

SECURITIES ARBITRATION DATABASE

EXECUTIVE SUMMARY

Securities broker/dealers require that all of their customers agree to arbitrate any disputes with the brokerage firms. If a securities broker steals money from a customer account, engages in churning of the account, or recommends unsuitable investments, the customer must file an arbitration to get redress.

State securities regulators have long been concerned as to whether the arbitration process is fair to investors. The problem is that regulators lacked a means of evaluating the fairness of the process. In July of 2006, State securities officials arranged to get copies of all arbitration awards and had them delivered to the Utah Division of Securities. The 22 boxes of awards reflected all arbitrations from 2000 to 2005.

The Utah Division of Securities first asked a vendor to create a database application that would allow some of the data from the awards to be captured and analyzed using an existing investigations software program. The shortcomings of this system quickly became apparent.

The Utah Division of Securities asked representatives of the Department of Technology Services (DTS) for ideas on inputting, formatting, and analyzing the arbitration award information. DTS employed a masterful approach in recommending and implementing a solution. Once the Division chose an approach, the DTS team made assignments to various employees to address the needs. Most of the development work fell to the database designer. Within two months, a beta model was being tested, and a month later, data input began.

Already, data from all 2005 arbitration awards have been input and analyzed. By early summer 2007, data from all six years will be undergoing analysis. Some results are consistent with expectations, while other results have yielded surprises.

Most important, the Division has the ability to review information it would not otherwise have seen, such as: what types of claims are most likely to succeed; which brokerage firms have claims filed against them most frequently; what are the most common types of problems (signaling where auditors should focus their attention); and, what patterns of improper conduct exist (such as agents asking to have their records expunged when large awards were entered against them).

DESCRIPTION OF PROJECT

Descriptions of the Business Problem

The Utah Division of Securities, along with the securities regulators from all states, was worried about the integrity and fairness of the securities arbitration system. Since 1987, all customers of brokerage firms have been required to arbitrate their complaints against securities broker/dealers, rather than filing suit in court. The arbitration system is run by the NASD (National Association of Securities Dealers), a trade association whose members are the brokerage firms handling customer accounts. To make matters worse, NASD rules require that at least one of the three arbitrators hearing most customer complaints must be a member of the securities industry.

A committee of state securities regulators decided to determine whether the arbitration process was fair. The group wanted to know whether information given by NASD about arbitrations was accurate and what impact the industry arbitrators had on the awards given to investors. The regulators persuaded NASD to provide copies of all arbitration awards from 2000 to 2005—about 10,000 awards. The copies were sent to the Utah Division of Securities.

Initially, the Securities Division attempted to create a spreadsheet for the information, but it became clear that that method would not capture the information needed or permit viable analysis. Next, the Division asked its outside consultant (who had created its investigative database) to design changes to the database to allow the input and analysis of this information. However, defects in this approach became apparent when the Division kept wanting to add functionality, and when other states offered to assist in inputting arbitration information. In October 2006, the Division came to DTS, asking for a solution.

Purpose and Objectives

The arbitration database was conceived as a means of testing the validity of assumptions underlying public policy positions and to guide future policy decisions. Because there is so much public debate about the fairness of private arbitration, policy makers from Utah and the association of all state securities regulators were looking for empirical evidence to guide their policy decisions.

The objective was to record information about every arbitration decision from a six-year period to produce a database of empirical information about multifarious aspects of arbitration. Policy makers could then analyze the arbitration system to determine the success rates for claimants, the average size of awards, the average portion of claim being awarded, the effect on award size of the presence of industry-sponsored arbitrators, and how the awards may be affected by the size of claim, size of firm, and the alleged misconduct.

Solution Description

DTS assembled a team to evaluate the Division's needs and to consider possible solutions. The team started with the goal of working within several parameters: making the database available for input by analysts in multiple states; providing adequate security for the information; ensuring robust analytical capability; and creating a system that could incorporate information already input under the previous system. DTS employed a masterful approach in recommending and implementing a solution. Once the Division chose an approach, the DTS team made assignments to various employees to address the needs. Most of the development work fell to the database designer.

By December 2006, DTS had a beta model of the database ready for testing. By January 2007, analysts from several states were inputting information. The Web-based system allowed analysts to input data from any location. Temporary employees input data from college campuses and home computers, while others input data from the offices of state securities regulators.

The site proved to be exceptionally well designed, was visually appealing, and intuitive, allowing for easy input of information. It was designed to minimize errors and omissions through the use of pop-up messages indicating information that was omitted or entered incorrectly. Analysts were given the ability to correct errors, but could not alter another's entries, while supervisors could review information and make corrections.

All 2005 data has been entered and is undergoing analysis. By early summer of 2007, all award data from 2000 to 2005 will be entered.

Length of Time in Operation

Data input began in January 2007. By April 2007, all data from arbitration awards concluded in 2005 were entered and some preliminary analysis was conducted. It is expected that all data from 2000 to 2005 will be entered by the summer of 2007. Data entry will continue for awards from 2006 and later.

SIGNIFICANCE TO IMPROVED GOVERNMENT OPERATION

Operational Maturity

The information derived from this project will provide securities regulators with information they had no way of knowing before. That information, in turn, will enable the regulators to focus their attention on brokerage firms that are causing the most problems, and tailor their audits so that they can detect those firms with inadequate compliance procedures for the products causing the most problems.

Predictable Results

The project is already providing analytical information to the Division. Of the 1,572 arbitration claims resolved in 2005, the Division already has been able to determine that 655 (41.67%) resulted in some award being given to the customer. The Division knows how many were awarded, which types of damages and fees, the average size of the award, what improper conduct led to the award, and which firms are the subject of the most claims and awards. Further analysis will reveal whether these results are consistent with the results of prior years and enable the Division to identify problem areas.

Cost Effective Development

This project was developed using the agency's in-house Web Services Coordinator and an outside consultant retained by the Securities Division. All costs of design, development, testing, and implementation were completed within the existing agency budget and no additional appropriation was required.

Reliability and Timeliness

The database was delivered on schedule and has proven extremely reliable in its operation, with no down time since it became operational.

PUBLIC VALUE OF THE PROJECT

Stakeholder Participation

Involvement of the Division of Securities was intense. In initial strategy meetings, the Division discussed the documents they had obtained about arbitration awards and identified what they would like to learn. Ideas were exchanged about possible ways of extracting and analyzing data. DTS employees shared their knowledge ideas based on the programs already in use in the Department, the capabilities of off-the-shelf software programs, and their technical capabilities to build a custom database. Ideas were exchanged about the disadvantages and advantages of a custom system, which design language to use, whether to make it Web based, and what types of functionalities would be best.

As ideas were exchanged, the possibilities were narrowed. Additional meetings with the Division resulted in common agreement on a design concept. At that point, a meeting was held with the Division and six different DTS employees, each of whom had specialized knowledge. The concept was refined at this meeting. At subsequent meetings with the Division, DTS employees reported back on their work in accomplishing their assignments and the pieces were assembled.

For the final design work, the DTS employee tasked with creating the custom database met and conversed frequently (generally many times daily) with the Division's point person to get information about the Division's needs and to verify approval of each phase of the project.

Public Policy Benefits

With this database, the policy makers will have empirical data which can be used to: test the validity of long-standing assumptions about the adequacy of arbitration as a forum for resolving customer disputes; measure the effect and effectiveness of recent changes to arbitration procedures; identify deficiencies in the arbitration process that need further changes; set new policies in public statements and recommended rules that accurately reflect the realities of the results of arbitrations; have demonstrable, empirical evidence that will bolster the effectiveness of their public pronouncements and recommendations for policy changes; identify which types of misconduct are most frequently encountered by customers and address those through public education, requiring broker/dealer firms to enhance their supervisory and compliance procedures, and through conducting examinations of firms that will target the problem conduct; and, find evidence to assist in resolution of other policy disputes, such as whether securities agents are improperly requesting expungements of arbitrations after being found responsible for a client's losses.

Supporting Client Services

Information from the database provides securities administrators with additional information in the discharge of their audit and adjudicating responsibilities. This will aid them in assuring fairness in audits and in determining where there may be abuse in the securities industry needing additional attention.

State and Agency Benefits

The most significant—and immeasurable—value of this project is that regulators will possess data that can be used to test the validity of their inchoate concerns about the effectiveness of arbitration as a means of resolving customer disputes. This information will be used to guide the public debate and legislative recommendations to Congress.

A second, yet still important, value of the project is that it will enable regulators to improve the efficacy of their regulatory process by moving from a random spot check of firms to a risk-based program. This will allow regulators to examine firms for compliance audits based on the firms' demonstrated propensity to engage in abusive practices and specific types of conduct. In other words, this application allows regulators to identify problems that otherwise might have been missed in a random spot check.

For government, the securities regulators will be able to identify more violative conduct with the same number of employees. For brokerage firms that are being audited, the auditors will need to spend less time at the firm because the absence of problems will be apparent more quickly (and, conversely, the existence of problems can be identified promptly). At the same time, all brokerage firms will have increased respect for the regulators as the firms recognize their technical skills. For the public (taxpayers), they will have increased confidence that public monies are being spent appropriately.

REALIZED RETURN ON INVESTMENT

Adoption

By early summer of 2007, the database will contain all arbitration award data from 2000 to 2005. Entry of data will continue each year to develop an historical repository of NASD information for continual evaluation. Three states have been actively involved (Illinois, Wisconsin, and Utah) and three other states have been involved in a limited basis (Massachusetts, New Jersey, and Texas).

Savings and Cost Avoidance

As this was a customized application developed internally and within existing agency budgets, the agency avoided the cost of attempting to locate and retain qualified outside resources. This approach eliminated the time and costs associated with preparing RFIs, RFPs, completing the bid process, etc.

Return on Investment

Although difficult to determine in terms of dollars and cents, the information developed from this application will, over the long term, help to direct State security administrators to isolate problematic areas, and make best use of their limited resources in auditing and regulating questionable areas. This leads to enhanced industry compliance, a healthier securities environment, and increased confidence in the profession and from the investing public.

Continuing Operational Benefits

When all data is entered, security regulators hope to detect any trends that might cause concern and can evaluate the effects of some of the procedural changes that have been implemented since 2000. The states will have the most current and complete information, as well as historical data for their use in analyzing awards. In addition, this information will be used to guide the public debate and legislative recommendations to Congress regarding the securities and investment industry. The regulators expect to continue using this database for many years; perhaps decades.