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BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
OF THE COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

HEARING ON SECURITIES ARBITRATION

MARCH 31, 1988

Chairman Markey and Members of the Subcommittee:

I am Stephen L. Hammerman, Executive Vice President and General Counsel of Merrill Lynch. I appreciate the opportunity to testify before the Subcommittee on the subject of securities arbitration.

1. Securities arbitration makes justice prompt and affordable for customers and securities firms.

Arbitration of securities disputes brings customers and firms prompt, affordable and just results; moreover, arbitration facilities are more accessible to investors than the federal courts.

Arbitration is quick in resolving securities claims. As we all know, "justice delayed is justice denied." A federal securities lawsuit often takes years to make its way through all the pretrial motions and the crowded court calendar to trial, not taking into account the additional time required for post-trial motions and appeals.

By contrast, an arbitration proceeding, from initiation of the claim to the award, is usually measured in months.[1/]

Arbitration is a streamlined process which is not bogged down with the intricate technicalities of court litigation. For instance, in arbitration a customer's case cannot be paralyzed for months by a motion to dismiss the complaint for failure to plead with particularity. An entire arbitration can be concluded in the time that it takes some courts to decide such a technical preliminary motion.

Another reason arbitration does not delay justice is that discovery is limited to essentials. By contrast, federal securities litigation often entails the time-consuming and exhausting abuses of the discovery process that have been denounced by the Chief Justice of the Supreme Court as well as many other judges.[2/]

Securities arbitrators are more likely to be familiar with investment terms and transactions than a jury, or even a judge, and there is less need to educate arbitrators in the customs and practices of the industry. On the other hand, a time-consuming aspect of securities litigation is educating a jury and a judge about the intricacies of the transactions in issue. Although arbitrators are like a jury in many ways, arbitrators have the following advantages: first, they have read the claim and answer before the testimony begins; second, they usually understand the issues; and third, they have the opportunity to question witnesses.

In most arbitrations between customers and broker/dealers, there are two public arbitrators and one securities industry arbitrator.[3/] The notion that arbitrators with industry experience are biased is, in our experience, unfounded. Most securities arbitration awards are unanimous, demonstrating that industry arbitrators vote with the public arbitrators most of the time.[4/]

Securities industry arbitrators are generally selected because of their stature and reputation. They are conscientious, fair-minded people who strive to do justice. The industry arbitrators are generally the most critical of members of their profession.[5/]

Thus, arbitration fulfills traditional American precepts of justice by giving investors prompt and fair resolution of their claims. Moreover, because the process is less formal and avoids delay, it is significantly less expensive.

Arbitration sponsored by the self-regulatory organizations ("SROs") is industry-subsidized so that customers have an accessible procedure for bringing their complaints. Thus, the bulk of the administrative costs of securities arbitration fall on the member organizations and not on the public taxpayers. In addition, customers have the support of the SROs in enforcing securities arbitration

awards, because if the broker-dealer does not pay an award promptly, the self-regulatory organization can impose sanctions. That threat of sanctions against the securities firm generally makes it unnecessary for the customer to confirm the arbitration award in court or to seek judicial remedies in order to receive payment.

Arbitration is not a place where the party who can afford the best lawyer wins. In fact, statistics show that the customer is successful in obtaining an award in most securities arbitrations.[6/] Although, on some occasions, these victories may amount to less than the damages sought (as is also generally the case with court decisions), I doubt very much whether the customer has a better success ratio in court.

Moreover, at a time when American financial service firms are competing in international markets with larger, more capitalized foreign entities, we should keep in mind that in the U.S., the incidence of litigation and its costs are much higher than abroad. Facilitating arbitration will also enable American financial service companies to pare expense and thus compete more effectively with their foreign counterparts.

II. SEC Oversight

Arbitration has long been accepted as effective and fair in resolving commercial disputes. This is particularly the case with securities arbitration, since both the SROs and

the Securities and Exchange Commission serve as the customers' watchdogs.

In its brief to the Supreme Court in the recent McMahon case, the SEC described its "sweeping authority over the rules adopted by SROs relating to arbitration of customer disputes."[7/] In general, the SROs cannot change any of their arbitration rules without SEC approval[8/]. Moreover, the SEC can abrogate, add to, or delete from any of those arbitration rules on its own initiative.[9/] Finally, the SEC conducts periodic inspections of the SROs' arbitration files, and investigates specific customer complaints concerning arbitration.

Although securities arbitration does a good job of providing customers with a fast, fair and effective vehicle to protect their rights, we support all efforts to improve the process. Working with the SEC, the self-regulatory organizations have already initiated proposals to enhance the arbitral process. These proposals include: increased disclosure of arbitrators' backgrounds; time limitations for responding to discovery requests; providing depositions of witnesses who would otherwise be unavailable; improved arbitrator training; and expanding the availability of arbitrators to resolve preliminary disputes.

III. Arbitration Clauses are Consistent with Public Policy

Securities arbitration has demonstrated the advantages of speedy dispute resolution by knowledgeable arbitrators at reasonable cost. With the growing emphasis on resolving disputes outside the formal court system, securities arbitration has become better accepted. The use of arbitration in the securities area more than tripled between 1980 and 1985.[10/] Thus, securities arbitration is a familiar and prevalent procedure, and one that is almost universally acclaimed as fair.

Requiring arbitration clauses in contracts is not at all unconscionable. By enacting the Federal Arbitration Act[11/] in 1924, Congress itself has declared a policy, which has been steadfastly adhered to, in favor of arbitration. That policy has been reinforced by the courts for some time.[12/] The Supreme Court recently concluded that "the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights."[13/] Especially in view of the Supreme Court's express endorsement in McMahon of the adequacy and presumptive fairness of securities arbitration procedures,[14/] arbitration agreements cannot reasonably be deemed unconscionable, much less unenforceable as a matter of law.[15/]

The overloaded federal court dockets have been the subject of much concern for many years.[16/] Limiting or precluding the use of arbitration clauses in securities agreements would further encumber our court system and increase the cost of dispute resolution.

Arbitration has the endorsement of the legislature as well as the courts in the commercial and labor contexts. The same should and generally does apply in the securities context.

Conclusion

Securities arbitration makes the prompt, affordable and just resolution of disputes available to customers. In addition to the usual advantages of commercial arbitration, SRO-sponsored arbitration gives customers the benefit of SEC oversight in protecting their rights. It also costs less for both taxpayers and the investing public and lessens the overload of the federal court system. Finally, arbitration enables American financial service companies to control costs and therefore compete more effectively with foreign rivals.

I appreciate the opportunity to appear before you today, and I would be glad to answer any questions you may have.

Footnotes

1/ See Composite Arbitration Figures, Fifth Report of the Securities Industry Conference on Arbitration, Ex. A (April 1986).

2/ See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740-41 (1975); Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 114, 116, 121, (2d Cir. 1982); Denney v. Barber, 576 F.2d 465, 470 (2d Cir. 1978)(Friendly, J.); Bartels v. Clayton Brokerage Co., 631 F.Supp. 442, 450 (S.D.N.Y. 1986).

3/ The Uniform Code of Arbitration requires that, unless the public customer requests otherwise, the dispute will be arbitrated by a panel "at least a majority of whom shall not be from the securities industry." Uniform Code of Arbitration, constituting Ex. C. in Fifth Report of the Securities Industry Conference on Arbitration 29 (April 1986) §8(b).

4/ See Robbins, Securities Arbitration: Preparation and Presentation, 42 The Arbitration Journal 3, 13 (1987).

5/ Id. at 12, 13.

6/ See Composite Arbitration Figures, Fifth Report of the Securities Industry Conference on Arbitration, Ex. A (April 1986).

7/ Brief of the Securities and Exchange Commission, Amicus Curiae, Shearson/American Exp. Co. v. McMahon, at 16.

8/ 15 U.S.C. § 78s(b)(1).

9/ 15 U.S.C. § 78s(c).

10/ See Composite Arbitration Figures, Fifth Report of the Securities Industry Conference on Arbitration, Ex. A (April 1986).

11/ 9 U.S.C. §2.

12/ See, e.g., Shearson/American Exp, Inc. v. McMahon, 107 S.Ct. 2332, 2337 (1987); Southland Corp. v. Keating, 465 U.S. 1, 10 (1984); Moses H. Cone Memorial Hospital v. Mercury Construction Corp., 460 U.S. 1, 24 (1983); Mar-Len of Louisiana, Inc. v. Parsons-Gilbane, 773 F.2d 633 (5th Cir. 1985); Morgan v. Smith Barney, Harris Upham & Co., 729 F.2d 1163 (8th cir. 1984); Hanes Corp. v. Millard, 531 F.2d 585 (D.C. Cir. 1976); Griffin v. Semperit of America, Inc., 414 F. Supp. 1384 (S.D.Tex. 1976); Local 719 v. Nat. Biscuit Co., 252 F. Supp. 768 (D.N.J. 1966); Proctor & Gamble Ind. Union v. Proctor & Gamble Mfg. Co., 195 F. Supp. 134 (S.D.N.Y. 1961).

13/ Shearson/American Express Inc. v. McMahon, 107 S.Ct. 2332, 2340 (1987) (Summarizing conclusions of Mitisubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. __ (1985)).

14/ Shearson/American Express Inc. v. McMahon, 107 S.Ct. 2332, 2341 (1987)

15/ See Cohen v. Wedbush, Noble, Cooke, Inc., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,652 (9th Cir. 1988).

16/ See, e.g., Scalia Urges Forming of Special Courts to Ease Caseload, L.A. Times, Feb. 16, 1987, pt. 1, at 19; See also, Statistical Analysis and Reports Division, Administrative Office of U.S. Courts, Federal Judical Workload Statistics A-9 (March 31, 1984).