

September 24, 2015

VIA ELECTRONIC MAIL

Office of Regulation and Interpretations  
Office of Exemption Determinations  
Employee Benefits Security Administration  
U.S. Department of Labor  
200 Constitution Ave., NW  
Washington, DC 20210

Re: Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice (RIN 1210-AB32); Proposed Best Interest Contract Exemption (ZRIN 1210-ZA25)

To the Office of Regulation and Interpretations:

I am submitting this comment letter on behalf of interested clients to address several issues that were raised in the recent hearings and comment period for the rules proposed by the Employee Benefits Security Administration to broaden the definition of “fiduciary” under ERISA and the Internal Revenue Code, and to create new prohibited transaction exemptions. Specifically, this letter addresses (1) four new research reports that were added to the rulemaking record by the Department; (2) the claim by some rulemaking participants that if the Department’s proposals are adopted, advisory firms operating on a fee-based model can be trusted to adequately serve investors with small accounts; and (3) commenters’ request that the Department’s prohibited transaction exemptions bar binding pre-dispute arbitration agreements.

**DISCUSSION**

**I. The Department’s Four New Studies Highlight Flaws In The Proposed Rules And In The Department’s Economic Analysis.**

The Department recently provided public notice of four studies that had been added to the rulemaking record. U.S. Dep’t of Labor, *Announcement of Transcript Availability and Comment Period Closing Date* (Sept. 8, 2015), <http://www.dol.gov/ebsa/regs/1210-AB32-2-HearingTranscriptAnnouncement.html>. One of the studies—by Advanced Analytical Consulting Group—is explicitly identified as having been prepared under contract with the Department. See Advanced Analytical Consulting Group, Inc., *Comments on a Review of a White House Report on Conflicted Investment Advice* at 10 (“Advanced Analytical Report”). The other three reports were “[p]repared for [the] Department of Labor” by the RAND

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Corporation, which has been under contract to provide other studies and research to the Department in connection with the “fiduciary” proposal. *See* RAND Labor and Population, *Financial Advice Markets: A Cross Country Comparison* (“Cross Country Report”); RAND Labor and Population, *Effective Disclosures in Financial Decisionmaking* (“Disclosures Report”); RAND Labor and Population, *Do Financial Advisers Influence Savings Behavior?* (“Savings Behavior Report”).

Rather than bolster the case for the Department’s proposals, these four reports highlight some of the flaws in the premise of the Department’s fiduciary proposal, and confirm commenters’ concerns with the proposals’ likely adverse effects, particularly for less affluent investors. This is the case in at least three important respects.

*First*, these new reports confirm the failure of the Department’s Regulatory Impact Analysis—and the rule proposals themselves—to give appropriate weight to the benefits consumers receive from the assistance and advice of financial professionals. Advanced Analytical Report at 2, 4-5; Savings Behavior Report at 1-2; *see also* Comment Letter of Securities Industry and Financial Markets Association, Appendix 1 at 17-22 (July 21, 2015) (report of NERA Economic Consulting). The very title of one of the RAND reports reflects the Department’s skeptical, and at-times contradictory, treatment of the role of financial advisers. The title asks: “Do Financial Advisers Influence Savings Behavior?” One would think that it is beyond dispute that financial advisers “influence” investors’ behavior. After all, the Department’s skeptical (and mistaken) view of the impact of advisers’ purportedly conflicted advice is the entire motivation for these far-reaching regulatory proposals. And yet, the Report’s authors opine, for instance, that “there is very limited evidence about a causal link between financial advice and savings.” Savings Behavior Report at 9.

It is unclear what value the Department sees in questioning whether financial advice is helpful. Plainly, it would be a grave mistake to premise these rule proposals on the speculation that financial advice is not valuable and can be dispensed with. The Savings Behavior Report itself concedes that financial professionals have “great potential” to help Americans save for retirement; among the benefits these professionals provide include “improvements in financial behavior, resulting in increased savings.” Savings Behavior Report at 1, 3. This advice “could be particularly valuable for those struggling to meet their financial goals,” since individuals receiving investment assistance may “be more likely to have a plan for retirement, more likely to feel confident about their retirement preparations, and more likely to have retirement goals.” *Id.* at 3, 18. Assistant Secretary Borzi stated at the hearing, “We strongly believe that individuals need this assistance in making these decisions because there is no GPS that an individual can rely on to help them reach their retirement goals.” Hr’g Tr. 13. The fiduciary proposal itself repeatedly characterizes financial products as complex, making education in the products valuable. *E.g.*, 80 Fed. Reg.

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21,928, 21,929 (Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509, 2510) (explaining that DOL is revisiting the 1975 regulation in light of “the need for plans and IRA owners to seek out and rely on sophisticated financial advisers to make critical investment decisions in an increasingly complex financial marketplace”), 21,932 (“the variety and complexity of financial products” lead investors to “rely on experts for advice”). Likewise, many of the proposals’ supporters consider the measures necessary precisely because of the enhanced advice consumers purportedly will receive as a result. *E.g.*, Comment Letter of Committee for the Fiduciary Standard at 1 (July 20, 2015) (proposals would provide “[m]illions of American retirement investors . . . the benefit of advice” in their best interest); Comment Letter of Consumer Federation of America at 5 (July 21, 2015) (“very few retirement savers have the financial expertise necessary” to make investment decisions without assistance from professionals). *See also* Hr’g Tr. at 813 (“[I]t’s important that families can turn to financial professionals to help them chart a course for retirement.”).

The Savings Behavior Report also strongly suggests that the benefits of financial advice are likely to be greatest for “low-income populations.” Savings Behavior Report at 6. Numerous commenters, also, spoke of the importance to middle- and lower-income investors particularly of receiving informed assistance with investment decisionmaking. *E.g.*, Comment Letter of National Association of Social Workers at 3-4 (July 21, 2015) (lower-income minority groups “have an even greater lack of investment knowledge on the average than the general population,” which makes them “more dependent on professional financial advisers”); Comment Letter of National Council of La Raza at 2 (July 20, 2015) (“Consumers [r]ely on [f]inancial [a]dvice to [n]avigate [c]omplex [o]ptions”); Hr’g Tr. 492:22-493:8 (statement of Martin Neil Baily) (“[I]t’s the lower middle and the upper middle we are most concerned about, making sure that they save enough and get the right kind of advice”).

None of these benefits of advice are captured in the DOL’s economic analysis of its proposed rules, however. *See, e.g.*, Jeremy Berkowitz, Renzo Comolli & Patrick Conroy, *Review of the White House Report Titled “The Effects of Conflicted Investment Advice on Retirement Savings”* at 4 (Mar. 15, 2015). Indeed, Advanced Analytical—in a report commissioned by the Department—states that the analysis by the Council of Economic Advisers (“CEA”) “‘gives short-shrift’ to the benefits that consumers receive from brokers,” and excessively discounts the benefits of the current marketplace as a result.<sup>1</sup> Advanced Analytical Report at 2, 4-5. Advanced Analytical attempts to excuse this failing by asserting

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<sup>1</sup> The DOL’s Regulatory Impact Analysis reaches conclusions similar to the CEA study, based on “the same literature” as the CEA report. Regulatory Impact Analysis at 97 n.189.

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that specific quantitative data on the benefits of brokers is lacking. Advanced Analytical Report at 4. Similarly, the Savings Behavior Report states that existing research generally does “not account for . . . benefits that investors might receive from financial advisers.” Savings Behavior Report at 1. The fact that the Department claims not to have specific data on these benefits is hardly justification, however, for proceeding with the rulemaking as if those benefits do not exist. To the extent that—as the Advanced Analytical Report asserts—“exploring the importance of these benefits is an important topic for future work,” *id.* at 5 (internal quotation marks and alteration omitted)—that “future” work should be performed now, before the Department institutes a regulatory framework that up-ends the means by which millions of Americans currently receive assistance and advice on financial planning.

*Second* and related, these additional research reports demonstrate that the Department has failed to properly reckon with the adverse consequences threatened by the proposed rule and exemptions. Chief among these is the likelihood that investors, especially the less affluent, will lose access to advice as a result of the Department’s regulatory changes.<sup>2</sup>

The description of the UK experience in the RAND Cross Country Report is particularly stark. In 2012, the UK’s “Retail Distribution Review,” or “RDR,” barred financial representatives from receiving commission payments on financial products. The toll this has taken in less than three years is startling: Fewer advisers exist, the cost of advice has risen, and lower-income clients in particular are losing access to advice. *See* Cross Country Report at 29-31. Between 2011 and January 2014, the number of advisers in the UK dropped by approximately 25 percent—from 40,000 to approximately 31,000—and “the estimated number of advisers working at banks dropped from about 8,600 to 3,600 over the period.” *Id.* at 29. More recent figures from Towers Watson show that the number of advisers has dropped even farther, to approximately 28,000. Towers Watson, *Advice Gap Analysis: Report to FCA* (Dec. 5, 2014), at 32 (“Towers Watson Report”).

With such a steep and sudden drop in the number of advisers, an increase in the cost of advice should be expected. And indeed, “the cost of receiving advice has increased” in the UK. Cross Country Report at 33. *See also* Advanced Analytical Report at 4. Moreover, the advisers who remain have shifted the services they provide to more costly offerings. The Cross Country Report cites a survey finding that 47 percent of advisers interviewed “had recently turned away clients because the cost of their service had become disproportionately

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<sup>2</sup> Other harms discussed in the new reports include that broker-dealers may be unable to provide the same quality of advice under a fee-based compensation structure, and that consumers will be harmed as a result. Advanced Analytical Report at 3 n.3. The CEA’s analysis did not consider this possibility. *Id.*

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high for some clients' needs." Cross Country Report at 29-30. Another survey found that approximately 20 percent of advisers—that is, fully a fifth—"would not advise on accounts below a certain threshold," while 50 percent believed they would decide whether to advise those accounts on a case-by-case basis. *Id.* at 30. Yet another survey reported that approximately 15 percent of advisers had "stopped providing service" to low-net worth consumers. *Id.* at 31. In short, the Cross Country Report concludes, "it appears that in some cases lower-wealth clients may now find it more difficult to receive advice." *Id.* at 38; *see also* Towers Watson Report at 8 ("[A]necdotal evidence of developments in the market post RDR suggests that advice capacity serving less affluent segments is likely to have reduced and there may therefore be reduced provision.").

The Towers Watson Report, as the Cross Country Report recognizes, purports to show that the supply of advice in the aggregate still exceeds demand, but concedes that "supply and demand may not be perfectly aligned across the market," and that "capacity mismatch" could result, "particularly at the lower end of the market." Cross Country Report at 30 (citing Towers Watson Report). Similarly, the Advanced Analytical Report cites a report by Europe Economics which suggests that clients who lost their advisers were able to find other advisers. Advanced Analytical Report at 4. But that report states merely that the authors "*assume[d]*" many of the clients who lost advisers "sought out another adviser" and were "largely successful" in doing so. *Id.* (emphasis added; internal quotation marks omitted). An "assumption" on such a critical issue is not an adequate basis for the Department's rulemaking.

The sudden and disturbing changes in the UK financial services industry since the RDR was implemented are already prompting a re-appraisal by UK authorities. Last month, the Financial Conduct Authority ("FCA") announced what it called a "major new review" of the steps needed to "radically improve" access to financial advice and assistance. *See Major new review to radically improve access to financial advice launched* (Aug. 3, 2015), <https://www.gov.uk/government/news/major-new-review-to-radically-improve-access-to-financial-advice-launched>. The review has been prompted by what FCA calls an "advice gap" for people seeking assistance with financial planning, particularly people who "do not have significant wealth." HM Treasury, *Financial Advice Market Review: Terms of Reference* (Aug. 3, 2015), <https://www.gov.uk/government/publications/financial-advice-market-review-terms-of-reference/financial-advice-market-review-terms-of-reference>. Among the top "[o]bjectives" the FCA has for its review are identifying "the regulatory or other barriers firms may face in giving advice," and, second, determining "how to give firms the regulatory clarity and create the right environment for them to innovate and grow." *Id.*

As the Labor Department contemplates its own sweeping changes to the provision of financial services in the U.S., it must carefully study the UK experience, including the effects

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of the “regulatory barriers” to advice that DOL is constructing, and the “regulatory clarity” that U.S. financial institutions need to “innovate and grow.” The UK experience confirms beyond a doubt that a loss of advice resulting from the DOL’s changes is a very real concern that must be carefully examined; it is not a red herring concocted by industry.

To be sure, there are differences between the RDR—which banned commissions entirely—and the DOL proposal, which purportedly would enable financial representatives to receive commissions through the Best Interest Contract Exemption. But there is broad consensus within industry and even among some supporters of the rule that the proposed Exemption is unworkable. *E.g.*, Hr’g Tr. 365:6-8; Comment Letter of Consumer Federation of America at 46; Comment Letter of Financial Planning Coalition at 25-26 (July 21, 2015). As a practical matter, therefore, the differences between the current DOL proposal and the RDR cannot be expected to be significant.

Moreover, the UK experience drives home that DOL cannot have it both ways when projecting the impact of its regulatory changes: DOL cannot claim, on the one hand, that it will reduce the compensation that broker-dealers and financial advisers receive in connection with their clients’ investment activity, while supposing—on the other hand—that reducing that compensation will not affect who enters the field, who remains in it, and the services they offer.<sup>3</sup> Rather, as a matter of simple economics and as the UK experience demonstrates, there will be an effect—DOL must study and estimate that effect with no less zeal than it has addressed the purported effects of “conflicted advice.” Likewise, to the extent the Department believes that its exemptions to its new fiduciary definition will enable financial representatives to continue to receive commission-based compensation, DOL bears an even greater burden to justify its claim that its rule will produce billions in dollars of benefits by eliminating the supposedly distorting effect that commissions have on the financial services industry. The Department cannot claim radical benefits, while insisting that it is not instituting radical changes.

Indeed, during the hearing, even vocal supporters of the rule testified that it will not deliver anything approaching the benefits claimed by the Department. Professor Mercer Bullard testified at length on the ways that he believes the rule will have little positive effect, including that “[t]he rulemaking will generally have no effect on financial advisors’ incentives to recommend a product in one compensation group over a product in another.”

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<sup>3</sup> The Advanced Analytical Report also observes that the CEA’s report fails to accurately measure the costs of the DOL’s proposed regulation because it ignores the fact that “additional obligations will likely translate into higher compliance costs” for broker-dealers. Advanced Analytical Report at 3 n.3.

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Hr'g Tr. 174-77; *see also id.* at 241 (similar argument by Professor Ron Rhoades regarding the Best Interest Contract Exemption).

In sum, the Department has not adequately assessed the benefits of the current marketplace for financial products and services, and the costs and purported benefits of the regime its proposals would establish instead. The four new studies confirm these shortcomings.<sup>4</sup>

A *third* notable aspect of the reports recently added to the rulemaking record concerns disclosure. DOL's proposal would impose complex and burdensome disclosure requirements on the premise that these disclosures will provide substantial benefits, yet the Department's new research does not support that claim. Indeed, it shows the opposite. The Disclosures Report concludes that to be effective, disclosures must be simple—excessive disclosures are counterproductive. The Report observes, for example, “Research has shown that the longer, more detailed disclosure documents have not been effective at helping consumers make informed choices in selecting mortgages, credit cards, and mutual funds, due to either limited attention or limited understanding of the material itself.” *Id.* at 18. While “simplicity” is “[o]ne common factor in . . . effective disclosures,” *id.* at 22, even more “simplified disclosures may still be too lengthy and complex for the average consumer[.]” *id.* at 24. “Additional research” would be “needed to more fully evaluate the effectiveness of disclosure as a policy intervention to protect customers,” the Report concludes. *Id.* at 10.<sup>5</sup>

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<sup>4</sup> The comment letter of the Consumer Federation of America cited a study by Edwin Weinstein in purported support of the Department's economic analysis. Comment Letter of Consumer Federation of America at 15 (citing Edwin Weinstein, *Mutual Fund Fee Research* (Spring 2015)). But many of Weinstein's observations actually demonstrate that regulation like the Department's is not appropriate at this time. Weinstein observed that “there is no such thing as a ‘behaviorally neutral compensation scheme,’” and that “[i]dentifying a problem with one form of compensation does not automatically imply that one specific alternative form of compensation is better.” *Mutual Fund Fee Research*, at 9-10. Weinstein concluded that important gaps remain in the research regarding whether a fee-based compensation model is superior to a commission model, and that accordingly “questions about the impact of new compensation schemes and their impacts . . . need to be addressed to ensure that undesirable and unintended outcomes are minimized.” *Id.* at 8.

<sup>5</sup> The authors of the Disclosures Report assume clients would make different decisions if they understood the disclosures, but another way of viewing this research is that the  
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Given the Department's professed uncertainty about the value of disclosure—and its endorsement of research indicating that effective disclosures must be simple—the requirements of the Department's proposed regulatory framework are indefensible. Consider, for example, the three required disclosures in the Best Interest Contract Exemption. The point-of-sale disclosure requires a representative to give an investor a detailed chart describing the “total cost” of the proposed investments over different periods of years, and the total cost for each investment must include granular detail such as loads, commissions, mark-ups, and account opening fees. 80 Fed. Reg. 21,960, 21,985 (Apr. 20, 2015). Investors must also be given an annual disclosure, containing the following: (1) identification of each asset purchased or sold during the year and the accompanying price; (2) a statement of the total dollar amount of all fees and expenses paid by the client, directly or indirectly, with respect to each asset; and (3) a statement of the total dollar amount of all compensation received by the representative and the firm, directly or indirectly, from any party as a result of each asset. *Id.* at 21,985. The web page disclosure must provide the public with information showing all direct and indirect compensation payable to the representative, firm, or other affiliate, with respect to each asset that an investor is able to purchase, hold, or sell through the representative and that has been purchased, held, or sold in the last year, along with the source of the compensation and how it varies within and among assets. *Id.*

These complex and technical disclosures are exactly the type of disclosure that the Disclosures Report concludes will likely provide no benefit, and may simply sow confusion among investors. *See* Disclosures Report at 22 (effective disclosures keep “technical jargon to a minimum”), 12 & 24 (reviewing research showing other disclosures in financial industry are too “complex for average consumers” and “confuse[]” them). The Report is further evidence that the Department must radically reduce the burdensome disclosure requirements in its regulatory proposals. The Department will also need to account for the Report's skeptical assessment of the value and effectiveness of disclosure as it proceeds toward finalizing a rule that, evidently, is substantially premised on the expectation that sweeping disclosures will prevent the losses that purportedly result from conflicted advice.

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client did in fact understand and was satisfied with the advice given. It may well be the case that a consumer weighs the costs and benefits of the purportedly conflicted advice, and determines that more is to be gained by continuing with that financial representative than abandoning the interaction.



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## **II. Firms Using A Fee-Based Model Cannot Be Expected to Fill The Advice Gap Resulting From DOL's Proposals.**

As the UK experience shows, there is substantial evidence that small accounts will suffer a loss of advice under the DOL's proposed rule. While the Best Interest Contract Exemption purports to permit the commission model to continue, there is broad agreement that the Exemption's requirements are too onerous to be workable. *See supra* p. 6. Consequently, it must be expected that large numbers of financial professionals will stop serving existing customers, especially the less wealthy, if the proposal is adopted. *See* Comment Letter of Oliver Wyman, Inc. at 38 (July 13, 2015) ("Individuals with small balance accounts are likely to lose access to retirement help and support with selecting appropriate products."); Comment Letter of Martin Neil Baily & Sarah E. Holmes at 17 (July 21, 2015) ("proposed rule will bring with it increased compliance costs" and additional litigation risks, which may lead to "households with modest savings" being "abandoned" by advisers). There is thus significant reason to be concerned that the people most in need of advice and assistance—low- to modest-income households—will be worse off under DOL's rule.

Some supporters of the rule have said that these concerns are misplaced because there already are firms and advisers that successfully serve small accounts on a fee-based model. *E.g.*, Comment Letter of Wealthfront, Inc. at 1-2 (April 21, 2015); Comment Letter of Financial Planning Coalition at 15 & n.48. The UK experience casts serious doubt on those claims, and an examination of those firms and their business models confirms that a fee-based model will not adequately serve small savers.

Most of the firms touted by supporters of the DOL's initiative have account minimums that would price out smaller accounts. Personal Capital and Rebalance IRA, for example, both require a \$100,000 minimum. Personal Capital, <https://www.personalcapital.com/> (last visited Sept. 23, 2015); Rebalance IRA, Frequently Asked Questions, <http://www.rebalance-ira.com/faq/> (last visited Sept. 23, 2015). ProVise Management Group, LLC normally requires an account minimum of \$250,000. ProVise Management Group, LLC, Brochure at 8 (July 22, 2015), *available at* [http://www.provise.com/wp-content/uploads/2012/10/FormADV\\_Part2A\\_Brochure\\_0722151.pdf](http://www.provise.com/wp-content/uploads/2012/10/FormADV_Part2A_Brochure_0722151.pdf). Seabridge Wealth Management, LLC requires a *million* dollar account minimum, with a minimum annual account fee of \$5,000. Seabridge Wealth Management, LLC, Firm Brochure at 3 (Oct. 7, 2013), *available at* [http://www.adviserinfo.sec.gov/Iapd/Content/Common/crd\\_iapd\\_Brochure.aspx?BRCHR\\_VRSN\\_ID=210608](http://www.adviserinfo.sec.gov/Iapd/Content/Common/crd_iapd_Brochure.aspx?BRCHR_VRSN_ID=210608). This bolsters the observation in Oliver Wyman's Comment Letter that "7 MM current IRAs would not qualify for an advisory account due to low balances" (pp. 6, 38).

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Even when fee-based firms have low account minimums or no minimums, there are other barriers to holders of small accounts obtaining meaningful advice. Financial Engines only provides advice to employees of participating companies, for example. Comment Letter of Financial Engines at 1-2 (July 21, 2015); Financial Engines, *Getting Started*, <http://corp.financialengines.com/individuals/getting-started.html> (last visited Sept. 24, 2015). The Garrett Planning Network does not provide compliance oversight, and some of the network's members are no longer accepting additional clients, *see* Garrett Planning Network, *Member Search*, <http://www.garrettplanningnetwork.com/find-an-advisor-map> (last visited Sept. 23, 2015). As for the "robo-adviser" Wealthfront Inc., it only has three Investment Advice Representatives and seven Registered Representatives, Wealthfront Inc. Form ADV (last amended Aug. 14, 2015), and its general online services provide advice using an approximately 10-question tool that "only takes 60 seconds," Wealthfront Inc., [www.wealthfront.com](http://www.wealthfront.com) (last visited Sept. 23, 2015). Advice provided under these circumstances is hardly comparable to the assistance obtained in a one-on-one interaction with a financial professional.

Indeed, the SEC and FINRA recently issued a joint investor alert cautioning *against* robo-advisers. Securities and Exchange Commission Office of Investor Education and Advocacy and Financial Industry Regulatory Authority, Joint Investor Alert, Automated Investment Tools (May 8, 2015), *attached hereto as Exhibit A*. The problems with robo-advisers identified in the alert are plentiful, but all point to the likelihood that an investor will receive and follow poor or incorrect investment advice. For example, the alert instructs investors to "[b]e aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation," and therefore it could "suggest investments . . . that may not be right for you." *Id.* The automated tool "may ask questions that are over-generalized, ambiguous, misleading, or designed to fit you into the tool's predetermined options." *Id.* And, if the automated tool "does not allow you to interact with an actual person," the alert warns, "you may lose the value that human judgment and oversight, or more personalized service, may add to the process." *Id.*

For all of these reasons, the DOL cannot base its final rules on a conclusion that firms operating on a fee-based model will bridge the "advice gap" created by the rules. That determination would rest on the unsubstantiated assertions of a small number of firms whose market position and viability are unknown to the Department, and would depend in part on increased use of an investment tool that the agency with expertise in the area has cautioned sternly against. A handful of unverified testimonials—from firms and an industry with which the Department has limited familiarity—are insufficient ground to reject the broad

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consensus of leading firms in the industry, with support from the industry's principal regulators.<sup>6</sup>

### **III. Commenters' Criticisms Of FINRA Arbitration Are Misplaced.**

A number of rulemaking commenters have urged the Department to revise the Best Interest Contract Exemption to preclude arbitration. Some of these commenters have been particularly critical of FINRA as an arbitral forum. *See, e.g.*, Comment Letter of Consumer Action at 2 (July 9, 2015) (alleging, without support, that arbitration is “an opaque, unfair process that benefits the brokerage industry”); Comment Letter of American Association for Justice at 4 (July 21, 2015) (stating, without analysis, that “the mandatory nature” of FINRA arbitration “undermines a fair and robust forum”). These comments reflect a mistaken understanding of the Department's statutory role and authority, and of the merits of arbitration as a means of resolving disputes.

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<sup>6</sup> A witness for the Consumer Federation of America suggested at the hearing that industry's concerns with a fee-based model are unfounded, and are similar to concerns that were voiced—but not borne out—during efforts to vacate SEC Rule 202(a)(11)-1. Hr'g Tr. 116. That rule would have allowed broker-dealers to offer fee-based brokerage accounts without registering as investment advisers. 70 Fed. Reg. 20,424 (Apr. 19, 2005). Some of that rule's supporters argued that broker-dealers would find it too expensive to offer the accounts as registered investment adviser (“RIA”) accounts, but this witness contended that after the rule was vacated by the D.C. Circuit, many broker-dealers did indeed convert the accounts to RIA accounts.

The comparison is inapt. Brokers offered fee-based brokerage accounts to clients that wanted that higher level of service and advice; the fees paid for that higher level of service, and therefore broker-dealers continued to offer the service after the rule was vacated. DOL, by contrast, would force customers onto a more expensive business platform that they do not want and that in many cases their accounts cannot sustain financially. Moreover, DOL's proposals would inaugurate a much more radical re-ordering of the industry than was at issue with the SEC's Rule. The same can be said of the argument that the DOL's proposals are akin to the Certified Financial Planner Board's recent establishment of Standards of Professional Conduct. *See* Hr'g Tr. 28. Professional standards set by a credentialing organization are different in kind and far less intrusive than the DOL's complex fiduciary rules, which—among other things—would be enforceable through private rights of action and class action litigation.

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As an initial matter, the Department has no authority to preclude parties from agreeing in advance that they will resolve any disputes by binding arbitration. *See* Comment Letter of Gibson, Dunn & Crutcher LLP at 16-17 (July 20, 2015). As the Supreme Court has repeatedly emphasized, the Federal Arbitration Act (“FAA”) embodies a “liberal federal policy favoring arbitration agreements,” *Moses H. Cones Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983), and only a “contrary congressional command” can override the FAA’s mandate that arbitration agreements be enforced according to their terms, *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665, 669 (2012) (internal quotation marks omitted). ERISA contains no such command. *See Kramer v. Smith Barney*, 80 F.3d 1080, 1084 (5th Cir. 1996); *Bird v. Shearson Lehman/Am. Express, Inc.*, 926 F.2d 116, 120 (2d Cir. 1991). It should go without saying, moreover, that the Department cannot use an authority to *exempt* entities from regulation as a means of precluding arbitration and compelling parties to litigate in court. If the Department were to attempt to do so, despite the clear command of the FAA and the vigilance with which that command has been enforced by the courts, it would only increase the appearance that the Department has improperly used its exemptive authority to augment its power and erect a new regulatory and enforcement framework. *See* Comment Letter of U.S. Chamber of Commerce & U.S. Chamber Institute for Legal Reform at 4-11 (July 20, 2015). And of course, such a major increase in the regulatory burdens of the original proposal would require re-proposal and the opportunity for notice and comment.

In any event, the criticisms of arbitration, and the FINRA forum in particular, are mistaken. Arbitration offers greater “simplicity, informality, and expedition” than litigating in court. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985). By agreeing to arbitrate, parties do not “forgo [their] substantive rights . . . [but] only submit[] to their resolution in an arbitral, rather than a judicial, forum.” *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 481 (1989) (quoting *Mitsubishi*, 473 U.S. at 628).

There is ample evidence that FINRA offers a fair arbitral forum that provides these benefits and guarantees investors all of the “[s]ubstantive [r]ights [a]vailable to [t]hem in [l]itigation,” including the ability to recover punitive damages and attorney’s fees. *See* SIFMA, *White Paper on Arbitration in the Securities Industry* at 33 (Oct. 2007) (citing *Rodriguez de Quijas*, 490 U.S. at 481), *attached hereto as Exhibit B* (“SIFMA White Paper”). FINRA arbitration is more efficient and less expensive than litigating in court, which is particularly beneficial to investors with small claims. FINRA arbitrations reach resolution quickly, in 14 to 15 months on average. FINRA, *Dispute Resolution Statistics* (Aug. 2015), *available at* <https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics> (last visited Sept. 23, 2015). In comparison, in the 12-month period ending in March 2014, the average case going to trial in federal court had taken 24.4 months to reach resolution. *See* U.S. Courts, *Table C-5 – U.S. District Courts – Civil Federal Judicial*

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*Caseload Statistics* (Mar. 31, 2014), available at <http://www.uscourts.gov/statistics/table/c-5/federal-judicial-caseload-statistics/2014/03/31>. Further, investors benefit from the speedy payment of FINRA awards—once a case is decided against a firm or individual broker, FINRA requires payment of the award within 30 days, upon penalty of suspension from the industry. Securities and Exchange Commission, *FINRA Statement on Key Issues*, SEC Investor Advisory Committee Panel on Securities Arbitration at 6 (May 17, 2010).

As for costs, the average legal costs of FINRA arbitration in 2007 were \$22,000 less than the costs for litigating in court, according to one estimate. SIFMA White Paper at 3. This is due in part to FINRA’s Customer Code of Arbitration, which “permits extensive document discovery while discouraging time-consuming and costly depositions,” and “explicitly empowers arbitrators to impose sanctions on any party for discovery intransigence.” Jill I. Gross, *The End of Mandatory Securities Arbitration?*, 30 Pace L. Rev. 1174, 1187 (2010). Unlike in court, moreover, the costs of arbitration are significantly subsidized by the industry; FINRA waives the hearing fees for investors who can show financial hardship and pays for the hearing facilities and arbitrator compensation at no cost to the parties. *FINRA Statement on Key Issues* at 3. While one commenter asserts that investors need experienced counsel to arbitrate before FINRA, see Comment Letter of Better Markets at 25-26 (July 21, 2015), litigating in court is no different. Moreover, parties who cannot afford counsel can represent themselves in FINRA or engage a non-attorney advocate. See SIFMA White Paper at 21 (citing FINRA, Code of Arbitration Procedure § 12202).

The lower costs and more efficient, expedited process associated with arbitration result in a far greater number of investors having their claims heard on the merits than occurs in court. About 20 percent of all arbitration claims before FINRA, for example, are heard on the merits and decided by arbitrators, compared with approximately 1.5 percent of all civil claims in court. SIFMA White Paper at 3.

Some rulemaking commenters find fault here too, objecting that arbitral awards are not “publicly available” and are not necessarily accompanied by an opinion explaining the basis for the decision. See, e.g., Comment Letter of Better Markets at 27. In fact, FINRA discloses all awards on a publicly-available, free database that has been searched more than five million times. *FINRA Statement on Key Issues* at 9. And FINRA Customer Rule 12904(g) expressly permits parties to jointly request an “explained decision,” which is “a fact-based award stating the general reason(s) for the arbitrators’ decision.” A written opinion is hardly necessary for parties to receive due process and a fair opportunity to be heard, however—juries, also, provide no written opinion—and it is entirely reasonable for parties to contract instead for the relatively swift, lower-cost forum provided by arbitration.

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Another criticism voiced by commenters is that some arbitrators apply equitable principles rather than hewing to black letter law. *E.g.*, Comment Letter of James D. Keeney at 2 (July 14, 2015) (“arbitrators are not required to follow federal or state statutes or regulations, including this one”). But numerous investor advocates have concluded that this reported tendency may make arbitration a *more favorable* forum for investors than being in court. *See, e.g.*, Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. Cin. L. Rev. 493, 509-10 (2008) (concluding that requiring arbitrators to strictly apply law without regard to equitable principles “would only worsen the available recoveries for investors”). These scholars contend that many “investors’ claims would face a far more hostile environment in court,” Gross, *The End of Mandatory Securities Arbitration?*, 30 Pace L. Rev. at 1189-90, and that the “equitable model of arbitration” may be its “great[est] advantage” because “[f]ederal securities law, in particular, is not investor-friendly,” Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 Pace L. Rev. 1, 12 (2004).

There also is no merit to the suggestion that the FINRA forum in particular is biased against investors. *See, e.g.*, Comment Letter of the Secretary of the Commonwealth of Massachusetts at 7 (July 21, 2015); Comment Letter of Better Markets at 26. FINRA provides numerous procedural safeguards to protect investors, including extensive disclosure of arbitrators’ biographies and previous awards, investor involvement in the selection of arbitrators, and sanctions against firms that do not comply with arbitration procedures. *See* SIFMA White Paper at 5. Participants in FINRA arbitrations largely perceive the system as operating fairly, *see id.* at 47 (citing Gary Tidwell et al., *Party Evaluation of Arbitrations: An Analysis of Data Collected from NASD Regulation Arbitrations* 3-4 (Aug. 5, 1999)), and a 1992 study by the Government Accountability Office found no evidence of an industry bias in the system, *id.* at 4. FINRA arbitration is subject to extensive SEC oversight, which is “designed to ensure FINRA’s rules . . . are fair and protect investors.” Gross, *The End of Mandatory Securities Arbitration?*, 30 Pace L. Rev. at 1185-86. FINRA statistics show that consumers win their cases approximately 40 to 50 percent of the time. FINRA, *Dispute Resolution Statistics*, *supra*.

For these reasons, while improvements could be made in the FINRA forum—as in any dispute resolution system—commenters’ assertions that arbitration “nullifies the benefits” of the DOL rulemaking, *see* Comment Letter of Better Markets at 24, and undermines investors’ access to a “fair and robust forum,” *see* Comment Letter of American Association for Justice at 4, are baseless. Certainly the record before the Department would not justify revising the proposed rules to bar parties from agreeing to resolve their disputes in a manner endorsed by Congress and the Supreme Court, in a forum overseen by the nation’s principal securities regulator.

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I hope that the Department finds this submission helpful, and please do not hesitate to contact me with any questions.

Respectfully submitted,

*Eugene Scalia* <sup>REM</sup>

Eugene Scalia

ES/bmr

cc: Office of Exemption Determinations

# Exhibit A





## Investor Alerts and Bulletins

## Investor Alert: Automated Investment Tools

May 8, 2015

*The SEC's Office of Investor Education and Advocacy (OIEA) and the Financial Industry Regulatory Authority, Inc. (FINRA) are issuing this alert to provide investors with a general overview of automated investment tools.*

At the swipe of a fingertip on a mobile device or the click of a mouse on a desktop computer, investors can access a broad range of automated investment tools. These tools range from personal financial planning tools (such as online calculators) to portfolio selection or asset optimization services (such as services that provide recommendations on how to allocate your 401(k) or brokerage account) to online investment management programs (such as robo-advisors that select and manage investment portfolios).

Many financial professionals have used automated investment tools for decades to help customers build and manage their investment portfolios, and a growing number of these tools are now available directly to investors from a variety of sources. While automated investment tools may offer clear benefits—including low cost, ease of use, and broad access—it is important to understand their risks and limitations before using them. Investors should be wary of tools that promise better portfolio performance.

### Automated Investment Tool Tips

Consider the following five tips before using any automated investment tool:

#### 1. Understand any terms and conditions.

Review all relevant disclosures for an automated investment tool. Understand any terms and conditions, such as the fees and expenses associated with using the tool or with selling or purchasing investments. Find out how you can terminate any agreement or relationship, and how long it may take to cash out any investments if you decide to stop using the tool. If anything is unclear or you need additional information, directly contact the automated tool sponsor.

Ask an automated investment tool sponsor whether it receives any form of compensation for offering, recommending, or selling certain services or investments.

#### 2. Consider the tool's limitations, including any key assumptions.

One type of automated tool called an investment analysis tool provided by [registered securities firms and individuals](#) must describe the criteria and methodology used, including the tool's limitations and key assumptions. Be aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation. For example, an automated investment tool may be programmed to use economic assumptions that will not react to shifts in the market. If the automated tool assumes that interest rates will remain low but, instead, interest rates rise, the tool's output will be flawed.

In addition, an automated investment tool, like other investment programs, may be

programmed to consider limited options. For example, an automated investment tool may only consider investments offered by an affiliated firm.

### **3. Recognize that the automated tool's output directly depends on what information it seeks from you and what information you provide.**

Which questions the tool asks and how they are framed may limit or influence the information you provide, which in turn directly impacts the output that an automated investment tool generates. If any of the questions are unclear or you do not understand why the information is being sought, ask the tool sponsor. Be aware that a tool may ask questions that are over-generalized, ambiguous, misleading, or designed to fit you into the tool's predetermined options.

In addition, be very careful when inputting your answers or information. If you make a mistake, the resulting output may not be right for you.

### **4. Be aware that an automated tool's output may not be right for your financial needs or goals.**

An automated investment tool may not assess all of your particular circumstances, such as your age, financial situation and needs, investment experience, other holdings, tax situation, willingness to risk losing your investment money for potentially higher investment returns, time horizon for investing, need for cash, and investment goals. Consequently, some tools may suggest investments (including asset-allocation models) that may not be right for you.

For example, an automated investment tool may estimate a time horizon for your investments based only on your age, but not take into account that you need some of your investment money back in a few years to buy a new home. In addition, automated tools typically do not take into account that your financial goals may change.

If the automated investment tool does not allow you to interact with an actual person, consider that you may lose the value that human judgment and oversight, or more personalized service, may add to the process.

### **5. Safeguard your personal information.**

Be aware that an automated tool sponsor may be collecting your personal information for purposes unrelated to the tool. Understand when and with whom your personal information may be shared. If you have questions that are not answered in the tool's privacy policy, contact the tool's sponsor for more information.

Also, look out for phishing and other scams designed to trick you into revealing personal financial information. Unless you are accessing an account that you established, do not provide bank or brokerage account numbers, passwords, PINs, credit card information, Social Security numbers, or other personally identifiable information.

When using investment tools online, take these steps to protect your personal financial information:

- Do not provide payment information if the address bar of the website indicates that the web address begins with "http" (instead of "https").
- Pick a "strong" password, keep it secure, and change it regularly.
- Password-protect mobile devices that are linked to investment tools or accounts.
- Avoid accessing investment tools or accounts on a shared computer or through an unsecure wireless connection.

For more online security tips, read [Investor Bulletin: Protecting Your Online Brokerage Accounts from Fraud](#) and ["Phishing" and Other Online Identity Theft Scams: Don't Take the](#)

## Bait.

While automated investment tools are programmed to generate outputs based on preset options, it is up to you to decide whether and when to rely on these tools in making your investment decisions.

### For More Information

Check the SEC's [Investment Adviser Public Disclosure \(IAPD\)](#) database or FINRA's [BrokerCheck](#) to research the background, including registration or license status and disciplinary history, of any individual or firm offering, recommending, or selling an investment.

Receive the latest Investor Alerts and Bulletins from OIEA by [email](#) or [RSS feed](#). Visit [Investor.gov](#), the SEC's website for individual investors. Like OIEA on [Facebook](#) at [www.facebook.com/secinvestoreducation](http://www.facebook.com/secinvestoreducation). Follow OIEA on [Twitter](#) @SEC\_Investor\_Ed.

[Ask a question](#) or call the SEC at (800) 732-0330 (or 1-202-551-6551 from outside of the U.S.).

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

*Modified: May 8, 2015*

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# Exhibit B



## WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY:<sup>2</sup>

*The success story of an investor protection focused  
institution that has delivered timely, cost-effective, and  
fair results for over 30 years.*

OCTOBER 2007

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<sup>1</sup> SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

<sup>2</sup> This paper is the collective effort of SIFMA staff, SIFMA's Arbitration and Litigation Advisory Committees, and the Compliance and Legal Division of SIFMA, which consists of over 2,500 professionals either employed by the industry, outside counsel or other entities serving the securities industry, in collaboration with outside counsel, Paul, Weiss, Rifkind, Wharton & Garrison LLP.

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## FOREWORD

In recent months, the use of predispute arbitration agreements in consumer contracts has come under attack from various critics, including members of the claimants' bar and the press. As part of this trend, legislators introduced the "Arbitration Fairness Act of 2007," H.R. 3010, in the United States House of Representatives on July 12, 2007. Along with its companion bill in the Senate, S. 1782, the legislation would ban predispute arbitration agreements in consumer contracts. The concerns that gave rise to these bills focus on unsupervised arbitration programs that use untrained arbitrators, conduct hearings far from the consumer's home, and involve hidden costs the consumer must bear.<sup>3</sup> Securities industry arbitration suffers none of these defects. Rather, securities arbitration affords investors the opportunity to have their claims heard close to home, before highly trained and experienced arbitrators, in a forum that has proven to resolve disputes at least as fairly as the judicial system, and much faster and less expensively.

This recent attack on predispute arbitration agreements is not the first. Congress considered and rejected similar legislation in 1988. That year, the "Securities Arbitration Reform Act" was introduced to amend the Securities Exchange Act of 1934

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<sup>3</sup> Sen. Feingold, Rep. Johnson Introduce Measure to Preserve Consumer Justice (July 12, 2007) *available at* <http://feingold.senate.gov/~feingold/releases/07/07/20070712.html>. On September 27, 2007 Senator Feingold released a statement regarding Public Citizen's recent report on arbitrations conducted by the National Arbitration Forum ("NAF") in California. The report asserts that private arbitration companies which receive millions of dollars in repeat business have a powerful incentive to rule in companies' favor and finds that NAF has, in fact, "ruled in favor of credit companies in 94 percent of the disputes it resolved." Statement of U.S. Senator Russ Feingold: At a Press Conference with Public Citizens on Protecting Consumers from Unfair Credit Card Contracts (September 27, 2007) *available at* <http://feingold.senate.gov/~feingold/statements/07/09/20070927mb.htm>. Securities arbitrators do not face a similar enticement: they are not employees of the self-regulatory organizations ("SROs") that conduct the arbitration and, no matter their decisions, will continue to be placed on neutral lists of potential arbitrators for a panel. Furthermore, as discussed *infra*, statistics cited by Public Citizen and Senator Feingold are simply not applicable to securities arbitration where two-thirds of all claimants recover damages or other non-monetary relief.



(“1934 Act”) to prohibit any broker or securities firm from entering into a predispute agreement to arbitrate so long as that agreement is a condition for establishing a customer account.<sup>4</sup> The House of Representatives held three hearings on the proposed legislation and heard testimony from, among others, the chairman of the Securities and Exchange Commission (“SEC”), legal scholars, investors, claimants’ attorneys and members of the securities industry, and it chose not to pass the legislation. As Congress recognized approximately twenty years ago, securities industry arbitration serves the interests of both investors and the industry; it should not now disrupt a system that not only continues to work well, but also continues to provide an ever-expanding array of safeguards for investors.<sup>5</sup>

## I. Executive Summary

For over three decades, applicable regulations have provided investors with an absolute right to have their disputes arbitrated.<sup>6</sup> Investment firms have gained the same right in return by entering into predispute arbitration agreements with their new customers. Such contracts ensure that both sides are treated fairly and effectuate the

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<sup>4</sup> See Securities Arbitration Reform Act of 1988, H.R. 4960, 100th Cong. (1988).

<sup>5</sup> Importantly, H.R. 4960 contained directives to the SEC that it shall, among other things, require that any “agreement to arbitrate future disputes... [be] clearly and prominently disclose[d] to the customer...” and to SROs that they “...specify the procedures for obtaining and enforcing, timely production of documents and witnesses...” as well as “provide the customer with reasonable biographical information and the right to challenge the selection of such arbitrators.” As discussed *infra*, these measures have been adopted—and often expanded upon—by the SROs.

<sup>6</sup> See § 12200 of the National Association of Securities Dealers (“NASD”) Code of Arbitration Procedure (“Code of Arbitration Procedure”) and Rule 600A(a)(ii) New York Stock Exchange Arbitration Rules (“NYSE Rule”) (directing that members of the securities industry must arbitrate upon demand of the customer). NASD’s rules have required member firms to arbitrate at the investor’s demand since March 1972. See NASD Manual (July 1, 1974) (noting that former Code of Arbitration Procedure ¶ 3702, § 2(a)(2) took effect on March 9, 1972).

public policy in favor of predispute arbitration agreements that has been recognized by both Congress and the United States Supreme Court.<sup>7</sup>

Opponents of predispute arbitration agreements, however, seek neither fairness nor equality; rather, they seek an unfair strategic advantage. They want investors to retain their right to arbitrate as they see fit, but to deprive investment firms of the same right. Equally importantly, they ignore the many unique and attractive features of securities arbitration, some of which include:

- **Securities arbitration is faster and less expensive than court-based litigation.**
  - A 1988 study found that average legal costs were \$12,000 less in arbitration than in litigation. Adjusting solely for inflation, average legal costs today are at least \$22,000 less in arbitration than in litigation. Given the significant increase in litigation costs since 1988, that gap is most likely substantially wider. More recent studies support this conclusion.
  - Cases filed in securities arbitration are resolved, on average, approximately 40 percent faster than cases filed in court.<sup>8</sup>
  - Arbitration saves time and money because motion practice and discovery—both of which may be used as expensive delaying tactics—are disfavored and more limited in arbitration versus litigation.
- **Securities arbitration is more accessible than court-based litigation.**
  - Relaxed pleading standards in securities arbitration encourage disputes to be filed. Recent Supreme Court decisions make certain that investors are far more likely to have their claims dismissed in court than in arbitration, where dismissals are rare. Thus, arbitration provides investors a much greater chance to have their “day in court.”
  - The statistics bear out this fact. Whereas 20 percent of all arbitration claims are ultimately heard on the merits and decided by arbitrators, only about 1.5 percent of all civil claims in court are decided by a judge or jury.<sup>9</sup>

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<sup>7</sup> *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 225-226 (1987).

<sup>8</sup> See Appendix B (Arbitration is Faster Than Litigation).

<sup>9</sup> See Appendix C (More Cases Are Heard Before a Decision-Maker in Arbitration Than in Court).

- Approximately 25 percent of all arbitrations involve claims of less than \$10,000, a sum for which it is often not cost effective to litigate, whether in federal or state court.<sup>10</sup>
- **Investors continue to fare well in securities arbitration.**
  - The percentage of securities arbitration claimants who recover—either by award or settlement—has held steady in recent years, and in 2006 was 66 percent.<sup>11</sup>
  - Between 1995 and 2004, investors’ average inflation-adjusted recoveries in securities arbitration have followed a generally increasing trend.<sup>12</sup>
- **Securities arbitration is perceived to be fair, and is in fact fair.**
  - The most recent survey of securities arbitration participants found that approximately 93 percent of those surveyed—more than 50 percent of whom were investors—believed their case had been handled fairly and without bias.<sup>13</sup>
  - A 1992 GAO evaluation of the securities arbitration system found “no indication of a pro-industry bias in decisions at industry-sponsored forums.”
  - A review of all 2005 and 2006 arbitration decisions found that the presence of an “industry” arbitrator has no material impact on customer wins.<sup>14</sup>
  - Securities arbitration is in fact fair because arbitrators understand the law and ensure it is properly followed and applied in each case.
- **Multiple regulators oversee the securities arbitration system and have ensured its development as an investor protection focused institution.**
  - For over 30 years, securities arbitration has been closely regulated by the SEC and by SEC-supervised SROs, such as the Financial Industry Regulatory Authority (“FINRA”).<sup>15</sup>

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<sup>10</sup> See Appendix F (Many Cases are Small Claims, Which are Better-Suited for Arbitration Than Litigation).

<sup>11</sup> See Appendix D (The Total Percentage of Claimants Who Recover Damages or Other Relief in Arbitration or by Settlement is Favorable).

<sup>12</sup> See Appendix E (Investors’ Inflation-Adjusted Recoveries in Arbitration Have Increased).

<sup>13</sup> See Gary Tidwell, Kevin Foster and Michael Hummel, *Party Evaluation of Arbitrations: An Analysis of Data Collected from NASD Regulation Arbitrations 3* (Aug. 5, 1999), available at [http://www.nasd.com/web/groups/med\\_arb/documents/mediation\\_arbitration/nasdw\\_009528.pdf](http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_009528.pdf).

<sup>14</sup> See Appendix G (The Presence of an “Industry” Arbitrator has No Material Impact on Customer Wins).

<sup>15</sup> FINRA was established on July 30, 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE. See FINRA News Release,

- Numerous procedural safeguards have evolved to protect investors and ensure fairness in securities arbitration, including:<sup>16</sup>
  - The requirement that arbitrators must provide and regularly update extensive biographical disclosures, including employment history, training, conflicts and associations with industry members;
  - Disclosure of prior awards of each proposed arbitrator;
  - Investor involvement in the selection process for arbitrators and arbitration panels;
  - Availability of sanctions against securities firms for failure to comply with the Code of Arbitration Procedure, including discovery obligations, and disciplinary referrals to SRO regulators for potential violations of federal securities laws or SRO rules;
  - Assurance that a hearing will take place at a location close to the customer's residence; and
  - Smaller fees for investors than for member firms.
- **Predispute arbitration agreements are fair to investors and serve the public interest.**
  - Predispute arbitration agreements contribute a valuable degree of predictability to the relationship between the parties.
  - Predispute arbitration agreements put the parties on equal footing once a dispute emerges and deter forum selection tactics.
  - In the absence of a predispute arbitration agreement, decisions whether to arbitrate an existing dispute will be governed by tactical advantage. The evidence shows that the odds of an agreement to arbitrate being entered into after a dispute has arisen are very low.
- In summary, the existing system serves the best interests of investors. Predispute arbitration agreements make it possible for investors to pursue small claims, provide a friendly forum for pro se investor claimants, lower overall costs borne by investors and securities firms, and secure the oversight of expert regulators, all within a framework that was specifically designed for investor claims and has demonstrated fairness for decades.

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"NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA"(July 30, 2007), *available at* <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P036329>.

<sup>16</sup> See Appendix A (Chronology of Improvements to Securities Arbitration Procedures).

## II. History of Arbitration in the Securities Industry

For over 130 years, arbitration has been used to resolve disputes between individual investors and members of the securities industry.<sup>17</sup> Since 1872, the securities exchanges and regulators have developed rules for the fair and effective administration of disputes so that today, FINRA, the securities industry's largest SRO, manages the resolution of over 4,000 disputes a year.<sup>18</sup>

Since the Federal Arbitration Act ("FAA") became law in 1925,<sup>19</sup> the legal system has had a "healthy regard for the federal policy favoring arbitration."<sup>20</sup> Based upon Congress' clear direction to place arbitration agreements "upon the same footing as other contracts,"<sup>21</sup> courts have consistently enforced agreements to arbitrate statutory claims.<sup>22</sup>

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<sup>17</sup> In 1817, NYSE allowed its members to arbitrate disputes that arose between them. In 1872, NYSE expanded the jurisdiction of its arbitral forum to hear disputes between individual investors and member firms. See Jill I. Gross, *Securities Mediation: Dispute Resolution for the Individual Investor*, 21 Ohio St. J. on Disp. Resol. 329, 336 (2006). NASD established its arbitral forum in 1968. See Testimony of Linda D. Fienberg, President NASD Dispute Resolution, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Committee on Financial Services United States House of Representatives (March 17, 2005), available at <http://www.finra.org/PressRoom/SpeechesTestimony/LindaFienberg/p013652> ("NASD has operated the forum since 1968, providing a fair process through arbitration and mediation for investors to settle disputes with their brokers.").

<sup>18</sup> Prior to the consolidation of NASD and NYSE, the NASD administered "over 94 percent of the investor-broker disputes filed every year." Letter from Linda D. Fienberg, NASD, dated January 26, 2007 (referencing the SICA 13th Report (2005)).

<sup>19</sup> 9 U.S.C. § 1 *et seq.* (2000).

<sup>20</sup> *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24 (1983).

<sup>21</sup> H.R. Rep. 68-96, 1, 2 (1924).

<sup>22</sup> See e.g., *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 30 (1991) ("...generalized attacks on arbitration 'res[t] on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants,' and as such they are 'far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.'" (citing *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 481 (1989)); *McMahon*, 482 U.S. 220; *Southland Corp. v. Keating*, 465 U.S. 1 (1984).

The validity of a predispute arbitration agreement in the setting of securities claims was considered and confirmed in the Supreme Court's 1987 decision in *Shearson/American Express, Inc. v. McMahon*. In *McMahon*, Justice O'Connor noted that securities arbitrators are "readily capable" of handling complex claims, that streamlined procedures are not inconsistent with the underlying substantive rights, and that judicial scrutiny of arbitration awards—while limited—is sufficient to ensure that arbitrators meet their statutory obligations.<sup>23</sup> The Court also found that any mistrust of arbitration as an efficient and fair means to resolve disputes is particularly unfounded in the context of securities arbitration, which is regulated by the SEC, which has "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs."<sup>24</sup>

Two years later, the Court reinforced the importance of this unique aspect of securities arbitration when it held that claims brought pursuant to the Securities Act of 1933 ("1933 Act") may also be arbitrated pursuant to a predispute agreement made between the brokerage firm and the investor.<sup>25</sup> Since these rulings, members of the securities industry have generally included arbitration agreements in their contracts with investors to secure the benefits of arbitration first recognized by Congress more than 80 years ago.

### **III. For Over Thirty Years, the Public Has Had a Role in the Oversight of Securities Arbitration for the Benefit of Investors**

Beginning in 1971, Congress undertook a "searching reexamination of the competitive, statutory, and economic issues facing the securities markets, the securities industry, and of course, public investors" in order to ensure that the regulatory structure

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<sup>23</sup> *McMahon*, 482 U.S. at 232 (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 633-34 (1985)).

<sup>24</sup> *Id.* at 233.

<sup>25</sup> *Rodriguez de Quijas*, 490 U.S. at 481-483. The claim in *McMahon* was brought pursuant to the 1934 Act.

had kept pace with the economic growth and shift in public investment patterns since the early 1930s.<sup>26</sup> The result was that the SEC was granted “expansive power” to ensure the adequacy of the various exchanges and NASD’s arbitration rules and procedures.<sup>27</sup> Since 1975, the SEC has used this authority to enhance the accessibility, neutrality, and fairness of the forum, all to the benefit of investors.

As recently as July 26, 2007, the SEC exercised its expansive oversight power when it approved NASD’s proposal to consolidate the NASD and NYSE arbitration forums.<sup>28</sup> In so doing, the Commission addressed the argument that public investors be permitted to resolve their disputes either in court or in arbitration. The SEC concluded that in “light of the policy supporting arbitration evinced by the Federal Arbitration Act and the Supreme Court precedent upholding securities arbitration agreements, and the requirements of Section 19(b)(2) of the Exchange Act” that dictate the SEC act consistently with the requirements of the 1934 Act, consolidation of the two arbitral forums need not be “conditioned on providing customers with a choice of another dispute resolution forum.”<sup>29</sup>

**A. All Proposed SRO Arbitration Rules are Subject to Public Comment and SEC Approval**

Each SRO, including FINRA, is required to file with the SEC any proposed rule or proposed change to its rules—including rules concerning the arbitration process—which the SEC, in turn, publishes for public comment.<sup>30</sup> Only after the public has had a meaningful opportunity to review and comment upon the proposed rule or rule

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<sup>26</sup> H.R. Conf. Rep. No. 94-229, 91 (1975).

<sup>27</sup> See *McMahon*, 482 U.S. at 233-234; see also 15 U.S.C. § 78s (2000).

<sup>28</sup> Securities and Exchange Commission, Release No. 34-56145, 77-78 (July 26, 2007), available at <http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf>.

<sup>29</sup> *Id.* at 78.

<sup>30</sup> 15 U.S.C. § 78s(b)(1) (2000).

change will the SEC either disapprove or approve a rule change.<sup>31</sup> The SEC will approve a rule change only if it finds the change to be “consistent with the requirements of [the 1934 Act] and the rules and regulations thereunder.”<sup>32</sup> The rule must also be designed to “protect investors and the public interest” and cannot “permit unfair discrimination between customers, issuers, brokers, or dealers.”<sup>33</sup>

The SEC and, in turn, the SROs, have been responsive to public comments concerning the effect of certain proposed rules upon investors: observations from interested parties have often resulted in an SRO amending or abandoning proposed rules. One example of this responsiveness is NASD’s decision to abandon its proposed rule on the use of choice-of-law provisions in predispute arbitration agreements.<sup>34</sup> On November 29, 1999, the SEC published for comment a proposed rule change to amend NASD Rule 3110(f) to provide, among other things, that choice of law provisions are unenforceable “unless there is a significant contact or relationship between the law selected and either the transaction at issue or one or more of the parties.”<sup>35</sup> The purpose of the rule was to protect investors from the use of arbitrary choice of law provisions in predispute arbitration agreements.<sup>36</sup>

After several amendments to the proposed rule change, notice of the proposal was again published in the *Federal Register* on September 12, 2003. The SEC

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<sup>31</sup> 15 U.S.C. § 78s(b)(2) (2000); see also 5 U.S.C. § 553 (2000).

<sup>32</sup> 15 U.S.C. § 78s(b)(2)(B) (2000).

<sup>33</sup> 15 U.S.C. § 78f (b)(5) (2000).

<sup>34</sup> See Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change as Amended and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 by the National Association of Securities Dealers, Inc., regarding NASD Rule 3110(f) Governing Predispute Arbitration Agreements with Customers, 69 Fed. Reg. 70,293 (Dec. 3, 2004).

<sup>35</sup> *Id.* at 70,294.

<sup>36</sup> *Id.*



received 24 comments on the proposal, the majority of which opposed the proposed provision relating to the use of choice-of-law provisions.<sup>37</sup> Commentators, including claimants' counsel, were concerned that "because relevant case law regarding choice-of-law provisions in predispute arbitration agreements has evolved considerably over the past five years....proposed paragraph (f)(4)(B) could be interpreted to endorse choice-of-law clauses that may not be enforceable under state law."<sup>38</sup> In response to these comments, NASD withdrew this proposed provision on January 9, 2004.<sup>39</sup>

Finally, two additional protections exist to ensure that substantive and procedural arbitral rules are consistent with the overarching goal of the 1933 Act and the 1934 Act to protect investors. First, SEC rulemaking is subject to judicial review under the Administrative Procedure Act ("APA").<sup>40</sup> Courts will review any alleged failure of the SEC to follow the "notice and comment" procedures provided for in § 553 of the APA. Second, 15 U.S.C. § 78s(c) grants the SEC the power, on its own initiative, to "abrogate, add to, and delete from" any SRO rule, including arbitration rules, to ensure that securities arbitration adequately protects the statutory rights guaranteed under the 1933 and 1934 Acts.<sup>41</sup>

#### **B. Regulatory Oversight Extends Beyond the Rulemaking Process**

The SEC oversight of securities arbitration extends beyond the rulemaking arena. For instance, the SEC engages in frequent review of SRO arbitration facilities to "identify areas where procedures should be strengthened, and to encourage

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<sup>37</sup> *Id.* at 70,293.

<sup>38</sup> *Id.* at 70,295.

<sup>39</sup> *Id.* at 70,293, 70,295.

<sup>40</sup> 5 U.S.C. § 702 (2000).

<sup>41</sup> 15 U.S.C. § 78s(c) (2000).

remedial steps either through changes in administration or through the development of rule changes.”<sup>42</sup> Such proactive efforts have ensured that the rules governing securities arbitration provide the investor a fair, efficient and impartial forum.

In the late 1970’s, for example, the SEC played a pivotal role in the establishment of the Securities Industry Conference on Arbitration (“SICA”). SICA’s members consist of a majority of representatives of the investing public (including claimants’ lawyers), a securities industry representative, and representatives of various securities regulators, among others. SICA was originally charged with developing, and did develop, a Uniform Code of Arbitration (“Uniform Code”) which harmonized the various rules and procedures that SROs had been employing at the time and codified procedures that had been informally utilized.<sup>43</sup> Following the formation of FINRA, however, SICA no longer maintains or continues to amend the Uniform Code.

Notwithstanding the obsolescence of its original charter, SICA’s diverse constituencies continue to meet on a regular basis to discuss specific rule proposals, and to discuss and debate current issues relating to arbitration, including, among others, arbitrator qualification and classification issues, electronic discovery issues, arbitrator disclosure and removal issues, and explained awards. Such meetings are another unique aspect related to securities arbitration: no other forum is the subject of conferences at which both investor and industry representatives, arbitrators, arbitration service providers and state and federal regulators convene to discuss pressing issues relating to the efficacy of the forum.

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<sup>42</sup> Self-Regulatory Organizations; National Association of Securities Dealers, Inc; Order Granting Approval to Proposed Rule Change Relating to the Arbitration of Employment Discrimination Claims, 63 Fed. Reg. 35,299, 35,303 n.53 (June 29, 1998).

<sup>43</sup> J. Kirkland Grant, **SECURITIES ARBITRATION FOR BROKERS, ATTORNEYS, AND INVESTORS** 94-95 (Quorum Books 1994).

Another example of SEC action includes the 1998 initiative to encourage SROs to use “plain English” in disclosure documents and other materials used by investors, including the Code of Arbitration Procedure.<sup>44</sup> NASD implemented the SEC’s “plain English” guidelines, simplifying language, eliminating legalistic verbiage, and providing definitions to eliminate the potential for consumer confusion. But NASD then went several steps further: it reorganized the Code of Arbitration Procedure into a more user-friendly format, creating a separate arbitration code specific to customer disputes and reorganizing the sections of the Code of Arbitration Procedure to follow the chronology of a typical arbitration.<sup>45</sup> The SEC found that NASD’s revisions “make the process of arbitration more transparent and more accessible to users of the forum, including those who may file arbitration claims *pro se*.”<sup>46</sup>

Finally, the SEC has commissioned studies to investigate the adequacy of certain aspects of SRO arbitration. Such studies have led to enhancements of SRO arbitration procedures. For instance, in July 2002, the SEC retained Professor Michael Perino from St. John’s University School of Law to assess the adequacy of arbitrator disclosure requirements at NASD and NYSE. Professor Perino concluded that, in his review of data from more than 30,000 SRO arbitrations, there was no evidence of

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<sup>44</sup> Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendments 1, 2, 3 and 4 to Amend NASD Arbitration Rules for Customer Disputes and Notice of Filing and Order Granting Accelerated Approval of Amendments 5, 6, and 7 thereto; Order Approving Proposed Rule Change and Amendments 1, 2, 3 and 4 to Amend NASD Arbitration Rules for Industry Disputes and Notice of Filing and Order Granting Accelerated Approval of Amendments 5, 6, and 7 thereto, 72 Fed. Reg. 4,574, 4,575 (Jan. 31, 2007); see also Code of Arbitration Procedure, available at <http://www.finra.org/ArbitrationMediation/Arbitration/CodeofArbitrationProcedure/p009566>. With the creation of FINRA, all securities arbitration claims filed after August 6, 2007 are administered under the Code of Arbitration Procedure. See NYSE Rule 600A(a)(i). A FINRA Code does not yet exist, but will “be melded from a harmonization of the NASD and NYSE Codes.” See *2006 Annual Award Survey: A SAC Award Survey Comparing Results in 2006 to 2000-20005*, Securities Arbitration Commentator, Inc. 12 (Vol. 2007, No. 2).

<sup>45</sup> 72 Fed. Reg. at 4,576.

<sup>46</sup> *Id.* at 4,601.

favoritism toward either industry members or customers, or undisclosed conflicts of interest, but he made a series of recommendations for strengthening the arbitrator disclosure requirements nonetheless.<sup>47</sup>

Professor Perino's recommendations led NASD to modify Sections 10308 and 10312 of the Code of Arbitration Procedure<sup>48</sup> to expand the types of relationships with the securities industry that would require an arbitrator to be classified as an industry arbitrator, delineate the standards for removing an arbitrator from hearing a dispute, and clarify that arbitrators have a mandatory duty to disclose and update conflict information, all to "provide additional assurance to investors that arbitrations are in fact neutral and fair."<sup>49</sup>

### **C. Legislative and SRO Oversight**

Unlike other arbitral forums, securities industry SROs are subject to extensive Congressional oversight, principally through Congress' investigative arm, the Government Accountability Office, formerly known as the General Accounting Office ("GAO"). For example, in 1992, the GAO evaluated a "number of issues relating to the arbitration process sponsored by the securities industry self-regulatory organizations."<sup>50</sup> The review found that there was "no indication of a pro-industry bias in decisions at industry-sponsored forums."<sup>51</sup> The GAO nonetheless suggested that SROs implement

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<sup>47</sup> Michael A. Perino, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Arbitrations* 3-5, 48 (Nov. 4, 2002).

<sup>48</sup> The changes are now reflected in Code of Arbitration Procedure §§ 12100(p), 12408(a), and 12410.

<sup>49</sup> See NASD Notice to Members 04-49, Arbitrator Classification (effective July 19, 2004), available at [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p002727.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p002727.pdf).

<sup>50</sup> U.S. General Accounting Office, *Securities Arbitration: How Investors Fare* 1 (1992).

<sup>51</sup> *Id.* at 6.

“internal controls” related to arbitrator qualification and selection in order to further ensure the fairness of arbitral proceedings.<sup>52</sup>

In 2000, the GAO updated its 1992 study and found that the SROs had appropriately implemented the GAO’s 1992 recommendations by “giving arbitration participants a larger role in selecting arbitrators, periodically surveying arbitrators to verify background information, and improving arbitrator training.”<sup>53</sup>

Public oversight of securities arbitration is not limited to the executive and legislative branches of government. The SROs actively oversee the arbitration process, and obtain extensive public participation in so doing. For instance, FINRA’s Board of Governors is composed of both public representatives, who hold a majority of seats, and industry members.<sup>54</sup>

The securities arbitration process is also overseen by the National Arbitration and Mediation Committee (“NAMC”). The Code of Arbitration Procedure provides that the NAMC has “the authority to recommend rules, regulations, procedures and amendments relating to arbitration, mediation and other dispute resolution matters to the Board” and “has such other power and authority as is necessary to carry out the purposes of the Code.”<sup>55</sup> NAMC is also charged with the “recruitment, qualification,

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<sup>52</sup> *Id.* at 55-61.

<sup>53</sup> U.S. General Accounting Office, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards* 4 (2000).

<sup>54</sup> An Interim Board of Governors will serve until FINRA’s three-year Transition Board of Governors is elected in October 2007. “Both Boards will include 11 public governors appointed from outside the securities industry and 10 governors from inside the securities industry.” See FINRA Announces Interim Board of Governors to Serve Until Annual Meeting for Board Elections (August 2, 2007), *available at* <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P036351>.

<sup>55</sup> Code of Arbitration Procedure § 12102(b). See also NASD Manual, Corporate Organization, Plan of Allocation and Delegation of Functions by NASD to Subsidiaries, NASD Dispute Resolution, Inc., National Arbitration and Mediation Committee, *available at* [http://finra.complinet.com/finra/display/display.html?rbid=1189&element\\_id=1159000411](http://finra.complinet.com/finra/display/display.html?rbid=1189&element_id=1159000411).

training, and evaluation of arbitrators and mediators,” and the “evaluation of existing rules, regulations, and procedures.”<sup>56</sup> Like FINRA’s Board of Governors, the NAMC is also composed of a majority of non-industry members.<sup>57</sup> Thus, non-industry participants have a significant role in shaping the procedures relating to securities arbitration.

FINRA also provides investors with many other tools to help understand and easily navigate the arbitration process. For instance, FINRA provides investors with numerous resources on its website, including “Frequently Used Forms,” a “Questions and Feedback” forum, “Dispute Resolution Statistics,” the “Neutral Corner” publication,<sup>58</sup> and “Resources for Parties,” which provide, at one source, case-related guidance, the Code of Arbitration Procedure, and other helpful information for parties considering filing a claim or already in arbitration.<sup>59</sup>

In sum, having been subject to stringent oversight for over 30 years, and with the meaningful input and contributions of SICA and NAMC, among other groups, SRO arbitration has evolved into a forum that offers significant and ever-improving safeguards to its customers.

#### **IV. Securities Arbitration Offers Strong Procedural Protections to Ensure Investors a Fair Process and an Impartial Forum**

The rules and procedures employed by FINRA are designed to encourage and facilitate the filing of claims and the resolution of investor disputes by ensuring and improving the quality and fairness of the process. In short, claimants in

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<sup>56</sup> See National Arbitration and Mediation Committee, *available at* <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/WhatisDisputeResolution/NationalArbitrationMediationCommittee/index.htm>.

<sup>57</sup> See Code of Arbitration Procedure § 12102(a)(1).

<sup>58</sup> See Arbitration and Mediation, *available at* <http://www.finra.org/ArbitrationMediation/index.htm>.

<sup>59</sup> See Resources for Parties, *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforParties/index.htm>.

SRO arbitration enjoy significant control over the process and stronger procedural protections than they would have in other arbitral forums.

**A. Procedural Safeguards Ensure Fairness in the Selection of an Arbitrator or Panel**

The Code of Arbitration Procedure provides three major procedural safeguards to ensure investor participation in the selection of a fair and unbiased arbitrator or arbitral panel.

**1. Potential arbitrators are required to provide detailed biographical information and to disclose potential conflicts of interest**

FINRA Dispute Resolution, which oversees all securities industry arbitrations between member firms and their customers, carefully selects arbitrators from a broad cross-section of applicants, diverse in culture, profession and background. To qualify, applicants must have at least “five years of full-time, paid business or professional experience.”<sup>60</sup> Applicants must also be recommended in writing by two persons who can personally attest to their integrity and skills. These letters are reviewed by FINRA staff and a subcommittee of the NAMC.<sup>61</sup> Once selected, arbitrators must provide and regularly update extensive biographical disclosures, including employment history, education, training, conflicts, and associations with industry members.<sup>62</sup> In addition, before being appointed to hear a dispute, arbitrators are required to make a

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<sup>60</sup> See Frequently Asked Questions About Becoming a FINRA Arbitrator, *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforArbitratorsandMediators/ArbitratorRecruitment/FrequentlyAskedQuestionsAboutBecomingaFINRAArbitrator/index.htm>.

<sup>61</sup> Dispute Resolutions Forms, *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforArbitratorsandMediators/CaseRelatedInformationandForms/index.htm>. See also NASD Dispute Resolution Arbitrator Application Booklet, May 2007, *available at*, [http://www.finra.org/web/groups/med\\_arb/documents/mediation\\_arbitration/p017271.pdf](http://www.finra.org/web/groups/med_arb/documents/mediation_arbitration/p017271.pdf).

<sup>62</sup> See Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Proposal to Conduct Background Verification and Charge Application Fee for NASD Neutral Roster Applicants, 68 Fed. Reg. 5,6661-5,6662 (Oct. 1, 2003).

reasonable effort to learn of, and must disclose, any conflicts of interest related to hearing a particular case.<sup>63</sup> Finally, if during the course of a hearing a conflict arises, an arbitrator must disclose it so that a decision can be made as to whether he or she should be voluntarily removed from the case or whether the matter should be referred to the Director or President of FINRA Dispute Resolution.<sup>64</sup>

**2. Either a sole public arbitrator or a panel composed of a majority of public, non-industry arbitrators will hear a dispute**

Arbitration panels are composed of either a sole “public” arbitrator or a panel of three arbitrators, two of whom must be public, and one of whom is “non-public.” As defined in Code of Arbitration Procedure § 12100(p), a non-public arbitrator is a person who was, within the past five years, associated with a broker or dealer, registered under the Commodity Exchange Act, a member of an exchange or a futures association or associated with a person or firm registered under the Commodity Exchange Act. Additionally, arbitrators are often defined as non-public or “industry” arbitrators if they spent a substantial part of their careers, including legal careers, engaging in, or working on behalf of, the above listed businesses. Finally, any person who is employed by a financial institution that effects transactions in securities or monitors compliance with securities laws also is classified as a non-public or “industry” arbitrator.

Under Code of Arbitration Procedure § 12100(u), the term “public arbitrator” refers to a person who is not engaged in any of the activities described in § 12100(p) and has not been engaged in those activities for over 20 years. Additionally, a public arbitrator cannot be an investment advisor, an attorney or accountant whose firm derives over 10 percent of its revenue from any persons or entities listed in

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<sup>63</sup> Code of Arbitration Procedure § 12408(a).

<sup>64</sup> See Code of Arbitration Procedure §§ 12408(b-c), 12410(b).



§ 12100(p);<sup>65</sup> an employee, a spouse or an immediate family member of any entity that controls or is controlled by a member of the securities industry; or a director or officer, or a spouse or an immediate family member of a person who is a director or officer of an entity that controls or is controlled by a member of the securities industry.

When a claim is \$25,000 or less, it is heard by a single public arbitrator.<sup>66</sup> If the claim ranges between \$25,000 and \$50,000, the FINRA panel will consist of one public arbitrator, unless any party requests a panel of three arbitrators, which must include two public arbitrators.<sup>67</sup> If the investor's claim is more than \$50,000, or if the claim does not specify damages, the panel will consist of three arbitrators, unless both parties agree in writing to one arbitrator.<sup>68</sup> A three-member arbitration panel must include two public arbitrators, one of whom serves as the chairperson.<sup>69</sup> To qualify as a chair, an arbitrator must either 1) have a law degree, be a member of the bar of at least one jurisdiction, and have served as an arbitrator on at least two prior SRO arbitrations in which hearings were held, or 2) have served as an arbitrator through award on at least three arbitrations administered by an SRO in which hearings were held.<sup>70</sup>

Before serving on an arbitral panel, a candidate must complete FINRA's comprehensive arbitrator training program which consists of an eight-hour online training

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<sup>65</sup> In order to further enhance investor confidence in the fairness and neutrality of its arbitration forum, on March 12, 2007, NASD filed a proposed rule change to amend the definition of public arbitrator so that a professional could not be classified as a "public" arbitrator if his or her firm derived over \$50,000 or more in annual revenue in the past two years from any persons listed in § 12100(p). Self-Regulatory Organizations; National Association of Securities Dealers, Inc., Notice of Filing of Proposed Rule Change to Amend the Definition of Public Arbitrator, 72 Fed. Reg. 3,9110, 3,9111 (July 17, 2007).

<sup>66</sup> Code of Arbitration Procedure § 12401(a).

<sup>67</sup> Code of Arbitration Procedure §§ 12401(b), 12402(b).

<sup>68</sup> Code of Arbitration Procedure § 12401(c).

<sup>69</sup> Code of Arbitration Procedure § 12402(b).

<sup>70</sup> Code of Arbitration Procedure § 12400(c).

course and a four-hour onsite classroom session, which provides “practical guidance for resolving common issues that arise during arbitration.”<sup>71</sup> FINRA also offers subject-specific online training modules on arbitrators’ duty to disclose and parties’ duties during the discovery process, among others. Arbitrators wishing to serve as chairperson must complete an additional nine-hour course to ensure that they are capable of assuming such significant responsibilities.<sup>72</sup>

### **3. Investors are able to choose the arbitrators to hear a dispute**

Claimants in SRO arbitration, unlike plaintiffs in court, have significant input in the composition of an SRO arbitration panel. Once a claim has been filed, FINRA sends both parties a randomly generated list of eight public arbitrators, eight non-public arbitrators, and eight public chairperson-eligible arbitrators to hear the dispute.<sup>73</sup>

The parties receive extensive disclosures regarding each potential arbitrator, including employment history for the past 10 years and other background information. The parties also have access to potential arbitrators’ prior awards on the FINRA website or by contacting FINRA directly. Each party may perform web-based searches for FINRA arbitration awards, free of charge, by simply entering the name of the potential arbitrator into the online database.<sup>74</sup>

After considering the relevant background information and prior awards of the list of potential arbitrators, each party may strike up to four arbitrators from each list

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<sup>71</sup> Arbitrator Training, *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforArbitratorsandMediators/ArbitratorTraining/ArbitratorTrainingPrograms/index.htm>.

<sup>72</sup> *Id.*

<sup>73</sup> Code of Arbitration Procedure § 12403(a). If a panel consists of only one arbitrator, FINRA will send the parties a list of eight potential arbitrators from the chairperson roster. Code of Arbitration Procedure § 12403(a)(1).

<sup>74</sup> FINRA Dispute Resolution Homepage, *available at* <http://www.finra.org/ArbitrationMediation/index.htm>.

of eight arbitrators, and rank their preferences from the remaining arbitrators.<sup>75</sup> The ranked lists of both parties are then combined and the highest-ranked potential arbitrators are appointed by the Director of FINRA Dispute Resolution.<sup>76</sup>

The Supreme Court has recognized that these extensive requirements and procedures promote the fairness of the process in securities arbitrations. In *Gilmer v. Interstate/Johnson Lane Corp.*, the Court considered NYSE rules requiring arbitrators to disclose extensive background information (NYSE Rule 608) and conflicts of interest (NYSE Rule 610), the rule permitting parties to inquire further into arbitrators' backgrounds (NYSE Rule 608), and the rule permitting parties to challenge arbitrators (NYSE Rule 609).<sup>77</sup> The Court noted that these rules "provide protections against biased panels" and concluded that "[t]here has been no showing in this case that those provisions are inadequate to guard against potential bias."<sup>78</sup>

**B. Procedural Safeguards in Favor of the Investor Exist Throughout the Entire Arbitration Process**

Federal oversight and public input have ensured that procedural protections exist for the investor throughout dispute resolution proceedings. Examples of such protections are codified in several of FINRA's rules, including:

- Code of Arbitration Procedure § 3110(f) requires that "in any agreement containing a predispute arbitration agreement, there shall be a highlighted statement...that the agreement contains a predispute arbitration clause."<sup>79</sup>

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<sup>75</sup> Code of Arbitration Procedure § 12404.

<sup>76</sup> Code of Arbitration Procedure § 12406.

<sup>77</sup> *Gilmer*, 500 U.S. at 30. The Code of Arbitration Procedure provides investors the same procedural protections as the NYSE rules the Supreme Court considered in *Gilmer*. See e.g., Code of Arbitration Procedure §§ 12403(b)(1), 12408(a), 12403(b)(2), 12404.

<sup>78</sup> *Id.* at 30-31.

<sup>79</sup> Code of Arbitration Procedure § 3110(f)(2)(A).

- FINRA also ensures that the substantive provisions of an agreement to arbitrate protect the investor: the arbitration clause cannot limit the ability of a party to file a claim or the ability of an arbitrator to make an award.<sup>80</sup> Thus, all of the remedies available to an investor in court are also available to an investor in arbitration. Should an arbitration clause be challenged, this rule facilitates judicial review of the agreement to determine its enforceability under the FAA.<sup>81</sup>
- Investors are not required to arbitrate disputes with members of FINRA whose memberships have been terminated, suspended, cancelled or revoked or against members who have been expelled.<sup>82</sup>
- Investors may represent themselves or may be represented by a person who is not an attorney in arbitration. This rule is particularly beneficial for investors with small claims who “may be unable to retain an attorney because the attorney may believe that the attorney’s share of any award would be too small to justify the effort.”<sup>83</sup>
- Sections 12204 and 12205 of the Code of Arbitration Procedure provide that class action claims and shareholder derivative actions may not be

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<sup>80</sup> Code of Arbitration Procedure §§ 3110(f)(4)(B-D). In some jurisdictions, claimants may have greater remedies available in arbitration than they would in court. For example, in New York, in the absence of a statute, punitive damages are available in a limited number of circumstances. *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 795 (N.Y. 1976). Similarly, in Massachusetts, the general rule is that punitive damages are not available absent specific statutory authority. *Santana v. Registrars of Voters of Worcester*, 398 Mass. 862, 867 (1986). Yet, in securities arbitration proceedings held in that state, claimants frequently seek punitive damages under the provision of the Code of Arbitration Procedure that allows arbitrators to award any damages they deem appropriate.

<sup>81</sup> 9 U.S.C. §§ 3, 4 (2000).

<sup>82</sup> Code of Arbitration Procedure § 12202.

<sup>83</sup> Securities and Exchange Commission, Release No. 34-56540, 3 (September 26, 2007), *available* at <http://www.sec.gov/rules/sro/nasd/2007/34-56540.pdf>.

arbitrated.<sup>84</sup> Under these provisions, members of the securities industry may not enforce arbitration agreements against any member of a certified or putative class unless the claimant has opted out of the class.<sup>85</sup> However, individual investors may, at their election, proceed to arbitrate disputes based upon the same facts and law underlying the class action if they opt out of the class action proceeding or otherwise provide notice that they will not participate in the class action or in any class recovery.<sup>86</sup> These rules regarding class actions must be disclosed in the text of an agreement to arbitrate.<sup>87</sup>

- Arbitration hearings are held at the location closest to the customer's residence at the time of the events giving rise to the dispute, or elsewhere as fairness to the customer may dictate.<sup>88</sup> FINRA has 73 hearing locations—including at least one in every state—and locations in Puerto Rico and London, England.<sup>89</sup> Therefore, the brokerage firm must be prepared to travel and arbitrate in any of the fifty states or abroad.
- Investors are subject to modest fees for filing a claim, and filing fees for investors are smaller than those for member firms.<sup>90</sup> For example, an

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<sup>84</sup> Code of Arbitration Procedure §§ 12204, 12205.

<sup>85</sup> Code of Arbitration Procedure § 12204(d).

<sup>86</sup> Code of Arbitration Procedure § 12204(b).

<sup>87</sup> Code of Arbitration Procedure § 3110(f)(6).

<sup>88</sup> Code of Arbitration Procedure § 12213(a).

<sup>89</sup> See FINRA Mediation Regional Offices and Hearing Locations, *available at* <http://www.finra.org/ArbitrationMediation/Mediation/FINRAMediationRegionalOfficesandHearingLocations/index.htm>.

<sup>90</sup> Code of Arbitration Procedure § 12900. It is important to note that broker-dealers bear 75 percent of the cost of administering SRO arbitrations. *The Arbitration Policy Task Force*

investor submitting a claim with damages in the amount of \$2,501.00 to \$5,000 must pay a \$175.00 filing fee.<sup>91</sup> Furthermore, the SRO may defer an investor's payment of all or part of the filing fee on a showing of financial hardship,<sup>92</sup> and an investor's filing fee is partly refundable if the case is settled or withdrawn more than 10 days before a hearing, a frequent occurrence.<sup>93</sup>

- An arbitrator or arbitration panel may sanction a securities firm for failure to comply with the Code of Arbitration Procedure, including discovery violations.<sup>94</sup> An arbitrator or arbitration panel may also initiate a disciplinary referral to SRO regulators for perceived violations of federal securities laws or SRO rules.<sup>95</sup>
- Code of Arbitration Procedure §12904(i) requires payment of an award within 30 days unless a motion to vacate is filed. Penalties for non-compliance include monetary fines and suspension of a firm's membership license.<sup>96</sup>
- FINRA has implemented various measures to expedite arbitration proceedings in matters involving elderly or seriously ill investors. In such

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*Report—A Report Card at 25 (July 27, 2007), available at [http://www.finra.org/web/groups/rules\\_regs/documents/rules\\_regs/p036466.pdf](http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p036466.pdf).*

<sup>91</sup> *Id.* In comparison, a FINRA member firm with a claim of the same amount must pay \$525.00 to file its claim. Plaintiffs filing a civil suit in U.S. district court must currently pay a filing fee of \$350.00. See *Frequently Asked Questions, available at <http://www.uscourts.gov/faq.html#filing>.*

<sup>92</sup> Code of Arbitration Procedure § 12900(a)(1).

<sup>93</sup> Code of Arbitration Procedure § 12900(c).

<sup>94</sup> Code of Arbitration Procedure § 12212(a). At the conclusion of the case, the arbitration panel may also refer firms and individuals to regulatory authorities for potential violations of federal securities laws or SRO rules. Code of Arbitration Procedure § 12212(b).

<sup>95</sup> See Code of Arbitration Procedure § 12212(b).

<sup>96</sup> See FINRA Sanction Guidelines at 20.

cases, FINRA staff begins the arbitrator selection process, schedules the initial pre-hearing conference and serves the final award as quickly as possible.<sup>97</sup>

Supplementing the Code of Arbitration Procedure are manuals, available to the parties and the arbitrators, that explain the arbitration rules. For example, FINRA has published a Discovery Guide that explains the discovery rules contained in the Code of Arbitration Procedure.<sup>98</sup> The Discovery Guide specifically identifies categories of documents that are discoverable in all customer cases and sets forth additional categories of documents that should be exchanged in cases with particular types of claims.<sup>99</sup> The lists serve as a guide to ensure that all relevant material is exchanged, but the parties and arbitrators retain the flexibility to make adjustments to the types of materials exchanged based upon the particular claims at issue.<sup>100</sup> The Discovery Guide thus facilitates the exchange of documents and information early on in the proceedings and ensures that customers are seeking and obtaining discovery that is relevant to their claims.

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<sup>97</sup> NASD Announcement, "Notice to Parties - Expedited Proceedings for Elderly or Seriously Ill Parties," (June 7, 2004), *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforParties/p009636>. The expedition of proceedings for infirm or elderly parties is the result of just one of several pilot programs FINRA has undertaken in order to determine how to better serve investors. For instance, FINRA has also established the Discovery Arbitrator pilot program, which involves appointing one arbitrator to resolve all discovery disputes prior to the hearing. NASD Announcement, "Discovery Arbitrator Pilot" (July 27, 2005), *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforParties/p014765>. In addition, the Mediation Settlement Month program, which offers reduced mediation rates, encourages more "parties to experience the benefits of mediation for the first time and to reinforce its value and effectiveness to those who have benefited from mediation before." FINRA Announcement, "October 2007 is FINRA Mediation Settlement Month," *available at* <http://www.finra.org/ArbitrationMediation/Mediation/MediationSettlementEvents/p011328>.

<sup>98</sup> *The Discovery Guide*, *available at* [http://www.finra.org/web/groups/med\\_arb/documents/mediation\\_arbitration/p018922.pdf](http://www.finra.org/web/groups/med_arb/documents/mediation_arbitration/p018922.pdf).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

To further assist arbitrators and to ensure that customers are receiving the protections of the Code of Arbitration Procedure, SICA compiled The Arbitrator's Manual (the "Manual") to supplement and explain the Uniform Code of Arbitration.<sup>101</sup> Among other things, the Manual attaches the Code of Ethics for Arbitrators in Commercial Disputes and explains the arbitrators' ethical responsibilities and duty to disclose conflicts.<sup>102</sup> The Manual also encourages arbitrators to "be sensitive to a party who is not represented by counsel," and to provide guidance to such a party by, among other things, explaining the purpose of the opening statement and ensuring "that the party has had an opportunity to present all evidence."<sup>103</sup> The Manual also explains the type of relief the panel may award, including compensatory damages, punitive damages, injunctive relief, interest and attorneys' fees.<sup>104</sup>

Thus, the procedural rules of the Code of Arbitration Procedure, which are supplemented by guides that discuss and explain them, are designed to assist investors seeking to pursue a claim and ensure that their substantive and procedural rights are adequately protected.

## **V. Securities Arbitration Is Faster and Less Costly Than Litigation**

SRO arbitration is more efficient and cost effective than litigation. During the twelve-month period between March 2005 and March 2006, the median time interval for federal courts to reach a decision on the merits at a trial was 22.2 months.<sup>105</sup> By

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<sup>101</sup> *The Arbitrator's Manual*, January 2007, available at [http://www.finra.org/web/groups/med\\_arb/documents/mediation\\_arbitration/p009668.pdf](http://www.finra.org/web/groups/med_arb/documents/mediation_arbitration/p009668.pdf).

<sup>102</sup> *Id.* at 40-51.

<sup>103</sup> *Id.* at 6-7.

<sup>104</sup> *Id.* at 30-31.

<sup>105</sup> Federal Judicial Caseload Statistic[sic], March 31, 2006, Table C-5, available at [www.uscourts.gov/caseload2006/tables/C05Mar06.pdf](http://www.uscourts.gov/caseload2006/tables/C05Mar06.pdf).



contrast, in NASD arbitration, the average turnaround time for cases in 2006 was 13.7 months.<sup>106</sup> As these figures demonstrate, disputes submitted to SRO arbitrations are resolved approximately 40 percent faster than cases filed in federal court.<sup>107</sup>

The faster resolution of disputes in arbitration is largely due to a number of procedural practices that distinguish SRO arbitration from litigation. For example, while motion practice is almost a given in court, it is disfavored in arbitration.<sup>108</sup> Likewise, whereas expansive discovery is typical in court, focused discovery is mandated in arbitration.<sup>109</sup> As a result of these measures, parties' claims are resolved more expeditiously and at a lower cost in SRO arbitration than in litigation.

#### **A. Motion Practice Is Limited in Arbitration**

Whereas motion practice is standard in court, SRO arbitration generally discourages dispositive motions. Under the Federal Rules of Civil Procedure, a defendant may file a motion to dismiss and any party may file a motion for judgment on the pleadings or motion for summary judgment before trial.<sup>110</sup> While motions are permitted under the Code of Arbitration Procedure and have become more common in

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<sup>106</sup> Dispute Resolution Statistics August 2007, *available at* <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/index.htm>.

<sup>107</sup> Appendix B (Arbitration is Faster Than Litigation). Similarly, state courts' crowded dockets make it highly unlikely that claimants will have their dispute resolved more quickly in that forum than in arbitration.

<sup>108</sup> FINRA Announcement, "FINRA Board Approves Rule to Limit Motions to Dismiss in Arbitration" (September 26, 2007), *available at* <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P037048>.

<sup>109</sup> See *The Discovery Guide*, *supra* note 98; see also Code of Arbitration Procedure § 12507(a)(1) ("Parties may also request additional documents or information from any party by serving a written request directly on the party. Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute; such requests should be reasonable in number and not require narrative answers or fact finding. Standard interrogatories are generally not permitted in arbitration.").

<sup>110</sup> Fed. R. Civ. P. 12, Fed R. Civ. P. 56.

SRO arbitrations in recent years,<sup>111</sup> their numbers are likely to decrease in the near future: FINRA announced on September 26, 2007 that its Board of Governors had approved rule amendments to significantly limit the number of dispositive motions filed in arbitration.<sup>112</sup>

In contrast, recent Supreme Court case law addressing pleading standards in federal court has led to an increase in the frequency of motions to dismiss in that forum. Earlier this year, the Court found that a plaintiff in a securities fraud action must allege “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” The Court held that an inference of fraudulent intent alleged in the complaint “must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”<sup>113</sup> Similarly, in 2005, the Supreme Court held that a plaintiff asserting a securities fraud claim must not only allege that he purchased a security at a price that was inflated because of the fraud but he must also plead loss causation—a causal connection between the economic loss suffered and the misrepresentation alleged.<sup>114</sup> The result of these decisions is that, for securities class action cases filed between 2005 and 2007, dismissals have accounted for 39.1 percent of dispositions.<sup>115</sup> While a claimant asserting a fraud claim in arbitration must ultimately prove loss causation, the issue is much less likely to be determinative at the pleading stage in arbitration than it is in court. The foregoing demonstrates an additional reason

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<sup>111</sup> See Code of Arbitration Procedure § 12503.

<sup>112</sup> See *supra* note 108.

<sup>113</sup> *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2504-05 (2007).

<sup>114</sup> *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 347 (2005).

<sup>115</sup> Todd Foster, Ronald I. Miller, Ph.D., Stephanie Planchich, Ph.D., Brian Saxton, and Svetlana Starykh, NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But Are These Trends Reversing?*, 7 (September 2007), available at [http://www.nera.com/image/PUB\\_RecentTrends\\_Sep2007-FINAL.pdf](http://www.nera.com/image/PUB_RecentTrends_Sep2007-FINAL.pdf).

why arbitration is attractive to investors: it is highly unlikely that a claim will be dismissed solely on pleading grounds in arbitration, whereas in court the risk is much higher.

**B. Discovery Is Narrowly Tailored and Less Costly in Arbitration**

The time-consuming and costly discovery procedures available in court are generally not present in arbitration. Rule 26 of the Federal Rules of Civil Procedure permits a party to obtain, with certain enumerated exceptions, discovery “regarding any matter, not privileged, that is relevant to the claim or defense of any party.”<sup>116</sup> Such discovery is guided by the parties, who are free to make broad requests for disclosure within the scope of Rule 26.<sup>117</sup> Under the Federal Rules, parties are also able to depose as many as ten witnesses without leave of the court (and more with leave of the court) in advance of trial.<sup>118</sup>

In contrast, the Code of Arbitration Procedure tailors the exchange of documents and information to presumptively discoverable material enumerated on specific discovery lists.<sup>119</sup> Parties may request additional documents or information, but requests for information are generally limited to “identification of individuals, entities, and time periods related to the dispute.”<sup>120</sup> Interrogatories are generally not permitted in SRO arbitrations.<sup>121</sup> Similarly, depositions are strongly discouraged in SRO arbitrations, and are only permitted under very limited circumstances, such as where a witness is ill or dying.<sup>122</sup> Thus, the discovery process is more streamlined in arbitration and does not

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<sup>116</sup> Fed. R. Civ. P. 26(b).

<sup>117</sup> Fed. R. Civ. P. 26.

<sup>118</sup> Fed. R. Civ. P. 30.

<sup>119</sup> Code of Arbitration Procedure § 12506.

<sup>120</sup> Code of Arbitration Procedure § 12507(a)(1).

<sup>121</sup> *Id.*

<sup>122</sup> Code of Arbitration Procedure § 12510.

entail the significant costs associated with numerous depositions and expansive document production that are typical in court proceedings.

The discovery procedures in place in SRO arbitration enable the parties to obtain information relevant to their claims in a process that is streamlined, efficient, economical and specifically tailored to investor claims.

### **C. Faster Resolution of Disputes Benefits Both Parties**

Shortened resolution times such as these come with a myriad of benefits to parties. First, faster resolution of the dispute reduces the costs incurred by both parties. Indeed, a study conducted by Deloitte Haskins found that for the period between October 1, 1987 and June 30, 1988, “the average legal costs are \$12,000 less in arbitration than for litigation.”<sup>123</sup> Thus, after adjusting solely for inflation, this disparity would have grown to at least \$22,000 in 2007, but given that litigation costs have significantly out-paced inflation since 1988, that gap is most likely substantially wider. More recent studies support this conclusion. A former president of the American Bar Association found that a “ratio of 3 or 4 to one, litigation versus arbitration, is a fairly realistic estimate [of the cost savings from arbitration] and a reasonable expectation is that the cost of an arbitration will not be in excess of half the cost of litigating.”<sup>124</sup> The cost effectiveness of the process serves as a “relative economic benefit favoring arbitration for the customer.”<sup>125</sup> Thus, as the Supreme Court has noted, “it is typically a

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<sup>123</sup> Grant, *supra* note 43 at 96.

<sup>124</sup> William G. Paul, *Arbitration v. Litigation in Energy Cases*, First Annual Energy Litigation Program (Co-sponsored by the Center for American and International Law and by the ABA Section of Environment, Energy and Resources) (Nov. 2002), *available at* <http://www.arb-forum.com/rcontrol/documents/ResearchStudiesAndStatistics/2002PaulArbitrationVLitigationInEnergyCases.pdf>.

<sup>125</sup> *Securities Industry Ass'n v. Connolly*, 703 F. Supp. 146, 159 (D. Mass. 1988); *see also* Appendix F (Many Cases are Small Claims, Which are Better-Suited for Arbitration Than Litigation). Between 1995 and 2004, approximately 25 percent of arbitrations filed with NASD or NYSE involved claims of less than \$10,000, a sum for which it is often not cost effective to litigate, whether in federal or state court.

desire to keep the effort and expense required to resolve a dispute within manageable bounds that prompts [parties] mutually to forgo access to judicial remedies.”<sup>126</sup>

As discussed further below, the greater speed and lower cost of SRO arbitration also leads to the desirable result that more cases are resolved by decisionmakers on a full factual record in arbitration than in court.<sup>127</sup> Further, prompt resolution of the dispute improves the reliability of witness accounts and averts difficulties that may arise in locating witnesses, documents, and other evidence many years later.<sup>128</sup>

FINRA’s mediation program is another aspect of its dispute resolution system that facilitates the efficient resolution of investor claims. FINRA Dispute Resolution developed the mediation program to provide additional dispute resolution options for parties.<sup>129</sup> Mediators are selected by NAMC and are required to have formal mediator training and prior experience serving as a mediator in order to be considered.<sup>130</sup> Mediation is a flexible, informal and voluntary process in which an impartial person, trained in negotiations, assists the parties in reaching a mutually acceptable resolution.<sup>131</sup> Mediation allows the parties to resolve disputes even more

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<sup>126</sup> *Mitsubishi Motors Corp.*, 473 U.S. at 633.

<sup>127</sup> See Appendix C (More Cases Are Heard Before a Decision-Maker in Arbitration Than in Court).

<sup>128</sup> Testimony of Marc E. Lackritz before the Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives, “A Review of the Securities Arbitration System,” (March 17, 2005), *available at* <http://www.sifma.org/legislative/testimony/archives/Lackritz3-17-05.html>.

<sup>129</sup> See FINRA Mediation: An Alternative Path, *available at* <http://www.finra.org/ArbitrationMediation/Mediation/MediationAnAlternatePath/index.htm>.

<sup>130</sup> See Mediator Recruitment Information, *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforArbitratorsandMediators/ArbitratorRecruitment/p011392>.

<sup>131</sup> *Id.*

quickly than arbitration, saving them substantial time and expense. In 2005 and 2006, 10 percent of cases closed were resolved via mediation.<sup>132</sup>

## **VI. The Overwhelming Weight of the Evidence Illustrates that Securities Arbitration is Fair to Investors**

The demonstrated efficiencies of SRO arbitration, as discussed above in Section V, do not come at the cost of fairness in the process or in the results. Parties in arbitration are far more likely than parties in court to have their disputes resolved by a decisionmaker on a full factual record. Also, SRO arbitration provides parties with all of the substantive rights (and then some) to which they would be entitled in litigation. Moreover, as discussed above in Section IV, SRO arbitration procedures include numerous safeguards against arbitrator bias, which, as the data show, lead to equitable outcomes. Finally, and not insignificantly, studies show that both sides have found SRO arbitrations to be fair.

### **A. Parties in Arbitration Are Far More Likely To Have Their Claims Decided Based on a Full Factual Record**

Claims brought in court are subject to higher pleading standards than those brought in arbitration. The Federal Rules of Civil Procedure require a plaintiff claiming fraud to allege “with particularity” the specific facts upon which his claim is based,<sup>133</sup> and the Private Securities Litigation Reform Act of 1995 (“PSLRA”) further heightens a securities plaintiff’s burden under the already strict pleading standard. The PSLRA requires that any private plaintiff bringing an action under the 1934 Act (which provides remedies for fraud in connection with the purchase or sale of securities) must include in his complaint, “each statement alleged to have been misleading, the reason or

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<sup>132</sup> *Supra* note 106.

<sup>133</sup> Fed. R. Civ. P. 9(b).

reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”<sup>134</sup>

Under the PSLRA, a plaintiff is also required to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind [scienter].”<sup>135</sup> As discussed previously, the significance of this heightened pleading requirement was recently clarified by the United States Supreme Court, which held that in the context of the PSLRA, “an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”<sup>136</sup>

In contrast, though arbitrators follow the substantive law, pleading standards in SRO arbitrations are relaxed in order to *encourage* claimants to file their disputes. Indeed, under Code of Arbitration Procedure § 12302(a)(1), a claimant is simply required to file a Statement of Claim, “specifying the relevant facts and remedies requested.”<sup>137</sup> Consequently, the leeway given to SRO arbitrators “may result in arbitrators seeking to be ‘fair’ [by reaching the merits of an action] whereas such claims may have been dismissed by a court.”<sup>138</sup> In other words, the lesser pleading

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<sup>134</sup> 15 U.S.C. § 78u-4(b)(1) (2000). A number of claims brought in arbitration are based upon state or common law claims and are not subject to the strict pleading requirements of the PSLRA.

<sup>135</sup> 15 U.S.C. § 78u-4(b)(2) (2000).

<sup>136</sup> *Tellabs Inc.*, 127 S. Ct. at 2505.

<sup>137</sup> Code of Arbitration Procedure § 12302(a)(1).

<sup>138</sup> Marc Steinberg, *Securities Arbitration: Better for Investors than the Courts?*, 62 Brook. L. Rev. 1503, 1506 (1996). The effect of the PSLRA on the number of securities cases dismissed at the pleading stage has been significant. While dismissals accounted for only 19.4 percent of dispositions for securities class actions filed between 1991 and 1995, dismissals accounted for 39.1 percent of all dispositions for cases filed between 2001 and 2005. *Supra* note 115.

requirements available in arbitration are more likely to prevent dismissal of a claim in the early stages of the dispute resolution process and allow a party to have his claim heard by a decisionmaker after development of a full factual record.

The effect of these rules is evidenced by the number of claimants whose disputes are resolved by a decisionmaker in an SRO arbitration versus court.<sup>139</sup> In 2005, 20 percent of all NASD arbitrations closed were decided after a hearing. In 2006, 18 percent of NASD arbitrations were decided after a hearing.<sup>140</sup> In contrast, from March 31, 2005 through March 31, 2006, only 1.3 percent of all civil cases resolved in federal district courts were heard by a judge or jury.<sup>141</sup>

**B. SRO Arbitration Provides Parties with All of the Substantive Rights Available to Them in Litigation**

Parties participating in SRO arbitration are guaranteed all of the substantive rights to which they would have been entitled if the action had been brought in court. The Supreme Court, in upholding predispute arbitration agreements, has so noted, stating that “by agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral rather than a judicial forum.”<sup>142</sup>

Accordingly, an arbitrator may award punitive damages, attorneys’ fees and any other award that a court of competent jurisdiction could make. Even though a court would likely uphold an agreement to limit punitive damages, member firms are prohibited by rule from including restrictions on punitive damages in their customer

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<sup>139</sup> See Appendix C (More Cases Are Heard Before a Decision-Maker in Arbitration Than in Court).

<sup>140</sup> *Supra* note 106.

<sup>141</sup> Federal Judicial Caseload Statistic[sic], March 31, 2006, Table C-4, *available at* <http://www.uscourts.gov/caseload2006/tables/C04Mar06.pdf>.

<sup>142</sup> *Rodriguez de Quijas*, 490 U.S. at 481 (citing *Mitsubishi Motor Corp.*, 473 U.S. at 628).



agreements.<sup>143</sup> This prohibition is enforced by disciplinary referrals. In this regard, investors in arbitration proceedings claimed punitive damages in “about 20 percent of the 1,552 total cases decided in 1998.”<sup>144</sup> Investors also sought “reimbursement for attorney fees in about 10 percent of the 1,552 total cases decided in 1998.”<sup>145</sup> Finally, in SRO arbitration, investors have an additional mechanism by which to ensure payment of an award that is not available to them in court: FINRA has the ability to suspend a member’s license if it does not promptly pay an arbitration award.<sup>146</sup>

### **C. SRO Arbitration Is Unbiased**

Opponents of arbitration sometimes assert that SRO arbitration is biased in favor of the financial services industry.<sup>147</sup> The evidence is to the contrary. The evidence confirms that SRO arbitration does not favor industry members over investors.

#### **1. Statistical evidence shows that SRO arbitrations are not biased in favor of the industry**

Studies show that customers fare better in SRO arbitration than in litigation. A 1992 GAO study, updated in 2000, concluded that there was “no indication of a pro-industry bias in decisions at industry-sponsored forums.”<sup>148</sup> That study found no statistically significant difference between the results in SRO arbitrations and non-SRO arbitrations.<sup>149</sup> Likewise, data collected between 1980 and 2001 shows that 52.26

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<sup>143</sup> See NASD Conduct Rule 3110(f)(4).

<sup>144</sup> *Supra* note 53 at 29.

<sup>145</sup> *Id.*

<sup>146</sup> *Supra* notes 96 and 128.

<sup>147</sup> See, e.g., Testimony of Joseph Borg before the United States Senate Committee on Banking, Housing and Urban Affairs, “Consolidation of NASD and the Regulatory Functions of the NYSE: Working Towards Improved Regulation,” at 8 (May 17, 2007), available at [http://banking.senate.gov/\\_files/ACF1D.pdf](http://banking.senate.gov/_files/ACF1D.pdf).

<sup>148</sup> *Supra* note 50 at 6.

<sup>149</sup> *Id.*

percent of securities arbitrations conducted by SROs resulted in awards for customers.<sup>150</sup>

Nor is there evidence that the presence of a non-public or “industry” arbitrator on a three-member panel in SRO arbitrations somehow infuses pro-industry bias into the process. A May 2005 study conducted by Securities Arbitration Commentator, Inc. (“SACI”) on industry bias in SRO panels found that the presence of non-public arbitrators yielded “no material impact on customer wins” when compared to “win” rates on awards which public arbitrators adjudicated alone.<sup>151</sup> In that study, SACI also considered 162 arbitrations where a dissent was filed by an arbitrator.<sup>152</sup> Of those cases, claimants won 63 percent of the time, and more than 70 percent of the dissents were filed by *public* arbitrators.<sup>153</sup> SIFMA’s own review of available decisions from 2005 and 2006 further supports the SACI study’s findings: in 2005, arbitration panels, which include an “industry” arbitrator, found for claimants in 60 percent of cases whereas cases decided by a single arbitrator, which by rule must be a “public” arbitrator, found for claimants in 50 percent of cases. Similarly, in 2006 panels found for claimants in 55 percent of cases they heard.<sup>154</sup>

Nor have “industry” arbitrators objected disproportionately to large compensatory damage awards against securities firms or those involving punitive damages. In the five cases studied in which punitive damages were awarded against

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<sup>150</sup> Perino, *supra* note 47 at 32.

<sup>151</sup> *Industry Arbitrator Award Survey: Does the Securities Industry Arbitrator’s Presence Create a Discernible Shift in Award Outcomes?*, Securities Arbitration Commentator, Inc. 8 (Vol. 2005, No. 4), available at <http://sec.gov/rules/sro/nasd/nasd2005094/rpryder091905.pdf>.

<sup>152</sup> *Id.* at 5-6. The SACI study noted that of the 7,127 arbitration awards made from 2000-2004, only 186 awards (2.6 percent) included a dissent. *Id.* at 5.

<sup>153</sup> *Id.* at 6-7.

<sup>154</sup> See Appendix G (The Presence of an “Industry” Arbitrator Has No Material Impact on Customer Wins).

securities firms, “industry” arbitrators filed not a single dissent.<sup>155</sup> Moreover, in cases granting large compensatory awards to investors, public arbitrators dissented from decisions granting large compensatory awards eighteen times compared to just five such dissents from “industry” arbitrators.<sup>156</sup> These figures led SACI to conclude that the data did not suggest that a non-public or “industry” arbitrator serves in a “less neutral role than his or her Public Counterparts.”<sup>157</sup>

By virtue of his or her extensive experience and expertise, the inclusion of a non-public “industry” arbitrator benefits both parties to a dispute. As has been noted

[o]ne of the benefits associated with the arbitration model...is decision making by those knowledgeable in the field, and the industry arbitrator provides that expertise. The SEC has not questioned the presence of an industry arbitrator, and at least one independent arbitration forum saw value in industry expertise.<sup>158</sup>

“Industry” arbitrators also benefit the public panelists as they can serve to educate them about financial products and services, industry customs and practices and other legal industry-related issues.<sup>159</sup> For this very reason, the presence of an industry arbitrator may also reduce costs: parties need not call expert witnesses in order to educate a

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<sup>155</sup> *Supra* note 151 at 6.

<sup>156</sup> *Id.*

<sup>157</sup> *Id.* at 8.

<sup>158</sup> Barbara Black, *Is Securities Arbitration Fair to Investors?* (The Eighth Annual James D. Hopkins Lecture), 25 Pace L. Rev. 1, 7 (2004). The author notes that before the AAA effectively ceased operating as a securities arbitration forum, it also classified arbitrators as neutral or industry parties. See Am. Arbitration Ass'n, Supplementary Procedures for Securities Arbitration, available at <http://www.adr.org>.

<sup>159</sup> “Industry” arbitrators are standard in other arbitration forums as well. For example, arbitration panels in the construction industry are typically composed of persons with experience in the construction field. See Am. Arbitration Ass'n, Construction Industry Arbitration Rules and Procedures, available at <http://www.adr.org/sp.asp?id=22004>. Similarly, arbitrators in reinsurance and insurance disputes are generally former officers or executives of insurance companies. See, e.g., *Reinsurance Arbitration—A Primer*, available at <http://www.irmi.com/Expert/Articles/2006/Schiffer06.aspx>.

panel about certain products or industry practices. As a result of their expertise and career in the industry, non-public arbitrators are more likely to be offended by, than protective of, misbehavior by other brokers or securities firms. His or her primary concern in deciding cases is to ensure the facts are weighed fairly, the law is applied correctly, and that justice is done, all of which serves to protect the reputation of the securities industry and the integrity of the arbitral forum.<sup>160</sup>

## **2. The Solin Study criticizing SRO arbitrations is fundamentally flawed**

These well-documented facts notwithstanding, a recent study by Daniel Solin, a securities arbitration claimants' counsel, and Edward O'Neal, a professional expert witness who regularly testifies against brokers and their firms,<sup>161</sup> contends that investors do not fare well in securities arbitration. In particular, Solin and O'Neal conclude that:

- 1) between 1999 and 2004 investor-claimant win rates declined 15 percent;
- 2) claimants were less successful when they brought claims against large brokerage houses;
- 3) claimants who won at arbitration recovered a decreasing percentage of the amount claimed; and

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<sup>160</sup> Non-public arbitrators do not have any vested interest in the outcome of an arbitration. Although arbitrators receive an honorarium from FINRA, they are not employees of FINRA. See Code of Arbitration Procedure § 12214. As a result, FINRA arbitrators need not be concerned that a decision against the financial industry may result in termination of their employment. Likewise, a decision against a member firm will not preclude an arbitrator from being placed on a FINRA generated list of potential arbitrators for any particular panel. This independence—unlike elected judges or other arbitration forums where arbitrators are employed by the arbitration organization itself—ensures that FINRA arbitrators have no incentive to rule in favor of one party or another. The data demonstrates that this is the case: as shown above, the presence of an industry arbitrator does not adversely affect claimants.

<sup>161</sup> See Securities Litigation and Consulting Group, Testifying Experts, *available at* <http://www.slcg.com/resumes.php?c=1b>.

- 4) the average amount of expected recovery has decreased since 1998.<sup>162</sup>

The Solin Study, however, ignores the increasingly important role of settlements, the means by which the vast majority of securities arbitrations are resolved, in determining whether claimants achieved a favorable outcome. It also fails to account for or address a number of historically significant events that occurred during the time period covered by the study. Specifically, the Solin Study ignores the bursting of the stock “bubble” and the ensuing bear market of the early 2000s. The study also fails to address the particularly aggressive claimants’ bar at that time, which filed an enormous number of arbitration cases, many with overstated losses and meritless claims—based on allegedly inaccurate stock research reports—which failed for many reasons, including the lack of a connection between their allegations and the losses they sought to recover. As a result, arbitrators decided against the claimant in more than two-thirds of analyst claims.<sup>163</sup>

These historical factors, as well as the circumstances discussed below—the evidentiary hurdles faced by investors in proving fraudulent research claims, the increase in the number of settlements and the 300 percent increase in the amount of damages requested during this time period—easily explain the study’s findings of decreased win rates and diminished awards relative to the amount claimed. As a result, the Solin Study presents a fundamentally distorted picture of the fairness of SRO arbitration.

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<sup>162</sup> Edward S. O’Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes-A Statistical Analysis of How Investors Fare* 17 (2007) (“Solin Study”).

<sup>163</sup> *Supra* note 18 (regarding the proposed consolidation of the NASD and NYSE Regulation arbitration programs).

**(a) The Solin Study’s focus on “win rates” ignores that the period analyzed in the study was one in which many dubious securities claims were filed.**

The rate at which claimants prevail over a specific period of time is not an empirically valid basis on which to judge the fairness of a dispute resolution forum.

Perhaps this explains why not even the court system is evaluated in this manner.

Although the Solin Study itself admits that win rates are “an inaccurate and misleading basis for determining the fairness of the mandatory arbitration system,” it then proceeds to rely heavily on this concededly flawed metric to attack SRO arbitration.<sup>164</sup>

The effort to draw broad conclusions from claimant win rates during the period that the Solin Study focuses on is particularly suspect. Although the Solin Study reviews arbitration statistics for the period from 1995 through 2004, it predicates its condemnatory conclusions about the fairness of SRO arbitration almost entirely on reported results during 2002-2004. In particular, the Solin Study contends that during this period arbitration claimants prevailed less frequently than in years past and recovered a smaller percentage of their claimed damages.<sup>165</sup> Although the authors acknowledge that “[t]here may well be innocent explanations” for the decline in win and

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<sup>164</sup> Solin Study at 5. For the same reason, the Securities Arbitration Commentator Inc.’s survey of 2006 arbitrations, which highlights the gap in claimants’ win rates when bringing “small claims” (i.e., those under \$25,000) versus larger-dollar claims, does not impugn the fairness or efficacy of SRO arbitration. Furthermore, the rate at which investors win “small claims” has remained relatively constant when compared to the rate at which investors win larger-dollar claims: in 2000, there was a 9 percent difference in win rates between “small claims” and all other claims; in 2002, there was a 15 percent difference in win rates, and in 2005, there was, again, a 9 percent difference in win rates between larger-dollar claims and claims under \$25,000. See *2006 Annual Award Survey: A SAC Award Survey Comparing Results in 2006 to 2000-20005*, Securities Arbitration Commentator, Inc. 2-4, Chart 1 (Vol. 2007, No. 2).

<sup>165</sup> Solin Study at 11 (“The award percentages reached a high in 1998 of 68% and have steadily declined in the later years of the sample to stabilize at approximately 50% in the 2002-2004 time period. Note that this decline in the award percentage roughly corresponds to the decline in win rates over the same period. Toward the end of the sample period, investors were winning less frequently and, when they did win, they were being awarded a smaller percentage of their claim.”).

recovery rates for arbitration claimants during that period, they quickly dismiss this possibility with the unsupported assertion that “the misconduct of [brokerage] firms reached its apex with the analyst fraud scandal” during this same period.<sup>166</sup> The Solin Study evidently considers this a sufficient evidentiary basis to indict SRO arbitration as a “damage containment and control program masquerading as a juridical proceeding,’ intended to protect the major brokerage firms from significant damages.”<sup>167</sup>

The Solin Study, however, fails to give serious consideration to the fact that arbitration claims resolved during the 2002-2004 time period were qualitatively different from those decided in earlier periods—during which time investors secured unprecedented gains in the markets—and that those differences reduced their chances of prevailing at arbitration. As the Solin Study notes, the number of arbitration claims resolved markedly increased toward the end of their sample period. In fact, the number of arbitrations decided rose from 747 in 1999 to 2,021 in 2004.<sup>168</sup> And during the 2002-2004 time period, SROs resolved 47 percent more cases than during the prior three-year period.<sup>169</sup>

The Solin Study recognizes that the explosion in arbitration claims was likely driven by the collapse of the stock market and, more particularly, the implosion of the technology sector.<sup>170</sup> While it doubtless is true that investors are more likely to file claims when a bear market causes their investments to decline in value or to give back paper profits, it does not follow that investors have viable causes of action against their

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<sup>166</sup> *Id.* at 17.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at Fig. 1.

<sup>169</sup> *See id.* at 6-7.

<sup>170</sup> *See id.* (attributing increase in number of arbitrations during period to “the bear market and resulting investor losses in the 2000 to 2002 period”).

brokerage firms for such market losses.<sup>171</sup> The Solin Study offers no basis for its evident assumption that the incidence of broker misconduct would have increased proportionately with the number of claims during this period such that the claimant win rate should have been expected to remain constant.

Another distinctive feature of the arbitration claims resolved during the 2002-2004 time frame is the high percentage of claims premised on allegedly inaccurate analyst reports published by major brokerage firms.<sup>172</sup> As noted in the Solin Study, regulatory investigations and settlements concerning the integrity of analyst research reports further fueled the claimants' bar and prompted the filing of record numbers of arbitration claims.<sup>173</sup> In the months after the global research settlement with regulators, three claimants' firms alone "signed up" 10,000 potential arbitration claimants among them.<sup>174</sup> Several claimants' law firms advertised on television and the internet, posting estimates of potential recovery amounts and draft complaints containing boilerplate allegations. These advertisements encouraged the filing of claims by assuring investors there was no cost to filing a claim and therefore they had nothing to lose. Absent this extensive publicity from claimants' firms, promising recovery without costs, it is doubtful whether many of these claims would have been filed. The claimants' bar's aggressive solicitation of claimants thus undoubtedly resulted in a higher number of dubious claims.

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<sup>171</sup> See, e.g., *Dura Pharmaceuticals, Inc.*, 544 U.S. at 345 (noting that securities laws make private securities fraud actions available not to "provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause").

<sup>172</sup> Brooke A. Masters & Ben White, *Wall St. Facing Legal Blitz; 'Global' Settlement Prompts Investor [sic] to File Claims*, THE WASHINGTON POST, Jul. 3, 2003, at E01.

<sup>173</sup> Solin Study at 13 ("The rise in award requests was likely driven by a combination of the technology bear market which began in 2000 and lasted through 2002 and the analyst fraud scandal..."). In some cases, analyst claims were brought by investors who did not even hold accounts at the firms against whom they filed their disputes.

<sup>174</sup> Masters & White, *supra* note 172.



Analyst claims, in particular, are difficult to win. To prevail on such claims, investors have to establish, among other things, that (1) specific research reports did not reflect the subjective views of the research analyst about a stock, (2) the investor reasonably relied on those reports for his decision to buy or sell the stock, and (3) the purportedly false research opinion itself, as opposed to an overall market collapse or some other reason, actually caused the investment to decline in value.<sup>175</sup> As Solin himself acknowledges in his book, *Does Your Broker Owe You Money?*, “[t]he primary hurdle that investors may find difficult to overcome is proving that they relied on the conflicted analyst reports in making their decision to invest.”<sup>176</sup> In view of the substantial hurdles relating to analyst claims, it is hardly surprising that arbitrators awarded damages in fewer than one-third of analyst cases.<sup>177</sup> Indeed, when investors sued on these claims in court, they fared no better.<sup>178</sup>

**(b) The Solin Study ignores the many claims resolved in mutually agreeable settlements**

By narrowly focusing on claimant win rates at arbitration, the Solin Study also dramatically understates the percentage of arbitration claimants who receive some form of recovery in the arbitral process. The Solin Study ignores that the percentage of claims settled has increased markedly in recent years, including the very period during which the investor win rate has declined. For instance, in 2003, only 52 percent of cases

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<sup>175</sup> See *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003), *aff'd in part and rev'd in part sub nom.*, *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005); *cert. denied*, 126 S. Ct. 421 (Oct. 11, 2005).

<sup>176</sup> Daniel R. Solin, *DOES YOUR BROKER OWE YOU MONEY?* 203 (Penguin Books 2004).

<sup>177</sup> *Supra* note 18 (regarding the proposed consolidation of the NASD and NYSE Regulation arbitration programs).

<sup>178</sup> See, e.g., *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351; *Lentell*, 396 F.3d 161 (holding that plaintiffs failed to plead loss causation); *In re Initial Public Offering Secs. Litig.*, 2005 WL 1529659, at \*4 (S.D.N.Y. June 28, 2005); *Joffe v. Lehman Bros., Inc.*, 2005 WL 1492101, at \*14 (S.D.N.Y. June 23, 2005).

were settled directly by the parties or via mediation; by 2006, that number had grown to 60 percent of all arbitrations filed.<sup>179</sup> Currently, settlements are responsible for the resolution of “about 70% of closed cases.”<sup>180</sup> Solin himself acknowledges in his book that he settles “somewhere over two-thirds of the claims” he brings and that he usually settles for damages of between 50-60 percent of the claim.<sup>181</sup>

Firms are more likely to settle meritorious claims since these are the claims that pose the greatest risk at arbitration. If a higher number of the claims with merit are being settled, then the claims that proceed to hearing are more likely to be weak or at least more difficult to prove, which would account for the declining win rate for those claims resolved at a hearing. In fact, over the past several years, because the percentage of cases that settle has increased at a greater rate than the decline in the win rate, the net effect is that an *increasing* percentage of claimants are receiving relief through the arbitral process. For example, whether through settlement or a decision on the merits, claimants recovered damages in two-thirds of the cases resolved in 2006, a fact that the Solin Study disregards.<sup>182</sup>

**(c) The Solin Study’s conclusions about the percentages of claimed damages recovered are misleading and, in all events, not meaningful.**

The Solin Study also decries that in the period from 2002-2004 prevailing arbitration claimants recovered a smaller percentage of their claimed damages. Like “win” rates, however, the percentage of claimed damages recovered has never been

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<sup>179</sup> *Supra* note 106.

<sup>180</sup> *2006 Annual Award Survey: A SAC Award Survey Comparing Results in 2006 to 2000-20005*, Securities Arbitration Commentator, Inc. 2, (Vol. 2007, No. 2).

<sup>181</sup> *Supra* note 176 at 219. Solin’s settlement range (50-60 percent of the claim amount) is on par with the historical percentage of requested damages awarded claimants in arbitration. Solin Study at 11, Fig. 7.

<sup>182</sup> *Supra* note 106; *see also* Appendix D (The Total Percentage of Claimants Who Recover Damages or Other Relief in Arbitration or by Settlement is Favorable).

accepted as a valid measure of the fairness of arbitration. Again, the court system certainly is not evaluated by this metric. Nor should it be, for it is widely known and well accepted that claimants tend to overstate the amount of damages requested in their statements of claim.<sup>183</sup>

Significantly, as even the Solin Study recognizes, arbitration claimants dramatically increased the amount of their claimed damages following the bear market and the bursting of the “internet bubble.”<sup>184</sup> Indeed, it is likely that many claimants calculated their claimed damages as the difference between the value of their stock portfolios at the market’s height during the late 1990s and their values following the market’s decline. For example, in one securities arbitration that received media attention, Joseph Kenith, a Morgan Stanley client from 1996 to 2001, brought a \$3.3 million dollar arbitration claim against Morgan Stanley alleging, among other things, negligence, breach of contract, breach of fiduciary duty, and failure to supervise.<sup>185</sup> According to his attorney, the \$3.3 million that Kenith claimed as damages “represented the value of his account at the market’s peak,”<sup>186</sup> but that is a measure of damages for which the law provides no support.<sup>187</sup> Significantly, Kenith had no out-of-pocket losses

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<sup>183</sup> The Neutral Corner—June 2006, Seth E. Lipner, *Study of Arbitration Recovery Statistics*, available at <http://www.finra.org/ArbitrationMediation/ResourcesforArbitratorsandMediators/GeneralInformationandReference/TheNeutralCorner/p016939> (“In many cases, the amount a claimant demands in the arbitration statement of claim bears only a tenuous relationship to the damage incurred.”); *id.* (“[C]laimants will generally overstate the amount of damages they request in the statement of claim.”).

<sup>184</sup> See Solin Study at 13; see also Appendix E (Investors’ Inflation-Adjusted Recoveries in Arbitration Have Increased).

<sup>185</sup> Gretchen Morgensen, *Market Place: Morgan Stanley Seeks to Change Basis for Award in Stock Case*, N.Y. TIMES, Aug. 21, 2003, at C1; *Arbitration Award Against Morgan Stanley Not Within Arbitrators’ Jurisdiction to Alter*, BNA Corp. Law and Business Center, Aug. 25, 2003, available at <http://corplawcenter.bna.com/pic2/clb.nsf/id/BNAP-5QMU3E?OpenDocument>.

<sup>186</sup> Morgensen, *supra* note 185.

<sup>187</sup> See *Dura Pharmaceuticals, Inc.*, 544 U.S. at 343-344.

at all and even made \$500,000 while a Morgan Stanley client.<sup>188</sup> The NASD arbitration panel nonetheless awarded Kenith \$100,000.<sup>189</sup> As this case illustrates, because claimants and their counsel may claim almost any amount as damages, need not justify the amount claimed, and have an incentive to inflate their purported damages, the difference between a party's claimed damages and the amount a claimant recovers is meaningless.

As the Solin Study suggests, the significant change between 2002-2004 and earlier periods was not the amounts arbitration panels awarded to prevailing plaintiffs, but only the amounts that claimants and their counsel were requesting. Between 1998 and 2004, even after adjusting for inflation, SRO arbitration awards to prevailing claimants increased 6 percent.<sup>190</sup> Over the same period, however, the amounts claimants and their counsel claimed in damages increased 300 percent.<sup>191</sup> These figures suggest that it is not the arbitration panels that have changed in recent years, but only the assertiveness of the claimants' bar.

Notwithstanding the marked increase in claimed damages in recent years, recent and historical statistics show that arbitration claimants still recover a substantial percentage of claimed damages when they prevail in arbitration. Statistics included in the Solin Study show that even in recent years, investors receive about half

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<sup>188</sup> Morgensen, *supra* note 185. Damages are to be calculated to compensate a claimant only for what he lost because of the fraud, not to compensate him for what he might have gained. Restatement (Second) of Torts, § 549 cmt. b. ("[T]he recipient of a fraudulent misrepresentation is entitled to recover from its maker in all cases the actual out-of-pocket loss which, because of its falsity, he sustains through his action or inaction in reliance on it.").

<sup>189</sup> *Id.*

<sup>190</sup> See Solin Study at 13.

<sup>191</sup> See *id.*; see also Appendix E (Investors' Inflation-Adjusted Recoveries in Arbitration Have Increased).

of the amount they claim.<sup>192</sup> By contrast, investors who pursue similar claims in litigation do not fare nearly so well. For example, among all securities class action settlements in 2005, investors received 3.1 percent of their estimated damages. In 2006, that figure dropped to 2.4 percent.<sup>193</sup>

**(d) The Solin Study's conclusions about win and recovery rates for large brokerage firms are misleading**

The Solin Study further concludes that recovery rates in arbitration decline as the size of the claim increases and when claims are asserted against larger brokerage firms. The Solin Study suggests that this says something troubling about the fairness of the arbitration process. What this result actually suggests, however, is quite different.

First, large firms are generally subject to heightened regulatory scrutiny, and due to their greater resources and relatively greater reputational risk, they tend to invest more heavily in the training and procedures likely to detect and prevent securities-related employee misconduct. It therefore is not surprising that large firms might be expected to fare better in arbitration proceedings where claimants seek to recover for the alleged misdeeds of their employees.

Second, it is the larger brokerage firms that employ research analysts and that would be largely, if not exclusively, subject to claims of fraudulent research. As discussed above, due to the significant hurdles involved in such claims, panels have

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<sup>192</sup> See Solin Study at 11 & Fig. 7. Similarly, the Securities Arbitration Commentator Inc.'s recent survey found that investors recovered, on average, 54 percent of their claimed damages in 2006. *Supra* note 180 at 7.

<sup>193</sup> Laura E. Simmons and Ellen M. Ryan, Cornerstone Research, *Securities Class Action Settlements: 2006 Review and Analysis*, 6 & Figure 5, available at [http://securities.stanford.edu/Settlements/REVIEW\\_1995-2006/Settlements\\_Through\\_12\\_2006.pdf](http://securities.stanford.edu/Settlements/REVIEW_1995-2006/Settlements_Through_12_2006.pdf).

awarded damages in fewer than one-third of analyst claims, which is significantly lower than average.<sup>194</sup>

Third, again, due to their greater resources, including very experienced legal staffs, larger brokerage firms are particularly likely to settle meritorious claims asserted against them prior to hearing.<sup>195</sup> Solin himself has acknowledged that “[o]nce the brokerage firm decides to take a case to hearing, it has determined that it has a reasonable prospect of winning. Otherwise, it would have settled the case.”<sup>196</sup> For all these reasons, none of which provide any basis to question the fairness of the arbitral process, it is not surprising that recovery rates against larger firms will be lower than those against smaller firms.

#### **D. Parties Believe SRO Arbitrations are Fair**

Significantly, participants in SRO arbitrations—including claimants themselves—perceive the process as fair. In fact, a 1999 study analyzing the perception of fairness of NASD proceedings concluded that 93.49 percent of the individuals surveyed—54 percent of whom were claimants— found that their case was “handled fairly and without bias.”<sup>197</sup> Similarly, in a 2001 study, 85 percent of those surveyed agreed that their cases were handled fairly and without bias.<sup>198</sup> No participants in that study strongly disagreed with the statement that their cases were handled fairly and

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<sup>194</sup> *Supra* note 18 (regarding the proposed consolidation of the NASD and NYSE Regulation arbitration programs).

<sup>195</sup> Tony Chappelle, *Advisors Score Big in Arbitration Study*, *On Wall Street* (June 1, 2007), available at <http://www.onwallstreet.com/article.cfm?articleid=3635> (“[B]ig firms can afford to settle cases that have merit, and most times, they do. That leaves the relatively weaker cases. Smaller firms can ill afford to settle cases involving a couple of hundred thousand dollars.”).

<sup>196</sup> *Supra* note 176 at 227.

<sup>197</sup> Tidwell, *supra* note 13 at 3-4.

<sup>198</sup> Perino, *supra* note 47, n119 (citing NASD-DR, *Customer Satisfaction Survey Results 1* (May 2001)).

without bias.<sup>199</sup> Relying on this data, one commentator concluded that “[a]vailable empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair.”<sup>200</sup>

That participants believe SRO arbitration to be fair and efficient is underscored by their continued use of SRO arbitration, even when alternative forums are available. In 2000, SICA commissioned a pilot program that permitted select customers to choose a non-SRO arbitration forum instead of standard SRO arbitration. Only 8 of the 277 participants chose to arbitrate their claim with a non-SRO entity.<sup>201</sup>

In short, there is no empirical data showing that SRO arbitrations are, or are thought by the parties to be, unfair. Rather, the data show that no industry bias exists in SRO arbitration and participants believe the SRO arbitration process is just.

## **VII. The Use of Predispute Securities Arbitration Agreements Is Fair to Investors and Serves the Public Interest**

Given the fairness, speed and cost-effectiveness of arbitration, there is no sound public policy reason to preclude securities firms from providing for arbitration in customer agreements. Predispute arbitration agreements put the parties to a dispute on equal footing once a dispute emerges, and deter forum-selection tactics that serve no public purpose.

In addition, predispute arbitration agreements contribute a degree of predictability to the relationship between investors and members of the securities

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<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 48.

<sup>201</sup> Final Report, *Securities Industry Conference on Arbitration: Pilot Program for Non-SRO Sponsored Arbitration Alternatives*, available at <http://www.lgesquire.com/SICA%20Pilot%20Report.pdf>. The eight claimants selected either AAA or JAMS arbitration.

industry.<sup>202</sup> Such agreements provide both parties with the knowledge that they must resolve any dispute in SRO arbitration, mitigating the complex and often time-consuming and expensive process of examining other venues.<sup>203</sup> Investors are assured that firms must comply with the law or risk losing their licenses. Investment firms—both small introducing firms and larger clearing firms—are assured that they can avoid expensive litigation which encourages the settlement of frivolous claims. In effect, firms “accept the fact that a case with ‘bad facts’ will be adjudicated quickly so they will be forced to settle and they will accept having a very limited right of appeal in exchange for not having to extend the costs of a court defense or unpredictable jury damage awards.”<sup>204</sup> This arrangement ensures the survival of small introducing firms, part of the fabric of American small business, who can serve their customers knowing that they will not be engulfed by defense costs in spurious court cases which could threaten their existence.

Those who would preclude the use of predispute arbitration agreements are not arguing for equal treatment. They are not arguing that arbitration should occur only when both parties agree to it after a dispute has arisen. Rather, they are arguing for an advantage not found elsewhere in dispute resolution: they want investors to have a unilateral right to choose whichever forum—arbitration or litigation—they think will benefit them in a particular case, giving securities firms no voice at all. It is not the norm in our judicial system that a plaintiff can unilaterally choose between litigation and arbitration; rather, the norm (absent agreement) is that a plaintiff is free to litigate, and can arbitrate only with the consent of the defendant.

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<sup>202</sup> See David Sherwyn, *Because It Takes Two: Why Post Dispute Voluntary Arbitration Programs Will Fail to Fix the Problems Associated with Employment Discrimination Law Adjudication*, 1 Berkeley J. Emp & Labor L. 21-22, 67-68 (2003).

<sup>203</sup> *Id.* at 21-22.

<sup>204</sup> *Id.* at 67.



That norm, which would lead to litigation unless the parties agree otherwise, would be harmful to investors, and no one is seeking it here. Many investor claims—even ones involving substantial amounts—are not large enough to support the high cost of commencing and pursuing a lawsuit in court.<sup>205</sup> In cases involving amounts large enough to justify the costs of litigation, it is not uncommon for claimants (particularly elderly ones) to desire the expedition of arbitration, especially in an era of congested court dockets that give priority to criminal cases over civil cases and in consideration of the lengthy appellate process involved in civil litigation. It is for these reasons that FINRA requires securities firms to submit to arbitration at a customer's request.<sup>206</sup>

The use by securities firms of a predispute arbitration agreement thus does not give them an advantage—it provides them the same right as customers to choose arbitration. It places the parties on equal footing.

There is good reason to favor arbitration as the norm and therefore provide for it in customer agreements. While there is no evidence—and it is not the general experience of the industry—that arbitration leads to more favorable verdicts overall, the arbitration system provides significant benefits that have been enjoyed for more than three decades by both investors and the securities industry:

- It provides faster resolution of disputes.
- It reduces legal costs.
- It operates under rules tailored to investor claims.

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<sup>205</sup> See Appendix F (Many Cases are Small Claims, Which are Better-Suited for Arbitration Than Litigation).

<sup>206</sup> Code of Arbitration Procedure § 12200 (providing for arbitration when (1) it is required by written agreement or (2) it is requested by a customer).

- It provides predictability as to process, under rules that are uniform regardless of the state or county in which the case is brought.
- It is administered by a staff that is familiar with these types of disputes and often can provide greater attention to the cases than clerks in congested courts.
- It uses arbitrators who, by virtue of training and experience, often come to cases with an understanding of the rules and norms of the securities industry.

These are legitimate and sound reasons, all consistent with public policy, for the securities industry to secure for itself the same right as investors to seek arbitration in most cases.

In the absence of a predispute arbitration agreement, decisions whether to arbitrate an existing dispute will be governed by tactical advantage. As one commentator has noted,

“the one overriding problem with post-dispute voluntary arbitration is that, according to the evidence... and a logical analysis of the economic, political, and legal incentives of the parties and their lawyers, it is extremely rare for both the plaintiff’s and defense’s attorneys in a case to select arbitration after the dispute has arisen.”<sup>207</sup>

This dilemma has also been described by William Paul, former President of the American Bar Association,

“The odds of an agreement for binding arbitration being entered into after a dispute has arisen are not great. At that stage one party or the other will have a view that traditional litigation offers some advantage which the party does not choose to relinquish... So if you prefer binding arbitration, put a provision for it in the contract, up front, when the deal is made, and before the dispute arises and then, and only then, will you have assured arbitration as the preferred dispute resolution mechanism.”<sup>208</sup>

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<sup>207</sup> Sherwyn, *supra* note 202 at 7.

<sup>208</sup> *Supra* note 124.

Studies regarding the frequency of post-dispute voluntary arbitration bear this out. In a survey of AAA employment arbitrations conducted in 2001 and 2002, only 6 percent in 2001 and 2.6 percent in 2002 were the result of post-dispute arbitration agreements.<sup>209</sup> Likewise, a review of AAA business-to-business arbitrations revealed that only 1.8 percent of claims were brought pursuant to a post-dispute agreement to arbitrate.<sup>210</sup>

Parties wanting a prompt, fair, economical resolution will likely prefer arbitration, for the reasons described in the preceding pages. But litigation may, in a particular case, appeal to claimants' counsel seeking to drive up costs to induce a nuisance settlement; use a judicial forum to seek prejudicial publicity or solicit other clients; or hope for "jackpot justice;" or benefit from an anti-business jury pool in a carefully selected jurisdiction. Litigation may, by the same token, appeal to securities firms seeking to use their greater financial resources to the detriment of the small investor by engaging in extensive discovery or filing numerous motions. Precluding the use of binding predispute arbitration agreements will leave the choice between litigation and arbitration to be made on the basis of tactical considerations such as these. While a particular party in a particular case may benefit from these tactics, the public interest and the overall interests of market participants are poorly served by such gamesmanship. Predispute arbitration agreements strike the "right balance between investor protection and market competitiveness" by providing investors with a fair and impartial forum in

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<sup>209</sup> Lewis L. Maltby, *Out of the Frying Pan, into the Fire: The Feasibility of Post-Dispute Employment Arbitration Agreements*, at 4 (May 2003), available at [http://www.workrights.org/current/cd\\_adr.pdf](http://www.workrights.org/current/cd_adr.pdf).

<sup>210</sup> *Id.* at 6-7.

which to resolve disputes and protecting companies from meritless lawsuits which threaten their effectiveness in the market and even their very existence.<sup>211</sup>

In summary, the use of predispute arbitration agreements is fair—it provides no advantage to either side—and it brings about a result that serves the overall interests of both investors and the securities industry.

## **VIII. Conclusion**

The current effort to make predispute securities arbitration agreements unenforceable is a solution in search of a problem. There is no credible evidence that SRO-regulated arbitration is unfair to investors or otherwise fails to protect their interests. Rather, objective and empirical evidence has proven that investors' claims are more likely to be heard on the merits, more quickly and with less cost, in arbitration than they are in federal or state court. Arbitration permits investors with claims too small to litigate a cost-effective opportunity to be heard, and provides those with larger claims a forum capable of bringing experience and knowledge to bear in resolving their disputes. Furthermore, securities arbitration has received high ratings for investor satisfaction, and it is unique among arbitration regimes in that it is closely supervised and regulated by independent regulators, including the SEC.

Prohibiting predispute arbitration agreements would simply produce more protracted, costly litigation. This result would not serve the best interests of investors or the U.S. capital markets. Congress should not disturb a system that is working.

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<sup>211</sup> Opening Remarks by Treasury Secretary Henry M. Paulson, Jr. at Treasury's Capital Markets Competitiveness Conference (March 13, 2007), *available at* <http://www.ustreas.gov/press/releases/hp306.htm>.

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## Appendix A

# Chronology of Improvements to Securities Arbitration Procedures

Date	Initiative	Benefit to Investors
<b>1994</b>	NASD establishes a Blue Ribbon Task Force of experts, led by former SEC Chairman David Ruder, to conduct a comprehensive study of securities dispute resolution and recommend needed changes. <sup>1</sup>	Subjects the forum in which investor claims are heard to comprehensive review and improvement
<b>January 1996</b>	The Arbitration Policy Task Force releases its report, the most “wide-ranging examination of securities arbitration since the 1987 Supreme Court decision that holds predispute arbitration agreements enforceable...” containing more than 70 recommendations for change. <sup>2</sup>	Subjects the forum in which investor claims are heard to comprehensive review and improvement
<b>October 1998</b>	Neutral List Selection System is implemented whereby arbitrator lists are generated in a neutral fashion and available arbitrators are “rotated” through the system. <sup>3</sup>	Grants parties direct input into the arbitrator selection process

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1. See NASD Dispute Resolution, *The Arbitration Policy Task Force Report—A Report Card 5* (July 27, 2007), available at [http://www.finra.org/web/groups/rules\\_regs/documents/rules\\_regs/p036466.pdf](http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p036466.pdf).

2. *Id.*

3. NASD NTM 98-90 (effective November 17, 1998), available at [http://finra.complanet.com/file\\_store/pdf/rulebooks/nasd\\_98090.pdf](http://finra.complanet.com/file_store/pdf/rulebooks/nasd_98090.pdf).

<b>1998</b>	Initiative is begun to encourage the use of “plain English” in disclosure documents and other material used by investors, including the Code of Arbitration Procedure. <sup>4</sup>	Ensures that the arbitration process is more transparent and accessible to users of the forum
<b>September 1999</b>	NASD announces the implementation of the <i>Discovery Guide</i> , which requires parties to produce specific categories of documents at the outset of arbitration, provides that certain categories of documents are presumptively discoverable, and directs arbitrators to sanction parties for violating written discovery orders. <sup>5</sup>	Aids parties and arbitrators in discovery by streamlining the process
<b>1999</b>	Annual focus groups are launched to gather feedback from constituents on targeted areas of the process. <sup>6</sup>	Helps ensure that constituents have input into the arbitration process

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4. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendments 1, 2, 3, and 4 to Amend NASD Arbitration Rules for Customer Disputes and Notice of Filing and Order Granting Accelerated Approval of Amendments 5, 6, and 7 thereto; Order Approving Proposed Rule Change and Amendments 1, 2, 3, and 4 to Amend NASD Arbitration Rules for Industry Disputes and Notice of Filing and Order Granting Accelerated Approval of Amendments 5, 6, and 7 thereto, 72 Fed. Reg. 4,574, 4,575 (Jan. 31, 2007).

5. NASD NTM 99-90, *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p004058.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p004058.pdf).

6. See FINRA Dispute Resolution Fact Sheet, August 23, 2007, *available at* <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/FINRADisputeResolutionFactSheet/index.htm>.

<b>August 2000</b>	NASD requires firms to certify in writing that they have paid arbitration awards within 30 days of a decision. <sup>7</sup>	Helps ensure prompt payment of awards to investors
<b>February 2001</b>	Code of Arbitration Procedure is amended to allow the Director of Arbitration to remove arbitrators for cause once a hearing has begun. <sup>8</sup>	Helps ensure arbitrator impartiality
<b>May 2001</b>	Code of Arbitration Procedure is amended to prohibit a firm that has been terminated, suspended, or expelled from NASD, or that is otherwise defunct, from enforcing a predispute arbitration agreement against a customer in the SRO arbitration forum. <sup>9</sup>	Provides customers an avenue in which to seek relief against firms no longer subject to SRO jurisdiction and regulatory oversight
<b>September 2002</b>	Arbitration process is streamlined for claimants filing against defaulting, suspended, or terminated industry respondents. <sup>10</sup>	Makes it faster and cheaper for investors to get default judgments in arbitration against members not in good standing with the securities industry SRO

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7. NASD NTM 00-55 (effective September 18, 2000), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p003993.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003993.pdf).
8. NASD NTM 01-13 (effective March 8, 2001), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p003916.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003916.pdf).
9. NASD NTM 01-29 (effective June 11, 2001), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p003875.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003875.pdf).
10. NASD NTM 02-58 (effective October 14, 2002), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p003483.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003483.pdf).



<b>2002</b>	SEC commissions study to assess the adequacy of arbitrator disclosure requirements. <sup>11</sup>	Helps ensure impartiality of decision makers in the arbitration process
<b>October 2003</b>	Systematic arbitrator background check system is enhanced to include criminal checks, employment verification, and professional license verification. <sup>12</sup>	Helps to ensure the accuracy and reliability of information parties use in selecting arbitrators
<b>2003-2004</b>	A series of steps to control discovery abuse is announced and implemented. NASD reminds member firms of their obligations under the rules to cooperate in the voluntary exchange of documents and information at the outset of arbitration. <sup>13</sup>	Requires industry members to be more responsive to their discovery obligations
<b>2003-2004</b>	Customer, Industry, and Mediation Codes of Procedure are simplified and filed with SEC. <sup>14</sup>	Allows investors to more easily navigate the arbitration process

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11. Michael A. Perino, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Arbitrations 2* (Nov. 4, 2002).

12. NASD NTM 03-64 (effective October 1, 2003), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p003097.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003097.pdf).

13. NASD NTM 03-70 (effective November 6, 2003), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p003073.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003073.pdf).

14. See FINRA Dispute Resolution Fact Sheet, August 23, 2007, *available at* <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/FINRADisputeResolutionFactSheet/index.htm>.

<b>June 2004</b>	Procedures to reduce case processing time for matters involving elderly or infirm parties are implemented. <sup>15</sup>	Allows faster resolution of certain investors' claims
<b>June 2004</b>	Code of Arbitration Procedure is amended to expand the definition of "industry arbitrator" to exclude individuals with minor or even indirect ties to the securities industry from serving as public arbitrators in NASD arbitrations. <sup>16</sup>	Reduces the perception of a pro-industry bias in the roster of those eligible to sit as public arbitrators in NASD arbitrations
<b>June 2004</b>	Code of Arbitration Procedure is amended to grant parties' requests to challenge arbitrators for cause "where it is reasonable to infer an absence of impartiality, the presence of bias, or the existence of some interest on the part of the arbitrator in the outcome of arbitration." Close questions involving challenges brought by investors are resolved in favor of the customer. <sup>17</sup>	Helps ensure arbitrator impartiality and resolve close questions involving partiality and bias in favor of investors
<b>August 2004</b>	NASD implements on-line filing of claims. <sup>18</sup>	Improves the efficiency of securities arbitration by allowing claimants to file their claims faster and with greater assistance from the SRO

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15. NASD Announcement, "Notice to Parties - Expedited Proceedings for Elderly or Seriously Ill Parties," June 7, 2004, *available at* <http://www.finra.org/ArbitrationMediation/ResourcesforParties/p009636>.

16. See NASD Notice to Members 04-49, Arbitrator Classification (effective July 19, 2004), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p002727.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p002727.pdf).

17. *Id.*

18. NASD NTM 04-56 (effective August 5, 2004), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p009899.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p009899.pdf).

<b>August 2004</b>	NASD amends its by-laws to allow it to institute suspension proceedings against a formerly associated person for failing to pay an award or settlement for a period of two years after the award was entered or the settlement was entered into; the amendments also grant NASD the authority to suspend a broker's ability to associate with a member in any capacity until an award or settlement is paid. <sup>19</sup>	Prevents formerly associated brokers who fail to pay awards or settlements from re-entering the securities industry
<b>August 2004</b>	NASD amends Code of Arbitration Procedure to allow parties and arbitrators, at the first pre-hearing conference, to establish guidelines for direct contact with arbitrators. <sup>20</sup>	Allows parties to streamline the process for filing pleadings and corresponding with the arbitrators
<b>January 2005</b>	NASD amends rule governing predispute arbitration agreements with customers to require delivery and customer acknowledgment of the agreement at the place and time of signing. <sup>21</sup>	Ensures that customers fully understand and acknowledge that they agree to arbitrate their disputes

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19. NASD 04-57 (effective September 9, 2004), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p009798.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p009798.pdf).

20. NAST NTM 04-62 (effective September 30, 2004), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p009904.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p009904.pdf).

21. NASD NTM 05-09 (effective June 1, 2005), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p013203.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p013203.pdf).

<b>2005-2006</b>	NASD conducts extensive business process reviews to streamline case processing. <sup>22</sup>	Improves efficiency of arbitration process
<b>July 2007</b>	NASD Dispute Resolution issues “The Arbitration Policy Task Force Report—A Report Card.” The Report card states in pertinent part that “NASD has implemented nearly every key recommendation” made in the 1996 report and concluded that ten years after the Blue Ribbon Task Force was established NASD arbitration is more “fair to participants, and offers investors procedures for dispute resolution with broker-dealers that are equal to and frequently superior to actions in courts.” <sup>23</sup>	Reviews and reports on tangible steps taken by the securities arbitration forum to ensure that investor claims are heard in a forum that is fair

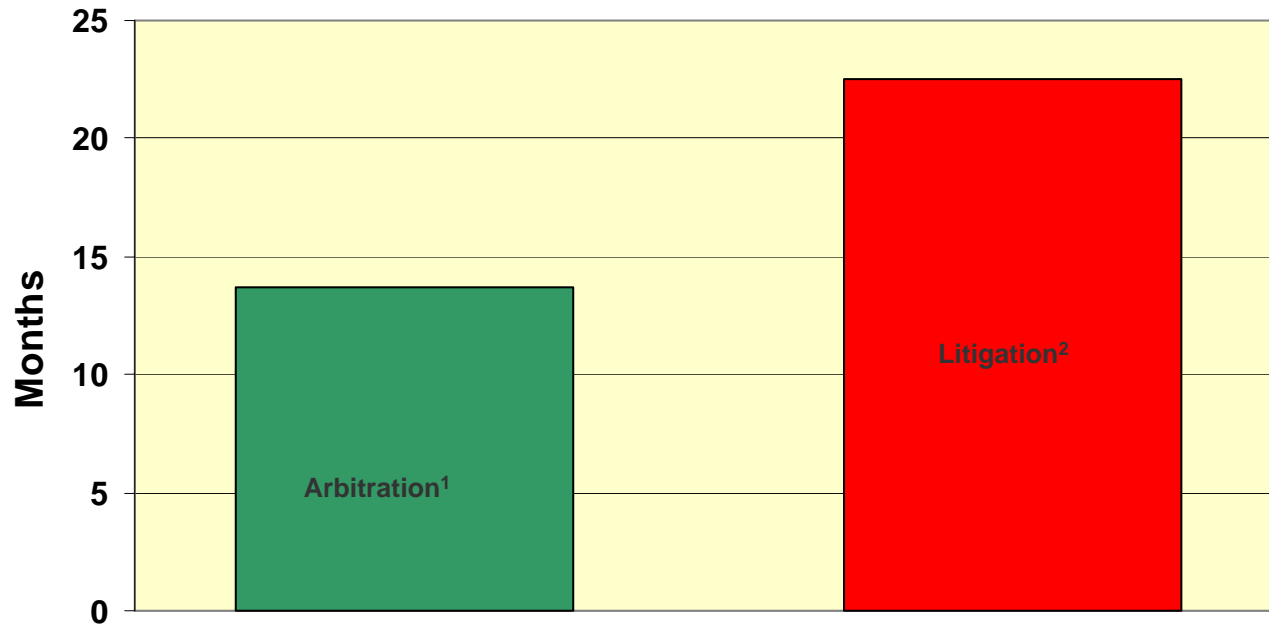
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22. See FINRA Dispute Resolution Fact Sheet, August 23, 2007, *available at* <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/FINRADisputeResolutionFactSheet/index.htm>.

23. See NASD Dispute Resolution, *The Arbitration Policy Task Force Report—A Report Card 1, 5* (July 27, 2007), *available at* [http://www.finra.org/web/groups/rules\\_regs/documents/rules\\_regs/p036466.pdf](http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p036466.pdf).

# Arbitration Is Faster Than Litigation

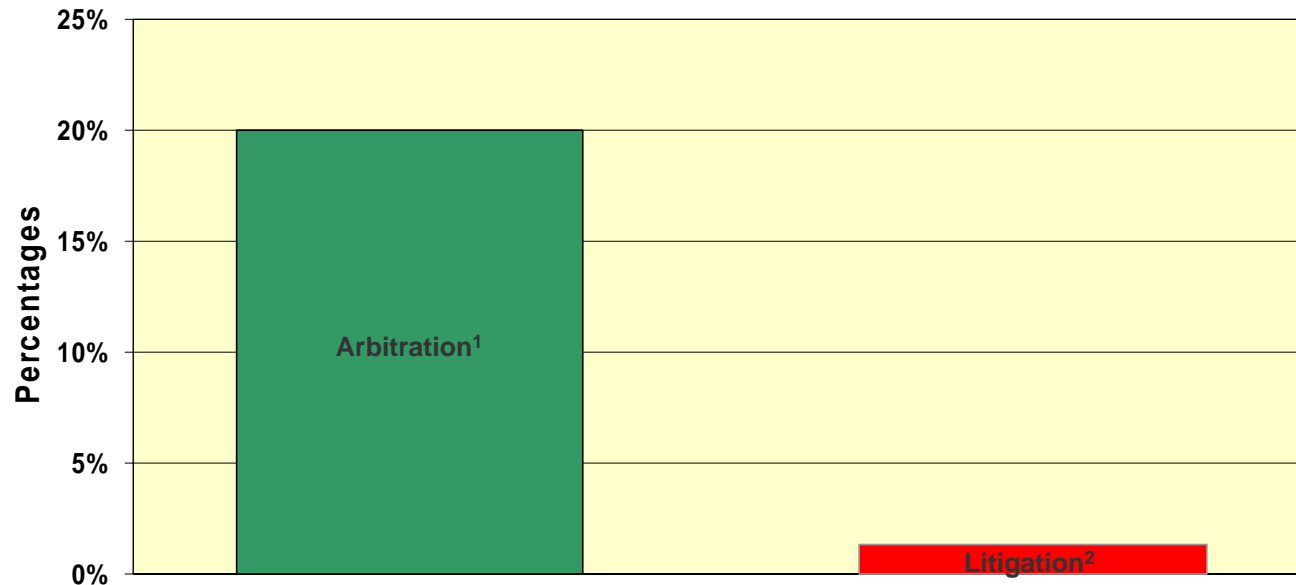
Duration of Cases in Arbitration vs. Litigation



1. Arbitration statistics are based on data for a 12-month period ending August 2007 and reflect the average duration of an arbitration proceeding from the filing of the complaint to completion of the case. See Dispute Resolution Statistics *available at* <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/index.htm>.
2. Litigation statistics reflect median time intervals from filing to disposition of civil cases filed in U.S. district courts during the 12-month period ending March 31, 2006. See Federal Judicial Caseload Statistic[sic], March 31, 2006, Table C-5, *available at* [www.uscourts.gov/caseload2006/tables/C05Mar06.pdf](http://www.uscourts.gov/caseload2006/tables/C05Mar06.pdf).

## Appendix C

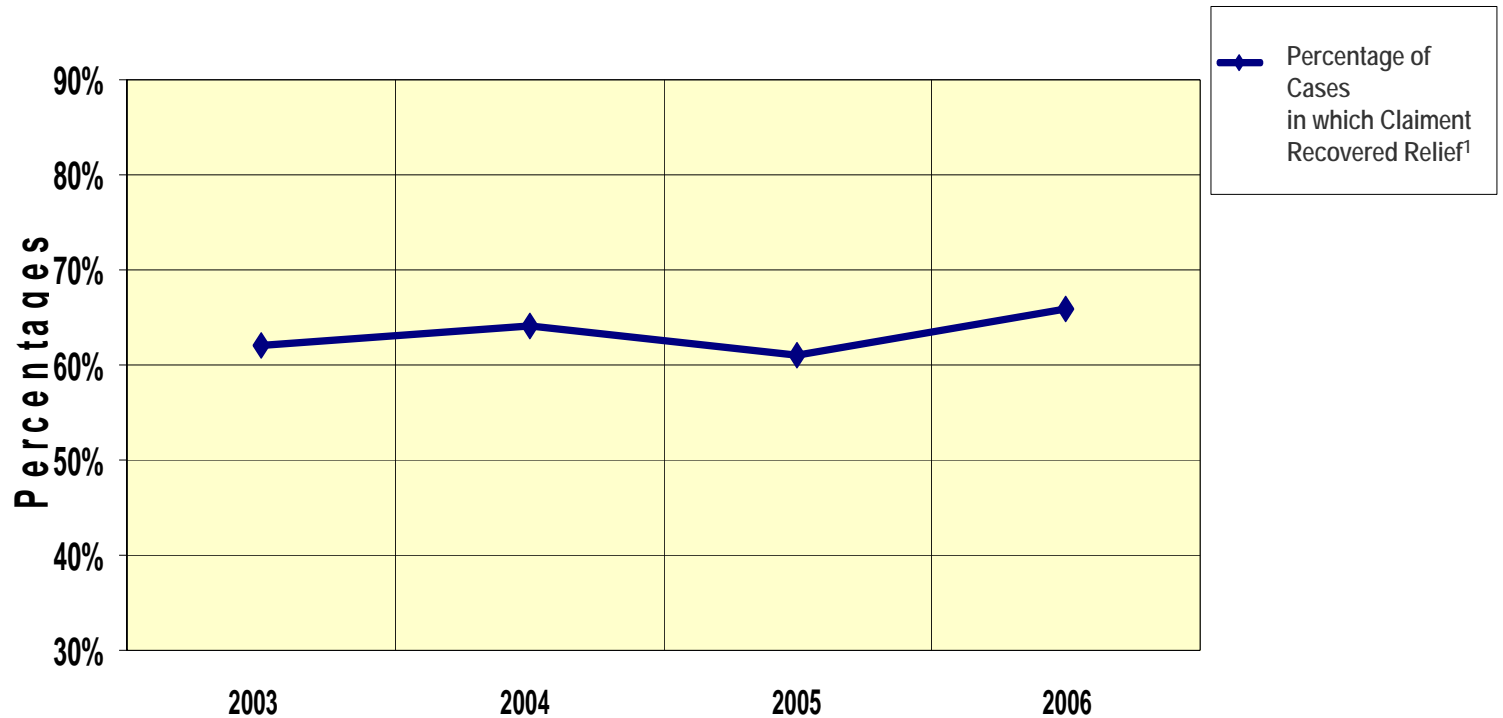
# More Cases Are Heard Before a Decision-Maker in Arbitration Than in Court



1. Source: Dispute Resolution statistics, *available at* <http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/Index.htm>. Data reflect percentage of arbitration cases heard on the merits in 2005.
2. Source: Federal Judicial Caseload Statistic [sic], March 31, 2006, Table C-4, *available at* <http://www.uscourts.gov/caseload2006/tables/C04Mar06.pdf>. Data reflect percentage of cases that reached trial in U.S. district courts for the 12-month period ending March 31, 2006.

## Appendix D

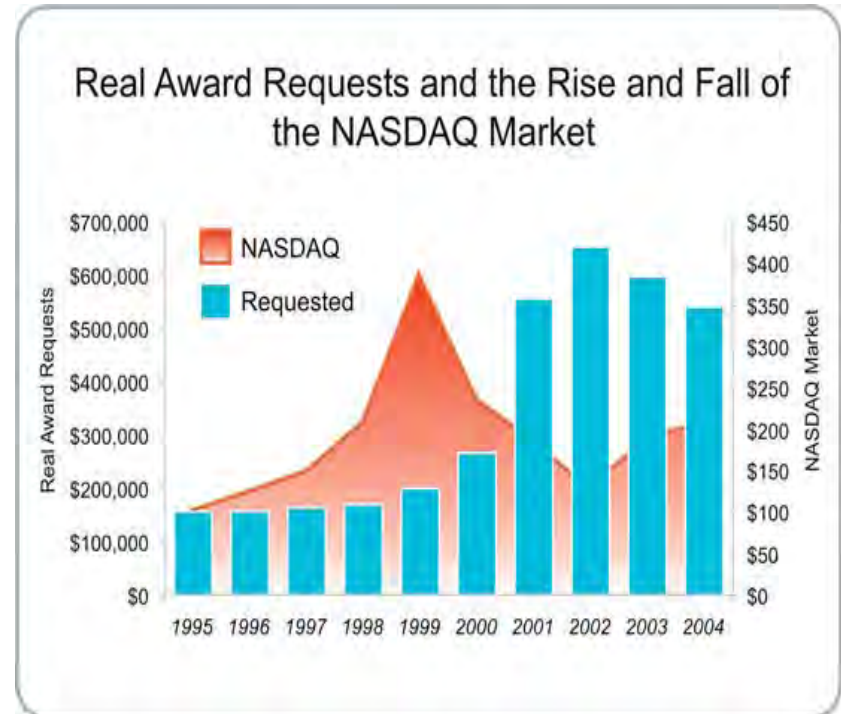
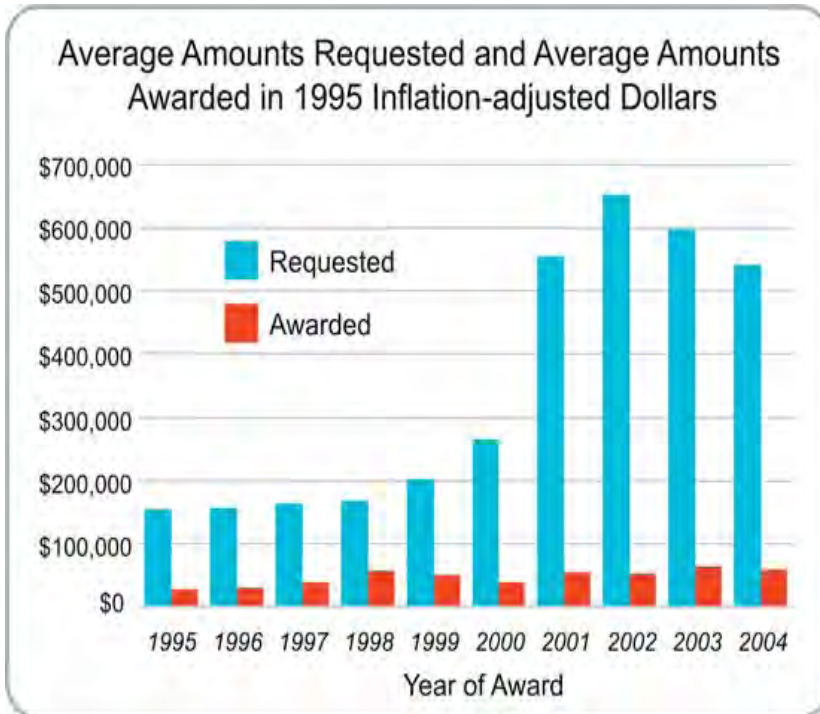
### The Total Percentage of Claimants Who Recover Damages or Other Relief in Arbitration or By Settlement is Favorable



1. Source: Dispute Resolution Statistics available at <http://www.finra.org/AbitrationMediation/FINRADisputeResolution/Statistics/Index.htm>. Data shows percentage of cases in which claimants, including claimants other than customers, recovered damages or other relief either in arbitration or by settlement.

# Appendix E

## Investors' Inflation-Adjusted Recoveries in Arbitration Have Increased<sup>1</sup>

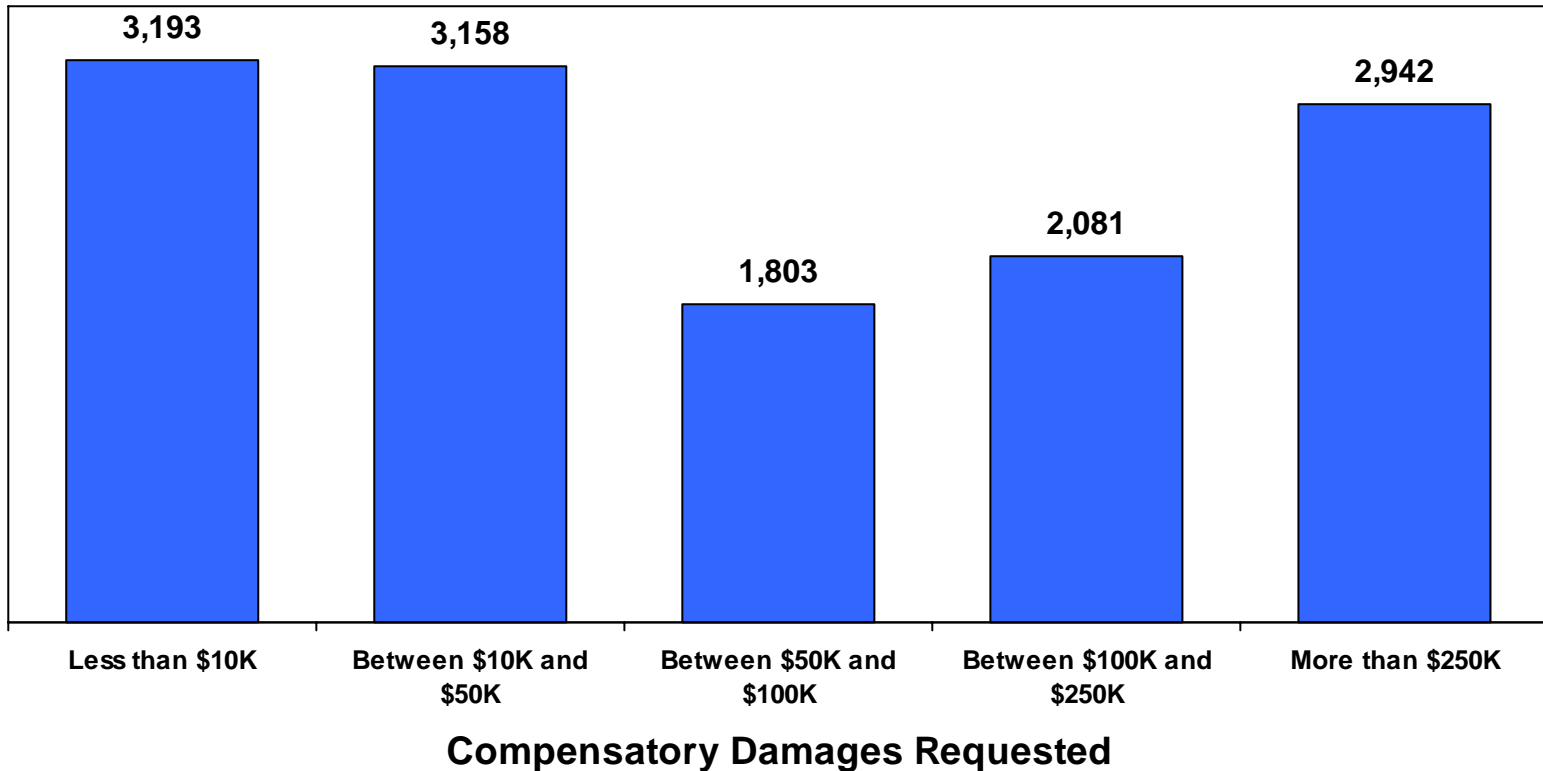


1. Source: Edward S. O'Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare* (2007) at 14, Figs. 10 & 11.



## Appendix F

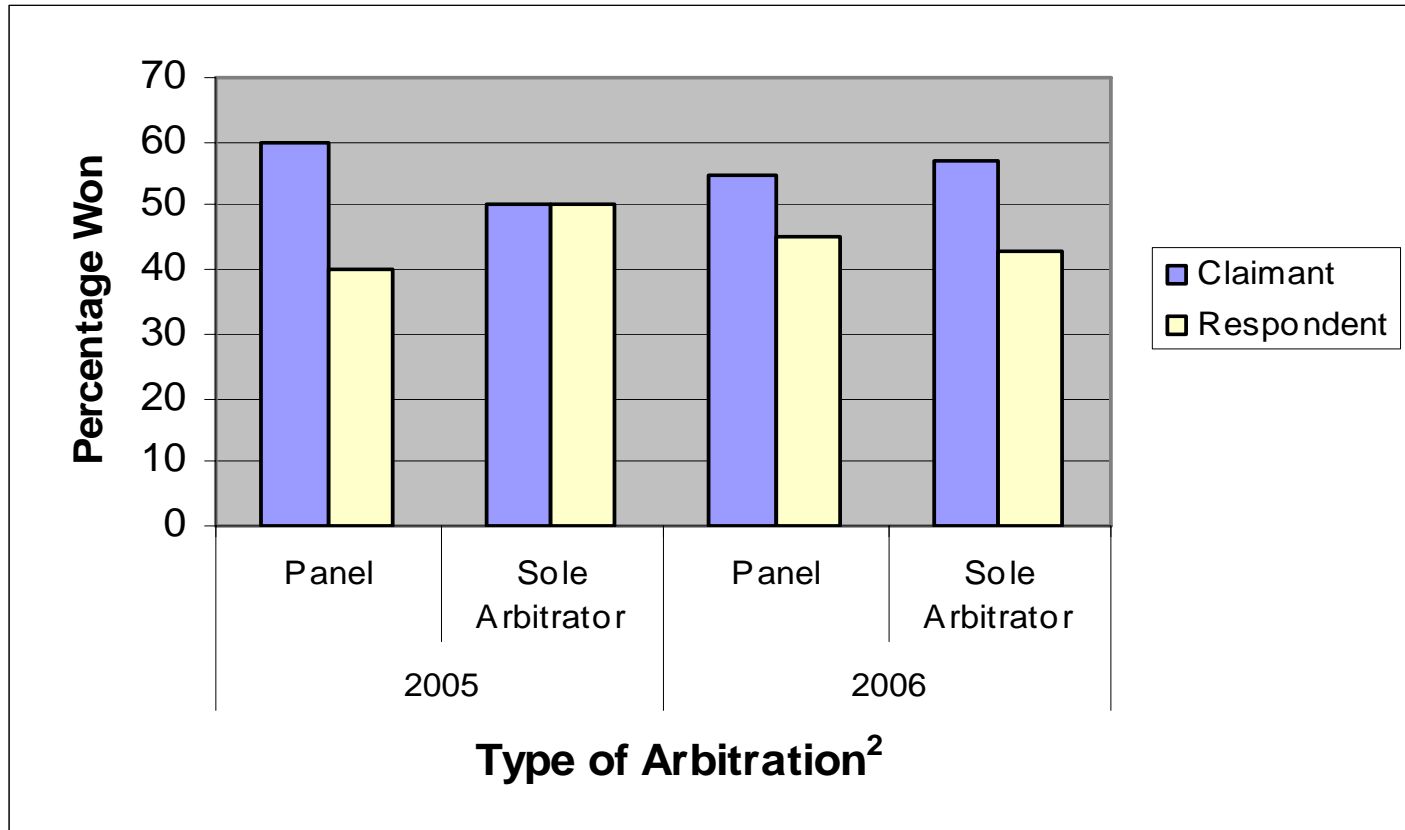
# Many Cases are Small Claims, Which are Better-Suited for Arbitration Than Litigation<sup>1</sup>



1. Source: Edward S. O'Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare* (2007) at p. 8, Fig. 3. The statistics reflected are based on data regarding NASD and NYSE arbitrations occurring between January 1995 and December 2004. Solin Study at 5.

## Appendix G

# The Presence of an "Industry" Arbitrator Has No Material Impact on Customer Wins<sup>1</sup>



1. Source: September 2007 review of all 2005 and 2006 arbitration decisions available on the FINRA website. See <http://www.finra.org/ArbitrationMediation/ResourcesforParties/FINRAArbitrationAwardsOnline/index.htm>. Any arbitration decision in which the Claimant received some form of requested relief is included among the "Percentage Won" above.
2. Arbitrations are decided by panel or sole arbitrator. A panel consists of three arbitrators, two of whom must be public, and one of whom is non-public or "industry." A sole arbitrator is always a public arbitrator.