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June 25, 2012

Ms. Monica Jackson
Office of the Executive Secretary
Consumer Financial Protection Bureau
1700 G Street, NW
Washington, DC 20552

Re: Comments in Response to Docket No. CFPB-2012-0017, Request for Information Regarding Scope, Methods, and Data Sources for Conducting Study of Pre-Dispute Arbitration Agreements.

Dear Ms. Jackson:

The North American Securities Administrators Association, Inc. ("NASAA")[1] submits the following comments in response to the above-referenced information request. NASAA appreciates the Consumer Financial Protection Bureau's ("CFPB" or "Bureau") efforts to launch a public inquiry into pre-dispute arbitration agreements ("PDAA"), as NASAA has historically opposed the use of such agreements by broker-dealers and investment advisers. Although the CFPB's jurisdiction does not extend to securities industry participants such as broker-dealers and investment advisers, PDAAs are a standard in the securities industry. Accordingly, in the comments below, NASAA offers its experience and knowledge of PDAAs in order to aid the CFPB in its inquiry into the use of these provisions in the consumer financial products context.

Background

PDAAs became a securities industry standard after the U.S. Supreme Court decision in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), which held that pre-dispute arbitration clauses were enforceable in contracts between customers and those providing investment services. This decision effectively nullified the fundamental right of investors under the Seventh Amendment to the United States Constitution to have their day in court, and consequently deprived investors of important substantive rights under state and federal securities laws adopted expressly for the protection of investors.

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as the forum for these regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

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Assessing the Prevalence of PDAAs in the Securities Industry.

In Question 1.i., the Bureau asks how it should determine the prevalence of pre-dispute arbitration agreements. In NASAA's experience, the prevalence of PDAAs in the securities industry is pervasive. They are used in customer contracts and employment contracts. We believe that similarities can be drawn between the use of such provisions in the securities industry with the use of PDAAs in consumer finance markets.

Assessing the prevalence of PDAAs is a simple task in regard to securities broker-dealers as virtually all firms include a mandatory PDAA as a part of the form that every investor signs in order to open an account. As to investment adviser firms, they are required to register with either the SEC or the states, and provide a Form ADV Part 2 to the regulator and their customers. This form indicates whether a PDAA is used in the Investment Adviser contract. NASAA has informally observed a growing trend in the use of these agreements by investment advisers, which NASAA sees as a serious conflict of interest between the investment adviser and the customer, to whom the adviser owes a fiduciary duty.

NASAA urges the Bureau to recognize the harm to consumers from the continued use of mandatory PDAAs, as well as their encouragement by recent US Supreme Court decisions, and encourages the Bureau to expeditiously assess this practice and to restore the constitutional rights of consumers as quickly as possible.

NASAA is not aware of any independent clearinghouse of information on the prevalence of PDAAs. The most accurate way to assess the extent of PDAA use is to require all financial service companies who utilize such agreements to submit them and disclose a) whether they are mandatory, b) when they began using them, c) when they became mandatory (if not always so) and if not, d) how they make the customer aware that it is optional, how to object, and the number of customers who reject them in proportion to the number who accept them.

Prevalence Review Focus.

Question 1. ii. asks whether the Bureau should focus its prevalence review on particular markets for consumer financial products and services. Given NASAA's experience with the use of such provisions in investor contracts, NASAA believes that the CFPB should pay particular attention to the use of such provisions in agreements with smaller, retail customers. Further, the Bureau should also seek information on any differences in the use or terms of these provisions based on the type of customer. For instance, customers with substantially more bargaining power are treated differently than customers of less means.

Limiting Terms.

Question 1.iii. asks whether the Bureau should focus on particular terms in its review. Of paramount concern to NASAA is the denial of due process created by mandatory PDAA use, restricting the fundamental right of customer and investors to their constitutionally protected day in court. Once choice is restored to investors, the Bureau should certainly look at terms that

require a particular forum, venue or choice of law, and terms that limit class actions or consolidated arbitrations.

Evolution of PDAAs.

Question 1.iv. asks if the Bureau should look at the evolution of PDAAs over time. NASAA believes a review of the history of arbitration is very relevant to the Bureau's inquiry. Arbitration began as a way for two parties of equal power and often with the same or similar expertise in an industry to agree to have their dispute heard by a neutral third party who also had the same or similar expertise in the industry. This arbitration proceeding was a private non-judicial forum that was binding on the parties, could only be appealed on the most narrow of grounds, and did not require the arbitrator to follow any law. No legal precedent was created, and the findings were not public. The expense (attorney fees, discovery, depositions, etc.) and delays of litigation were avoided in exchange for the right of due process.

Somewhere along the way, it was forgotten that arbitration was not merely litigation in another forum, but involved a private system without full discovery and a very limited right of appeal; no requirement that the law be applied, no creation of legal precedent; and no transparency to protect the parties from corruption. Court decisions were rendered that mistakenly viewed arbitration as a separate but equal dispute resolution process. This was where the system started to fall apart, and customers with little or no bargaining power started to be forced into signing PDAAs in order to purchase a good or service.

At first, courts accepted the argument that, if customers were not happy with arbitration as their mandatory remedy, they would stop purchasing the goods and services of that provider. This was short-sighted, however, since once mandatory PDAAs received the courts' blessing, every service provider in the industry began to use them, realizing the advantages they had. The PDAAs were no longer voluntary on the part of customers.

Again, drawing on the development and use of these provisions in the securities industry, before the *McMahon* decision in 1987, use of mandatory PDAAs was not common among broker-dealers. Since the *McMahon* decision allowing the use of mandatory PDAAs by broker-dealers, virtually every broker-dealer firm now requires mandatory PDAAs. While NASAA has advocated for reforms to the dispute resolution process involving investors, the fundamental problem remains that individual investors should not be prohibited from choosing the forum in which they can pursue their claims against their broker-dealer. They should be able to choose to have the law applied to their claims, to pursue full discovery, to appeal the decision, to have a written decision explaining the outcome, in a public venue open to public review and allowing the development of the law and preventing corruption.

Pertinent Data and Studies.

Question 1.v. asks what data should be obtained and reviewed by the Bureau, and whether any studies exist which address these issues.

In addition to our suggested inquiries to financial services providers addressed in Question 1.i. above, the Bureau should also review the study by Jill Gross *"Perceptions of Fairness of Securities Arbitration: An Empirical Study,"* 2008 J. DISP. RESOL. 349 (2008), and the study by Edward S. O'Neal and Daniel S. Solin entitled *"Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimants Fare,"* www.slcg.com/pdf/news/mandatory%20Arbitration%20Study.pdf (last visited June 25, 2012). The Public Citizen has studied costs of arbitration, and a discussion of its report (on file with author), *available at* http://www.citizen.org/publications/publicationredirect.cfm?ID=7173 (last visited June 25, 2012).

The CFPB Should Determine How Often Consumers Bring Claims in Arbitration.

Question 2.A.i. asks whether the Bureau should determine how often consumers bring claims in arbitration.

PDAAs are virtually mandated in broker-dealer account opening agreements, therefore, customers of those firms are required to resolve their disputes through arbitration using the Financial Industry Regulatory Authority ("FINRA") Dispute Resolution process. The number of customers who pursue arbitration in this venue, in addition to a variety of arbitration statistics, are posted on FINRA's website at:

http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ (last visited June 25, 2012).

These statistics clearly demonstrate the prevalence of arbitration in the securities industry. The Bureau should require all financial services providers to disclose similar information to the Bureau. It is difficult to determine how many investors have disputes with the broker-dealers who elect not to arbitrate, however, a correlation to the total number of unresolved customer complaints received by broker-dealer firms may provide some indication.

The Subject Matter of an Arbitration Claim is Inconsequential When Compared to the Denial of Due Process Rights.

Question 2.A.ii asks whether the Bureau should analyze the types of claims that consumers bring in arbitration.

Given the diversity of claims brought by customers in the financial products and services industry, NASAA believes that the Bureau's resources would be better served by ensuring consumers' access to their right to due process by prohibiting the use of mandatory PDAA clauses. Determining whether to act in support of consumer rights should not be dependent upon the subject matter of the claim. If the Bureau agrees with NASAA's assertion that consumers should have the right to choose the forum and process by which their disputes are

resolved, then the basis of the claim should have no bearing on the vehicle used to supply that remedy.[2]

Analyzing the Cost, Speed, and Outcome of Arbitration Claims Will Reveal the Inefficiencies of Arbitration Not Often Discussed.

Question 2.A.iii inquires whether the Bureau should seek to analyze: (a) the cost and speed of dispute resolution; and/or (b) the outcome of disputes for claims that consumers bring in arbitration.

NASAA supports the Bureau's investigation into the cost and speed of dispute resolution as well as dispute outcomes. It is NASAA's experience that each of these measurements will demonstrate that PDAAs in the securities industry neither expedite resolution nor reduce the expense of traditional litigation. NASAA has also expressed concern over the consumer win rate in arbitrations, especially as measured by FINRA. NASAA believes that the results of Bureau's analysis into these elements will disprove claims that arbitration is less expensive and more expeditious than a similar proceeding in court.

According to Public Citizen, a non-profit organization serving the people's voice in the nation's capital, "although the claim is frequently made that arbitration costs less than litigation, no research has ever been undertaken to substantiate it. No interest group has commissioned a study. No Member of Congress has asked for a General Accounting Office report."

Public Citizen has created a report on the costs of arbitration that should be referenced as a part of the Bureau's analysis on this topic. They found that; a) the cost to a plaintiff of initiating arbitration is almost always higher than the cost of instituting a lawsuit, and b) arbitration costs are high under a pre-dispute arbitration clause because there is no price competition among providers, among other findings. To obtain a copy of their entire analysis, see instructions at: http://www.citizen.org/publications/publicationredirect.cfm?ID=7173#o

The Bureau Should Seek to Assess Consumers' Understanding and Satisfaction With Arbitration.

Question 2.A.iv asks whether the Bureau should seek to assess consumers' understanding of, and satisfaction with, the resulting dispute resolution process and whether the Bureau should seek to determine the factors that impact consumer understanding and satisfaction.

Consumer understanding of and satisfaction with the resulting dispute resolution process is key to assessing whether PDAAs are being accurately represented and explained in their respective contracts. The consumer perspective is critical, and should be solicited directly from the

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[2] For the Bureau's information, however, claim types are detailed in FINRA's arbitration statistical reporting at: http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/

participants in the arbitration system. For the broker-dealer industry, the names and addresses of all customers who filed arbitration claims with FINRA, whether resolved by award or settlement, should be contacted to determine this information.

The *New York Times* cites in an article by Amalia D. Kessler published March 6, 2012 that "because arbitration decisions are typically not disclosed and not subject to appeal, consumers are left without recourse and must bear the cost of unfair, deceptive and harmful practices." Amalia Kessler, *Stuck in Arbitration*, NEW YORK TIMES, Mar. 6, 2012, (on file with author) *available at*, http://www.nytimes.com/2012/03/07/opinion/stuck-in-arbitration.html. The lack of transparency and inopportunity to appeal is a significant factor in the dissatisfaction with the FINRA arbitration process.

Empirical Studies of Securities Arbitrations.

In Question 2.A.vi, the Bureau asks whether it should address some or all of the issues identified in 2.A.i-v above, and if so, what methods of study should it use? What new data, if any, should the Bureau seek and from which entities? What existing studies or empirical data, if any, should the Bureau use? Should the Bureau focus on particular product markets? Should the Bureau focus on the impact to arbitral proceedings of particular terms in pre-dispute arbitration agreements?

As addressed above, to better inform its understanding of the use of PDAAs, the Bureau should seek information (see Q1.) from a wide range of customers including customers of securities broker-dealers. The Bureau should also, require financial service companies who utilize such agreements to submit them to the Bureau and disclose a) whether they are mandatory, b) when they began using them, c) when they became mandatory (if not always so) and if not, d) how they make the customer aware that they are not required, how to object, and the number of customers who reject them in proportion to the number who accept them.

NASAA recommends that the Bureau review the study by Jill Gross *"Perceptions of Fairness of Securities Arbitration: An Empirical Study,"* 2008 J. DISP. RESOL. 349 (2008), and the study by Edward S. O'Neal and Daniel S. Solin entitled "*Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimants Fare,"*
www.slcg.com/pdf/news/mandatory%20Arbitration%20Study.pdf (last visited June 25, 2012).

In addition, the Bureau should utilize the information compiled by Public Citizen's Access to Justice – Fair Arbitration research, available at, http://www.citizen.org/Page.aspx?pid=2512

Claims Made by Financial Services Providers Against Consumers.

Questions B.i.- v. ask for information about arbitration claims made by financial services providers against consumers. NASAA is not aware that this has been a problem, and probably occurs most often when customers do not meet their margin calls. NASAA believes the other issues raised in this request for comment are more important than any of the questions raised in Section B.

Mandatory PDAAs Do Not Give Customers Notice of Their Rights and Result in a Lack of Precedent and Transparency.

Question 3 raises very important issues regarding the impact of widespread use of consumer arbitration on society in general as well as the individual claimants. As to Question 3.i., because of the high costs of not only filing a claim in arbitration but paying for each hearing in addition to other expenses such as attorney fees, mandatory PDAAs have a chilling effect on consumers in determining whether to bring a claim. Because arbitrators are not trained or required to apply state or federal laws and are reluctant to award the full measure of damages, it is difficult for consumers to find attorneys willing to represent them on a contingency basis unless their claims are very large. This greatly diminishes the rights of small investors. Further, when companies know that customers have no practical way of enforcing their rights, they have less incentive to fully comply with the law.

Customers are rarely fully aware of their legal rights when obtaining services from covered persons so it is not surprising that they do not realize the significance of signing a PDAA. They do not understand that they are giving up the right to have the law applied to their claims, to have full access to discovery, to have a record created of their trial, and to appeal the final decision if they wish. Even when they are not comfortable signing the PDAA, they are often too intimidated to ask if that clause could be stricken, or to object to it. The customer also rarely understands at the time of signing that arbitration forums have significant filing fees and assess expenses to the parties for every hearing.

Mandatory PDAAs not only harm individual customers, but, more importantly, harm society as well. When virtually all customer claims go to arbitration, the development, interpretation, and application of the rule of law vanishes. This has already occurred with respect to customer claims against their broker-dealers. There has been no development of legal precedent in this area since all firms started using mandatory PDAAs. Most post-*McMahon* court decisions in securities cases involve class actions or jurisdictional dismissals of cases where the customer is simply referred to arbitration.

Another serious problem is the lack of transparency or accountability when all claims are required to be heard in a private forum. The strength of the American legal system resides in its accessibility and that virtually all matters are a part of the public record. Thus, our system is less susceptible to bias or corruption than a private system. These important standards are undermined by the use of mandatory PDAAs. It is important to restore to customers the right to choose their forum freely after the dispute has occurred. Mandatory PDAAs are never appropriate unless freely entered into by parties of relatively equal bargaining power, and that is not the case in customer arbitrations.

Further, Question 3.ii. asks whether the Bureau should study how the use of pre-dispute arbitration agreements impacts consumers and/or covered persons in any other ways that are independent of their role in particular arbitral proceedings. The Bureau should seriously consider the impact of the use of mandatory PDAAs in the customer context on the legal system, not only

on the development of the law, but on the transparency of the proceeding and need for due process.

Finally, Question 3.iii. asks what methods of study and data the Bureau should seek. As stated above, NASAA believes that mandatory pre-dispute arbitration agreements have been detrimental to individual customers and society in general. NASAA is often frustrated by a lack of current data to compare the success of investors in court versus in arbitration because all customer cases against broker-dealers go to arbitration. Perhaps this detriment to the legal system can be of some help to the Bureau in reviewing what happens once customers are precluded from the legal system, as occurred since the *McMahon* decision in the securities broker-dealer context. Any review of court decisions, however, must discount any implication that arbitration is merely an alternative but equal forum, because as we have discussed above, any forum which does not require the law be applied, that does not allow full discovery and that does not provide for full appeal rights and transparency is NOT equal.

In addition to a review of court decisions, the Bureau should review studies done by Public Citizen (referred to above), the Consumer Federation of America, as well as the study by Jill Gross, *"Perceptions of Fairness of Securities Arbitration: An Empirical Study,"* 2008 J. DISP. RESOL. 349 (2008), and the study by Edward S. O'Neal and Daniel S. Solin entitled "*Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimants Fare,*" available at, www.slcg.com/pdf/news/mandatory%20Arbitration%20Study.pdf (last visited June 25, 2012), and David Schwartz, *Claim Suppressing Arbitration – the New Rules*, 87 IND. L.J. 239 (2012). FINRA has a great deal of data on arbitration proceedings, most of which is public. In addition to the published award information and statistical information, the Bureau should request any additional information needed from FINRA, such as the names and addresses of all customers filing arbitration claims, including those that withdrew or settled their claims, so they can be surveyed.

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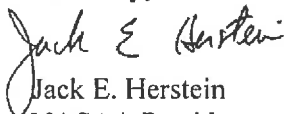
NASAA commends the Bureau for undertaking this study. We believe that the studies and other research referenced throughout this letter regarding the use of PDAAs by broker-dealers and investment advisers can inform the Bureau in this important undertaking. Although not subject to the Bureau's jurisdiction, the widespread use of PDAAs in the securities industry and its effects on investors should be considered in any study on the subject of pre-dispute arbitration agreements. Ultimately, we are confident that the Bureau will conclude that the use of these provisions within consumer contracts should be prohibited thereby restoring to consumers their full rights to seek redress under the constitution.

Sincerely,



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