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 15c2-2[2], 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 years[4] since *McMahon*, when substantially all individual customer cases have been heard in arbitration, industry claims of the advantages of the system[5] 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 Finance[11] 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 Members[14] 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 letter[15] 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).

ATTACHMENTS

Biographical Information for Theodore G. Eppenstein, Esq.

Theodore and Madelaine Eppenstein, "An Arbitration Albatross," The New York Times, June 8, 1997, Business Section 3 at p.12

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)

NASD Dispute Resolution Statistics-Results of Customer Complaint Arbitration Award Cases at p. 4

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

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)

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

Biographical Information for Theodore G. Eppenstein, Esq.

Theodore G. Eppenstein founded the law firm Eppenstein & Eppenstein which has an international practice representing investors and is widely known for their work in advocating the rights of the public for over two decades.

Mr. Eppenstein argued before the highest federal and state appellate courts including on behalf of investors before the U.S. Supreme Court in 1987 in *Shearson v. McMahon*, a landmark case which has been analyzed extensively and to this day continues to draw transnational attention. In the wake of *McMahon*, Mr. Eppenstein was asked to testify before two U.S. Congressional subcommittees.

The U.S. House of Representatives Subcommittee on Telecommunications and Finance invited Mr. Eppenstein to appear before it in 1988 and present his opinion of compulsory arbitration and arbitration reform. After testifying, along with his partner Madelaine Eppenstein Mr. Eppenstein assisted the Subcommittee in drafting remedial legislation (H.R. 4960). Mr. and Ms. Eppenstein were also asked to testify before the U.S. House of Representatives Subcommittee on Criminal Justice to present their opinions on civil RICO reform.

In 1998 Mr. Eppenstein was appointed to be one of three public members of the Securities Industry Conference on Arbitration ("SICA"), a think tank on arbitration including SRO and industry representatives, which meets regularly to discuss arbitration issues, drafted and revises the Uniform Code of Arbitration and the Arbitrator's Manual, and whose meetings are attended by representatives of the SEC. Mr. Eppenstein was reappointed to a second term in 2002.

The New York Stock Exchange (NYSE) invited Mr. Eppenstein in 1994 to express his views at the NYSE Symposium on Arbitration in the Securities Industry, where he appeared as a speaker and as a participant. The NASD's Arbitration Policy Task Force requested that Mr. Eppenstein present his opinion as a representative of investors at two sessions held in 1995. The NYSE and the Moscow Interbank Currency Exchange invited Mr. Eppenstein to participate in a two day symposium about arbitration in the United States held in Moscow in April 2000. In March 2003, the NYSE and the Cairo-Alexandria Stock Exchanges sponsored a two day symposium in Cairo covering arbitration topics at which Mr. Eppenstein was a principal speaker. From time to time, Mr. Eppenstein's opinions have been solicited by the General Counsel's office of the SEC and by the Directors of Arbitration at the NYSE and NASD, and several of his arbitration recommendations have been adopted by SICA and those self-regulatory organizations.

Mr. Eppenstein has argued on behalf of the investing public for over two decades. He also successfully litigated the "Amex Window" procedural mechanism for providing investors access to the American Arbitration Association (AAA) through the New York State appellate courts; his unanimous victory in *Cowen & Co. v. Anderson* in the New York Court of Appeals in

1990 established the law in New York State giving hundreds of thousands of investors the right to arbitrate at the independent AAA and not just within the confines of self-regulatory securities industry organizations. Mr. Eppenstein was also a member of the AAA's Securities Arbitration Rules Task Force, and a member of the AAA's Securities Advisory Committee. The Firm has also counseled attorneys transnationally on litigation, arbitration and mediation of investment fraud matters. The firm has prosecuted investment fraud claims for clients from coast to coast in the U.S. and for clients from England, France, Germany Spain, Belgium, Switzerland, Indonesia, Hong Kong, Ivory Coast, and the Middle East. The Wall Street Journal reported that the firm won the largest arbitration award ever for customers in 2001.

Mr. Eppenstein, along with Ms. Eppenstein, has co-authored many articles on securities arbitration and litigation, and they have both been on the faculty of professional seminars and conferences.

Mr. and Ms. Eppenstein's views have been quoted by many major national and international press. For example, The New York Times requested an opinion piece in 1997 about securities arbitration since the *McMahon* decision and published an article written by the Eppensteins. (The Times chose the title, "An Arbitration Albatross.") The New York Times (Front Page Sunday Business Section), The Wall Street Journal, The Washington Post, Barron's, Newsweek, Business Week, Smart Money, Forbes, Money Magazine, Investment Dealer's Digest, Investor's Daily, Bloomberg, The Chicago Tribune and The Los Angeles Times are among the publications that have interviewed Mr. Eppenstein on securities and commodities arbitration issues. Worth Magazine ran a profile of Madelaine and Theodore Eppenstein entitled "Two for the High Road, to the Eppensteins, Shareholders' Rights Are Sacred." Mr. Eppenstein also appeared on the cover of Investment Dealers' Digest and was prominently featured in the cover story "Taking Brokers to Court." The Wall Street Journal published a piece in August 2007 entitled "Out of Court Fight" which covered current arbitration issues featuring an e-mail exchange between Mr. Eppenstein and an attorney giving the opposing view.

Media coverage of Mr. Eppenstein and the firm Eppenstein and Eppenstein has also included numerous television shows such as the NBC Today Show on two occasions, CBS Business News, NBC Business News, ABC, PBS Wall Street Week, Court TV, CNN, CNBC, Financial News Network, Law Line and other cable shows.

A graduate of the State University of New York at Stony Brook (B.A. 1968) and St. John's Law School (J.D. 1973), Theodore G. Eppenstein was a recipient of Stony Brook's Distinguished Alumnus Award in 1991 for his work on behalf of the public investor. While attending Stony Brook, Mr. Eppenstein held 14 school basketball records, including most points in a game and in a career, and was inducted into the University's Athletic Hall of Fame in 1994. Mr. Eppenstein served as a member of the President's Intercollegiate Athletic Advisory Committee. In conjunction with Stony Brook's 40th Anniversary, Mr. Eppenstein was profiled as one of the University's finest 40 graduates in 1998 and served on the Board of Directors of the

Stony Brook Seawolves, which advised the Athletic Department. Mr. Eppenstein currently serves as a member of Stony Brook University's Business School MBA Advisory Board.

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The New York Times
Sunday, June 8, 1997
Money&Business
WC. Section 3

VIEWPOINT

MADELAINE and THEODORE G. EPPENSTEIN

An Arbitration Albatross

Elliott Banfield

WHAT do you tell someone who says he lost his life savings to an unscrupulous stockbroker and now wants to sue in court and get a jury trial? There may be more than 10 million stock brokerage accounts out there, but the answer is, "Sorry, you can't go that route."

Ten years ago today, the Supreme Court, with the blessing of the Securities and Exchange Commission, locked the courthouse doors to such investors by granting the brokerage industry's wish that customer claims be limited to arbitrations conducted by industry tribunals.

In this landmark case, Shearson/American Express v. McMahon, the Justices in the narrow 5-to-4 majority found that the "bargained for" customer contract calling for mandatory arbitration of securities fraud disputes was enforceable. The decision proclaimed that the long-perceived mistrust of arbitration was, by 1987, a myth and that investors could get a fair deal in arbitration. In his dissent, Justice Harry A. Blackmun said the decision was "animated" by a desire to pare down the Federal court docket. And he asserted that investors should not lose their day in court at the whim of the industry and predicted that more litigation would ensue. This analysis has proved prophetic.

In the years that followed, the S.E.C., investor advocates, the Securities Industry Conference on Arbitration and the industry itself have been involved in a continuing effort to reform the process. There were some early and positive changes in the rules governing arbitration proceedings at the tribunals of the major self-regulatory organizations, the National Association of Securities Dealers and the New York Stock Exchange. For instance, all important information and documentation exchanges were once permitted to languish until the first day of a hearing; now the exchange of evidentiary material is slugged out by the lawyers before the arbitrator-referees well ahead of the hearings on the merits.

But substantive improvement has been slow, and a perception remains that arbitration is a stacked deck. Skepticism persists largely because the rules require a person affiliated with the industry to sit as an arbitrator on every three-member panel.

The industry asserts that it is better for the customer to have an individual knowledgeable about the workings of the market sitting in judgment of fraud claims. But the public suspects that an industry arbitrator will have difficulty determining impartially whether another firm engaged in fraudulent activity like unauthorized trading, unsuitable investing or churning. And will that industry arbitrator have the courage to render a multimillion-dollar award, including punitive damages, against another member of the Wall Street club? An industry arbiter who does that risks being blackballed by the industry in his career and in future cases.

But there is no need for the purported expertise of the industry "Solomon" on these panels because most disputes turn on the credibility of witnesses, not on technical trading issues. And our judicial system has generally functioned well over the centuries by leaving it up to lay jurors to understand even the most complex disputes.

The industry, which forced arbitration on investors — and which could stop forcing it anytime by removing the mandatory arbitration clauses from customer contracts — has tried in recent years to frustrate arbitration by going to the very courts it seeks to prevent its customers from using.

The most pernicious tactic has been to initiate litigation requesting state court judges in New York to dispose of customer claims before they reach arbitration, often regardless of the residence of the investor. Lawsuits by the hundreds were filed and temporary restraining orders were obtained stopping arbitration in its tracks while New York judges were asked to decide defense issues of statutes of limitations, redundant "eligibility" rules in arbitration and whether investors could proceed to argue for punitive damages. This wasteful and delaying tactic has continued, although it appears from recent decisions that New York's judges are tiring of it.

One legacy of Shearson v. McMahon is that arbitration for public investors has become more like court litigation, but without the safeguards built into the judicial system. As a result, the broker-dealers have devised strategies to frustrate the proceedings.

An early reform was to liberalize the discovery phase before the hearings. The industry has seized upon this as an opportunity to harass claimants and prolong the proceedings. Document requests are now a lengthy list that the broker-dealer churns out of its word processor. The most personal information is demanded, along with data about every investment the claimant ever made.

OFTEN, brokers also string out the discovery process when it comes to providing documents requested by investors. Despite repeated pre-hearing conferences, there are many cases in which the most important documents are not produced until the end of the process, and sometimes not even until the trial begins.

We are sure that one of our adversaries maintains an antique photocopier solely for use in providing illegible copies in response to customer requests. In one case, we fought for the right to see the original as well as the photocopy we had been furnished. When we finally got to look at it, it turned out to be the smoking gun. On the original, it could be seen that the word "no" had been erased at a crucial point. The erasure had not been apparent on the copy. The brokerage firm's settlement offer was ultimately doubled.

There are now two controversial proposals that the N.A.S.D. may send up for S.E.C. approval: a cap on punitive damage awards, and an opportunity for the industry, in claims based on activity more than six years old, to choose unilaterally to kick the claimant out of arbitration.

The punitive damage cap (the lesser of $750,000 or two times the compensatory loss), is perhaps the most disturbing of these proposals, especially when the most recent court decisions allow unrestricted punitive damages. Apparently, it is not enough to force customers to arbitrate rather than go to court. The N.A.S.D. also thinks that the industry should be able to impose what it views as a fair limit on what the arbitrators can award.

This is not the "justice" that the Supreme Court, in 1987, envisioned as a fair, fast, cost-effective alternative method of resolving disputes. Ideally, Congress should recognize that and undo the McMahon decision.

But if forced arbitration is to continue, changes are needed. There should be no six-year eligibility limit because brokers are fully protected by applicable statutes of limitations. The right to punitive damages should be made crystal clear, and arbitrary limits on them not allowed. The pool of arbitrators should include more of a cross-section of the investor's community, and the industry arbitrator should be removed unless the investor requests otherwise. And abuses to the discovery process should not be countenanced.

Given the power of the securities industry to fashion its own rules, and the inability of investors to have a real say in the administration of arbitration justice, there will no doubt be further erosion of public confidence in the system if the system is not improved. □

Madelaine and Theodore G. Eppenstein are the founding partners of the New York law firm of Eppenstein & Eppenstein; they represented the investors in Shearson American Express v. McMahon and have testified before Congress on investor rights.

THE WALL STREET JOURNAL.

MONDAY, AUGUST 6, 2007

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Investing in Funds: A Monthly Analysis

Out-of-Court Fight: Two decades after mandatory arbitration took effect for investors' disputes, debate over it gains renewed momentum

BY JAIME LEVY PESSIN

The debate hasn't lost heat in two decades.

Twenty years ago, the Supreme Court ruled that securities brokerage firms could require their customers to take disputes to arbitration. Now, the critics of that ruling are at it again: Following a stream of statements and letters from legislators, lawyers and consumer groups urging the Securities and Exchange Commission and Congress to ban mandatory arbitration, Sen. Russell Feingold (D., Wis.) and Rep. Hank Johnson (D., Ga.) introduced legislation in mid-July that would make pre-dispute mandatory-arbitration agreements unenforceable.

Matt Farley

Motivating some critics is the consolidation of the industry's two primary arbitration forums, the National Association of Securities Dealers, with NYSE Regulation, a unit of NYSE Euronext. The merger, finalized last week, "raises the stakes for getting [arbitration] right" with a forum that is "independent and fair to investors," the head of the North American Securities Administrators Association testified before a Senate subcommittee in May.

Have any of the debating points changed? Will the latest push from arbitration's critics lead to an overhaul of the current arrangement?

The Wall Street Journal invited two lawyers to discuss the issue: Ted Eppenstein, who represented investors in the 1987 Shearson/American Express v. McMahon case and is currently a member of the Securities Industry Conference on Arbitration; and Matt Farley, a partner with the law firm Drinker Biddle & Reath, who defends brokerage firms in arbitration and litigation and is a member of the Securities Industry and Financial Markets Association Compliance and Legal Division. Here are excerpts from the email discussion:

The Wall Street Journal: Why has this topic heated up again?

Mr. Farley: Could it possibly be that, with the market not only fully recovered but seeming to hold steady these past few years, most if not all of the meritorious cases have already proceeded through the pipeline to an award? It isn't the "investors" who are seeking return to the pre-1987 option of going to court. It is the attorneys who don't have enough good cases to bring who are seeking new opportunities to "lock and load" with meritless claims that they know experienced arbitrators will likely dismiss.

Mr. Eppenstein: While the dark side is always quick to "blame the victim" or chastise their lawyers, here all the public wants is the right to choose the forum in which to fight financial fraud. The right of investors to a jury trial proceeding in a court of law was judicially usurped in the 5-4 McMahon decision. It's time for a sea change, to give back to public investors the American way: the choice to go to court if they desire.

WSJ: Why is Wall Street so adamant about mandatory arbitration? Even though arbitration takes longer than it has in the past, it is still faster and cheaper than taking a case through the legal system, suggesting that most investors would choose the arbitration route if they had a choice, right?

Mr. Farley: It is not a question of one or the other. Prior to McMahon, a case could -- and many cases did -- find themselves in both forums: the federal claim in a district court, all the other claims in arbitration.

A $25,000 case that would be "small claims" in most states [went] forward in a federal action, opening the door to every discovery mechanism afforded by [federal rules]. And a parallel arbitration was happening right alongside it, covering essentially the same facts and events. The situation was, logistically and economically, a nightmare. Securities firms rightly and naturally sought relief from the often recklessly wielded bludgeon of wide-ranging and all but limitless discovery.

Ted Eppenstein

Mr. Eppenstein: The [benefits of courts] over arbitration are discovery procedures which are monitored by the court, defined rules of evidence, legal precedents that are required to be followed, and most important, an impartial judge and a jury. There is the right to full appellate review. Court is an open forum, another plus for the public.

Because individual investors have not been permitted to bring their claims of securities fraud, unauthorized trading, unsuitable investments, churning [frequent trading to generate commissions], common-law claims, and the like into the courtroom, the public is also denied the ability to have the media fully and fairly report on the abuses on Wall Street that continue to befall the unwary investor. These get played out instead in a semi-secret arbitration proceeding.

Mr. Farley: Arbitration is cheaper, and faster. And more likely to have a measure of predictability than, say, a jury trial. And for those very reasons,

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like transactions in automobiles, credit cards, home improvements, garment production, construction of virtually all types, software disputes, and major-league athletics, the industry participants have generally opted for arbitration for the resolution of disputes.

Mr. Eppenstein: Matt, I agree with you that arbitration [run by self-regulatory organizations] is more likely to have a measure of predictability for the industry than a jury trial. That's because the [current] arbitration system can be viewed as a stacked deck against the investor. Thus, it is no surprise that arbitration would be cheaper, faster and a better way for the financial industry to trim its defense costs. Fast resolution at a cheap rate is what the industry seeks; the investor wants justice, even if it takes a little longer to achieve in court.

Even the NASD, the major provider of arbitration for customers in 2006, reports that its "win-loss" percentage of 42% is [lower than it has been since at least 2000].

WSJ: What role has the consolidation of regulatory functions of the NASD and NYSE Regulation, to form the Financial Industry Regulatory Authority, played in the renewed push for investors to have the option of going to court?

Mr. Farley: I see no connection between the merged arbitration facilities and whether the customer should have an ability to opt for a court proceeding. In recent years, [the NASD] has processed the vast majority of filed cases and aggressively served the investor community by making venues more local and convenient throughout the country. The attorneys who regularly represent customers have shown no lack of energy and imagination when it comes to urging and getting procedural rule changes that ease the prosecution of customer claims.

Mr. Eppenstein: When Wal-Mart and Costco are both in town, the consumer can decide where to shop for a better deal. The consolidation of the [NASD and NYSE] securities-arbitration forums effectively takes the last vestige of choice away from the public.

There are significant differences in arbitration at the NASD and the NYSE forums, such as the arbitrator selection process, different procedures to administer cases and different locations for the hearings.

I fully understand, Matt, that you don't perceive any difference. After all, the arbitrator pools are similar, and the win rates for investors are low at both [forums]. However, earlier this year all three current public members of the Securities Industry Conference on Arbitration and all public emeritus members joined together to complain to the SEC that consolidation would not be in the investor's best interest.

WSJ: Would it make sense for investors to have more choice in arbitration forums – like opening it up to the American Arbitration Association or Judicial Arbitration and Mediation Services?

Mr. Farley: Their fees are significantly higher than NASD/NYSE because they lack the subsidy that securities-industry member firms [pay as part of their regulatory fees]. In a pilot case some years back, several of the larger firms opened up their arbitration clauses to AAA, but there were few takers.

Mr. Eppenstein: The mini program you refer to was doomed from the start. Only a handful of [large brokerages] signed on for a few months, and then it was with certain conditions. What we need is an independent forum, funded by the industry, but independently run and operated with SEC oversight.

WSJ: Do you expect the SEC or Congress to make a change on this issue?

Mr. Farley: With the market up the past several years, the number of open arbitration cases has plummeted. While the trial bar always has its agenda, I don't see any broad constituency for legislation to alter the current situation or any obvious "injustice" crying out for relief. There is no empirical evidence at all that investors systematically fare worse in arbitration than they would in court with the same case. So I would say legislative or regulatory action is unlikely.

Mr. Eppenstein: Anyone with a sense of history can look at the declining, dismal results that [NASD and NYSE] arbitration has yielded to the investor over the past 20 years to see that the system is not a level playing field. NASD stats show the investor "win rate" has steadily declined. And when the customer does win something, the award is often only a small portion of the loss.

This information is well known to the SEC, but will they act? As predicted by [Supreme Court] Justice Harry Blackmun in the McMahon dissent, arbitration reform may ride on the seriousness of purpose of our elected members of Congress to right the wrong inflicted on the investing public 20 years ago. Congress must not only step up to the plate by writing letters and holding hearings – it has to hit the ball over the fence and pass legislation to reverse the injustice. I think it will.

Mr. Farley: The decline in average recovery stats is misleading. The recovery rate has been fairly uniform until just the past few years, which included two new phenomena: claims involving self-directed Internet trading and alleged reliance on "tainted" research [by Wall Street analysts seeking to please their firms' investing-banking clients].

Whether in court or in arbitration, these are always tough sells and there is no study or any reasoned basis to argue that these cases would have done better in court. In fact, many of the so-called analyst cases [that were filed in court seeking class-action status] were summarily dismissed upon motion. [The fact that class members might have had individual accounts subject to an arbitration agreement doesn't preclude a class-action suit from going forward if the premise of the claim is viable.]

Mr. Eppenstein: However you want to argue it, the statistics are the knockout punch. Take your argument that there is no empirical study to show that investors would do better in court. Of course this is true, since there can be no case litigated both before a jury and then re- litigated before a securities arbitration panel. There will be no study done, but this is really just a red herring.

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How Arbitration Cases Close

Cases Decided by Arbitrators	2003	% of Cases	2004	% of Cases	2005	% of Cases	2006	% of Cases	Apr-2007	% of Cases
After Hearing	1,764	24%	1,915	21%	1,767	20%	1.265	18%	343	18%
After Review of Documents	313	4%	508	6%	355	4%	192	3%	42	2%
Total	2,077	29%	2,423	27%	2,122	24%	1,457	21%	385	21%
Cases Resolved by Other Means	2003	% of Cases	2004	% of Cases	2005	% of Cases	2006	% of Cases	Apr-2007	% of Cases
Direct Settlement by Parties	2,616	36%	3,700	41%	3,940	44%	3,503	50%	1,048	56%
Settled Via Mediation	1,182	16%	1,201	13%	910	10%	730	10%	148	8%
Withdrawn	647	9%	677	7%	806	9%	643	9%	150	8%
All Others*	679	9%	1,073	12%	1,127	13%	738	10%	130	7%
Total	5,124	71%	6,651	73%	6,783	76%	5,614	79%	1,476	79%

*All Other reasons for closed includes cases closed by: Stipulated Award, Bankruptcy of critical party; Uncured Deficient Claim; Forum Denied; Stayed by Court Action, etc. Note cases counted as closed in this report do not include those cases that closed and were then reopened.

Results of Customer Claimant Arbitration Award Cases

Year Decided	All Customer Claimant Cases Decided (Hearings & Paper)	All Customer Claimant Cases Where Customer Awarded Damages	*Percentage of Customer Award Cases
2000	1,196	635	53%
2001	1,172	637	54%
2002	1,330	702	53%
2003	1,513	742	49%
2004	1,894	888	47%
2005	1,610	687	43%
2006	1,011	425	42%

* Percentage of customer claimant award cases has been recalculated to reflect only instances in which investors as claimants recovered monetary damages or non-monetary relief.

Arbitrators by Type

This report lists all available arbitrators by Non-Public and Public Type.

Arbitrator Type **Total**

SECURITIES LAW REFORM: RESTORING THE PUBLIC CUSTOMERS' FREEDOM OF CHOICE OF FEDERAL COURT ADJUDICATION FOR INVESTOR/BROKER-DEALER FRAUD CLAIMS

Testimony of
Theodore G. Eppenstein, Esq.
Eppenstein & Eppenstein
Attorneys of Record for Investor Respondents in
Shearson/American Express v. McMahon

Before the
Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
U.S. House of Representatives

Wednesday, March 31 , 1988

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U.S. House of Representatives
Wednesday, March 16, 1988

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INTRODUCTION AND SUMMARY

I am honored to be asked to appear before you today to participate in the Subcommittee's hearings on the McMahon case and its aftermath, the disputed "voluntariness" of customer/brokerage agreements, the inadequacies of SRO arbitration systems and procedures and the need for amendments to the securities laws to ensure that the rights and claims of investors will be adequately protected in a forum consistent with our traditional American concepts of fairness, justice and due process.

The fundamental premise of this testimony is that the McMahon decision has erroded the confidence of the investing public in: the fairness and integrity of the customer/brokerage relationship; the customer/brokerage agreement which now almost universally contains a mandatory arbitration clause; and the arbitration procedures of the self-regulatory organizations for the adjudication of their claims.

At issue is the public's right to federal court adjudication and the ability to exercise a meaningful and voluntary choice as to a forum for the adjudication of securities law fraud claims. Surely Congress intended in its enactment of the 1933 and 1934 Acts, and in the amendments thereof in 1975, that public customers should not be permitted to prospectively waive the federal court forum. The core of

this legislative history and its underlying principle of the nonarbitrability of securities law claims had been adhered to for more than three decades at least, and was fully supported until the McMahon case by the overwhelming majority of federal Circuit Courts of Appeals and by the Securities and Exchange Commission. While the SEC has proposed significant changes to SRO arbitration systems which underscore the inherent lack of fairness to the public in SRO arbitration procedures, the Commission has yet to propose a meaningful mechanism such as that promoted by the Commodities Exchange Act and the CFTC to ensure the voluntariness of arbitration agreements.

The many significant rights, both substantive and procedural, that are unavailable in the arbitration process gives rise to the necessity of restoring to the investing public their choice of forum for the adjudication of investor claims arising under the securities laws. The public is awaiting the action of Congress to restore to investors the necessary protections that they are entitled to, consistent with the goals of the securities laws and traditional American principles of fair adjudication and due process. Reform of arbitration, while desirable for those customers who choose that alternative forum, is not a substitute for restoring the choice of jury trial to the American public.

BACKGROUND: THE PERVASIVENESS OF SECURITIES LAW FRAUD

As attorneys who represent defrauded investors in securities law litigation, our experience has shown that securities fraud is a pervasive and economically devastating problem for the public today. After the events of the last few months in the capital markets, no one can disagree that the confidence of the investing public is a very crucial factor in promoting stability and soundness in the financial marketplace, as well as prosperity for the brokerage industry. Yet the fraud that occurs in this area is so invasive that it has the potential to undermine this confidence and the integrity of the system.

Securities law fraud affects investors large and small, and does not distinguish between individuals and groups such as are represented by pension funds. As the attorneys who represented the McMahon plaintiffs in their federal court fraud case concerning arbitration-related securities fraud and RICO issues known as Shearson/American Express v. McMahon, __U.S.__, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987), we can illustrate some of the facts underlying many of the more typical securities fraud complaints brought against the securities industry by public customers.

In the McMahon case, for example, it is alleged in the amended complaint that the broker: engaged in the fraudulent and wilful churning , or practice of trading excessively solely to maximize commissions, not only of the McMahons' individual accounts, but also of their fiduciary pension trust accounts, thereby violating Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. Section 78j(b) (the "1934 Act") and SEC Rule 10b-5, 17 C.F.R. Section 240.10b-5, promulgated thereunder, by making false statements and omitting material facts in the advice and financial projections given to the McMahons; by fraudulently dissipating the funds of Mrs. McMahon and those of numerous other investors representing the general public in a scheme known as the "Golden Apple" investment fund; and by violating the provisions of RICO. The amended complaint also alleges pendent common law claims of fraud, misrepresentation and breach of fiduciary duty.

The McMahons' claims include allegations of multiple acts of fraudulent, inappropriate and excessive trading on the part of their broker in connection with the joint account of the individual investors, in which, for example, over 400 options were allegedly traded with commissions totalling approximately $50,000. Also alleged are claims of securities fraud in relation to four trust accounts where over 3,500 options trades allegedly enabled the broker to reap overall more than $200,000 in excessive commissions. These options

trades were not in accordance with the investors' stated conservative investment objectives, and were not suited to secure either the McMahons' or their employees' retirement objectives.

As is fairly typical in these cases, the McMahon investors were unsophisticated in the securities field, having no college degrees nor financial market acumen and no prior investment experience in anything more risky then, e.g., short term municipal bonds, treasury bills and money market accounts. The broker, who actively sought and obtained complete discretion in the handling of these accounts, failed to disclose to these unsophisticated investors the volatility of the markets in which their personal investment funds and the funds of several pension trusts were at risk. Representations were allegedly made by the broker of a guarantee of appreciation through conservative investment policies which did not come to fruition; indeed, the gravamen of the investors' complaint is that the practices of the broker caused substantial losses.

The McMahon investors' complaint also alleges a scheme by the broker to defraud Mrs. McMahon and to utilize her good name in recruiting members of the general public to similarly invest in a so-called "Golden Apple" investment scheme, where the dissipation of substantial investments was caused by the injudicious trading of options by the broker. The complaint

also includes a RICO claim. It seeks treble damages for the underlying predicate offenses which comprise a pattern of illegal conduct allegedly aimed at defrauding the investors and the general public.

Over the past months since the market meltdown we have heard of many other striking events which all serve as indications of the pervasiveness of this type of fraud.

Surely, the debate over amending the regulations that govern the capital markets must take into serious account the enormity of this problem which injures not only the individual investors who are hurt economically, but commerce and society as a whole.

THE SECURITIES LAWS SHOULD BE AMENDED TO PRESERVE THE PUBLIC'S RIGHT TO FEDERAL COURT ADJUDICATION

Predispute arbitration clauses until this year were viewed virtually uniformly by Congress, the Courts and the Securities and Exchange Commission for over three decades as a particularly coercive and unfair trade practice. The fundamental philosophy of federal securities regulation that promotes full disclosure to investors and confidence of the investing public in the integrity of the capital marketplace underlies this long-settled policy, which for decades held

predispute arbitration clauses such as are routinely included in preprinted customer/brokerage agreements to be unenforceable.

Yet the Supreme Court's decision in McMahon in June 1987 held, unanimously on RICO and by a 5-4 vote for §10(b) violations, that valid predispute arbitration clauses are enforceable and that both RICO and 1934 Act claims are arbitrable, despite the contrary view of eight federal Circuit Courts of Appeals, prior SEC releases dating to 1951 and the high Court's own precedent. The Supreme Court's decision, many experts believe, may have been motivated by a desire to reduce the federal court caseload, even though less than 2% of the approximately 250,000 civil cases filed in fiscal year 1986 in the federal court system were securities law-related, and fewer than 1,000 civil RICO cases were filed with 40% of these based upon alleged securities fraud, according the Administrative Office of the U.S. Courts. See McMahon, 107 S.Ct. at 2359, 96 L.Ed.2d at 220 ("It is thus ironic that the Court's decision, no doubt animated by its desire to rid the federal courts of these suits, actually may increase litigation about arbitration.") (Blackmun, J. dissenting).

It is our view and that of many others familiar with this area of the law that the Supreme Court's decision in the McMahon case has effectively obliterated a long-revered policy of investor protection by limiting severely the defrauded

public investor's access to federal court adjudication of securities law fraud claims. Immediate remedial steps are now necessary to reinstate for public investors this important protection against an overreaching, coercive and unfair trade practice. These include: a) amendments of the securities laws to make explicit Congress' intent that the antiwaiver clauses thereof (§14 of the 1933 Securities Act and, analogously, §29(a) of the 1934 Exchange Act) prohibit the enforceability of predispute arbitration clauses because they effectively deprive investors of the statutory right to a judicial forum and promote broker-dealer deviation from compliance with the letter and spirit of the anti-fraud provisions of these laws; b) amendment of civil RICO provisions to preserve the right of the civil RICO plaintiff to federal court adjudication of these claims; and c) amendment of the Federal Arbitration Act, discussed infra.

The issues before this honorable body are being followed by and are of the utmost concern to members of the general public who participate in the financial markets, many of whom have already invested their savings, wages, and retirement funds in the stock market and have been defrauded by their stock brokers and their brokerage firms. We have had the opportunity to communicate with many defrauded individuals and pension participants who have almost uniformly pleaded ignorant of the fact that they have relinquished substantial statutory

and constitutional rights by virtue of having signed a printed agreement prepared by securities industry professionals containing a predispute choice of forum arbitration clause. At the heart of this problem is the complete absence of knowing waiver of the judicial forum, and the lack of meaningful voluntariness in surrendering these important rights on the part of the investor when the customer/broker agreement is placed in front of him or her by the brokerage firm or its representative.

The typical customer/broker agreement is a printed document containing standard industry "boilerplate" provisions. Typically, there is no negotiation between customer and broker over the terms of the agreement which has been carefully drawn by the legal counsel of the brokerage firm. The form which the customer/broker agreement takes, although it may differ from firm to firm, will now, in light of the McMahon decision, uniformly contain a predispute choice of forum clause mandating arbitration at the instance of the brokerage firm. There will be no choice at all for the public customer on this very uneven playing field where the securities professionals control the game. The brokerage firm even has the right to limit arbitration to whatever specific forum it chooses in its printed form (even though by doing so it may abrogate the constitution or rules of SRO's such as the NASD providing customer access), by using language which limits the choice of forum to a particular SRO, such as the NYSE. As has

been recently brought to the attention of the SEC by an attorney for a customer, in the aftermath of McMahon brokers have even resorted to arbitration clause language providing for a one-year time limitation on submission to an SRO, in clear derogation of the six year limitation found in §4 of SICA's Uniform Code of Arbitration. Shearson's multi-page form of agreement that the McMahons executed, which was presented to them unceremoniously by their broker as part of the "red-tape" necessary to open their accounts, is similar to many others we have seen. The arbitration clause can be found almost literally buried within the text on page 2 paragraph 13 where, without the benefit of even a subheading, in the middle of a paragraph concerning rights inuring to the benefit of heirs, we find those ominous words to the effect that any controversy between broker and customer will be determined by arbitration.

It should be a matter of grave concern that public customers are being coerced into choosing a forum in advance of a dispute, or even as a precondition of opening an account, in order to determine future disputes which have not yet arisen. Clearly, at the time the investor opens up a brokerage account, his or her trust in a broker and a brokerage firm is at its highest. After all, the investor is now willing to part with real money and deposit it with or borrow it on margin from the brokerage firm. In return he or she expects at a minimum total honesty in connection with the account. At this point

typically investors are neither represented by counsel nor are given the option of negotiating the terms of the pre-printed account forms. The "red tape" of opening up a brokerage account includes signing the customer agreement. We are told by investors that time and time again brokers advise them that the procedure is merely a "formality," the agreement does not have to be gone over with a fine tooth comb and that it is just like opening up a bank account. If investors seriously question the terms, including the arbitration clause, we are advised by our clients that they are quickly told by the broker that the provision is inviolable and an absolute requirement of the brokerage firm.

There is ample evidence to support the conclusion that the customer/broker agreement represents a clear contract of adhesion that should be deemed unenforceable especially in the aftermath of the Supreme Court's decision. Almost immediately after the Court's opinion in McMahon was published on June 8, 1987, the president of the Securities Industry Association ("SIA"), the powerful brokerage industry lobby, was quoted by reporters that henceforth brokerage firms will insist upon predispute arbitration clauses in their customer agreements; unless they sign on the dotted line, relinquishing their right to a day in Court, customers will not be able to do business in the marketplace. See New York Newsday, p. 49, col.3 (June 9, 1987); Barron's, p.38, cols. 4-5 (June 15, 1987).

While it may be argued that the investor might be inclined to shop around for a better deal, it is quite clear that the SIA and all of its approximately 500 members will act in unison and require public customers to sign an unequivocal arbitration agreement as a precondition to opening an account. Those few investors who actively read the small, fine print of the form, assuming they understand the significance of a predispute arbitration choice of forum, which is seriously in doubt, will most probably not be able to find another brokerage firm who will take them in without the clause. The only exception to this dilemma might be the institutional investor who has greater business and investment saavy and clout, and may have the ability to negotiate this issue. We know of no public customer who has been able to do this to date, including one customer who annually pays almost two million dollars in commissions, yet was unable to negotiate amendment to or removal of the mandatory arbitration clause.

Simply put, investors should not be permitted to, or more accurately stated, should not be coerced into waiving their right to a judicial forum, particularly in the predispute setting. To permit this to occur would undermine the policy of investor protection which places the investor on a different footing than the inherently superior position of the securities industry professional. See McMahon, 107 S.Ct. at 2350-2351 and n.9, 96 L.Ed. 2d at 210-211 and n.9 (Blackmun, J., dissenting).

LEGISLATIVE HISTORY

The fact that the antiwaiver provisions of the 1933 and 1934 Acts (Sections 14 and 29(a), respectively): a) protect investors against prospective waiver of their Section 22 and Section 27 rights to judicial resolution of their disputes; and b) act as a general limitation on the Federal Arbitration Act, 9 U.S.C. §1 et seq. ("FAA" or "Arbitration Act"), is confirmed not only in the text and legislative history of the 1934 Act particularly, but also in the legislative history of the Securities Act Amendments of 1975, Pub.L. 94-29, 89 Stat. 97 (the "1975 Amendments").

A discussion of the legislative history in Congress underlying the concept of the nonarbitrability of securities law claims, a principle that in most cases previously barred arbitration of RICO claims and their underlying securities fraud claims, would not be complete without reference to Justice Blackmun's cogent dissent in McMahon, which reviewed the evolution of the important public policy rationale forming the basis for the rule of nonarbitrability that was so long considered uncontroversial and widely adhered to since 1953:

> Both the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted to protect investors from predatory behavior of securities industry personnel. In Wilko v. Swan, 346 U.S. 427 (1953), the Court recognized this basic purpose when it declined to enforce a predispute agreement to compel arbitration of claims under the

> Securities Act. Following that decision lower courts extended Wilko's reasoning to claims brought under §10(b) of the Exchange Act, and Congress approved of this extension.
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> * * *
>
> If, however, there could have been any doubts about the extension of Wilko's holding to §10(b) claims, they were undermined by Congress in its 1975 amendments to the Exchange Act. . . . These amendments. . . are regarded as "the 'most substantial and significant revision of this country's Federal securities Laws since the passage of the Securities Exchange Act of 1934.'" Herman & MacLean v. Huddleston, 459 U.S. 375, 384-385 (1983), quoting Securities Acts Amendments of 1975: Hearings on S.249 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess., 1 (1975). More importantly, in enacting these amendments, Congress specifically was considering exceptions to §29(a), 15 U.S.C. §78cc, the nonwaiver provision of the Exchange Act, a provision primarily designed with the protection of investors in mind. The statement from the legislative history ["It was the clear understanding of the conferees that this amendment did not change existing law as articulated in Wilko v. Swan . . . H.R.Conf. Rep. No. 94-229, p. 111 (1975)"], on its face indicates that Congress did not want the amendments to overrule Wilko. Moreover, the fact that this statement was made in an amendment to the Exchange Act [Section 28(b)] suggests that Congress was aware of the extension of Wilko to §10(b) claims. . . . it implies that Congress was not concerned with arresting this trend. Such inaction during a wholesale revision of the securities laws, a revision designed to further investor protection, would argue in favor of Congress' approval of Wilko and its extension to §10(b) claims.

McMahon, 107 S.Ct. at 2346, 2347-2348, 96 L.Ed.2d at 204, 206-207 (footnotes omitted).

In a further remark underscoring the protective policy rationale behind Congress' major revision of the securities laws in 1975, Justice Blackmun stated:

> Common sense suggests that, when Congress states that it is not changing the law, while at the same time undertaking <u>extensive</u> amendments to a particular area of the law, one can assume that Congress is approving the law in existence.

<u>McMahon</u>, 107 S.Ct. at 2348 n.5, 96 L.Ed.2d at 207 n.5. (Blackmun, J., dissenting). Thus, Congress' ratification of existing law in 1975, that investors could not be compelled to waive, in advance of an actual dispute, their right to choose between the arbitral and judicial forums, arose clearly in the context of the 1975 amendments.

Yet the five-member majority opinion in <u>McMahon</u>, although apparently swayed by the Securities and Exchange Commission's <u>amicus</u> intervention, could not come to a firm conclusion as to the true import of the 1975 amendments' House Conference Report as an expression of congressional intent that section 29(a) and analogously, section 14, of the 1934 and 1933 Acts respectively, bar enforcement of predispute arbitration clauses. <u>See</u> <u>McMahon</u>, 107 S.Ct. at 2343, 96 L.Ed.2d 200-201. ("The committee may well have mentioned <u>Wilko</u> for a reason entirely different . . . . even assuming the conferees had an understanding of existing law that all agreed upon, they specifically disclaimed any intent to change it.").

Justice Stevens, in his terse two paragraph dissenting opinion as to <u>Wilko's</u> applicability to the 1934 Act, had no

such difficulty in discerning clear congressional policy and intent and the fact that the McMahon majority "changes a settled construction of the relevant statute":

> Gaps in the law must, of course, be filled by judicial construction. But after a statute has been construed, either by this Court or by a consistent course of decision by other federal judges and agencies, it acquires a meaning that should be as clear as if the judicial gloss had been drafted by the Congress itself. This position reflects both respect for Congress' role, see Boys Market, Inc. v. Retail Clerks, 398 U.S. 235, 257-258, 90 S.Ct. 1583, 1595-1596, 26 L.Ed.2d 199 (1970) (Black, J., dissenting), and the compelling need to preserve the courts' limited resources, see B. Cardozo, The Nature of the Judicial Process 149 (1921).
>
> During the 32 years immediately following this Court's decision in Wilko v. Swan, 346 U.S. 427, 74 S.Ct. 182, 98 L.Ed.168 (1953), each of the eight circuits that addressed the issue concluded that the holding of Wilko was fully applicable to claims arising under the Securities Exchange Act of 1934 . . . . This longstanding interpretation creates a strong presumption, in my view, that any mistake that the courts may have made in interpreting the statute is best remedied by the legislative, not the judicial, branch.

McMahon, 107 S.Ct. at 2359, and n.2, 96 L.Ed.2d at 220, and n.2. (Stevens, J., dissenting) (footnote omitted).

As part of the 1975 amendments Congress provided for arbitration involving disputes among securities industry

professionals under §28(b) of the 1934 Act. As several other defrauded investors who were supporting the McMahons pointed out in their brief amici curiae to the Supreme Court:

> Sections 28(b)(1) and (2) insure that no other provision of the Exchange Act will operate to bar disputes between members or participants of SROs [self-regulatory organizations such as the stock exchanges] where the SRO has established such a procedure. Neither Section 28(b)(1) nor Section 28(b)(2) requires a member or participant in the SRO to agree to compulsory arbitration in order to be subject to it. Section 28(b)(3) is different. In order for a person subject to Section 28(b)(3) to be bound to arbitrate a dispute in accordance with SRO arbitration rules governing SRO members or participants, that person must agree to be bound by those rules. Once agreeing to arbitrate, the person cannot be relieved of the contract by resort to any other provisions of the Exchange Act. However, unless there is some other provision of the Exchange Act to resort to avoid the agreement's consequences the general scope of the Arbitration Act would be sufficient to compel a person who agreed to arbitrate under SRO rules to honor this agreement. Thus, in the absence of such other provision, Section 28(b)(3) would be wholly unnecessary. At the very least, then, its inclusion expresses Congress' understanding and intent that some provision [the antiwaiver clause, Section 29(a)] of the Exchange Act operates as a general limitation on the Arbitration Act, necessitating the provisions of Section 28(b)(3).
>
> Also in 1975, Congress established and enumerated the rule making responsibilities of the Municipal Securities Rule Making Board (the "Board"). Pub.L. 94-29, §13, 89 Stat. 131. As a result Exchange Act Section 15B(b)(2)(D), 15 U.S.C. §78o-4(b)(2)(D), empowers the Board to provide for arbitration of "claims, disputes and controversies relating to transactions in municipal securities." Id. However, the Board's arbitration rules may not compel a municipal securities customer to submit to such arbitration "except at his instance and in accordance with" Section 29 of the Exchange Act. Id. By itself, the language "at his instance" might permit a pre-dispute agreement to arbitrate. But Section 15B(b)(2)(D) requires that the customer's "instance" also be in accordance with Section 29 of the Exchange Act. If Section 29 meant only that a customer cannot

waive a dealer's compliance with Exchange Act provisions, then requiring a customer's arbitration agreement to be "in accordance with" Section 29 is essentially meaningless because a dealer's compliance with Exchange Act obligations is not at issue in an arbitration agreement. "In accordance with Section 29" is meaningful, then, only if Section 29 means that a customer is protected from agreements which waive the customer's rights, including rights under Section 27 of the Exchange Act.

That Congress understands and intends that Section 29(a) operates to preclude waiver of a customer's rights under the Exchange Act, and not simply waiver of a defendant's obligations under the Act, is confirmed by the legislative history of the Securities Act Amendments of 1975, Pub.L. 94-29, 89 Stat. 97 (the "1975 Amendments"). In connection with amendments to Exchange Act Section 28(b), the Conference Report stressed: "It was the clear understanding of the conferees that this amendment did not change existing law, as articulated in Wilko v. Swan, 346 U.S. 427 (1953), concerning the effect of arbitration proceedings provisions and agreements entered into by persons dealing with members and participants of self-regulatory organizations." H.R. Rep. No. 94-229, 94th Cong. 1st Sess., 111 (1975), U.S. Code Cong. & Admin. News, 1975, p. 342 (hereinafter, the "Conference Report").

In Wilko, the Court held that Section 14 of the Securities Act prohibited pre-dispute agreements to arbitrate because those agreements waived the customer's rights under Section 22. Wilko, 346 U.S., at 432-3, 434-5. Wilko's holding is predicated on interpretation of Section 14's "waive compliance" language to prohibit waiver of investors' rights, not just waiver of a seller's obligations under the Act. Wilko v. Swan, 346 U.S. at 434-35. The Conference Report confirms that with the 1975 Amendments Congress ratified Wilko's interpretation of Section 14. If Congress did not intend Section 14 of the Securities Act (or its equivalent, Section 29(a) of the Exchange Act) to bar the waiver of an investor's rights generally, and not just the waiver of the defendant's obligations under the Act, Congress could have rejected Wilko's interpretation of the "waive compliance with" language in Section 14. But, "Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change . . . ." Lorillard v. Pons, 434 U.S.

575, 580 (1978). See also, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 381-2 (1982), Herman & MacLean v. Huddleston, 459 U.S. at 385-6. Here, one need not merely presume that Congress was aware of Wilko's interpretation of Section 14. The legislative history of Section 28(b) makes clear Congress' full awareness of Wilko and its acceptance of the law as articulated by Wilko. Necessarily, the equivalence of Section 14 of the Securities Act and Section 29 of the Exchange Act extends Wilko's interpretation to the Exchange Act as well.

Brief for Willie D. Chandler, et al., Amici Curiae, McMahon, at 11-13.

Congress has thus asserted its abiding interest in setting policy in this area. The important public policy rationale underlying the enactment of the securities laws and amendments of certain sections thereto in 1975 is unambiguous. It is to advance the protections afforded to investors under the federal statutory regime governing the securities marketplace. Rather than undermine these protections by reading the laws narrowly so as to deprive investors of their right to choose the forum in which to adjudicate their securities law claims, Congress in 1933, 1934 and 1975 explicitly enacted antiwaiver provisions and carved out exceptions to mandatory arbitration in order to protect public investors in the predispute setting from waiving their statutory right to the federal court forum.

It is obvious that an amendment to these laws is now necessary in order to preserve investor rights under the antiwaiver clauses of the securities laws and prevent further

erosion of the public's right to federal court adjudication of their federal statutory claims. With respect to amendment of RICO where securities fraud is often a predicate, any suggestion that the McMahon holding should somehow be codified is antithetical to the concept of investor protection and would be highly imprudent. Since the result of this current inquiry will have a significant impact on the effectiveness of investor protections and the level of investor confidence which is so compelling in this volatile economic climate, any action which would further restrict access of RICO plaintiffs to the federal courts is equally unwarranted.

The Arbitration Act was never meant to override these public policy considerations underlying federal court adjudication of statutory claims arising under the securities laws:

> The legislative history of the Arbitration Act shows if not that the Act "was to have a limited application to contracts between merchants for the interstate shipment of goods . . .", Prima Paint, 388 U.S. at 409 (Black, J. dissenting), then at least that Congress' attention was focused only on arbitration of such contracts and not the arbitration of statutory claims. Sales and Contracts to Sell in Interstate and Foreign Commerce, and Federal Commercial Arbitration Before a Subcommittee of the Senate Committee on the Judiciary, 67th Cong. 4th Sess., 3, 5, 7, 9, 10 (1923) ("Hearing on S. 4213 and S. 4214"); Arbitration of Interstate Commercial Disputes, Hearing on H.R. 646 and S. 1005 before the Joint Committee of the Subcommittees on the Judiciary, 68th Cong., 1st Sess. 7, 27 (1924) ("Joint Hearings"). Indeed, one of [the] principal participants in the drafting of and Congressional hearings on the Arbitration Act

[footnote follows] [see Joint Hearings, 13 (Statement of Julius Cohen)] wrote one year after its enactment:

> Not all questions arising out of contracts ought to be arbitrated. It is a remedy peculiarly suited to the disposition of the ordinary disputes between merchants as to questions of fact - quantity, quality, time of delivery, compliance with terms of payment, excuses for non performance, and the like. It has a place also in the determination of the simpler questions of law - the questions of law which arise out of these daily relations between merchants as to the passage of title, the existence of warranties, or the questions of law which are complementary to the questions of fact which we have just mentioned. It is not the proper method for deciding points of law of major importance involving constitutional questions or policy in the application of statutes. Speaking generally, it is a proper remedy for the determination of these classes of disputes which arise day by day in the common experience of the disputants and the individuals to whom the dispute is to be referred, where all meet upon a common ground.

Cohen and Dayton, The New Federal Arbitration Law, 12 Va. L. Rev. 265, 281 (1926), cited in Brief for Willie D. Chandler, et al., Amici Curiae, McMahon, 6-7.

REGULATORY POLICY AND OVERSIGHT

For over thirty years, in a policy predating the Wilko case in 1953, and prior to the McMahon case, the SEC not only supported the position of investors such as the McMahons who had unwittingly waived their statutory rights to go to Court by signing the arbitration clause, but the SEC actually opposed predispute agreements that might mislead a public customer into giving up statutory rights. In consistently rejecting the

validity of such clauses, which it deemed possibly actionable under the securities laws, the SEC time and again denounced the predispute arbitration clause which we are inquiring into here as a deceitful, unfair trade practice inimical to the rights of investors, which may in and of itself be a matter of fraud and violative of Rule 10b-5.

Through various releases and in the filing of an *amicus* brief in a Third Circuit case known as *Ayers v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976), the SEC informed both the brokerage industry and the public of its belief in the inherent unfairness and unenforceability of the predispute arbitration agreement. The Commission did so based upon its independent analysis of both regulatory and public policy concerns, and *not* solely upon judicial interpretation of the law. *See* Securities Exchange Act Release No. 19813 (May 26, 1983), [1982-83 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 83,356, at p. 85,967 and n.6. *See also* SEC Securities Exchange Act Release No. 20397, [1983-84 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 83,452 (November 18, 1983); SEC Securities Exchange Act Release No. 15984, [1979 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 82,122 (July 2, 1979). The SEC, apparently frustrated by the fact that many brokerage firms did not heed this message, promulgated Rule 15c2-2, 17 C.F.R. Section 240.15c2-2, in 1983, which codified its prior position.

Former Rule 15c2-2, which was in place at the time of the SEC's *amicus* appearance in *McMahon* before the Supreme Court, is highly instructive. Enacted in November 1983, it mandated that brokerage firms, after finishing off their old inventory of customer agreement forms, use a new form of agreement which was required to provide that, despite any predispute arbitration clause which might be found elsewhere in the agreement, the customer nevertheless had the right to go to court for violations arising under the federal securities laws. The SEC required that then current inventories were to be modified by the use of a sticker with these terms clearly printed on it to be affixed to the old forms until they were used up. There was even a deadline set for the time in which brokers could use up old stock. The SEC also required, for the hundreds of thousands of customers who had agreements in place containing an arbitration clause, that the brokerage firms notify their customers in writing of the customers' right to maintain an action in court for claims arising under the federal securities laws.

In our practice we have reviewed many predispute arbitration clauses that were supposed to have complied with Rule 15c2-2 and have found that this is an area in which the brokerage firms' general counsel became quite creative. Because the exact terms of the required new notice to customers was left to the discretion of the industry, many amended

arbitration clauses were not in compliance with either the letter or the spirit of the rule. In any event, the SEC promulgated Rule 15c2-2 after hearing comment from the brokerage industry, and the rule was on the books when the McMahon case was pending before the Supreme Court.

Despite the Commission's laudable thirty year track record of unequivocal support for investors in this area, punctuated by the promulgation of Rule 15c2-2, to the great shock and chagrin of investors and the plaintiffs' securities law bar, the SEC did not support the public but filed an amicus brief and argued on behalf of the industry in the McMahon case, largely on the stated grounds that its oversight authority could "insure" the fairness of SRO arbitration. Curiously, the SEC did so without, to our knowledge, advising the Supreme Court of its then pending 18-month inquiry that would ultimately result on September 10, 1987 in sweeping proposals for SRO arbitration reform. In effect, the SEC's proposals underscore the lack of fairness to the public in the SRO arbitration system and the "limits inherent in the current arbitration rules." SEC Division of Market Regulation, Letter from Richard G. Ketchum, Director, to All Members of Securities Industry Conference on Arbitration, at 1 (September 10, 1987).

Our response to the SEC's proposals for changes in current arbitration practices, dated December 23, 1987, is annexed as an Exhibit hereto.

On October 15, 1987, just before the unprecedented events in the financial markets unfolded, the SEC unceremoniously repealed Rule 15c2-2. SEC Securities Exchange Act Release No. 34-25034 states summarily that the Rule "is no longer appropriate." Thus a regulation only recently considered necessary to correct a deceptive, pervasive and coercive trade practice has been wiped off the books of investor protection.

The public had previously enjoyed the right to choose between court or arbitration, since the securities laws as well as RICO provide for exclusive federal court jurisdiction (the 1933 Act provides for concurrent state-federal jurisdiction). The quantum-leap decision to authorize compelled arbitration and support the industry in this matter, which was essentially a choice of forum question in which the customer could by no stretch of the imagination gain to benefit from the deprivation of a previously vested 7th Amendment right to trial by jury, was justifiably disheartening for all investors around the country. It was our view then, as now, that the fundamental goals of investor protection of the 1933 and 1934 Acts as well as the deterrent goals of RICO are impermissibly undermined by prospective waivers of these statutorily provided rights to a judicial forum. Indeed, as we brought to the Supreme Court's attention in the McMahon respondents' brief:

Just last term, [the Supreme Court] revisited the legislative rationale underlying the protections with which public customers are vested under the 1934 Act:

> ". . . Congress' aim in enacting the 1934 Act was not confined solely to compensating defrauded investors. Congress intended to deter fraud and manipulative practices in the securities markets, and to ensure full disclosure of information material to investment decisions. Affiliated Ute Citizens, supra, at 151, 92 S.Ct. at 1471; see also Hermann & MacLean, 459 U.S., at 386-387, 103 S.Ct. at 1144-1145."

Randall v. Loftsgaarden, supra, _____ U.S. _____, 106 S.Ct. at 3154.

Consistent with these fundamental goals, the clear concern of the SEC, in addressing the pervasiveness of overreaching and manipulative practices in the securities industry in its dealings with public customers, has been the deterrence of fraud and ensuring the fullest possible disclosure. Thus, in 1979, the SEC acknowledged the self-same problem of non-disclosure and manipulation occurring at the time a customer opens an account that is at issue in the McMahon case:

> "It is the Commission's view that it is misleading to customers to require execution of any customer agreement which does not provide adequate disclosure about the meaning and effect of its terms, particularly any provision which might lead a customer to believe that he or she has waived prospectively rights under the federal securities laws . . . . Customers should be made aware prior to signing an agreement containing an arbitration clause that such a prior agreement does not bar a cause of action arising under the federal securities laws."

SEC Securities Exchange Act Release No. 15984, [1979 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶82,122, at 81,977-81,978 (July 2, 1979). See also SEC Securities Exchange Act Release No. 19813, [1982-83 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶83,356, at 85,967 n.6 (May 26, 1983).

Just three short years ago, the SEC enacted regulation 15c2-2, 17 C.F.R. Section 240.15c2-2, to correct the continuing industry-wide practice among brokers of failing to disclose to their public

customers that, by signing a boiler-plate form of customer agreement containing an arbitration clause, the customer had not necessarily prospectively waived vested rights to a judicial forum under the federal securities laws. SEC Securities Exchange Act Release No. 20397, supra, [1983-84 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶83,452. Although the SEC, as Amicus Curiae 18, has not explicitly asserted in this case a repeal of Rule 15c2-2, its argument in support of a repeal of Wilko (SEC as Amicus Curiae 20) effectively undermines its earlier effort in support of full disclosure to public customers of their rights and against overreaching by brokers.

The obvious inconsistencies of this position render its premise, that full disclosure is now somehow obviated by oversight, untenable, especially since the SEC as Amicus readily concedes that "[t]his Court noted in Mitsubishi Motors Corp., slip op. 12, that fraud and overreaching remain grounds for revoking an arbitration agreement." SEC as Amicus Curiae 19. But in Mitsubishi, the Court also stated that "the first task of a court asked to compel arbitration of a dispute is to determine whether the parties agreed to arbitrate that dispute," Mitsubishi, supra, 105 S.Ct. at 3354, and that "[o]f course, courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds 'for the revocation of any contract.'" Id. Clearly, petitioners' [Shearson's] efforts to abridge or abrogate altogether public customers' statutorily provided rights to full disclosure, by seeking to enforce all prospective waivers of such rights, represent an unwarranted, intolerable departure from congressional intent and prior SEC releases, as interpreted by almost all the Circuit Courts of Appeals, and would also conflict with the plain meaning of Mitsubishi.

Nor may petitioners [Shearson] reasonably claim that the SEC's position is strictly a result of its previous understanding of the application by the courts of the Wilko rule to Section 10(b) claims. As early as 1951, in a release that pre-dates Wilko, the SEC censured the brokerage industry for the use of analogous clauses which, lacking adequate disclosure, were deemed patently inconsistent with "just and equitable principles of trade and may raise serious questions of compliance with the anti-fraud provisions of the federal securities laws" including the 1934 Act. [footnote follows] SEC Securities Exchange Act

Release No. 58, (Apr. 10, 1951), quoted in SEC Securities Exchange Act Release No. 19813, [1982-83 Transfer Binder] Fed.Sec.L.Rep (CCH) ¶83,356, 85,967 n.6, states, in pertinent part:

> "This reasoning by the Commission was not novel. In 1951, the Commission released an opinion by its General Counsel concerning the use of 'hedge clauses' by brokers, dealers, investment advisers and others who sought thereby to avoid liability for a representation which they knew, or in the exercise of reasonable care could have discovered, to be false and misleading. The courts had repeatedly struck down such clauses. See Investment Advisers Act Release No. 58 (April 10, 1951). The position expressed in Release No. 58 was as follows:
>
> 'All the statutes administered by the Commission provide that any condition, stipulation or provision which binds any person to waive compliance with their requirements shall be void . . . . The question arises, therefore, whether the result, if not the purpose, of such a legend is to create in the mind of the investor a belief that he has given up legal rights and is foreclosed from a remedy which he might otherwise have . . . under the SEC statutes. . . .the antifraud provisions of the SEC statutes are violated by the employment of any . . . provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have, ...[under] Section 10(b) of the Securities Exchange Act of 1934 and Rule [10b-5] thereunder, Section 15(c)(1) of that Act and Rule [15c1-2] thereunder. . . .'"

Id. at ¶83,356, 85,967 n.6.

The SEC's obvious and sustained concern over three decades has been that public customers, such as respondents [the McMahons], would be induced to either submit to arbitration, uninformed of their vested rights to a judicial forum under the securities laws, or possibly not pursue their claims at all. SEC Exchange Act Release No. 15984, supra, [1979 Transfer Binder] Fed.Sec.L.Rep.(CCH) ¶82,122 at 81,978. Yet SEC endorsement of disclosure is linked to the limitations of oversight. In response to an inquiry by Chairman Dingell of the House Subcommittee on Oversight and Investigations, the SEC recently conceded its total lack of oversight authority over

actual SRO arbitration proceedings: "The Commission has no authority to review a specific arbitration to assure either compliance with the procedural requirements of the Code [Uniform Code of Arbitration] or accurate interpretations of underlying federal securities law or other claims by the arbitrators." [footnote follows] SEC Report of the Division of Market Regulation In Response to An Inquiry By the Honorable John D. Dingell, Chairman of the Committee on Energy and Commerce Concerning a Complaint by Joan Hunt Smith (August 28, 1986) (available from H.R. Committee on Energy & Commerce) (emphasis added).

Since SEC oversight authority does not police the actual day to day broker-customer relationship, the intent if not the letter of SEC regulations now in place, which promote full disclosure, should not be unnecessarily curtailed by the judiciary at a time when customers need more, not fewer, protections.

Brief for Respondents, McMahon, at 35-37.

The controversial decision to eviscerate investor protection in the McMahon case, in these critical times of insider trading and financial market instability, bodes ill for the plight of millions of American investors. It is time for Congress to step in, to assert its role in the safeguarding of the investing public and the integrity of the capital markets by clarifying immediately its intent underlying investor protection written into the securities laws. In order to accomplish this end, Congress may of necessity have to amend these laws as well as the Arbitration Act. We are mindful that Congress has acted in this manner from time to time to correct not only misapplications and erroneous interpretations of Congressional intent but also usurpation of Congressional policy-making in a wide range of contexts. Most recently, for

example, the House passed H.R. 585 in order to bolster the rights of antitrust plaintiffs whose dilemma was no less threatening than the current plight of defrauded investors who, as a result of McMahon, may be thoroughly disenfranchised of their statutory remedies. See Report of the House Committee on the Judiciary, accompanying H.R. 585, H.Rep.No. 100-421, 100th Cong., 1st Sess. 25 (1987).

Unwittingly or not, Congressional intent with respect to the proscription against predispute waivers has been clouded by the McMahon decision. Only Congress can now restore to the investing public choice of forum and the important right to federal court adjudication of securities law grievances.

CHOICE OF FORUM IS NECESSARY IN ORDER TO PROTECT STATUTORY RIGHTS WHICH CAN ONLY BE FULLY VINDICATED BY JUDICIAL REVIEW

The risk that arbitration, lacking many of the fundamental safeguards built into federal and state court litigation procedures, may not vindicate the statutory rights at issue is at the center of this controversy. The vast differences between the judicial and arbitral forums makes such a risk a factor the public must reckon with. This is all the more significant when one considers the admission of the SEC to Chairman Dingell of the Committee on Energy and Commerce, House Subcommittee on Oversight and Investigations (cited above at p.29) conceding its total lack of oversight authority over

actual SRO, and by implication, all other arbitration proceedings: "The Commission has no authority to review a specific arbitration to assure either compliance with the procedural requirements of the Code [Uniform Code of Arbitration] or accurate interpretations of underlying federal securities law or other claims by the arbitrators." SEC Report of the Division of Market Regulation in Response to An Inquiry By the Honorable John D. Dingell, Chairman of the Committee on Energy and Commerce, supra, (August 28, 1986) (emphasis added).

The problems of oversight in this area are compounded by well-known budgetary constraints:

> In selecting matters for investigation, Commission managers consider not only specific characteristics, such as the potential dollar value and number of investors involved, but also intangible factors such as the deterrent value of a particular case.

SEC Enforcement Program: Information on Productivity; Statements and Cases Closed Without Action, GAO/GGD-86-106BR, at Appendix IV, 21 (Aug. 26, 1986) (Letter of George G. Kundahl, July 11, 1986).

In an amicus filing in a recent case, the SEC similarly advised the Supreme Court of the limits on oversight that affect enforcement:

> [the Commission] 'does not have the resources to police the industry sufficiently to ensure that false

> tipping does not occur or is consistently discovered,' and that '[w]ithout the tippees' assistance, the Commission could not effectively prosecute false tipping - a difficult practice to detect.'

Bateman Eichler v. Berner, ____U.S.____, 105 S.Ct. 2622, 2631 (1985), citing Brief for SEC as Amicus Curiae 25; H.R.Rep.No. 98-355, at 6 (1983). See also GAO Report, GAO/GGD-86-106BR, supra, App. IV at 21; H.R.Rep. 99-155, 99th Cong., 1st Sess. (1985) ("the SEC has limited resources and, understandably, must target its efforts on the largest, national threat to investor protection and market integrity.") Id. at 26 (Letter from President, North American Securities Administrators Assoc., Inc. to Hon. Timothy E. Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection and Finance).

These serious limitations of oversight and regulation extend to SRO arbitration, thus affecting the substantive and procedural rights of public investors. The Supreme Court itself has stated on many previous occasions that "the choice of forums inevitably affects the scope of the substantive right to be vindicated," Alexander v. Gardner-Denver Co., 415 U.S. 36, 57 (1974), citing U.S. Bulk Carriers v. Arguelles, 400 U.S. 351 (1971), and that "arbitration, whatever its merits or shortcomings, substantially affects the cause of action created by the State. The nature of the tribunal where suits are tried is an important part of the parcel of rights behind a cause of action. The change from a court of law to an arbitration panel may make a radical difference in ultimate result." Bernhardt v. Polygraphic Co. of America, Inc., 350 U.S. 198, 203 (1956).

Arbitration, while relatively shorter, inexpensive and informal when compared to a court proceeding, must be balanced against the loss of constitutional guarantees of due process, trial by jury, findings of fact and conclusions of law, federal pleading, discovery and evidentiary rules, and compulsory, orderly discovery; the risk that the law will be improperly applied to the facts at issue; the possible risk of collateral estoppel or inconsistent verdicts; and the unlikelihood, if not unavailability, under various rules of the industry's SROs, of the right to appeal. See, e.g., Sobel v. Hertz, Warner & Co., 469 F.2d 1211 (2d Cir. 1972), rev'g 338 F.Supp. 287 (S.D.N.Y. 1971). See generally Uniform Code of Arbitration, N.A.S.D. Manual (CCH) ¶¶ 3701-3743 (1986); Arbitration Rules of the American Stock Exchange, 2 Am. Stock Ex. Guide (CCH) ¶¶9540-9551J (1984); and Arbitration Rules of the New York Stock Exchange, Inc., 2 N.Y.S.E. Guide (CCH) ¶¶2600-2634 (1985).

The limited right to appeal is diminished still further because arbitrators are not required to state the basis for their decisions, thus eliminating any rational grounds for testing the legal sufficiency or remedial adequacy of awards. This is so in part because arbitration institutionalizes the practice of rendering decisions without giving reasons. According to the President of the American Arbitration Association, Robert Coulson: "Written opinions can be dangerous because they identify targets for the losing party to

attack." R. Coulson, Business Arbitration - What You Need to Know 26 (1980), cited in Note, Arbitrability of Claims Arising Under the Securities Exchange Act of 1934, 1986 Duke L.J. 548, 553 n.37. Under the Arbitration Act, 9 U.S.C. §10, and the various uniform rules at the stock exchanges and elsewhere governing arbitration, the only limited grounds to challenge an award are: undisclosed relationship affecting impartiality of panel; corruption of arbitrator; unfair conduct of hearing; and relief not authorized under contract. Erroneous findings of fact or misinterpretations of relevant laws are not usually grounds for a court to reverse an award, absent irrationality or manifest disregard of law. And arbitrators are not even bound to follow the precedent of prior awards. Note, supra, 1986 Duke L.J. at 553-54, n.38 and citations therein. See also J. Malcolm & E. Segall, The Arbitrability of Claims Arising Under §10(b) of the Securities Exchange Act: Should Wilko Be Extended?, 51 Albany L. Rev. 1 (Winter 1987). Under existing rules as well as SEC proposals, a designated member of the brokerage industry always sits on (and usually chairs) the arbitration panel. As one commentator has noted:

> Arbitration procedures have not changed sufficiently since Wilko was decided to eliminate the . . . fundamental objections to allowing adversaries to arbitrate Securities Act claims. Arbitration is not as effective as adjudication in federal court as a means of protecting investors' rights because the purposes underlying arbitration fundamentally conflict with the right to a federal forum granted under the Securities Act and the Exchange Act.

Note, supra, 1986 Duke L.J. at 552 and discussion with citations at 552-555. See also McMahon, (Blackmun, J., dissenting); SEC Securities Exchange Act Release No. 20397 [1983-84 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶83,452 at 86,357 and n.6. (Nov. 18, 1983), discussed above.

The overriding policy consideration involved in the McMahon case was the protection of the public investor against manipulation and deception in the financial markets, the same consideration which culminated in Congress' enactment of the securities laws in the first place. There are many significant rights, both substantive and procedural, that are literally unavailable in the arbitration process. Consequently, when a customer is not given the opportunity to make an informed choice, and prospectively forfeits the judicial forum, the result is not only to give unfair advantage to the brokerage industry, but to encroach upon the very substantive rights provided in the 1934 Act, among them full disclosure, fair dealing and judicial scrutiny.

The federal legislative policy underlying the securities laws can best be developed in the courts, where the private litigant has the procedural safeguards of judicial fact-finding, the rules of procedure and evidence that do not apply in the typical arbitration proceeding, the benefit of a complete record, additional safeguards of appellate review and

judicial expertise in interpreting and developing the law of a statutorily created cause of action. Such a course had been set by the Supreme Court previously, before McMahon, despite the general federal policy favoring arbitration, and even in the absence of statutory antiwaiver provisions. See generally McDonald v. City of West Branch, Michigan, 466 U.S. 284 (1984); Barrentine v. Arkansas-Best Freight System, Inc., 450 U.S. 728 (1981); Alexander v. Gardner-Denver Co., 415 U.S. 36 (1974).

The importance to private RICO enforcement of judicial interpretation of the parameters of this relatively new law makes arbitration of RICO, in this context RICO based upon securities fraud predicate acts, an unacceptable mandatory forum. Arbitral panels are not trained in interpreting the complexities and ramifications of RICO, and lack the judicial mandate of issuing findings of fact and conclusions of law and following precedent. RICO thus cannot be fully and fairly evaluated and interpreted, not least because appellate review of arbitration awards is virtually nonexistent.

Since judicial review of both SRO and American Arbitration Association decisions is strictly limited, and there are no measures currently in place to ensure that customer agreements are executed voluntarily, the widespread use of mandatory predispute arbitration clauses may effectively insulate the securities industry from statutory liability and

judicial scrutiny of RICO and predicate securities fraud claims brought by public customers who have prospectively waived their rights arising under both the 1933 and 1934 Acts and, analogously, RICO.

Ultimately, there is the danger that compelled predispute waiver of the judicial forum, now the likely consequence of McMahon, may not only curtail but may eliminate altogether the Section 10(b) remedy.

This development is all the more ominous when one considers that enforcement and oversight by the Commission is significantly enhanced by the existence of the investing public's Section 10(b) remedy. See SEC Brief, Amicus Curiae, McMahon, at 26. Without Congress' speedy intervention, McMahon may signal the end of the judicial development of the law of securities fraud.

PUBLIC CUSTOMERS ARE RELYING UPON CONGRESS TO RESTORE THEIR RIGHTS

The SEC's proposals illustrate the deplorable fact that for over ten years SRO arbitration has been a "stacked deck" favoring the industry to the detriment of the public investor. We are concerned that, as reported by the Division of Market Regulation to Chairman Dingell in August, 1986, the SEC lacks the resources and oversight capability to ensure that

the securities laws and the rights of investors are being successfully vindicated within any particular arbitration. While it is extremely important to amend SRO arbitration procedures in order to place the investor on a more equitable footing with the industry than now exists, adoption of the SEC amendments as proposed or as modified are, in our view, insufficient.

The voluntariness of arbitration agreements which were held enforceable by the Supreme Court in the McMahon case is of great concern to the investing public, especially since, in light of that decision, customers now are almost universally unable to open a brokerage account without signing such an agreement, thus effectively abrogating the investing public's right to a day in Court. The SEC, despite a thirty-year history of deeming this a deceptive and unfair trade practice, did not include in its arbitration reform proposals a revision to the customer/broker agreement which would ensure the voluntariness of the agreement of investors entering into predispute arbitration agreements. Compounding this omission to address the voluntariness issue in its proposals was the SEC's perfunctory rescission of Rule 15c2-2, enacted in 1983 to combat the abuse of mandatory arbitration clauses in the standard customer/broker agreement.

There is clearly no benefit to the public investor for him or her to choose prospectively, at the time of opening an account, a forum for the future adjudication of claims including securities law and RICO violations predicated upon securities fraud, and common law claims. There is, moreover, simply no valid rationale for requiring, in this coercive manner, a customer to sign an agreement with an arbitration clause as a precondition to do business in the marketplace, which is the common trade practice encouraged by the brokerage industry both before and since McMahon was decided. Shearson, in fact, now claims that the arbitration clause is a valid, enforceable contract of adhesion.

Ensuring the voluntariness of prospective agreements to arbitrate is a necessary concomittant of fairness and equitable practices of trade toward public investors. As we stated in the McMahon respondents' Petition for Rehearing to the Supreme Court:

> There is good reason for supporting such principles, as recognized by other regulatory agencies besides the Commission [the SEC]. In order to ensure the voluntariness of a customer's execution of an agreement to submit future disputes to arbitration, the Commodity Futures Trading Commission almost since its inception has enacted rules requiring that the signing of such an agreement, as a separate clause with its own signature line, by the customer "must not be made a condition for the customer to utilize the services" of the member firm. 41 Fed. Reg. 27, 520, §180.3(b)(6) (July 2, 1976). The Commodity Exchange Act itself requires commodity exchanges to "provide a fair and equitable procedure through arbitration or

otherwise . . . for the settlement of customers' claims and grievances against any member or employee thereof: Provided that (i) the use of such procedure by a customer be voluntary . . . ." 7 U.S.C. §7a(11) (1922). No similar provisions are now being enforced by the Commission with respect to investors in the national securities markets.

Of additional concern is the fact that SICA has voiced major objections and apparently has not yet formally endorsed the SEC's proposals. According to Robert Love, counsel to the Division of Market Regulation, reforms may not be instituted until 1989, and then only after negotiation.

In light of the McMahon decision and the ongoing securities industry practice of requiring predispute arbitration agreements, we respectfully urge Congress to amend both the Securities Act of 1933 and the Securities Exchange Act of 1934, specifically the antiwaiver provisions found in Section 14 and 29(a) thereof, respectively, in order to clarify the intent of Congress that a) the antiwaiver clauses explicitly prohibit enforcement of predispute choice of forum clauses such as the arbitration agreements we have been discussing, and b) that these antiwaiver provisions explicitly mandate that the grant of federal court jurisdiction under Section 27 of the 1934 Act and Section 22(a) (concurrent state/federal court jurisdiction) of the 1933 Act may not be waived prospectively. The scope of the antiwaiver clauses should also embrace common law claims ancillary to securities law claims asserted pursuant to principles of pendent jurisdiction.

We believe that clarification and amendment of the 1933 Act is also necessary because the Supreme Court in McMahon, while holding 1934 Act claims arbitrable pursuant to valid, enforceable arbitration clauses, left the door open for a challenge to the still valid nonarbitrability rule that was first enunciated in Wilko v. Swan in 1953 with respect to 1933 Act claims.

We also suggest that in connection with such amendments, the Federal Arbitration Act should be amended in order to explicitly prohibit prospective waivers of federal court, or concurrent federal/state court, adjudication of federal statutory claims and common law claims pendent thereto, such as those arising under the securities laws and the RICO statute. We believe that Congress never intended the FAA to be used as a vehicle to frustrate the public's right to jury trial in appropriate cases.

Additionally, consideration should be given to amendment of the RICO statute, which is under consideration by the House Committee on the Judiciary, Subcommittee on Criminal Justice, to include a similar antiwaiver clause ensuring that the RICO statute's grant of federal court jurisdiction cannot be prospectively stipulated or contracted away. In this regard, we testified before the House Subcommittee on Criminal Justice, Committee on the Judiciary, chaired by the Honorable John Conyers, Jr., on December 3, 1987.

Finally, we and the public have been made aware, through the extensive media coverage of the hearings being conducted by the Subcommittee, that the protection of both the securities markets and the investing public is of utmost importance to Chairman Markey and the Subcommittee in order to ensure the integrity of the system, that the events connected with October 19, 1987 can never occur again and that past abuses rampant in the securities industry are rooted out.

Consistent with these goals and in order to effectuate the anti-fraud purposes of the securities laws embodied in the 1933 and 1934 Acts, we respectfully suggest that any amendments as discussed above must include a provision for retroactivity of these important protective measures. For example, any amendment to the securities laws should include a clause providing that such provisions shall be applied to any claims arising under the relevant statute and to any claims heretofore filed in federal district court (or state court as the case may be). Another way of stating this would be that, as of the effective date of any amendment, all compulsory arbitration agreements which do not comply with the statute as amended would be null and void, including those arbitration agreements heretofore signed by customers.

We recognize that questions might arise as to the applicability of such amendments to preexisting disputes on

constitutional grounds. We wish to point out that numerous courts have previously found that Congress does have the power to abrogate arbitration procedures that were previously contracted for, particularly where the clearly adequate remedy of court adjudication remains standing in place of arbitration. See Ames v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 567 F.2d 1174 (2d Cir. 1977). A discussion of the voluntariness issue with respect to prospective, compulsory arbitration contracts is also part of the Circuit Court's opinion in the Ames case at page 1179.

It is our belief, as confirmed by the dissenting opinion of Justice Harry A. Blackmun in McMahon, 107 S.Ct. at 2359, that it is now up to Congress to restore rationality to this once settled area of law. The public eye is now focused intently on the current efforts of Congress to legislate the necessary protections that investors require in order to restore their confidence in the financial marketplace and to restore to the judiciary the role of interpreting and enforcing the federal securities laws and other anti-fraud federal statutes. For the investing public, Congress is the last hope for restoring an important measure of integrity and justice in the adjudication of investor claims arising under the securities laws.

- EXHIBIT TO EPPENSTEIN TESTIMONY -

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December 23, 1987

VIA FEDERAL EXPRESS

Richard G. Ketchum, Director
Division of Market Regulation
Securities & Exchange Commission
450 5th Street NW
Washington, D.C. 20549

Re: Letter sent to all SICA members dated September 10, 1987

Dear Mr. Ketchum:

We are the attorneys who represented the McMahon investors in Shearson/American Express v. McMahon, U.S. Supreme Court No. 86-44. We are writing at the recent invitation of Mark A. Fitterman, Associate Director, who also requested that we send copies of this letter to Chairman Ruder and Commissioner Fleischman, with respect to our comments on the letter sent by the Division of Market Regulation to all SICA members on September 10, 1987 regarding reform of self-regulatory organization - sponsored arbitration. The following is the substance of my testimony given on December 3, 1987 before the U.S. House of Representatives Subcommittee on Criminal Justice, Committee on the Judiciary.

The proposals to enhance the fairness of the SRO arbitration system advocated by the SEC in its 13 page letter to SICA members on September 10, 1987 (the "proposals"), should be embraced whole-heartedly by all concerned. Public confidence in the marketplace is at stake along with the American ideal that grievances between parties should be fairly adjudicated.

The proposals are a necessary if overdue step in the right direction. However, we believe that they fall short in many respects and would, even if adopted in their entirety, still leave the investor with a forum composed of a "stacked deck" in favor of the industry and fail to provide many safeguards to investors. Comprehensive suggestions for SRO

arbitration procedure reform which this firm presented recently before the 70th Annual Conference of the North American Securities Administrators Association in Snowmass, Colorado on August 31 through September 3, 1987, would further ensure that the public's right to a fairer hearing than is currently available in SRO arbitration would be available to investors choosing the arbitral forum in order to vindicate fully their federal statutory claims arising under the securities laws and RICO.

Among the most urgent of our recommendations is that the panel not contain any industry representatives or individuals related to the securities industry. This would allow the arbitration panelists who are the judges of both fact and law to more closely represent the cross-section of the lay community such as the juries we find in state and federal courts.

The adoption of rules of evidence are long overdue to ensure uniformity of decision-making and to clarify for both the customer and brokerage firm what standards will be applied at the arbitration. The proposals do not address this issue.

One of the proposals suggests that the results of the arbitration proceedings be made public. This falls short of permitting the sessions themselves to be open to the public; thus the deterrent effect of publicity will be restricted to the limited case summaries suggested instead of open sessions. In this regard, it should be remembered that the issues which will be brought before the SRO arbitrations concern broker fraud such as misrepresentation, unauthorized trading, churning, unsuitable investments, and violations of RICO. Such matters are extremely serious and the public should be fully informed as to the arbitration hearings. This can only be achieved through open sessions.

Additionally, we note that a spokeman for the SIA has expressed concern that the proposals could lead to the issuance of formal opinions and findings. Speaking from the investors' point of view, written opinions and findings of fact based upon the evidence and conclusions of law, not merely the proposed preservation of the record and summarization of legal issues resolved, are essential to the integrity of arbitral process and would be necessary elements to preserve the right of either party to appeal a decision which might not follow existing legal precedent. The SEC's Division of Market Regulation has previously stated that it has no authority to ensure that the federal securities laws are being correctly applied in arbitration and that they have no authority to overturn any particular result. See SEC Report of the Division of Market Regulation in Response to An Inquiry by the Honorable John D. Dingell, Chairman of the Committee on Energy and Commerce

(August 28, 1986). Thus, in the event an arbitration panel went astray of the law, a federal court would have a fully-documented record to review where reasons are given for the decision. Judges would also be in a better position to determine whether the award should stand or be vacated.

This problem inherent in SRO arbitration recently came to light in a case pending in the Southern District of New York before The Honorable Judge Shirley Wohl Kram, known as Tinaway v. Merrill Lynch, 658 F.Supp. 576, 579 (S.D.N.Y. 1987). Judge Kram found, on the basis of her review of an arbitration finding that reduced a claimant's loss by 95%, that there was evident partiality on the part of the arbitrators. The Judge vacated the award. Justice Blackmun in the McMahon dissent noted that the federal district courts will now be called upon to determine the correctness of awards more than ever before. Findings of fact and conclusions of law are necessary for this process to work efficiently.

Only one peremptory challenge is permitted under the Uniform Code of Arbitration which can be utilized by either side when challenging a panelist. This is insufficient. The number of challenges not for cause should be increased so that bias and prejudice can be weeded out in light of the expanded disclosure of the panelists' background provided for in the proposals. Providing for public access to full written opinions, findings and conclusions, not just summary results, is the only way to give investors a meaningful ability to evaluate the system.

In connection with the proposal concerning the purported need for industry expertise on the panels, we respectfully but strenuously object based upon the fact that the proposals also recommend that "arbitration panels include persons who are not so connected with the industry that it may hinder their ability to make independent judgments with respect to specific industry practices." Proposals at 2. It is proposed that the Uniform Code of Arbitration be amended to restrict those persons who may serve as public arbitrators to people wholly unconnected to the industry. We submit that if the list of so-called public arbitrators should not include persons who are connected with the industry in light of their potential bias, the exclusion should logically also apply to the industry representative serving as the panel chairman, whose opinions and expertise are often deferred to by the "public" arbitrators.

Investors are entitled to a panel whose members are totally objective. We agree with the SEC that fairness is of paramount importance with respect to SRO arbitrations. To ensure that the appearance of impropriety or bias does not exist, panels must be cleansed of industry representatives and

of the "public" arbitrators who currently have or have had ties to the securities industry in the past. The proposal that would still permit a person who has left the securities industry for a non-industry position to serve as a public arbitrator after the passage of three years is accordingly inappropriate, since the mere passage of time does not begin to address the potential for bias. The fact that these persons subsequently held non-industry positions does not necessarily eradicate from the process the "old boy" network that Wall Street breeds.

The proposals would permit partners of lawyers and accountants who regularly provide services to the securities industry to serve as public arbitrators. We object to this practice since it is obvious that legal and accounting partners share in fees generated by securities industry clients and thus may be biased by virtue of this association. Mere disclosure of this fact to the parties or a de minimus, 10% cap on billings/two year exception to the exclusion for attorneys and accountants who provide services to the industry does not in any way ameliorate the appearance of and potential for serious conflicts of interest.

The prospect that under the proposals three years may be permitted to expire before the new criteria for public arbitrators go into effect is subject to criticism. Despite the fact that the proposals seem to provide that in the interim public arbitrators will at least be subject to challenges for cause, this would merely delay rather than correct an inherent unfairness in the composition of the panel. The concern that the current pool of arbitrators would be substantially reduced if it were to take immediate effect is appropriate but not significant since the American Arbitration Association has a substantial pool of arbitrators without any securities industry ties who presumably would be readily available to step in and take up the slack. Moreover, it should not be too difficult for SROs to obtain other qualified non-industry arbitrators from bar association lists and by actively soliciting interest from the public sector. Unlike the juror who is paid a modest fee to serve, members of the general public empanelled as public securities arbitrators would receive a more remunerative stipend as an incentive to serve. The immediate result of enlisting truly impartial public panelists would be to infuse the system with the long-neglected objectivity to which the public investor is entitled.

The proposals imply that the brokerage firms who utilize the SRO arbitration process have historically kept extensive information on the voting patterns and awards rendered by the arbitrators, while the public's access is confined to the percentage of cases in which investors were awarded an unrevealed portion of their claims. All data

regarding claims and awards should be subject to pre-hearing disclosure so that the investors and their counsel will be on a more equal footing with the brokerage firm and its counsel. Challenges would thus become a meaningful concept.

Arbitrator evaluations should be kept by the SROs, but the concept should be expanded by requiring such evaluations to be filed independently with the SEC as a means of enhancing its oversight capability. In this age of the computer, data can be tabulated in connection with arbitrators the same way data can be tabulated in connection with brokers and their firms who have been found by arbitration panels to have commited fraudulent activities. Regulatory oversight over SRO arbitration would thereby be enhanced.

The proposal to make awards part of the public record would benefit investors and serve "to balance out the inherently unequal familiarity with the system of investors and member firms." Proposals at 8. However, the proposals would not require the arbitration panels in smaller disputes (for example, up to $15,000.00) to issue written findings of fact and conclusions of law. This would greatly serve to prejudice all but the largest claimants by denying most claimants and relatively small investors the ability to ascertain the rationale behind the arbitrators' decision.

The proposals with regard to discovery, historically one of the more deficient aspects of SRO arbitration, are somewhat limited in scope. There is a real need for pre-hearing conferences and preliminary hearings in all cases regardless of size of claim, and not just the complex ones the proposals mention. These conferences will not only serve to "delineate the issues in dispute, result in stipulations, and otherwise set the focus for the hearing on the merits," Proposals at 10, but may also be used to explore settlement. The problem arising at the hearing of arbitrators precluding evidence germane to proving a claim will thus be avoided. Any evidentiary problems or witness unavailability difficulties can be explored and resolved and depositions can be directed where appropriate at such conferences. They are a necessary addition to the SRO system.

We take issue with the limited use of the deposition process as proposed. Although we agree that in many court proceedings the discovery process is sometimes abused by counsel we find that it does serve to delineate the issues in controversy and to provide a record of each party's sworn testimony. Where the issues are sufficiently complex to require that such testimony be given, the depositions of parties involved in the dispute should be extended to necessary witnesses and other brokerage firm personnel such as compliance officers and branch managers.

The lingering problem of brokers stonewalling any meaningful document production prior to the hearing is serious and the proposals attempt to address it. From the start, however, the investor should be able to obtain a de minimus list of documents prior to commencing an arbitration. These documents would go a long way in assisting the defrauded investor and counsel and as to whether or not his or her claims are substantiated by documentation in the hands of the broker, and may also shed light on the prospects for ultimate success on the merits. A few of the documents which should be voluntarily disclosed are: a) the customer/broker agreement that was executed; b) account information forms; c) margin agreement, if any; d) correspondence between customer and the brokerage firm; e) disciplinary proceedings that are of record against the broker or branch office involved; f) market reports or evaluations upon which the brokerage firm's recommendations were based, if this is an issue, and other such basic documents depending upon the nature of the dispute.

Leaving aside for a moment the real necessity to reinstate investor rights abrogated by the McMahon decision by amendment to the securities laws, in the immediate future everyone envisions an increase in the number of arbitrations of securities fraud claims. Yet during this hopefully interim period of uncertainty, while the SROs are still thrashing out adoption of the SEC proposals for amendments to their rules and elimination of certain types of individuals from their panels, the brokerage firms should not be permitted to limit the choice of a panel to one of the SROs. The American Arbitration Association, as recommended by the proposals, should be a required alternative to be chosen by the customer at his or her option in the event SRO procedures are not deemed desirable by the customer.

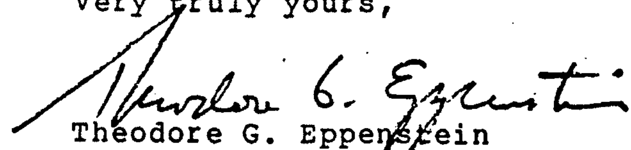
Although reference to a replacement for former Rule 15c2-2 is notably absent from the proposals, we believe consideration should be given to adoption of a rule to ensure the voluntariness of a customer's execution of an agreement to submit future disputes to arbitration. The Commodity Futures Trading Commission rules provide a useful model. The CFTC almost since its inception has enacted rules requiring that the signing by the customer of such an agreement, as a separate clause within the customer/brokerage agreement with its own signature line, "must not be made a condition for the customer to utilize the services" of the member firm. 41 Fed.Reg. 27, 520, Section 180.3(b)(6) (July 2, 1976). The Commodity Exchange Act itself requires commodity exchanges to "provide a fair and equitable procedure through arbitration or otherwise. . . for the settlement of customers' claims and grievances against any member or employee thereof: Provided that (i) the use of such procedure by a customer be voluntary. . . ." 7 U.S.C. Section 7a(11) (1922) (emphasis

added). No similar provisions are in effect with respect to investors in the national securities markets.

With respect to fraudulent activity that is confirmed in an arbitration award, such findings should be sent to the SEC for its review and further action if needed.

We hope that you will consider our suggestions and comments on the proposals for reforming SRO arbitration in the spirit in which we have offerred them, which is to promote the dialogue regarding these issues in a fair and democratic manner.

Very truly yours,



Theodore G. Eppenstein

TGE/mo

cc: The Hon. David Ruder, Chairman
The Hon. Edward H. Fleischman, Commissioner
Mark A. Fitterman, Associate Director
Division of Market Regulation

PUBLIC MEMBERS OF SICA

SECURITIES INDUSTRY CONFERENCE ON ARBITRATION

PUBLIC MEMBERS
THEODORE G. EPPENSTEIN
CONSTANTINE N. KATSORIS
J. PAT SADLER

EMERITUS PUBLIC MEMBERS
PETER R. CELLA
THOMAS R. GRADY
THOMAS J. STIPANOWICH

January 12, 2007

The Honorable Christopher Cox
Chairman
The U.S. Securities and Exchange Commission
100 F. Street NE
Washington, DC 20549

Re: The Public's Concerns about the Newly Combined <u>NASD/NYSE Arbitration Forum and SICA's Mandate</u>

Dear Chairman Cox:

The Public Members of the Securities Industry Conference on Arbitration are independently appointed, unaffiliated with the securities industry and serve to help protect the interests of public investors in securities arbitration. It is in this capacity that we communicate our concern regarding the recently announced proposed merger of the arbitration departments of the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") (collectively "the Consolidated SRO"), which will effectively create the only forum available for the resolution of disputes between public customers and the securities industry. All the Public Members (and the retired Emeritus Public Members) wish to address certain questions raised by the consolidation with respect to the future of securities arbitration. We suggest several measures that we believe would assist the investing public's perception of fairness as well as the process of arbitration.

SICA was established in April 1977 with the support of the Securities and Exchange Commission. It was tasked to create a comprehensive Uniform Code of Arbitration ("Uniform Code") to cover all claims by investors, in all self-regulatory organizations ("SRO's"). The Uniform Code that was developed harmonized the rules of the various SROs and codified procedures that previously had been informally utilized. The original Uniform Code was developed by SICA in the late 1970's, and since that time SICA has met on a regular basis to review and amend it as necessary.

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When in 1987 the U.S. Supreme Court decided that arbitration clauses would be enforced in 1934 Exchange Act securities cases,[1] investors became generally obligated to arbitrate their disputes with the industry, pursuant to predispute arbitration agreements. Two years later, the Supreme Court similarly upheld the arbitrability of claims under the Securities Act of 1933 pursuant to predispute arbitration agreements.[2] These two decisions transformed SRO arbitration from a voluntary process to a mandatory procedure for the resolution of most public investor disputes.

After 1987, brokerage firms utilized arbitration clauses in their customer agreements that required that all customer claims and controversies were to be tried in an arbitration forum operated by the various self-regulatory organizations. At the time there were multiple arbitration forums, including the NASD, NYSE, American Stock Exchange, Pacific Stock Exchange and Boston Stock Exchange, to name a few. Over the past decade, securities arbitration was principally administered by the NASD and the NYSE, the two major forums with the majority of the case filings. The remaining SRO's substantially reduced their caseload, while other exchanges were absorbed or gave up their arbitration programs entirely. According to a recent SICA subcommittee report, aside from the NASD and NYSE there were a bare handful of cases filed at all the other SRO forums in 2005. With the consolidation of the NASD and the NYSE arbitration departments there will be only one securities industry funded arbitration forum to which all investors must bring their claims and controversies.

The prospect of a single securities arbitration forum maintained and funded by the securities industry will only heighten the suspicion long held by many public investors that the system they are compelled to use is less than independent and hence less than fair. In the past SICA and particularly its Public Members have been able to exert some effect upon the uniform arbitration rules and their administration. The consolidation potentially creates a securities industry dispute resolution structure that will inherit all the present problems in the arbitration process in addition to a heightened degree of doubt as to its fairness. This is particularly so given the recent securities market abuses in which public investors were severely damaged while many, as the public observed, in the industry reaped substantial profits at the expense of their customers. The real issue is whether the Consolidated SRO should have the responsibility for providing the only arbitration forum to resolve investors' disputes, as opposed to having this critical function given to, or shared with, another forum totally independent of the securities industry?

We recall that the Commission had recommended in 1987 that an alternative to SRO arbitration should be made available for customers, and had asked SICA to encourage broker-dealers to include the option of a non-industry forum in future predispute arbitration clauses: "We recommend that SICA encourage broker-dealers to

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[1] *Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).*

[2] *Rodriguez de Quijas v. Shearson/American Express, 490 U.S. 477 (1989).*

include in their arbitration clauses the option of using AAA arbitration as well as SRO arbitration forums."[3] At that time, SICA advised the SEC that the SIA's standard customer agreement included non-SRO alternative forums,[4] which is no longer the case. In fact, the SEC mandated in 1989 that the securities industry could no longer preclude access of investors to their choice of SRO forums. The SEC was clear that the SRO "rules are intended to effectuate an underlying policy of allowing the customer to choose the most appropriate forum for resolution of his or her particular claim."[5]

It has been reported by the NASD that the customers' chances of winning an award had substantially dwindled to around forty-three percent by 2006.[6] Yet historically, after McMahon (1989-90) the win rate at the NASD/NYSE was about sixty percent, as reported by the GAO,[7] and when investor awards are granted, they are frequently only for a small percentage of the loss suffered by the investor, sometimes not even enough to pay their costs to arbitrate. Indeed, the public has been warned by a well-respected journalist that: "If you're an investor who has filed an arbitration case against your stockbroker, you would be wise to steel yourself for an irrational and unjust outcome."[8]

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[3] Letter of Richard G. Ketchum, Director, SEC Division of Market Regulation, September 10, 1987 at p. 11.

[4] *See* SICA Letter to Richard G. Ketchum, Director, SEC Division of Market Regulation, December 14, 1987 at p. 9.

[5] Litigation Release No. 12198, 44 S.E.C. Docket 461, 1989 WL 992090 (S.E.C. Release No.). *See also* SEC Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc., Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Release No. 34-26805, 43 S.E.C. Docket 1250, 54 FR21144, 1989 WL 991624(S.E.C. Release No.).

[6] *See* NASD Dispute Resolution Statistics-Results of Customer Complaint Arbitration Award Cases at
www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm
NASD's statistics also show a drop of around 20% in the customer's chances from 2000 levels to 2005 levels. *Id.*

[7] General Accounting [Government Accountability] Office, GAO/GGD-92-74, Securities Arbitration-How Investors Fare (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.

[8] Gretchen Morgenson, "FAIR GAME; When Winning Feels A Lot Like Losing," New York Times Business Section, December 10, 2006, p.1.

A single, independent securities arbitration forum, with SEC oversight and public investor and securities industry participation, would serve to contribute to the reduction of this negative perception.

Another alternative to compulsory SRO arbitration would be to again provide the public investor with the right to choose to bring grievances to court or to arbitration. While not all cases would be susceptible to resolution in court (for example, claims under $25,000), it would permit the public investor the choice as was their right prior to1987.

The creation of the Consolidated SRO underscores the continuing importance of maintaining SICA and the Public Members' role in attempting to ensure an arbitration process that protects public investors' rights in securities arbitration. The Public Members voice their concerns and make recommendations for reform. SICA's three voting Public Members are augmented by the experience of the Emeritus Public Members. No Public Member is affiliated with the securities industry. While the Emeritus Public Members do not have a vote, as the current Public Members do, they can also attend meetings, receive agenda books, submit agenda items, invite guests and participate in the discussions, all of which benefits public investors and aids the perception of integrity and fairness in monitoring the SRO arbitration system.

In light of the fact that there will now realistically be only one SRO arbitration forum, we must strengthen SICA's role as a watchdog over the arbitration process and, in addition, ensure that at least one-half of the future voting members of SICA be Public Members, for only then will public investors be persuaded that they have a real voice in a process they are being forced to participate in.

The continuation of the role of SICA and that of its independent Public Members is necessary in order to secure and maintain balance and fairness in securities arbitration.

Securities industry considerations have been the focus of the present consolidation, particularly the great savings achieved for the Consolidated SRO. It is not unreasonable to suggest that the public investors' interests be considered in order to ensure a truly level playing field for their claims in arbitration.

Respectfully,

The Public Members of SICA*

Current Public Members	Emeritus Public Members
Theodore G. Eppenstein	Peter R. Cella
Constantine N. Katsoris	Thomas R. Grady
J. Pat Sadler	Thomas J. Stipanowich

* *The Public Members and Emeritus over the long history of SICA have developed innovative ideas, vigorously represented the public investors' interests, and worked with industry and SRO representatives in order to revise and reform the securities arbitration system. Each of the current Public Members and Emeritus have extensive experience in preserving the rights of the investing public.*

The three public members are Theodore G. Eppenstein, Esq., Professor Constantine Katsoris, and J. Pat Sadler, Esq.

Theodore G. Eppenstein is a partner in the New York law firm Eppenstein & Eppenstein. He and his firm represented the investors in the McMahon *case. He has testified before two Congressional subcommittees, assisted in drafting securities arbitration reform legislation, and has been a successful practitioner in this field, including winning a historic arbitration case against Refco, Inc. and succeeding in a precedent-setting case before the New York State Court of Appeals. Mr. Eppenstein has been a Public Member of SICA since 1998. He has worked on many subcommittees and has been chair of several subcommittees including Electronic Discovery, Special Procedures for the Elderly and Infirm Parties and Employment Disputes. Mr. Eppenstein and his partner Madelaine Eppenstein have co-authored many articles on securities arbitration and litigation, and he has regularly commented on matters that concern public investors, including before the Ruder Commission and the NYSE. Mr. Eppenstein was part of the NYSE's "Dream Team" which gave presentations on U.S. securities arbitration at the NYSE/MICEX Symposium in Moscow in 2000 along with Peter Cella, Esq., Professor Katsoris and Professor Thomas J. Stipanowich. He was also part of another NYSE delegation and was a principal speaker on arbitration at the Cairo and Alexandria Stock Exchanges in 2003 along with Professor Katsoris.*

Professor Katsoris is Wilkinson Professor of Law at the Fordham University School of Law in New York where he has taught courses in taxation and other business related courses. He was one of the original Public Members when SICA was formed in 1977 and returned as a Public Member and Chair of SICA in January 2003. His service to the public has been well documented and includes co-chairing the NYSE Symposium on Arbitration, testifying before Congress on securities arbitration issues and speaking at various industry and arbitration related seminars. He is a well known commentator and has written numerous articles, some of which have been noted by the U.S. Supreme Court and the SEC. He is also a public arbitrator for the NASD and NYSE for over 35 years and an active mediator in securities disputes. At the suggestion of past SEC Chairman Arthur Levitt nearly ten years ago he was instrumental in establishing the securities arbitration clinic at Fordham and elsewhere.

J. Pat Sadler is a partner in Sadler & Houdesvan in Atlanta, Georgia, and represents the public's interest as a major part of his professional activity. Mr. Sadler is a former president of the Public Investor Arbitration Bar Association ("PIABA") and serves as a director of that organization. He is an experienced and active litigator and arbitrates before the various SRO's on behalf of claimants. He joined SICA as a Public

Member in 2005 and has assisted in many of SICA's subcommittees and projects, including as Chair of the subcommittee planning the survey on arbitration which will be shortly disseminated. Mr. Sadler also was a member of the NASD's NAMC.

The Emeritus Public Members are Peter R. Cella, Esq., Thomas R. Grady, Esq. and Professor Thomas J. Stipanowich. Mr. Cella was one of the original public members when SICA was formed in 1977. He served for about 18 years before taking Emeritus status. He is a renowned securities litigator representing public customers who have constituted a significant portion of his practice. He was part of the NYSE's "Dream Team" that went to Moscow in 2000. In 1984 Governor Mario Cuomo appointed Mr. Cella to the Citizen's Planning Committee Against Crime, an advisory group to the Governor of New York. Mr. Cella represents investors in his practice and is an arbitrator at the NASD and NYSE.

Thomas R. Grady is another Emeritus Public Member. Mr. Grady is Of Counsel to the firm of Ackerman, Link & Sartory and practices securities arbitration and litigation throughout the country from his offices in Naples and West Palm Beach, Florida. As a Public Member, Mr. Grady co-authored revisions to eligibility rules, helped to draft the Uniform Code into plain English with the coordination of representatives from the industry and fought against discovery and motion practice abuses in arbitration. Mr. Grady's insights over the years have been invaluable to the public.

Thomas J. Stipanowich, Emeritus Member, is Professor of Law at Pepperdine University School of Law and Academic Director of the Straus Institute for Dispute Resolution. He is the co-author of a five-volume treatise on the Federal Arbitration Act and many other works on arbitration and conflict resolution including a new law school book and materials Resolving Disputes: Theory, Practice and Law *(Aspen 2005). From 2001-2006 he was President and CEO of the International Institute for Conflict Prevention and Resolution (CPR), a prominent international think tank based in New York City. He was also Academic Advisor for the revision of the Uniform Arbitration Act and was the Academic Reporter and primary drafter of the Consumer Due Process Protocol for arbitration. During his tenure as a SICA Public Member and Chair of SICA he was William L. Matthews Professor at the University of Kentucky.*

cc: The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Kathleen L. Casey
The Honorable Annette L. Nazareth

The Honorable Max Baucus
The Honorable Christopher J. Dodd
The Honorable Daniel K. Inouye
The Honorable Chuck Grassley
The Honorable Richard C. Shelby
The Honorable Ted Stevens

The Honorable Rick C. Boucher
The Honorable John Conyers, Jr.
The Honorable John David Dingell, Jr.
The Honorable Barney Frank
The Honorable Edward John Markey
The Honorable Spencer Bachus
The Honorable Lamar S. Smith
The Honorable Joe Barton
The Honorable Fred Upton

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The Honorable Bryan Lantagne
The Honorable Melanie Senter Lubin
The Honorable Tanya Solov
The Honorable Patricia D. Struck
The Honorable Karen Tyler

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Linda D. Fienberg, President, NASD DR
George H. Friedman, Director of Arbitration, NASD DR
Richard G. Ketchum, CEO, NYSE Regulation
Dan Beyda, Chief Administrative Officer, NYSE Regulation
Karen Kupersmith, Director of Arbitration, NYSE Regulation

Amal Amy, Ass't Gen. Counsel, SIA

SICA Members and Invitees

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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February 12, 2007

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Public Member of SICA Regarding the Combined NASD/NYSE

Dear Chairman Cox:

I write in my capacity as Chair of the North American Securities Administrators, Inc. ("NASAA") Project Group on Arbitration (the "Project Group"). I was recently copied on a letter to you dated January 12, 2007 from the public members of the Securities Industry Conference on Arbitration ("SICA").[1] That letter highlighted a number of serious concerns raised by the consolidation of the arbitration departments of the New York Stock Exchange Regulation and the NASD. While the project group shares the concerns raised by the SICA public members, at this time I will focus on one particular concern raised by the public members in their letter. Specifically, that the average investor believes that, "the system they are compelled to use is less than independent and hence less than fair." This is the Achilles Heel of the current arbitration system and it can only be addressed by changing the composition of the arbitration panel.

NASAA shares the SEC's goal of creating an arbitration forum that is, both in perception and in fact, fair to all parties. NASAA applauds both the SEC and the NASD for the recent user-friendly revisions to the NASD Code of Arbitration Procedure. As Joseph Borg, President of NASAA, stated in his recent remarks setting out NASAA's legislative agenda, "[s]tate securities regulators believe Congress should review the manner in which arbitrations are conducted to determine: if there is sufficient disclosure of potential

[1] While NASAA is not a voting member of SICA, we are an invited attendee and an active participant in its meetings.

President: Joseph P. Borg Esq. (Alabama) • President-Elect: Karen Tyler (North Dakota) • Past-President: Patricia D. Struck (Wisconsin)
Secretary: James O. Nelson, II (Mississippi) • Treasurer: Fred J. Joseph (Colorado) • Director: Michael Johnson (Arkansas) • Director: Glenda Campbell (Alberta)
Director: Denise Voigt Crawford (Texas) • Director: James B. Ropp (Delaware)
Ombudsman: Don B. Saxon (Florida)
Executive Director: Russel P. Iuculano

conflicts by panel members; if selection, qualification, and composition of the panels is fair to the parties; whether the arbitrators receive adequate training; if explanations of awards are sufficient; if the system is fast and economical for investors; and if the entire arbitration process should be optional, not mandatory, for investors."

The purpose of this letter is to set forth the Project Group's position that arbitration panels must be unquestionably neutral. As long as arbitration panels remain comprised of a mandatory industry representative and public arbitrators who maintain significant ties to industry, the process is fundamentally unfair to investors.

Many have justified mandatory industry participation based on the industry representative role as an educator for the other panelists. This justification of an industry presence on the panel is spurious. First and foremost, expert witnesses ably serve the purpose of educating the arbitrators. The very notion of having a matter heard by a panel of independent arbitrators assumes that they come to the arbitration process with no preconceived opinion or interest in any party or issue at conflict. It stretches credulity to believe that arbitrators who are affiliated with industry can remain entirely impartial, but even if that were the case, the industry arbitrator creates a presumptive of bias that is poisonous to the principles of fair play and substantial justice. Do courts in complex medical malpractice cases insist that one physician be empanelled in order to "educate" the other members? Clearly, such a requirement in a judicial proceeding would be dismissed as creating a bias that would taint the final ruling and pervert the concept of a fair hearing. NASAA submits that intellectual honesty should not be discarded at the door of the arbitration forum.

Additionally, one could readily conclude that the assertion that arbitrators must be "educated" by an industry-affiliated panelist indicates that the current training of arbitrators is inadequate. While a pool of uneducated arbitrators is a serious problem, there are ways to correct this which will not taint the average investor's view of a currently mandatory process.

With the advent of a single forum for customer arbitration, any suggestion of bias must be removed from that forum with undue speed. Removing industry's role in the arbitration forum will instill confidence in the average investor that they will receive a fair and unbiased forum in arbitration. A goal, I am sure that all regulators wish to achieve. We urge you to address this matter and remove the requirement for the a mandatory industry representative and prohibit public arbitrators from having significant ties to industry

Please contact me if you have questions about this letter or if I can assist you in any way.

Sincerely,

Bryan J. Lantagne
Director
Massachusetts Securities Division and
Chair, NASAA Arbitration Project Group

cc: The Honorable Paul S. Atkins
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