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July 15, 1988

Richard G. Ketchum, Director
Division of Market Regulation
Securities & Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Mr. Ketchum:

On behalf of Ralph Nader and Public Citizen, as well as Phyllis Starker and Ray Mobarrez -- two investors who have had nightmarish experiences with the securities arbitration system -- we are writing in response to your letter, dated September 10, 1987, to the Securities Industry Conference on Arbitration ("SICA") ("Letter of September 10"), which proposed certain changes in the rules governing arbitrations conducted by self-regulatory organizations ("SROs"). We have both substantive and procedural concerns with the manner in which the Commission is approaching the issue of arbitration rules.

While we strongly support your effort to improve the arbitration system, we believe that, in several crucial areas, your proposals do not go far enough. Our related procedural concern is that the Commission's approach -- i.e., "recommending" that SROs adopt specific changes in the arbitration system -- effectively prevents the investing public, in contravention of Congress' intent, from influencing the way and degree to which the arbitration system is to be reformed. We will explain this procedural problem more fully after delineating our substantive concerns.

A. Substantive Comments

1. Selection of Arbitrators

While we agree that the process for selecting arbitrators is in dire need of reform, we believe that more fundamental changes are necessary than those proposed in your September 10 letter. According to the letter (at 2), the Commission "continues to believe that the provision of mixed public/industry arbitration panels will contribute to fair and accurate resolutions of disputes between investors and broker-dealers." Accordingly, the Commission has merely offered several recommendations for ensuring that so-called public arbitrators are not excessively tied to the securities industry.

In our view, the Commission's letter glosses over the crucial threshold question that should be resolved regarding the selection of arbitrators -- i.e., whether a system in which at least

some of the arbitrators must be intimately tied to the securities industry furthers the public's "paramount" interest that "arbitration be fair." Letter of September 10 at 13. Thus, the Commission's letter simply assumes, without providing any explanation, that there must be a "balance . . . between the need for impartial arbitrators and the need for industry expertise." Id. at 2. It is clear, however, that the system most consonant with established standards of American jurisprudence, as well as basic notions of fairness, would be one in which none of the arbitrators is, in the Commission's own words, "so connected with the industry that it may hinder their ability to make independent judgments with respect to specific industry practices." Id. Stated somewhat differently, since the industry representatives on arbitration panels "are frequently the targets of the antifraud provisions they are asked to interpret, it is not surprising that they apply a narrow reading of the federal scheme of regulation." Comment, Arbitration of Investor-Broker Disputes, 65 Cal. L. Rev. 120, 130 (1977).

Moreover, the suggestion that industry representatives are needed to effectively adjudicate securities disputes is belied by both empirical evidence and common sense. Thus, in advocating the selection of effective public arbitrators -- who must constitute a majority of the arbitrators on any particular panel -- the Commission is tacitly conceding that arbitrators can be selected who are both neutral and sufficiently "expert" in securities law and practice. Likewise, since many standard industry-drafted arbitration clauses authorize the investor to select the American Arbitration Association, in addition to the industry-dominated arbitration schemes, the industry itself has, in effect, acknowledged that fair, knowledgable arbitration panels can be established without direct industry representation. See Fletcher, Privatizing Securities Disputes Through Enforcement of Arbitration Agreements, 71 Minn. L. Rev. 393, 451 (1987). Similarly, the fact that federal judges routinely and satisfactorily resolve securities disputes confirms that industry representation is not indispensable to the effective resolution of such disputes.

We therefore urge the Commission to consider alternatives to both the existing system and the Commission's current proposal for selecting arbitrators. One such alternative, which has recently been advocated by G. Richard Shell, Assistant Professor at the Wharton School of the University of Pennsylvania, is simply to allow the parties to choose their arbitrators from lists of experienced public arbitrators. See Shell, Arbitration After the Crash, National Law Journal, p. 14 (March 21, 1988). Furthermore, in order to ensure that there are a sufficient number of such arbitrators, those lists should be shared among the SROs. See Katsoris, Arbitration of Securities Disputes, 53 Fordham L. Rev. 279, 312 (1984). Such a system would not only ensure that all arbitrators are in fact neutral and experienced, but, just as importantly, it would help alleviate perceptions of bias by giving investors an affirmative role in the selection process.

Even if the Commission does not agree to reconsider the established SRO system for selecting arbitrators, its proposals for tightening the definition of public arbitrators still do not go far enough. First, under the Commission's proposal, persons who have worked their entire lives in the securities industry may serve as public arbitrators so long as they have been employed in another capacity for the prior three years. It is obvious that three years in another, possibly even related, area is unlikely to eliminate the biases and predilictions that are built up over many years of employment in the securities field. The only way to establish an effective, objective rule on this issue is to prohibit anyone who has had long-term employment with the securities industry (i.e., three years or more) from serving as a "public" arbitrator.

Second, the Commission has recommended that lawyers and accountants who regularly provide services to the securities industry should not be permitted to serve as public arbitrators, yet it has undercut the force of this recommendation by adding two major loopholes: (1) that professionals whose partners regularly represent broker-dealers could serve as public arbitrators, and (2) that professionals whose billings to the securities industry do not exceed 10% of total billings for the preceding two years may serve as public arbitrators. These loopholes fly in the face of the assumption, which presumably underlies the general restriction on the use of industry attorneys and accountants, that individuals who stand to profit from specific industry practices should not be labeled "public" arbitrators. Obviously, the partner of an attorney or accountant who exclusively represents broker-dealers knows that his economic well-being is directly tied to the securities industry, and thus there is at least an "appearance of bias" for such an individual, just as there is for a relative of a securities industry professional. Letter of September 10 at 3. It makes no sense to preclude family members from serving as public arbitrators, as the Commission has recommended, yet allow partners, who may have an even greater and more direct financial stake in the securities industry, to serve in that capacity.

Likewise, it is illogical to allow a 10% exception to the general rule. For one thing, 10% of an attorney's or accountant's total billings over a two year period can hardly be deemed "de minimis," as the Commission seems to believe. Letter of September 10 at 3. Indeed, in some cases, 10% of total billings from one broker-dealer could represent the single greatest and most consistent source of income for a particular attorney or accountant. Moreover, if 10% of a professional's time is consistently spent representing the securities industry, that is likely to be more than enough to impinge on the individual's "ability to make independent judgments with respect to specific industry practices." Letter of September 10 at 2. Once again, the only sensible course of action is to establish a flat rule that anyone who derives any income, either directly or indirectly, from rendering professional assistance to broker-dealers, cannot serve as "public" arbitrators. At a minimum, SRO rules should provide that such individuals, as well as persons who formerly held long-term employment in the securities industry, can always be challenged "for cause" if they are appointed as "public" arbitrators. See Letter of September 10 at 7.

Finally, the SEC should ensure that arbitrators in small claims cases, i.e., those involving less than $2,500, are not intimately connected to the securities industry. Under current rules, such disputes can be resolved by a single arbitrator. While SICA's November 15, 1977 report to the SEC admonished that "reasonable efforts" should be made to select the arbitrator of small claims cases "from the public sector," there is no requirement in this regard. Accordingly, it is possible, under the rules as currently drafted, for the single arbitrator in small claims cases to be an industry representative. That is clearly unacceptable, particularly since investors with small claims are likely to be unrepresented by attorneys and relatively unsophisticated. See Katsoris, supra, at 289.

2. Written Decisions

We strongly support the Commission's recommendation that all arbitration decisions be embodied in written rulings that are made available to parties, courts, and the public at large.

Such written decisions should not only summarize the legal and factual issues involved, as the Commission suggests, but should also specifically explain why the majority and any dissenting panelists resolved these issues in the way that they did.

Moreover, while a verbatim transcript of an arbitration hearing is important and may be somewhat helpful to a reviewing court, it is clearly does not, contrary to the Commission's implication, provide a sufficient basis to enable courts to apply the "manifest disregard" standard to arbitration decisions. Letter of September 10 at 8. Under the "manifest disregard" standard, courts generally do not vacate arbitration decisions unless there is some indication that the arbitrators have ignored the applicable law or simply refused to apply it. See Fletcher, supra at 456. It is difficult to see how a court could make that evaluation without having the benefit of the arbitrators' own statement of the law and the reasons for their decision applying it. For purposes of judicial review, it is plain that a transcript of proceedings simply cannot substitute for a written ruling.

SICA's reasons for resisting written decisions, as articulated in its December 14, 1987 letter to you, border on the absurd. Thus, the notion that written decisions should not be maintained because arbitrators would "prefer to consider each case anew, without even a possibility that his or her past record may be a conscious or unconscious influence on the decision" overlooks the obvious -- that arbitrators already are at least generally familiar with how they have ruled in prior cases, and thus it is impossible to eliminate "conscious or unconscious influence[s]" on their decisions. Indeed, since, as SICA admits, SROs and industry attorneys already maintain detailed records regarding the prior decisions of arbitrators, it is only investors -- especially those who cannot afford to hire attorneys -- who currently have no access to information regarding the leanings and decisionmaking habits of particular arbitrators. And, to the extent that arbitrators actually become more "conscious" of how they have ruled in prior cases, that would seem, contrary to SICA's implication, to be a benefit rather than a drawback. Thus, a fundamental tenet of American jurisprudence is that consistency in decisionmaking and adherence to precedent are preferable to arbitrary and ad hoc dispute resolution -- which is precisely the opposite of the premise underlying SICA's response.

Equally tenuous is SICA's other basis for resisting written decisions -- that it is "not reasonable to conclude" that written awards "could capture the decision making process of a panel." While no system for reporting decisions is perfect, written awards explaining the views of the majority and dissenting arbitrators would certainly "capture the decision-making process" far better than having no written decisions at all, which is the current state of affairs. The only conceivable conclusion that can be drawn from SICA's arguments is that it is concerned that written awards will highlight flaws and inconsistencies in the arbitration process, and potentially open up an additional number of such awards to judicial reversal under the "reckless disregard" standard or lead to more reforms in the arbitration process. When viewed in this light, we submit that SICA's strained arguments provide additional, compelling basis for requring written decisions.

3. Discovery

We support the Commission's effort to broaden the discovery rights of parties, but, once again, we do not believe that the Commission has gone far enough. To begin with, it is important to explicitly recognize that restrictive discovery rules unquestionably favor the securities industry. Without discovery, investors may be precluded from learning, for example, the volume of commissions generated by their accounts in relation to other accounts, the nature of investment recommendations made by a broker's research department, and possible broker conflicts of interest. See Comment, 65 Cal. L. Rev. at 131. In contrast, brokers generally have all of the information about the investor that they need to prepare their defense, including, for example, forms completed by the investor, confirmation slips, and account statements.

In order to remedy the inequities created by the current constraints on discovery, we support the Commissions's reccommendations for promoting more efficient and fairer document exchange, and for resolving discovery disputes in advance of hearings on the merits. However, we believe that the Commission's recommendations regarding the use of depositions are too restrictive. While it may be desirable to limit "wholesale use of depositions," there is no apparent reason to prevent parties from taking one or two depositions where they can establish that the information being sought is necessary to the resolution of the dispute. Contrary to the implication in the Commission's letter (at 10), depositions may in fact "facilitate a faster or fairer resolution" of many cases which are not especially large or complex." Particularly where there are genuine factual conflicts or significant credibility questions, a deposition in advance of a hearing may be essential to a smooth, fair adjudication of the dispute, or may even lead to a settlement of the dispute.

Since the Commission has suggested the creation of procedures for resolving discovery disputes prior to hearings on the merits, we see no reason why such procedures cannot also be used for determining whether depositions should be taken in any particular case and for setting the ground rules for them. If a party can demonstrate to the arbitrators that a deposition is necessary to develop his case, and that he cannot obtain equivalent information from documents alone, then, under SRO rules, the deposition(s) should be permitted.

4. Class and Multi-Party Actions

A rule change that has not been proposed by the Commission, but should be considered by it in the context of public proceedings, concerns procedures for certifying class actions and/or consolidating claims presenting similar issues. If arbitration is to be one of the principal means of enforcing the requirements of the Securities Act, some consideration must be given to methods for joining together claims that are individually small, but collectively significant. Otherwise, the arbitration process will effectively insulate from review a repeated pattern of statutory violations that are simply not worth an individual investor's time and resources to pursue.

5. Limitations on Use of Arbitration Clauses

We fully concur in the SEC staff's belief, which was discussed at the Commission's June 1 meeting, that broker-dealers should not be permitted to condition access to brokerage services on the investor's signing of an arbitration agreement. In a separate letter we have responded to your June 3 letter inviting comments on the staff's recommendations regarding limitations on the use of arbitration clauses and the prior notice that investors should receive concerning the implications of signing an arbitration clause. We wish to take this opportunity, however, to point out that the recommendations discussed in your June 3 letter should be viewed as inextricably intertwined with the arbitration changes proposed in your September 10 letter to SICA. Stated simply, the fewer measures that are taken to ensure that the arbitration process itself is fair to investors, the more important it is that investors be permitted to opt out of the arbitration system and also receive complete, accurate information regarding the risks that they are taking when they sign an agreement containing an arbitration clause.

For example, if the Commission continues to adhere to the policy that at least some arbitrators in each dispute may be representatives of the industry, it is imperative that investors be informed of this before they sign away their rights to pursue claims in a neutral forum, i.e., a federal district court. Likewise, if the Commission declines to significantly broaden discovery rights in arbitration proceedings, prospective investors should be informed of restrictions on their ability to engage in fact-finding should a dispute be referred to arbitration. Thus, we believe that it is imperative that the Commission consider changes to arbitration rules in conjunction with proposals for ensuring that investors are fully informed before they consent to submit all disputes to arbitration.

6. Effective Date of Changes in SRO Rules

To the maximum extent feasible, any reforms in the arbitration process that are adopted or accepted by the Commission should be applied to all disputes that have already been submitted to SROs for arbitration, and not simply to disputes that are filed in the future. Except for possible difficulties in ensuring a sufficient number of public arbitrators, the September 10 letter does not suggest that any of the changes proposed by the Commission cannot be applied to existing disputes. Moreover, if there are problems in attaining arbitrators who meet any new selection criteria that are adopted, the Commission should not simply allow those selection criteria to be phased in over a long period of time, as the September 10 letter suggests (at 3). Instead, it should require SROs to adopt measures designed to increase the number of available public arbitrators, e.g., by requiring SROs to increase the fees now paid to arbitrators. See Shell, supra at 13.

B. The Commission Should Employ the Public Notice and Comment Procedures Enumerated in Section 19(c) of the Securities Act.

The issues discussed above raise fundamental questions regarding the extent to which the arbitration system should be reformed, and thus they are of overriding concern to the investing public. As articulated in your letter to SICA, the Commission's recommendations are intended

to promote the public's "paramount" interest "that arbitration be fair." Letter of September 10 at 13. It is difficult to see how the Commission can hope to promote the public's interest in fair, efficient arbitration procedures without ensuring that there is a complete public airing and resolution of the proposals developed by the Commission, as well as any reasonable, albeit possibly more dramatic, alternatives to those proposals. More importantly, we believe that Congress clearly intended that these kinds of issues be resolved by the Commission only after full, early public participation.

As you know, Section 19 of the Securities Exchange Act provides that the Commission may not amend the rules of a self-regulatory organization unless it first publishes notice of the proposed amendment in the Federal Register and gives interested persons an opportunity for the "presentation of data, views, and arguments" regarding the rule change. 15 U.S.C. §§ 78 s(c)(1), (2). As explained in the Senate Report, Congress intended that "if the SEC deems a change in a self-regulatory organization's rules to be necessary or appropriate in the public interest or for the protection of investors," it must follow a "specified procedure" including "(1) publishing notice of the proposed rulemaking in the Federal Register including the text of the proposed amendment with a statement of the Commission's reasons for believing the change is appropriate . . . ; (2) providing an opportunity for interested persons in writing and in person, to express their views and present evidence; [and] (3) publishing an explanation and justification of its reasons for any final action changing a self-regulatory organization's rules . . .." S. Rep. No. 75, 94th Cong., 1st Sess. 131 (1974). As the Commission's September 10, 1987 letter to SICA makes clear, the Commission has determined that certain changes in the rules governing arbitration are necessary, yet it is not following the procedures ordained by Congress.

We recognize that in the event that SICA ultimately agrees to adopt any or all of the rule changes proposed by the Commission, such changes will, at that time, most likely be subjected to public notice and comment proceedings. See 15 U.S.C. § 78s(b)(1). It is apparent, however, that such proceedings will essentially be a sham if, prior to their initiation, the Commission and the industry have already engaged in extensive discussion and negotiations, and agreed on a comprehensive package of specific rule changes. See Moss v. CAB, 430 F.2d 891, 893 (D.C. Cir. 1970) (by "suggesting" rather than "ordering" certain rate changes, CAB could not effectively "fence[] the public out of the [statutory] rate-making process"). Thus, if the industry agrees to the Commission's recommendations regarding, for example, arbitrator selection or discovery rights, it is obvious that there will be no genuine consideration of more sweeping alternatives to reforming these aspects of the arbitration process.

Moreover, as suggested above, Congress clearly intended the procedures set forth in section 19(c) to apply when the Commission has elected to initiate rule changes, rather than the procedures in section 19(b), which were intended to apply when an industry group has initiated the amendment process. Indeed, this distinction makes perfect sense from the standpoint of maximizing public participation: when the Commission itself is contemplating rule changes, the public should be given an opportunity equal to that accorded industry to influence the Commission's analysis and approach to the issues. The only way such equality can be accomplished is by inviting all interested persons to comment, both in writing and in person, on the Commission's proposals for reforming the arbitration system.

In sum, since the Commission has decided to consider changes in the rules governing arbitration, it should follow the public procedures specified in section 19(c) of the Securities Act. It should not, in contrast, continue on its current course of soliciting and considering comments from only selected groups and individuals. Accordingly, we urge the Commission to immediately initiate public proceedings to consider the modifications proposed in the Commission's September 10 letter, as well as the related issues discussed above.

Sincerely,

Eric R. Glitzenstein

Alan B. Morrison