

OVERSIGHT OF SELF-REGULATORY ORGANIZATION ARBITRATION

EXECUTIVE SUMMARY

We conducted an audit of the Commission's oversight of Self-Regulatory Organization (SRO) arbitration programs.¹ Overall, we found that oversight operations were effective and efficient. Commission review of SRO rule filings and inspections of SRO arbitration programs were generally thorough and timely. Additionally, officials from the SROs, industry groups, and academia were mostly complimentary of the Commission's oversight and spoke highly of the professionalism and experience of Commission staff.

SRO and investor representatives to whom we spoke identified several policy issues, the majority of which Commission staff were aware of and had either considered or had plans to address. These issues involved predispute arbitration agreements, unpaid arbitration awards, panel selection, securities mediation, contingency plans, on-line filings, legal representation, the Securities Industry Conference on Arbitration, and noteworthy practices memoranda.

We also identified potential enhancements to Commission oversight operations, which would enhance public understanding of and confidence in SRO arbitration programs. Specifically, we are making recommendations regarding public awareness, data analysis and tracking, complaint information, and arbitration guidance.

BACKGROUND

Arbitration resolves disputes between two or more parties through decisions made by impartial, knowledgeable persons. Because arbitration is inexpensive and fast, it has long been used as an alternative to the courts to resolve disputes between broker-dealers and their clients. An arbitration award is generally final and binding, subject to review by a court only on a very limited basis. Parties using arbitration generally give up their right to pursue the matter through the courts.

The total number of arbitration cases received at the SROs in 1997 was 6,665. Of this amount, 5,997 (or 90%) and 546 (or 8%) were filed at the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE), respectively. Thus, almost all (98%) of 1997 arbitration cases were filed at the NASD and the NYSE.

¹ We reviewed Commission oversight operations, but not the results of Commission oversight policies.

Broker-dealers typically require prospective customers to sign an agreement with a predispute arbitration clause. Under the agreement, the parties agree to resolve future disputes through arbitration rather than litigation or some other method. Such agreements may also require arbitration to occur in an SRO forum rather than a nonaffiliated forum, such as JAMS/ENDISPUTE or the American Arbitration Association (AAA).

Most securities industry arbitration agreements may be enforced under the Federal Arbitration Act, which places these agreements on the same footing as other contracts. Additionally, these predispute agreements have been found to be consistent with the Securities Exchange Act of 1934 (the Act).

The Uniform Code of Arbitration (the Code), which was adopted by the SROs in 1979-80, established a uniform system of procedures for all SRO arbitrations. The Code, with some variations, is contained within the arbitration rules of each SRO.

The Commission has statutory authority to ensure that SRO arbitration procedures are adequate and consistent with the Act. Commission oversight includes two main components. The Division of Market Regulation (MR) reviews SRO arbitration rule filings and the Office of Compliance Inspections and Examinations (OCIE) conducts periodic inspections of SRO arbitration programs to ensure compliance with applicable rules.

In response to Commission initiatives on arbitration, the SROs formed the Securities Industry Conference on Arbitration (SICA) in 1977. The purpose of SICA was to develop uniform rules governing SRO arbitrations between broker-dealers and customers. SICA, which meets four times a year, includes representatives from SROs, as well as three public members and one securities industry member. These positions have included representatives of the Public Investors Arbitration Bar Association (PIABA), academia, and the Securities Industry Association (SIA). The Commission staff regularly attend SICA meetings. Occasionally, others, including staff of the Commodities Futures Trading Commission (CFTC), the North American Securities Administration Association, and the AAA also attend SICA meetings.

SCOPE AND OBJECTIVES

Our review focused on Commission oversight operations. To avoid duplicating audit steps being taken in a concurrent General Accounting Office (GAO) review, we did not analyze specific arbitration statistics, such as win/loss rates for customers and broker-dealers or award amounts and collections. Nor did we specifically address Commission actions taken in response to recommendations made in a May 1992 GAO report.² Finally, we did not review the results of specific arbitration cases.

² In GAO/GGD-92-74, Securities Arbitration: How Investors Fare, GAO recommended that the Commission require the SROs to a) develop formal standards for selecting arbitrators, b) verify information submitted by prospective and existing arbitrators, and c) establish a system to ensure arbitrators are adequately trained in the arbitration process. GAO is following-up on these recommendations as part of its concurrent review.

The primary audit objectives were to evaluate the effectiveness and efficiency of Commission operations in overseeing SRO arbitration. We did not evaluate the results of the Commission's oversight policy. The audit was performed from October 1998 through March 1999 in accordance with generally accepted government auditing standards.

AUDIT METHODOLOGY

To obtain an understanding of securities arbitration, we reviewed prior reports issued by GAO, SROs, and industry organizations. Additionally, we reviewed relevant statutes and case law, SRO arbitration rules and procedures, industry newsletters, press releases, and news articles.

Other documentation we reviewed included Commission reports of arbitration inspections, relevant SRO rule filings, and arbitration correspondence among the Commission, SROs, and industry organizations. In addition, we examined automated listings of arbitration complaints received by the Commission and of inspections conducted of SRO arbitration programs.

Finally, we interviewed selected officials from the Commission, SROs, industry organizations, brokerage firms, and academia.

AUDIT RESULTS

Overall, we found that Commission oversight operations were effective and efficient. Commission review of SRO rule filings and inspections of SRO arbitration programs were generally thorough and timely. Additionally, officials from the SROs, industry groups, and academia were mostly complimentary of the Commission's oversight and spoke highly of the professionalism and experience of Commission staff.

SRO and investor representatives identified several policy issues, most of which Commission staff were aware of and had either considered or had plans to address. These issues involved predispute arbitration agreements, unpaid arbitration awards, panel selection, securities mediation, contingency plans, on-line filings, legal representation, the Securities Industry Conference on Arbitration, and noteworthy practices memoranda.

We also identified opportunities, as described below, for enhancing the Commission's arbitration oversight and increasing public understanding of and confidence in SRO arbitration. Specifically, we are making recommendations regarding public awareness, data analysis and tracking, complaint information, and arbitration guidance.

PREDISPUTE ARBITRATION AGREEMENTS

Most officials from the Commission, SROs and broker-dealers whom we interviewed felt that the existing arbitration process is, in fact, fair to both parties. Moreover, all the officials we spoke with emphasized the benefits of arbitration, namely, that arbitration is more efficient and less expensive than litigation in court.

Officials we interviewed, primarily those from PIABA and law firms representing investors, believe that investors would perceive the securities arbitration process more favorably if they were not required to sign predispute arbitration agreements when opening brokerage accounts. A NASD task force study, performed during 1994 and 1996, indicated that to the extent investors are unable to open accounts without signing predispute arbitration agreements, they perceive that their participation in securities arbitration is involuntary. The NASD study further pointed out that most agreements limit the investor to SRO-sponsored arbitration, which some investor proponents argue is biased in favor of the industry.³

According to the NASD study, the industry advocates predispute arbitration agreements as a means of controlling the high costs of defending lawsuits in state and federal courts. Some industry representatives told us that they regard SRO arbitration as a voluntary process, notwithstanding the use of mandatory arbitration agreements. These representatives pointed out that a number of firms only require customers to sign predispute arbitration agreements when opening option or margin accounts; customers of these firms with cash or IRA accounts are not required to sign these agreements.

Virtually all the officials we spoke with during the audit believed that the number of arbitration claims would not change significantly over time, even in the absence of firms requiring customers to sign predispute arbitration agreements. These officials reason that the majority of investors would still choose arbitration because of its advantages over litigation (*e.g.*, lower costs, less time, *etc.*). Also, some officials pointed out that attorneys representing investors are better educated in the arbitration process today than they were in past years.

Similarly, most officials we interviewed generally felt that the number of SRO arbitrations would not change significantly over time if investors were allowed to choose between SRO and non-SRO forums. These officials pointed out that SRO forums are usually less expensive (because of SRO subsidies) and may be more efficient than non-SRO forums. The SICA, in coordination with the SIA and PIABA, is organizing a two-year pilot program. This program will allow a limited number of claimants to choose between SRO and non-SRO forums, such as JAMS/ENDISPUTE or the AAA.⁴

³ We did not perform any testing to determine whether this argument is factually correct. Moreover, several officials from the Commission and SROs stated that they believe the statistics show that the process is, in fact, fair and unbiased.

⁴ During the course of our audit, we learned that the CFTC offers another dispute resolution option for commodities investors. Pursuant to 1975 legislation, the CFTC has adjudicative authority to decide investor commodities disputes on their merits. The CFTC is also authorized to enforce collection of awards by suspending a firm's registration and trading privileges. In contrast to arbitration, this reparations process is voluntary, reparations claimants have appeal rights and adjudicators must document the basis for their decisions. We did not address additional resource requirements for such a reparations program.

The MR officials responsible for overseeing arbitration were well aware of the arguments in favor of and against mandatory predispute arbitration agreements. In 1988, MR forwarded a legislative proposal to the Commission that would have prohibited broker-dealers from requiring customers to sign predispute arbitration agreements as a condition of opening brokerage accounts. The proposal included a two-part approach, suggesting both that a legislative proposal be forwarded to Congress, and that the SROs be asked to take similar steps through rulemaking. The proposal explained that the creation of an alternative should increase incentives to SROs and their members to ensure that the arbitration forum remains fair and efficient. Additionally, it stated that the proposal should increase the perception of fairness in the securities business and, therefore, increase investor confidence.

MR withdrew its legislative proposal and recommended that the Commission instead ask the SROs to address issues that would increase investor confidence in arbitration, including arbitration contract issues. As a result of this process, in 1989, the Commission approved changes to SRO rules, including the requirement that new account agreements contain increased disclosures to customers.

In approving the rules, the Commission stated that it was reluctant to dictate the terms of a fully-disclosed agreement between a broker-dealer and a customer and that improved disclosure provided in the rules would effectively alert investors to the consequences of signing predispute arbitration clauses. Additionally, the Commission stated that it would continue to monitor the effectiveness of SRO disclosure provisions and the use of predispute arbitration agreements.

MR officials stated that they had intermittently reviewed arbitration agreements, particularly during 1993 and 1994. In addition, MR officials told us that they have reviewed drafts of the SICA pilot program and that they plan to evaluate the results of the pilot.⁵

UNPAID AWARDS

Our audit disclosed that unpaid arbitration awards due to bankrupt broker-dealers are rare with larger, more established firms. However, we learned that unpaid awards are a concern in arbitrations involving smaller and more volatile firms. PIABA officials estimated that about \$25 million in arbitration claims are left unpaid annually due to broker-dealer insolvency, while MR officials feel that the annual number is much lower. GAO will be calculating the amount as part of their concurrent review.

The Securities Investor Protection Corporation (SIPC), which is designed to protect customer funds held by failed broker-dealer firms, covers few unpaid arbitration claims. While SIPC will cover claims for stolen funds or funds used for unauthorized trading, it does not provide any protection for funds lost due to other broker-dealer abuses, such as refusing to sell a stock or making of false claims about a security.

⁵ On June 22, 1997, the Commission approved an NASD rule proposal (SR-NASD-97-77) that eliminated the requirement under NASD rules for employees to arbitrate employment discrimination disputes. This rule change did not impact the arbitration of customer disputes.

MR officials agree that unpaid arbitration awards are a concern and that they are working on ways to address the problem. However, MR officials do not consider the possible expansion of SIPC to be a viable solution. These officials believe that an expansion of SIPC's coverage would hinder achievement of SIPC's original objectives.

PANEL SELECTION

The NASD recently implemented a sophisticated computer system for collecting arbitrator data and creating a list of potential panelists. In place of administrative appointment of arbitrators by NASD staff, this system provides each party with lists of arbitrators whom they may rank by preference. The lists of arbitrators are generated, on a rotational basis, by the new NASD system. Only if this process fails to produce a panel will the staff appoint a panel.

OCIE officials agreed that selection lists are important to the perception of NASD arbitration fairness and stated that it began an inspection of the new system in July 1999. Additionally, OCIE stated that this inspection will consider key issues, such as the objectivity, accuracy, and reliability of system data.

SECURITIES MEDIATION

The NASD implemented a securities mediation program in the summer of 1995. This program was well received and has become increasingly popular. Under the program, an impartial person facilitates negotiations between disputing parties, in an effort to reach a mutually-acceptable solution. Unlike arbitration (and litigation), the mediator does not impose a solution, but rather, helps the parties create their own mutually-satisfying solution. Thus, mediation is voluntary and not binding on the parties.

OCIE officials said that its staff was conducting research on mediation and that the first inspection of the NASD's mediation program is planned for the fall of 1999. OCIE indicated that it will prepare a detailed plan for reviewing this program, which will include key factors, such as mediator qualifications, training, and selection. Additionally, OCIE will consider how (or if) mediation should fit into existing inspection cycles.

CONTINGENCY PLANS

A correlation between investor losses and subsequent claims filed has been reported.⁶ In fact, many broker-dealers, in anticipation of an increase in claims because of a market drop, have set up early intervention groups to deal with claims before they go to arbitration. SRO officials acknowledged this correlation and said that they had seen an increase in claims associated with the market drop in August of 1998.

SRO officials stated that they had no formal contingency plans for accommodating a large inflow of arbitration filings in case of a major market downturn or prolonged bear market. In the past, SROs have hired temporary staff and/or allowed for additional case processing time.

⁶ "Dueling for Dollars...if bear returns, Wall Street's arbitration wars will escalate," Barron's, November 24, 1998, Pg. 24, and "Market Drop Boosted Investor Complaints," Wall Street Journal, January 11, 1999.

MR officials were aware of the correlation between investor losses and subsequent claims. However, they do not believe that formal contingency plans are necessary. MR officials pointed out that cases will not come immediately following a market event, but some time later. They believe that SRO budgets can be adjusted following a market event to maintain acceptable case processing times.

OCIE officials stated that they believe SRO contingency plans are a necessary part of effective regulation and that they currently inquire about SRO staffing levels on inspections. As a result of our review, OCIE plans to emphasize its review of formal arbitration contingency plans during future arbitration inspections.

ON-LINE FILINGS

The SROs do not offer on-line filing of arbitration claims. Although the NASD and NYSE are having internal discussions on the topic, neither has definite plans to offer this option. We found that the National Arbitration Forum (NAF), a non-SRO organization, offers on-line filing. Although the NAF currently handles few securities disputes, NAF officials said that they were actively trying to increase their securities arbitration capability. While on-line filings could increase investor convenience and satisfaction, it could also increase the number of frivolous claims.

MR officials believe that on-line filing of legal documents is an option that should be explored with caution. They also indicated that once courts allow on-line filing of civil cases,⁷ it would encourage the SROs to consider applying on-line filing to arbitration.

LEGAL REPRESENTATION

Investors with small monetary claims against broker-dealers often have difficulty obtaining legal representation in arbitration. Most securities attorneys either require an up-front fee or work on a contingent fee basis. Although 40% of investors represent themselves in securities arbitrations, investors win more frequently when represented by counsel and achieve a significantly higher recovery rate than pro se claimants.⁸ However, this statistic does not consider the merits of the underlying claims.

At the request of the Commission's Chairman, Pace University in New York established one of the first law school clinics to provide student representation (with faculty supervision) to investors with securities arbitration claims under a certain dollar amount. Since then, other schools across the country have established similar clinics.⁹

These clinics are useful in providing legal assistance to otherwise pro se claimants and in educating law students in arbitration. MR plans to continue supporting these clinics and to determine where it makes sense to create more of them.

⁷ Courts are experimenting with electronic filing of court papers. Rule 5(e) of the Federal Rules of Civil Procedure authorizes courts to permit electronic filing by local rule, consistent with any technical standards that the Judicial Conference of the United States establishes. The Administrative Office of the U.S. has published Technical Specifications and Technical Guidelines for electronic filing.

⁸ "How Fares the Pro Se Investor in Arbitration?" *Securities Arbitration Commentator*, February 1997.

⁹ MR officials stated that SUNY Buffalo School of Law, Brooklyn Law School, and Fordham University School of Law had begun arbitration clinics. Additionally, Stetson University and the University of Arizona have expressed interest in developing similar clinics.

SECURITIES INDUSTRY CONFERENCE ON ARBITRATION

Most officials interviewed recognized the benefits of a forum that allows voices from different perspectives to come together and address their viewpoints. However, SRO officials felt that, given significant developments in securities arbitration (e.g., SRO forum consolidation, trend towards mediation, etc.), since SICA's inception in 1977, SICA's mission, goals, and objectives should be re-evaluated.

MR officials believed that SICA, in its current form is effective because it is a forum for creating a uniform arbitration code that serves as a model for various SROs. Consequently, the smaller SROs benefit from the uniform procedural rules. Additionally, SICA allows the NASD to hear arbitration views from other forum administrators, as well as from industry and public members.

NOTEWORTHY PRACTICES MEMORANDA

In May 1997, OCIE issued a memorandum to SRO arbitration programs identifying noteworthy practices and recommendations arising from OCIE inspections of arbitration programs. Although OCIE does not share results of specific SRO inspections with other SROs, it issued this memorandum to inform each SRO of noteworthy arbitration practices that OCIE observed during inspections of several SRO arbitration programs.

The noteworthy practices memorandum was well received by the SROs and proved to be an effective mechanism for communicating lessons learned. SRO officials felt that it provided valuable insights and helped in effectively managing their programs. OCIE officials may issue similar memoranda in the future, if warranted.

RULE FILINGS

Although complimentary of the Commission's efforts, officials from the SROs and broker-dealers expressed concern over the length of time required by MR to review certain arbitration rule filings, particularly controversial ones.

In a prior audit,¹⁰ our office recommended that MR review and consider what action, if any, should be taken on all rule filings open for more than 365 days. MR officials stated that this recommendation has been implemented and that they review, on a quarterly basis, all rule filings open for more than 90 days.

PUBLIC AWARENESS

Some officials from broker-dealers and PIABA did not clearly understand the nature of the Commission's oversight role (i.e., approving rule filings and conducting inspections) regarding securities arbitration. These officials felt that increasing public awareness of rule filings and inspection efforts would benefit the arbitration process. Examples of additional steps the Commission could take include:

¹⁰ Commission Review of SRO Rules, Audit No. 272, issued July 14, 1998.

- broader discussions of the Commission's oversight role during its participation in continuing education programs and SICA meetings, both of which are attended by key SIA and PIABA representatives; and
- presentations by Commission staff at SIA Law and Compliance section meetings and PIABA meetings, if officials of those groups feel that Commission staff participation would be useful.

The Office of Investor Education and Assistance (OIEA) recently implemented a new website (<http://www.sec.gov/oiea1.htm>). Enhancements that could increase public awareness and help ensure that investors have access to current dispute resolution information are stated below. OIEA officials were receptive to including these suggestions on the new website:

- a clear description of the Commission's arbitration oversight role;
- descriptive information about securities mediation;
- securities arbitration and mediation information in the Commission's on-line investor tool kit; and
- links to SIA and PIABA websites.

Recommendation A

The Division of Market Regulation, in consultation with OCIE, should consider implementing steps, such as those outlined above, to increase public awareness of the Commission's arbitration oversight role.

Recommendation B

The Office of Investor Education and Assistance, in consultation with MR and OCIE, should increase dispute resolution information available on its Internet site, as outlined above.

During June 1999, we observed that OIEA had incorporated many of the suggestions, as outlined above, on its new website.

DATA ANALYSIS AND TRACKING

OCIE receives annual arbitration data from SICA, which includes statistics (*e.g.*, total cases received, total cases concluded) by year from 1980 to the present. OCIE reviews this data, along with independent studies performed by the SAC, an industry newsletter, to analyze arbitration trends. Upon initiating an arbitration inspection, OCIE obtains from each SRO more comprehensive statistical data, typically covering the period since the last inspection.

Additional data OCIE could consider tracking include arbitrator disclosure data, outstanding awards, award frequency and timeliness at each arbitration level (*e.g.*, claims less than \$25,000), and complaint information. Analyzing and tracking this data could enhance targeting efforts and help determine SRO inspection frequency. Additionally, increased data analysis and tracking could assist in identifying rulemaking areas for referral to MR, as well as violations of law for referral to the Division of Enforcement. OCIE officials recognized that there may be value in obtaining periodically some additional information outside of the inspection process.

Officials from the SROs, PIABA, and OCIE agreed that a periodic analysis of arbitration data would be useful to identify broad based trends and to improve targeting efforts. However, all officials interviewed cautioned about the limitations of analyzing statistical data. For example, it would be difficult to make meaningful comparisons (*e.g.*, win/loss rate for investors) between programs at the NASD and the NYSE, given the disparity in filing volume and nature of members.

Recommendation C

The Office of Compliance Inspections and Examinations should consider whether to require the SROs to provide additional limited arbitration information on a periodic basis and to analyze such information.

COMPLAINT INFORMATION

Most arbitration complaints are received by OIEA. OIEA forwards significant complaints to MR, which then forwards appropriate data to OCIE. OCIE reviews these complaints upon receipt and considers them in planning SRO arbitration inspections. OCIE also routinely reviews complaints received by the respective SRO arbitration program.

OCIE staff with whom we spoke were not aware of any significant arbitration complaint information that had not been forwarded to OCIE. At the present time, however, they could not state with certainty whether they were being provided with all significant arbitration complaint data.

Most OCIE staff does not have access to OIEA's complaint database. Consequently, many examiners were not fully aware of the nature and type of data available from OIEA. For example, examiners did not know that OIEA used six codes to categorize arbitration complaints. OCIE staff believes having read-only access to OIEA's system, along with a listing of arbitration codes, could be helpful in planning arbitration inspections. OIEA officials were receptive to these improvements.

Recommendation D

The Office of Investor Education and Assistance, in consultation with OCIE, should provide the appropriate OCIE examiners (including those in the field offices) with read-only access to its complaint data base and a listing of all complaint inquiry codes (including arbitration codes) to ensure that examiners have knowledge of OIEA complaint data.

ARBITRATION GUIDANCE

We reviewed arbitration and mediation pamphlets distributed to investors upon request. Overall, we found that these materials were adequate in most cases, but could be improved. Specifically, some arbitration pamphlets were out of date (printed in 1992 or 1996), and did not reflect recent arbitration changes (e.g., NASD list selection, current SRO forums available).

Due to the complexities and dynamic nature of securities arbitration, improving arbitration guidance provided to Commission staff who field investor inquiries would help ensure that consistent and accurate information is provided to investors. Additionally, OIEA could ensure that its program staff are aware of arbitration information, such as the NASD and NYSE programs and the Commission's role in the process.

Recommendation E

The Office of Investor Education and Assistance, in consultation with MR and OCIE, should improve arbitration guidance (including related topics such as mediation) provided to investors and appropriate Commission staff, as outlined above.