

**Before the Subcommittee on Commercial and Administrative Law
U.S. House of Representatives Committee on the Judiciary**

**HEARING ON: H.R. 3010,
THE "ARBITRATION FAIRNESS ACT OF 2007"
October 25, 2007**

**Written Statement of Theodore G. Eppenstein, Esq.
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**IN SUPPORT OF PROHIBITING
MANDATORY ARBITRATION OF INVESTOR CLAIMS
IN SECURITIES ARBITRATION**

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INTRODUCTION

I am honored to have been invited to participate in the Subcommittee's Hearing on H.R. 3010, the "Arbitration Fairness Act of 2007," and to recommend in connection with that Bill the prohibition of mandatory arbitration for the adjudication of securities fraud and other financial services misconduct, and to also recommend the establishment of an alternative forum independent from that industry for public investor disputes.

The Constitutional right to trial by jury for investors was rendered meaningless after the U.S. Supreme Court held, upon the urging of the SEC in the landmark arbitration case *Shearson/American Express v. McMahon* (which I argued for the customer), that predispute

arbitration clauses were enforceable ¹ in the securities context. Investors have suffered for the last twenty years following the Court's narrow 5-4 decision in favor of the industry, when the brokerage industry made the arbitration clause mandatory.

A crisis exists today in self-regulatory organization (SRO) arbitration, which has replaced the American way -- trial in court by a jury of your peers. The securities industry customer contracts and their predispute arbitration clauses that require most if not all investors in the financial markets to submit to industry arbitration are not entered into at arm's length, and are almost always non-negotiable by the customer. The SRO arbitration system in which investors must file their disputes has failed to provide a fair forum for the public and tilts in favor of the brokerage firms. The Securities and Exchange Commission (SEC) has been of little help since its historic about-face in the *McMahon* case, when it submitted an amicus brief that supported the industry at the public's expense. Previously the SEC had taken a different view, upholding the rights of public investors to air their grievances in a court of law, and promulgating Rule 15c2-2², which prohibited mandatory predispute arbitration clauses for federal statutory claims of

securities fraud.

The dissenting Justices in the *McMahon* case maintained that predispute arbitration agreements for securities customers were unenforceable, pursuant to the statutory anti-waiver provisions, the policy of investor protection inherent in the securities laws, and the Court's own precedent, namely the seminal case of *Wilko v. Swan*, 326 U.S. 427 (1953) . The *McMahon* dissenters were seemingly astonished by the reversal of the previously long-held position of the SEC favoring non-arbitrability, and predicted that Congress was the last resort for the investing public to restore access to the courts. *McMahon*, 220 U.S. at 266-67. Now there is renewed hope with H.R. 3010 that Congress will return to investors the Seventh Amendment right to have all investment claims heard by a judge and jury and to prohibit mandatory arbitration.

THE CRISIS IN MANDATORY SECURITIES ARBITRATION

For sure, arbitration has served the securities industry well these past 20 years, where public scrutiny of all kinds of brokerage evils are hidden behind arbitration's closed doors and the firms' pocketbooks are sheltered from a jury's wrath. But the abrogation of basic fairness in

favor of the “black hole” into which most investor gripes fall should be evident even to the short sighted regulators. At the top of the list is the perception, and for many veterans of SRO arbitration the harsh reality, that there is a stacked deck against the public. That’s because investor complaints in the SRO arbitration system, which is unlike any other, are typically decided by three individuals, one of whom must be reared, and usually is embedded, in the very industry on trial. That panelist is called a “non-public” or “securities industry arbitrator” by the forum. Yet there is no designated “investor arbitrator” to counterbalance the industry’s representative on the panel, merely a pool of so-called “public” arbitrators who supposedly have no significant ties or sympathies with the industry. But the customer often faces panelists who are mis-classified and connected to the industry, administratively appointed by the SROs without any peremptory challenge available to the investor, trained to look for mitigating circumstances that will spare the brokerages big hits, and often financially reliant on being selected to adjudicate future cases. Because all arbitrators are aware that their final rulings are made public, this can cause concern even to the fairminded that issuing large awards to customers can put that

arbitrator on the industry's blacklist and on the sidelines for future assignments.

Securities arbitration has not been the fair, fast and economical path to recovery it was reputed to be. Higher fees, lack of disclosure of potential conflicts of interest by potential arbitrators, more "preliminary" hearings, endless motion practice, voluminous document demands, lengthy interrogatories, arbitrary evidentiary rulings by arbitrators precluding evidence of industry wrongdoing, and almost every type of delay imaginable just to get to the start of the trial can easily frustrate, overwhelm and exhaust the ordinary investor. And then, if the customer survives the blame the victim tactic that forms the bedrock of the defense, in a few years from filing there will be a decision, but with a limited ability for the parties to appeal it if the arbitrators got it wrong, or didn't compensate the victimized investor adequately.

Unfortunately for the investing public, the Supreme Court did not have at its disposal in 1987 the arsenal of statistics and studies which we now know demonstrate conclusively that customers fare poorly in SRO arbitration. Indeed, as shown in the materials supplied with this written statement, customers' chances of even winning anything in an SRO arbitration, much less

recovering a substantial portion of their losses, have declined precipitously since *McMahon* was decided. It's gotten so bad that not only do customers in SRO arbitration lose everything 58% of the time (in 2006, according to the NASD), but when they do win some recovery it's only a small fraction of their losses, and can be less than the expenses paid to the forum to hear their case.³

Thus, in the intervening twenty years⁴ since *McMahon*, when substantially all individual customer cases have been heard in arbitration, industry claims of the advantages of the system⁵ is belied by the overwhelming evidence of the unfairness of mandatory arbitration, where even the SEC has long conceded that enforcement of the securities laws in SRO arbitration cannot be insured by its oversight.

Further complicating matters for investors is that until 2007 there were several SRO arbitration forums to choose from, with modest differences in the arbitration rules providing some competition and choice, even though they all were run by the industry. These SRO forums, through a steady process over the years of consolidation or attrition, have been reduced to only one: FINRA (the Financial Industry Regulatory Authority, created by the combination of the

regulatory and arbitration functions at the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD)). Now that there's no competition, the concern of customers is that they may be worse off than ever before.

**STUDIES DEMONSTRATE MANDATORY
SRO SECURITIES ARBITRATION IS A FLAWED SYSTEM**

But you don't need a PhD to understand what investors have been fuming about most: it's the poor results inappropriately labeled "awards" by the SROs. The analyses of these panel "awards" done by the U.S. Government Accountability Office (GAO) and others over the past 20 years graphically illustrate the exponential increase in detrimental outcomes for the public. These studies refer to customer "win rates" and the percentage of claimed amounts awarded, but count investors to be "winners" even if they don't get back enough to cover their costs to arbitrate.

The first GAO analysis in 1992 demonstrated that shortly after the McMahon case (1989-1990) investors received a favorable decision almost 60% of the time for cases arbitrated at the NASD and NYSE – and the winners recovered about 61% of their losses at the SROs. A

leading independent arbitration commentator (SAC) in 1996 issued its 1989-1995 survey of 10,000 SRO “awards” and found a “steady downward trend” in the “win rate” for cases in which customers prevailed.⁶ This was followed by another GAO report at the request of the House of Representatives in 2000, which surveyed the awards from 1992-1998 and confirmed the downward curve of favorable SRO awards issued to investors in the 1992-1996 period, to an average of only about 51% for those years (although this “win rate” was on the up tick in 1997-1998).⁷ Significantly, the government analysis also showed that the percentage of the amount awarded compared to the amount claimed had also slipped big time from the level of its earlier study – down from 61% in 1989-90 to 51% for the 1992-1998 period.

SAC published in February 2007 another survey of SRO arbitration results for the years 2000-2005 indicating the SRO “win rate” of all customer cases in 2000-2001 was 52-53%, where the customer won at least something.⁸ But then the public’s “win rate” fell further in successive years at the NASD, the largest SRO forum (2002 53%; 2003 49%; 2004 47%; 2005 43%). When the NASD published its results of “win rates” in customer cases decided in 2006, to the surprise

of absolutely no one who follows SRO arbitration, the grim results indicated the chance of investors winning at least \$1 in arbitration at the NASD hit an all time low – a dismal 42%.⁹ (The NYSE “win rate” was reportedly even lower!) And these diminishing “win rates” mean that at the NASD 58% of the time last year the brokerages, who often hire big gun outside law firms to doggedly protect their interests, shot down most public investors, sending John Q. Public home with a zero recovery for investment losses.

Looking back throughout the past two decades of SRO arbitration results invites comparison of the GAO’s 60 percent win rate in 1989-90 to the NASD’s paltry 42 percent in 2006, a decline that translates to about a 30 percent reduction in investor win rates over twenty years. The NASD’s statistics also show a decline of around 20% in investors’ chances from 2002 to 2006 levels.

The publication in June 2007 of the O’Neal/Solin Analysis (see endnote 3), based on almost 14,000 arbitration results from 1995 through 2004 (which overlaps the latest GAO and SAC surveys, and NASD statistics), should silence any doubters that SRO arbitration is a failed

system. The O’Neal/Solin study, using what the authors deem a “better measure for assessing the arbitration process” (of predicting outcomes for customers called the “Expected Recovery Percentage” which factors in the “win rates” with “award percentages”), found that the Expected Recovery Percentage for an investor during this 10 year period was at the high in 1998 of 38 cents to the dollar, and dropped to a low in 2004 (the last year analyzed) of 22 pennies on the dollar! And this decline does not take into account the customer’s “share” of paying costs, expenses and fees.

It is almost twenty years since my last appearance and testimony at a different House Judiciary Committee hearing in December 1987, before the Subcommittee on Criminal Justice, in connection with efforts in Congress then to preserve a federal court option for the adjudication of RICO statute claims predicated on securities fraud.¹⁰ That effort and others followed in the wake of the *McMahon* decision. In March 1988 I testified before the House Committee on Energy and Commerce, Subcommittee on Telecommunications and Finance¹¹ which was exploring securities law reform to restore to public customers the choice of federal court

adjudication of securities fraud claims instead of mandatory arbitration, and assisted the subcommittee in drafting such remedial legislation in order to retroactively reverse the *McMahon* decision, to restore to investors the right to a jury trial and to require certain SRO arbitration reforms.¹² Soon after *McMahon*, even the SEC recommended that investors be given contractual access to alternative arbitration forums outside of the industry.¹³

Yet sadly, the alternative forum never materialized, and nothing meaningful has changed since then except that SRO arbitration has become a trap for investors. Investors are still compelled to use an arbitration forum run by the industry's self-regulator under industry approved rules, where one member of every three-member arbitration panel is required to be from the industry itself, enforcing the perception (and in some cases the harsh reality) held by the public that the system is a stacked deck.

ALL THE PUBLIC MEMBERS OF SICA SUPPORT PROHIBITION OF MANDATORY SECURITIES ARBITRATION AND ESTABLISHMENT OF A NEW, INDEPENDENT SYSTEM OUTSIDE THE INDUSTRY

The Securities Industry Conference on Arbitration (SICA) was established in 1977 with the support of the SEC to create a Uniform Arbitration Code to harmonize the rules of the

various SRO arbitration forums then in existence. Since 1977, SICA has met on a regular basis to discuss SRO arbitration and to review and revise the Uniform Code. Besides three public members, all the SROs also have had voting membership in SICA along with the SIA (Securities Industry Association, now SIFMA), and the SEC has regularly attended quarterly meetings. SICA also drafted and revised the Arbitrator's Manual that was in use at the NASD and NYSE.

In January 2007, fully thirty years after the founding of SICA, all three Public Members¹⁴ of SICA and all three Public Members Emeritus recognized that the crisis in the system required returning the court option to investors and creating a forum for securities arbitration totally independent from the industry to insure that the integrity of the process and the rights of customers were being fully protected. The Public and Emeritus Members of SICA signed a comprehensive letter¹⁵ to the SEC in support of this initiative, with copies to NASAA (the North American Securities Administrators of America), and to members of the U.S. Congress, including the House Committee on the Judiciary Chairman. This effort was supported by NASAA, the umbrella organization of state securities administrators, in a letter from the

chairman of its Arbitration Project Group that advocated the elimination of the requirement for an industry arbitrator and barring public arbitrators with significant ties to the industry.¹⁶

CONCLUSION

The history of securities arbitration and the way in which customer disputes are litigated there makes abundantly clear why the system has become hopelessly flawed and harmful to the public. Further, the conceded inability of the SEC to insure that the federal securities laws are properly enforced in SRO arbitration decisions makes it all the more imperative that mandatory arbitration be eliminated and that other alternatives to the current process be made available to customers. Following are three practical recommendations for reform of the current process:

- Prohibit mandatory SRO arbitration and give investors the right to go to court;
- Mandate creation of a new arbitration system for those customers who, for various reasons, would prefer a faster and less costly resolution process by creating a new forum outside of the securities industry, but with SEC oversight, under a new set of rules that removes the requirement of an industry arbitrator; that prohibits motions to dismiss

entirely; that appoints arbitrators early on to oversee discovery issues; and where the parties agree on three neutrals without the appointment of an arbitrator experienced in the industry unless the parties agree. This forum should be funded and maintained by contributions from the industry to reduce costs to the investor.

- Until such a new independent forum is established, require FINRA to revise its rules and remove the industry arbitrator requirement at FINRA; cleanse the public pool of arbitrators to eliminate everyone who has ties to the industry; prohibit all motions to dismiss prior to the end of the case; and prohibit abusive discovery stonewalling by the industry, among other negative features of the current SRO arbitration process.

We ask that Congress fulfill the wishes of public investors and the hope of the late Justice Harry Blackmun – that Congress will give investors the relief that the highest Court denied them twenty years ago.

ENDNOTES

¹ 482 U.S. 220 (1987). Not long after, 1933 Act cases were also made subject to mandatory arbitration in *Rodriguez de Quijas v. Shearson/American Express*, 490 U.S. 477 (1989).

² Securities and Exchange Commission Rule 15c2-2, 17 C.F.R. Section 240.15c2-2(a). The rule provided in pertinent part: “It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer.” Cited in *McMahon*, 482 U.S. at 264, n. 24.

³ G. Morgenson, “When Winning Feels a Lot Like Losing,” *The New York Times*, Business Section, December 10, 2006, p. 1. *See also* J. O’Neal and D. Solin, “Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimant’s Fare” (2007) (the “O’Neal/Solin Analysis”).

⁴ On the tenth anniversary of the *McMahon* decision in 1997, *The New York Times* ran an Op Ed article critical of the SRO system and noting the same SRO arbitration problems that the public faces today. Theodore and Madelaine Eppenstein, “An Arbitration Albatross,” *The New York Times*, June 8, 1997, Business Section 3 at p.12 (Exhibit Attached).

⁵ *See* J. Pessin, “Out of Court Fight - Two Decades after Mandatory Arbitration Took Effect in Investor’s Disputes, Debate over It Gains Momentum,” *Wall Street Journal* (August 6, 2007), for a statement of the issues at stake in mandatory arbitration and the problems with the current system, giving the industry perspective in contrast to the investor’s point of view. (Exhibit Attached).

⁶ General Accounting [Government Accountability] Office, GAO/GGD-92-74, “*Securities Arbitration-How Investors Fare*,” at 35 (May 11, 1992). *See also* Sec. Arb. Commentator, *Public Customer Award Survey-The First 10,000 Awards* (May 1996)(“A steady downward trend in the ‘customer win’ rate is revealed. . . .”), commenting on Awards in the 1989-1995 time period.

⁷ GAO/GGD-00-115, “*Securities Arbitration: Actions Needed to Address the Problem of Unpaid Awards*” (June 15, 2000).

⁸ Sec. Arb. Commentator, *Year(s) in Review II, A SAC Award Survey Comparing Results in 2005 to 2000-2004*, at 3 (February 2007) (“On the customer side Chart I discloses a downward trend that has been evident for some time in SAC’s surveys and in the Award statistics that NASD publishes – a big decline in the “win” rate. We already know that this trend continues into 2006 Awards (likely, beyond the impact of Market 2000) and that it affects both Customer-Member

and Small Claims Awards.”).

⁹ See NASD Dispute Resolution Statistics-Results of Customer Complaint Arbitration Award Cases at p. 4 (Exhibit Attached).

¹⁰ Written Testimony of Theodore G. Eppenstein, “Civil RICO Reform: Federal Court Adjudication of Broker-Dealer/Investor Fraud Claims,” December 3, 1987.

¹¹ Written Testimony of Theodore G. Eppenstein, “Securities Law Reform: Restoring the Public Customer’s Freedom of Choice of Federal Court Adjudication for Investor/Broker-Dealer Fraud Claims,” March 31, 1988 (Exhibit Attached) for a full review of the Congressional, legal and regulatory history leading up to *McMahon*, and the arguments made then to restore investors’ rights to choose court and a jury.

¹² H.R. 4960, otherwise known as the “Securities Arbitration Reform Act of 1988” (A Bill to amend the Securities Exchange Act of 1934 to provide for the fair, equitable and voluntary arbitration of customer-broker disputes, and for other purposes.).

¹³ Letter of Richard G. Ketchum, Director, Division of Market Regulation, September 10, 1987 at p. 11.

¹⁴ Theodore G. Eppenstein has been a Public Member since 1998.

¹⁵ Letter of The Public Members of SICA to Hon. Christopher Cox, et. al, “The Public’s Concerns about the Newly Combined NASD/NYSE Arbitration Forum and SICA’s Mandate,” (January 12, 2007) (Exhibit Attached).

¹⁶ Letter of Bryan J. Lantagne to Hon. Christopher Cox, et. al, “Public Member[s] of SICA Regarding the Combined NASD/NYSE” (February 12, 2007) (Exhibit Attached).