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The Honorable Richard H. Baker
Chairman, House Financial Services Subcommittee on Capital Markets,
Insurance & Government-Sponsored Enterprises
2129 Rayburn H.O.B.
Washington, D.C. 20515

Re: **Hearing Entitled “ A Review of the Securities Arbitration System”**

Dear Congressman Baker:

Please accept this written testimony, respectfully submitted for the record in advance of the March 17, 2005, hearing entitled “A Review of the Securities Arbitration System.” I plan to be at the hearing and would be honored to answer any questions from the Subcommittee.

I am a leading attorney representing individual investors around the U.S. in securities arbitration against their stockbrokers for fraud and misconduct. In fact, I brought the first arbitration case on behalf of an investor against former Merrill Lynch internet analyst Henry Blodget, and subsequently shared my findings with the House Financial Services Committee in connection with the June 2001 hearings on stock analysts’ conflicts of interest. The case also led to an investigation which culminated in the landmark \$1.4 billion Global Wall Street settlement on research conflicts.

A careful assessment of securities arbitration shows that changes must be made to level the playing field for individual investors. Indeed, Congress and the Securities and Exchange Commission must revisit the issue of whether individual investors who have waived their right to a jury trial are getting a fair shake in securities industry arbitration.

In assessing the system and its fairness towards individual investors, there are several important questions to ask, including:

- Do practices of self-regulatory organizations provide adequate protection to the individual investors who work hard to save and play by the rules?
- Are changes to the Federal Arbitration Act, 9 U.S.C. §1, et seq. (FAA) necessary to provide adequate protection to investors?
- It's one thing to require every customer in the securities industry to waive his or her right to sue – but has the Industry stacked the deck in a way which denies individual investors due process, even through arbitration?

There are three primary concerns that, if addressed by Congress, the SEC, the National Association of Securities Dealers and the New York Stock Exchange, would make a considerable difference in the fairness and quality of the arbitration process.

First, after 20-plus years of handling securities arbitration cases, I can attest that the pool of arbitrators needs to be expanded. It lacks meaningful diversity and essentially is an “old white men’s club,” a dirty little secret in the securities industry.

Second, new NASD rules re: “broker expungement” and the obtaining of “reasoned arbitration awards” need to be critically examined and changed to meet investors’ interests.

Third, investors need to be encouraged to consider the possible ramifications of requesting a written explanation for an arbitration panel’s decision.

1. The Pool of Available Arbitrators

At the NASD and the NYSE, investor cases are heard by a three-member panel – one “industry” arbitrator and two “public” arbitrators. As a representative of individual public investors, this makeup leaves much to be desired:

- Quite often the public arbitrators are really *industry* arbitrators in public arbitrators’ clothing. Many of the public arbitrators have financial ties to the securities industry or are dependent upon securities arbitration for their livelihood and, accordingly, develop a bias against investors that often results in little or no award to investors in meritorious cases, despite the strength of their claims.

The SEC and Congress should consider eliminating the need for one securities industry arbitrator on each arbitration panel. It seems that the time has passed where an industry arbitrator is required in each case and this undoubtedly works against the interest of individual investors in arbitrating their cases. Public arbitrators are fully capable of

understanding the workings of the securities markets and can make the same assessments of dealings between brokers and customers as industry arbitrators.

- The pool of available arbitrators at the NASD and NYSE is not very deep nor does it reflect the diversity of backgrounds which we see in our jury pools around the country. To be blunt, arbitration panels are composed largely of older white men and lack proper representation by women, African-Americans, Latinos or Asian-Americans.
- The roster of available arbitrators has grown stale and no real effort has been made by the NASD or NYSE to enlist different people to serve as arbitrators or to significantly expand the pool. As a practitioner who deals with these organizations every day on behalf of investors, I continually see the same group of names offered as potential arbitrators. This is one clear area where steps need to be taken to insure that investors get a “fair shake” in arbitration given that they have waived their right to a jury trial.
- Often arbitrators’ decisions reflect a bias against investors even if the investor “wins” the case. Thus, for example, a New York Federal Court refused to confirm an arbitration award under the Federal Arbitration Act because the arbitrators awarded the investor just \$25,000 or 3% of his \$800,000 loss at Prudential. The Court found “strong evidence” of Prudential’s liability and opined that the award was “incomprehensible” and “shocked the conscience of the court”. Tripi v. Prudential Securities, 303 F. Supp. 2d 349 (S.D.N.Y. 2003)

2. The NASD’s New Expungement Rule

On April 12, 2004, The NASD adopted Rule 2130 regarding expungement of customer dispute information for the Central Registration Depository (CRD), a regulation designed to maintain a CRD system that “provides public investors and regulators access to accurate information about firms and brokers and maintains the integrity of the arbitration process.”

Unfortunately, in the 10 months since the rule was enacted, hurdles have prevented investors and regulators from obtaining accurate information about brokers. In fact, while 80% to 90% of customer arbitration cases are eventually settled, such deals often come at a stiff price as brokerages generally won’t agree to settle unless customers acquiesce to having the broker’s misdeeds expunged from the record. The practical effect is that customers have either agreed to a “phony” expungement process or, even worse, will not even name a broker as a respondent in a case for fear of impeding a potential settlement.

The NASD and the SEC must immediately look at how the rule is being used to suppress naming of brokers as respondents in cases as, in effect, this leads to the possibility of more investors being taken advantage of by that same broker down the road.

3. A “Reasoned” Arbitration Decision? Be Careful What You Wish For

After years of criticism from investors and lawyers, the NASD has approved an amendment to the NASD Code of Arbitration Procedure which, if approved by the SEC, will allow customers arbitrating disputes with brokers to receive a “written explanation” of the arbitration panel’s decision. And, of course, registered representatives (brokers) arbitrating industry disputes would also be able to receive written explanations of the decisions. Currently, issuing an explained decision is solely within the discretion of an arbitration panel; the new rule may be enacted by the end of 2005.

While investors and their attorneys may be heartened that they can now choose to obtain a “reasoned” (written) explanation of the arbitration panel’s decision, that choice should be used sparingly, as it could be a double-edged sword. If a customer requests a written decision and then “wins” the arbitration, the customer is providing fodder for the brokerage firm to try to vacate the award in a court if the panel’s reasoning is not sound or is subject to other legal challenges. If an investor requests a reasoned decision and “loses” the arbitration case, the decision will offer little solace and probably little opportunity to vacate an award and obtain new arbitration hearings given the stringent legal standards governing appeals of arbitration awards.

In any event, the appeal process is time-consuming and expensive, and it undercuts the purportedly expeditious and cost-effective nature of arbitration. For that reason, investors should rarely and prudently exercise the option to avoid giving the brokerage firms an opportunity to challenge the “reasoned” award.

Ideally, the arbitration process would be one that serves the investor and ensures that individuals are treated fairly by the brokerage firms that take their money and offer their advice. Unfortunately, as you can see, that isn’t often the case.

I would greatly appreciate the opportunity to present my views to the Subcommittee and offer my firm’s services as resource to the Subcommittee on issues affecting individual investors in securities arbitration.

Respectfully submitted,

Jacob H. Zamansky