

April 11, 2003

The Honorable John D. Dingell
Ranking Minority Member
Committee on Energy and Commerce
House of Representatives

The Honorable Edward J. Markey
Ranking Minority Member
Subcommittee on Telecommunications
and the Internet
Committee on Energy and Commerce
House of Representatives

Subject: *Follow-up Report on Matters Relating to Securities Arbitration*

Our June 2000 report *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards* revealed that, although investors had won a majority of awards against brokers, a high proportion of those awards had not been paid.¹ Nearly all of the unpaid awards involved cases decided in the National Association of Securities Dealer's (NASD) arbitration program and most involved brokers that had left the securities industry. A year later we reported on limited data suggesting that the rate of unpaid awards had declined.² However, we noted that given the short time period that the data covered, regulators needed to continue monitoring the payment of the awards to determine whether additional steps need to be taken. Arbitration attorneys and claimants have also expressed concern about the timeliness of NASD's updating of arbitrator disclosure information, which can be used by the parties in arbitration to judge the competence and objectivity of arbitrators, and with NASD's ability to remove arbitrators from cases if conflicts arise. In addition, arbitration attorneys also expressed concern about the use of motions to dismiss and motions for summary judgment to terminate NASD-administered arbitration cases.³

¹ U. S. General Accounting Office, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, [GAO/GGD-00-115](#) (Washington, D.C.: Jun. 15, 2000).

² U. S. General Accounting Office, *Evaluation of Steps Taken to Address the Problem of Unpaid Arbitration Awards*, [GAO-01-654R](#) (Washington, D.C.: Apr. 27, 2001).

³ There are basically two categories of motions for prehearing dismissal. Motions to dismiss are based exclusively on the allegations of the statement of claim. Motions for summary judgment are those that depend, at least in part, on some facts that go beyond those allegations.

This report responds to your May 2, 2001, April 15, 2002, and May 21, 2002, requests that we review the status of issues relating to securities arbitration and award payment. Our objectives were to (1) describe NASD's procedures to ensure the timely updating of disclosure information that arbitrators provide and NASD's procedures for removing arbitrators from cases, (2) provide information on the use of motions to dismiss and motions for summary judgment in arbitrations, and (3) describe recent changes in the rate of unpaid awards and the number of arbitration claims filed with NASD.

Results in Brief

NASD has made important changes to its arbitration program procedures, specifically in updating and entering arbitrator disclosure information and removing arbitrators from cases. To better manage the data entry process, in 2001 NASD centralized the arbitrator disclosure information function in its New York City offices. NASD also put a reporting form on line allowing arbitrators to submit new background information such as their education and training, employment, past arbitration experience, finances, and conflicts of interest. Also, in 2004 NASD plans to start a new computer system that would allow arbitrators to update their own records. Since November 2001, when the Securities and Exchange Commission (SEC) reported that NASD and SEC had not received any new complaints about the currency of arbitrator disclosure information, NASD has received one complaint. In addition, NASD has adopted a rule change that gives its Director of Arbitration and the President, NASD Dispute Resolution, indelegable authority to remove an arbitrator from a case after the hearing process has begun based on information not known to the parties when the arbitrator was selected. NASD has used this authority in nine instances since the change became effective in March 2001.

Motions to dismiss were filed and granted in NASD-administered arbitration cases. Although NASD does not keep track of such motions, in 2001, for example, we determined that motions to dismiss or motions seeking summary judgment were filed in 55, or about 8 percent, of 719 investor-initiated, NASD-administered cases in which the investors won a monetary award.⁴ We identified 54 instances in which motions were denied and 28 instances in which the motions were granted.⁵ NASD rules do not prohibit either of the parties in arbitration from filing or the arbitrators from granting prehearing motions to dismiss. Further, the courts have consistently recognized the authority of arbitrators in NASD cases to grant prehearing motions to dismiss. Moreover, an NASD official told us that these motions can save time and resources by helping to weed out certain cases that, based on the facts set out in the parties'

⁴ Securities arbitration cases are categorized as broker-broker, employee-broker, and customer-broker cases. Because the customers of brokers are generally investors, in this report we refer to the customers as investors.

⁵ The total number of motions filed exceeded the number of cases because many cases involved multiple respondents and multiple filings of motions. In some instances in which motions to dismiss were granted, awards were still rendered against other parties responding to the claims.

filings, clearly would not satisfy procedural requirements for cases in the arbitration forum. However, a member of the Securities Industry Conference on Arbitration said that such motions ought to be discouraged because discovery and appeal rights in arbitration are limited.

In 2001, 236 or about 33 percent of the 719 NASD-administered monetary awards on claims filed by investors were not fully paid, down from 64 percent not fully paid in 1998, as we reported in June 2000. About 55 percent of the \$100.2 million NASD arbitrators awarded to investors in 2001 was unpaid, down from 80 percent of the total \$161 million awarded to investors in 1998.⁶ The majority of unpaid awards in both 1998 and 2001 resulted from brokers leaving the securities industry. For example, 192 of the 236 unpaid awards in 2001 involved defunct brokerage firms or individual brokers. Since 1998, NASD has introduced award-monitoring procedures that are designed to encourage payment. NASD also has introduced procedures for investors to avoid the problem of unpaid awards by defunct brokers by giving investors more options for handling claims against defunct brokers. The noted decline in the rate of award nonpayment also might be related to a difference in methodologies used to measure that rate. In 2000, we directly surveyed a sample of investors to determine if awards were paid in 1998, while for this report we used NASD data based on its monitoring of payment for the entire year 2001. The 5,974 arbitration claims that investors filed with NASD in 2002 have increased by 64 percent over the 3,637 claims filed in 2000.

We recommend that the President, NASD Dispute Resolution, make available on NASD's Web site current statistics showing the frequency with which arbitration awards against defunct brokers are not fully paid.

Background

The securities industry uses arbitration to resolve disputes among industry members, their employees, and individual investors. Arbitration, an alternative to suing in court, uses neutral third parties to resolve differences between parties to a controversy. Cases involving investors, other than relatively small claims, are resolved by a panel of three arbitrators. Two are public arbitrators and one is a nonpublic arbitrator who brings a greater degree of expertise in the workings of the industry. Arbitrators' decisions are final and can be appealed to the courts only for narrowly-defined reasons such as misconduct, bias, or a manifest disregard of the law on the arbitrators' part. Arbitration awards are to be paid within 30 days of the date of the award, unless a party seeks a judicial review. SEC oversees the arbitration programs administered by securities industry self-regulatory organizations (SRO) such as NASD. NASD administers the largest SRO arbitration program, for example, its

⁶ In 2001, \$12 million of the unpaid awards were not due because the respondents had requested a hearing, filed for bankruptcy, or filed a motion to vacate.

program accounted for about 90 percent of securities arbitration cases in 2000 and 2001.⁷

Investors have a right under NASD (and other SRO) rules to require that brokers-dealers and individual brokers arbitrate any disputes they may have. In addition, most broker-dealers require customers, when opening an account, to sign a customer agreement that includes a predispute arbitration clause. If a dispute subsequently arises between the investor and the broker-dealer, the investor can file an arbitration claim with the forum indicated in the predispute agreement and with any SRO of which the broker-dealer is a member.

In an investor-initiated arbitration case, the investor files a statement of claim with the designated SRO-sponsored arbitration forum. The forum's director of arbitration serves the statement of claim on the broker-dealer or individual broker (called respondents) against whom the claim has been brought. The respondent has from 20 to 45 days, depending on the forum used, to answer the claim with any defenses and related claims. After the filing process, the director of arbitration provides the parties with a list of potential arbitrators to hear the dispute. The parties indicate their preference and may challenge specific arbitrators on the list.

Once the panel of arbitrators has been selected, the panel conducts hearings that may last a day or more depending on the complexity of the case. Arbitrators are to render their decisions after the presentation of the evidence at the hearings. Arbitrators issue a written "award" at the end of a case. The written award is not required to include a reason or formal written opinion supporting the award. However, the award is required to include a statement setting out certain issues, including the basic issues raised and resolved in a case, the amount claimed and awarded, and any other, non-monetary issues resolved.

New NASD Procedures Address Concerns about Information on Arbitrators and Removing Arbitrators from Cases

NASD has taken steps to improve its procedures for updating arbitrator disclosure information and removing arbitrators from cases. The arbitrator update improvements included centralizing the process for updating arbitrator profiles and making an on-line reporting form available for arbitrators to submit new disclosure information. Another change allows the President, NASD Dispute Resolution, and its Director of Arbitration to remove an arbitrator from a case once the hearing process has begun and new information about the arbitrator has been disclosed.

⁷ NASD Dispute Resolution facilitates the resolution of monetary, business, and employment disputes between investors, securities firms, and employees of securities firms, offering both arbitration and mediation services.

NASD Procedures Help Ensure That Arbitrator Disclosure Information Is Updated Regularly

In selecting individuals to be in its pool of potential arbitrators, NASD relies on background information that prospective arbitrators provide. This information is first entered into the NASD arbitrator information database when arbitrators enroll in the program and is to be updated for any new information. NASD uses the background information to classify arbitrators as “public” or “nonpublic.”⁸ The parties in a dispute also use this information in deciding whether to accept arbitrators to be assigned to their case. NASD arbitrator disclosure reports include information on education and training, employment, past arbitration experience, finances, and conflicts of interest. The reports also include a narrative section, written by the arbitrators, describing their professional duties and responsibilities.

As we reported in November 2000, NASD has taken steps to improve its procedures for updating and entering arbitrator disclosure information.⁹ We reported that the new procedures appeared reasonable and were likely to reduce the possibility for errors and improve the promptness of data entry. The improvements included

- centralizing the process for updating arbitrator profiles in the Department of Neutral Management in the New York City offices of NASD’s Division of Dispute Resolution, and
- using an on-line reporting form on which arbitrators submit updated disclosure information via a NASD dispute resolution program Web site.

NASD procedures state that all updated arbitrator records, whether received on-line or by phone or fax, are to be reviewed by a quality control supervisor after they are initially entered. Records of arbitrators currently serving on panels are to be updated within 24 hours, while updates from nonserving arbitrators can be entered in 3 to 5 days. NASD staff are also to monitor and track all entries to arbitrator profiles and prepare a biweekly report to department managers on the receipt and computer entry of arbitrator updates. For each arbitrator submission, the biweekly reports list the date the information was received by the Department of Neutral Management and the date computer entry of the information was completed. The department manager is to use the report to verify the timeliness of the process.

In November 2001, SEC reported that, after the new procedures were implemented, neither SEC nor NASD had received any new complaints regarding the arbitrator

⁸ A public arbitrator has had no recent association with the securities industry whereas a nonpublic arbitrator has had recent or has current association with or experience in the securities industry. Public arbitrators are used in all investors’ cases. In single arbitrator cases in which claims are \$50,000 or less, the arbitrator is a public arbitrator. In cases with three arbitrators in which claims are more than \$50,000, two of the arbitrators are public arbitrators.

⁹ U.S. General Accounting Office, *Procedures for Updating Arbitrator Disclosure Information*, [GAO-01-162R](#) (Washington, D.C.: Nov. 9, 2000).

disclosure records. According to NASD, from November 2001 through the end of 2002 it had logged one complaint about an arbitrator failing to update his background information. In that case, according to NASD, a party in a dispute asked the arbitrator for new information, and the arbitrator sent the new information to the party by fax and to NASD by mail. As a result, the party received the information before NASD could receive it, update its disclosure information database, and make the information available. SEC officials said that they did not recall receiving any new complaints and SEC has indicated that its inspection staff will continue to monitor NASD's process for updating arbitrator profiles. In 2004, NASD plans to use a new computer system that would enable arbitrators to access and update their own disclosure records on-line at a NASD Web site.

New Procedures Make Removing Arbitrators from Cases Easier

Effective March 2001, SEC-approved amendments to NASD's Code of Arbitration Procedure gave the President, NASD Dispute Resolution, and its Director of Arbitration indelegable authority to remove an arbitrator at any juncture in the arbitration process. These amendments allow for removal of an arbitrator from a case after a prehearing conference or a hearing has been started, based on new information that was not known to the parties at the time of the arbitrator's appointment but that the arbitrator, pursuant to NASD rules, should have disclosed.

Under the old rule, the director could disqualify an arbitrator from serving on a case when information revealed a conflict of interest or bias such as a relationship with one of the parties. However, this authority to disqualify was limited to the time before the start of the prehearing conference or the first hearing. After that point, the parties would have needed to make a motion before the arbitration panel asking the arbitrator to recuse himself or herself or seek a court action to remove an arbitrator from a case. In approving the rule change, SEC noted that the change should result in lower litigation expenses for the parties, because they would not have to seek judicial intervention to remove an arbitrator. SEC also noted that the change would help ensure greater confidence in the fairness and neutrality of the administration of arbitration cases.

According to NASD, after the new rule became effective in March 2001 and through the end of 2002, NASD had received 47 requests for the Director of Arbitration to exercise the authority to remove an arbitrator. NASD reported to us that the Director denied these requests in 38 instances and removed an arbitrator in 9 instances.

Motions to Dismiss Are Used in NASD Arbitrations

Prehearing motions to dismiss are used in NASD-administered arbitration cases. NASD, however, does not centrally track the motions filed in its numerous cases. Data that we assembled from 719 investor-initiated, NASD-administered monetary arbitration awards in 2001, showed that motions to dismiss were filed in 54 cases and a request for summary judgment in one case, or in about 8 percent of all the cases. In

the 54 cases, 124 motions were filed. We identified 42 instances in which the motions were not decided because the claims had been dismissed for other reasons or settled by the parties before the case was decided. We identified 54 instances in which the motions were denied and 28 instances in which the motions were granted. The total number of motions filed exceeded the number of cases because any one case may involve multiple respondents and multiple filings of motions. SEC officials said that some motions to dismiss are based on substantive arguments, while others assert practical ones, for example, that the wrong party was named or served. The awards did not provide enough detail about the motions for us to determine the reasons for their being filed.

NASD arbitration rules do not specifically provide for dismissal motions or for motions for summary judgment. However, nothing in the rules prohibits the parties from filing motions or precludes panels from granting them. NASD rules are consistent with the practice of disposing of claims by motion. NASD rules allow prehearing conferences at which the presiding person can require the briefing of contested issues and address “any other matters which will expedite the arbitration cases.”¹⁰

The case law consistently has recognized the authority of arbitrators to grant prehearing motions to dismiss. For example, in *Warren v. Tacher* the underlying dispute in the arbitration proceeding involved alleged investor losses in a brokerage account.¹¹ The investors brought a claim for arbitration against the broker-dealer that maintained the account and the clearing broker-dealer. The clearing broker-dealer moved to dismiss all claims on the ground that it had no responsibility to claimants. The claimants filed a written response to the motion and the arbitration panel held oral argument. The arbitration panel dismissed all claims against the clearing broker-dealer. The claimants appealed and sought to have the arbitrators’ decision vacated on the ground that the arbitrators engaged in misconduct and exceeded their powers by dismissing the claims against the clearing broker-dealer prior to discovery and an evidentiary hearing. The court stated that courts have recognized the authority of NASD arbitrators to decide prehearing dismissals for failure to state a claim under the NASD Code.¹² The court rejected an argument that the arbitrators displayed a “manifest disregard for the law” by their determination to dismiss all claims against the clearing broker-dealer.

¹⁰ NASD Code §10321(d)(1). General Provisions Governing Pre-Hearing Proceedings, Pre-Hearing Conference, (1) Upon the written request of a party, an arbitrator, or at the discretion of the Director of Arbitration, a prehearing conference shall be scheduled. The presiding person shall seek to achieve agreement among the parties on any issue that relates to the prehearing process or to the hearing, including but not limited to stipulation of facts, identification and briefing of contested issues, and any other matters which will expedite the arbitrations.

¹¹ 114 F. Supp. 2d 600 (W.D. Ken. 2000).

¹² *Goldman, Sachs & Co. v. Patel* (N.Y.L.J. Aug. 18, 1999, p. 23, co. 6) (“Contrary to respondent’s assertion, the NASD panel has the power to decide a motion to dismiss a claim on legal grounds without holding an evidentiary hearing.”).

The court in *Warren v. Tacher* also addressed the issue of whether the grant of a prehearing motion to dismiss is tantamount to a refusal to hear evidence. The court rejected this argument and explained that while the granting of a prehearing motion to dismiss usually means that the arbitrator “refused to hear evidence,” that, by itself, is insufficient to vacate the award. Claimants must also show that the excluded evidence was material to the panel’s determination and that the arbitrator’s refusal to hear the evidence was so prejudicial that the party was denied fundamental fairness.¹³ In addition, the court held that a hearing for purposes of NASD rules does not necessarily mean an evidentiary hearing. The court found that the claimants did have a “hearing.” They were given adequate opportunity to respond to the clearing agent’s motion to dismiss and they did so.

The courts have upheld arbitrators granting of dismissal motions in other cases. These include dismissal on the grounds of the timeliness of the claims, a respondent’s involvement in the matter in controversy, or whether the claimant has a private right of action for alleged violation of an SRO rule.¹⁴ We have not found any cases that do not recognize arbitrators’ authority to grant prehearing motions to dismiss. Moreover, an NASD official told us that these motions can save time and resources by helping to identify certain cases that would not prevail in a hearing on the merits. For example, in some cases the parties’ pleadings may clearly show that the case, or some portion of the case, does not fall within the NASD’s procedural rule covering filing time limits, which would send the case instead to court. On the other hand, a member of the Securities Industry Conference on Arbitration said that motions to dismiss and motions of summary judgment ought to be discouraged because discovery and appeal rights in arbitration are limited. Another arbitration official also said that parties in arbitration deserve the right to be fully and fairly heard.

Rate of Unpaid Awards Has Decreased, but Many Investors Are Not Paid Awards against Defunct Brokers

Data for 2001 show that the rate of unpaid NASD-administered arbitration awards had decreased from the levels we previously reported for 1998. NASD procedures for monitoring awards encourage payment by still-active brokers. However, defunct brokers continue to not pay awards. The recent rise in arbitration claims may result in more investors not being paid their awards.

¹³ 9 U.S.C. § 10(c); *Campbell v. Cantor Fitzgerald & Co.*, 21 F. Supp. 2d 341, 344 (S.D.N.Y. 1998).

¹⁴ In *Howsam v. Dean Witter*, 123 S.Ct. 588 (2002), the United States Supreme Court recently held that arbitrators can decide that a claim is ineligible for arbitration under an NASD rule that provides that claims submitted a certain time after they arose are ineligible. The Court’s decision does not address whether arbitrators should make such a decision in response to a motion to dismiss an arbitration claim. Dean Witter did not file a motion to dismiss the arbitration claim. It brought an action in federal court asking the federal court to decide that the arbitration claim was untimely.

Payment Rates Have Improved, but
Many Awards Still Are Not Fully Paid

Although the rate of unpaid arbitration awards has fallen, many awards rendered by NASD arbitration panels remain unpaid. In 2001 about 55 percent, or \$55 million, of the \$100.2 million NASD arbitrators awarded to investors was unpaid. However, \$12 million of the unpaid awards were not required to be paid because the respondents had requested a hearing, filed for bankruptcy, or filed a motion to vacate. In our June 2000 report, we estimated that about 80 percent of the \$161 million awarded to investors in 1998, which were primarily NASD-administered awards, was unpaid. In that report, we estimated that 64 percent of NASD-administered monetary arbitration awards won by investors in 1998 had not been fully paid. Our analysis of NASD award payment data for 2001 found that 33 percent of awards to investors were unpaid. Of the total of 719 monetary awards that investors won in 2001, 236 awards were not fully paid. (Nothing was paid on 216 awards and 20 awards were partially paid.)

In June 2000, we reported that most of the unpaid arbitration awards in 1998 were against broker-dealer firms and associated persons that had left the securities industry. Awards that were not fully paid in 2001 also were against such defunct brokers. More specifically, as shown in table 1, nonpayment of 192 awards (\$41 million) in 2001, was attributed to brokers that had terminated their NASD membership. In an additional 16 awards, NASD suspended firms or individual brokers for failing to pay \$2.1 million of awards. In 29 awards, \$12 million awarded was not paid because the respondents had requested a hearing, filed for bankruptcy, or filed a motion to vacate the award.¹⁵

¹⁵ NASD procedures allow the respondent to request a hearing on the matter to consider whether (1) the respondent was given notification of the award, (2) the respondent satisfied the award, and (3) a valid reason exists for the respondent's failure to comply with the award.

Table 1: Number and Amount of Dollars Not Fully Paid by Broker-dealers or Individual Brokers with NASD-administered Arbitration Awards against Them and Award Nonpayment Status in 2001

	Terminated NASD membership	Suspended	Requested a hearing	Filed for bankruptcy	Filed motion to vacate	Total
Number of awards not fully paid	192	16	7	5	17	237 ^a
Dollars not paid (in millions)	\$41	\$2	\$2	\$1	\$9	\$55

Source: NASD (data); GAO (analysis).

^aThe sum of these unpaid cases exceeds the 236 unpaid awards because cases with multiple respondents can have different outcomes.

**NASD Procedures to Monitor the Payment
of Awards Are Designed to Encourage Award Payment**

NASD has put procedures in place for monitoring the payment of awards that are designed to encourage award payment. In September 2000, NASD began requiring its member broker-dealers to certify that they had paid or otherwise complied with an award against them or their associated persons within 30 days after the award was served. NASD also began asking the claimants who had won awards to notify it if an award had not been satisfied within the 30-day period. If an award is not paid, NASD begins the process of suspending the license of the broker-dealer firm or the individual broker responsible for payment of the award. In 2001, NASD suspended one or more of the respondents in 12 cases for failing to pay awards. Members and individuals who fail to pay awards cannot apply to restore their licenses until an award against them is satisfied.

Although these procedures may have helped to reduce the rate of unpaid awards, the previously discussed reduction in the rate of unpaid awards also might reflect differences in the methodologies used to compile the data used to calculate the rate. Our June 2000 report was based on data that we obtained by surveying a sample of investors that had won arbitration awards in 1998. For this report, the rate was calculated from data obtained from NASD based on its monitoring of award payment for the entire year of 2001. Additionally, arbitration attorneys said that they have begun scrutinizing cases more closely to avoid taking cases where awards might not be paid, a factor which may also have contributed to a reduction in the rate of unpaid awards.

NASD Has Implemented Changes to Help Address the Problem of Unpaid Awards by Failed Broker-Dealers

NASD is helping to address the problem of unpaid awards by defunct brokers by making it easier for investors to seek alternative means of relief or obtain a judgment against the broker. These procedures address the problem of unpaid awards by defunct brokers, for example, by helping shorten the time period for obtaining a court judgment that could be used to seize remaining assets of a defunct broker. In April 2001, SEC approved amendments to NASD's Code of Arbitration Procedure, §10301, effective June 2001, that provided that a broker-dealer that has been terminated, suspended, or barred from NASD, or that is otherwise defunct cannot enforce a predispute arbitration agreement against an investor in NASD's arbitration forum. Also, in June 2001, NASD began to advise claimants in writing, at the time they file a claim, of the registration status (for example, terminated, out-of-business, bankrupt) of broker-dealers or associated persons so that the claimants can evaluate whether to continue with the arbitration. In October 2002, a new NASD rule, which SEC approved in July 2002, took effect. The rule provides for streamlined default proceedings where the terminated or defunct broker-dealer or associated person does not answer or appear, but the claimant affirmatively elects to pursue the arbitration. Under the streamlined proceedings, an arbitrator can make a decision based on the statement of claim and any other material submitted by the claimant. In addition, in August 2002, the NASD Board of Directors approved a proposed amendment, which was submitted in January 2003 to SEC for approval, that would strengthen NASD's authority to preclude member broker-dealers from using structural changes, such as consolidations or other asset sales and transfers, to avoid meeting their arbitration obligations to investors. Also, NASD officials said that NASD's Enforcement Division had started reviewing new arbitration claims as they come in as part of an effort to identify potentially troublesome members.

In our June 2000 and April 2001 reports, we discussed proposals made by investors' attorneys to address the unpaid award problem such as insurance and bonding. In the June 2000 report we recommended that, to the extent unpaid awards remain a problem, the SEC's Chairman should establish a process to assess the feasibility of alternative approaches to address the problem. In response SEC officials said that after our report was issued SEC staff assessed other approaches addressed in the report including insurance and bonding. According to the officials, SEC staff met with broker-dealer representatives and insurance companies to discuss existing broker-dealer insurance and bonding requirements. The officials said that after those consultations, the staff concluded that expanding broker-dealer insurance and bonding requirements would not be an appropriate means of addressing unpaid arbitration awards. Instead, SEC staff concluded that the efforts of NASD—which conducts most broker-dealer examinations—to institute a procedure of reviewing all arbitration claims as they are filed to identify problem brokers early through related examinations and as appropriate, enforcement action, would limit the harm they cause investors. The officials said that this, as well as other initiatives NASD has taken, which are described earlier in this report and in our June 2000 and April 2001 reports, should be given time to work. SEC's continuation of the process we

recommended in June 2000 to assess the feasibility of alternative approaches to address the problem of unpaid awards by defunct brokers could further reduce the incidence of unpaid awards. This process could consider how SEC and NASD programs for broker registration, regulation, enforcement, as well as arbitration, and other areas as appropriate, can further reduce the incidence of unpaid awards.

In June 2000, we also recommended that the SEC Chairman work with the SROs to develop and publicize information to focus investor attention on the possibility of unpaid arbitration awards. In response, NASD and SEC made information available on their Web sites to caution investors about the possibility of having an unpaid award. That information, while helpful, does not provide any data to inform investors of the scope of the problem or the frequency with which awards are unpaid by defunct brokers. Increasing investors' awareness of the scope and frequency of the problem may better inform investors that broker-dealers that stay in business generally pay awards and help to reduce unpaid awards by defunct brokers.

Recent Increase in Arbitration Claims Suggests That Many Future Awards also Might Not Be Paid

Arbitration claims have increased sharply, which may mean, assuming the rate of unpaid awards remains the same; more investors may not be paid. In 2001, 6,926 arbitration claims were filed with NASD. In 2002, the number of new cases further increased to 7,709, or a 39 percent increase over the 5,565 total claims filed in 2000. In most of these cases—4,849 in 2001 and 5,974 in 2002—investors filed claims against their brokers. Through 2002, these investor-initiated cases increased by 64 percent from the 3,637 claims filed by investors in 2000. NASD officials said that whether this increase in claims will mean more unpaid awards depends on the types of broker-dealers any resultant awards might be against. For example, if the increase in claims results in more awards against large viable broker-dealers that tend to pay awards, the number of unpaid awards could decrease.

NASD officials said that the increase in claims filed was the result of changes in the economy. The officials said the downturn in and increased volatility of the stock market in 2001, an influx of new inexperienced investors during the boom years of the late 1990s, and the overall increased number of securities holders contributed to the increase in arbitration claims filed. According to NASD, claims alleging broker failure to supervise their sales representatives, breach of fiduciary duty, misrepresentation, and negligence also had increased.

Conclusions

The rule and procedural changes that NASD has adopted to improve the arbitrator information update process and its ability to remove arbitrators from cases appear reasonable and could improve the effectiveness and efficiency of arbitration. These changes could help NASD to keep current the information that parties in arbitration use in selecting arbitrators and allow for faster and less costly removal of arbitrators in cases where there has been an undisclosed conflict of interest.

Motions to dismiss are used, but not with great frequency, in NASD arbitrations. Arbitration law and codes do not explicitly prohibit the use of these motions. Because appeal rights and evidentiary discovery are limited, a Securities Industry Conference on Arbitration member said that arbitration forums should discourage the granting of these motions. However, NASD officials have contended that use of these motions helps to make the arbitration process more efficient.

Data show that the rate of unpaid awards has diminished since our June 2000 report. However, continued unpaid awards, regardless of how effective and fair the arbitration process may be, could negatively affect investors' confidence in arbitration and potentially the securities markets in general. Unpaid awards also may discourage attorneys from taking investors' cases. It is important that regulators continue to issue a strong message to investors about being cautious in choosing their brokers because some brokers will never pay for the damage they cause. Moreover, given that continued unpaid awards could erode investors' confidence in arbitration, SEC's Chairman should continue the process we recommended in June 2000 to assess the feasibility of alternative approaches to address the problem of unpaid awards by defunct brokers. This process could consider how SEC and NASD programs for broker registration, regulation, enforcement, as well as arbitration, and other areas as appropriate, could further reduce the incidence of unpaid awards. Further, NASD needs to be concerned about unpaid awards, which represent inefficient use of NASD dispute resolution program resources and futile efforts by defrauded investors seeking restitution. By making data on the frequency with which awards are unpaid by defunct brokers publicly available, NASD could better inform investors of the possibility of unpaid awards by defunct brokers and increase investors' awareness of the scope of the problem. This, in addition, could cause investors to be more cautious in choosing their broker and also help them decide whether to file an arbitration claim or seek alternative means of obtaining relief and avoid unnecessary expenses.

Recommendation for Executive Action

We recommend that the President, NASD Dispute Resolution, make available on NASD's Web site current statistics showing the frequency with which arbitration awards against defunct brokers are not fully paid.

Agency Comments and Our Evaluation

SEC and NASD provided written comments on a draft of this report, which are reprinted in enclosures I and II. SEC and NASD also provided technical comments, which were incorporated into the final report. SEC agreed with the contents of this report and noted that our work demonstrates that NASD has developed necessary tools to administer its growing caseload and that implementation of our June 2000 recommendations has helped achieve an appreciable reduction in the rate of unpaid awards. SEC commented that it welcomes our recommendation that NASD make available on its Web site current statistics showing the frequency with which arbitration awards against defunct brokers are not fully paid. SEC said that this more

explicit data should help deliver to investors the educational message to choose investment professionals carefully. SEC noted that SEC staff believe that more time is needed to realize the full effects of the steps taken after our June 2000 report and that it continues to work with NASD to better identify individuals responsible for unpaid awards.

NASD generally agreed with the contents of this report and provided additional information on the various steps it has taken related to its addressing the problem of unpaid awards. NASD also noted the dramatic improvement in the rate of unpaid awards from our June 2000 report and provided updated information on the status of awards we found to be unpaid. NASD updated the payment status of awards that were paid after it threatened suspension of the member or a motion to vacate was denied or which had motions to vacate still pending, which reduced the percent of awards unpaid from 55 percent to 53 percent. NASD stated that it would consider our recommendation and additional ways to enhance investor education about the problems associated with terminated members and the payment of awards. NASD commented that it strives to strike a balance between disclosing information and not discouraging investors from filing valid claims. NASD stated that, with that concern in mind, it will develop an approach to enhance the data available to investors to enable them to make more informed decisions about whether to pursue a claim. NASD also commented that it welcomes the opportunity to participate in a feasibility study of alternative solutions to address the problem of unpaid awards that we recommended in June 2000.

We commend SEC and NASD for the efforts they have taken to monitor and educate investors about unpaid awards, and provide investors viable options when faced with the possibility of unpaid awards. However, the extent to which awards are unpaid by defunct brokers shows that unpaid awards, even when reduced to 53 percent for 2001, as NASD adjusted it, is still a serious problem that can affect investors' confidence in arbitration and potentially the securities markets and discourage attorneys from taking investors' cases. It is, therefore, important that NASD make available to investors current statistics on the frequency with which awards are unpaid by defunct brokers and that regulators continue to monitor unpaid awards and consider ways of addressing the problem.

Scope and Methodology

We analyzed information on NASD procedures for updating arbitrator disclosure information and removing arbitrators from cases based on our review of NASD's procedures and interviews of NASD officials. We analyzed information on the use of motions in arbitration based on interviews of officials of NASD and the Securities Industry Conference on Arbitration. We also reviewed arbitration rules of NASD and other forums and federal case law regarding the uses of motions to dismiss and motions for summary judgment in NASD cases. We then identified the extent to which these motions were used in 2001 NASD investor-initiated cases in which monetary award decisions were rendered in favor of investors.

To determine changes in arbitration claims and the rate at which awards in investor-initiated cases were paid, we analyzed NASD data. Initial testing of the NASD data on award payment found errors that could overstate the extent to which awards were paid that were significant enough to require further verification and correction. We then had NASD correct any errors found and then further tested the accuracy of the data. We reviewed a randomly-selected sample of 34 cases out of 719 monetary awards in 2001 to verify that NASD had documentation showing that the awards were paid. From our random sample of 34 awards 1 award was initially listed as paid, but we discovered on further review that the award was unpaid, and the respondent had filed for bankruptcy. Subsequently, NASD discovered an additional award that was mistakenly classified as unpaid. The number and magnitude of these data errors are small enough that the data are sufficiently reliable for our purposes and should not materially affect the estimates of payment rates in this report. Nevertheless, we apprised SEC officials of the errors. The officials said that SEC examiners would test the accuracy of the award payment data as part of SEC's routine inspections of NASD's dispute resolution program. NASD officials told us that the errors resulted from NASD not having a means of tracking the payment status of awards. Once an award was granted, NASD gave the case a closed status and NASD staff had to manually compile the payment data from documents in case files. The NASD officials said that NASD has since entered new status codes in its computer system for tracking the payment status of awards. They said that they can now track different outcomes related to award payment such as receiving a broker's certification that an award was paid or that a broker had filed a motion to vacate an award in a court. The officials said that this change should minimize the opportunity for compilation errors.

We conducted our work in Washington, D.C., and New York, N.Y., from April 2002 through March 2003, in accordance with generally accepted government audit standards.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will provide copies of this report to the Chairman, House Committee on Energy and Commerce; the Chairman, Subcommittee on Telecommunications and the Internet, House Committee on Energy and Commerce; the Chairman and the Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; and the Chairman and the Ranking Minority Member, House Committee on Financial Services. Copies also will be provided to the Honorable William H. Donaldson, Chairman, SEC; Mr. Robert R. Glauber, Chairman, NASD; and other interested parties. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

Please call me or Orice M. Williams, Assistant Director, at (202) 512-8678 if you or your staff have any questions concerning this report. David Tarosky and Cindy Udell also contributed to this report.

A handwritten signature in black ink, reading "William O. Jenkins Jr." in a cursive script.

William O. Jenkins Jr.
Director, Financial Markets
and Community Investment

Enclosures

Comments from the Securities and Exchange Commission



DIVISION OF
MARKET REGULATION

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

March 28, 2003

William O. Jenkins Jr.
Director, Financial Markets
and Community Investment
General Accounting Office
Washington, DC 20548

Dear Mr. Jenkins:

The Commission staff appreciates the opportunity to comment on the General Accounting Office's draft report entitled *Follow-up Report on Matters Related to Securities Arbitration*. The draft report provides a useful snapshot of the current status of several aspects of the process used to resolve investor and other securities disputes.

GAO's draft report confirms that NASD has implemented procedures for updating and entering arbitrator disclosure information that parties use when selecting arbitrators. It also describes arbitrator removal procedures implemented under a rule that became effective in March 2001. Those procedures enable NASD to remove an arbitrator based on information not known to the parties when the arbitrator was selected. The draft report also discusses motion practice in NASD arbitration. Finally, the draft report provides a helpful update regarding GAO's findings of a decreased incidence of unpaid arbitration awards since GAO's June 2000 report *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*.

GAO's work demonstrates that NASD, which administers about 90% of securities arbitration cases, has developed necessary tools – for the maintenance of its arbitrator pool and removal of arbitrators from particular cases – to administer its growing caseload. GAO also observed that motions to dismiss are not used with great frequency. Used sparingly, as the draft report reflects, such motions can be used effectively to conserve the parties' resources or direct parties to a correct forum outside of arbitration.

Much of the draft report updates GAO's earlier work concerning the incidence of unpaid arbitration awards. As in GAO's June 2000 report, GAO reports here that the vast majority of broker-dealers pay arbitration awards entered against them. Defunct firms that harm investors before going out of business do not. Implementation of GAO's June 2000 recommendations has helped achieve an appreciable reduction in the rate of unpaid awards.

As GAO reports, since its June 2000 report, much has been done to contain this problem. For example, NASD refined existing procedures in order to be able to identify and suspend more quickly firms or individual brokers that do not pay awards. NASD also adopted rules that give

William O. Jenkins Jr.
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choices to investors on how to proceed against defunct firms – investors now have the option of going to court against defunct firms, or of using expedited procedures against defunct firms that do not participate in the arbitration. Those steps were designed to help a narrow band of investors possibly reach remaining assets of defunct firms. In addition, SEC, NASD and New York Stock Exchange educational materials were amended to alert investors to the risk of unpaid awards, and to reinforce the message that investors should investigate before they do business with a particular firm. Investors who review Central Registration Depository (CRD) information showing the regulatory history of broker-dealers and individual registered representatives make more informed decisions.

The staff welcomes GAO's recommendation that NASD make available on NASD's Web site current statistics showing the frequency with which arbitration awards against defunct brokers are not fully paid. More explicit data, already used by NASD and SEC regulators, should help drive home the educational message to choose investment professionals carefully. While GAO reports that there are fewer unpaid awards in its more recent case review, all unpaid awards are of concern. GAO's draft report states that its estimate of the percentage of unpaid awards to investors reduced to about 33% for cases from 2001 from about 64% for cases in 1998, and that its estimate of the unpaid dollar amount awarded reduced to about 55% from 80%.¹

The staff believes that more time is needed before we feel the full effects of the steps taken after GAO's June 2000 report. Cases concluded in 2001 are likely to have resulted from investment relationships begun before the educational effort to publicize this problem was launched. The cumulative effects of educational efforts may help investors avoid problem firms. Similarly, procedures allowing access to court against defunct firms (effective June 2001) and providing expedited procedures for cases where defunct firms do not answer a claim or appear in an arbitration (effective October 2002), may reduce unpaid awards to some extent. In addition, GAO reports that NASD's Enforcement Division is reviewing new arbitration claims at the beginning, rather than at the end of a case in order to identify potential problem firms more quickly, and to take action more quickly, before more investors may be harmed. This step also may further reduce the nonpayment of awards.

The staff agrees with GAO that we should continue to consider how SEC and NASD programs can further reduce the incidence of unpaid awards. The staff is working with NASD to develop better means to identify through the registration process individuals who may have had some responsibility for unpaid awards at firms with which they were previously affiliated. Moreover, we will continue to explore ways to identify problem firms before they harm investors, and to promote the full payment of arbitration awards.

¹ The staff understands that GAO is refining its data in conversations with NASD. GAO's data indicates that 29 awards (out of 236) representing about \$12 million (out of \$55 million) are in post-arbitration proceedings. Some part of those sums is either not yet payable, because motions to vacate have not been decided, or may never be payable, because motions to vacate have been granted.

Enclosure I

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Thank you again for the opportunity to comment on the draft report. The Division requests that this letter be appended to the final report delivered to Congress.

Sincerely,

A handwritten signature in cursive script, appearing to read "Annette L. Nazareth", with a stylized flourish at the end.

Annette L. Nazareth
Director

Comments from NASD

Linda D. Fienberg
President, Dispute Resolution
Executive Vice President and Chief Hearing Officer, Regulatory Policy and Oversight



March 26, 2003

Mr. William O. Jenkins, Jr.
Director, Financial Markets and Community Investment
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Re: *Follow-up Report on Matters Relating to Securities Arbitration*

Dear Mr. Jenkins:

NASD appreciates the opportunity to comment on the GAO Report entitled: *Follow-up Report on Matters Relating to Securities Arbitration* (GAO Report or Report).

The GAO Report covered three areas:

1. Improvements in the rate of unpaid arbitration awards in NASD's forum;
2. Enhancements to NASD's procedures to ensure timely updating of arbitrator disclosure information and to remove arbitrators from cases; and
3. The use of dispositive motions in arbitration.

We respond below to the GAO's findings in each of the three areas and describe numerous initiatives NASD has implemented to improve our arbitration forum. We highlight the improvement in award payment results since the GAO's review of 1998 cases and provide a complete picture of the results of NASD arbitration cases involving public investors in 2001. We also discuss our proposed actions to implement the GAO recommendations regarding measures to address further the problem of terminated broker-dealers failing to pay awards. In addition, we discuss NASD initiatives to improve arbitrators' disclosures of relationships they have with participants in the arbitrations before them. Last, we examine NASD's approach to dispositive motions.

Executive Summary

GAO previously found that that a large percentage of the 1998 NASD arbitration awards was not paid. NASD committed to Congress to implement significant procedural changes to increase the number of paid awards. These changes had a positive impact. As a result, both the percentage of unpaid awards and the percentage of unpaid damages in 2001 declined significantly. As in 1998, over 80 percent of the 2001 cases in which awards were unpaid involved a terminated broker-dealer or associated person – that is a firm or individual who is no longer in good standing with NASD and therefore unable to sell securities to the public.

GAO's review of arbitration awards issued in 2001 shows that the majority of the 719 NASD arbitration awards in which arbitrators granted relief to investors were paid in full. Specifically, awards were fully paid in two-thirds (67 percent) of the cases. Additionally, investors received

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partial payment in three percent of the cases. This is a dramatic improvement from the 1998 awards that the GAO studied in the 2000 Report.

GAO found that, of the cases NASD closed in 2001, only 34 percent were resolved by arbitrator decision. Most of the remainder resulted in settlements. Of the claims decided by arbitrators, 53 percent resulted in an award in favor of the investor. Accordingly, the combination of settlements and awards reflects that over 70 percent of the cases filed in the NASD forum in 2001 resulted in a disposition favorable to the investor. In effect, the damages awarded to investors in the 719 cases studied by GAO represent only a fraction of the compensation granted to investors through the NASD forum. When viewed in that context, the 224¹ cases in which a customer award was not paid represent about six percent of the 3,499 investor cases that NASD closed in 2001. While NASD is concerned about even one unpaid award, the significant improvement over the 1998 results demonstrates that the measures we have implemented have been effective. And, since many of the cases in which awards were issued in 2001 were filed before these new initiatives were in place, we expect these positive effects to continue.

Call for a Forum on Unpaid Awards

NASD recognizes that an effective dispute resolution process is an integral part of securities industry regulation and that new measures to prevent unpaid awards should be part of the larger effort to restore investor confidence. NASD concurs with GAO's recognition that the problem of unpaid awards goes beyond the scope of NASD's authority, and also with GAO's recommendation that a broad range of participants in the securities arbitration field – government regulators, SROs, investors, broker-dealers, registered representatives, and other interested parties – convene to address important "next steps" in solving the problem of unpaid awards.

NASD also concurs with GAO's findings that NASD is addressing appropriately the important task of providing updated information on arbitrator disclosures and properly managing dispositive motions.

I. Unpaid Arbitration Awards

GAO's 2000 Report on Arbitration Award Payment

The GAO's June 2000 Report, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards* (2000 Report), concerning payment of 1998 arbitration awards, concluded that 49 percent of those awards were not paid at all and an additional 12 percent were only partially paid. NASD made several significant commitments in response to the 2000 Report, all of which we have fulfilled. We provide a summary of NASD's five initiatives as follows:

1. Require member firms and associated persons to notify NASD Dispute Resolution when they have satisfied an award.

¹ GAO reported 236 unpaid awards. As discussed in more detail below, NASD suggests that the actual number of unpaid awards is 224.

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NASD Dispute Resolution issued Notice to Members 00-55, effective September 18, 2000, which requires firms to certify that they have paid or complied with an award against them or their associated persons within 30 days after service of the award. Since September 2000, NASD Dispute Resolution has been sending two new letters to the parties when it serves awards. We send one letter to members and associated persons against whom an award has been rendered. It requires members to inform NASD Dispute Resolution whether they or their associated persons have paid awards against them.² NASD Dispute Resolution begins the process to suspend members or associated persons from NASD if the 30-day period has passed and payment of the award has not been confirmed or the respondent has not met one of the enumerated justifications for non-payment. If suspended, the firm or individual cannot sell securities to the public or reenter the industry until the award is satisfied.

2. Request in the award service letter that investors notify NASD Dispute Resolution if the award has not been paid within thirty days of service.

Notice to Members 00-55 also invites claimants to inform NASD Dispute Resolution if the firm or associated person has not paid the award so that NASD can begin the suspension process. The second letter, also implemented in September 2000, is sent to all parties with service of their award. It restates the requirement to pay awards within 30 days of service, and requests parties who have prevailed against a member or associated person to inform NASD Dispute Resolution if their award has not been paid within the 30-day period.

3. Propose a rule amendment that a firm that has been terminated, suspended, or barred from the NASD, or that is otherwise defunct, cannot enforce a predispute arbitration agreement against a customer in the NASD forum.

The Boards of NASD Dispute Resolution and NASD approved this proposal in December 2000. The SEC approved the rule change on April 6, 2001.³ The rule change was effective for all claims served on or after June 11, 2001, giving investors the option of taking claims to court if the brokerage firm is no longer in business.⁴

4. Advise claimants in writing at the time of claim filing of the status of a firm or associated person (e.g., terminated, out of business, or bankrupt) so they can evaluate whether to proceed with arbitration.

We implemented this procedure in June 2001, in connection with the previous item. Dispute Resolution sends notice letters to claimants at the time the claim is served.

² The firm or associated person also may provide a justification for non-payment: for example, that the parties have agreed to installment payments, that the award has been modified or vacated by a court, that a motion to vacate or modify the award has been timely filed with a court of competent jurisdiction and such motion has not been denied by that court, that there is a pending bankruptcy petition, or that the award has been discharged in bankruptcy.

³ Exchange Act Release No. 44158 (April 6, 2001) (File No. SR-NASD-01-08), 66 Federal Register 19267 (April 13, 2001).

⁴ Through March 18, 2002, 33 out of 399 eligible customers exercised this option.

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5. Propose a rule amendment to provide streamlined default proceedings where the terminated or defunct member or associated person does not answer or appear, but the claimant affirmatively elects to pursue arbitration.

The Boards of NASD Dispute Resolution and NASD approved this proposal in October 2001. The SEC issued an order approving the rule change on July 17, 2002, for all claims filed on or after October 14, 2002.⁵ This rule provides an expedited default procedure for situations in which a suspended, terminated, or otherwise defunct member or associated person fails to answer a claim in an arbitration proceeding, but the claimant nevertheless elects to pursue arbitration. The procedures are designed to make it easier for claimants to obtain an award against a defunct, non-answering party that the investor can then seek to enforce in court.⁶

NASD also developed and publicized Web site information to focus investor attention on the possibility of unpaid arbitration awards. That information includes a reference to the 2000 GAO study on unpaid awards and a link to the GAO Web site and the 2000 Report. NASD also took action to encourage investors to investigate their broker's background more thoroughly before investing.

GAO's Study of 2001 Award Results

Review of the Data

GAO's review of arbitration awards issued in 2001 shows that the majority of the 719 NASD arbitration awards in which arbitrators granted relief to investors were paid in full. Specifically, awards were fully paid in two-thirds (67 percent) of the cases. Additionally, investors received partial payment in three percent of the cases. This is a dramatic improvement from the 1998 awards that the GAO studied in the 2000 Report. Nevertheless, NASD recognizes that more remains to be done.

NASD Department of Enforcement Actions Related to Arbitration Awards

Under current procedures, if a respondent member firm or associated person does not pay an arbitration award in a timely fashion, Dispute Resolution begins a suspension proceeding by advising that NASD intends to suspend the member in 15 days. NASD's Department of Enforcement is responsible for litigating these matters and, under the NASD Code of Procedure, an NASD professional hearing officer serves as the sole trier of fact.

NASD's Department of Enforcement tracks its actions by calendar year rather than on the basis of the year in which an arbitration case closed. We are not able to match the Department of Enforcement actions with the specific cases covered in the GAO study of arbitration awards issued in 2001. However, the following information related to calendar year 2002 provides an example of the scope and nature of the actions taken to enforce arbitration awards: In 2002,

⁵ Exchange Act Release No. 46221 (July 17, 2002) (File No. SR-NASD-2002-15), 67 Federal Register 48237 (July 23, 2002).

⁶ Because the rule went into effect so recently, there are no meaningful data on its use.

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NASD sent out 248 "15-day letters" (warning of possible suspension in 15 days) for failure to comply with arbitration awards or arbitration and mediation-related settlement agreements. The vast majority -- 154 individuals or firms -- either settled or paid the awards in full after receiving NASD's letter. NASD suspended another 33 individuals who failed to request a hearing or to raise a valid defense after receiving a "15-day letter." The remaining 48 matters culminated in hearings, with more than one-third of those resulting in settlements or payments of the awards in full.⁷

NASD Department of Enforcement Actions Related to Arbitration Awards Issued in 2001

The GAO noted that in seven of the 2001 awards that were unpaid, the individual or firm requested a hearing. NASD's Department of Enforcement disposed of these matters,⁸ and, in one case, the respondent paid the \$33,000 award prior to the disciplinary hearing.

NASD suspended all active firms or individuals who did not promptly fulfill their obligations. The remaining awards were unpaid because of terminated membership, bankruptcy, or court challenges to the awards. Federal bankruptcy law provisions and NASD By-Laws prohibit disciplinary action for non-payment in these circumstances. These numbers demonstrate that NASD has used every available means to ensure payment of awards and settlements, and has aggressively pursued disciplinary action against those who nevertheless fail to pay.

Adjustments to Unpaid Award Data

The GAO Report observes that respondents did not pay 236 of the 719 arbitration awards issued in 2001 in the customer's favor. NASD suggests that the number of unpaid awards, and associated amounts, should be adjusted based on updated information of the payment status of these matters.

Two Awards Subsequently Paid

As indicated above, in one case, an award counted as unpaid was subsequently paid prior to the requested disciplinary hearing. In another case, the respondent paid the award after the court denied the motion to vacate. These cases should not be included in the number of unpaid awards. This reduces the number of unpaid awards to 234.

Three Awards Vacated by a Court

GAO noted that motions to vacate had been filed in 17 of the cases involving unpaid awards. In three of these cases, a court decision to vacate the award nullified the award

⁷ Of the 48 matters that resulted in hearings, 15 individuals or firms settled or paid the awards in full prior to a hearing. Three matters resulted in bankruptcy filings. Seven individuals were suspended by decision after a hearing took place. Three cases were dismissed after a hearing took place, and the hearing officer found the respondents had a bona fide inability to pay the award. Six matters were dismissed because of a pending motion to vacate the arbitration award in court. Six matters were dismissed prior to hearing by the Department of Enforcement based on a review of financial information and a determination of a valid inability to pay. The remaining 8 hearings were set for dates in 2003.

⁸ Two matters resulted in bankruptcy filings. Two matters resulted in suspensions. One matter resulted in a termination. One matter was dismissed based on inability to pay. One matter was dismissed because a motion to vacate was filed. One matter was dismissed because the award was paid. One matter is still pending. Note: numbers do not add up to seven because, in some cases, there were multiple dispositions (e.g., one party filed for bankruptcy but the case proceeded against the remaining party).

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and therefore the obligation to pay. Thus, these three cases should not be included in the number of unpaid awards. This further reduces the number of unpaid awards to 231.

Seven Motions to Vacate Still Pending

In seven of the cases involving unpaid awards, motions to vacate the awards are still pending in court.⁹ While it is true that, as a technical matter, these awards are not yet paid, the firms and individuals in these cases do not have an obligation to pay unless the court denies the challenges to the award. Accordingly, these seven cases should be excluded from the calculation of unpaid awards until the courts decide the motions to vacate. Excluding these seven cases reduces the meaningful number of unpaid awards to 224.

Adjustments to Unpaid Award Amounts

The Report states that 55 percent (approximately \$55 million) of the \$100 million awarded to customers in the 2001 awards studied was unpaid. We suggest that the amount of total damages awarded and the total damages unpaid also should reflect the pending motions to vacate and those decided in favor of the respondent, and the two awards paid after threat of suspension or denial of the motion to vacate. The result of excluding these cases is to reduce the total damages owed by \$4.2 million. With this adjustment, the damages remaining unpaid are approximately \$50.5 million out of \$96 million, or a total of 53 percent unpaid.¹⁰ Of course, this reduced figure is still entirely too high, and is of great concern to NASD.

Unpaid Awards in Context

As the GAO pointed out in its earlier 2000 Report, awards alone do not tell the entire story of investor results in arbitration and, in fact, represent only one of several ways investors can recover damages for their losses.

In 2001, NASD processed 3,499 public customer cases. Of these, nearly two-thirds were resolved without the need for an arbitrator to decide the matter. In over 55 percent of the cases that NASD closed (i.e., 1,927 cases), the parties agreed on a resolution, either through direct negotiation, mediation, or in a stipulated award. (See Exhibit 1 attached). These cases resulted in economic recovery for the investor claimants. Claimants withdrew another seven percent of the cases. NASD does not require investors to specify reasons for withdrawals, but it is likely that most of the withdrawn cases also involved settlements, and thus resulted in recoveries for the investor claimants.

⁹ The court denied the motion to vacate in the remaining six of the 17 cases listed by GAO as being subject to a motion to vacate. In each of these cases, NASD pursued suspension after the court denied the motion to vacate. Each of the involved firms and individuals has been suspended or terminated, and the underlying awards, totaling \$4.4 million, have not been paid.

¹⁰ Moreover, we note that several unpaid awards exceeded \$1 million. Specifically, the 11 largest unpaid awards, constituting less than five percent of the unpaid awards, all exceed \$1 million and comprise 42 percent of the unpaid damages total (\$21.2 million). These very large awards present a skewed picture of the results; this is demonstrated by the additional fact that the median unpaid award amount was approximately \$70,000, and nearly 60 percent of the unpaid awards involved less than \$100,000. Excluding these 11 large cases as statistical "outliers" further reduces the unpaid damages to 39 percent of the total dollars awarded.

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In sum, of the cases NASD closed in 2001, only 34 percent were resolved by arbitrator decision. Of the claims decided by arbitrators, 53 percent resulted in an award in favor of the investor. Accordingly, the combination of settlements and awards reflects that over 70 percent of the cases filed in the NASD forum in 2001 resulted in a disposition favorable to the investor. In effect, the damages awarded to investors in the 719 cases studied by GAO represent only a fraction of the compensation granted to investors through the NASD forum. When viewed in that context, the 224 cases in which a customer award was not paid represent about six percent of the 3,499 investor cases that NASD closed in 2001. The significant improvement over the 1998 results demonstrates that the measures NASD has implemented have been effective. And, since many of the cases in which awards were issued in 2001 were filed before these new initiatives were in place, we expect these positive effects to continue.

NASD's Regulatory Initiatives

In addition to the efforts of Dispute Resolution to address the problem of unpaid awards, NASD has implemented significant measures to promote the fairness and efficacy of NASD's arbitration system. These initiatives include restrictions on expungement of awards from the Central Registration Depository (CRD) system, prohibitions against use of NASD regulatory "close-out" letters in related proceedings (such as arbitration), preventing parties who have not paid arbitration awards from becoming members of NASD, enhanced reporting of civil and criminal complaints and arbitration claims, and the systematic review of new arbitration claims.

Expungement of CRD Records

In 2002, NASD worked to preserve the integrity and accessibility of its public records system. Specifically, in October 2002, NASD's Board of Governors approved a rule proposal limiting the removal of customer dispute information from the CRD.¹¹ The CRD system, which is operated by NASD's Regulatory Services and Operations Division, is the registration and licensing system for the United States securities industry and its federal and state securities regulators and SROs. NASD and the North American Securities Administrators Association (NASAA) jointly administer the CRD system. The new CRD policy will be implemented after NASD's rule proposal is reviewed and approved by the SEC.¹² It will make permanent a moratorium imposed in early 1999, requiring that a court must confirm any arbitration order before customer dispute information can be removed from CRD. In addition, NASD members and associated persons would be required to make NASD a party to a court proceeding seeking to confirm an arbitration expungement order. NASD will oppose attempts to confirm expungement awards unless the elimination of the information is based on findings by the arbitrators or judge that the subject matter of the claim or the information in the CRD system: (1) is without factual basis (i.e., is factually impossible or unclear); (2) fails to state a claim (i.e., fails to state a claim upon which relief can be granted or is frivolous); or (3) is defamatory in nature. NASD also proposes to include a process by which it will waive the requirements to be made a party if it determines that the expungement meets one of the above standards.

¹¹ NTM 01-65; NASD News Release, Oct. 1, 2002.

¹² NASD filed the proposed new rule (Rule 2130) with the SEC on November 19, 2002 and filed an amendment to the proposed rule with the SEC on January 28, 2003. On March 4, 2003, the SEC published notice of the proposed new rule for comments from interested persons. Securities Exchange Act Rel. No. 47435, 2003 SEC LEXIS 507 (Mar. 4, 2003).

Mr. William O. Jenkins, Jr.
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The goal of the proposed rule is to balance investor protection and the investor's ability to make an informed decision with the legitimate fairness issues of individuals.

Use of NASD Regulatory Policy and Oversight "Close-out Letters" in Related Proceedings

In 2002, NASD issued Notice To Members 02-53 indicating that it has revised the letters NASD sends to customers and members when a determination is made to close an investigation without disciplinary action. The revised letters now state that a determination by NASD not to take action against a member or a member's associated person has no evidentiary weight in any mediation, arbitration, or judicial proceeding. Further, the notice states that NASD considers it inconsistent with its conduct rules (just and equitable principles of trade)¹³ for a member or a member's associated person to attempt to introduce such a determination into evidence in any mediation, arbitration, or judicial proceeding.

NASD's decision to close out an investigation without further action can be the result of many factors unrelated to the merits of a complaint, such as jurisdictional limitations, the existence of an ongoing investigation, resource limitations, or a completed enforcement action by another regulator. Accordingly, NASD made clear that it is unethical and misleading to suggest to an arbitrator, mediator, or adjudicator that NASD's decision not to pursue an investigation is probative evidence in a dispute on a related claim.

Preventing Parties with Unpaid Awards from Becoming Members of NASD

In January 2003, NASD proposed rule amendments that strengthen NASD's authority to preclude firms from using structural changes to avoid meeting their arbitration obligations to investors by enhancing the authority to screen membership applications. NASD has filed with the SEC a proposed rule change to amend NASD Rule 1014 to clarify the current standards of membership admission.¹⁴ The amendment would specifically allow consideration of the existence of unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims, when reviewing membership applications.

Enhanced Reporting of Criminal and Civil Complaints and Arbitration Claims

In August 2002, NASD filed with the SEC a proposed rule change to amend NASD Conduct Rule 3070 to broaden the reporting requirements. The SEC approved the proposed rule change on March 3, 2003.¹⁵ The rule change requires members promptly to file copies with NASD of certain criminal and civil complaints and arbitration claims filed in other forums against a member or a person associated with a member. The purpose of the rule change is to improve the quality and flow of information to NASD with respect to allegations of broker misconduct, so that NASD can enhance investor protection efforts by promptly taking appropriate regulatory action to address the specific alleged misconduct and to prevent similar or related misconduct in the future.

¹³ NASD Conduct Rule 2110.

¹⁴ File No. SR-NASD-2003-007, filed January 16, 2003.

¹⁵ Securities Exchange Act Rel. No. 47434 (Mar. 3, 2003).

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Review of New Arbitration Claims

In June 2002 NASD's Regulatory Policy and Oversight Division began a review of new arbitration claims as part of its effort to spot trends early that adversely impact investors. These measures, combined with the continued impact of the initiatives described above, should improve future award payment results.

GAO Recommendation Regarding Web Site Information

The Report recommends that NASD Dispute Resolution make available on its Web site current statistics showing the frequency with which arbitration awards against defunct brokers are not fully paid. The NASD Web site currently contains information helpful to investors by highlighting the difficulty in using NASD enforcement procedures to force payment when a firm or broker is out of the securities business. In addition, our Web site provides a direct link to the GAO Web site and the information needed to obtain the 2000 Report on unpaid awards. As GAO suggests, we will consider additional ways to enhance the education of investors about the problems associated with terminated members and the payment of awards. NASD strives to strike a balance of disclosing information while not discouraging investors from filing valid claims. With that concern in mind, we will develop an approach to enhance the data available to investors to enable them to make more informed decisions about whether to pursue a claim.

GAO Recommendation for a Feasibility Study

The problem of terminated or defunct firms failing to fulfill monetary obligations is not unique to the arbitration process. As in 1998, over 80 percent of the 2001 cases in which awards were unpaid involved a terminated broker-dealer or associated person. Thus, the same collection problems would exist if investors brought their complaints in a civil court proceeding: it is very difficult to collect funds from a defunct or bankrupt entity that has little or no assets. Nevertheless, NASD believes that, because the securities arbitration process is part of an overall regulatory system, it should strive to provide mechanisms that are more effective than the civil court system in these circumstances. The GAO proposes bringing together expertise from many interests (such as the Securities and Exchange Commission, self-regulatory organizations and other regulators; investors; brokerage firms; and registered representatives) to address the problem. NASD welcomes the opportunity to participate with the GAO, Congress, the SEC, other SROs, and other interested parties to consider appropriate means to address the problem of unpaid awards. Such a group could assess the feasibility of some of the alternative approaches noted by the GAO in the 2000 Report such as:

- o A change in the net capital rule;
- o Insurance or bonding requirements; or
- o Expanded SIPC coverage or a separate SIPC type of fund for unpaid arbitration awards.

In addition, NASD believes the participants should include consideration of changes to the Bankruptcy Code or requiring bonds at the time claims are filed for firms with marginal net capital reserves or with a questionable regulatory history.

NASD recognizes that any proposed solution has positive and negative aspects and must fit within the overall regulatory scheme protecting the investing public. Some approaches will involve legislative solutions. Others will require regulatory changes that will invoke the formal

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rule-making apparatus of the Administrative Procedure Act. Still other improvements will require various entities to change internal procedures and systems. As GAO recognizes, solving the problem of unpaid arbitration awards at this juncture goes beyond the scope of NASD's authority, and will involve a broad coalition of participants.

II. Initiatives Related to Arbitrator Disclosure

The new GAO Report notes NASD Dispute Resolution's improved procedures to monitor the receipt and entry of arbitrator update information. In recent years, NASD Dispute Resolution has instituted numerous changes responsive to recommendations contained in prior GAO reports such as:

- o Establishing formal arbitrator qualification standards;
- o Creating a training requirement in 1993 and a testing requirement in 1998 for new arbitrators;¹⁶
- o Periodically collecting questionnaires from all members of the arbitration roster to verify the accuracy of their background and experience;
- o Instituting the Neutral List Selection System (NLSS), in November of 1998, which gives the parties significant control in the selection of their panel; and
- o Creating in 1999 the Director of Neutral Management position with central responsibility for all neutral qualification and maintenance issues.

In 1999, the NASD staff updated the records of over 6,500 arbitrators based on the arbitrators' responses to a November 1998 questionnaire, and eliminated from the roster arbitrators who failed to respond to the questionnaire. Dispute Resolution senior staff members conduct regular audits to ensure that the staff inputs in a timely manner important updates provided by arbitrators.

NASD Dispute Resolution recognizes the importance of updating its arbitrator records in a timely and accurate manner. We believe that when parties consider an arbitrator for possible service, they should have information that is up-to-date, correct, and relevant. To strengthen our procedures in this area, Dispute Resolution took the following actions to supplement its existing efforts:

- o *Centralized Roster Maintenance Function:* Beginning in November 2000, the Department of Neutral Management, located in New York City, became solely responsible for updating and revising arbitrator records. This centralization makes record maintenance easier to control and reduces the possibility of errors.
- o *Online Update Form:* Since November 15, 2000, arbitrators have been able to update their records online via NASD Dispute Resolution's Web site. We have

¹⁶ We have revised and updated the arbitrator training program and materials several times since 1993.

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designed an easy, step-by-step form that allows arbitrators to update their information and to submit it electronically to the Department of Neutral Management.¹⁷

- *Exchange of Arbitrator Disclosure Reports:* Since November 1, 2000, arbitrators serving on three-person panels receive a copy of the disclosure reports of their fellow arbitrators. This practice gives arbitrators a better understanding of the expertise and background of the people with whom they are serving, and encourages panel members to consider the disclosures made by other arbitrators and to make similar disclosures themselves.
- *Redesign of the Computer System:* NASD Dispute Resolution has begun an ambitious project to redesign its legacy computer system. The new system, (MATRICS¹⁸), will be implemented in phases over the next few years and will feature a web-based gateway for parties, counsel, arbitrators, mediators, and staff. Among other things, the new system will enable neutrals to access and update their own records on our system.

As noted in the GAO Report, NASD in March 2001 amended the Code of Arbitration Procedure to allow NASD to remove an arbitrator from a case after a pre-hearing conference or a hearing has started.¹⁹ The removal can only be based on new information that was not known to the parties at the time of the arbitrator's appointment, but that the arbitrator should have disclosed under NASD rules. The authority to remove an arbitrator at these stages can only be exercised by the President of Dispute Resolution or the Director of Arbitration; it cannot be delegated.²⁰ This new power enhances our ability to enforce the requirement that arbitrators make all required disclosures to parties.

III. The Use Of Motions to Dismiss and Motions for Summary Judgment in Arbitration

The GAO Report also reviews the use of dispositive motions, such as motions to dismiss or for summary judgment, in arbitration. NASD's rules do not prohibit parties from filing dispositive motions; nor do they prohibit arbitrators from granting them. And, as GAO notes, courts have consistently recognized NASD arbitrators' authority to rule on dispositive motions. Nevertheless, as the GAO Report concludes, dispositive motions are rare in NASD arbitrations.

We fully agree with the GAO Report that parties deserve the opportunity to be fully and fairly heard. NASD attempts to provide procedural safeguards by administratively managing this motion practice to ensure that each side gets a fair opportunity to be heard on any matter presented to the arbitrators. Our administrative procedures and arbitrator training focus on providing that opportunity. While arbitrators may address such motions prior to the beginning of a hearing, the arbitrators always accept arguments from all sides, either through written

¹⁷ Arbitrators may also print the form, complete it by hand, and fax or mail it to the Department of Neutral Management.

¹⁸ MATRICS is an acronym for Mediation and Arbitration Tracking and Retrieval Interactive Case System.

¹⁹ Code of Arbitration Procedure, Rules 10308(d)(2) and 10312(d)(2).

²⁰ As the GAO Report notes, NASD exercised this authority nine times in 47 instances from March 2001 through the end of 2002.

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submissions or oral argument, before ruling. Further, the full panel is always involved in these decisions. We allow the parties to practice advocacy as they choose and try to provide a fair and efficient mechanism to assist the parties in reaching a resolution.

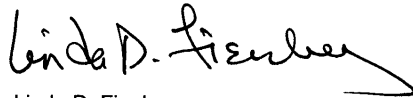
IV. Conclusion

We concur with GAO's findings about the efficacy of NASD's arbitrator disclosure process and with its findings concerning dispositive motions. We are pleased that the many steps we have taken to improve these processes have been effective.

The scope of the unpaid award problem has diminished significantly since 1998. NASD Dispute Resolution's initiatives and the changes implemented by NASD's Regulatory Policy and Oversight and Regulatory Services and Operations Divisions should result in continuing improvement. Nevertheless, as the GAO notes, regardless of how effective and fair the arbitration process may be, unpaid awards can erode investors' confidence in arbitration and in the securities markets. Further, the vast majority of broker-dealers, which meet their award obligations fully, are harmed by the unscrupulous practices of a very small number of firms, which do not. When investors expend the time, effort, and resources to pursue a claim, it is critical to the integrity of the process that arbitrators' awards be satisfied. An effective dispute resolution process is an integral part of an efficient marketplace, and new measures to prevent the problem of unpaid awards should be part of the larger effort to restore investor confidence.

Thank you for the opportunity to respond to the GAO Report and to work with your staff to help fashion responsive initiatives. If you have any questions or require further information, please contact me at (202) 728-8407.

Very truly yours,

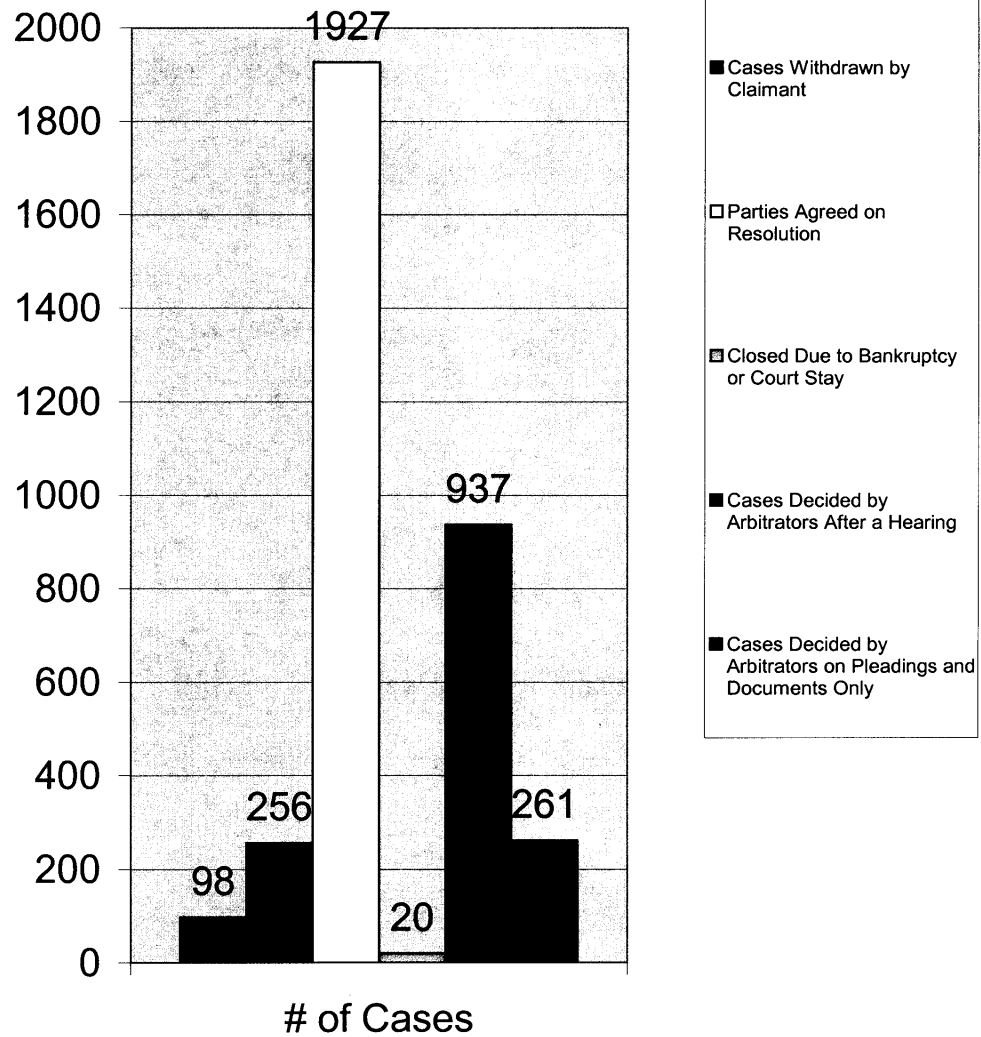


Linda D. Fienberg
President

cc: Orice M. Williams - GAO
David Tarosky - GAO
Robert Love - SEC

Exhibit 1

**How Investor Cases
Closed
2001**



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