The hearing will consist of two panels. Professionals who represent investors and the industry during the arbitration process and the Executive Director of Consumers Federation of America will constitute Panel I. Panel II will consist of academics and lawyers who have studied the arbitration process, and are well versed in this issue. They will discuss whether the current system works in producing "justice" consistent with the traditional American concept of a fair trial. Does the efficiency and inexpensiveness of arbitration compensate for sometimes hasty and unfair rulings? If the witnesses deem reform necessary, what type of modifications would be necessary to create a superior system for the resolution of broker-dealer/client disputes?

The question of the voluntariness of investor entry into arbitration contracts will also be addressed. After the decision by the Supreme Court in Shearson/American Express v. McMahon, will the client have an option not to sign an arbitration clause, or will they become mandatory if one wishes to participate in the securities markets. Are these contracts of adhesion and should Congress formulate legislation to override the McMahon decision? Members may also want to focus on whether clients sign these agreements with a full understanding that a trial by judge and jury and judicial appeal will be unavailable should a conflict arise.

HISTORY OF SECURITIES ARBITRATION BEFORE SHEARSON

Section 29(a) of the Securities and Exchange Act of 1934 (the '34 Act) is an anti-waiver provision which declares void any agreement to waive "compliance with any provision of the (Act)." Originally, this section of the '34 Act was interpreted to make unenforceable mandatory arbitration clauses in written customer agreements. The 1953 U.S. Supreme Court case, Wilko v. Swan, held that matters in dispute under the terms of the 1933 Securities and Exchange Act (the '33 Act) were not subject to compulsory arbitration under an arbitration agreement. The Wilko decision established a broad presumption regarding the ineffectiveness of predispute arbitration agreements for causes of action arising under the federal securities laws. Until recently, the U.S. Securities and Exchange Commission (SEC) was clear in its opposition to mandatory arbitration agreements. In 1983, the SEC issued Rule 15c 2-2 which, in part, declared:

> "Requiring the signing of an arbitration agreement without adequate disclosure as to its meaning and effect violates standards of fair dealing with customers and constitutes conduct that is inconsistent with just and equitable principles of trade. In addition, they raise serious questions of compliance with the anti-fraud provisions of the federal securities laws."

An interesting comparison lies within the Commodity and Exchange Act (CEA), written by Congress in the mid 70's in such a way as to expressly forbid mandatory arbitration clauses in written customer agreements. This Congressional intent is clearly expressed in the rules of conduct for the Chicago Board of Trade (CBOT) and consumer education materials distributed by the National Futures Association (NFA), the self-regulatory organization of the commodities industry.

THE DIVISION ON THE COURT OVER SHEARSON

In finding for the plaintiff, Shearson, that the arbitration clause contained in its written customer agreement with the defendants, the McMahons, should be enforceable, the U.S. Supreme Court relied heavily on the terms of the 1924 Federal Arbitration Act (the '24 Act), which upholds the general concept of arbitration as a means of complaint resolution. The '24 Act provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity."

The McMahons argued that their claims of fraud under SEC Rule 10b-5 and the RICO (Racketeer Influenced and Corrupt Organizations) Act should allow them to set aside the arbitration agreement, freeing them to pursue litigation against Shearson. In its majority opinion, the Supreme Court sided with Shearson, holding that "...we have concluded that the streamlined procedures of arbitration comply with the requirements of the statute."

Central to the ruling is the Court's assumption that the reasons for the "judicial mistrust of the arbitral process" evident in the Wilko decision "do not hold true today." Proof of the progress in arbitration, the Court claimed, is to be found in Congress' 1975 amendments to the '33 Act extending the powers of the SEC to include general oversight of the arbitration process, if not particular cases. The majority Shearson opinion notes: "The Commission has had expansive powers to ensure the adequacy of the arbitration process employed by the SROs (self-regulatory organizations)."

In a stinging dissent, Justice Blackmun warned of the consequences of the majority Shearson ruling: "The Court thus approves the abandonment of the judiciary's role in the resolution of claims to the arbitral forces of the securities industry at a time when the industry's abuses toward investors are more apparent than ever."

Blackmun noted that the Shearson majority opinion "accepts uncritically" the SEC's assurances that it now has "sweeping" powers to police the arbitration process. (In citing evidence to the contrary, Blackmun notes that, while the SEC weighed in on the side of the plaintiffs, Shearson, et. al., the Commission had not taken the time to remove its anti-mandatory arbitration Rule 15c 2-2 from the books.) Blackmun suggested that the Court's blind-faith reliance on the SEC was particularly disturbing since the Commission "neither polices nor monitors the results of these arbitrations for possible misapplication of securities law or for indications of how investors fare in these proceedings."

Reflecting the views of the critics of securities arbitration who feel that the process is deeply flawed, Blackmun suggested: "in this era of deregulation, the growth in complaints about the securities industry, many of which find their way to arbitration, parallels the increase in securities violations and suggests a market not adequately controlled by the SROs."

The dissenting justice also catalogued more than half a dozen major aspects of securities arbitration which suggest it does not work to protect consumers. Blackmun dismissed industry claims that those initiating arbitration cases frequently are awarded some amount of money. He pointed out: "Such statistics...do not indicate the damages to which they believe they were entitled. It is possible for an investor to 'prevail' in arbitration while recovering a sum considerably less than the damages he actually incurred."

REACTION TO SHEARSON

The Shearson decision immediately was hailed by the securities industry as a "green light' for brokerage firms to include mandatory arbitration clauses in written customer agreements. Industry officials announced that the decision would save them millions of dollars each year in litigation costs. Robert Love, a special counsel of the SEC Division of Market Regulation, stated in January 1988 that "virtually every securities firm in the U.S." now uses the binding predispute agreements in at least some accounts, particularly contracts involving options and margin trading. Love predicted "most of the ones that don't have them in cash account agreements are in the process of putting them in." Public comments from officials of the Securities Industry Association (SIA) confirm these observations.

Carrying through on its reverse of field in its brief filed with the Supreme Court in the Shearson case, the SEC removed Rule 15c 2-2 from its books in 1987. However, the Commission took a new tack on arbitration on September 10, 1987 in a letter from Robert G. Ketchum, director of the Division of Market Regulation, to the members of the Securities Industry Conference on Arbitration (SICA). The Ketchum letter outlined several specific proposals for reform of the arbitration process. The SEC and SICA are now in the process of discussing the prospects for reform of the arbitration process.

THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION UNIFORM CODE

The Securities Industry Conference on Arbitration (SICA) was established in 1977 at the urging of the SEC to develop a "uniform system of dispute grievance procedure for the adjudication of small claims." SICA was originally comprised of the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, the National Association of Securities Dealers, Inc., the Securities Industry Association and three public representatives.

During 1979 and 1980, the participating self-regulatory organizations adopted the Uniform Code of Arbitration ("Code") as a basis for conducting arbitration. Over the years, SICA members have continued to meet regularly to assess the effectiveness of the Code, and since its adoption, several fine-tuning amendments have been incorporated. The Code set guidelines for the schedule of fees for arbitration, the classification of public arbitrators, number of arbitrators on each panel, arbitrators' disclosures, initiation of proceedings, representation by counsel, determinations of arbitrators, record of proceedings and awards to plaintiffs.

Before being appointed to a panel, each arbitrator is required to disclose to the Director of Arbitration any circumstances which might preclude such arbitrator from rendering an objective and impartial decision. The Director may dismiss any arbitrator if he deems that person unable to formulate an impartial decision. All rulings and determinations of the panel are decided by a majority of the arbitrators.

Presently, all Self-Regulatory Organizations (SROs) subscribe in principle to these arbitration regulations and are governed by the Code. Broker/dealer complaints by investors are usually directed to the self-regulatory organizations.

THE NATURE OF ARBITRABLE COMPLAINTS

The expansion of the markets in the early 1980s created an euphoric mood among brokers and clients alike. Large numbers of inexperienced brokers and inexperienced clients were suddenly brought together. With this atmosphere, brokers began to invest their clients increasingly in more risky investments, often on margins.

Losses were not uncommon and complaints to the SROs and to the Commission increased. Complaints included many forms of misconduct including: churning accounts (trading excessively in order to generate commissions), engaging in unsuitable or unauthorized trading, failing to follow instructions, misrepresentations, market manipulation, and charging excessive markups.

Needless to say, these investors were frequently dismayed to find that upon opening their accounts they had signed the following:

> Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules, then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I [the customer] may elect.

<u>AWARDS IN ARBITRATION PROCEEDINGS</u>

Supporters of arbitration claim that around 50% of all cases before arbitration panels are decided in favor of the client. Opponents state that of those cases that are decided in favor of the client, very few awards amount to much monetarily. Oftentimes an investor may win the case, but receive only a fraction of the damages actually sustained. Punitive damages are rarely awarded, and, many times, the award does not cover the attorneys fees. Exhibits 1 and 2 are compilations of claims and awards compiled by the New York Stock Exchange in 1985 and 1986 for cases involving churning and unsuitability.

As the exibits show, 67 cases out of 71 awarded the plaintiff less money than was claimed. One of the few studies written on arbitration statistics was done by a law professor from Catholic University, David A. Lipton, who found that "in 40 randomly selected cases, more than 57% of the claimants 'won.' But 78% of those were awarded 60% or less of the amount they said they lost."

<u>ARBITRATION IN LIGHT OF THE MARKET CRASH</u>

Since the October 1987 market crash, investor complaints have increased substantially. Following the crash, the North American Securities Administrators Association (NASAA) opened an "800" hotline number to receive complaints dealing with actions by broker/dealers during the decline of the market. Over 6,000 phone calls of this nature were received by NASAA in the first few weeks of the program.

The New York Stock Exchange estimates that about 120 cases have been filed each month since the market crash -- that is a 60% increase over last years totals. The NASD states that 1987 cases grew 82% over the 1986 level, and this year, they estimate an additional 45% increase in the filing of cases for 1988. This influx of customer complaints has caught many arbitration departments and law firms understaffed. There is a scramble to beef up arbitration staffs, but in the meantime, arbitration proceedings are extending longer than normal.

SEC PROPOSALS

In light of the continuing disputes over the effectiveness and fairness of the arbitration process, the SEC has, over the past two years, examined arbitration procedures. It has recently set forth its observations and suggestions in a letter directed to Securities Industry Conference on Arbitration ("SICA") members and dated September 10, 1987. In this letter, the SEC urged that various arbitration practices needed to be reformed.

a. Selection of Arbitrators

The SEC acknowledged the contradictory nature of the need for impartial arbitrators and industry expertise in the same individuals. The SEC recommends that SICA revise the Uniform Code to redefine those who may serve as public arbitrators and to amend the circumstances under which they may serve. Thus, the SEC has suggested that while former employees of the securities industry who have worked outside the industry for three years may serve as "public" arbitrators, this fact should be disclosed to the parties and will sustain a challenge for cause.

The SEC also recommended a thorough check into the disciplinary background of potential arbitrators. To facilitate this procedure, the SEC suggested that a new arbitrator file be created to collect data on arbitrators. SICA has established an arbitrator information card, but the SEC believes that it is not detailed enough to provide necessary information to the parties.

b. Arbitrator Training

Although the SEC accepts arbitration as a just method of resolving disputes, SROs have offered virtually no formal training for arbitrators on matters relating to arbitration law, including the scope of arbitrators' authority, relevant state law, or securities law. The SEC proposes to rectify this void by educating arbitrators through the immediate institution of a regular newsletter and the development of a comprehensive manual for arbitrators. Through these media, arbitrators could follow new securities developments and precedent-setting cases. Also, this would create principle-setting guidelines and a quality standard to govern activities of all arbitrators.

c. Arbitrator Evaluation

The SEC has recommended that in order to ensure the quality of the ongoing performance of arbitrators, a written evaluation be prepared for each arbitrator. These evaluations would consist of comments by parties describing the actions of individual arbitrators. The evaluation system would be structured so as to address competence, preparedness and fairness without interfering with a party's ability to vacate an adverse award.

d. Discovery

Pre-hearing discovery in arbitration cases is covered by exchange arbitration rules. Generally, discovery is quite limited, compared to judicial proceedings. Under existing rules, documents that a party requests pursuant to subpoena do not have to be produced until minutes before a hearing is to begin. There have been many customer complaints over the lack of cooperation over discovery matters. Parties are expected to exchange documents informally, but reality falls short of expectations when objections of privilege or relevance are asserted. There are no established enforcement mechanisms to ensure cooperation.

The SEC recommends that rules be adopted to codify the goal of drawing the arbitrators into the discovery process prior to the hearing of the case. The SEC supports a 20 business day time frame for document requests and a 15 business day time frame for responses.

e. Opinions

The SEC suggests that when arbitrators prepare written opinions, those opinions should be made publicly available through the procedures developed for making available summary data on arbitration results. This will provide guidance to future arbitrators, particularly in large and complex cases.

LEGISLATIVE OPTIONS

Legislative responses to shortcomings in securities arbitration could address either or both of the two large issues, voluntariness and fairness. Legislation could effect the following changes:

- o Forbid conditioning of acceptance of a customer upon the signing of a binding arbitration agreement;
- o Require "plain-English" disclosure of the meaning of the arbitration clause;
- o Disallow "public" arbitrators who have direct or indirect ties to the securities industry (such as lawyers who represent brokerage clients);
- o Require greater disclosure of arbitrators' backgrounds well

in advance of arbitration proceedings;

- o Allow greater discovery well in advance of hearing dates;
- o Require reporting of evidence of law violations to disciplinary authorities;
- o Require maintenance of a record of proceedings;
- o Require written findings to explain awards (or lack thereof).
- o Authorize awards of punitive damages or attorneys' fees.

CUSTOMER COMPLAINTS AGAINST THE ARBITRATION PROCESS

Aggrieved customers have found it very difficult to be compensated for lost investment capital. The SEC has focussed largely on other issues, such as insider trading, and, due to funding and staffing inadequacies, has left the policing of brokers largely to the exchanges and the National Association of Securities Dealers. These same investors have found themselves involved in a system that is perceived to be largely unregulated. For this reason, many investors feel that arbitration is good for the industry and bad for the investor.

Many investors subject to arbitration clauses are fighting against the enforcement of these clauses in securities-related cases. They claim that they signed the agreements unknowingly as part of the barrage of papers before them when opening an account. Others contend that they did not recognize the full implications of signing a brokerage contract that included an arbitration clause.

Another major concern, is the question of whether an investor has a realistic option of not signing the arbitration clause. Do major brokerage houses refuse potential clients on the grounds that an arbitration clause was not signed? Many experts are worried that in light of the McMahon case, future investors will be required to sign clauses in order to open an account. After the Supreme Court's decision, many wondered what would happen to the ground rules for the public customer. When asked "[w]hat investors should do if they prefer to go through the time and expense of a jury trial," Edward O'Brien, President of the Securities Industry Association stated, "[t]hey then shouldn't open a brokerage account." A leading financial weekly newsletter predicted that," in light of [the Court's ruling,] no broker will accept a margin account unless a customer signs an agreement to arbitrate all future disputes." (Barrons, p. 38, June 15, 1987). Respondents' Petition for Rehearing, in McMahon stated:

> The immediate result of this Honorable Court's decision will be to turn the brokerage industry's institutional desire to shield its activities from judicial scrutiny into an industry-wide practice of manipulation, coercion and over-reaching aimed at bludgeoning the public customer into submission to the industry's choice of forum, a practice which is, beyond peradventure, unlawful under Section 10(b) of the Securities Exchange Act of 1934.

The petition argued that "as a direct consequence of the Court's decision, the public now has one of two alternatives: being coerced into the industry's choice of forum or not being able to invest in the secondary national securities markets at all."

SHEARSON/AMERICAN EXPRESS V. McMAHON

In 1984, Julia and Eugene McMahon filed a $5 million federal court lawsuit against their broker Mary Ann McNulty of the brokerage firm Shearson/American Express. Prior to establishing the brokerage relationship with McNulty, they had kept over $1 million of their personal pension funds and those of their employees in conservative investments -- CDs, municipal bonds and Treasury bills. In 1980, they decided to try a different approach, and turned their accounts over to McNulty. By 1982, the McMahons realized that a large portion of their investment had been lost due to a whirlwind of risky investments made on their behalf by McNulty. McNulty reaped $216,000 in commissions alone from allegedly churning the McMahon's account.

The McMahons decided against arbitration, and filed a suit against McNulty for violation of the Racketeer Influenced and Corrupt Organizations Act (RICO). RICO allows punitive damages and permits a private plaintiff to recover triple his actual losses as well as attorneys' fees. Mr. McMahon stated at the time, "It's the American way. If I go to court, they're going to listen to my case. Then they can make a judgement." They claimed that Shearson and its broker violated section 10(b) of the Securities Exchange Act of 1934, which is the statute's major anti-fraud provision. They alleged that McNulty, with the consent and knowledge of the firm, fraudulently engaged in excessive and inappropriate trading in their accounts and made certain misrepresentations and omissions in rendering investment advice, all contrary to the RICO prohibitions against fraud and breach of fiduciary duty.

The defendant raised the Federal Arbitration Act as a defense. The Arbitration Act establishes a federal policy favoring arbitration, requiring that the courts rigorously enforce arbitration agreements. It provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." The McMahons attempted to defeat application of the Arbitration Act by demonstrating that Congress intended to make an exception for claims arising under RICO and the Exchange Act, for in the Exchange Act, Congress did not specifically address the question of the arbitrability of 10(b) claims.

Like the McMahons, many disgruntled investors had begun to file cases under RICO and other federal statutes in order to bypass the signed arbitration agreement and sue broker/dealers in court. In previous cases, RICO disputes had not been subjected to arbitration. Lower federal courts have split over the arbitrability of RICO cases. In the McMahon case, the United States District Court for the Southern District of New York ruled that the McMahons had the right to sue Shearson in a court of law. This opinion was based upon the controlling precedent, Wilko v. Swan. In 1953, the Supreme Court had decided that arbitration contracts were not enforceable with regard to federal securities law claims and that investors had the right to present their claims to judges and juries. In the Court's view, arbitration was incapable of effectively enforcing the protections of the Securities Act as compared with judicial proceedings. But in the 1985 Supreme Court ruling in Dean Witter Reynolds Inc. v. Byrd, the Court indicated it might be ready to reconsider the Wilko decision. Since that case, the securities industry had been pushed for an overruling of Wilko.

That opportunity came with the McMahon case. Several "amicus curiae" briefs in support of the plaintiffs (Shearson/American Express) were submitted by industry representatives including briefs from the SEC and attorneys for the Securities Industry Association, Inc. stating views in favor of enforcing arbitration agreements. On June 8, 1987, the Court decided in favor of the enforceability of arbitration clauses and overruled the lower court decision.