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Report to Congressional Requesters

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SECURITIES ARBITRATION

How Investors Fare

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The Honorable John D. Dingell
Chairman, Committee on Energy
and Commerce
House of Representatives

The Honorable Edward J. Markey
Chairman, Subcommittee on
Telecommunications and Finance
Committee on Energy and Commerce
House of Representatives

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

The Honorable Alan J. Dixon
United States Senate

The Honorable Terry Sanford
United States Senate

The Honorable Timothy E. Wirth
United States Senate

The Honorable Richard Bryan
United States Senate

This report responds to your January 31, 1990, and March 28, 1990, requests that we evaluate a number of issues relating to the arbitration process sponsored by the securities industry self-regulatory organizations. The report offers recommendations to the Securities and Exchange Commission concerning the selection and training of arbitrators.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the Securities and Exchange Commission, the Director of the Office of Management and Budget, appropriate congressional Committees, and other interested parties.

Major contributors to the report are listed in appendix VI. If you have any questions, please call me on (202) 275-8678.

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

Broker-dealer firms may require investors, as a condition of doing business with the firm, to agree to use arbitration to resolve any securities disputes between the investor and the firm. Firms may also require that such arbitration be conducted at a forum sponsored by the securities industry and operating under the Uniform Code of Arbitration developed by industry representatives. Congress, state regulators, and investor groups have raised concerns about whether industry-sponsored arbitration is fair to investors. A primary concern is that arbitration at an industry-sponsored forum may have a pro-industry bias.

The Chairmen of the House Committee on Energy and Commerce and its Subcommittee on Telecommunications and Finance, and the Chairman and four members of the Senate Committee on Banking, Housing, and Urban Affairs asked GAO to (1) determine broker-dealer firm policies that require investors to settle disputes through arbitration; (2) analyze the results of securities arbitration at industry-sponsored forums; and (3) compare these results with those of the American Arbitration Association (AAA)—the primary independent forum for securities arbitration, commodities arbitration, and litigation. They also asked GAO to collect and analyze other data and review practices in securities arbitration that are relevant to assessing the need for changes in the process.

Background

The most frequently used method to resolve securities disputes between investors and broker-dealer firms is arbitration, a process in which decisions are rendered by persons called arbitrators. Arbitration of securities disputes has been long used and supported by the securities industry because it is believed to be faster and less expensive than litigation. Arbitration is also used to resolve commodities disputes.

Broker-dealer firms may require prospective securities investors to sign an agreement to resolve disputes through arbitration rather than litigation or some other method. This agreement includes a clause, called a predispute arbitration clause, that compels both parties to arbitrate disputes. It also may require that the arbitration take place in an industry-sponsored forum rather than an independent forum like AAA.

The results of securities arbitration decisions are expressed in terms of awards and claims. Either the investor or the broker-dealer initiates the case by filing a claim. The case may proceed through one or more hearings, or it may be decided by a review of written evidence from the parties involved. Panels of three arbitrators with a mixture of industry and

nonindustry backgrounds preside over hearings; one arbitrator reviews written evidence. The party in whose favor a case is decided receives an award that is the amount or some proportion of the claim.

The Securities and Exchange Commission (SEC) regulates securities arbitration as it regulates the industry, generally through its oversight of self-regulatory organizations (SRO). These organizations, which include the securities exchanges and the National Association of Securities Dealers, operate and regulate their markets with delegated primary responsibility to enforce compliance with legal and ethical standards. SROs also administer securities arbitration forums, which are subsidized by the broker-dealer member firms of SROs. In recent years, SEC has designed its oversight of the arbitration process primarily toward reforming arbitration procedures of SROs to provide reasonable assurance that industry-sponsored arbitration is fair, efficient, and affordable. Recently, SEC also has been encouraging the industry to allow investors to use more independent forums to resolve disputes. GAO believes these SEC efforts are worthwhile and supports them.

Arbitration forums select arbitrators on the basis of background information, references, and professional or other qualifications. The background information provided by the candidates includes their employment history, education, and knowledge of and relation to the securities industry. Administrators of arbitration forums and the parties in a dispute to be arbitrated use this information, supplemented by securities disciplinary history and additional disclosures in specific cases, to determine whether the individual should be used to decide cases. Each party to the dispute is allowed to remove one arbitrator for any reason and an unlimited number for cause. But the arbitration forum makes the final selection of arbitrators, unlike other areas where arbitration is used and the parties directly involved select them. The selection of the arbitrators by the forums could possibly raise questions of fairness. Addressing this issue was beyond the scope of this GAO effort.

To do its work, GAO sent a questionnaire to a sample of broker-dealer firms that were most likely to do business with individual investors to determine their policies with respect to predispute arbitration clauses. GAO also used statistically projectible sampling and analytical procedures to compare arbitration results at selected securities industry-administered arbitration forums; AAA; and the National Futures Association (NFA), the major commodities industry-administered arbitration forum. GAO contacted securities industry representatives, broker-dealer firms, investor groups,

selected individual investors, and others to obtain their views on whether specific changes needed to be made to the arbitration process. GAO also interviewed SEC and forum officials to obtain information on the selection and training of arbitrators.

Results in Brief

Whether arbitration clauses were required of investors by broker-dealer firms as a condition of doing business with the firms depended on the types of accounts the investors wished to open. Cash accounts were less likely to require an arbitration clause, particularly in large firms, than were margin or options accounts. The latter types of accounts involved more complex or riskier transactions, and investors were nearly always required to resolve their disputes through industry-sponsored arbitration forums.

GAO's analysis of statistical results of decisions in arbitration cases at both industry-sponsored and independent forums showed no indication of a pro-industry bias in decisions at industry-sponsored forums. Statistically, neither the specific forum nor whether the forum was industry-sponsored or independent affected arbitration decisions. While GAO's review showed that an investor was no more likely to prevail in an independent forum than in an industry-sponsored forum, it did not directly address the fairness of the arbitration process.

GAO did not attempt to subjectively evaluate the fairness of the decisions reached because to do so, GAO would have had to analyze and judge the merits of the facts and reasoning in each case in its study. GAO could not compare arbitration and litigation results because of the limited number of retail investor cases decided through litigation and the inherent differences between the processes.

GAO's review of arbitration procedures showed that arbitration forums lacked internal controls to provide a reasonable level of assurance regarding either the independence of the arbitrators or their competence in arbitrating disputes. Because the independence and experience of arbitrators can determine the fairness of decisions, such internal controls are important to maintaining the integrity of arbitration.

Principal Findings

Mandatory Arbitration Clauses Were More Likely for Margin and Options Accounts Than for Cash Accounts

Broker-dealers' policies on the use of mandatory arbitration clauses differed by the size of the firm and the type of account. GAO categorized broker-dealer firms into three groups—large, medium, and small—on the basis of the number of registered representatives they had that dealt with individual investors. Large firms, which have almost 75 percent of the individual investor accounts in the United States, usually did not require such clauses for individual cash accounts or institutional accounts. However, all large firms required the clauses for individual investors' margin and options accounts, which are riskier or involve more complex transactions than cash accounts. About 40 percent of medium and small firms required the clauses for individual cash and institutional accounts, while over 90 percent of medium firms and over 70 percent of small firms required such clauses for individual margin and options accounts. Large firms had no plans to change their policies in the future, while a number of medium and small firms that had not required the clauses planned to start requiring them. (See pp. 28-30.)

Arbitration Forum Did Not Affect Investors' Chances of Receiving an Award

Statistical analysis of decisions in cases initiated by investors at all arbitration forums—industry and nonindustry—showed that the forum at which the decision was made did not affect an investor's chances of receiving an award. The results of securities arbitration at all industry-sponsored forums were similar to each other and to the results of securities arbitration at AAA and for commodities arbitration by NFA. For most securities disputes decided at industry-sponsored forums and AAA, about 60 percent of investors received an award, and the amount awarded averaged about 60 percent of the amount claimed. The results were similar at NFA. Thus, the results at industry-sponsored forums show no indication of a pro-industry bias. However, GAO's statistical analysis did not directly address the fairness of the arbitration process.

Statistically, several factors increased investors' chances for receiving either an award or a larger proportion of their claim. For claims initiated by investors, their chances of receiving an award were about 1.4 times more likely when their cases were decided after arbitration hearings rather than an arbitrator's review of written submissions from the parties involved, and about 1.8 times more likely when their claims involved commodities options rather than other products. Similarly, investors with

attorney representation were about 1.6 times as likely to receive an award in excess of 60 percent of their claim, the average amount awarded. Also, claims under $20,000 were about 3.7 times as likely as larger claims to result in an award greater than 60 percent of the amount claimed. (See pp. 35-41.)

Forums Need Better Procedures to Select and Train Arbitrators

Statistical analysis of overall arbitration results indicated little about the fairness of individual cases. Fair proceedings in individual cases are important because of the financial consequences of arbitrators' decisions to investors and broker-dealer firms and because those decisions are generally not subject to review.

The fairness of arbitration cases, regardless of the forum, depends largely on the impartiality and competence of individual arbitrators. The primary ways that industry-sponsored forums can ensure that their arbitration process is as fair as possible are to select arbitrators with appropriate backgrounds and experience and ensure that they are trained to know and understand the arbitration process.

Industry forums obtain background information about people who agree to be arbitrators, require arbitrators to update the information when changes in their backgrounds occur, and ask for evaluations from the participants in cases about their arbitrators' proficiency. However, the forums had no established formal standards to initially qualify individuals as arbitrators, did not verify background information provided by prospective or existing arbitrators, and had no system to ensure that arbitrators were adequately trained to perform their functions fairly and appropriately. Enhancing their procedures to select and train arbitrators can provide industry-sponsored arbitration forums better assurance that their arbitrators are independent and competent. (See pp. 55-61.)

Recommendations

GAO recommends that the Chairman, SEC, require SROs that administer arbitration forums to

- develop formal standards for selecting arbitrators,
- verify information submitted by prospective and existing arbitrators, and
- establish a system to ensure that these arbitrators are adequately trained in the arbitration process.

Agency Comments

GAO obtained informal comments on a draft of this report from the four SROs as well as AAA and NFA, and obtained written comments from SEC. (See app. V.) The SROs, AAA, and NFA agreed with GAO's findings, and the SROs and AAA told us they would study how the recommendations could be implemented but expressed concern about the potential costs of any needed changes. SEC, while appearing to generally agree with GAO's intent, also expressed concerns that the recommendations "risk increasing significantly the costs of securities arbitration and reducing the pool of qualified arbitrators without materially improving the general quality of the arbitrator pool or increasing assurances of the independence or capability of individual arbitrators."

GAO believes that SEC's comments reflect a reading of the recommendations with the most stringent possible implementation measures in mind and with a focus on the potential cost of such measures. Such a reading could be overly prescriptive for achieving GAO's intent, which was to enhance the level of assurance provided by present procedures that individual arbitrators, and consequently the pool, are highly qualified and capable. GAO recognized that options for achieving this intent range across a spectrum and that some options would be more cost effective than others. Accordingly, GAO worded its recommendations to permit latitude in deciding how best they could be implemented. GAO believes the actions suggested by SEC and the SROs, if effectively implemented, will be generally responsive to GAO's intent.

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Abbreviations

AAA	American Arbitration Association
Amex	American Stock Exchange
CBOE	Chicago Board Options Exchange
CFTC	Commodity Futures Trading Commission
NASD	National Association of Securities Dealers
NFA	National Futures Association
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SIA	Securities Industry Association
SICA	Securities Industry Conference on Arbitration
SRO	self-regulatory organization

Introduction

The securities industry has chosen arbitration as the method it uses most often to resolve disputes between its members and individual investors.[1] The industry intends for arbitration to provide a fair and impartial means of dispute resolution that is faster and less expensive than resolution through the courts. However, in recent years Congress, state regulators, and investor groups have raised concerns about whether arbitration as mandated and practiced by the securities industry is fair and impartial in resolving disputes between broker-dealers and individual investors. A primary concern expressed is that arbitration administered by the securities industry may have a pro-industry bias.

In response to these concerns, the Chairmen of the House Committee on Energy and Commerce and its Subcommittee on Telecommunications and Finance and the Chairman and four members of the Senate Committee on Banking, Housing, and Urban Affairs asked us to review arbitration practices in the securities industry.

Securities Industry Organizations Administer and Oversee Securities Arbitration

The securities industry administers and oversees arbitration according to the industry's principle of self-regulation. Under this principle, the industry regulates itself through various self-regulatory organizations (SRO) that are overseen by the Securities and Exchange Commission (SEC). SROs are groups of industry professionals that both operate and regulate market facilities. They have primary regulatory responsibility under the Securities Exchange Act of 1934 to adopt and enforce standards of conduct for their member securities firms.

SROs include, among other groups, the nine securities exchanges—such as the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex)—and the National Association of Securities Dealers (NASD), which regulates the over-the-counter market. SROs are funded by their member broker-dealer firms and other participants in the securities markets. Generally, SROs fix and levy from their members fees, assessments, and other charges for use of facilities or systems SROs administer.

To ensure that SROs comply with the Securities Exchange Act of 1934, as amended, SEC approves SRO rules, reviews disciplinary actions and various other activities, and inspects SRO operations, including arbitration. In December 1990, SEC consolidated many of its existing arbitration oversight activities and established a branch for arbitration oversight in the Office of

[1]Arbitration forums may also resolve disputes among broker-dealers and between a broker-dealer and its employees.

Inspections and Financial Responsibility, Division of Market Regulation. One of the branch's responsibilities is to inspect all SRO arbitration programs to ensure that SROs have systems in place to comply with securities laws and their own rules.

Securities arbitration operates under SRO rules that are based on the Uniform Code of Arbitration, which was developed by the Securities Industry Conference on Arbitration (SICA). SICA was formed by the securities industry in 1977 at SEC's invitation to review then existing securities arbitration procedures.[2] Comprising SICA's membership are representatives of each SRO and the Securities Industry Association (SIA), and four public members selected by the current public members on the basis of experience and demonstrated interest in arbitration.

The American Arbitration Association Also Administers Securities Arbitration

SROs are not the only forums for securities arbitration. The American Arbitration Association (AAA), an independent, not-for-profit organization that administers arbitrations and other private dispute resolution processes for a variety of industries, also does securities arbitration. In administering securities arbitration cases, AAA is not subject to SEC oversight, but AAA's securities arbitration rules are generally similar to the Uniform Code.

SEC has encouraged broker-dealers to allow investors a choice between any industry forum and a forum independent of the industry, like AAA, to resolve securities disputes. According to SEC, investor access to an independent forum might enhance investor confidence in the fairness of securities dispute resolution proceedings and also help relieve some of the caseload pressures on SROs' forums. In a September 1987 letter to SICA members, SEC recommended that broker-dealers give their customers the option of bringing their disputes to AAA. Also, in 1989, SEC's Division of Market Regulation urged many large broker-dealers to include the option of AAA arbitration for individual investors. Despite these initiatives and support from some SROs, SEC's Director, Division of Market Regulation, concluded in May 1990 that most firms did not allow individual investors a choice of a non-SRO arbitration forum.

In September 1990, NASD's Board of Governors recommended that broker-dealers consider using a non-SRO arbitration forum to resolve disputes arising in the securities industry. In January 1991, five NYSE

[2]SICA's original mandate was to develop rules for the resolution of disputes involving small claims. Over time, SICA assumed responsibility for formulating uniform arbitration rules for all securities SROs.

member firms agreed to participate in a pilot program to allow investors to have their claims arbitrated by AAA even though the firms' account agreements limited investors to SRO forums. The program allows each of the firms to agree to AAA arbitration of disputes on a case-by-case basis and to vary the terms and conditions of the pilot as each sees fit. In spearheading the pilot, NYSE hopes to encourage voluntary rather than mandatory use of nonindustry arbitration. SEC plans to evaluate the results of the pilot when it has sufficient information on it. As of January 1992, SEC had received two quarterly reports relating to the number of requests approved for AAA arbitration and background on the cases.

How Securities Arbitration Is Designed to Work

SRO rules provide broker-dealer firms with the use of arbitration as a dispute resolution mechanism for their individual customers. An individual investor's first exposure to the concept of arbitration can occur when opening a cash,[3] margin,[4] options,[5] or other account with a broker-dealer. For example, as a condition of opening an account with some firms, the investor might be asked to sign an agreement containing a "predispute arbitration clause." This clause requires that any future disputes be resolved through arbitration rather than litigation. As discussed, most firms use clauses that specify that an industry forum be used, which has the effect of precluding the use of any forum operating independently of an industry-sponsored forum.

If a dispute should arise, an investor (or a broker-dealer) can initiate arbitration proceedings by filing a statement of claim, a submission agreement, and other information with the Director of Arbitration at the relevant arbitration forum. The statement of claim is to provide information on the dispute, including relevant dates and names, as well as the damages being requested. The submission agreement binds the parties to abide by the arbitration award. The filing also is to include the claimant's filing fee deposit and the counsel's name, address, and telephone number if the claimant plans to be represented by counsel. All parties to a dispute have the option of being so represented.

[3]With a cash account, an investor purchases securities without an extension of credit and receives cash for securities sold.

[4]With a margin account, the broker-dealer may extend credit of up to 50 percent of the purchase price to the investor to purchase securities.

[5]With an options account, the investor may purchase the right to buy or sell securities on or before a specific date.

When the forum receives the statement of claim, a notification is to be sent to the opposing party or parties, called the respondent. Respondents may be investors, a broker-dealer, or employees or representatives of a broker-dealer. The respondent has 20 days to answer the claim. In answering the claim, the respondent may file a counterclaim against the claimant or a cross-claim against a third party.

Before a hearing, the Director of Arbitration at each forum is to select an arbitrator or a panel of arbitrators and designate a chairperson. Unless the claimant requests otherwise, the majority of the arbitration panel members are to be from outside the securities industry. Small claims can be decided by one arbitrator not associated with the securities industry but familiar with how the industry works.

The Uniform Code directs SROs to provide to the disputing parties the arbitrators' names and business affiliations at least 8 business days before the initial hearing. The Uniform Code also directs SROs to provide the arbitrators' employment histories over the past 10 years and any circumstances that might preclude the arbitrators from rendering an objective and impartial decision. Parties also have the right to request more information. Each party is allowed to remove one arbitrator for any reason and to remove an unlimited number of arbitrators for cause. Action must be taken within 5 business days of the notification to remove an arbitrator for any reason. Removing an arbitrator for cause may be exercised without time constraint.

Most hearings generally follow the same case presentation used in court proceedings. Each party is to be allowed to present an opening statement, evidence, and closing arguments, and to cross-examine witnesses called by the opposing party. Arbitrators can question witnesses at any time during the proceedings. A record of the hearing is kept either by tape recorder or court reporter, and parties may purchase a transcript of the hearing.

The Uniform Code encourages arbitrators to decide a case within 30 business days after the date the record is closed. The decision is to contain, among other things, the names of the parties, a summary of the issues, the damages requested and awarded, and the signatures of the arbitrators who concur in the award. Arbitrators are not required to provide reasons for their decision. The decision is final and subject to court review for only limited reasons, including arbitrator partiality, fraud, or disregard of the law.

Arbitration Has Been Widely Used

With impetus from legislation and some Supreme Court decisions, arbitration has been widely used for many years to resolve securities disputes. In 1872, NYSE became the first securities exchange to provide arbitration as an alternative to litigation in resolving disputes. In 1925, arbitration became a legislated alternative to litigation when Congress passed the Federal Arbitration Act. The act was intended to provide disputing parties the opportunity for faster, more economical resolution than that available in the federal courts. In addition, the act made arbitration mandatory when parties had valid written agreements to arbitrate disputes. Section 2 of the act made these written agreements to arbitrate disputes valid, irrevocable, and enforceable to the same extent as any other contracts. Section 3 of the act requires a court to stay a trial on any issue referrable to arbitration under a written agreement.

In the past decade, the number of arbitration cases filed with the securities SROs has increased approximately 540 percent, from 830 in 1980 to 5,332 in 1990. Securities trading volume has also grown. Between 1980 and 1990, the annual share volume in securities at NASD increased about 400 percent, from 6.7 billion shares to 33.4 billion shares. NYSE share volume increased about 250 percent, from 11.4 billion shares to 39.7 billion shares.

Mandatory Arbitration Has Been Controversial

Broker-dealer policies that require investors to sign agreements mandating arbitration and forcing them to give up their rights to court resolution have been controversial. Conflicting legislation and Supreme Court decisions on the issue are evidence of the controversy. In reaction to the stock market crash of 1929, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 to protect investors' rights. The 1933 act provided that investors can enforce their right to recover in court losses due to fraudulent practices in connection with the purchase or sale of securities. Additionally, investors can file suit under the antifraud provisions of the 1934 act. These provisions conflicted with the 1925 Arbitration Act, which made predispute arbitration agreements enforceable.

The Supreme Court first considered this conflict in Wilko v. Swan, 346 U.S. 427 (1953). The Court held that a predispute agreement to compel arbitration of a claim under the antifraud provisions of the 1933 act was not enforceable. The majority opinion of the Court held that the 1933 act's provisions giving investors the right to sue for damages in connection with the purchase or sale of securities indicated that Congress had intended to override the Arbitration Act's general principal of enforceability.

In Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), the Supreme Court ruled that investors who had signed predispute arbitration clauses could be compelled to resolve their disputes arising under the 1934 act by arbitration.[6] The Court found that the decision in Wilko only barred waiver of a judicial forum when arbitration was inadequate to protect investors' substantive rights. The Court's majority stated that the success of securities arbitration in settling disputes eradicated the mistrust of arbitration that had formed the basis for the Wilko opinion. This opinion was based on the Court's view that arbitration forums, and SEC's regulatory oversight over those forums, provided investors adequate protection. The Court found that an arbitration agreement does not waive the 1934 Act's investor protections.

Debate over predispute arbitration clauses has continued since the 1987 Supreme Court decision. In July 1988, SEC reported that it was concerned by an apparent trend toward the use of predispute arbitration clauses as a condition of doing business with a broker-dealer. Congress considered but did not act on legislation in 1988 that would have prohibited brokers from requiring customers to sign arbitration clauses.

States have also opposed mandatory predispute arbitration clauses. For example, in 1988, the Massachusetts Division of Securities adopted regulations banning mandatory arbitration clauses by making them an "unethical" practice. However, the U.S. District Court in Boston declared that the Federal Arbitration Act preempted the regulations and prohibited their enforcement. This decision was affirmed by the Court of Appeals for the First Circuit, and the Supreme Court declined to review the decision. Also, in 1990, the North American Securities Administrators Association, which is comprised of the securities administrators of the 50 states, the District of Columbia, Puerto Rico, Mexico, and Canada, testified in congressional hearings that Congress should consider prohibiting mandatory predispute arbitration clauses.

[6]The May 1989 Supreme Court decision in Rodriquez de Quijas v. Shearson/American Express, 109 U.S. 1917 (1989), explicitly overruled Wilko v. Swan and made predispute arbitration agreements enforceable for claims arising under the 1933 act.

Concerns Have Prompted Changes and Proposals to Change SRO Arbitration Programs

SEC officials reported that they began an 18-month review of the fairness and efficiency of SRO arbitration programs in 1985, after the Supreme Court's decision in Dean Witter Reynolds Inc., v. Byrd, 470 U.S. 213 (1985). They said that case signaled the likely increased use of SRO arbitration. The Court's 1987 decision in McMahon affirmed SEC's broad authority to oversee and regulate the arbitration process in the securities industry. In September 1987, SEC recommended changes to SICA's Uniform Code of Arbitration and then worked with SICA to improve the securities arbitration rules. After extensive negotiations, in 1989 SEC approved new rules governing the securities arbitration process. The rules made more specific the requirements for arbitrators considered to have nonindustry or public backgrounds, established formal procedures for the prehearing discovery process, and required arbitrators' decisions to be made public, among other changes.

Concerns of industry members and individual investors prompted interest in further changes in securities arbitration. To possibly reduce the administrative costs of operating the 10 industry-operated arbitration forums, SICA studied the feasibility of consolidating the forums into a single forum. In October 1991, SICA concluded that there were no material economies of scale in implementing a single arbitration forum.

Objectives, Scope, and Methodology

In response to the concerns of industry members and individual investors, the Chairmen of the House Committee on Energy and Commerce and its Subcommittee on Telecommunications and Finance, and the Chairman and four members of the Senate Committee on Banking, Housing, and Urban Affairs requested that we examine arbitration practices in the securities industry. As agreed with the Committees and Subcommittee, we examined issues related to

- broker-dealer firms' use of predispute arbitration clauses in customer agreements,
- the results of arbitration in the securities and commodities markets and how the results of arbitration compare to those for litigated disputes,
- the procedural differences between arbitration and litigation,
- industry and investor views on potential changes to the arbitration process, and
- the selection and training of arbitrators.

As agreed, we focused our review on arbitration cases involving individual investors in disputes with members of the industry. We also agreed to use several statistical techniques to ensure that information gathered on the use of predispute arbitration clauses and the results of arbitration cases would represent conditions in the entire industry. We designed procedures to provide a 95-percent confidence level that our results would represent industrywide practice with a sampling error of plus or minus 5 percent. Except where noted, the sampling errors are no greater than plus or minus 5 percent. These procedures are summarized in this chapter and discussed in detail in appendix III. We visited SEC and the Commodity Futures Trading Commission (CFTC) in Washington, D.C.; Amex, NASD, NYSE, and AAA in New York City; and the Chicago Board Options Exchange (CBOE) and National Futures Association (NFA)—which operate the major arbitration forum in the commodities industry—in Chicago. We did our work between May 1990 and September 1991 in accordance with generally accepted government auditing standards.

Broker-Dealers' Use of Predispute Arbitration Clauses

To obtain information on the securities industry's policies, practices, views, and plans concerning the use of predispute arbitration clauses in customer account agreements, we sent a questionnaire to a sample of broker-dealer firms. We selected our sample using two different sources: SIA's Securities Industry Yearbook, 1990-1991 and the more inclusive Central Registration Depository list of NASD member firms. Using these

sources, and controlling for duplicate listings, we identified 980 firms that were most likely to do business with individual investors.

We categorized each firm as large, medium, or small on the basis of its number of registered retail representatives. The 10 SIA firms with the most retail representatives comprised the large class, and the next 32 rank-ordered SIA firms comprised the medium class. The remaining 938 small firms were NASD member firms not included in the large or medium classes.

We mailed questionnaires to all large and medium firms and a randomly selected sample of 311 of the 938 small firms. A copy of the questionnaire is included as appendix IV. We mailed the questionnaires in early December 1990 and did follow-up mailings in January and February 1991. At the end of February and beginning of March 1991, we telephoned firms that had not responded. We adjusted the original sample of 353 firms to 224 because we found that some were no longer in business, and some did not do the type of retail business we were examining—retail business with public customers having cash, margin, or options accounts. We received 188 responses to our survey, which gave us a response rate of 84 percent. Table 2.1 shows the final sample selection and response rates.

Table 2.1: Broker-Dealer Questionnaire Selection and Response, by Firm Size

Firm size	Original universe	Original selection	Number out of business	Number not retail	Final selection	Number of actual responses	Adjusted universe
Large	10	10	0	0	10	9	10
Medium	32	32	1	0	31	26	31
Small	938	311	11	117	183	153	552
Total	**980**	**353**	**12**	**117**	**224**	**188**	**593**

As table 2.1 shows, we deleted 1 medium firm and 128 small firms from our original selection because they were either out of business or not retail firms. For the medium firms, we adjusted the original selection for the firm that was out of business. For the small firms, the adjusted universe total was determined by the proportion of deleted cases to the original sample size. We then calculated weighing factors on the basis of the adjusted universe total. As a result, each of the responses we received from small firms represents the estimated responses of three small broker-dealer firms, and the 153 actual responses thus provide estimated results for 459 firms. We use the 459 weighted number for small firms

throughout the report. Because we reviewed all of the large and medium firms still in business, our weighing factor for these responses is 1, and the numbers we use throughout the report are for 9 large firms and 26 medium firms.

The Results of Securities and Commodities Arbitration

To make statistically valid comparisons of the results of the arbitration (i.e., whether the investor or the broker-dealer received an award and the percentage of claim awarded), we visited six arbitration forums and used several analytical procedures. We compared results among forums and between the securities and commodities industries. We also separately discuss in this report results of cases decided by arbitrators and cases settled by the parties thus eliminating the need for an arbitration decision. As agreed with the Committees and Subcommittee, the six arbitration forums included in our analysis were Amex, CBOE, NASD, NYSE, AAA, and NFA. Amex, CBOE, NASD, and NYSE operate securities industry-administered arbitration forums. In 1990, NASD and NYSE together processed 94 percent of the disputes filed for arbitration at the securities industry forums. NFA began operations in October 1982 as a futures association registered with CFTC. It is an SRO fully funded by the futures industry and mandated by Congress to help protect the public interest.

The six arbitration forums gave us lists that included a total of 6,647 arbitration cases closed between January 1, 1989, and June 30, 1990. We asked for retail cases that involved public customers and were resolved through the arbitration process, either by arbitrators' decisions or by settlement agreements between the parties. We reviewed all the arbitration case files from AAA, Amex, CBOE, and NFA. Because of the large number of cases and resource limitations, we randomly sampled the cases from the two largest forums, NYSE and NASD.

After we began collecting our data, we found cases that did not meet our review criteria. We deleted these cases and adjusted our universe. Tables 2.2 and 2.3 show the final results of our case selection.

Table 2.2: Decided Cases Selected and Reviewed

Forum	Original universe	Original selection	Number of cases			Adjusted universe
			Missing	Deleted	Reviewed	
AAA	283	283	11	24	248	259
Amex	32	32	0	2	30	30
CBOE	65	65	0	6	59	59
NFA	246	246	1	1	244	245
NASD	2,873	376	38	8	330	2,812
NYSE	801	297	50	10	237	774
Total	**4,300**	**1,299**	**100**	**51**	**1,148**	**4,179**

Table 2.3: Settled Cases Selected and Reviewed

Forum	Original universe	Original selection	Number of cases			Adjusted universe
			Missing	Deleted	Reviewed	
AAA	209	209	79	8	122	201
Amex	36	36	0	1	35	35
CBOE	14	14	0	0	14	14
NFA	207	207	0	1	206	206
NASD	1,369	305	19	4	282	1,351
NYSE	512	229	48	15	166	478
Total	**2,347**	**1,000**	**146**	**29**	**825**	**2,285**

As tables 2.2 and 2.3 show, we deleted 80 cases (51 decided by arbitrators and 29 settled by the parties) because they did not involve a retail investor in the arbitration or otherwise did not meet our criteria for review. Accordingly, for the forums that we sampled, we adjusted the universe totals by the proportion of deleted cases to the original sample size. For the forums where all cases were selected, we adjusted the universe totals by subtracting the number of deleted cases from the original universe.

We were unable to review some cases because their files were missing; thus we further adjusted the universe totals. We asked forum officials to explain why the missing files could not be located. They could provide no specific reason for the missing files. We have no reason to believe that the missing files were not randomly distributed throughout the universe of files and thus believe that they would be unlikely to have any characteristics that would distort the results of our analysis.

AAA could not provide 90 files because they had been destroyed or could not be located. Of these, 11 involved decided cases and 79 involved settled cases. AAA officials said that AAA policy is to destroy files of settled cases after 1 year.

Notwithstanding our intent to use the data in the case files for statistical purposes only, AAA was unwilling to give us full access to its case files without permission from the parties involved. To get permission, AAA contacted the disputants involved in the arbitration cases we asked to review. Some objected to our reviewing their files, and AAA denied us access to these files. To assist our review, the House of Representatives subpoenaed the files for the House Committee on Energy and Commerce. AAA complied with the subpoena, so we were ultimately able to review the files for which we were initially denied access.

We designed and pretested a data collection instrument to ensure that we would collect systematic and accurate information from each arbitration case file. We also established coding rules to ensure consistent interpretation and recording of data from the files.

For each case, we collected information about the claim and award, including amounts asked and awarded for compensation, punitive damages, interest, attorney fees, and other fees. In 505 cases, claimants asked for punitive damages, but damages were awarded in only 28 cases. Because these claims were related to punishment rather than claimant losses or costs and including these claims would significantly skew the summary statistics in relation to their occurrence, we excluded punitive claims and awards from our summary analyses.

To more thoroughly analyze the arbitration results, we developed loglinear models to determine whether relationships existed between 10 explanatory variables and 3 separate outcome variables. We judgmentally selected these variables after a preliminary analysis of the arbitration process and the information available in arbitration case files. We analyzed whether the 10 explanatory variables (forum, decision procedure, claimant class, attorney representation, state of residence, option to buy a security or commodity, claim size, securities or commodities product, counterclaim, and processing time) were associated with the three outcomes: (1) whether the claim was settled or decided by arbitration; (2) if decided, whether the claimant received an award; and (3) if the claimant

received an award, whether the award was more or less than 60 percent of the total claim amount.[1]

We were unable to compare the results of arbitration with the results of litigation because of a lack of cases and the inherent differences between the two processes. However, to get some idea of what happens to cases litigated in court, we reviewed securities and commodities cases closed between January 1, 1989, and June 30, 1990, in the Federal District Courts of the District of Columbia, Maryland, Northern Illinois, Southern New York, and Eastern Virginia.[2] We selected these districts because their locations were convenient to where we were doing other work. From the list of 790 securities and commodities cases closed in these district courts, we identified 161 cases that involved retail investors. Of these, 100 cases were either decided or settled, with the remainder sent back to arbitration, transferred to another district, or otherwise moved from the jurisdiction of the district court or dismissed. We reviewed all 100 court cases—6 from the District of Columbia, 9 from Maryland, 26 from Northern Illinois, 56 from Southern New York, and 3 from Eastern Virginia. The results of these 100 cases cannot be generalized to all litigated securities and commodities cases. In addition, we found that the inherent differences between arbitration and litigation as discussed in appendix I prevented meaningful comparisons of the two processes on their respective outcomes. Appendix II discusses other alternative dispute resolution methods.

Procedural Differences Between Arbitration and Litigation

To assess procedural differences between arbitration and litigation, we interviewed arbitration forum officials. We also reviewed and compared the Uniform Code of Arbitration, rules and regulations of each arbitration forum, and selected laws pertaining to the arbitration and litigation processes.

Industry and Investor Views on Potential Changes to Arbitration

We contacted securities industry representatives, broker-dealer firms, investor groups, selected individual investors, and others to obtain opinions on the need for specific changes to the securities arbitration system. These changes related to (1) federal legislation prohibiting mandatory arbitration clauses, (2) a mandatory nonbinding arbitration system, (3) a single agency to administer securities arbitration, and (4)

[1]The average amount awarded for all the claims we reviewed was about 60 percent of the amount requested. For a discussion of these results, see chapter 4.

[2]We did not select nonfederal courts because they do not maintain information on securities cases that would allow us to determine whether retail investors were involved.

federal legislation requiring arbitrators to write a brief statement and/or complete a checklist explaining the reasons for their decisions.

To obtain broker-dealer views, we included specific questions in the questionnaire we sent to firms on their use of predispute arbitration clauses. The views we obtained are representative of all broker-dealers who do business with retail public customers. In addition, we did structured interviews in person or by telephone between May and August 1991 with 2 industry representatives, 5 investor groups, 14 individual investors, 4 arbitrators, and 7 attorneys. The groups and individuals we interviewed (1) had contacted the Committees, Subcommittee, or us with information about their particular case or ideas about the arbitration system; (2) were referred to us by an investor representative, regulators, or arbitration participants; or (3) were judgmentally selected because of their knowledge or experience in the field. Their opinions are not representative of all investors, arbitrators, and attorneys.

Selection and Training of Arbitrators

To obtain information on the selection and training of arbitrators, we interviewed SEC and arbitration forum officials and analyzed the forums' files on certain selected arbitrators. We obtained and reviewed arbitrator profiles, arbitrator applications, questionnaires, resumes, and other background information that SROs use to place arbitrators into the arbitrator pool and classify them as "public" or "industry" arbitrators. These documents can be used by SROs and AAA to select arbitrators for a specific case. The parties use arbitrator profiles to accept or challenge individual arbitrators.

We interviewed forum officials about the evaluation of arbitrators, training requirements, and identification of training needs. We also reviewed the arbitrators' manual and various schedules of courses available. In addition, on the basis of our case file review, we gathered information on how frequently the same arbitrator was used.

Use of Predispute Arbitration Clauses

Our analysis showed that an individual investor's best chance of opening an account with a broker-dealer firm without signing an agreement containing a predispute arbitration clause was to open a cash account with a large broker-dealer firm. If individual investors opened margin or options accounts at any firm, they were more likely to have to sign an agreement including a predispute arbitration clause. When they encountered arbitration clauses in account agreements, they were likely to find that the firm was not willing to waive or negotiate the arbitration clause. An individual investor's best chance of finding an account agreement with an arbitration clause that included the alternative of arbitration by an independent forum was at a smaller broker-dealer firm.

Finally, our data show that the firms we surveyed used arbitration clauses in account agreements with institutional investors about as frequently as in cash account agreements with individual investors. Although determining the specific reasons for individual broker-dealer firms' policies was beyond the scope of our review, the reasons cited by one industry representative and attributed to others by SEC generally related to the risk and complexity of transactions and the perception that arbitration costs less than litigation.

Firms Varied in Use of Arbitration Clauses With Individual Investors

Some broker-dealer firms required or planned to require individual investors to sign agreements containing predispute arbitration clauses; others did not and had no plans to do so. These policies and plans for the future varied in some respects by the size of the firm and the type of account. Table 3.1 shows that of the nine large broker-dealer firms, which handled nearly 75 percent of individual accounts of all types, most did not require individual investors who opened cash accounts to sign agreements containing arbitration clauses. However, a substantial minority of medium and small firms did have such requirements.[1] Specifically, only one of the large firms (or 11 percent) required individual investors opening cash accounts on or after December 1, 1990, to sign such an agreement. Of the medium and small firms, 46 and 37 percent, respectively, required such agreements. On the other hand, all the large firms, over 90 percent of the medium firms, and over 70 percent of the small firms required arbitration clauses for individual investors opening margin and options accounts.

[1]The results for small firms throughout this chapter are estimated. See chapter 2 for a discussion of our sampling techniques.

Table 3.1: Number and Percent of Firms Requiring Predispute Arbitration Clauses in Accounts for Individual Investors

			Type of account								
			Cash[a]			Margin			Options		
	Number of firms responding	Percent of retail accounts	Number of firms requiring clauses	Number of firms with cash accounts	Percent of firms requiring clauses	Number of firms requiring clauses	Number of firms with margin accounts	Percent of firms requiring clauses	Number of firms requiring clauses	Number of firms with options accounts	Percent of firms requiring clauses
Large firms	9	74									
Dec. 1, 1987			2	9	22	7	9	78	6	8	75
Dec. 1, 1990			1	9	11	9	9	100	8	8	100
Future policy			1	9	11	9	9	100	8	8	100
Medium firms	26	13.5									
Dec. 1, 1987			9	26	35	21	25	84	20	25	80
Dec. 1, 1990			12	26	46	23	25	92	23	25	92
Future policy			15	26	58	24	25	96	24	25	96
Small firms[b]	459	12.4									
Dec. 1, 1987			105	459	23	135	255	53	126	234	54
Dec. 1, 1990			168	459	37	180	255	71	168	234	72
Future policy			225	459	49	207	255	81	195	234	83

Note: At a 95-percent level of confidence, the sampling errors for small firms range from plus or minus 5.4 percent to plus or minus 9 percent.

[a]Excludes specialized accounts such as IRA and 401 K accounts.

[b]Weighted data (see ch. 2 for a discussion of how we weighted the small firms).

Source: GAO survey of retail broker-dealer firms.

Our analysis indicated a trend among medium and small firms of increasing use of arbitration clauses in account agreements signed by individual investors. The number of large firms with a policy requiring arbitration clauses has remained relatively constant since 1987, while the number of medium and small firms requiring the clauses has increased. One of the two large firms that required clauses for cash accounts in 1987 had dropped this requirement as of December 1, 1990; however, two large firms that did not require the clauses for margin and options accounts in

1987 did so as of December 1, 1990. Although the number of both medium and small firms including the clauses in all types of account agreements increased from 1987 to 1990, the number of small firms doing so increased the most. For example, our data show that of the 459 small firms, the number including clauses in cash account agreements increased from 105 to 168, or 14 percent.

In response to our questionnaire, representatives of the large firms reported that they intended to continue generally not requiring arbitration clauses for cash accounts but requiring them for margin and options accounts. However, some medium and small firms that did not require clauses as of December 1, 1990, reported that they do plan to start such requirements for all types of individual retail accounts—cash, margin, and options. For example, as shown in table 3.1, 57 of the 459 small firms that did not require arbitration clauses for cash accounts as of December 1, 1990, plan to require them in the future.

Most Firms Rarely Waived or Negotiated Arbitration Clauses for Individual or Institutional Investors

Most of the firms that required arbitration clauses in account agreements with individual and institutional[2] investors never or almost never waived or negotiated the clauses. In response to our questionnaire, the one large firm that required its individual investors to sign cash account agreements with an arbitration clause reported that it almost never waived or negotiated the clauses. Nine of the 12 medium firms (75 percent) and 162 of the 168 small firms (96 percent) that required clauses for cash accounts reported that they never or almost never waived or negotiated the clause for individual investors during 1990. For individual investors' margin and options accounts, over 75 percent of the firms, regardless of their size, that required arbitration clauses indicated that they never or almost never waived or negotiated the clause during 1990.

Our analysis of data on firms' use of arbitration clauses shows that retail broker-dealer firms required arbitration agreements of institutional investors about as frequently as they did of individual investors with cash accounts. Because our survey was designed to focus on individual rather than institutional accounts—in keeping with the request for this study—we focused on retail broker-dealers and collected only summary data on institutional investor accounts at these broker-dealers. That is, we asked large, medium, and small retail broker-dealer firms if they required agreements to arbitrate disputes with institutions generally, without

[2]An institution is a large organization, such as a bank, mutual fund, or pension fund, that buys and sells securities.

regard to the three specific types of accounts (cash, margin, and options). Table 3.2 compares the use of arbitration clauses as of December 1990 for institutional and individual cash accounts by size of firm.

Table 3.2: Number and Percent of Firms Requiring Arbitration Clauses for Institutional and Individual Cash Accounts

	Number and percent of firms requiring clauses as of December 1, 1990	
Firm size	**Individual cash accounts**	**Institutional accounts[a]**
Large	1 of 9, or 11%	2 of 8, or 25%
Medium	12 of 26, or 46%	10 of 24, or 42%
Small	168 of 459, or 37%[b]	111 of 303, or 37%[c]

[a]Of the nine large firms, eight had institutional accounts, which could include cash, margin, or options accounts. Similarly, 24 of 26 medium firms had institutional accounts, and a weighted 303 of 459 small firms had institutional accounts. (See ch. 2 for a discussion of how we weighted the small firms.)

[b]The sampling error is plus or minus 6.2 percent.

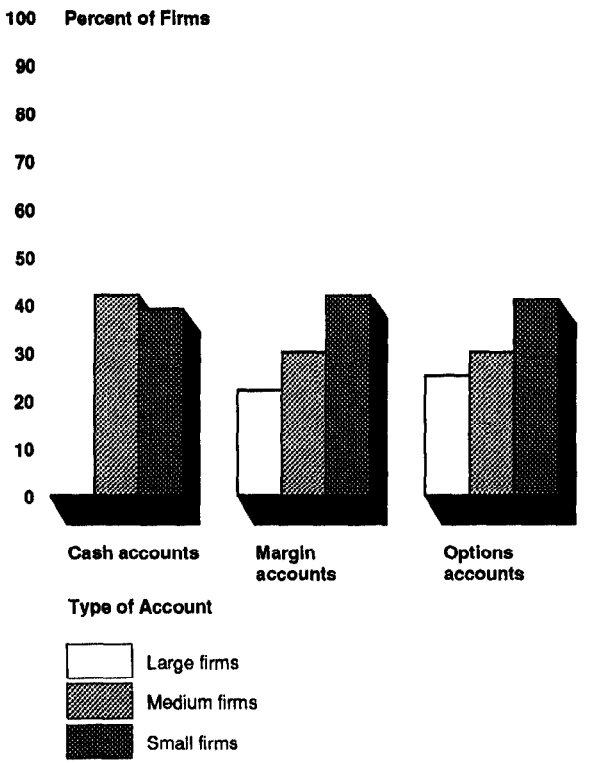
[c]The sampling error is plus or minus 7.7 percent.

With regard to institutional investor accounts, one of the two large firms that required clauses indicated it almost never waived or negotiated the clauses during 1990. At least 60 percent of medium firms and over 85 percent of the small firms also reported they never or almost never waived or negotiated the clauses.

Most Broker-Dealers Did Not Offer AAA as an Alternative Forum

Our questionnaire results indicated that large firms seldom included AAA as an alternative forum in their account agreements with individual investors, while medium and small firms more often did. Figure 3.1 shows the percent of firms that included AAA as a forum choice in their account agreements as of December 1, 1990.

Figure 3.1: Percent of Firms That Included AAA as a Forum Choice in Their Account Agreements



Note: Sampling errors for small firms range from plus or minus 10.2 percent to plus or minus 10.6 percent.

Source: GAO survey of retail broker-dealer firms.

Despite SEC's encouragement to broker-dealer firms to allow customers the alternative of independent forums, the firms' policies of requiring customers to resolve disputes at industry-sponsored forums have changed little since 1987. Only one large firm changed its policy since 1987 to offer AAA arbitration as an alternative for margin and options account customers. The proportion of medium and small firms providing AAA as an alternative forum generally has remained the same since 1987.

As discussed in chapter 1, five NYSE broker-dealer firms have agreed to allow selected customers to use AAA for arbitration. As of July 1991, the 5 firms had allowed 25 customers to have their cases resolved by AAA. It

should be noted that the firms in this program had not changed their policies regarding independent arbitration; they were allowing, on an experimental basis, some exceptions to their policies requiring SRO arbitration.

Reasons for Broker-Dealer Firm Arbitration Clause Policies

Although determining the reasons for specific broker-dealer policies requiring predispute arbitration clauses was beyond the scope of our review, we noted from our data that, overall, broker-dealer firms tended to require arbitration clauses in agreements for accounts that involved greater risk and more complex transactions. As our study showed, arbitration clauses were less likely to be found in agreements for cash accounts than in margin and options accounts.

In interpreting our findings, we noted that margin and options transactions present unique financial risks to broker-dealers. An option is a contract giving the holder the right to buy or sell a stated number of shares of a stock at a fixed price within a predetermined period. As a New York Institute of Finance handbook states, "Option trading is a highly specialized and time-consuming area of investment. Unlike many investments that can be purchased and held for an indefinite period with little or no management, option investment requires constant vigilance. A relatively small change in the price of the underlying security may result in a large percentage change in the value of an options contract."[3] In 1988 testimony before Congress, the SEC Chairman noted that broker-dealers would argue,

> . . . among other things, that they are at financial risk with margin accounts and therefore have a right to insist on the forum to resolve disputes. They would also argue that the issues involving options and margin are more technical and complicated than those involving cash accounts and, thus, arbitration is the more appropriate forum. Additionally, they would point out that margin and options accounts are more likely to result in litigation and that, therefore, arbitration, as the less costly forum, is particularly appropriate for these types of accounts.[4]

The Chairman concluded that the issues were complicated and required further analysis.

[3]Victor L. Harper, Handbook of Investment Products And Services, New York Institute of Finance (1977), p.139.

[4]From testimony by David Ruder, SEC Chairman, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (July 12, 1988).

Margin accounts present greater risk to the broker-dealer than cash accounts. In a margin account, broker-dealers extend credit to customers to purchase equity securities or options. Margin is the equity in the account—that is, the value of the securities in the account minus any credit extended. When the customer buys securities in a margin account, the securities act as collateral for the extension of credit by the broker-dealer. Although the margin should protect the broker-dealer against loss due to adverse movements in the prices of the security,[5] problems can arise that might cause an uncollected debit balance.[6]

Data we collected showed that arbitration clauses were about as likely to be included in agreements with institutional investors as in cash account agreements with individual investors. A representative of the securities industry told us that institutional account transactions are generally overseen by managers in the institutions who tend to be more sophisticated than most individual investors, thus reducing opportunities for misunderstandings or miscommunication between broker-dealers and customers. For this reason, the risk of disputes is lower with institutional accounts.

[5]The October 1987 Market Break, Division of Market Regulation, SEC (Feb. 1988), pp. 5-11.

[6]From remarks by Edward O'Brien, President, SIA, at the 17th Annual Securities Regulation Institute (Jan. 24, 1990).

Arbitration Case Results

Statistical analysis of decisions in cases initiated by investors at all arbitration forums—industry and nonindustry—showed that the forum in which the decision was made was not a factor affecting investors' chances of receiving awards. The results of securities arbitration at all industry-sponsored forums were similar to each other and to the results of securities arbitration at AAA and for commodities arbitration by NFA. Decision outcomes varied depending on several factors, such as attorney representation and claim size. The analysis also showed that when broker-dealers initiated the claims, arbitrators' decisions usually favored the broker-dealers and that these cases usually involved well-documented investors' debt to the broker-dealer.

In addition to cases decided by arbitrators, the disputing parties settled about one-third to one-half of the cases we reviewed without requiring arbitrators' decisions. Our analysis of these cases showed that several factors, such as attorney representation and claim size, influenced whether the parties were able to settle their cases.

We could not compare our analysis of arbitration results with litigated cases because (1) we found relatively few litigated cases involving individual investors' disputes and (2) there were inherent differences between the two processes. Most of those cases were settled out of court with little or no information available on the outcomes.

No Indication of Pro-Industry Bias in Arbitration Decisions at Industry-Sponsored Forums

At the four SRO-sponsored arbitration forums—Amex, CBOE, NASD and NYSE—arbitrators decided in favor of investors in a combined average of about 59 percent of the cases in which investors filed claims against broker-dealers.[1] Also, investors receiving awards got an overall average of about 61 percent of the amount they claimed. Both percentages were similar for NASD and NYSE, which together handled more than 90 percent of securities arbitration cases at industry forums.[2] Our multivariate analysis showed that the forum in which a case was arbitrated was not a factor that affected whether investors received an award or the proportion of any award the investor received.

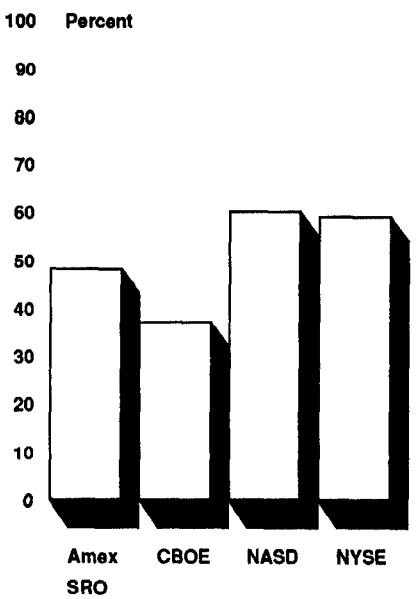
As shown in figure 4.1, the percentage of cases decided in favor of investors at both NASD and NYSE averaged nearly 60 percent. At Amex and CBOE, investors received an award in about 48 and 37 percent of the cases,

[1]Most cases we reviewed came to arbitration because investors filed claims. Cases initiated by broker-dealers against investors constituted only about 10 percent of the cases.

[2]The results for NASD and NYSE are estimated. See ch. 2 for a discussion of our sampling techniques.

respectively. Despite the differences in the percentage of awards investors received at NYSE and NASD compared to those received at Amex and CBOE, our multivariate analysis showed that these differences were not associated with the forum but with other factors we analyzed, as discussed later. This type of analysis, explained in detail in appendix III, allows simultaneous evaluation of the effects of several factors on a particular result and isolation of the effect of any one factor by controlling or holding constant all other factors. This method is superior to evaluating each factor separately, a process that could result in misleading conclusions.

Figure 4.1: Percent of Investors Receiving an Award, by SRO



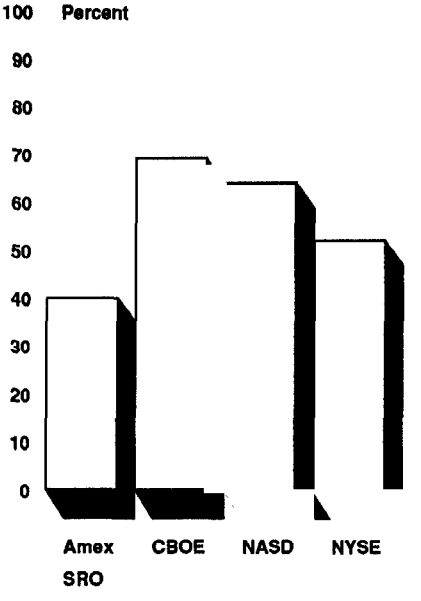
Note: For NASD and NYSE the sampling errors are plus or minus 5.2 percent and plus or minus 5.4 percent, respectively. Because we examined all cases at Amex and CBOE, there are no sampling errors.

Source: GAO analysis of closed arbitration cases.

Figure 4.2 shows the average percent of the claim amount awarded to investors by each SRO-sponsored forum. At NASD and NYSE, these averages were 64 and 52 percent, respectively. The average at CBOE was 69 percent and at Amex, 40 percent. Our analysis included amounts claimed and

awarded but did not include any punitive damages claimed or awarded. Investors sometimes received more than the total amount they claimed. In such cases, arbitrators may have decided to award more than the investor claimed or actual amounts for attorney fees, interest, and other costs that investors requested in their claims by name but not by dollar amount. In about 30 percent[3] of the disputes, arbitrators at SROs awarded investors the total amount claimed or more.

Figure 4.2: Percent of Claim Awarded by SRO



Note: The sampling errors for NASD and NYSE are plus or minus 16 percent and plus or minus 9 percent, respectively. There are no sampling errors for Amex and CBOE.

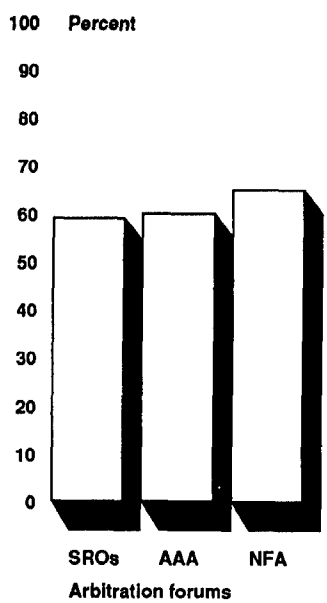
Source: GAO analysis of closed arbitration cases.

[3]The sampling error is plus or minus 5.2 percent.

Combined Securities SRO Results Were Similar to Those at AAA and NFA

Figure 4.3 shows that arbitrators decided in favor of the investor in a combined average of about 59 percent of the cases at the forums sponsored by the securities industry and in about 60 percent of the cases at AAA. At NFA, about 65 percent of the investors received an award.[4] These percentages vary somewhat. However, the results of our multivariate analysis showed no differences caused by the particular forum relating to (1) the making of an award or (2) the proportion of the claim awarded when controlling for all the other factors we analyzed.

Figure 4.3: Percent of Investors Receiving an Award at Securities SROs, AAA, and NFA



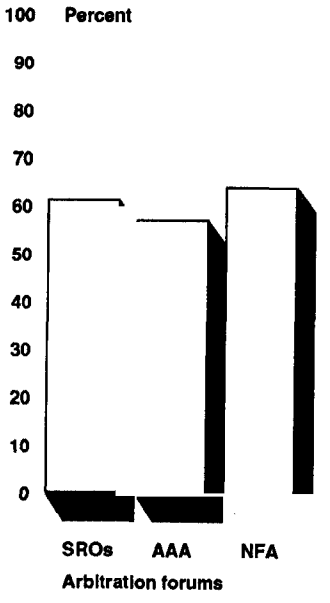
Source: GAO analysis of closed arbitration cases.

Figure 4.4 shows that when investors received an award, they were awarded about 61 percent of their claim at securities SROs and about 57

[4]Arbitration is only one alternative that investors have to resolve commodity futures disputes, because while commodities firms may employ predispute arbitration clauses, they may not make adherence to the clauses a precondition of doing business. If customers have not signed arbitration clauses in their commodities agreements, they also have the right to take their cases through the courts. Moreover, commodities customers may opt to use the reparations procedures administered by CFTC regardless of whether they have signed predispute arbitration clauses. In addition, mediation services are available from various providers; for instance, NFA offers mediation as an adjunct to its arbitration facilities.

percent of their claim at AAA. NFA's investors' awards averaged about 64 percent of their claims. As previously discussed, our multivariate analysis indicated that these differences are not caused by the particular forum when controlling for all other factors we analyzed.

Figure 4.4: Percent of Total Claim Awarded at Securities SROs, AAA, and NFA



Note: The sampling error for SROs is plus or minus 13 percent. There are no sampling errors for AAA and NFA.

Source: GAO analysis of closed arbitration cases.

Factors Affecting Arbitration Results

In addition to determining whether cases decided by arbitration differed depending on which forum was used, we also looked for differences in results caused by other factors of the arbitration process. These nine other factors were (1) the basis for the arbitrator's decision, either a hearing or a review of written evidence; (2) claimant class; (3) state of residence; (4) attorney representation; (5) involvement of options accounts; (6) claim size; (7) securities or commodities product; (8) filing of a counterclaim; and (9) processing time.

Our multivariate analysis showed that the only factors increasing the investors' chances of receiving an award were whether (1) decisions were

based on hearings rather than on written submissions and (2) commodities options were involved in the dispute. Factors increasing the proportion of the claim awarded were whether (1) there was representation by an attorney and (2) the claims were under $20,000. Claims initiated by the broker-dealer also affected whether the claim was awarded and the proportion of the award. The broker-dealer effect is discussed later in this section. All other factors had no statistically significant effect on the results of arbitration.

Factors Affecting Whether an Award Was Made

Securities investors whose cases were decided after a hearing, whether at SRO-sponsored forums or AAA, were 1.4 times more likely to receive an award than investors whose cases were decided only on a review of written evidence.[5] The results for NFA commodities cases were the same.

Unless the investor requests a hearing or the arbitrator calls one, claims of $10,000 or less are decided by one public arbitrator after a review of written evidence that both parties submitted. Claims over $10,000 are usually decided by a panel of three arbitrators after presentation of evidence at a hearing. Industry-sponsored forums use $10,000 as a cutoff for deciding which process to use. AAA uses $5,000 as its cutoff, but our sample had only a few AAA cases with claims under $5,000. For commodities cases at NFA, $10,000 is the cutoff point for cases to be decided by one arbitrator; $2,500 is the cutoff for cases to be decided by a review of written evidence.

Investors with claims involving commodities options were 1.8 times more likely to receive an award as investors with other types of products involved in their claim. Other products, including securities options, stocks, futures, bonds, and government and municipal securities, had no significant effects on case outcomes.

Factors Affecting the Amount Awarded

Investors were represented by an attorney in 58 percent of the cases at securities SROs, 93 percent of the AAA cases, and 39 percent of the NFA cases. Although attorney representation did not affect whether an investor received an award, it did affect award size when awards were made.

[5]Our multivariate analysis allowed us to isolate and quantify the effects of all 10 factors on whether an award was made. The results reported, therefore, are only for the one factor, controlling for the effects of all the other factors. For example, cases decided after a hearing were 1.4 times more likely to be decided in favor of the claimant than cases decided by written submissions, regardless of the forum, attorney representation, the presence of an option, the size of the claim, the duration of the process, the initiator of the claim (broker-dealers or investors), or any other factor tested.

Investors with representation were 1.6 times as likely to receive an award in excess of 60 percent of their claim, the average percent awarded. Also, claims under $20,000 were 3.7 times as likely as larger claims to result in an award greater than 60 percent of the amount claimed.

When Broker-Dealers Initiated Cases, Arbitration Decisions Favored the Broker-Dealers

Arbitrators more often decided in favor of broker-dealers rather than investors in cases initiated by broker-dealers. Broker-dealer claims against investors were 3.3 times as likely to be decided in favor of the broker-dealer as investor claims against broker-dealers. However, the substance of broker-dealer claims was usually an unpaid debit balance in an investor's account. SRO arbitration officials told us these claims are easier for broker-dealers to prove because the evidence usually includes written documents. Evidence for investor claims such as unauthorized trading usually is not written.

About 10 percent of securities SRO disputes resulting in an arbitration decision and about 13 percent of AAA disputes resulting in an arbitration decision involved claims initiated by broker-dealers against investors. Broker-dealer firms received awards in 90 percent[6] of the cases at SROs, and they received an average of 91 percent[7] of their total claim. At AAA, broker-dealer firms received awards in 81 percent of the cases, and they were awarded 93 percent of their total claim. Our multivariate analysis showed that the differences in these results were not caused by the forum but by other variables.

In addition to initiating claims against investors, broker-dealers can make counterclaims in response to investors' claims. Our estimated results for securities SRO cases showed that broker-dealers made 265 counterclaims. Broker-dealers received awards in 17 percent[8] of these cases in which they filed counterclaims and received 92 percent[9] of the total amount named in the counterclaim. In the AAA cases, broker-dealers made an estimated 30 counterclaims. They received awards in 33 percent of these cases and were awarded 64 percent of the counterclaim. However, our multivariate analysis showed that a counterclaim had no relationship to any arbitration outcome.

[6]The sampling error is plus or minus 6.6 percent.

[7]The sampling error is plus or minus 9 percent.

[8]The sampling error is plus or minus 10 percent.

[9]The sampling error is plus or minus 9 percent.

In commodities cases at NFA, the broker-dealer equivalent, called a "futures commission merchant," filed an initial claim or counterclaim against investors only 22 times in 481 total decided cases. Arbitrators decided in favor of the futures commission merchant in half of the cases.

Other Similarities and Differences Among Forums and Types of Disputes for Cases Initiated by Investors

In addition to comparing the results of arbitration at the various forums, we compared types of allegations in securities and commodities disputes. Also, we compared arbitration forums with regard to the size of claims made, the duration of the processing, the extent of punitive damage awards, and the costs to investors.

Investors generally made similar allegations in both securities and commodities disputes, although the frequency of types of allegations varied between the two kinds of disputes, and the claim size was larger for securities disputes. Case processing time from start to finish was about 1 year for securities SROs and AAA and longer for commodities arbitrations at NFA. Arbitrators rarely awarded punitive damages in deciding securities disputes. We could not make a comparison to commodities disputes because NFA has allowed investors to claim punitive damages only since August 1989.

Finally, from information in files kept by securities SROs and AAA, we could not determine the total costs of particular arbitration cases, but for those costs we could identify, AAA was generally more expensive than SROs.

Allegations in Securities and Commodities Disputes Were Similar in Kind but Different in Frequency

In their arbitration claims, investors in securities typically specified more than one allegation relating to or arising from the business activities of their broker-dealers. The three most frequent allegations in securities claims, as shown in table 4.1, were brokers' misrepresentation of investment risks; negligence; and unauthorized trading. The table also shows that commodities investors made similar allegations, but the frequency of each type varied from those made in securities cases.

Table 4.1: Percent of Completed Cases Involving Each Type of Allegation

Allegation	Percent	
	Securities cases	Commodities cases
Misrepresentation	35	59
Negligence	32	15
Unauthorized trading	26	37
Suitability	25	7
Fraud	22	16
Breach of fiduciary duty	20	41
Failure to obey	18	25
Churning	12	29
Breach of contract	10	10
Nondisclosure	5	20

Source: GAO analysis of closed cases.

Amount of Claims Was Highest in Disputes at AAA

The amount of investors' claims against broker-dealers varied among securities SROs, AAA, and NFA. Table 4.2 shows that securities claims were higher than commodities claims. In addition, the claims investors filed at AAA were higher than those filed at securities SROs.

Table 4.2: Size of Claims by Type of Forum

Forum	Range		Mean	Median
	Low	High		
Securities SROs	$25	$24,000,000	$171,294	$23,459
AAA	1,425	30,000,000	310,583	80,000
NFA	269	1,349,168	29,357	9,512

Note: These amounts do not include punitive damages.

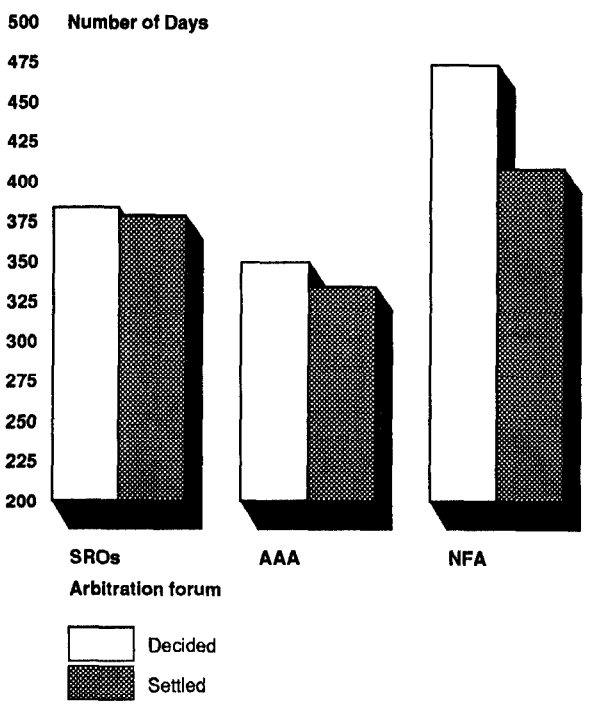
Source: GAO analysis of closed cases.

The Time to Process Securities Claims Was About 1 Year at SROs and AAA

The time it took investors to resolve securities disputes averaged over 1 year at SROs and slightly less than 1 year at AAA. Disputes decided at NFA took longer to resolve than disputes at securities SROs. Whether the case was decided after a review of written evidence or after a hearing affected case processing time.

We defined processing time as starting when the forum receives an investor's claim and ending when the forum sends the arbitrators' decision to the party or the forum receives notice of settlement terms. As indicated in figure 4.5, the average time to process a decided case at forums sponsored by the securities industry was 383 days, compared to 378 days for a settled case. The average processing time for a decided case at AAA was 349 days, with 334 days for a settled case. A comparison of NFA to forums sponsored by the securities industry showed that NFA took about 3 months longer to decide a case and about 1 month longer to settle a case.

Figure 4.5: Processing Time by Decided and Settled Case and by Forum



Note: The sampling errors for SROs' decided and settled cases are plus or minus 47 days and plus or minus 36 days, respectively. There are no sampling errors for AAA and NFA.

Source: GAO analysis of closed arbitration cases.

At all arbitration forums, claims that were decided by a single arbitrator on the basis of written evidence generally took less time than cases decided

after a hearing. The average time to process a case decided on the basis of written evidence at forums sponsored by the securities industry was 279 days,[10] significantly shorter than the average time of 449 days[11] for cases in which the parties presented evidence at a hearing, usually to a panel of arbitrators. At AAA, the average processing time for cases decided after a hearing was 350 days. Of the two AAA cases that were decided on the basis of written evidence, one took 127 days and the other, 325.

Arbitrators Rarely Awarded Punitive Damages

A party in an arbitration dispute may claim punitive damages, or compensation in excess of actual damages that is intended to punish a wrongdoer. Such claims occurred in 28 percent of the securities cases decided at SROs and 48 percent of the cases decided at AAA. As previously indicated, because NFA did not allow punitive damages claims until after August 1, 1989, we were unable to compare punitive damages claimed and awarded at NFA.

Arbitrators at SROs awarded punitive damages in 12 percent[12] of the decided securities cases in which such damages were requested, and AAA arbitrators awarded punitive damages in 9 percent of the cases in which such damages were requested. The median for such awards was 11 percent of the amount claimed at the industry-sponsored forums and 5 percent at AAA.

Total Costs to Investors of the Arbitration Process Could Not Be Determined

The securities arbitration case files that we reviewed did not contain adequate information for determining the total costs of the process for investors. However, a comparison of the limited information available at each forum on the costs investors paid for filing fees and for arbitrators showed that AAA can be the most expensive forum. We also obtained limited information about attorney fees and travel costs for investors. With regard to the latter, our analysis indicated that arbitration hearings generally were held in the same geographical location as the investor's residence.

Arbitration Fees Varied

All the arbitration forums require investors to submit a filing fee when they file an arbitration claim. Forums sponsored by the securities industry require investors to pay a filing fee ranging from $15 for the smallest claim to $300 for disputes of more than $5,000,000. In addition, investors at these

[10]The sampling error is plus or minus 66 days.

[11]The sampling error is plus or minus 53 days.

[12]The sampling error is plus or minus 5.3 percent.

forums pay a deposit ranging from $15 to $1,500 for the first hearing session and session fees for each hearing session after the first. AAA filing fees range from a minimum of $300 to $14,250 plus one-tenth of 1 percent of claims exceeding $5,000,000 and up to $50,000,000. There is no additional fee for claims over $50,000,000. AAA also charges investors a $75 fee for each session after the first. NFA filing fees range from $50 to $1,550, depending on claim size.

Investors may recover all or part of these fees because arbitrators make the final assessment of the fees against a party. In the cases we reviewed at the forums sponsored by the securities industry, arbitrators assessed all forum fees against investors in about 40 percent of the cases and against broker-dealers in 40 percent of the cases. Arbitrators assessed some part of the fees to both parties in about 20 percent. AAA arbitrators assessed all forum fees against investors in 21 percent of the cases and against broker-dealers in 26 percent. Both parties were assessed some part of the fees in 53 percent. NFA arbitrators assessed all forum fees against investors in 86 percent of the cases, futures commission merchants in 9 percent of the cases, and both in about 5 percent of the cases.

AAA Arbitration Can Be More Costly

Although SRO and AAA fees vary according to the size of the claim and the number of sessions, the total arbitration costs for AAA arbitration can be higher compared to costs for arbitration at the forums sponsored by the securities industry. Parties to disputes at AAA are required to pay not only the fees but also arbitrators' compensation and other costs. At securities SROs, arbitrators' compensation and other costs are subsidized by SROs.

As table 4.3 indicates, our analysis of filing fees and session fees that could be required for various claim amounts and number of hearing sessions showed that AAA fees would be higher for almost all cases requiring one session, regardless of claim size. AAA fees were also higher for claims of $40,000 or more requiring two sessions. Over 60 percent of the cases at SROs and AAA took two or fewer sessions. Arbitrating claims at AAA can also be more costly to investors because they must pay AAA arbitrators' expenses, including arbitrators' compensation, travel, and other expenses.

Table 4.3: AAA and Securities SROs Filing and Session Fees

	1 Session		2 Sessions		3 Sessions	
Claim	SROs	AAA	SROs	AAA	SROs	AAA
$5,000[a]	$ 125	$ 300				
15,000[b]	500	450	$ 900	$ 525	$1,300	$ 600
20,000[b]	500	600	900	675	1,300	750
40,000	520	1,050	920	1,125	1,320	1,200
75,000	650	1,500	1,150	1,575	1,650	1,650
150,000	950	2,000	1,700	2,075	2,450	2,150
300,000	950	2,500	1,700	2,575	2,450	2,650
1,200,000	1,250	4,750	2,250	4,825	3,250	4,900
6,000,000	1,800	15,250	3,300	15,325	4,800	15,400

Note: SROs define a session as 4 or fewer hours of hearings, while AAA considers a session to include any part of the day, such as from 1 hour to 8 hours.

[a]Unless the investor requests a hearing, claims at SROs of $10,000 or less and claims at AAA of $5,000 or less are decided on the basis of an arbitrator review of the written submissions of the parties. The fees shown in the table are those for the reviews of written submissions.

[b]For claims between $10,000 and $30,000 at NASD, unless the investor requests a panel of arbitrators, one arbitrator is used. NASD fees are $400 for one session, $700 for two sessions, and $1,000 for three sessions. NASD panel fees are the same as those shown for the other SROs.

Information on Attorney Fees Was Limited

Investors requested attorney fees as part of their arbitration claim in about 30 percent of the cases decided at securities SROs.[13] The investors were awarded attorney fees in 17 percent[14] of these cases. We were unable to determine whether (1) other awards that did not specify amounts for attorney fees were meant to include attorney fees or (2) the attorney fees awarded represented the total costs to the investor for attorney representation. At AAA, investors requested attorney fees in 58 percent of the cases and were awarded these fees in 9 percent of these cases. At NFA, 25 percent of the cases included a request for attorney fees. Such fees were awarded in 10 percent of the cases.

Investors' Travel Expenses

In most instances, investors did not travel long distances to attend hearings. Generally, all forums held hearings in the same geographical location as the investor's residence. For example, 422 of 486 securities cases heard in New York, about 87 percent,[15] involved investors from New York, New Jersey, or Connecticut. Over 90 percent of the cases at all

[13]For those cases in which investors did not request attorney fees, we could not determine why investors did not make such a request.

[14]The sampling error is plus or minus 5.5 percent.

[15]The sampling error is plus or minus 6.7 percent.

forums were heard in the same state or a state adjoining the investor's state of residence.

Investors' travel expenses were also limited because most hearings were completed in a single day or in consecutive days. The forums sponsored by the securities industry completed 65 percent[16] of the hearings in 1 day and 9 percent in 2 or more consecutive days. The remaining 26 percent of the hearings were not held on consecutive days. At AAA, 42 percent of the hearings were completed in 1 day and 24 percent in 2 or more consecutive days. The remaining 34 percent were held on nonconsecutive days. Over 90 percent of the commodities hearings at NFA were completed in 1 day.

Many Disputes Were Resolved Through Settlement by Parties Rather Than Decisions by Arbitrators

The parties to the disputes settled between one-third and one-half of all their claims filed for arbitration, thus eliminating the need for an arbitration decision. Investors and broker-dealer firms resolved disputes through settlements in about 44 percent of the cases at the securities SROs and 33 percent of the cases at AAA. At NFA, the parties settled 46 percent of the cases before arbitration was completed.

We identified four factors affecting whether a case was settled by the parties or decided by arbitrators: (1) attorney representation, (2) options involvement, (3) claim size, and (4) number of days the case had been in processing. Claimants represented by an attorney were 1.7 times as likely as those not represented to settle their disputes, regardless of all other factors. Those represented by an attorney settled their disputes 52 percent of the time, and those without attorney representation settled their disputes 30 percent of the time. Disputes involving options on stocks or commodities were 1.5 times as likely to be resolved through settlement as claims that did not involve options. Disputes involving claims of less than $5,000 were twice as likely to be decided rather than settled as those involving more than $5,000. In addition, claims that had been in processing more than 300 days were 1.9 times more likely to be decided than claims of shorter duration. We were unable to obtain data on settlement amounts because settlement agreements were generally not made public.

Few Securities and Commodities Disputes Are Litigated

Most of the securities and commodities cases we reviewed that were litigated at the five federal district courts we selected did not involve disputes between individual investors and broker-dealers. The few cases that did were usually settled out of court or dismissed.

[16]The sampling error is plus or minus 5.1 percent.

The Administrative Office of the U.S. Courts identified 790 securities- and commodities-related cases at the five federal district courts that were terminated (settled by the parties before trial, dismissed by the court, or decided by the court) between January 1, 1989, and June 30, 1990. Of these cases, we identified 161 that involved disputes between individual investors and their broker-dealers. Only 23 of these, or 14 percent of the investor-broker disputes, actually resulted in a court decision. Seventy-seven cases, or 48 percent, were settled by the parties before a court decision, and the remaining 61, or 38 percent, were dismissed for various reasons, including being remanded to arbitration or transferred to another district.

Of the 23 cases the courts decided, the decision favored the investor in 9, or 39 percent. Of these nine, six cases received 100 percent of the compensatory amount claimed, one case received 22 percent, one case received 20 percent, and one case received 5 percent. We could not determine total claims because investors often claimed attorney fees, interest losses, and other costs not quantified in either the claim or the award. The investors requested punitive damages in 11 of the 23 cases, but no punitive damages were awarded.

The average time to litigate the 23 cases was 744 days and the median time 594 days. The average time to settle securities cases involving disputes between individual investors and broker-dealer firms in the five U.S. district courts was 510 days; the median time was 365 days.

Views on Whether the Securities Industry Arbitration System Should Be Changed

As might be expected, industry and investor views varied on the need for specific changes to the securities arbitration system. The broker-dealer firms we sampled generally supported the current arbitration system and did not want to change the system to prohibit mandatory predispute arbitration clauses or institute mandatory nonbinding securities arbitration. Nearly two-thirds of the firms supported the concept of a single arbitration agency[1] requiring arbitrators to state the reasons for their decisions, which they are not now required to do.

Investor groups, on the other hand, generally thought the system should be changed to eliminate mandatory arbitration clauses and allow nonbinding arbitration. They also generally supported a single arbitration agency and a requirement that arbitrators state the reasons for their decisions. The 14 individual investors we interviewed (after receiving unsolicited information on their cases directly or through the requesting committees) generally thought the current system was unfair and should be changed.

Nearly all of the 11 attorneys and arbitrators we interviewed were opposed to a nonbinding arbitration system, but their opinions were mixed on the other three issues.

Most Industry Representatives Said They Would Not Support Legislation Prohibiting Predispute Arbitration Clauses, but Others Would

The majority of industry representatives, including broker-dealer firms that responded to our survey on the use of predispute arbitration clauses, favored mandatory arbitration clauses. Individual investors and investor groups we interviewed said broker-dealers should be prohibited from requiring customers to sign agreements that contain such clauses. The views of arbitrators and attorneys were mixed, with as many favoring as opposing mandatory arbitration.

Most broker-dealer firms favored current public policy on the use of arbitration clauses. None of the large or medium broker-dealer firms said they would support federal legislation that would prohibit arbitration clauses for customers. Less than 10 percent of the small firms responding said they would support such legislation for any investor accounts.

Of the 14 investors we interviewed who had used arbitration, 13 said that broker-dealers should be prohibited from requiring their customers to sign arbitration clauses. For example, 1 of these 13 investors said that permitting broker-dealer firms to require customers to sign arbitration

[1]Question 24 in our questionnaire concerning firms' views on the concept of a single arbitration agency could have been misleading. A study of the feasibility of a single forum was initiated by SICA and endorsed by SIA. A single forum was not directly proposed by SIA.

clauses puts investors at a disadvantage by allowing the broker-dealers to restrict methods of resolving potential disputes. Of the 14 investors we interviewed, 10 also said they were unaware that they were signing an arbitration clause when they opened their account. These account agreements, which were later completed and dated by the brokers, contained an arbitration clause.[2] Four of the five investor groups we interviewed said that they believe brokers should be prohibited from requiring customers to sign agreements with arbitration clauses. Four also said they thought that most investors were not made aware of the arbitration clause in their account agreements.

The views of the 11 attorneys and arbitrators we interviewed were about evenly divided for and against requiring customers to sign arbitration clauses. However, 10 of the 11 said that they believe customers are not aware of the arbitration clauses when they sign account agreements.

Industry Representatives Generally Did Not Support Establishing a Mandatory Nonbinding Arbitration System, but Investors Did

Unlike the current binding arbitration system that is used to resolve disputes between broker-dealers and investors, a nonbinding arbitration system would permit the appeal of arbitrators' decisions. Although representatives of the securities industry, arbitrators, and attorneys were generally opposed to establishing a mandatory nonbinding arbitration system, individual investors and investor groups we interviewed favored such a system.

All of the large broker-dealers said they would oppose a nonbinding arbitration system for cash, margin, and options accounts, and eight of nine, or 89 percent, opposed it for institutional accounts. Most small and medium firms also opposed such a change for all account types. Some broker-dealers said that government should not interfere with the securities industry's arbitration system. Several broker-dealers described the current mandatory and binding arbitration system as fairer, quicker, and much cheaper than litigation. One broker-dealer firm said that establishing a mandatory nonbinding arbitration system would produce fewer prehearing settlements, delay final adjudication, and increase costs to all parties. An industry representative said nonbinding arbitration destroys the purpose of arbitration by eliminating the finality of arbitration decisions, thus making arbitration simply another court system.

[2]In May 1989, SEC approved new rules that were intended to increase disclosure of predispute arbitration clauses to customers when opening accounts.

Two broker-dealer firms, however, described the current binding arbitration system as unfair. One firm said that arbitration is prejudiced against the customer and employees of a firm. In addition, the firm said that the securities industry has effectively hidden behind the screen of binding arbitration to prevent it from having to weed out unscrupulous brokers who make the firms a great deal of money. The other firm said that mandatory binding arbitration limits a customer's course of action for handling disputes, including litigation.

Of the 11 arbitrators and attorneys we interviewed, 10 were opposed to establishing a mandatory nonbinding arbitration system. They indicated that establishing a nonbinding appeals system would defeat the purpose of arbitration, benefit the broker-dealers who are better able to afford the cost of continued appeals, and establish another litigation system.

Thirteen of the 14 individual investors and 3 of the 5 investor groups we interviewed favored a mandatory nonbinding arbitration system. Eight of the 13 investors told us they generally viewed the current mandatory binding arbitration system as unfair. Individual investors generally described the current system as biased, self-serving, and not in the best interest of the individual investor. One investor said that investors do not realize how unfair mandatory binding arbitration is until they go through the process. Another said that if arbitration continues to be mandatory, then a nonbinding system should be established that allows investors to appeal a decision.

Most Industry Representatives and Investors Supported the Concept of a Single Agency to Administer Securities Arbitration

Both industry and investor representatives we interviewed generally favored having a single agency administer the arbitration process. Arbitrators and attorneys, however, had mixed views on the single-agency proposal, with as many favoring such reform as opposing it.

Sixty-three percent of broker-dealer firms who responded to our survey and two industry representatives we talked with said they favored a single agency to administer the securities industry arbitration system. However, only three of the seven large firms that responded to this question said they would support the proposal.

Nine of the 14 individual investors and 4 of the 5 investor groups we interviewed also favored a proposal to establish a single arbitration agency. Those supporting the proposal generally favored establishing an agency independent of the securities industry. Only one individual investor

was opposed to the proposal, saying that such a system would become another bureaucracy. Four investors did not have an opinion.

The views of the 11 arbitrators and attorneys we interviewed were divided, with about as many favoring as opposing the single-agency proposal. Some of those favoring the proposal said they supported a forum independent of the securities industry. Others said they supported expanding one of the current arbitration forums or giving the responsibility to a single agency familiar with the securities industry. Some of those opposed to the single-agency proposal said that one agency would be overburdened, overly uniform and bureaucratic, and restrictive of investors' options.

Most Industry Representatives and Investors Would Support Federal Legislation Requiring Arbitrators to Explain Their Decisions

Representatives of the securities industry and the investors we talked with generally supported federal legislation requiring arbitrators to write a brief statement or complete a checklist explaining the reasons for their decisions. The views of arbitrators and attorneys, however, were divided.

About 70 percent of all the broker-dealer firms said they would support federal legislation requiring arbitrators of securities disputes to write a brief statement explaining the reasons for their decisions, and 65 percent said they would support requiring arbitrators to complete a checklist covering the main reasons for their decision. However, for large firms the result was different. Only two of the nine large broker-dealer firms said they would support legislation requiring a written explanation, and only three of the nine large firms said they would support legislation requiring completion of a checklist. One of the industry representatives also favored federal legislation requiring a brief statement or completion of a checklist, saying that such a requirement would be helpful to investors.

Of the 14 investors we interviewed, 12 said they were unaware of the reasons for the arbitrator's decision in their cases. They said that the best way for arbitrators to communicate their decisions would be to provide a written explanation specifying the reasons for a decision. Eleven of the 14 investors and all 5 investor groups we interviewed said such a requirement would help parties better accept the arbitrators' decisions. One investor said that a written explanation would (1) provide more specifics on why such a decision was made, (2) provide some background information in presenting future cases, and (3) provide an investor with the basis for judging the logic behind an arbitration decision. Eight of the 14 investors also viewed as helpful a requirement for arbitrators to complete a checklist, but some said this would not be as helpful as providing investors

with a written explanation. Only one of the five investor groups viewed completing a checklist as helpful.

Arbitrator and attorney views were divided on whether to support or oppose federal legislation requiring arbitrators to write a brief statement or complete a checklist. Although 7 of the 11 arbitrators and attorneys we interviewed said they would support federal legislation requiring arbitrators to write a brief statement, 10 of the 11 said they opposed federal legislation requiring completion of a checklist. Two did not regard a checklist as helpful to investors because it could lead to a more costly and time-consuming arbitration system. An attorney who represented several clients in arbitration said that such a system would encourage broker-dealers' lawyers to find grounds for appeals based on a very fine interpretation of the arbitrators' written statements. An arbitrator, who also opposed this change, said it would defeat the purpose of using arbitration instead of litigation as a simple approach to resolving disputes.

How SROs and AAA Select Arbitrators

Investor confidence in arbitration depends on investors' perceptions of the fairness and expertise of those who decide the cases—the arbitrators. When securities SROs and AAA select individuals to act as arbitrators, they rely on background information that prospective arbitrators provide. SROs and AAA also use this information to classify arbitrators as "public" or "industry" and determine which arbitrators would be best suited to resolve specific disputes. The parties in a dispute also use the background information in deciding whether to request more information or accept or challenge arbitrators proposed for their case.

However, AAA and SROs lack internal controls to reasonably ensure that their arbitrators are qualified to decide securities disputes. Neither verify the background information it receives and has on file. In addition, neither SROs nor AAA has any formal standards related to education or work experience to qualify an individual to be an arbitrator. Finally, neither SROs nor AAA has any formal training programs for arbitrators or any system to assess arbitrators' training needs.

SROs and AAA Have No Internal Controls to Ensure the Accuracy of Background Information

Although all forums rely on background information provided by individuals volunteering to serve as arbitrators, SRO and AAA officials told us that when they receive the background information (including employment history, education, and source of income), they do not routinely verify the accuracy of that information. They also said that they do not routinely verify information they have on file to ensure that it is accurate or current. The forums require arbitrators to update the information when changes in their background occur. The accuracy of the background information is important because the forums use the information to ensure the impartiality and expertise of their arbitrators, and the parties use the information to determine whether to accept particular arbitrators.

Forum administrators use the background information to select individuals to serve as public or industry arbitrators. The Uniform Code requires SRO arbitration panels involving public customers in disputes of more than $10,000 ($30,000 by regulation at NASD) to have at least three arbitrators, with public arbitrators in the majority. Generally, one public arbitrator is required for cases with claims under $10,000 ($30,000 by regulation at NASD). AAA requires three arbitrators, with at least two classified as public, for cases with claims over $25,000.

The Uniform Code defines an industry arbitrator as one who is associated with a member of an SRO, broker-dealer firm, government securities broker-dealer, municipal securities dealer, or registered investment adviser. (NASD permits investment advisers to serve as public arbitrators.) In addition, the code classifies a person who has been associated with securities within the past 3 years (NYSE and CBOE extended the time to 5 years) or retired from any of these professions as an industry arbitrator. Attorneys, accountants, and other professionals who have devoted 20 percent or more of their work effort to securities industry clients in the last 2 years are also classified as industry arbitrators according to the code. On the other hand, the code classifies a public arbitrator as one not associated with the securities industry. Further, the spouse or other member of a household of a person associated with a registered broker-dealer firm, municipal securities dealer, government securities broker-dealer, or investment adviser cannot be a public arbitrator. AAA's definition of a public arbitrator is similar to the Uniform Code's.

SROs and AAA also use the background information to select arbitrators for a specific case. Officials from SROs and AAA told us that they select arbitrators from their list of industry and public arbitrators on the basis of a number of factors. These include availability, the appearance of a conflict of interest, and experience in products or issues similar to those in the dispute. Forum administrators are also to send the background information submitted by the arbitrators to each of the parties in a dispute before the arbitration hearing. The parties are to use this information to decide whether to request more information, accept or challenge the independence or bias of prospective arbitrators, or request their removal. Each party is allowed to remove one arbitrator for any reason and to challenge and remove an unlimited number of arbitrators for cause.

AAA's selection process differs from the SROs' in that it sends a list of industry and public arbitrators to the parties involved. The parties can remove arbitrators from the list and indicate the order of preference for the remaining arbitrators. If the parties cannot agree on which arbitrators to use, AAA makes the selection.

An SEC review of NYSE's arbitration department in July 1990 identified some concerns about the process of selecting arbitrators, including problems with the background information on arbitrators' profiles. Two 1991 SEC inspections—the Pacific Stock Exchange and Municipal Securities Rulemaking Board—also concluded that problems existed with arbitrators' disclosure of employment history and the frequency with

which the information was updated. SEC officials told us that they encouraged SROs to check individual employment and disciplinary history with NASD's Central Registration Depository. This system primarily contains information on broker-dealer firms and their representatives and does not include information on other types of arbitrators, such as accountants or attorneys.

SROs and AAA Have No Formal Standards to Qualify Individuals as Arbitrators

Although securities SROs used the Uniform Code standards discussed earlier to classify arbitrators as industry or public, none of the SROs had formal standards to initially qualify individuals as arbitrators. Instead, SROs decide informally on a case-by-case basis whether individuals are qualified, taking into account the individual's employment history; education; any experience as an arbitrator at another forum; and any references from experienced arbitrators, judges, or business associates. However, none of the SROs apply formal standards that specify minimum professional or educational requirements.

Like SROs, AAA also determines whether individuals are qualified to become arbitrators on a case-by-case basis. AAA applies no formal educational standards in its selection of arbitrators but generally selects arbitrators with 5 to 8 years of experience in the securities industry for industry arbitrators or in the individual field of expertise for public arbitrators. However, these standards may be waived if AAA experiences a shortage of arbitrators.

SROs and AAA compensate the arbitrators for deciding securities disputes. SROs pay arbitrators an honorarium of $150 for a single session (4 hours or less) and $225 for a double session. The chairman of the arbitration panel receives an additional $50 a day. Arbitrators who decide cases on the basis of the written evidence without a hearing receive $75 per case. At AAA, the arbitrators' compensation is negotiated between AAA, the parties, and the arbitrators. The arbitrators usually do not receive compensation for their first day but generally receive between $250 and $750 per day thereafter.

One practice of some SROs that may have created an appearance of partiality toward the industry is the relatively frequent use of certain arbitrators. The NASD and NYSE Directors of Arbitration said that they have been criticized for this practice, and NASD is acting to remedy the situation. The Director of Arbitration at NYSE told us that senior arbitrators were frequently used in the past but that the practice has been stopped. One arbitrator at CBOE decided 47 percent of the cases we reviewed. The CBOE

Director of Arbitration said that she did not see this as a problem because this arbitrator was readily available and very efficient. Although the frequent use of some arbitrators may create an appearance of partiality toward the industry, our review found no evidence that arbitrators' decisions favored investors or the industry. We identified 23 arbitrators that were used 5 or more times in the cases we reviewed at SROs. Fourteen of these arbitrators decided in favor of investors more frequently than broker-dealers, and eight decided in favor of broker-dealers more frequently than investors. One arbitrator's decisions were evenly divided. Two arbitrators, one at Amex and the other at CBOE, decided in favor of the broker-dealer in all five cases they decided. At CBOE, the arbitrator that decided 47 percent of the decided cases we reviewed decided in favor of the broker-dealer in 71 percent of these cases. SEC's 1991 inspection of CBOE's arbitration program also had similar conclusions.

We found during our reviews of case files that AAA did not use the same arbitrators as often as SROs did. Only one arbitrator was used 5 or more times in the cases we reviewed. AAA officials told us that they try to select arbitrators randomly, although they consider whether candidates have chaired an arbitration panel, the complexity and claim amounts of cases heard, areas of expertise, compensation requirements, availability, and how recently candidates have served as arbitrators.

SROs and AAA Have No Formal Training Program and No System for Assessing Training Needs of Arbitrators

In 1987, SEC recommended that SROs implement effective programs to educate arbitrators on a broad range of substantive law, arbitration law, and securities law issues that are likely to arise in arbitration. However, although SROs have taken a number of initiatives to address arbitrators' needs for information about such issues, neither SROs nor AAA has mandatory training programs for arbitrators. SRO and AAA officials told us that all arbitrators are given arbitration manuals and the option of making use of additional materials or training. For instance, CBOE officials told us that new arbitrators attend an arbitration proceeding and are shown video tapes relating to arbitration issues. NASD frequently sponsors seminars that are open to all SRO and AAA arbitrators.

In addition, SROs have no system for identifying the training needs of arbitrators. In 1987, SEC recommended that SROs use written evaluations to monitor arbitrators' performance. SROs ask the parties in the disputes to complete a questionnaire evaluating the competence, preparedness, and fairness of the arbitrators hearing their case. Arbitration department staff and arbitrators are also requested to complete evaluations. The

evaluations are designed to help arbitration departments select arbitrators, develop educational programs, and identify problem areas. SROs and AAA mainly used these tools to evaluate arbitrator performance and decide which arbitrators they should continue to use. SROs and AAA could use the results of these evaluations to determine the training needs of the arbitrators.

Conclusions and Recommendations

Conclusions

We were asked to evaluate the arbitration process because of congressional concerns about the fairness of a system in which broker-dealer firms require investors, as a condition of transacting business with the firms, to resolve securities disputes at industry-sponsored arbitration forums. To improve the public's perception of fairness, SEC has urged broker-dealer firms to allow investors the option of using AAA as an arbitration forum. In addition, NYSE and AAA have begun a pilot program to allow investors to have this option. We believe these SEC efforts are worthwhile, and we support them.

Our statistical analysis of case results and comparison of results between arbitration forums showed no evidence of pro-industry bias at industry-sponsored forums. Investors received awards in more than half the disputes they initiated, and the awards received in industry-sponsored forums were not statistically different from awards at AAA or NFA. Although our review shows that an investor was no more likely to prevail in an independent forum than in an industry-sponsored one, it does not address the fairness of the arbitration process in individual cases. Fair arbitration proceedings are especially important given the financial consequences of arbitrators' decisions on investors and broker-dealer firms because, unlike the judicial process, arbitrators' decisions are generally not reviewable. Further, arbitrators do not have to explain how they made their decisions. We could not address the fairness issue directly because to do so would have required us to make a subjective analysis and judge the merits of the facts and reasoning in each case.

Regardless of forum, the fairness of any arbitration proceeding depends largely on the independence and capability of the arbitrators. The primary ways that industry-sponsored forums can ensure that their arbitration process is as fair as possible are to select arbitrators with appropriate backgrounds and experience and ensure that they are appropriately trained in the arbitration process.

Current policy at industry-sponsored arbitration forums is to obtain background information about people who agree to be arbitrators, require arbitrators to update the information when changes in their backgrounds occur, and in some cases, obtain evaluations from the participants about their arbitrators' proficiency. However, the forums had no established formal standards to initially qualify individuals as arbitrators, did not verify background information provided by prospective or existing arbitrators, and had no system to ensure that arbitrators were adequately trained to perform their functions fairly and appropriately.

SEC should hold industry-sponsored forums responsible for making their arbitration process as fair as possible whether or not investors are given a choice of forums. Enhancing their procedures to select and train arbitrators can provide industry-sponsored arbitration forums better assurance that arbitrators are independent and competent.

Recommendations to SEC

GAO recommends that the Chairman, SEC, require SROs that administer arbitration forums to

- develop formal standards for selecting arbitrators,
- verify information submitted by prospective and existing arbitrators, and
- establish a system to ensure these arbitrators are adequately trained in the arbitration process.

Agency Comments and Our Evaluation

We obtained informal comments on a draft of this report from the four securities SROs as well as AAA and NFA and obtained written comments from SEC. (See app. V.) The securities SROs, AAA, and NFA agreed with our findings, and the securities SROs and AAA told us they would study how our recommendations could be implemented but expressed concern about the potential costs of any needed changes. SEC, while appearing to generally agree with the intent of our recommendations, also expressed concerns that our recommendations "risk increasing significantly the costs of securities arbitration and reducing the pool of qualified arbitrators without materially improving the general quality of the arbitrator pool or increasing assurances of the independence or capability of individual arbitrators."

We believe that SEC's comments reflect a reading of our recommendations with the most stringent possible implementation measures in mind and with a focus on the potential cost of such measures. Such a reading could be overly prescriptive for achieving our intent. Our intent was to enhance the level of assurance provided by present procedures that individual arbitrators, and consequently the pool, are highly qualified and capable. We recognized that options for achieving this intent range across a spectrum and that informed choices would need to be made regarding which options would be most cost-effective in enhancing the present level of assurance. Similarly, we considered that SEC and SROs, given their detailed knowledge of the arbitration process, were in the best position to evaluate the merits of various options. Accordingly, we worded our recommendations to permit latitude in deciding how best they could be

implemented. As discussed in the following paragraphs, we believe the actions suggested by SEC, if effectively implemented, will be generally responsive to our intent.

With respect to our recommendation on developing selection standards, SEC pointed out that a number of factors are already in place to help ensure that selections are appropriate. For example, SEC stated that arbitrators are currently selected on the basis of referrals, recommendations, membership in civic or professional groups, and general reputation in the community, in addition to the information provided in the arbitrators' applications. SEC was concerned that requiring formal standards for arbitrators would either homogenize the pool of arbitrators and thus lose the benefits of a diverse pool or be so loose as to be meaningless. SEC stated that standards that might require all arbitrators to have advanced degrees or a minimum number of years experience in certain professions could foreclose investor choice and exclude individuals with expertise, such as individual investors or other capable arbitrators.

Notwithstanding these concerns, SEC said that it would be appropriate for the SROs to review their arbitrator selection and qualification procedures to determine whether they can be refined to ensure that they have independent and capable arbitrators. If SEC takes action to see that the SROs review and refine their qualification procedures, such action would conform with the intent of our recommendation.

Regarding our recommendation that SROs verify background information submitted by arbitrators, SEC was concerned that significant costs would be incurred if the SROs were to fully check arbitrators' backgrounds. SEC was further concerned about the potential for a reduced applicant pool because of the additional intrusion and increased complexity of the process. SEC pointed out that assurances already exist that background information provided by potential arbitrators is accurate. For example, arbitrators are required to attest to the veracity of their applications when they sign the forms. Also, for arbitrators with securities industry backgrounds, the SROs are expected to examine NASD's Central Registration Depository for any disciplinary history that might exclude them from the arbitrator pool. SEC stated further that, without any evidence indicating a problem in this area, it is reasonable for the SROs to rely on the word of their arbitrators, particularly when many of them are lawyers and other licensed professionals who may risk losing their licenses by making false or misleading statements regarding their backgrounds and experience, and

others might risk damage to their reputations should untruths be uncovered. Finally, SEC stated that arbitrators have a responsibility under their Code of Ethics to provide additional disclosures when they feel it is appropriate to a specific case, and the parties to an arbitration have the right to question potential arbitrators and influence the composition of the panel.

We agree that these factors should provide some assurance that arbitrators supply correct information about their backgrounds and experience. Our intent was to provide for additional verification to enhance the SROs' assurance that arbitrator-supplied information is correct and current. It seemed to us that such assurance might be worth some additional cost for two reasons. First, we note that, while the Central Registration Depository provides a check on background information for arbitrators from the securities industry, it does not include information on other types of arbitrators, such as accountants or attorneys, who may be classified as public arbitrators. Second, SEC itself has reported problems with information the SROs maintain on their arbitrators and concerns about arbitrators' disclosure of employment history and the frequency with which that information was updated.

We agree with SEC that the additional cost of efforts to verify arbitrator background information should be considered. We also note that options for achieving a greater level of assurance might include checking backgrounds for a random sample of arbitrators rather than for all those who apply. Such checks would be consistent with the intent of our recommendations and might provide further assurance that arbitrator information is accurate without adding significant additional costs. Moreover, making all prospective and existing arbitrators aware that the information they provide is subject to verification might be a cost-effective means to help promote full and accurate disclosure.

Finally, with respect to our recommendation concerning arbitrator training, SEC stated that "it would be appropriate to study whether there are cost-effective means to assess arbitrators' training needs and provide better training." This action is consistent with the intent of our recommendation, and the SROs told us they plan to begin such a study.

Comparison of Arbitration and Litigation Procedures

	Securities SROs	AAA	Court
1. Discovery (determining the elements of an opponent's case)	Extensive pretrial discovery permitted in courts is not available in SRO arbitration proceedings. Discovery in arbitration is more focused than in litigation. The Uniform Code encourages the parties to exchange documents and information before the first hearing session and establishes procedures to resolve contested requests for information. The Uniform Code also establishes timetables for the transfer of documents and provides for prehearing conferences.	AAA prehearing rules provide that an administrative conference can be scheduled to expedite the arbitration hearings. In large or complex cases, a preliminary hearing may be held to specify the issues to be resolved, stipulate the uncontested facts, and consider any matters that will expedite the arbitration proceedings.	Federal and state rules of civil procedure provide extensive opportunities to discover the elements of an opponent's case. Discovery is controlled by the parties rather than the courts. Attorneys have a considerable range of discretion in serving interrogatories and taking depositions.
2. Right to appeal	An arbitration award is final and the parties are bound to it; however, an award can be modified or vacated by a court for limited reasons, including arbitrators' partiality or misconduct, prejudicial conduct of the hearing, corruption or fraud in procuring the award, and manifest disregard of the law.	Like SROs awards, AAA awards are also final and binding, subject to the same limited review by the courts.	Unlike arbitration, a court decision can be appealed, which may prolong the final resolution of the dispute.
3. Punitive damages	The federal appellate courts are split on whether punitive damages are available in arbitration. None of the SROs prohibit arbitrators from hearing claims for punitive damages or awarding them.	AAA rules neither permit nor prohibit punitive damage claims. The rules state "the arbitrator may grant any remedy or relief which the arbitrator deems just and equitable and within the scope of the agreement of the parties..."	Punitive damage awards are not available in causes of action arising under express liability provisions of the Federal Securities Acts. Courts prohibit such awards in causes of action implied from the provision. However, exemplary awards are available in court when litigants join pendant state claims with federal claims where the underlying state law so provides.

(continued)

	Securities SROs	AAA	Court
4. Attorney fees	Investors can request attorney fees. While the general legal rule is that each party bears its own legal expenses, arbitrators do award legal fees in some cases if a statutory or contractual basis exists.	Same as SROs. Also see comments for punitive damages.	The right to recover attorney fees from one's opponent in litigation does not exist in common law. It must be authorized by statute, a rule of court, or some agreement of the parties. In federal court, attorney fees may be awarded in various cases under federal statutes, including the 1933 and 1934 securities acts. No attorneys' fees are available in securities fraud litigation.
5. Preservation of a record	The Uniform Code requires that "a verbatim record by stenographic reporter or tape recording of all arbitration hearings shall be kept." A party requesting a transcript must pay for it, unless the arbitrators direct otherwise.	A verbatim record of the proceedings is not required; however, AAA rules indicate that parties wanting a record of the proceedings must make arrangements directly with a stenographer and notify the other parties of these arrangements in advance of the hearings.	Each district court must appoint one or more court reporters who are required to record verbatim all open proceedings in cases unless the parties, with the judge's approval, agree otherwise.
6. Rules of evidence	Federal Rules of Evidence do not apply in arbitration hearings. Arbitrators can determine the materiality and relevance of any evidence presented and can accept whatever information they deem necessary to understand and determine the dispute.	Same as SROs.	Federal Rules of Evidence govern federal court proceedings. The rules govern the definition of relevant evidence; the treatment of irrelevant evidence as inadmissible; the exclusion of relevant evidence on the grounds of prejudice, confusion, or waste of time; privileges; and exceptions to the hearsay rule.
7. Availability and rationale of arbitration and court awards	SRO arbitration awards are available to the public. The awards disclose the names of the parties (NYSE and Amex will exclude the names of customer parties if requested), a short summary of the dispute and issues involved, damages requested and awarded, and the names of the arbitrators. (NASD excludes arbitrators' names on public information about awards.) The arbitrators generally do not give reasons for their decisions.	AAA rules are less specific than SRO rules regarding the content of awards. Like SRO awards, AAA awards will generally not be accompanied by an opinion. AAA has no specific requirement with respect to publicizing awards; however, it does give a confidentiality pledge to the parties involved, which makes the awards unavailable to the public.	Court decisions are available to the public and contain findings of fact and conclusions of law and give substantive reasons for the decision. However, the large number of filings in litigation does not allow every court decision to have a written opinion.
8. Production of documents and appearance of persons.	SRO arbitrators can direct the appearance of industry personnel or the production of documents in control of industry personnel without a subpoena.	AAA arbitrators may establish, at a preliminary hearing, the extent of and schedule for the production of documents.	A court may order discovery of documents or subpoena appearance of persons or production of documents.

Other Dispute Resolution Procedures

Mediation—an Alternative Dispute Resolution Process

Mediation may offer a quick and inexpensive alternative to arbitration for resolving securities disputes. Mediation conferences are voluntary and comparatively informal meetings where the parties submit their dispute to a neutral third party who works with them to reach a settlement. Unlike arbitration, mediation involves neither formal hearings nor binding decisions. If the parties fail to reach a settlement agreement, they can take the case to arbitration or litigation. Even when a dispute is not fully resolved by mediation, the process may streamline arbitration and litigation by helping the parties settle some of the issues, complete some of the discovery process, and clarify the issues.

In July 1989, NASD began a pilot mediation program in conjunction with two nationwide organizations that resolve private disputes: AAA and U.S. Arbitration and Mediation, Inc. In May 1991, NASD revised its mediation program and added Judicate as one of its mediation partners. The goal of NASD's pilot mediation program is to provide a mechanism to encourage member firms and investors to resolve their differences quickly. To encourage participation, NASD does not require investors to pay any administrative fees. NASD requires broker-dealers to pay conference fees.

Between June 1 and September 20, 1991, 230 disputes at NASD were selected for mediation, but investors and broker-dealers agreed to mediation in only 55 of these disputes. Mediation conferences have been held to resolve 16 of these 55 disputes, and 6 of the 16 cases have been settled in mediation. In addition to the 230 cases, on September 20, 1991, NASD selected 93 more cases for mediation. According to the NASD Arbitration Director, broker-dealers may not wish to mediate a claim for several reasons. First, a broker-dealer may believe that it can settle the claim in-house and not incur any mediation fees. Second, the firm may believe that the investor's claim and the firm's position are too far apart to settle in mediation.

AAA, which has had its own securities mediation services since 1983, will arrange a mediation conference at any stage in an arbitration proceeding. If parties to pending arbitration agree to mediate through AAA, they are not required to pay any additional administrative fees. Parties not involved in pending arbitration must pay an administrative fee based on the amount of the claim. AAA mediated 30 securities cases in 1989 and 15 cases in 1990.

In June 1991, CFTC approved the proposed amendments to NFA's arbitration code that incorporated mediation into NFA's arbitration program. In August 1991, NFA started recommending mediation for most cases. As of February

1992, NFA officials told us that they had not seen any noticeable increases in settlements and that NFA plans to evaluate the policy in June 1992.

Reparations—a Commodities Dispute Resolution Process

In addition to arbitration and litigation, customers in the commodities markets can choose to resolve their disputes through CFTC's reparations process. Depending upon the dollar amount of the claim and the desires of the parties in a dispute, CFTC offers three types of reparation proceedings: voluntary, summary, and formal. In voluntary proceedings, the least expensive (with filing fees of $25) and most expeditious option, either party can claim an unlimited amount for damages. In addition, all parties must agree to use this procedure. Decisions under this proceeding are final—that is, they cannot be appealed to CFTC or a court. Following discovery and submission of final written materials, a judgment officer decides the claim solely on the basis of the documentation the disputing parties submit. The decision contains only a conclusion for whether violations have been shown and an award, if warranted, but there are no findings of fact or reason for the decision.

Summary proceedings, which involve a filing fee of $100, may be used to resolve disputes involving claims of $10,000 or less. Similar to voluntary proceedings, discovery in summary proceedings allows the parties to collect information and documents from one another and submit relevant evidence to CFTC. Unlike voluntary proceedings, in summary proceedings the CFTC judgment officer may request relevant information and documents. Limited oral testimony and cross-examination is permitted in a telephone hearing or, if both parties agree, at a hearing in Washington, D.C. The decision will include a brief written statement explaining the reasons for the decision, which can be appealed to CFTC and a federal appellate court.

Parties who do not choose voluntary proceedings and who are involved in disputes with claims of $10,000 or more may resolve disputes through formal reparation proceedings. Such proceedings, which require a filing fee of $200, include more extensive procedures, such as prehearing filings, in-person hearings at various locations throughout the United States, and posthearing memoranda. They are decided by a CFTC administrative law judge. The decision contains specific findings of fact explaining the ruling, which can be appealed to CFTC and a federal appellate court.

From January 1989 to June 1990, CFTC Administrative Law Judges or Judgment Officers adjudicated 563 reparation cases. According to CFTC,

250 cases were decided in reparation proceedings; investors received an award in 141 of those cases (56 percent) and were awarded 65 percent of the amount claimed. For 208 of the 563 cases (37 percent) the parties settled during reparation proceedings. The remaining 105 cases were dismissed for various reasons.

Loglinear Methodology and Analysis Results

This appendix provides additional technical detail on our analytical approach on the arbitration data. It contains a general description of loglinear methodology, describes the variables analyzed and how they were categorized, presents the loglinear models tested, and reports the results of our analyses.

Data Analysis Approach

We used logit analysis, a form of loglinear modeling, to test associations between various independent variables and three dependent (outcome) variables. In succession, we tested whether the independent variables were associated with (1) whether the case was settled or decided by arbitration; (2) if decided, whether the claimant received an award or not, and (3) if the case was awarded, whether the individual was awarded a "high" portion or a "low" portion of the claimed amount. Only decided cases were used in the second and third analyses because settled cases could not be classified as either awarded or not awarded, and because data on awards were often very limited or missing from the settled case files.

Our study consisted of 1,973 cases for the decided/settled analysis, 1,148 cases for the award analysis, and 700 cases for the award-high/award-low analysis. Our analytic approach, described in the following sections, consisted of three steps: preliminary bivariate analyses, grouping categories of variables, and multivariate analyses.

Preliminary Bivariate Analysis

On the basis of our survey work, knowledge of the arbitration process, and available information in case files, we hypothesized that as many as 10 variables may be associated with the outcomes. Table III.1 identifies the 10 variables that were tested in each of the 3 separate analyses. Our analyses of these three outcomes proceeded as follows.

Given the number of cases that were available for analysis, it was not practical to test all 10 variables simultaneously. Therefore, we applied bivariate loglinear techniques to examine the relationship of each independent variable with each dependent variable. This allowed us to establish, at least tentatively, which variables were significantly associated with the different outcomes and should be included in our multivariate analyses.

While it would be preferrable to test the significance of all factors in a multivariate context (i.e., by testing the effect of any one variable after

controlling for the effects of the other one), the size of the sample with which we were working did not permit this.

Table III.1: Bivariate Tests of Association Between 10 Independent Variables and 3 Outcome (Result) Variables

	Result variables								
	Settled vs. decided			Award vs. no award			Award-high vs. award-low		
Independent variables	**df**	**L^2**	**p**	**df**	**L^2**	**p**	**df**	**L^2**	**p**
Forum	5	40.44	<.001	5	*16.81	.005	5	5.01	.415
Type of decision				1	*11.19	.001	1	*13.60	<.001
Class of arbitration	1	0.25	.615	1	*25.49	<.001	1	*60.64	<.001
Attorney representation	1	*29.94	<.001	1	3.73	.053	1	*6.43	.011
State of residence	1	3.01	.083	1	2.67	.102	1	0.10	.756
Option at issue	2	*8.06	.018	2	*8.31	.016	2	1.10	.578
Size of claim	3	*38.30	<.001	3	*10.15	.017	3	*32.57	<.001
Type of product	1	2.63	.105	1	1.19	.275	1	0.92	.337
Counterclaim	1	3.48	.062	1	2.86	.091	1	0.50	.479
Number of days	3	*9.03	.029	3	2.33	.506	3	0.34	.952

Factor categories
(F) Forum :1=AAA, 2=CBOE, 3=NFA, 4=NYSE, 5=NASD, 6=Amex
(T) Type of decision :1=Hearing, 2=Written submission
(C) Class of arbitration :1=Investor claims vs. broker, 2=Broker claims vs. investor
(A) Attorney representation :1=Yes, 2=No
(L) State of residence :1=Same as hearing location, 2=Different from hearing location
(O) Option at issue :1=Security, 2=Commodity, 3=All others
(S) Size of claim :1=<$5,000, 2=$5,000-$9,999, 3=$10,000-$19,999, 4=$20,000+
(P) Type of product :1=Security, 2=Commodity
(M) Counterclaim :1=Yes, 2=No
(N) Number of days :1=<300, 2=300-364, 3=365-499, 4=500+

* = Statistically significant at the .050 level.

df = degrees of freedom
L^2 = Maximum likelihood chi-square
p = Probability

Although it was possible that each of the variables would be associated with the three outcomes we considered, as table III.1 shows, the state of residence, type of product, and existence of a counterclaim were not significantly related to any of the outcomes. Therefore, we excluded these factors from further analysis.

Other variables were significantly associated with some outcomes but not others. For example, an association existed between attorney representation and whether the case was decided or settled and whether

the claimant was awarded more or less than 60 percent of the awarded claim, but no significant association existed between attorney representation and whether the claimant received an award or not.

Grouping Categories of Variables

Before undertaking the multivariate analyses, we did preliminary analyses to determine whether variables with multiple response categories could be grouped into fewer categories. The intent of the grouping was to reduce the number of categories into which variables were divided, without losing significant explanatory power. This would allow us to analyze numerous variables simultaneously. We would have preferred to discern whether collapsing was justified in a multivariate context, after controlling for other factors, but the sample size did not permit this.

Likelihood ratio chi-square statistics were compared before and after collapsing different categories of variables to determine whether the collapsing was justified. The variables with multiple response categories—forum, option at issue, size of claim and number of days—were grouped for each outcome accordingly. The exception was the option at issue variable for the award/no award analysis where we did not group this variable for the analysis. Table III.2 shows the results of those groupings and the final list of the variables used in the multivariate analyses.

Table III.2: Variables Used and Categories Into Which They Were Grouped

	Analysis		
Variable	**Decided vs. settled**	**Award vs. no award**	**Award-high vs. award-low**
Forum	(1) AAA (2) NFA, NYSE, NASD, and Amex[a]	(1) AAA (2) NFA,NYSE,NASD,and Amex[a]	Not applicable
Attorney representation	(1) Yes (2) No	Not applicable	(1) Yes (2) No
Options	(1) Securities and commodities (2) Other than options	(1) Securities (2) Commodities (3) Other than options	Not applicable
Size of claim	(1) <$5,000 (2) $5,000 +	(1) <$5,000 (2) $5,000 +	(1) <$20,000 (2) $20,000+
Processing length: Number of days	(1) <300 (2) 300-499 (3) 500 +	Not applicable	Not applicable
Type of decision	Not applicable	(1) Hearing (2) Written submission	(1) Hearing (2) Written submission
Class	Not applicable	(1) Investor vs. broker (2) Broker vs. investor	(1) Investor vs. broker (2) Broker vs. investor

[a]CBOE is excluded from these multivariate analyses because there were too few CBOE cases (only 73) to reliably measure differences between CBOE and other forums across all categories of the other independent variables.

Multivariate Analysis

The objective of the multivariate analyses was to determine which variables, after controlling for the effects of other variables, had statistically significant relationships with the outcomes. To accomplish this, we fit a set of logit models that allowed for associations among the independent variables and varied in terms of their direct or interactive relationships with the outcome variable. Beginning with a base model that postulated no association between the independent variables and the outcome, we built a series of hierarchical models varying only one variable at a time. We used the maximum likelihood statistics to compare the fit of various models with one another. For each outcome, we chose as preferred the model that provided for the simplest description of the pattern of associations present, so long as it fit the data acceptably and was not improved upon significantly by other models, which included additional, or more complex, associations. The expected frequencies obtained from the preferred model were used to estimate the odds and odds ratios. Using the odds, we could estimate the likelihood that an outcome would occur (e.g., that a case would be decided rather than

settled) given a particular combination of variables (e.g., that it was an option on security or commodity, over $5,000, and the claimant was represented by an attorney in AAA). Using the odds ratio, we could estimate the extent to which one outcome was more likely than another (e.g., how much more likely it was for a case to be decided rather than settled when it was handled in AAA rather than other forums). The odds and odds ratios obtained were estimates of the net effects after the influence of all the other variables in the model were controlled. These estimates are subject to specification error. If significant variables affecting outcomes are excluded from our models, then our estimates of the variables included may be biased.

Logit Models Tested and Results

We carried out three sets of analyses, one for each outcome. In each analysis, we examined the relative fit of a number of hierarchical logit models to identify the preferred model and the odds and odds ratios resulting from that model. The models tested and results obtained follow.

Decided Versus Settled Cases

Table III.3 shows the likelihood-ratio chi-square values and degrees of freedom obtained from 20 models that were tested on settled versus decided case data. In these analyses, we examined whether and how the factors forum (F), attorney representation (A), size of claim (S), number of days since claim was filed (N), and option (O) were related to the outcome (R). The manner in which we specified these variables is shown in table III.2.

Table III.3 shows that model 18 is the preferred model. It is the only model that is preferred over model 2, which cannot be improved upon by any of the other models. Because model 18 is simpler than model 2, and since model 2 does not improve significantly over it, model 18 was chosen as the preferred model.

This model states that attorney representation, option, size of claim, and number of days have a direct relationship whether a case is decided or settled. With respect to number of days, model 18 posits that the outcome is affected only when comparing claims with processing lengths of less than 300 days with claims of greater duration. Forum was also found to have a direct effect, although, for reasons discussed below, we discount the substantive significance of the statistically significant effect.

Table III.3: Decided vs. Settled Cases: Logit Models Tested to Examine Relationships With Forum, Attorney Representation, Options, Size of Claim, and Processing Length

Model	Models tested						df	L^2
1	[FAOSN]	[R]					38	157.09
2	[FAOSN]	[FR]	[AR]	[OR]	[SR]	[NR]	32	34.48
3	[FAOSN]	[FR]	[AR]	[OR]	[SR]		34	69.38
4	[FAOSN]	[FR]	[AR]	[OR]		[NR]	33	56.86
5	[FAOSN]	[FR]	[AR]		[SR]	[NR]	33	47.72
6	[FAOSN]	[FR]		[OR]	[SR]	[NR]	33	56.24
7	[FAOSN]		[AR]	[OR]	[SR]	[NR]	33	90.49
8	[FAOSN]	[FAR]	[OR]	[SR]	[NR]		31	33.45
9	[FAOSN]	[FOR]	[AR]	[SR]	[NR]		31	32.25
10	[FAOSN]	[FSR]	[AR]	[OR]	[NR]		31	33.94
11	[FAOSN]	[FNR]	[AR]	[OR]	[SR]		30	33.06
12	[FAOSN]	[AOR]	[FR]	[SR]	[NR]		31	33.75
13	[FAOSN]	[ASR]	[FR]	[OR]	[NR]		31	33.58
14	[FAOSN]	[ANR]	[FR]	[OR]	[SR]		30	29.84
15	[FAOSN]	[OSR]	[FR]	[AR]	[NR]		31	34.11
16	[FAOSN]	[ONR]	[FR]	[AR]	[SR]		30	33.55
17	[FAOSN]	[SNR]	[FR]	[AR]	[OR]		30	31.48
18[a]	[FAOSN]	[FR]	[AR]	[OR]	[SR]	[N^1R]	33	35.63
19	[FAOSN]	[FR]	[AR]	[OR]	[SR]	[N^2R]	33	51.06
20	[FAOSN]	[FR]	[AR]	[OR]	[SR]	[N^3R]	33	67.68

[a]Preferred model (p value = .346)

(R) Result :1= Decided, 2= Settled
(F) Forum :1= AAA, 2= NFA, NYSE, NASD, and Amex
(A) Attorney representation :1= Yes, 2= No
(O) Option at issue :1= Security and commodity, 2= All others
(S) Size of claim :1= <$5,000, 2= $5,000+
(N) Number of days :1= <300, 2= 300-499, 3= 500+

To estimate the size of the relationships among these five factors and the outcome, we used the expected frequencies obtained from model 18 to compute the odds on claims being decided versus settled, and the ratios of those odds across different categories of the factors. This information is presented in table III.4.

Table III.4: Expected Frequencies: Settled vs. Decided Cases, Odds and Odds Ratios From the Preferred Model

Forum	Attorney	Option	Size	Days
AAA	Yes	Securities/ commodities	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +
		Other	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +
	No	Securities/ commodities	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +
		Other	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +
Others	Yes	Securities/ commodities	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +
		Other	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +
	No	Securities/ commodities	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +
		Other	< $5,000	< 300
				300 +
			$5,000 +	< 300
				300 +

Expected frequencies				Odds ratios				
				Forum		Option	Size	Days
Settled	Decided	Total	Odds on decided	AAA; other[b]	Attorney No: yes	Other: securities/ commodities	<$5,000: $5,000+	300+: <300
0.90	2.10	**3**	2.33				1.98	
0.00	0.00	**0**	[a]				[a]	[a]
22.59	26.41	**49**	1.17					
25.99	57.01	**83**	2.19					1.88
1.15	3.85	**4**	3.35			1.45	1.98	
0.00	0.00	**0**	[a]			[a]	[a]	[a]
34.86	59.14	**94**	1.70			1.45		
19.84	63.16	**83**	3.18			1.45		1.88
0.40	1.60	**2**	4.00		1.74		1.98	
0.00	0.00	**0**	[a]		[a]		[a]	[a]
1.65	3.35	**5**	2.03		1.74			
0.62	2.38	**3**	3.83		1.74			1.88
0.44	2.56	**3**	5.82		1.74	1.45	1.98	
0.00	0.0	**0**	[a]		[a]	[a]	[a]	[a]
3.80	11.20	**15**	2.95		1.74	1.45		
0.77	4.23	**5**	5.49		1.74	1.45		1.88
2.77	2.29	**5**	0.83				1.98	
1.55	2.45	**4**	1.58				1.98	1.88
41.40	17.60	**59**	0.42					
141.82	113.18	**253**	0.80					1.88
9.89	12.11	**22**	1.22			1.45	1.98	
8.79	20.21	**29**	2.30			1.45	1.98	1.88
66.79	41.21	**108**	0.61			1.45		
161.71	187.29	**349**	1.16			1.45		1.88
12.98	19.02	**32**	1.47		1.74		1.98	
10.40	28.60	**39**	2.75		1.74		1.98	1.88
17.25	12.75	**30**	0.74		1.74			
42.74	59.26	**102**	1.39		1.74			1.88
51.17	108.83	**160**	2.13		1.74	1.45	1.98	
16.62	66.38	**83**	3.99		1.74	1.45	1.98	1.88
41.02	43.98	**85**	1.07		1.74	1.45		
43.15	86.85	**130**	2.01		1.74	1.45		1.88

[a]Where expected frequencies are 0, odds and odds ratios cannot be meaningfully calculated.

[b]Odds ratios for forum are not reliable. See page 78.

Results

Forum: As indicated in table III.4, we did not estimate the size of the relationship between forum and outcome because 79 (38 percent) of the cases we scheduled for review at AAA were missing. All of these involved settled cases. Because of the large proportion of missing cases, any estimate of such an association would be unreliable. Our previous bivariate analysis showed no significant differences among NFA, NYSE, NASD, and Amex with regard to the decided versus settled outcome.

Attorney representation: Claimants not represented by an attorney were 1.74 times as likely as claimants represented by an attorney to have their claims decided rather than settled.

Option to buy a security or commodity: Claims that did not involve options were 1.45 times as likely to be decided rather than settled as claims that did involve an option to buy either a security or commodity.

Size of claim: Claims involving less that $5,000 were 1.98 times as likely as claims involving more than $5,000 to be decided by arbitration rather than settled.

Number of processing days: Longstanding claims, or claims that took 300 days or more to process, were 1.88 times more likely than claims of shorter duration to be decided than settled.

Decided Cases Award Versus No Award

Table III.5 shows the likelihood-ratio chi-square values and degrees of freedom associated with 21 models that were fit to the award versus no award data. In this analysis, we examined the nature of the associations between the outcome (R) and forum (F), type of decision (T), class of arbitration (C), option (O), and size of claim (S).

In these analyses the forum variable was specified to contrast AAA claims with all others, except for CBOE claims, which were deleted from this analysis because of their small number. While our bivariate analyses suggested that AAA did not differ from other forums with respect to this outcome, we nonetheless retained the forum variable in this analysis to test whether forum might interact with other variables in affecting whether claims were awarded. The other variables were grouped into the categories shown in table III.2.

Table III.5 indicates that model 20 is the preferred model. It is the only model that is preferred over model 8. Model 8 cannot be improved upon by

any other model. Since model 20 is a simpler model than model 8, and model 8 cannot improve upon model 20, it is chosen as the preferred model.

This model states that whether or not an award was made in decided cases was a function of type of decision, class of arbitration, and option at issue. Further, option at issue involved only a difference between claims in which an option to buy a commodity was at issue and all others.

Table III.5: Award vs. No Award: Logit Models Tested to Examine Relationships With Forum, Type of Decision, Class of Arbitration, Options, and Size of Claim

	Models tested							
Model							**df**	**L^2**
1	[FTCOS]	[R]					31	71.69
2	[FTCOS]	[FR]	[TR]	[CR]	[OR]	[SR]	25	33.88
3	[FTCOS]	[FR]	[TR]	[CR]	[OR]		26	33.89
4	[FTCOS]	[FR]	[TR]	[CR]		[SR]	27	41.67
5	[FTCOS]	[FR]	[TR]		[OR]	[SR]	26	58.90
6	[FTCOS]	[FR]		[CR]	[OR]	[SR]	26	37.68
7	[FTCOS]		[TR]	[CR]	[OR]	[SR]	26	33.95
8	[FTCOS]		[TR]	[CR]	[OR]		27	33.97
9	[FTCOS]	[FTR]	[CR]	[OR]	[SR]		24	33.84
10	[FTCOS]	[FCR]	[TR]	[OR]	[SR]		24	33.86
11	[FTCOS]	[FOR]	[TR]	[CR]	[SR]		23	33.41
12	[FTCOS]	[FSR]	[TR]	[CR]	[OR]		24	33.88
13	[FTCOS]	[TCR]	[FR]	[OR]	[SR]		24	33.13
14	[FTCOS]	[TOR]	[FR]	[CR]	[SR]		23	33.55
15	[FTCOS]	[TSR]	[FR]	[CR]	[OR]		24	33.87
16	[FTCOS]	[COR]	[FR]	[TR]	[SR]		23	30.84
17	[FTCOS]	[CSR]	[FR]	[TR]	[OR]		24	32.64
18	[FTCOS]	[OSR]	[FR]	[TR]	[CR]		23	31.56
19	[FTCOS]	[TR]	[CR]	[O^1R]			28	40.68
20[a]	[FTCOS]	[TR]	[CR]	[O^2R]			28	34.89
21	[FTCOS]	[TR]	[CR]	[O^3R]			28	41.90

[a]Preferred model (p value = .173)

(R) Result :1= Award, 2= No award
(F) Forum :1= AAA, 2= NFA, NYSE, NASD, and Amex
(T) Type of decision :1= Hearing, 2= Written submission
(C) Class of arbitration :1= Investor claims vs. broker, 2= Broker claims vs. investor
(O) Option at issue :1= Security, 2= Commodity, 3= All others
(S) Size of claim :1= <$5,000, 2= $5,000+
(N) Number of days :1= <300, 2= 300-499, 3= 500+

Table III.6 shows the odds and odds ratios of the results of the preferred model.

Table III.6: Expected Frequencies: Award vs. No Award, Odds and Odds Ratios From the Preferred Model, Decided Cases Only

							Odds ratios		
			Expected frequencies				Type of decision	Class of arbitration	Option
Type of decision	Class of arbitration	Option	No award	Award	Total	Odds on award	Hearing: written submission	Broker: investor	Commodity: other
Hearing	Investor claim	Other	258.79	398.21	657	1.54	1.41		
		Commodity	25.49	69.51	95	2.73	1.41		1.77
	Broker claim	Other	14.42	72.58	87	5.03	1.41	3.27	
		Commodity	0.30	2.70	3	9.00	[a]	3.27	1.77
Written submission	Investor claim	Other	96.51	105.49	202	1.09			
		Commodity	10.21	19.79	30	1.94			1.77
	Broker claim	Other	3.28	11.72	14	3.57		3.27	
		Commodity	0.00	0.00	0	[a]		[a]	[a]

[a]Where expected frequencies are 0, odds and odds ratios cannot be meaningfully calculated.

Results

Type of decision: Claims that involved a hearing were 1.4 times more likely to receive an award than claims that involved written submissions.

Class of arbitration: Although there were few claims brought by brokers, when there were such claims, brokers' claims were 3.27 times more likely to receive an award than investors' claims. Most of the brokers' claims were for nonpayment of debt.

Option to buy a security or commodity: Claims that involved an option to buy only a commodity were 1.77 times as likely to be awarded as claims that involved options on securities or no options. No difference was found between claims that involved an option to buy a security and claims that involved no option to buy either a security or commodity.

Award-High or Award-Low Awarded and Decided Cases[1]

Table III.7 shows the 15 models tested in our analysis of high- versus low-award cases. These analyses examined associations between the outcome (R) and type of decision (T), class of arbitration (C), attorney representation (A), and size of claim (S).[1]

Model 13 improves significantly upon simpler models and cannot be significantly improved upon by more complex models. Thus it is the preferred model.

The model indicates size of claim is directly associated with the outcome, while class of arbitration and attorney representation interact in affecting the outcome.

Table III.7: Award-High vs. Award-Low Cases: Logit Models Tested to Examine Relationships With Type of Decision, Class of Arbitration, Attorney Representation, and Size of Claim

	Models tested						
Model						df	L^2
1	[TCAS]	[R]				11	114.70
2	[TCAS]	[TR]	[CR]	[AR]	[SR]	7	14.29
3	[TCAS]	[TR]	[CR]	[AR]		8	41.12
4	[TCAS]	[TR]	[CR]		[SR]	8	17.53
5	[TCAS]	[TR]		[AR]	[SR]	8	80.52
6	[TCAS]		[CR]	[AR]	[SR]	8	16.16
7	[TCAS]	[TCR]	[AR]	[SR]		6	12.69
8	[TCAS]	[TAR]	[CR]	[SR]		6	12.69
9	[TCAS]	[TSR]	[CR]	[AR]		6	14.29
10	[TCAS]	[CAR]	[TR]	[SR]		6	8.28
11	[TCAS]	[CSR]	[TR]	[AR]		6	12.77
12	[TCAS]	[ASR]	[TR]	[CR]		6	10.46
13[a]	[TCAS]	[CAR]	[SR]			7	10.63
14	[TCAS]	[CSR]	[AR]			7	14.67
15	[TCAS]	[CAR]	[ASR]			6	9.27

[a]Preferred model (p value = .153)

(R) Result :1= Award-high, 2= Award-low
(T) Type of decision :1= Hearing, 2= Written submission
(C) Class of arbitration :1= Investor claims vs. broker, 2= Broker claims vs. investor
(A) Attorney representation :1= Yes, 2= No
(S) Size of claim :1= <$20,000, 2= $20,000 +

[1]If the claimant was awarded in excess of 60 percent of his/her total claim, not including punitive or "excessive" other claims or awards, we defined the case as "award-high." Claimants awarded less than that proportion are defined as "award-low."

Table III.8 shows the odds and odds ratios resulting from this analysis.

Table III.8: Expected Frequencies: Award-High vs. Award-Low Cases, Odds and Odds Ratios From the Preferred Model, Decided and Awarded Cases Only

			Expected frequencies			Odds ratios			
							Size of claim	Attorney representation	Class of arbitration
Class of arbitration	Attorney representation	Size of claim	Award-low	Award-high	Total	Odds on award-high	<$20,000: $20,000+	Yes: no	Broker: investor
Investor claim	Yes	<$20,000	28.09	49.91	78	1.78	3.65	1.57	
		$20,000+	180.91	88.09	269	0.49		1.57	
	No	<$20,000	104.32	117.68	222	1.13	3.65		
		$20,000+	23.68	7.32	31	0.31			
Broker claim	Yes	<$20,000	1.25	13.75	15	11.00	3.65	0.19	6.2
		$20,000+	9.75	29.25	39	3.00		0.19	6.2
	No	<$20,000	0.33	18.67	19	56.58	3.65		50.0
		$20,000+	0.67	10.33	11	15.42			50.0

Results

Size of claim: The size of the claim was not statistically associated with whether the claim was awarded or not, but it was associated with the size of the award if the claim was awarded. Smaller claims involving less than $20,000 were 3.65 times more likely than larger claims in excess of $20,000 to result in an award in excess of 60 percent of the total claim.

Attorney representation/class of arbitration: Although attorney representation had no effect on whether a claim was awarded, it did make a significant difference in the amount of the award if granted. Investors represented by attorneys were 1.57 times as likely as investors not represented by attorneys to receive more than 60 percent of their claims. At the same time, brokers represented by attorneys were less likely than unrepresented brokers to receive a high award by a factor of 0.19. An alternative explanation is that brokers not represented by an attorney were 5.14 times more likely to receive a high award than brokers represented by an attorney.

Broker claims against investors were more likely than investor claims against brokers to receive more than 60 percent of their claims especially when claims involving no attorney representation were considered. Among claims in which the claimant was represented by an attorney, broker claims were 6.2 times as likely as investor claims to receive a high

award. Among claims in which the claimant was not represented by an attorney, broker claims against the investor were 50 times as likely as investor claims to result in brokers receiving more than 60 percent of the total claim.

One possible explanation for these effects is that brokers rarely bring claims; but when they do, it is because the investors have not paid their bills. Also, SRO arbitration officials told us that these claims are easier for broker-dealers to prove because the evidence usually includes written documents, while investor claims are not so clear-cut.

Survey of the Securities Industry's Use of Predispute Arbitration Clauses

United States General Accounting Office

Survey of the Securities Industry's Use of Predispute Arbitration Clauses

Introduction

The U.S. General Accounting Office (GAO), an agency of Congress, is reviewing the use of predispute arbitration clauses in the securities industry. Congress has requested that GAO ascertain securities industry practices, trends, and views with respect to predispute arbitration clauses.

Please answer the questionnaire based on the current status of your firm. When answering, please consider your entire operation, including all branches. The questionnaire should be answered by the person most knowledgeable about the use of predispute arbitration clauses in customer agreements.

The questions can be easily answered by checking boxes or filling in blanks. The questionnaire should take about 20 minutes to complete, depending upon the availability of your records. Space has been provided at the end of the questionnaire for any additional comments you may want to make. If you have any questions, please call Monty Kincaid or Diane Morris at (202) 272-3003.

Your responses will be treated **confidentially** and will not be used in any way that will identify you or your organization. The questionnaire is numbered only to aid us in our follow-up efforts. Please return the completed questionnaire in the enclosed pre-addressed, pre-paid envelope within 10 days of receipt. In the event the envelope is misplaced, our return address is:

U.S. General Accounting Office
Mr. Monty Kincaid
441 G Street, N.W., Room 3660
Washington, D.C. 20548

Thank you for your help.

* * * * *

ID(1-3)

A. Background

CARD1(4)

1. Does your firm currently do any business with retail customers? *(Check one.)* (5)

   1. [ ] Yes *(Continue to Question 2.)*
   2. [ ] No *(See note.)*

> *Note: If your firm does no business with retail customers, please stop here and return the questionnaire in the enclosed envelope. Thank you.*

2. As of December 1, 1990, about how many registered representatives (RRs) of your firm in each of the following categories were actively engaged in trading with customers? *(Enter your best estimate. If none, enter "0.")*

	Estimate	
1. Retail only RRs	_____	(6-10)
2. Institutional only RRs	_____	(11-14)
3. RRs that are both retail and institutional	_____	(15-18)

3. About how many retail and institutional customer accounts does your firm have (i.e., number of customer accounts that had a position, balance, or activity in the month of November, 1990)? *(Please consider your entire operation, including all branches. Do not include correspondent accounts that may have been opened by another company and cleared by your firm. Enter your best estimate or check "don't know." If none, enter "0.")*

	Number of accounts (estimate)	Don't know	
1. Retail customer accounts	_____	[ ]	(19-25) (26)
2. Institutional customer accounts	_____	[ ]	(27-31) (32)

4. About how many of your firm's retail accounts (in Question 3.1) are approved to make trades on margin? *(Please consider your entire operation, including all branches. Do not include correspondent accounts that may have been opened by another company and cleared by your firm. Enter your best estimate or check "don't know." If none, enter "0.")* (33-39)

   Retail accounts approved to trade on margin _____ (estimated number)

   [ ] Don't know (40)

5. About how many of your firm's retail accounts (in Question 3.1) are approved to trade options? *(Please consider your entire operation, including all branches. Do not include correspondent accounts that may have been opened by another company and cleared by your firm. Enter your best estimate or check "don't know." If none, enter "0.")* (41-47)

   Retail accounts approved to trade options _____ (estimated number)

   [ ] Don't know (48)

6. About how many of your firm's retail accounts (in Question 3.1) are approved to trade on a cash basis only? *(Please consider your entire operation, including all branches. Do not include correspondent accounts that may have been opened by another company and cleared by your firm. Enter your best estimate or check "don't know." If none, enter "0.")* (49-55)

   Retail accounts approved to trade on a cash basis only _____ (estimated number)

   [ ] Don't know (56)

7. As of December 1, 1990, did your company clear trades for your own customers (i.e., self-clearing), or did your company use another firm to clear trades? *(Check one.)*

   1. [ ] Yes, my company was self-clearing (57)

   2. [ ] No, used another firm to clear trades

8. As of December 1, 1990, did your company clear any trades for customers who placed orders with other firms? *(Check one.)* (58)

   1. [ ] Yes, cleared trades for customers who ordered with other firms

   2. [ ] No, did not clear such trades

B. Past Policy/Practices

9. As of December 1, 1987, were any of your firm's existin retail or institutional customer accounts covered by a predispute arbitration agreement? *(Check one.)* (59)

   1. [ ] Yes *(Continue to Question 10.)*

   2. [ ] No *(Skip to Question 13.)*

10. As of December 1, 1987, did your company policy require customers who had already opened accounts without predispute arbitration clauses to sign predispute arbitration clauses?

    (When answering, please consider all accounts opened on or before December 1, 1987. If your company policy has always required predispute arbitration clauses, check the "yes" column. Check one box in each row.)

1987: EXISTING ACCOUNTS	Requirement for Clauses? Yes (1)	No (2)	No account of this type (3)	
1. Retail: Plain cash accounts				(60)
2. Retail: IRA cash accounts				(61)
3. Retail: 401K cash accounts				(62)
4. Retail: Other cash accounts *(Specify.)* _____				(63)
5. Retail margin accounts				(64)
6. Retail options accounts				(65)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____				(66)
8. Institutional accounts				(67)

11. For the following types of new accounts opened on December 1, 1987, did your company policy require customers to sign predispute arbitration clauses?

(Check one box in each row.)

1987: NEW ACCOUNTS	Requirement for Clauses? Yes (1)	No (2)	No account of this type (3)	
1. Retail: Plain cash accounts				(68)
2. Retail: IRA cash accounts				(69)
3. Retail: 401K cash accounts				(70)
4. Retail: Other cash accounts *(Specify.)* _____				(71)
Retail margin accounts				(72)
6. Retail options accounts				(73)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____				(74)
8. Institutional accounts				(75)

ID(1-3)
CARD2(4)

12. On December 1, 1987, did your firm include the American Arbitration Association (AAA) as one of the arbitration forum choices for the following types of new or existing accounts?

(Check one box in each row. If your firm had no accounts in a category, or if your firm did not use predispute arbitration clauses, check "Does not apply.")

NEW OR EXISTING ACCOUNTS	1987: AAA a Choice? Yes (1)	No (2)	Does not apply (3)	
1. Retail: Plain cash accounts				(5)
2. Retail: IRA cash accounts				(6)
3. Retail: 401K cash accounts				(7)
4. Retail: Other cash accounts *(Specify.)* _____				(8)
5. Retail margin accounts				(9)
6. Retail options accounts				(10)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____				(11)
8. Institutional accounts				(12)

C. **Present Policy/Practices**

13. As of December 1, 1990, were any of your firm's existing retail or institutional customer accounts covered by a predispute arbitration agreement? *(Check one.)* (13)

    1. [ ] Yes *(Continue to Question 14.)*

    2. [ ] No *(Skip to Question 22.)*

14. As of December 1, 1990, did your company policy require customers who had already opened accounts without predispute arbitration clauses to sign predispute arbitration clauses?

    (When answering, please consider accounts opened on or before December 1, 1990. If your company policy has always required predispute arbitration clauses, check the "yes" column. Check one box in each row.)

1990: EXISTING ACCOUNTS	Requirement for Clauses? Yes (1)	No (2)	No account of this type (3)	
1. Retail: Plain cash accounts				(14)
2. Retail: IRA cash accounts				(15)
3. Retail: 401K cash accounts				(16)
4. Retail: Other cash accounts *(Specify.)* _____				(17)
5. Retail margin accounts				(18)
6. Retail options accounts				(19)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____				(20)
8. Institutional accounts				(21)

15. For the following types of new accounts opened on December 1, 1990, did your company policy require customers to sign predispute arbitration clauses?

    (Check one box in each row.)

1990: NEW ACCOUNTS	Requirement for Clauses? Yes (1)	No (2)	No account of this type (3)	
1. Retail: Plain cash accounts				(22)
2. Retail: IRA cash accounts				(23)
3. Retail: 401K cash accounts				(24)
4. Retail: Other cash accounts *(Specify.)* _____				(25)
5. Retail margin accounts				(27)
6. Retail options accounts				(27)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____				(28)
8. Institutional accounts				(29)

16. During 1990, how often, if at all, did your firm waive predispute arbitration clauses for customers opening the following types of new accounts? *(Check one box in each row. If your firm does not require clauses, or has no accounts in a category, check column 8.)*

1990: NEW ACCOUNTS	Waiver of Clauses? Always (100%) (1)	Almost always (81-99%) (2)	Most of the time (61-80%) (3)	About half the time (41-60%) (4)	Some of the time (21-40%) (5)	Almost never (1-20%) (6)	Never (0%) (7)	Does not apply (8)	
1. Retail: Plain cash accounts									(30)
2. Retail: IRA cash accounts									(31)
3. Retail: 401K cash accounts									(32)
4. Retail: Other cash accounts *(Specify.)* _____									(33)
5. Retail margin accounts									(34)
6. Retail options accounts									(35)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____									(36)
8. Institutional accounts									(37)

If your firm never waived arbitration clauses for customers opening new accounts during 1990, skip to Question 18. Otherwise, continue to Question 17.

17. Which of the following characteristics, if any, made a difference in whether customers opening new accounts were granted a waiver of arbitration clauses (in Question 16)? *(Read entire list before answering. Check all that apply.)*

1. [ ] Account's investment objective (38)
2. [ ] Expected account revenues (39)
3. [ ] Registered representative who handles the account (40)
4. [ ] Type of account (41)
5. [ ] Other *(Specify.)*_____ (42)

18. During 1990, how often, if at all, did your firm allow customers opening the following types of new accounts to negotiate arbitration clauses? *(Check one box in each row. If your firm does not require clauses, or has no accounts in a category, check column 8.)*

1990: NEW ACCOUNTS	Negotiation of Clauses? Always (100%) (1)	Almost always (81-99%) (2)	Most of the time (61-80%) (3)	About half the time (41-60%) (4)	Some of the time (21-40%) (5)	Almost never (1-20%) (6)	Never (0%) (7)	Does not apply (8)	
1. Retail: Plain cash accounts									(43)
2. Retail: IRA cash accounts									(44)
3. Retail: 401K cash accounts									(45)
4. Retail: Other cash accounts *(Specify.)* _____									(46)
5. Retail margin accounts									(47)
6. Retail options accounts									(48)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____									(49)
8. Institutional accounts									(50)

If your firm never allowed customers opening new accounts during 1990 to negotiate arbitration clauses, skip to Question 21. Otherwise, continue to Question 19.

19. Which of the following characteristics, if any, made a difference in whether customers opening new accounts were allowed to negotiate arbitration clauses (in Question 18)? *(Read entire list before answering. Check all that apply.)*

1. [ ] Account's investment objective (51)
2. [ ] Expected account revenues (52)
3. [ ] Registered representative who handles the account (53)
4. [ ] Type of account (54)
5. [ ] Other *(Specify.)*_____ (55)

20. Which of the following aspects, if any, could be negotiated by customers opening new accounts? *(Check all that apply.)*

1. [ ] Maximum dollar amount of claim that could be arbitrated (56)
2. [ ] Type of arbitration forum (57)
3. [ ] Type of claim that could be arbitrated (58)
4. [ ] Other *(Specify.)*_____ (59)

21. On December 1, 1990, did your firm include the American Arbitration Association (AAA) as one of the arbitration forum choices for the following types of new or existing accounts?

(Check one box in each row. If your firm had no accounts in a category, or if your firm did not use predispute arbitration clauses, check "Does not apply.")

NEW OR EXISTING ACCOUNTS	1990: AAA a Choice? Yes (1)	No (2)	Does not apply (3)	
1. Retail: Plain cash accounts				(60)
2. Retail: IRA cash accounts				(61)
3. Retail: 401K cash accounts				(62)
4. Retail: Other cash accounts *(Specify.)* _____				(63)
5. Retail margin accounts				(64)
6. Retail options accounts				(65)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____				(66)
8. Institutional accounts				(67)

D. Future Plans

22. At any point in the next few years, does your firm plan to require customers who have already opened accounts without predispute arbitration clauses to sign predispute arbitration clauses? *(Check one box in each row. If clauses are already required, check column 1.)*

FUTURE PLANS: EXISTING ACCOUNTS	Existing Accounts: Plans for Clauses?							
	Already required (1)	Definitely yes (2)	Probably yes (3)	Uncertain (4)	Probably no (5)	Definitely no (6)	No account of this type (7)	
1. Retail: Plain cash accounts								(68)
2. Retail: IRA cash accounts								(69)
3. Retail: 401K cash accounts								(70)
4. Retail: Other cash accounts *(Specify.)* _____								(71)
5. Retail margin accounts								(72)
6. Retail options accounts								(73)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____								(74)
8. Institutional accounts								(75)

23. At any point in the next few years, does your firm plan to require customers opening the following types of new accounts to sign predispute arbitration clauses? *(Check one box in each row. If clauses are already required, check column 1.)*

FUTURE PLANS: NEW ACCOUNTS	New Accounts: Plans for Clauses?							
	Already required (1)	Definitely yes (2)	Probably yes (3)	Uncertain (4)	Probably no (5)	Definitely no (6)	No account of this type (7)	
1. Retail: Plain cash accounts								(5)
2. Retail: IRA cash accounts								(6)
3. Retail: 401K cash accounts								(7)
4. Retail: Other cash accounts *(Specify.)* _____								(8)
5. Retail margin accounts								(9)
6. Retail options accounts								(10)
Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____								(11)
8. Institutional accounts								(12)

E. Views on the Arbitration System

24. The Securities Industry Association (SIA) has proposed establishing a single agency to administer the securities arbitrat system. Do you support or oppose this SIA proposal? *(Check one.)* (13)

1. [ ] Strongly support
2. [ ] Generally support
3. [ ] Neither support nor oppose
4. [ ] Generally oppose
5. [ ] Strongly oppose

- - - - - - - - - - - - - - - - - -

6. [ ] No basis to judge

25. Would you support or oppose federal legislation that would prohibit brokers from requiring customers to sign arbitration clauses for the following types of accounts? *(Check one box in each row.)*

ACCOUNT TYPE	Prohibit Brokers from Requiring Customers to Sign Clauses?						
	Strongly support (1)	Generally support (2)	Neither support nor oppose (3)	Generally oppose (4)	Strongly oppose (5)	No basis to judge (6)	
1. Retail: Plain cash accounts							(14)
2. Retail: IRA cash accounts							(15)
3. Retail: 401K cash accounts							(16)
4. Retail: Other cash accounts *(Specify.)* _____							(17)
5. Retail margin accounts							(18)
6. Retail options accounts							(19)
7. Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____							(20)
8. Institutional accounts							(21)

26. Would you support or oppose mandatory non-binding arbitration (i.e., arbitrators' decision can be appealed) for the following types of accounts? *(Check one box in each row.)*

ACCOUNT TYPE	Views on Mandatory Non-binding Arbitration: Strongly support (1)	Generally support (2)	Neither support nor oppose (3)	Generally oppose (4)	Strongly oppose (5)	No basis to judge (6)	
1. Retail: Plain cash accounts							(22)
2. Retail: IRA cash accounts							(23)
3. Retail: 401K cash accounts							(24)
4. Retail: Other cash accounts *(Specify.)* _____							(25)
5. Retail margin accounts							(26)
6. Retail options accounts							(27)
Other retail accounts (e.g., correspondent accounts) *(Specify.)* _____							(28)
8. Institutional accounts							(29)

27. Would you support or oppose federal legislation requiring arbitrators of securities disputes to write a brief statement explaining the reasons for their decision? *(Check one.)*

1. [ ] Strongly support (30)
2. [ ] Generally support
3. [ ] Neither support nor oppose
4. [ ] Generally oppose
5. [ ] Strongly oppose
6. [ ] No basis to judge

28. Would you support or oppose federal legislation requiring arbitrators of securities disputes to complete a checklist of the main reasons for their decision? *(Check one.)*

1. [ ] Strongly support (31)
2. [ ] Generally support
3. [ ] Neither support nor oppose
4. [ ] Generally oppose
5. [ ] Strongly oppose
6. [ ] No basis to judge

F. General Information

Please provide the following information in case we need to contact you for clarification regarding this survey.

29. Name of your firm:_____

_____

30. Your name:_____

31. Your title:_____

_____

32. Your phone number: (_____) _____

33. How long have you worked in the securities industry? *(Round to the nearest year. If less than 6 months, enter "0.")*

_____ Years (32-33)

34. Are you currently, or have you ever been, on any self-regulatory organization (SRO) arbitration roster? *(Check one.)*

1. [ ] Yes (34)
2. [ ] No

GGD KEJ 12/90

G. Comments

35. If you have any comments on this survey, or on q[illegible] we should have asked but did not, please enter them in the space provided on this page. Also, if you have any comments on the use of predispute arbitration clauses or comments on arbitration, use the space provided. If necessary, you may attach additional sheets.

(35)

Thank you for your help! Please remember to return your questionnaire in the postage-paid envelope.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

March 12, 1992

Richard L. Fogel
Assistant Comptroller General
United States
General Accounting Office
Washington, D.C. 20548

Re: Draft Report entitled "Securities Arbitration: How Investors Fare"

Dear Mr. Fogel:

The Division of Market Regulation appreciates the opportunity to review and comment upon the General Accounting Office's draft report entitled Securities Arbitration: How Investors Fare. The Division shares the concerns of the Chairmen of the House Committee on Energy and Commerce and its Subcommittee on Telecommunications and Finance that led them to request this study and report. The Division is committed to the promotion of fair, efficient and affordable arbitration forums for the resolution of disputes between investors and their broker-dealers.

See p. 60.

The draft report indicates that the GAO found no indication of a pro-industry bias in decisions at arbitration forums administered by the self-regulatory organizations ("SROs") regulated by the SEC. The draft report also is consistent with SEC staff findings since 1987 that ultimately the success and acceptance of SRO-administered arbitration depend largely on the independence and capability of the arbitrators selected to decide individual cases. For this reason, the staff concurs with the study's attention to the issue of arbitrator qualification, and the need for careful SRO attention to this area.

See p. 61.

The draft report, however, also makes three arbitrator-related recommendations that do not take into account the steps already taken by the SROs to develop effective arbitrator pools. These recommendations risk increasing significantly the costs of securities arbitration and reducing the pool of qualified arbitrators without materially improving the general quality of the arbitrator pool or increasing assurances of the independence or capability of individual arbitrators. The draft report recommends that the Commission require the SROs: (1) to develop formal standards for selecting arbitrators; (2) verify information submitted by prospective and existing arbitrators; and (3) establish a system to ensure these arbitrators are trained adequately in the arbitration process. The recommendations are made, we understand, without the study having

uncovered a single instance where an arbitrator had misrepresented qualifications to serve as an arbitrator, and I would urge the GAO to reconsider them.

See pp. 61-63.

Arbitrators are not selected, as stated in the draft report, based solely on the information they provide in their applications, but are instead selected based upon referrals or recommendations and general reputation in the community as well as upon the profile information that they supply. Moreover, SRO arbitration forums already conduct background checks on their arbitrators. A requirement that SROs engage in further review of the backgrounds of arbitrators is unwarranted, especially where there has been no evidence of abuse. Further steps to verify this data would produce costs that would have to be borne either by the parties or the SROs, which have other public obligations and priorities to fulfill in the regulation of the nation's securities markets.

See pp. 61-63.

In addition, basic training for arbitrators on the arbitration process already is provided through the Arbitrators' Manual, which was produced by the Securities Industry Conference on Arbitration in conjunction with its reform to the securities arbitration rules. We also believe, however, that it would be appropriate to study whether there are cost-effective means to assess arbitrators' training needs and provide better training for arbitrators.

See pp. 108-109.

The draft report also includes a number of statements or references that are either inexact or require, in our view, further comment. We have addressed these together with further discussion of the draft report's recommendations either in Attachment A, which is entitled "Technical Comments by the Division of Market Regulation" or in a second attachment, which consists of a series of pages from the draft report marked to show where edits, in the staff's view, should be made.

Thank you again for this opportunity to assist the GAO as it prepares its final draft of this report. I respectfully request that this letter, including Attachment A, be appended to the final report delivered to Congress.

Sincerely yours,

William H. Heyman

William H. Heyman
Director

Attachments: Attachment A - Technical Comments
Attachment B - Draft Pages Marked With Edits

Note: Attachment B is not reprinted because SEC requested that only its letter and attachment A be reprinted.

ATTACHMENT A
Technical Comments by the Division of Market Regulation

The draft report Securities Arbitration: How Arbitrators Fare includes a number of statements, references, or recommendations that are either inexact or require further comment, which are addressed below.

See pp. 61-63.

1. Arbitrator Selection Criteria -- Chapter 6. The draft report criticizes the self-regulatory organization ("SRO") arbitration forums for not having formal standards related to education or work experience to qualify an individual to be an arbitrator.

The Commission staff has focussed close attention on the issue of arbitrator qualification, particularly since 1985 when the Supreme Court's decision in Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213 (1985), signalled greater use of arbitration for the resolution of securities disputes. The staff at that time began an intensive review that resulted in the Commission's 1987 letters that resulted in significant reform of the securities arbitration procedures. Those letters included six recommendations directed at arbitrator qualifications. These related to: (1) appropriate distinctions between industry-affiliated and "public" arbitrators; (2) disciplinary history of arbitrators; (3) training of arbitrators; (4) arbitrator evaluations; (5) arbitrator disclosures; and (6) challenges for cause. These recommendations were the product of long study, and recognized the benefits to having arbitration pools composed of persons with various types of experiences and outlooks. 1/

The draft report's recommendation appears to stem in some measure from a misunderstanding of how arbitrators currently are selected in SRO arbitration, both for the arbitrator pools, and in the individual cases. The draft report states that "[i]ndividuals are selected to serve as arbitrators based on background information they provide to arbitration forums." 2/ This characterization of the selection process does not take into account the balance of considerations involved in arbitrator selection. Arbitrators generally are known in their communities and are most often recommended to the arbitration forums either by

1/ We do not discuss in any detail the changes to arbitration rules and procedures that were produced by these recommendations except to the extent where further improvement is necessary, or as otherwise appropriate in the discussion. These changes have already been discussed in Commission releases. See, e.g., Securities Exchange Act Release No. 26805 (May 10, 1989), 54 FR 21144 (May 16, 1989).

Now on pp. 4 and 55.

2/ Draft report at page 5 and Chapter 6, beginning at page 89.

arbitrators already known to the forum administrators, or by other persons known to the forum administrators. Arbitrators also are solicited from civic and professional groups, such as bar associations. 3/

We are concerned that if the SROs were to develop standards "to initially qualify" arbitrators, those standards would either homogenize the pool to such a degree as to lose the benefits of a diverse pool, or would be so loose as to be meaningless. Requirements for credentials such as the American Arbitration Association ("AAA") requirement of eight years of professional experience could serve to mask the need to evaluate closely the particular qualifications of individual arbitrators. Moreover, restrictive initial qualification standards that require all arbitrators to have advanced degrees or a minimum number of years in certain professions could foreclose investor choice in panel composition, and exclude individuals who manage family finances and have developed expertise as individual investors, or other categories of persons who may be capable arbitrators. Nevertheless, the staff strongly agrees with the draft report's emphasis on the need for independent and capable arbitrators. We believe it would be appropriate for the SROs to review their arbitrator selection and qualification procedures to determine whether they can be refined toward that end.

See pp. 61-63.

2. Verification of Information provided by Arbitrators -- Chapter 6. The draft report also states that the SRO arbitration forums do not verify the arbitrator background information they receive and maintain on file.

The current system includes steps to assure the veracity of information provided by prospective arbitrators. The existing procedures appear in our view to be reasoned and cost-effective as long as they are properly implemented. In particular, all arbitrators, industry-affiliated and public, are asked to sign, and affirm the veracity of, their arbitrator application profiles. We are not aware of any instances where arbitrators were discovered to have fabricated educational or professional histories, or to have hidden disciplinary or other significant events that should have been disclosed in their profiles. Furthermore, for those arbitrators that have either current or past affiliations with the securities industry, the SROs have all undertaken, and are expected, to examine the Central Registration Depository ("CRD") managed by the National Association of Securities Dealers ("NASD") for any disciplinary history on an applicant or current arbitrator

3/ See, e.g., the general discussion of arbitrator selection in Lipton, "Discovery Procedures and the Selection and Training of Arbitrators: A Study of Securities Industry Practices," 26 A.Bus. L.J. 441 (1988).

that would exclude him from the arbitrator pool. Some SROs report that they also compare other application data such as education or employment history against the data included in the CRD.

We do not believe that it is unreasonable, especially in the absence of evidence indicating any problem in this area, for SRO arbitration administrators to rely upon the word of their arbitrators. The staff believes that significant incentives already exist to assure that arbitrators do not make misrepresentations in connection with the information they provide to SROs. In this regard, lawyers and other licensed professionals may risk their licenses by making false or misleading statements regarding their experiences and background in the material they provide to the SROs in their arbitration profile. 4/ In addition, other members of the community who are not licensed professionals risk damage to their reputations should untruths be uncovered, for example, during proceedings to vacate an award. 5/

The report does not suggest what particular steps the General Accounting Office ("GAO") believes would be appropriate to verify arbitrator backgrounds. There would be appreciable costs, we believe, if SROs were required to contact an arbitrator's schools and employers, confirm arbitrators' publications, or the source of written recommendations. While most arbitrators understand the need to exclude from their ranks persons who provide false information, we assume that a certain percentage of arbitrators already known in their communities who volunteer their services to the arbitration systems will conclude that the related intrusion and complexity is simply not worthwhile, and they will decline to serve as arbitrators. Furthermore, verification efforts would impose costs which are unjustified given the absence of demonstrated abuse. These costs would be borne by the parties or the SROs, which have significant statutory responsibilities for the enforcement of the federal securities laws and, accordingly, have competing priorities for their funds.

Finally, the rules for arbitrator selection in particular cases suppose the active participation of many persons: arbitrators themselves and arbitration department staff, as well as parties and their counsel. In addition to general background information, arbitrators are required by the Code of Ethics for arbitrators, which has been incorporated in applicable part into the SRO rules, to provide additional disclosures that may be relevant to a particular case. Parties are entitled to receive this information

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4/ See, e.g., Rules 7.1 and 8.4 of the Rules of Professional Conduct of the Bar Association of the District of Columbia.

5/ Misconduct that prejudices the rights of a party is among the grounds for vacating an arbitration award. 9 U.S.C. § 10.

in order to determine whether to accept or challenge an arbitrator. Parties also have the right under the arbitration rules to request further information about a prospective arbitrator in order to make thoughtful decisions about accepting a proposed arbitrator. At this stage of the arbitrator selection process, parties may learn more about prospective arbitrators and influence the composition of a panel.

See pp. 61-63.

3. Arbitrator Training -- Chapter 6. The draft report also states that the SRO arbitration programs do not have formal training programs for arbitrators or systems to assess arbitrators' training needs, and recommends that the SROs establish a system to train arbitrators in the arbitration process.

Written materials, such as the existing manual for arbitrators that is provided to all arbitrators, already provide basic background information to the arbitrators. The manual addresses the mechanics of administering a hearing, comportment, ethical considerations and other introductory issues. The staff agrees that it would be appropriate to study whether there are cost-effective means to provide better training on arbitration procedure to arbitrators. Nevertheless, while the SROs should expand their training efforts, the staff does not believe that a prescription of specified courses should, or could, become an acceptable substitute for careful, varied evaluation by the arbitration departments to assure the independence and capability of arbitrators.

Moreover, the staff similarly believes that there is a risk in a simple reliance on training programs "to ensure these arbitrators are adequately trained in the arbitration process." The draft report at page 98 suggests that training could ensure that arbitrators "perform their functions fairly and appropriately." Although the Commission and staff have consistently pressed -- and will continue to press -- the SROs to improve their offerings of training for arbitrators, we have been reluctant to insist that the SROs impose mandatory training requirements for several reasons. First, the arbitrator's manual provides a basic training reference for commonly arising issues. Second, there are capable persons for whom introductory films on comportment and arbitration process would be a waste of time -- time that such persons may be unwilling to spend. In addition, we would be concerned that mere attendance at one or several continuing education programs could somehow become a proxy for qualification as an arbitrator. Neither arbitration administrators nor parties should assume that an individual is independent or capable merely because of several afternoons spent in training sessions. Our understanding is that, as a practical matter, new arbitrators are paired with experienced arbitrators to learn how to conduct hearings and better evaluate the cases before them.

The staff, however, agrees that reliance on on-the-job training for arbitrators does not, by itself, undercut the need for or importance of effective arbitrator training. We believe that the SROs must continue to improve access to training for the arbitrators, through written materials, films and conferences. While it would not be inappropriate for the SROs to deny or limit appointments to cases for arbitrators that had not expressed any interest in training programs or otherwise demonstrated competence in the field, an attempt at imposing uniform instruction on a varied group of persons may not be likely to provide any material improvements in the arbitrator pool. Before endorsing particular training requirements, the staff would want to understand better the variety of training interests held by the arbitrators and have some idea how many arbitrators the SROs would be likely to lose from their rosters if particular training requirements were imposed.

See comment 1.

Now on pp. 6 and 40.

Now on p. 41.

4. Small claims case recovery -- oral hearing v. paper cases. The draft report indicates at pages 11 and 62 that cases that go to oral hearings are 1.4 times more likely to result in an award for the claimant than are those resolved solely on the basis of the parties' written submissions. The draft report does not indicate whether the comparison was made between all cases, large and small, that went to oral hearing and those cases (all under $10,000) resolved on the papers, or between those cases under $10,000 that were resolved on the papers and those that were resolved after an oral hearing. It would be useful to clarify that point. Moreover, later at page 63, the draft report also notes that cases under $20,000, which include all of the cases that had been resolved based on written materials, were 3.7 times as likely to result in an award in excess of 60% of the amount claimed.

It is important to recognize that investors with claims under $10,000 always have the option under the SRO arbitration rules of requesting an oral hearing to present their cases. In fact, approximately one quarter of the small claims claimants at the NASD and New York Stock Exchange ("NYSE") did so for cases concluded in 1991. Hearings were held in 22% of the 332 small claims cases concluded at the NASD that year, and 25% of the 146 small claims cases concluded at the NYSE during the year.

It is also important to state the importance to investors of retaining the option of resolving cases on the papers. For the price of a postage stamp (and applicable fees), an aggrieved investor can place his case before an impartial decision maker. In many cases, the effort and expense of a full oral hearing would deny investors with smaller claims access to dispute resolution. While a party may in certain instances have a better opportunity to persuade arbitrators in person, as in cases that hinge on credibility, the paper case option remains vital to preserving investor confidence.

See comment 2.

Now on pp. 14-15.

5. The administration of SRO arbitration -- pages 19 and 20. The paragraph at the bottom of page 19 carrying over to page 20, which discusses the administration of SRO arbitration, does not address the regulatory responsibilities of the SROs imposed by Congress, and should be redrafted. Suggested language follows:

> Securities arbitration is administered by groups called self-regulatory organizations ("SROs"). Congress determined through the federal securities laws to regulate the securities markets through the combined efforts of the SEC and those of the SROs. The SROs are registered with the SEC, and have statutorily imposed responsibilities to regulate their member broker-dealers. SROs have many public functions. They write rules; they monitor trading in the markets; they enforce the securities laws and their own rules; and they administer systems of arbitration to resolve disputes between investors and their members.

See comment 3.

Now on p. 15.

6. SRO and AAA arbitration rules -- page 21. The draft report notes at page 21 that the "AAA's securities arbitration rules are generally similar to the Uniform Code of Arbitration" used by the SROs as a model for their rules. There are, however, important distinctions between the SROs' and AAA's rules. For example, the SROs require the maintenance of a record in all cases, while the AAA does not. Awards in cases at the SROs involving public investors are public, while they are not at the AAA. The SRO rules provide more specific procedures for obtaining prehearing discovery than do the AAA rules. In addition, SRO arbitrators also can compel the production of industry personnel or documents without a subpoena, which AAA arbitrators may not.

See comment 4.

Now on pp. 28 and 33.

7. Reasons for the use of pre-dispute arbitration clauses incorrectly attributed to the SEC -- references at pages 43 and 52.

The draft report incorrectly cites at page 52 former Chairman David Ruder's July 12, 1988 testimony before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce. The draft report cites to that testimony, stating:

> In 1988 testimony before Congress, the SEC Chairman noted the highly technical nature of issues in options trading and the greater likelihood of litigation to resolve disputes arising in options trading. [footnote omitted] In the same testimony, the SEC Chairman said that broker-dealers would argue that arbitration was the appropriate forum for resolving disputes in options accounts because it was the least costly forum.

In fact, the referenced testimony clearly states that the arguments concerning the technical nature of options trading and likelihood of litigation were made by broker-dealers.

> In support of mandatory clauses in margin and options accounts, broker-dealers argue, among other things, that they are at financial risk with margin accounts and therefore have a right to insist on the forum to resolve disputes. They also argue that the issues involving options and margin are more technical and complicated than those involving cash accounts and, thus, arbitration is the more appropriate forum. Additionally, they point out that margin and options accounts are more likely to result in litigation and that, therefore, arbitration, as the less costly forum, is particularly appropriate for these types of accounts." (emphasis supplied)

The apparent implication of the language in the draft report is that the former Chairman had endorsed the use of predispute arbitration clauses for options accounts based on these notions of the technical aspects of options trading. That is not accurate. After noting the arguments of both the securities industry and proponents of greater customer choice, the Chairman concluded that the issues were complicated, and required further analysis.

> Proponents of customer choice point out, on the other hand, that margin and options accounts often raise issues of fiduciary responsibility and customer suitability -- issues particularly appropriate for court adjudication. Because the issues concerning margin and options accounts are complicated and do not lend themselves to easy solution, I believe further examination and analysis are necessary before a judgment can be reached on the use of predispute clauses for these types of accounts.

Subsequent to the July 1988 testimony, the Commission approved rules that mandate explicit and prominent disclosures in conjunction with any use of predispute arbitration clauses. 6/ These rules also impose significant limitations upon the contents of the arbitration provisions. They explicitly prohibit any arbitration contract from including "any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits

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6/ The draft report does not indicate whether the investors interviewed by GAO staff who complained that they had been unaware of the arbitration provisions in the documentation they had signed in connection with their accounts had signed those documents before, or after, the imposition of these new requirements.

the ability of the arbitrators to make any award."7/ Additionally, customers have retained access to basic brokerage services without agreeing to pursue any future disputes through arbitration.

We also suggest that the GAO clarify in the report the fact that the availability of securities accounts with or without the signing of predispute arbitration clauses is not actually keyed directly to whether accounts are cash accounts, or margin or options accounts, but rather is instead keyed to whether any documentation is required to be signed in connection with an account. 8/ Required documentation, as we understand it, better explains differences in the use of arbitration clauses in the various types of accounts. The staff has observed that, generally, when there is documentation that establishes terms of the parties relationship that is to be signed in connection with the opening of an account, that document is likely to include a dispute resolution provision. Firms require documentation for margin and options accounts, retirement accounts, and trust accounts for regulatory and prudential reasons largely unrelated to arbitration or other forms of dispute resolution. Firms generally do not require the signing of any customer agreements for individual cash accounts, and have not elected to take on the administrative burdens and costs of such contracts solely to obtain predispute agreements to arbitrate.

See comment 5.

Now on p. 38.

8. Dispute resolution choices of investors in futures -- page 58, footnote four. The draft report indicates that futures investors may choose among arbitration, reparations, mediation or litigation. The discussion is incomplete, and would be more clear if the following were added:

> While commodities firms may employ predispute arbitration clauses, they may not make adherence to the clause a condition of doing business. Commodities investors have the right to take their cases through the courts only if they have not signed an agreement containing an arbitration clause. In addition, commodities investors

---

7/ See, e.g., NYSE Rule 636(d) and NASD Rules of Fair Practice, Article III, Section 21(f)(4).

8/ See, e.g., the Commission's release approving the major reforms to the arbitration process in May 1989: "At least five of the nation's largest broker-dealers, with offices around the country, do not require the signing of account agreements for individual cash accounts that do not otherwise require documentation in connection with other services provided in the account, such as individual retirement accounts or trustee controlled accounts." Securities Exchange Act Release No. 26805 (May 10, 1989), 54 FR at 21153 n.51. (emphasis supplied)

may opt for reparations procedures administered by the Commodities and Futures Trading Commission regardless of whether they have signed predispute arbitration clauses. Mediation services are offered by the National Futures Association as an adjunct to its arbitration facilities.

See comment 6.

Now on pp. 50-54.

9. Discussion at pages 80 through 88 of possible changes to the arbitration system. The staff strongly concurs with the draft report's conclusion not to make any recommendation for changes stemming from the results of the survey discussed in Chapter 5. The chapter discusses non-binding arbitration, the institution of a single SRO to administer arbitration cases, and a requirement that arbitration awards include a statement of reasons by the arbitrators. The staff has strong reservations about the framing of the questions and the sampling of respondents discussed in the chapter, as well as on the general concept of employing such a questionnaire as a means of public policy making.

In general, the questions did not fully or fairly apprise those questioned of the complicated range of issues related to appeal costs, single SRO cost and governance, or the implications of requiring arbitrators to write the reasons for their awards. These limitations undercut any potential value of the information provided by the respondents. We do not address these problems in any detail as the report correctly did not rely on such information to recommend any of the changes addressed in the survey questions.

See comment 7

Now on pp. 6 and 40.

10. Recovery rate for cases involving commodities options -- pages 11, 61 and 63. The report indicates that claims involving commodities options were 1.8 times more likely to receive an award of some amount as were those with other types of products. Our understanding after reviewing the technical appendix is that the reference in the text of the report to "commodities options" refers to options on securities and options on commodities (see e.g. pages 112, 120 [Table III-4], and 121.) We believe that it would be helpful to clarify the term "commodities options" in the text of the report.

Now on pp. 71, 76-77, and 78.

The following are GAO's comments on the Securities and Exchange Commission letter dated March 12,1992.

GAO Comments

1. The scope and methodology of our analysis are explained in detail in chapter 2 and appendix III. In addition, footnote 5 in chapter 4 further explains that we tested the effects of all 10 factors we evaluated, including hearings or review of evidence and claims over and under $20,000. As we stated on pages 39 through 41, the size of the claim did not have an impact on whether the award was made but did affect the amount awarded.

The description given on page 40 recognizes that investors with claims under $10,000 have the option of having a hearing or having their cases resolved on the basis of the written evidence. Our study was not designed to evaluate the importance to investors of retaining the option of resolving cases on the basis of the written evidence.

2. The description of how the securities industry administers and oversees arbitration was intended to provide a broad overview of the industry's principle of self-regulation and not a specific discussion on self-regulation. We have added language to indicate that the SROs' legal authority comes from the Securities Exchange Act.

3. We recognize that there are differences between SRO and AAA rules on arbitration. A number of these differences are compared in appendix I of the report as requested by the Committees and Subcommittee. As SEC indicated, there are other differences; however, in general, the procedures used by the SROs and AAA are similar.

4. We agree with SEC that our characterization of former Chairman David Ruder's July 12, 1988, testimony before the Subcommittee on Telecommunication and Finance of the House Committee on Energy and Commerce was incorrect. The Chairman was giving the views of broker-dealers and not his own. We modified the text on pages 28 and 33 to indicate that these are broker-dealers' views on the use of predispute arbitration clauses and that the former Chairman believed the issue should be further studied.

We disagree with SEC's suggestion that we clarify the report to indicate that the availability of accounts with or without the signing of predispute arbitration clauses is not actually keyed to the type of account—cash, margin, or option—but rather keyed to whether any documentation is

required to be signed in connection with an account. SEC states that types of accounts that require documents for reasons unrelated to arbitration usually also include dispute resolution provisions. Either way, however, it is the resulting requirements that are important, and our methodology captures those requirements.

5. We have modified footnote 4 in chapter 4 to include language proposed by SEC and CFTC officials.

6. As we clearly indicate in chapter 2, the opinions in chapter 5 should not be construed as being representative of those of all investors, arbitrators, or attorneys. In addition, as the title of chapter 5 indicates, the chapter contains only opinions and does not represent any analysis on which we would base recommendations.

7. Our conclusion in chapter 4 on commodities options claims is accurate. We tested for differences between commodities options, securities options, and other products. Commodities and securities options were separate categories in the analysis. The results showed that investors with claims involving commodities options were 1.8 times more likely to receive an award than investors with other products, including securities options. We revised the text on page 40 to clarify that our comparison included securities options.

Major Contributors to This Report

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