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ARBITRATION

Continuing Debate on Arbitrating Broker-Customer Disputes May Add Little

President Obama's plan for financial regulatory reform has refreshed the long-running debate over the merits of mandatory arbitration for investor complaints against broker-dealers, but possibly without the promise of new insight, a securities industry representative and a securities attorney suggested June 25.

In interviews with BNA, Travis Larson, spokesman for the Securities Industry and Financial Markets Association, and Elliott R. Curzon, a partner in Dechert LLP's Washington office, both pointed out that the matter has already been extensively studied. Indeed, Curzon noted that the SEC unsuccessfully tried to ban mandatory arbitration twice in the past; the practice also was upheld in 1987 by the U.S. Supreme Court.

Investor advocates, on the other hand, hailed the president's initiative. In a June 25 e-mail to BNA, Barbara Roper, director of investor protection at the Consumer Federation of America, assessed the administration's approach as an "important step in the right direction," though "we would prefer an outright ban on the use of pre-dispute binding arbitration clauses."

Petition for Change.

In one paragraph of his 85-page plan, Obama called on the Securities and Exchange Commission to study whether mandatory arbitration clauses harm investors and whether changes may be necessary, and then to pursue legislation as appropriate (41 SRLR 1139, 6/22/09). While arbitration may be reasonable for many consumers in the event of a dispute, mandating it and eliminating access to courts "may unjustifiably undermine investor interests," the plan said. The administration further recommended that Congress act to grant the SEC "clear authority" to prohibit these provisions in retail contracts with broker-dealers and investment advisers.

Less than a week before the president announced this and his other proposals for reform, the Public Investors Arbitration Bar Association June 11 petitioned the SEC to eliminate the requirement that an arbitrator affiliated with the securities industry sit on arbitration panels when the amount in dispute exceeds $100,000--a primary reason for investors' perception of unfairness in mandatory arbitration. PIABA contended that the parties should have the ability to decline to have an industry arbitrator on the panels deciding their cases.

That the president now wants the SEC to study whether changes--such as PIABA's petition--may be necessary does not mean that the agency will give the petition serious thought, according to Les Greenberg, a lawyer in Culver City, Calif. Greenberg for years has repeatedly lobbied for an end to mandatory arbitration.

FINRA's or SEC's Purview?

Greenberg June 25 shared with BNA a copy of his June 20 letter to the SEC, in which he "wholeheartedly" supported PIABA's petition, but added: "if recent history is any guide," it "will eventually end in a trash heap" at the SEC and "PIABA's efforts will be for naught."

Greenberg added: "The SEC has consistently failed, and, thus, refused, to accept recommendations," except those from self-regulatory organizations such as the New York Stock Exchange and the Financial Industry Regulatory Authority, to change the securities arbitration process. "Of course, SROs have no incentive to suggest improvements desired by the investing public as those changes would negatively impact their securities brokerage firm members."

The administration wants the SEC to study the issue of mandatory arbitration and for Congress to grant the SEC "clear authority" to prohibit the provisions in retail contracts with broker-dealers and investment advisers.

The SEC does not comment on correspondence it receives. However, regarding the PIABA petition, a spokesman pointed out that it has been posted to the agency's Web site as a public petition. The commission "responds in due course as appropriate" to public petitions, he added, declining to be more specific.

In March 2008, the SEC did respond to one of Greenberg's prior petitions for rule changes in this area. According to a copy of the letter posted on Greenberg's Web site, the SEC deferred consideration of Greenberg's petition to FINRA: "The Commission has carefully considered the Petition, as well as comments it has received about the petition,' and has determined to refer it to [FINRA], whose rules govern the securities arbitration system, for such action as it deems appropriate."

FINRA facilitates and oversees the mandatory arbitration system. Over 3,000 new arbitration cases have been filed already this year, compared to approximately 1,700 in the same period last year, and about 1,300 in the same period in 2007. Underlying the bulk of these cases were transactions in mutual funds or common stock, and claims of negligence, breach of fiduciary duty, or misrepresentation.

Following the president's announcement on June 17, a spokesman told BNA that FINRA has no position on whether arbitration should be mandatory; that is an issue best left to Congress and the SEC, the spokesman said.

Ongoing Study.

However, FINRA is now in the second year of a two-year pilot program evaluating arbitration panels. Instituted in light of concerns that arbitration panels with industry representatives are unfair to investors, the pilot offered investors a choice between a panel of three public arbitrators instead of the norm--two public arbitrators and one industry arbitrator (40 SRLR 1164, 7/28/08).

Announcing the pilot last June, Mary Schapiro--then FINRA's chief executive officer and now the SEC's chairman--said that the pilot "will give investors greater choice when selecting an arbitration panel," and "will allow us to see if a change in the way arbitration panels are selected is a better way to serve and protect the interests of investors."

Prior to FINRA's pilot, numerous studies over the last three decades have provided ample data to support those on both sides of the debate. Thus, to some, the idea of another study on mandatory arbitration, by the already resource-constrained SEC, is redundant.

Already Vetted.

According to Curzon, who spent 12 years at FINRA as assistant general counsel before joining Dechert, another study is not necessary; the current system has already been "thoroughly vetted many times." Moreover, the plaintiffs' bar is "well-represented" on FINRA's Arbitration Committee and has in the past sought to address perceived unfairness.

Larson recounted previous studies--including SIFMA's own research in 2007--showing that having an industry arbitrator on the panel does not affect the outcome of the controversy. He predicted that FINRA's pilot will result in similar findings. Until FINRA's study ends, any decision to change the current system would be "a rush to judgment without foundation and fact."

Contending the opposite, Roper said research has shown that investors "do not believe they get a fair shake in the industry-run arbitration system." CFA has long advocated for a ban on mandatory arbitration. Even with a ban, Roper predicted that "the vast majority of investor complaints would continue to be resolved through arbitration," because of the high, sometimes prohibitive costs of pursuing a complaint in court.

Nonetheless, from Roper's perspective, a ban would bring two "significant" benefits. First, cases that do not belong in arbitration because they involve complex legal questions or require the procedural protections available in a court case, could be litigated. This would also reduce the burden on the arbitration system, Roper said. Second, "more pressure would be brought to bear to reform the arbitration system so that investors begin to trust that it offers a fair and effective way to resolve their disputes."

Smaller Claims.

According to Larson, critics of the current system's fairness "forget" that investors must have a sufficiently sizeable claim to make it worthwhile to retain legal counsel. Approximately 25 percent of cases have a value under $10,000. Litigation in such cases would not be cost-effective. "So why disenfranchise a quarter of investors by making court the only option?"

Curzon agreed with that prospect, highlighting the fact that lawyers take cases on a contingency basis. It is not profitable for the plaintiffs' bar to risk substantial time and money on a contingency that might not produce anything, he said.

When asked about giving investors a choice--rather than mandating one forum or another--Larson pointed out that both sides--the defendant as well as the claimant--would have to be given a choice. Since studies have shown that one side will invariably choose court, this would "effectively bring arbitration" to an end, Larson contended.

The industry has consistently favored arbitration even as the process has become more claimant-friendly, according to Curzon. He said both the industry and investors have an interest in resolving the case as quickly and inexpensively as possible. Arbitration, Curzon stated, is consistently "proven" to be efficient in this sense.

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