Testimony of
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Introduction and Summary

Mr. Chairman and members of the Committee:

I am Marc Lackritz, President of the Securities Industry Association.[1] SIA appreciates the opportunity to testify before the Committee today on how well the securities arbitration process is serving our investors.

Public trust is critical to the success of our capital markets, the securities industry, and any dispute resolution process used by our customers. When disputes arise between customers and securities firms, the process of resolving those disputes must be fair in fact, and also perceived to be fair. That is why SIA commends the Committee for holding this hearing, and welcomes the opportunity to discuss the current system of dispute resolution as well as suggestions to improve that system. SIA has been active over the years in efforts to improve the dispute resolution process, and we share the Committee's objective of examining securities arbitration with that goal in mind.

SRO-sponsored securities arbitration is a system that works. It is a fair and efficient means of resolving disputes between customers and brokerage firms -- fair both to customers and to individuals and firms in the securities industry. We know this from the weight of both anecdotal evidence and empirical data.

Arbitration continues to be a far more efficient and cost-effective dispute resolution mechanism than traditional court-based litigation. On average, disputes are resolved much faster and at far lower cost to customers in the SRO-sponsored arbitration fora than in comparable

court cases. This allows participants to put a dispute behind them and move on with their lives, without the often all-consuming, years-long battles of traditional litigation.

Aggrieved customers get what so many say is what they really want: their "day in court." Unlike in court cases, claimants in arbitration are not held to technical pleading standards. Unlike in court cases, pretrial discovery in arbitration is focused and limited, and rarely includes expensive and time-consuming taking of depositions. Unlike in court cases, the hearings themselves are not intimidating, technical proceedings bound strictly by the rules of evidence, but are designed to be flexible and allow the arbitrators to reach the most equitable conclusion. The more streamlined process of arbitration, as compared with the many procedural and financial obstacles that must be overcome by a plaintiff in a court case, means that nearly every case brought in arbitration (other than those that are settled) goes to a full merits hearing.

So the system works. But it will continue to be superior to court-based litigation only if we guard against what I call the "creeping litigiousness" that is at the gates. Some of the changes that have been proposed, both formally and informally -- requiring written explanations of awards by arbitration panels, expanding pretrial discovery, broadening the scope of parties' rights to appeal from arbitrators' decisions – would undermine what has made arbitration an attractive alternative: the streamlined, efficient, and less costly means of resolving disputes. I urge the Committee and the Congress to be very reluctant to endorse this type of change to securities arbitration.

I address below a few of the issues in a little more detail.

Arbitration Offers Significant Benefits To Parties That Are Not Available In Court

SRO-sponsored securities arbitration allows parties to resolve disputes quickly, fairly and efficiently. As illustrated by the unbiased, third-party statistics below, arbitration offers significant benefits to *all* parties -- customers and securities firms alike -- that may not be achieved through litigation in the court system or in other forums.

SRO-Sponsored Arbitration Provides a Faster and More Efficient Method to Resolve Disputes

The hard data confirm that SRO-sponsored arbitration provides a faster and more efficient method for customers to resolve disputes. Specifically, new statistics published by the NASD show that for customer cases closed in 2004, the average turnaround time from filing to judgment was 17 months.[2] Conversely, recently compiled statistics for civil cases in the United States District Court for the Southern District of New York[3] show that for the 12-month period ending September 30, 2004, the median time from filing to trial -- not final resolution, just trial -- was 26.8 months.[4] The most obvious benefit of the speedy resolution is that successful plaintiffs obtain the relief they seek -- usually money -- more quickly, and all parties are able to resolve a dispute and move on to more constructive endeavors. In addition, the significant reduction in time to judgment benefits all parties involved in the process: if parties spend less time litigating, they spend less money.

Moreover, by providing parties with the early opportunity to have their case heard, arbitration avoids many of the problems typically associated with delay in the court system, such as a witness's inability to recall facts and difficulty locating witnesses and documents long after the events at issue. The more efficient process that exists in arbitration also lessens the

substantial disruption in the parties' businesses and lives that is often involved with protracted court proceedings. Such a waste of resources helps no one. Arbitration reduces that waste.

SRO-Sponsored Arbitration is Fair and Effective

Some critics of the SRO-sponsored arbitration fora complain that the NASD and New York Stock Exchange are controlled by the securities industry and deliver inequitable and unfair results to customers. These complaints are belied by the facts. For example, a report prepared by the Securities Industry Conference on Arbitration ("SICA") in 2001 found that, of the 31,001 public customer cases decided by SRO arbitrators between 1980 and 2001, 52.56 percent resulted in customer awards.[5] Similarly, the most recent NASD statistics show that, of the 2,019 customer cases decided in 2004, 55 percent resulted in customer awards.[6] This echoes the results of an earlier study by the GAO.[7] In that study, the GAO analyzed results in arbitrations over an 18-month period from January 1989 to June 1990 and found that arbitration panels found for investors in 59 percent of cases in fora sponsored by the SROs versus 60 percent in arbitrations brought before the American Arbitration Association ("AAA"), an independent organization not associated with any SRO or securities industry group. When investors prevailed in SRO arbitrations, they recovered approximately 61 percent of their claimed damages versus approximately 57 percent in AAA arbitrations.[8]

But even these numbers understate customers' success in securities arbitrations. When critics complain that customers prevail in "only" half of the cases they bring, they ignore the fact that a large percentage of cases brought in SRO-sponsored fora result in favorable settlements for customers prior to a hearing. NASD statistics for 2004 show that approximately 54 percent of arbitrations that were closed that year were settled by the parties, or with the help of a mediator,

prior to a hearing.[9] Likewise, recent NYSE statistics show that of the 1095 cases closed in 2004, 554 (or approximately 51 percent) were settled prior to a hearing.[10] Taken together, these numbers mean that customers are collecting money in more than three-quarters of the cases that they bring in arbitration. That success rate is hardly indicative of a system biased against customers.

These studies, all conducted by unbiased third-parties, confirm that a claimant's chances in an SRO-sponsored arbitration forum are as good, if not better, than his or her chances in court or in another independent arbitral forum. That does not mean that customers will win every claim brought against a broker: one certainly would not expect that to be the case. But the statistics strongly support the anecdotal evidence that customers are given a fair shake.

Furthermore, studies have shown that claimants have a favorable view of the SRO arbitration process as it is currently structured. Specifically, between December 1997 and April 1999, the NASD surveyed participants in 2,037 cases that were closed with an arbitration award.[11] The results, which were analyzed independently by the U.S. Military Academy at West Point, revealed that approximately 93 percent of those surveyed agreed that the process was fair. In addition, although not specifically quantified, the NASD survey found that "[b]y and large . . . claimants viewed the process somewhat more favorably than respondents did."[12]

And experience shows that, when given a choice, customers have chosen SRO arbitration. In January 2000, a two-year pilot program was offered by SICA in which investors could choose to arbitrate their claims in certain non-SRO forums, like JAMS or the AAA. Of the 277 cases eligible for the program, only eight were submitted to one of the alternative programs.[13] This is strong evidence that <u>all</u> participants – customers and industry-related – believe that SROs provide a fair forum for resolution of securities customers' complaints.

The Process of Arbitrator Selection and Panel Composition Is Fair

Another point of recent criticism has focused on the selection of arbitration panels and the inclusion in most customer cases of one so-called "industry" arbitrator. This criticism, too, misses the mark, and is unsupported by any empirical evidence of flaws in the process. The truth is that the arbitrator selection process and the inclusion of an independent industry arbitrator on three-member arbitration panels are both fair and beneficial to all of the parties. The notion of a systemic problem of conflicted arbitrators is fiction. As Professor Michael Perino concluded, in his 2002 Report commissioned by the SEC, "there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations. Available empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair."[14]

Under the current structure in arbitrations before the NYSE and NASD, a three-member panel is required to include one arbitrator with some experience in or around the securities industry. The "industry" arbitrator cannot have any affiliation with the industry member involved in the proceeding and sits on the panel with two "public" arbitrators, who must have no affiliation with the securities industry. In addition, like the public arbitrators, the industry arbitrator must abide by the rules requiring him or her to disclose any circumstances that might preclude him or her from rendering an objective and impartial determination.[15]

First, it should be noted that arbitration panels -- in *any* field, not just securities -- typically include one or more arbitrators with experience in that field. This is usually considered a positive for all involved, providing a level of expertise that would not otherwise be available to the panel (and certainly would not be expected on a jury). The inclusion of *one* such arbitrator, particularly when balanced against the requirement that *two* of the arbitrators will have no

affiliation at all with the securities industry, does not create any pro-industry bias. Indeed, simple mathematics suggests just the opposite.

Second, in light of the ever-growing complexity of the financial products that are often the subject of arbitrations (such as options, annuities and structured products for high-net-worth individuals), and the technical issues that sometimes arise (for example, margin loan requirements), SIA believes that the presence of one arbitrator who is more familiar with these products and their appropriate and/or inappropriate use greatly increases the chances for the fairest resolution of claims.

So many cases today revolve around expert testimony from both sides on these topics. An arbitrator with experience in the business is in the best position to evaluate, and to help co-arbitrators evaluate, that testimony. In addition, arbitrators who have had some experience in the securities industry are more likely to be well-versed in the supervisory and compliance structure of brokerage firms, the duties and obligations of brokers and other financial professionals, and the regulatory framework under which these individuals and firms are required to operate. This knowledge benefits all parties, and does not bias the proceedings in favor of the securities industry.

Third, it is worth noting that there is *no* evidence suggesting that industry arbitrators have dissented from awards in favor of customers with any degree of frequency, nor that public arbitrators have dissented often from awards in favor of an industry member. The most typical result -- a unanimous award -- is a testament both to the collaborative and deliberative process that the mixed Panels undertake, and to the fairness of the conclusions they reach.

Moreover, the selection process used to choose the public and industry arbitrators is extremely equitable and transparent. Under the current system, each party is given a list of

public and industry arbitrators and is asked to rank them in order of preference. Each party is provided with extensive disclosures from the prospective arbitrators describing their background and listing all prior arbitration awards they have issued. These awards are publicly available on the Internet and by request from the SRO fora, thus making the potential arbitrators' backgrounds and history completely transparent. If a party wishes to do so, it can strike an arbitrator's name from the list and therefore will not be required to present its case to an arbitrator it does not favor. And if a party believes that a designated arbitrator is conflicted or otherwise inappropriate to hear a particular case, the rules provide for that arbitrator's removal "for cause."

There is simply no evidence of any systemic problem with arbitrator selection.

SRO-Sponsored Arbitration Provides Claimants with an Opportunity for a Hearing, Which They May Not Otherwise Obtain in Court

In addition to the efficiency and fairness benefits described above, parties who utilize arbitration are far more likely to have their claims aired in a full hearing, and decided on the merits, rather than won or lost on technicalities. This is in sharp contrast to court proceedings, where a significant percentage of claims are dismissed on pre-hearing motions to dismiss or for summary judgment.[16] Many of these dismissals are on what may be described as technical, or procedural, grounds. This includes dismissals for pleading failures, jurisdictional deficiencies, and statutes of limitations bars.

A plaintiff in a court case may be faced with a daunting gauntlet of obstacles: a threshold motion attacking the sufficiency of pleading in a complaint; formal document requests with no presumption of anything being properly discoverable; written interrogatories; depositions of fact witnesses; discovery motions; written expert reports; depositions of expert witnesses; formal

requests for admissions; a pretrial motion for summary judgment; interlocutory appeals of any decisions rendered before a trial; motions to preclude or allow certain evidence at trial; and then, finally, for the few who make it that far, a trial followed by almost automatic appeals by the losing party. And, if a customer prevails in court after all of that, he may have to hurdle additional obstacles just to get that hard-earned judgment enforced.

That is the reality facing those who need to resort to the court system. In contrast, arbitration allows for a simple statement of claim, an answer, presumptive discovery, and then a full merits hearing. While pre-hearing motions are permitted in arbitration, they are vastly more limited than those in court. The costs to get to a hearing are a fraction of what they are in traditional litigation. As arbitration practitioners will readily acknowledge, many claims that would otherwise have been dismissed in court on legal grounds are nonetheless presented on the merits to arbitrators, allowing the claimants an opportunity which he or she may otherwise never have had – an opportunity to persuade arbitrators that fairness and equity dictate that relief should be granted, even if the technical aspects of the law may not be on their side. And, as reflected in the significant percentage of cases that settle before a hearing, customers are able to use the leverage of a speedy hearing in negotiating favorable resolutions of disputes through mediation or other settlement negotiations.

Mandatory Arbitration Benefits Small Investors

Some have questioned the "mandatory" nature of arbitration, the fact that many, if not most, securities firms include in their account agreements with their customers a contractual provision requiring that all disputes be resolved through binding arbitration. Some critics of the process ask "Why is it permissible for securities firms to force customers to give up some of their rights, and to deny their customers access to the courts without affording them any choice in the matter? Why can't we let the parties choose to arbitrate, or not, *after* a dispute has arisen?"

Posing the question as an issue of a limitation on customers' rights just distorts the issue. By agreeing to arbitration rather than court-based litigation, parties choose their forum, not their rights. Arbitrators are empowered to grant all relief that a court can grant, including in the appropriate case punitive damages and/or attorneys' fees. In fact, arbitrators have an additional power with respect to the securities firms and their associated persons: they can, and do, initiate referrals to regulatory and disciplinary authorities if in the course of an arbitration hearing they become aware of conduct that in their view may constitute violations of SRO rules or the federal securities laws. And, unlike in court, if an industry member does not pay an award promptly, the regulators have the ability to suspend the member's license. That protection for customers is *only* available in arbitration.

But the truth is that mandatory arbitration provides the greatest benefit to the customer with the small claim. If all parties to a dispute have to agree to arbitrate rather than litigate *after* the dispute arises, any party can block arbitration if he sees an advantage in doing so. And human nature being what it is (channeled through clever lawyers), when a dispute does arise between a customer and a securities firm, the deeper pocket may perceive some advantage in

proceeding through traditional, slow, expensive, court-based litigation and veto any attempt at arbitration.

The result of this may well be that aggrieved customers with relatively small claims will find themselves without any remedy at all, as their access to cost-efficient arbitration would be blocked, and their claims may be too small for an attorney to risk taking. With the possibility of facing the full panoply of defenses and discovery hurdles that I discussed earlier, customers who do manage to bring a claim in court may find themselves at a severe disadvantage to deeper-pocketed defendants.

Agreeing in advance to arbitrate *all* disputes is a neutral event. This pre-dispute agreement ensures that the benefits of arbitration will in fact be available to all parties if needed.

"Creeping Litigiousness" Should Be Stopped

If SRO-sponsored arbitration is going to continue to provide the fair, efficient and superior results that I have been describing, we must guard against the "creeping litigiousness" that is threatening to destroy the process. What I mean by this is the series of proposals to alter some of the basic rules and principles of arbitration in order to make it more like traditional litigation. I believe these proposals are misguided. Famed law scholar Grant Gilmore observed:

> The values of a reasonably just society will reflect themselves in a reasonably just law. The better the society, the less law there will be. In Heaven there will be no law, and the lion will lie down with the lamb. The values of an unjust society will reflect themselves in an unjust law. The worse the society, the more law there will be. In Hell there will be nothing but law, and due process will be meticulously observed.[17]

Arbitration should not take on more of the characteristics of a court case. Already, the length of hearings and number of sessions to conclude arbitrations have steadily increased over the last several years. Arbitrations have grown increasingly complex and are gradually adopting

litigation-style procedural devices that reduce the efficiency and anticipated economy of the system. Arbitration hearings used to seldom last more than a few days. Today, it is not at all uncommon for hearings to stretch over ten, twenty, or more days over several months or even years. This trend must be reversed if arbitration is to continue to fulfill its promise of less expensive, expeditious, *and consumer-friendly* resolutions of disputes.

Along those lines, some of the changes to the arbitration process that recently have been proposed should be rejected. For example, the NASD's recently proposed rule change that would require arbitration panels, upon request of a customer, to provide written explanations of their awards[18] would be counterproductive and contrary to the spirit of arbitration. By turning arbitrators into pseudo-judges, forced to write opinions that are subject to review, this rule would inevitably lead to more appeals from arbitration awards. Any explanation provided by an arbitration panel would be closely parsed by the losing party, in an effort to identify possible grounds for undermining the finality of the award. Although no doubt well-intended by people who believe written explanations will be helpful to customers, this new requirement will be anything but customer-friendly: it will undermine the chief benefit of arbitration by adding the opportunity for an additional layer of costs and legal maneuvering. The relative finality of arbitration decisions that exists today could be destroyed, which would be a detriment to investors and industry members alike.

Similarly, critics of the current system who have called for the expansion of pre-trial discovery are off the mark. The current system, which includes clear lists of presumptively discoverable material from both sides, works well. If parties in a particular case do not comply with their discovery obligations, arbitrators are empowered to deal with those violations. And the SROs have shown that they are ready and willing to act if they see more systemic problems

with member firms. But there is no reason to turn arbitration discovery into the war of attrition that is all too familiar to parties in court cases. It is the avoidance of full blown discovery in arbitration that permits the process to work for all, including customers with small claims.[19]

Conclusion

In conclusion, SIA believes strongly that the current system of SRO-sponsored arbitration not only works, it works well. Is it perfect? No, of course it is not, nor is any alternative system, currently in place or proposed, perfect. Inevitably, any system that processes thousands of cases a year will produce the occasional anomalous result. But the point is not to compare securities arbitration to utopia -- the only useful exercise is to compare arbitration with traditional, court-based litigation, and in that contest, arbitration wins hands-down for efficiency, user-friendliness, and fairness. The NASD, the New York Stock Exchange and the securities industry continue to work hard to take into account the concerns and issues raised by all participants, and to adjust the process as needed. The facts show that disputes continue to be resolved more expeditiously, efficiently, and fairly than they would be in our already overburdened court systems.

Thank you for holding this hearing and for inviting me to testify. I would be pleased to answer any questions.

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firm to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund

companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,0000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2004, the industry generated an estimated $228 billion in domestic revenue and $305 in global revenues.

[2] Obtained from the NASD's Web site at address: http: //www.nasd.com, visited as of March 9, 2005.

[3] The Southern District of New York was chosen because of the large number of securities-related cases filed in that court.

[4] Obtained from the Federal Court Management Statistics Web site at address: http://www.uscourts.gov/cgi-bin/cmsd2004.pl, visited as of March 14, 2005. This data is also supported by studies conducted in the employment context. In particular, a recent study comparing timing factors involved in 125 employment discrimination cases filed in the United States District Court for the Southern District of New York with 186 arbitrations involving employment disputes in the securities industry showed that arbitration was significantly more efficient than litigation in the court system. Specifically, the study found that the median time from filing to judgment was 16.5 months for arbitration and 25 months for claims brought in court. See Michael Delikat & Morris M. Kleiner, Comparing Litigation and Arbitration of Employment Disputes: Do Plaintiffs Better Vindicate Their Rights in Litigation?, A.B.A. Lit. Section Conflict Mgmt., Vol. 6, Issue 3, Winter 2003. The results of this recent study are not at all surprising, since they mirror the results of a similar study conducted by SIA in 1998. In the 1998 study, SIA compared the results of employment discrimination claims brought before the New York Stock Exchange ("NYSE") and the NASD between February 24, 1992 and March 31, 1998, with those brought in the federal court in New York. The study showed that the average length of time between the filing of a claim in arbitration and the rendering of an award after hearing was 15.6 months for the NYSE and 17.8 months for the NASD. Conversely, resolution of similar claims in the court system took 27.5 months to resolve.

[5] SICA, Eleventh Report 125 (2001).

[6] Obtained from the NASD's Web site at address: http: //www.nasd.com, visited as of March 9, 2005.

[7] See GAO, Securities Arbitration: How Investors Fare, Rep. No. GAO/GGD-92-74 (May 1992).

[8] A study of securities industry employment disputes, which compared various outcomes in employment discrimination cases filed in the Southern District of New York with similar cases brought in SRO arbitration for a, echoed these results. That study revealed that Claimants in arbitration prevailed 46 percent of the time, while plaintiffs who brought cases in court prevailed only 34 percent of the time. And arbitration outcomes generated a higher median monetary award for claimants in arbitration – $100,000 – versus plaintiffs in court – $95,554.Michael Delikat & Morris M. Kleiner, Comparing Litigation and Arbitration of Employment Disputes: Do Plaintiffs Better Vindicate Their Rights in Litigation?, A.B.A. Lit. Section Conflict Mgmt., Vol. 6, Issue 3, Winter 2003.

[9] Obtained from the NASD's Web site at address: http: //www.nasd.com, visited as of March 9, 2005.

[10] Obtained from the NYSE's Web site at address: http://www.nyse.com/pdfs/arbstats031105.pdf, visited as of March 9, 2005.

[11] 4,174 surveys were distributed (one to each side), and responses were received from 414 participants (54 percent returned by claimants, 46 percent returned by respondents).

[12] George H. Friedman, Selected Developments at NASD Dispute Resolution, in Securities Arbitration 2000 Today's Trends, Predictions for Tomorrow 153 (David Robbins ed. 2000).

[13] See SICA, Final Report Securities Industry Conference on Arbitration Pilot Program for Non-SRO Sponsored Arbitration Alternative (2002).

[14] Michael A. Perino, Report to the Securities Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, Nov. 4, 2002, at 48.

[15] See NYSE Arbitration Rules, Rule 610(a); NASD Code of Arbitration Procedure § 10312(a).

[16] Theodore Eisenberg, Federal District Court Civil Cases (obtained from Web site at address: http: //teddy.law.cornell.edu:8090/questcv3.htm, visited as of March 9, 2005).

[17] G. GILMORE, THREE AGES OF AMERICAN LAW 111 (1977).

[18] New Arbitration Rule Requires Award Explanations Upon Investor Request, NASD News Release, Jan. 27, 2005.

[19] For example, an investor with a claim for $50,000 would have great difficulty in finding an attorney to take her case if the specter of numerous depositions and detailed written discovery like what exists in court cases were to become part of arbitration. The costs associated with such discovery could quickly run into the tens of thousands of dollars, thus, again, defeating the purpose for which SRO-sponsored arbitration was created.