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Viewpoint

Securities arbitration rules should be revised

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On Jan. 31, 2011, the SEC approved a Financial Industry Regulatory Authority (FINRA) proposal giving investors who initiate arbitration claims against their brokers the option of using all-public arbitration panels. Previously, investor claims asserting damages of over $50,000 were required to have at least one "industry member" — a current or retired broker, branch manager, a securities defense attorney, or other industry representative — on the three-person arbitration panel. The oft-stated rationale for the prior rule was that the other arbitrators needed someone with industry expertise to help reach a proper decision.

In approving the new rule, the SEC said that giving investors the option to choose an all-public panel "will enhance the public's perception that the FINRA securities arbitration process and rules are fair." The perception of fairness is of course critical, and this incremental step in that direction is welcomed. But ultimately, allowing an aggrieved investor the choice of which forum in which to pursue their claims — court or arbitration — is the only way to assure that investors have confidence that their grievances will be considered on the merits in a truly unbiased forum.

Even with this rule change, there remains the perception that the securities arbitration system is unfair and unjust. After all, investors have no choice but to arbitrate. Buried in the stack of forms signed prior to opening a brokerage account is a non-negotiable stipulation that all claims concerning the investor's account must be arbitrated. The filing fees for such a claim can run into the thousands of dollars. The proceedings are not subject to public scrutiny. FINRA strongly discourages any public dissemination of the evidence gathered during the course of the case. Thus, even though there might well be other instances of a broker's similar misconduct, the investor is not likely to discover those facts, because those claims, too, would have been arbitrated in secret proceedings. Finally, an investor's ability to have a court overturn an obviously wrong decision is severely circumscribed.

If arbitration is to be fair and just, a dispute resolution process with these limitations and restrictions misses the mark. Yet this scenario fairly describes the gauntlet through which investors who have disputes with their brokers have to run. William Galvin, the secretary of the Commonwealth of Massachusetts, put it bluntly in testimony before Congress: FINRA's

mandatory arbitration system is "an industry-sponsored damage-containment and control program masquerading as a judicial proceeding."

It is at best unsettling, and at worst, fundamentally unfair, that investor claims must proceed in an arbitral forum run by the securities industry at a time when Wall Street is viewed with suspicion by a large portion of the population. In the last decade, we have experienced the tech bubble, which revealed Wall Street's capacity to market shares of risky Internet startups to the unsuspecting public via IPOs supported by fraudulent and conflicted analyst "buy" recommendations. Wall Street-manufactured "derivatives" were a significant part of the recent financial meltdown that almost brought the world to its economic knees. And Ponzi schemes like Bernie Madoff's flourished, without any concern that the fraud would be discovered by the SEC. An investor can rightly feel suspicious when, despite these repeated and costly failures, Wall Street and its regulators claim that they are nonetheless entirely capable of providing a fair forum in which to adjudicate an investor's dispute with their broker.

FINRA asserts on its website that it "is a trusted advocate for investors, dedicated to keeping the markets fair and proactively addressing emerging regulatory issues before they harm investors or the markets." But the reality is that FINRA is, in essence, a trade organization. Its members are brokerage firms. The vast majority of its revenues are derived from regulatory fees and user fees paid by its members.

If, in fact, the SEC has genuine concerns about the fairness and integrity of the FINRA arbitration, investors ought to be able to choose the forum in which to have their disputes resolved — court or arbitration. If arbitration is indeed a just process in which investor claims will be adjudicated fairly, then investors will voluntarily choose to use that forum.

An industry that operates at the very core of capitalism ought to have no objection to letting the market decide whether the courts or FINRA-run arbitration provide a full, fair and cost-effective resolution of claims. Continued insistence that investors be forced into mandatory arbitration would seemingly confirm that FINRA is not an advocate for individual investors, but instead trying to protect the very industry it is charged with regulating.

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