Testimony of Tanya Solov

Director, Illinois Securities Department
Illinois Secretary of State
On behalf of the North American Securities Administrators Association

Before the
United States Senate Committee on the Judiciary
Constitution Subcommittee

"S. 1782, the Arbitration Fairness Act of 2007"

December 12, 2007

Chairman Feingold, Ranking Member Brownback, and Members of the Subcommittee,

I am Tanya Solov, Director of the Illinois Securities Department and I am honored to convey the North American Securities Administrators Association's (NASAA)[1] support for S. 1782, the Arbitration Fairness Act of 2007. State securities administrators view this issue with such importance that the second item listed on NASAA's 2007 Pro-Investor Legislative Agenda was "Restore Fairness and Balance in the Securities Arbitration System." We're delighted with your leadership on this subject and thank you for the opportunity to testify about arbitration from the perspective of investors on Main Street.

The Role of State Securities Regulators

The securities administrators in your states are responsible for enforcing state securities laws, the licensing of firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials. Like me, ten of my colleagues are appointed by their Secretaries of State, others by their Governors, some are independent commissions, and five fall under the jurisdiction of their states' Attorneys General. We have been called the "local cops on the securities beat," and I believe that is an accurate characterization.

As the securities director for the state of Illinois, I interact with investors who approach me at various programs across the state or call my office with inquiries and complaints. My office works with criminal authorities to prosecute companies and individuals who

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

commit crimes against our citizens, and brings civil actions for injunctions, penalties and restitution for investors. We also educate our constituents through publications, videos and seminars so that they may be better able to protect themselves.

Mandatory Securities Arbitration

The Constitutional right of investors to have their day in court was rendered meaningless after the U.S. Supreme Court held in *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987), that predispute arbitration clauses were enforceable in the securities context. The impact of that decision is more profound today because the profile of those investing in our capital markets has changed significantly since the *McMahon* case was decided in 1987. We've gone from a nation of savers to one of investors. Twenty years ago, those investing in the securities markets were higher income individuals with other secure sources of income such as a defined benefit pension plan. Today, roughly half of all U.S. households rely on the securities markets to plan and prepare for their financial futures. They include school teachers, fire fighters and policemen who work in your communities, invest in their 401(k) retirement plans, and depend on their financial advisors' representations regarding their financial future.

Twenty years ago, investors had a choice of investing with a firm that required arbitration or one that recognized a judicial forum for disputes. Today, almost every broker-dealer includes in their customer agreements, a predispute arbitration provision that forces public investors to submit all disputes that they may have with the firm and/or its associated persons to mandatory arbitration. The only chance of recovery for most investors who fall victim to wrongdoing on Wall Street is through a single securities arbitration forum maintained by the securities industry. Many investors remain unaware of this industry arbitration provision, fail to appreciate its significance, or feel powerless to negotiate a different approach to dispute resolution with their brokers.

It is not surprising that many investors view industry arbitration as biased and unfair. Even in 1987, Justice Blackmun, in the *McMahon* dissent, noted: "The uniform

opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be *some* truth to the investors' belief that the securities industry has an advantage in a forum under its own control." (482 U.S. 220, 260, citing Sheldon H. Elson of the ABA Arbitration Task Force). Investors' perception that the industry has an advantage is bolstered by arbitration statistics. An investor's chance of winning an arbitration award has declined from approximately 60% in 1989-90 to about 43% by 2006. (See Securities Arbitration-How Investors Fare, GA/GGD-92-74, (May 11, 1992); NASD Dispute Resolution Statistics). It is also noteworthy that a "win" in arbitration often amounts to recovery of only a fraction of the losses incurred by the investor and, in certain instances, the sum awarded amounted to less than the costs and fees the investor paid out of pocket to pursue the case.

When arbitration is inadequate to protect the substantive rights of investors, an independent judicial forum must be an option. Arbitration may be desirable and adequate if both parties knowingly and voluntarily agree to waive the Constitutional rights provided in court. The decision to make this waiver should be made at the time the dispute arises. At this point, both parties may make the determination whether their particular dispute is best decided in a court of law with court-supervised discovery, a written opinion, and appellate review of complex legal issues.

The Financial Industry Regulatory Authority (FINRA) should require its member firms to offer their customers a meaningful choice between binding arbitration and civil litigation. If arbitration really is fair, inexpensive, and quick, as its adherents claim, then these benefits will prompt investors to choose arbitration. If, on the other hand, arbitration does not offer these advantages, then this mode of dispute resolution should not be forced upon the investing public.

NASAA believes the "take-it-or-leave-it" clause in brokerage contracts is inherently unfair to investors, and we support the Arbitration Fairness Act of 2007 as a positive step in the right direction. In the securities context, the investor and the brokerage firms are

not on equal footing. Brokerage firms have significantly more resources to fight investor claims and they currently have the benefit of arbitrating in their own industry forum with an industry member hearing the case. Adding to this advantage is the level of familiarity and comfort that firms have in the arbitration forum. Brokerage firms are literally "repeat customers" having resolved thousands of complaints by arbitration and by this fact enjoy an advantage over the individual investor who may well be facing an arbitration panel for the first time. The hazards of litigation for the firm are thereby reduced further diminishing a firm's motivation to settle a complaint. The option to litigate in an independent judicial forum would go a long way towards bringing balance to the process and helping wronged investors in their attempts to recover their losses.

Until mandatory securities arbitration is a thing of the past, NASAA will continue to work to eliminate the inherent industry bias in the existing system. NASAA has been at the forefront of trying to make certain the securities arbitration system is fair and transparent to all. We recognize that over the years NASD, now FINRA, adopted a number of changes in an effort to improve the arbitration system, but more is needed. The consolidation of NASD and NYSE into FINRA has effectively resulted in a single industry run forum for the resolution of disputes between public customers and the securities industry. As a consequence, NASAA's concerns, and those of others actively engaged in arbitration issues, have been further heightened. Indeed, the public members of the Securities Industry Conference on Arbitration (SICA) wrote to Securities and Exchange Commission Chairman Christopher Cox[2] to address certain questions raised by the consolidation with respect to the future of securities arbitration. NASAA believes that absent the option of pursuing a claim in court, investors should at least be given a choice of arbitration forums; however, where there is no choice but arbitration through a program administered by FINRA, then this one forum must at least be independent and fair to investors.

[2] Letter from Public Members of SICA to SEC Chairman Christopher Cox, (Jan. 12, 2007) (on file with author).

Reforms to the Current System

Securities arbitration cases are heard by a three-member panel that includes one "non-public" or securities industry member, and two "public" members, who may have worked in the industry. Neither of the public arbitrators is required to be an investor advocate, even though the non-public arbitrator *is* required to be an industry representative, and only FINRA, the industry SRO, selects who is qualified to be in the arbitrator pool. As long as arbitration panels include a mandatory industry representative of the securities industry and include public arbitrators who could have ties to the industry, the arbitration process will be both perceptively and fundamentally unfair to investors.

Many have justified mandatory industry participation based on the industry representative's role as an educator for the other panelists. It may be acceptable only if all parties in the case voluntarily agree that an industry expert is needed. However, if there is not agreement then there is no justification for the industry presence. First and foremost, expert witnesses ably serve the purpose of educating the arbitrators. In addition, where arbitration was once selected on a voluntary basis by investors seeking to handle simple disputes, the advent of mandatory arbitration moved all customer grievances to a more sophisticated arbitration process. Cases are typically presented by lawyers, they generally last for several days and the use of retained expert witnesses to present industry practices, procedures and rules to the panels is typical.

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. However, industry arbitrators bring their particular experiences, based on their firm's training, policies and procedures, to the decision-making process. As evidenced by industry scandals and regulatory enforcement actions, the industry's way of doing things is not always in conformance with the law. Even if the industry arbitrator has no preconceived notions, the industry arbitrator creates a presumption of bias that is contrary to the principles of fair play and substantial justice. Do courts in

complex medical malpractice cases insist that one physician be empanelled in the jury box to "educate" the other jurors? 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. It is also disconcerting that the industry believes that the public arbitrators are not capable of understanding a case and rendering a decision. If that is indeed true, investors should not be forced to bring their case in such a forum. NASAA submits that intellectual honesty should not be discarded at the door of the arbitration forum.

When *McMahon* was decided, that Court noted several arbitration forums where industry members sat on the panels. In most of those instances, the parties in arbitration were also both industry members who were on equal footing. Consequently, industry arbitrators and their expertise would have been appropriate. That is not the case in securities cases where the investor is not on equal footing with the brokerage firm. (*McMahon,* 482 U.S. at 224, citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.* 473 U.S. 614 (1985)).

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.

NASAA urges the removal of mandatory industry arbitrators from the arbitration process, and for public arbitrators to have no ties to the industry. This change will bring greater fairness to securities arbitration and instill greater confidence in retail investors that their complaints will be heard in a fair and unbiased forum.

Change The Definition Of A "Win" In Arbitration

FINRA should improve the statistics that it collects and disseminates on arbitration, particularly with respect to outcomes. Proponents of arbitration often point out that

investors receive "some amount of compensation" in over half of the arbitrations that result in a decision. *See, e.g.*, Linda D. Feinberg, Testimony Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, House Committee on Financial Services, at 1 (Mar. 17, 2005).[3] To the extent this statistic is intended to suggest that investors "win" more often than not, it is misleading. An investor who recovers only a small fraction of their losses in the arbitration process can hardly be described as a "winner," especially when attorneys' fees and costs are added to the mix. Much more accurate, for example, would be data reflecting the ratio of amounts awarded in relation to damages claimed. Fairly assessing the pros and cons of arbitration as a means of dispute resolution requires access to meaningful and accurate statistics.

State securities regulators often hear directly from investors who relay their experiences and concerns about the arbitration process. NASAA is in a position to communicate such problems to the SEC and FINRA. Recently, NASAA was admitted as a voting member to SICA which is one group that works on arbitration procedures and issues. It would also be beneficial to allow NASAA to be an official observer at the National Arbitration and Mediation Committee (NAMC) meetings where FINRA will address arbitration rules and procedures.

Conclusion

NASAA believes that securities arbitration system should be truly voluntary, that more meaningful and accurate statistics concerning arbitration outcomes should be compiled and disseminated, and the balance in the composition of arbitration panels should be restored.

As long as securities arbitration remains mandatory, investors will continue to face a system that is not fair and transparent to all. For this reason, NASAA supports the

[3] *Available at* *http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013652&ssSourceNodeId=1263*.

passage of S.1782, the Arbitration Fairness Act of 2007, and respectfully suggests that it be amended to clarify that its provisions extend to securities arbitration.

I thank the Chairman and each member of this Subcommittee for allowing me the opportunity to appear today. I look forward to answering any questions you have and providing additional assistance to you in the future.