Testimony of

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Before the

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

COMMITTEE ON ENERGY AND COMMERCE

U.S. HOUSE OF REPRESENTATIVES

ON

THE ARBITRATION OF BROKER-DEALER/CLIENT DISPUTES

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Mr. Chairman and members of the Committee, my name is Stephen Brobeck. I represent the Consumer Federation of America, a coalition of 240 pro-consumer groups with some 50 million members. A significant number of these individuals own stock, and a small but increasing number have complaints against their brokers. Many of these grievances include placing investors in unsuitable investments, losing orders or executing them at prices below specified minimums, not giving investors facing margin calls an opportunity to provide additional funds, and refusing to take calls or return them.

Complaints against brokers filed with the Securities and Exchange Commission grew from 7500 in 1982 to 15,000 in 1984. Calls to the North American Securities Administrators Association hotline established last fall have totaled over 10,000 to date. Many of these complaints do not involve trivial amounts: Several in fact exceed $1 million.

1. Current investor complaint remedies are inadequate.

As a result of a 1987 Supreme Court decision, a large and growing number of these grievances can be submitted only to an arbitration system controlled by the securities industry. In Shearson/American Express v. McMahon, the U.S. Supreme Court upheld the legality of provisions in stockbroker contracts

limiting investor remedies to arbitration. Because of this decision, the large majority of stockbroker agreements contain such provisions. Moreover, these provisions often specify that complaints can be filed only with one of the arbitration systems controlled by the industry -- those administered by the National Association of Securities Dealers, by the New York Stock Exchange, or by the American Stock Exchange.

Aggrieved investors are not well served by this industry arbitration system. A number of authorities have found these systems badly deficient. In a 1986 report evaluating the system's performance, the General Accounting Office revealed hundreds of securities law violations that arbitrators failed to detect. In his dissent to the Shearson ruling, Justice Blackman stated that the decision "leaves... claims to the arbitral forces of the securities industry at a time when the industry's abuses toward investors are more apparent than ever." Even the SEC has found the arbitration system in need of reform. In a document it prepared recommending a number of specific changes, the Commission stated that "there are numerous ways in which the prices can be improved."

The specific faults of the system are numerous and well-publicized. Several of the most important are described below.

1) Arbitration panels frequently are dominated by individuals with direct or indirect ties to the securities industry. While only one of the members is allowed to be a securities professional, current rules allow the "non-industry" slots to be filled by retired stockbrokers, spouses of brokers,

and lawyers and accountants in firms with securities industry clients.

2) With no rules of evidence, no consistent standards of judgement, and little or no outside oversight of the disposition of individual cases, the outcome of an individual arbitration proceeding is impossible to estimate beforehand. As a result, it is extraordinarily difficult for investors to make intelligent decisions in advance about the costs and benefits of pursuing an arbitration case.

3) Since punitive damages are rarely awarded, the most an aggrieved investor can hope to recover is all the money lost, or much more likely, some portion of the funds in a dispute with a broker. One study revealed that only 13 percent of those filing claims were awarded as much as 60 percent of claimed losses. Thus, arbitration decisions rarely compensate an investor for the lost earning power of the investment dollars in dispute in the arbitration suit. In addition, other costs, including legal fees, are subtracted from the arbitration award.

To make matters worse, most investors appear to be unaware that they are giving up a legal remedy for future disputes, and limiting the filing of grievances to an industry-controlled arbitration system, when they sign a stockbroker's agreement. Like most consumers signing detailed contracts containing complicated legal terminology, most investors do not read their stockbroker's agreement carefully before signing it.

2. Proposed SEC improvements to the industry arbitration system are inadequate.

The Securities and Exchange Commission has proposed a number of reforms to the existing industry arbitration system. Although these changes would improve the system, they are insufficient.

Specifically, these reforms fail to make the following needed improvements:

- permitting arbitration sessions to be open to the public, helping ensure that they will be conducted in a careful and unbiased manner;
- requiring written opinions and findings of fact based upon the evidence and conclusions of law, to ensure the integrity of the process and allow a fair appeal;
- allowing more than one preemptory challenge when panelists are selected;
- prohibiting partners of lawyers and accountants who regularly provide services to the securities industry to serve as public arbitrators.

The most important limitation of the proposed SEC reforms, however, is that they perpetuate a system that typically denies private rights of action and even appeal to other arbitration systems. In a court of law, investors may file claims alleging common law fraud or violation of state consumer protection laws.

Also, because they can sue for damages, investors have the possibility of recovering actual losses. Moreover, there is a well-established arbitration system outside the securities industry. Though somewhat more expensive for investors to use, the system run by the American Arbitration Association is more objective and unbiased than the industry's.

3. Congress should ensure that aggrieved investors have adequate means of redress.

Even though a recent federal jury ruling may allow some aggrieved investors a private right of action, Congress should act to ensure that all investors have available to them adequate means of redress. We recommend that Congress pass legislation guaranteeing investors their Seventh Amendment right to a jury trial. Such a guarantee should override any contractual limits on private rights to action. One way to accomplish this objective would be to assert unequivocally that the anti-waiver provision (29a) of the 1934 Securities and Exchange Act is intended to exclude mandatory arbitration clauses.

If Congress chooses not to adopt this approach, it should at minimum require a separate disclosure of any restriction on an investor's private right of action. This disclosure must clearly state how a stockbroker's agreement limits an investor's right to sue. It should be written in plain

English. Such a disclosure would give investors the opportunity to negotiate a modification or elimination of proposed restrictions on their right to sue, or failing that, to shop for another broker who would not impose such restrictions.

Along with this requirement, Congress should insist that stockbrokers using mandatory arbitration agreements allow investors to appeal to the arbitration system run by the American Arbitration Association. This system is generally less biased, and frequently better run, than those of the securities industry.

Only Congress can restore to aggrieved investors adequate means of redress. The rising number of investor complaints, some involving millions of dollars, emphasize the need for speedy and appropriate Congressional action.