MEMORANDUM

September 7, 1983

TO: Dan Goelzer

FROM: Russ Stevenson
Anne Chafer

RE: Advantages and Disadvantages of Arbitration and Litigation as a Means to Resolve Disputes Between Broker-Dealers and their Customers.

Introduction

We have listed below the general considerations related to the above-captioned topic as you requested. At the outset, however, I would like to bring to your attention certain considerations applicable if the Commission decides to support an effort to repeal the rule of Wilko v. Swan.

First, it requires legislation. Since, as discussed below, this legislation is likely to be viewed as being against the consumer interest, it unlikely to receive favorable consideration, particularly in an election year.

Second, as a quid pro quo for any such legislation, the Commission, in view of the disparity in bargaining power between broker-dealers and their customers, would likely be required to become more involved in the securities arbitration process and in determining what information should be provided to investors when they consent to arbitration.

Third, a successful effort to repeal Wilko would in all probability result in the arbitration process itself

becoming more formal -- perhaps by requiring increased protections such as a record and some sort of review -- and thus less efficient and more expensive.

Fourth, as long as the Commission (as it should) requires that broker-dealers make full disclosure to their customers of the consequences of signing a pre-dispute arbitration agreement and requires broker-dealers to obtain their separate consent to one, there is at least some doubt as to the extent of the practical result that would be achieved by legislation that reverses Wilko. This is because under such circumstances many customers probably would not sign a pre-dispute arbitration agreement unless the broker insisted on it as a condition of doing business. In that event it is possible that even if legislation were enacted a court would not consider the mandatory compulsory pre-dispute arbitration contemplated here a "hearing appropriate to the nature of the case." Mullane v. Central Hanover Trust Co., 339 U.S. 306, 313 (1950). Even Justice Frankfurter, who dissented from the Court's holding in Wilko, indicated that he would have decided differently in that event.

> "We have not before us a case in which the record shows that the plaintiff in opening an account had no choice but to accept the arbitration stipulation, thereby making the stipulation an unconscionable and unenforceable provision in a business transaction." 346 U.S. at 440.

Advantages and Disadvantages of Arbitration

There are certain generally recognized advantages to arbitration over litigation as a means for resolving disputes. As a general rule, the arbitration of disputes is faster, less formal and generally more efficient than litigation. As a result, arbitration is cheaper than litigation, particularly with regard to attorneys' fees, generally because of the less formal procedures employed and the finality of the process. This is also the case of arbitration of disputes in the securities industry. Moreover, because the laws, regulations and customs governing broker-dealer margin accounts are complex, disputes arising thereunder are often suitable for resolution by expert arbitrators. These general benefits in the arbitration process adhere to the advantage of both broker-dealers and customers.

However, broker-dealers and customers generally do not possess equal bargaining power, as, for example, may be the case in other contexts, such as labor union-management disputes. Accordingly, many persons perceive that the arbitration process will necessarily inure to the benefit of the party who holds the greater bargaining power -- in this case the industry -- in terms both of control over the arbitration forum and selection of individuals to serve as arbitrators, and in terms of the ultimate result of arbitration. In this view, only the litigation process can adequately protect the rights of customers. Similarly, arbitration often is perceived as being more solicitous

of industry rights than litigation. */

1. Advantages of arbitration (and consequent disadvantages of litigation).

   a) from the industry's perspective:

      1) the complexity of laws, regulations and customs governing use of margin accounts warrants the use of expert arbitrators to resolve disputes. (Barron's, Don't Pay the Two Dollars, Aug. 29, 1983, p. 15). On the other hand, the disputes do not usually present difficult or unusual fact patterns requiring the need for an expert fact-finder such as a trial judge (SIA Comment on proposed rule 17 CFR 240.15a2-2);

      2) availability of treble damage awards under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), which the courts have held can apply to a pattern of fraud by securities firms and their agents, presents an

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*/ See e.g., the comments of Martin S. Stolzoff on proposed rule 17 CFR 240.15c2-12, concerning disclosure regarding recourse to the federal courts notwithstanding arbitration clauses in broker-dealer customer agreements, who observes that the securities industry deliberately overstates the success rate of customer-claimants in arbitration by counting as successful any award for the customer, no matter how de minimis.

unwarranted bonanza for the already excessively litigious (Barrons, supra). This general problem probably should be remedied outside this context;

3) the arbitration procedures developed by the securities industry since the Wilko decision are fairer to customer rights than before. (Goldman, Sachs & Co.'s response to proposed rule 17 CFR 240.15a2-2);

4) arbitration "favors" customers as much as broker-dealers. For example, in situations where the broker-dealer determines that the odds of prevailing in court are in its favor, the arbitrator's penchant for splitting an award down the middle (see below) may result in the customer obtaining some award he would not receive in litigation. (Goldman, Sachs & Co.'s response to proposed rule 17 CFR 240.15a2-2).

b) from the customer's perspective

1) the general observation that arbitration is faster, less formal and more efficient;

2) because of the relative informality and finality of arbitration, legal fees are much less.

2. Disadvantages of arbitration (and consequent advantages of litigation).

a) from the industry's perspective

1) obtaining and training qualified individuals to serve as arbitrators requires expenditure of substantial resources. (Letter from Gordon S. Macklin to Chairman Williams, July 31, 1980);

2) questions of the impartiality of arbitrators calls into question the validity of the entire arbitration process. (Letter from Gordon S. Macklin to Chairman Williams, July 31, 1980);

3) there is a continuing controversy over whether qualifications for arbitrators should be prescribed. (Memorandum to Chairman Williams from the Office of Consumer Affairs, Feb. 7, 1980).

b) from the customer's perspective

1) because arbitrators are affiliated with the SROs, customers hesitate to use arbitration because they doubt the arbitrators' impartiality. (Securities Exchange Act Release No. 13470 (April 26, 1977); Krause, Securities Litigation: The Unsolved Problems of

Predispute Arbitration Agreements for Pendent Claims, 29 DePaul L. Rev. 693, 718 (1980);

2) arbitrators seem to be unaware of, or unwilling to enforce, their own procedural rules against the tactics of broker-dealers' counsel, such as the use of general denials in the answer or the refusal to cooperate in the discovery process. These tactics delay the resolution of the dispute and add to the customers' costs of arbitration. (Letter from Peter R. Cella to Robert Wolf, Director of Office of Consumer Affairs, April 15, 1981);

3) the arbitration process trades too much "fairness" for the sake of efficiency. [It should become more formal in order to assure greater fairness.] For example, a case-by-case record should be kept showing parties' names, the amount of each claim, the amount of each award and to whom made, etc. Actual arbitration results should be reported to prevent exaggerated industry claims of customer successes in the arbitration process. See note supra p. 3. Finally, the failure of arbitrators to

give a reasoned decision renders meaningless the power of courts under Section 10 of the Federal Arbitration Act to vacate an arbitrator's award not made in accordance with law. (Stolzoff's comment to proposed Rule 17 CFR 240.15a2-2);

4) the selection of arbitration prevents customers from obtaining treble damage awards under RICO (See discussion supra);

5) arbitrators have a well-known penchant for compromise. (See e.g., Note, 44 Harv. L. Rev. 1022, 1026 (1948) (commercial arbitration); Phillips, A Lawyer's Approach to Commercial Arbitration, 44 Yale L. J. 31, 49 (1934)). Thus, where the broker-dealer can show some equity in his favor, a customer is unlikely to receive as large an award as he would if successful in litigation;

6) although customers may be lulled into belief that arbitration proceedings do not require counsel, those procedures, which involve, inter alia, discovery rights and procedures to obtain witnesses, are too complex to allow lay customers to represent themselves competently. (Securities Exchange Act Release No. 13470 (April 26, 1977);

Krause, supra at 718). Accordingly, arbitration does not usually avoid the customers' need for counsel, although legal fees are usually much less in arbitration than in litigation because of the informal procedure and finality of the process. Of course, as noted above, the award to the customer also appears to be less;

7) as noted above, there are greater procedural and substantive rights accorded litigants than parties to an arbitration;

8) judges apply the law to the facts of the disputes before them. When new disputes arise lawyers and judges look to see how similar matters were resolved in the past. In this way the law evolves. Where disputes are arbitrated and not reported, however, there will be no opportunity for the securities law to adapt to new or changing circumstances. Accordingly, divesting the courts of jurisdiction to consider securities disputes will freeze the development of the law, except for cases brought by the Commission and those not involving broker-dealers.