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OFFICE OF
THE COMMISSIONER

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

August 28, 1986

The Honorable John D. Dingell
Chairman
Committee on Energy & Commerce
Room 2125
Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Dingell:

In the absence of Chairman Shad, I am writing to you in further response to your letter dated September 18, 1985, in which you requested that the Commission make an inquiry into a complaint by Joan Bunt Smith. In her letter to you dated August 30, 1985, Ms. Smith raised questions concerning the propriety of arbitration proceedings conducted by the Chicago Board Options Exchange and actions by Shearson Lehman Brothers, Inc. that were at issue in the arbitration.

The results of the staff's review are set forth in the enclosed report, prepared by the staff of the Commission's Division of Market Regulation, which I hope will prove useful to the Committee. Please contact Richard Ketchum at 272-3000 or Sarah Ackerson at 272-7471 if you require any further information for your inquiry.

Sincerely,

A handwritten signature in cursive script that reads "Charles C. Cox".

Charles C. Cox
Commissioner

Enclosure

REPORT OF THE DIVISION OF MARKET REGULATION IN RESPONSE TO
AN INQUIRY BY THE HONORABLE JOHN D. DINGELL, CHAIRMAN OF THE
COMMITTEE ON ENERGY AND COMMERCE, CONCERNING A COMPLAINT
BY JOAN HUNT SMITH.

John D. Dingell, Chairman of the House Committee on Energy and Commerce, requested in a letter dated September 18, 1985, that the Commission report to him with respect to allegations contained in an August 30, 1985 letter of complaint sent to him by Joan Hunt Smith ("Smith"). Smith complains in her letter both that she and related parties received unfair treatment in arbitration proceedings conducted by the Chicago Board Options Exchange ("CBOE") and that their accounts were mishandled while at the brokerage firm, Shearson Lehman Brothers, Inc. ("Shearson"). 1/

In order to respond to Chairman Dingell's inquiry the staff first discussed the allegations made by Smith with the appropriate self-regulatory organizations ("SROs") and then, in letters dated October 31, 1985, requested that the CBOE respond to Smith's challenges to the fairness of her arbitration proceeding at the exchange and that the New York Stock Exchange ("NYSE") investigate Smith's allegations concerning the opening and handling of her account. 2/ In ensuing months, the staff collected from both the SROs and Smith a full record relating both to the various accounts at issue in the dispute and the alleged defects in the arbitration.

Various issues raised by Smith have already been the subject of several legal proceedings, each of which has been resolved against her. The first proceeding, on November 13 and 14, 1984, was an arbitration hearing administered by the CBOE in which Smith and the related account holders sued Shearson for its alleged mishandling of the claimants' accounts. The claimants, after losing the arbitration, filed a motion with the CBOE to vacate the arbitration award. That motion was dismissed on March 25, 1985. The second proceeding was a confirmation hearing filed by Shearson in the United States District Court for the Northern District of Illinois, Eastern Division, to confirm the arbitration award in its favor. Smith appeared in that hearing, with counsel, and on April 19, 1985 the Court confirmed the award in Shearson's favor.

1/ Smith's complaints related to her own account, an account she held in trust for her daughter, Mary Duke Smith, and the account of a friend, George F. Hybert.

2/ These letters are attached as Exhibit A.

Smith appealed that decision to the Court of Appeals for the Seventh Circuit, where the appeal was dismissed on February 4, 1986. 3/ The third proceeding was a separate complaint brought in the United States District Court for the Northern District of Illinois, Eastern Division, by Smith and others alleging violation of the Racketeer Influenced and Corrupt Organizations Act, or RICO, as well as common law fraud by Shearson and one of its employees. On June 26, 1985 the RICO suit was also dismissed.

This report will address Smith's request that the Commission review her challenges to the arbitration proceedings administered by the CBOE and then the testimony regarding the opening and handling of her account by Shearson. 4/

I. Commission Review of Arbitration Proceedings Conducted by the CBOE

A. CBOE Arbitration Proceeding

The CBOE administers arbitrations between its members and their customers pursuant to a set of rules, the "Uniform Code of

3/ As Smith has pointed out, the grounds for appealing an arbitration award are quite limited. This is governed, however, by the Federal Arbitration Act. 9 U.S.C. §1 et seq. That Act generally upholds the validity of arbitration contracts and establishes narrow grounds for overturning an arbitration award. An arbitration award may be vacated where: (a) the award was procured by corruption, fraud, or undue means; (b) there was evident partiality or corruption in the arbitrators, or either of them; (c) the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; (d) the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made; or (e) an award is vacated and the time within which the agreement required the award to be made has not expired, the court may, in its discretion, direct a rehearing by the arbitrators. 9 U.S.C. §10.

4/ The file assembled by the staff in this matter includes a number of observations by Smith that fall generally into these two categories.

Arbitration," that is common to all of the securities industry SROs. The development of these rules had as its genesis a 1976 Commission release 5/ that solicited comment from interested persons on the feasibility of developing a "uniform system of dispute grievance procedure for the adjudication of small claims." That release led in the following years to public hearings and the formation of a Securities Industry Conference on Arbitration ("Conference" or "SICA") composed of representatives of the SROs, the public and the securities industry. The work of the Conference resulted in the Uniform Code of Arbitration ("Code") which lays out arbitration procedures for the resolution of both small and other grievances between members of SROs and their customers.

Each of the SROs adopted the Code as part of its own rules during 1979 and 1980. The Code was submitted at that time to the Commission for approval as required under the Securities Exchange Act of 1934 ("Act"). 6/

B. Commission Review

The Commission has no authority to review a specific arbitration to assure either compliance with the procedural requirements of the Code or accurate interpretations of underlying federal securities law or other claims by the arbitrators. The Commission has no authority to overturn an arbitration award, just as it cannot do so in other private dispute resolutions, such as civil litigation. Nevertheless, pursuant to your request the staff reviewed all of the documents submitted for evidence indicating whether the claimants had a fair opportunity to present their case, to challenge the selection of arbitrators and other indicia of fairness or unfairness evident in the files.

5/ Securities Exchange Act Release No. 12528 (June 9, 1976).

6/ See generally §19(b) of the Securities Exchange Act of 1934.

The arbitration rules lay out generally the procedures for submitting claims for resolution at the forum, timetables for pleadings, exchange of documents, selection of arbitrators and fee schedules. The rules are further supported by explanatory pamphlets published by SICA that explain somewhat more fully the SROs' administration of the Code. Although the pamphlets are not incorporated into the SROs' rules, all SICA members, including the CBOE, participate in their preparation. SRO procedures require that copies of both the Code and appropriate pamphlets (attached as Exhibit B) be given to all investors prior to their submission of claims for resolution under the Code.

C. Smith's Objections to the Arbitration 7/

Smith's principal objection to the arbitration proceedings arises out of her assertion that the arbitrators who served in her case may have been biased against her because of past business dealings they allegedly had with one another or with Shearson. She has also complained that the CBOE arbitration staff did not fully disclose the arbitrators' backgrounds.

However, in papers filed both in the confirmation proceeding in front of Judge Plunkett in the Northern District of Illinois, Eastern Division, and the appeal of the confirmation in the Seventh Circuit before Judge Easterbrook, Smith failed to present any persuasive evidence that backgrounds of the arbitrators were such as would create either an actual bias or an appearance of bias against her.

Further, it appears that Smith's counsel had ample opportunity to make inquiry concerning the background of the arbitrators but did not avail himself of that opportunity. The CBOE's rules provide that the exchange's Director of Arbitration must notify parties of the names and business affiliations of the arbitrators at least eight days prior to the arbitration. 8/ In addition, the explanatory booklet distributed to parties states "[a]dditional information concerning a particular arbitrator may be obtained by a party or a party's attorney upon request directed to the Director of Arbitration prior to the commencement of the hearing...." 9/

The record indicates that Smith's counsel was first informed of the arbitrators on the panel on February 21, 1984 almost a month prior to the first hearing on May 17, 1984 to resolve Shearson's (unsuccessful) motion to sever the claims of Smith and the other

7/ Attached as Exhibit C is a copy of the CBOE's response to Smith's charges, without attachments, which addresses Smith's letter on a point by point basis and should be helpful to the Committee. In addition, the staff has available for review in its files affidavits submitted in the litigation that followed this arbitration by various persons claimed by Smith to have tainted the arbitration proceedings.

8/ CBOE Rule 16.12.

9/ Arbitration Procedures, p. 3.

claimants. ^{10/} The substantive hearings took place six months later, on November 13 and 14, 1984. It would have been the responsibility of Smith's counsel to explore the backgrounds of arbitrators and raise any objections prior to that time.

Furthermore, the Code requires arbitrators to disclose to the Director of Arbitration any circumstances that they believe might preclude them from rendering an objective and impartial determination. ^{11/} In this case the arbitrators did not disclose anything in response to that requirement and nothing presented in subsequent litigation on this issue persuaded a court that the arbitrators had not fulfilled their obligations.

Smith has also stated that the arbitrators asked a disproportionately greater number of questions of the claimants and their witnesses than they did of the respondents and their witnesses. The staff notes that while the arbitrators did ask more questions of the claimants and their witnesses than of the respondents, the questions appeared relevant and revealing. Further, much of the claimants case was more elaborate than that offered by respondents, perhaps explaining the "imbalance" in questioning.

Smith also questioned the fairness of the chairman of the arbitration panel on the basis of several comments that he made during the hearings. Two principal strains of comments to which she objected concerned the secrecy of the proceedings and the need to expedite the proceedings.

Arbitrations have historically been considered to be private dispute resolution forums. They have not been open to the public, arbitrators generally do not provide written opinions explaining their awards and the awards are generally not known to the public unless disclosed by the parties. Hence, the panel chairman's comments concerning the private nature of the forum alone do not appear to be prejudicial.

With respect to Smith's claims that her counsel was rushed in his presentation of claimants case, the staff would first observe that it is not uncommon for triers of fact to encourage parties to proceed expeditiously with their case. Nevertheless, the staff's examination of the record does indicate that there was a consistent pattern of comments from the panel chairman that could

^{10/} See CBOE letter at pp. 6-7. The parties were informed on May 8, 1984 that one of this proposed panel of arbitrators was replaced.

^{11/} See CBOE Rule 18.13.

undermine the parties' confidence in the system. He consistently made reference to the late hour or the need for speed. Smith's counsel, however, was able to cross-examine all of the respondents' witnesses and otherwise present his clients' case. Further, the record does not indicate that he made any motion for additional time to present his case.

Finally, the staff reviewed the record to determine whether claimants were hampered in the preparation of their cases by an inability to obtain necessary documents from Shearson. Discovery under the Code, and arbitration generally, tends to be less formal and less extensive than in the courts. The record indicates that the CBOE staff actively facilitated discovery disputes by forwarding them to the chairman of the panel for resolution prior to the hearing. The staff has found nothing in the record to demonstrate that significant discovery disputes remained outstanding prior to the hearing. Also, the staff notes that much of claimants' case includes statistical information, which presumably came from Shearson's records, and was obtained prior to the hearing.

In summary, the staff is of the view that Smith has not substantiated her claim that the arbitration proceedings were unfair. It may be that it is the losses that resulted from the investment strategies used in the accounts -- both the suitability and control of which were the subject of sharp differences between the parties during the arbitration -- rather than the proceedings themselves that produced Smith's complaint.

II. Shearson's Opening and Handling of Smith's and Related Accounts

A. Commission Review

Smith's and the other claimants' case involved allegations of churning, unsuitability and inadequate supervision by Shearson. Ultimately, the arbitrators had to rest their decision upon a resolution of sharply differing testimony regarding the extent of claimants control over and understanding of the speculative uncovered options trading in their accounts. The staff has no authority to second guess the arbitrators' judgement as to whether the claimants adequately supported their claims of churning or unsuitability. However, the staff's review determined that the testimony at the hearing could reasonably support a decision adverse to the claimants.

Finally, Smith alleges that the procedures employed by Shearson to open and approve her account for uncovered options trading were defective. The staff is of the view that even if the account was improperly approved for uncovered options trading under the firm's internal rules, it would not necessarily be unreasonable

for the arbitration panel to conclude, if such in fact was the case, that Smith's subsequent participation in the trading of the account superceded this defect and that she in effect ratified the account by permitting this trading.

B. NYSE Review

By letter dated October 31, 1985, the staff requested that the NYSE investigate Shearson's actions with respect to the opening of Smith's account.

By letter dated April 18, 1986, the NYSE acknowledged that it was reviewing the opening of Smith's account at Shearson and that the exchange would visit the Shearson branch office in Chicago where Smith had her account as a part of the exchange's regular sales practices examination of the firm.

Later, the NYSE sent the staff two short internal reports dated June 3 and June 13, 1986 discussing its review of Shearson's records. At this time, the staff understands that the NYSE is reviewing its findings in order to determine whether Shearson may have violated certain NYSE rules in connection with Smith's account. In the event that the exchange institutes any formal proceedings against the firm, the staff will inform the Committee.

Conclusion

The staff would not recommend that the Commission take any action against either the CBOE or Shearson on the basis of Smith's complaint. ^{12/} Chairman Dingell's September 18, 1985 letter refers to a marked increase in arbitration related complaints received by the Committee. The staff is not aware of those complaints but would welcome the receipt of any additional information that could aid in its oversight role.

^{12/} The staff has not formed any opinion with respect to Smith's observations that her attorney[s] may not always have done as she wished.