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Government Sponsored Enterprises

A Review of the Securities Arbitration System

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Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, I am Bill Galvin, Secretary of the Commonwealth and Chief Securities Regulator in Massachusetts. Thank you for the opportunity to be here today to testify about arbitration in the securities industry — from the point of view of investors on Main Street.

I can speak to the concerns of small investors because they call or visit my office in Massachusetts all the time. Small investors, let's not forget, are the life blood of our securities markets. Without their faith and trust — and their hard-earned money — our markets couldn't function.

Unfortunately, in recent years their faith has been badly shaken. They've watched as giant companies, some with household names, were looted and run into the ground by corrupt management. They've seen respected Wall Street firms hype technology stocks using corrupt research reports — research that, we now know, was designed not to paint a true picture of the company or its prospects but to curry favor with a client in order to win lucrative investment banking business.

Corporate scandals and the collapse of the high-tech bubble have hurt countless Main Street investors. That's bad enough. What's worse in my opinion, is the rigged system we now have to help harmed investors seek a measure of justice.

Every year thousands of investors file complaints against their brokers. If these disputes aren't settled, they end up in mandatory arbitration, a system that I believe is fundamentally flawed and stacked against the individual investor. The sad thing is, industry-sponsored arbitration is the only game in town.

When an investor opens a brokerage account, in almost all cases he or she must sign away their right to a day in court should a dispute arise. Instead, they agree to have their claim heard by a panel of three arbitrators picked from a list compiled by the NASD, the so-called industry self-regulator.

The term “arbitration” as it is used in these proceedings is a misnomer. Most often, this process is not about two evenly matched parties to a dispute seeking the middle ground and a resolution to their conflict from knowledge, independence and unbiased fact finders, rather what we have in America today is an industry sponsored damage containment and control program masquerading as a juridical proceeding.

Of the three arbitrators on the panel, there is one with ties to the securities industry and two supposedly without ties to the industry. I believe the truth about the independence of these other arbitrators will reveal a troubling pattern and I invite your review.

Is it fair? The industry would say “yes.” But let’s think about it for a minute.

The NASD, the industry group, gets to decide who is qualified to be an arbitrator and who isn’t. They and only they — the NASD, that is — select the pool of arbitrators. There is no state in this union that gives to one party to litigation the unilateral right to choose the finding of fact or jury that will decide their case without regard to the other party’s choice. Would anyone seriously suggest that we apply this approach to any other industry?

For instance, would anyone here seriously suggest that in all future disputes between automobile manufacturers and their customers relating to defects that those who purchase an automobile can only bring their complaints and claims before a panel selected by GM, Ford or Chrysler? – I don’t think so.

Are not the financial futures of our citizens entitled to at least as much protection as in cars?

As further proof of this rigged system, I offer one example that I happen to be personally familiar with — John J. Mark, a former NASD arbitrator from Massachusetts.

Mark was an arbitrator with the Commonwealth of Massachusetts for many years, and an adjunct professor at Harvard and Boston University. As far as I know he's a man of impeccable credentials. And yet he was dropped from the NASD's pool of arbitrators.

Why? As he told a meeting of state securities regulators last summer, (and I quote): "the word on the street is if you rule against the (brokerage) houses, you will be removed from the list" (end quote).

To be sure, lately the NASD has been working on this arbitration process.

About nine months ago, for example, the NASD fined three large Wall Street firms — Merrill Lynch, Morgan Stanley and Smith Barney — $250,000 each for failing to produce documents in some 20 arbitration cases between 2002 and 2004. That was an overdue step in the right direction. Foot-dragging by Wall Street firms involved in disputes with investors must be punished.

But these fines are so small, they hardly operate as a deterrent to further stonewalling. Automatic default and treble damages on claims would be a far more effective remedy.

More recently, the NASD after deliberation has passed another milestone. Arbitrators may be required to put their decision in writing – for a fee. But no fine or other regulatory tinkering will address the more fundamental flaw of the so-called arbitration process — namely, that it's run by the industry and for the industry.

The system is unfair.

Consider this statistic. While the NASD asserts that in more than half the cases arbitration panels award money to investors the number of so-called investor "victories" does not tell the true story of how investors really fare in arbitration.

The NASD cites cases where the arbitrators make any cash award as a "victory" for the investor. But in fact, many of those awards often are for only a fraction of the amount claimed. Under this method of reckoning, a claimant who had $5 million losses but was awarded just $5.00 in restitution has received an "arbitration award." This is a pyrrhic victory, at best.

The arbitration system should be reformed to put investors' interests on the same level as those of Wall Street.

How can we do that?

Given that investors, by law today, have no choice but arbitration, we need to make the system more fair. The best way to do that is to take it out of the hands of the industry — put someone besides the NASD in charge. That's the best solution.

In the short-term, we need to increase oversight of the arbitration process. The S.E.C., state securities regulators — and perhaps even Congress — need to take a hard look at arbitration.

State securities regulators have begun this process by creating a task force to look at issues involving arbitration. These issues include how arbitrators are selected, trends in arbitration awards, and how cumbersome and expensive the system is for investors.

This is not a small thing.

We have almost 100 million investors in this country. In recent years we have made reforms to make sure Main Street investors get a better shake in the marketplace.

We now need to focus on reforming the dispute-resolution system. It’s the right thing to do — right for investors and right for our markets. It’s time to act.

Again, I am grateful for the chance to be here today to share some of my thoughts and I look forward to your questions.