post-gazette.com **Business News**

Pittsburgh, Pa.
Sunday, July 17, 2005

Heard Off the Street: System for resolving disputes may need an overhaul

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By Dan Fitzpatrick, Pittsburgh Post-Gazette

The wailing and gnashing of teeth over fortunes investors lost during the three-year bear market are a fading memory. What remains is the system for resolving disputes between those investors and their brokers, a system many say sorely needs to be overhauled.

Most investors who feel they have been wronged by their brokers must submit disputes to arbitration under the terms of agreements they sign when opening an account. It's been that way since 1987 when the U.S. Supreme Court upheld the validity of those contracts.

In theory, arbitration made sense. It was supposed to be cheaper, faster and less complex and intimidating than going to court. The NASD, the regulator that handles most arbitration cases, still sees it pretty much that way. While NASD acknowledges the need for some improvements, the industry group (formerly the National Association of Securities Dealers) believes the system works.

"Roughly three out of every four investors who bring an arbitration claim are awarded some amount of compensation," NASD attorney Linda D. Fienberg told members of a U.S. House subcommittee in March.

The panel heard from other witnesses whose testimony was liberally spiced with words like "rigged," "flawed" and "stacked."

Not all of the dissenters were firebrand lawyers chasing clients. One was a vote-seeking Democrat. Massachusetts Secretary of State William F. Galvin testified that mandatory arbitration "is fundamentally flawed and stacked against the individual investor."

Daniel Solin, an attorney and author of a book called "Does Your Broker Owe You Money?" told subcommittee members investors have "an exceedingly small statistical possibility" of recovering meaningful damages. Solin cited the case of one of his clients: a retired, divorced nurse whose broker turned her $1.3 million nest egg into less than $400,000. NASD arbitrators awarded her $5,000, then charged her $5,600 for the expense of hearing the case.

One of the biggest issues is the arbitrators themselves. While investors have a say about who hears their case, critics say the choice is limited because NASD decides who can be an arbitrator. According to Galvin's testimony, former NASD arbitrator John J. Mark told state securities regulators last year "the word on the street is if you rule against the [brokerage] houses, you will be removed."

In NASD cases involving claims exceeding $50,000, there are three arbitrators: one from the industry and two who are public, although "public" arbitrators frequently have spent part of their careers in the securities industry. Galvin says that's tantamount to having General Motors, Ford and Chrysler oversee disputes between car buyers and car dealers.

The Public Investors Arbitration Bar Association -- lawyers who represent investors who believe they've been wronged -- supports getting rid of the industry arbitrator. So does Les Greenberg, a Culver City, Calif., attorney who has been an NASD arbitrator since 1976 and has represented investor and industry clients during NASD hearings. But a proposal Greenberg submitted to the Securities and Exchange Commission in May goes much further.

Greenberg wants arbitrators to be able to research issues on the legal aspects of cases they hear, something he says they are currently prohibited from doing. He wants NASD and the New York Stock Exchange, which handles far fewer than the 9,000 cases NASD administered last year, to train arbitrators in relevant law and evaluate their performance.

If the SEC doesn't go along with getting rid of the industry arbitrator, Greenberg wants information that arbitrator provides to the other two arbitrators to be shared with both sides, something that currently doesn't happen.

Finally, Greenberg wants the SEC, which oversees the rules NASD develops for regulating itself, to take a more active interest in how the NASD administers arbitration cases.

"The NASD arbitration process and purported SEC oversight thereof constitutes a sham upon the investing public," Greenberg told the SEC.

NASD, which says it's doing a better job of training and evaluating arbitrators, declined comment on Greenberg's proposal. The agency recently submitted a proposal of its own: making written explanations of arbitrators' rulings available if investors asked for them in advance and agreed to pay $200 for them.

A handful of other observers have submitted comments that support Greenberg's proposals with various levels of ardor.

The reforms "would go a long way toward creating balance" in a system that is stacked against shareholders, James McRitchie of **CorpGov.net**, an online forum for corporate reform, wrote the SEC.

David Plimpton, a Maine attorney who has been involved in about 70 NASD arbitrations, told the SEC the system is "usually fair to both investors and the securities industry." However, Plimpton supports more training, better evaluation of arbitrators and fuller disclosure of information provided by industry arbitrators. He also thinks arbitrators should be better paid.

The March hearing and Greenberg's online survey of more than 1,000 NASD arbitrators demonstrates a need for change. Just what the SEC, whose leadership has come under scrutiny for its own close ties to Wall Street, will do remains to be seen.

The start of the workweek at PNC Financial Services Group will bring relief for some workers and anguish for others as the area's largest bank prepares to drop the ax on a portion of its 24,500-person payroll.

"Everyone, everyone is afraid they are going to lose their jobs," one worried bank employee said last week.

More than jobs are at stake, however. PNC's prestige -- and the future of Pittsburgh's once-dominant banking scene -- is also on the line.

The cost cutting is part of a larger initiative, called "One PNC," designed to lower expenses, identify new revenue opportunities and improve profitability -- all strengthening the bank's efficiency relative to its peers. The Tuesday announcement, coinciding with the release of second-quarter earnings, also is part of the bank's strategy to keep pace with larger and more formidable rivals, many of which have passed it in size over the last decade, and perhaps to allow PNC to reclaim some of its lost glory.

Only two decades ago, PNC was a rising star and darling of the industry, having engineered the 1983 blockbuster merger of Pittsburgh National and Philadelphia's Provident National, at the time the largest U.S. bank merger in history. PNC symbolized a new breed of super-regional banks -- like

Columbus, Ohio-based Bank One, NCNB Bank in Charlotte, N.C., and Minneapolis-based Norwest -- busting out of their traditional borders and acquiring other banks across state lines.

It was all part of a sweeping shift in banking, ensuring that the industry would no longer be dominated exclusively by New York and San Francisco.

After gobbling up the second-largest bank in Kentucky and the largest in Cincinnati, PNC eventually claimed a spot as the country's 11th-largest bank, having surpassed legendary crosstown rival Mellon Bank, itself one of the world's largest banks in the decades after World War II.

Somewhere along the line, though, PNC lost focus.

While super-regionals NCNB, Bank One and Norwest went on to become part of the nation's No. 2, No. 3 and No. 5 banks -- Charlotte-based Bank of America, New York-based JPMorgan Chase and San Francisco-based Wells Fargo, respectively -- PNC slid to No. 17 (up one spot in 2005 due to its acquisition of Washington, D.C.'s scandal-tarnished Riggs Bank), watching as a wave of consolidation relegated it to the status of minor player nationally.

With $89 billion in assets, PNC now is smaller than in-state rivals Citizens Financial Group, the Providence, R.I.-based banking subsidiary of Royal Bank of Scotland that purchased the former Mellon retail banking operations in 2001 and has $141 billion in assets in the United States, and Cleveland-based National City Corp., with $140 billion in assets. And it is far below the industry's big five banks in New York, Charlotte and San Francisco, three of which are now trillion-dollar institutions.

"Seven, eight years ago I called (PNC) the 'Beast of the East,' " said Arnie Danielson, a Rockville, Md., banking consultant who follows PNC and other major banks in the Northeast. "Right now, I think of it as a bank that is definitely falling behind."

Another analyst, Dick Bove, a St. Petersburg, Fla.-based banking analyst for Punk, Ziegel & Co., added: "I think it's true the industry has passed it by.

"That doesn't mean to say it's irrelevant."

Indeed, PNC is still strong in Pittsburgh -- No. 1 in market share with 26 percent, followed by National City at 17.7 percent. But at the same time, it is faltering elsewhere.

Citizens Bank, No. 3 in Pittsburgh with 12 percent of the market, is beating PNC "badly" in New Jersey, Philadelphia and other parts of the Northeast, according to Danielson. The Royal Bank of Scotland is an "800-pound gorilla ... sitting all over their territory," Danielson said.

In fact, Royal Bank of Scotland now has a 6.2 percent share of the market in a geographic area that includes New England, New York, New Jersey and Pennsylvania -- compared with PNC's 3.2 percent.

Because of its size, PNC now has virtually no chance at reaching the industry's upper tier, according to analysts, barring some sort of super-combination with like-size regional banks from around the country.

PNC may not even be able to survive much longer as an independent, stand-alone bank. Several analysts are convinced that PNC is now a potential target of Charlotte-based giant Wachovia Corp., the nation's fourth-largest bank that is considered to be hungry for another acquisition.

"PNC is the best fit for them," Danielson said.

Bove agreed. "Wachovia would be a good acquirer. A lot of people think

Wachovia will acquire PNC to broaden its base in the Northeast markets."

Other possibilities, according to Bove, include:

- Minneapolis-based US Bancorp, the nation's 7th-largest bank that is considered the most likely buyer after Wachovia.

- No. 5 Wells Fargo, which may try to buy PNC if it thought it could get the bank at a good price -- or, in Bove's words, "on the cheap."

- No. 6 HSBC, a London-based foreign-owned bank that wants to penetrate U.S. markets and could use PNC's franchise in the Northeast.

PNC Chief Executive Officer Jim Rohr has repeatedly stated his desire for the bank to remain independent, saying as recently as April in an interview with the Post-Gazette that "we certainly would not want to be sold."

But Miami-based banking expert Ken Thomas argues that "every bank always has a for-sale sign on it. You or I can't see it. But other banks see it. ... At some point, it is very likely that banks like Mellon and PNC, the way consolidation goes, will be bought. This is just part of the life cycle of banking."

How did PNC get itself in this position -- that of bit player nationally? How did the rest of the industry, as Bove put it, pass it by?

The consensus opinion is that PNC hunkered down and got defensive, licking wounds from a number of stumbles in the late 1980s, mid-1990s and early part of this decade. Bad real estate loans. Bad bets on interest rate investments. Questionable accounting and record-keeping practices that put it under regulatory oversight.

Meanwhile, regional rivals made big, risky moves.

"It's not as much what they did wrong as what they might have done that could have been better," Thomas said. "It is more what the other banks did right -- not so much what PNC did wrong."

But Bove was a bit harsher in his appraisal, saying that the bank "followed too many fads."

The banks that passed it by "stuck with their concept to be empires" through multiple acquisitions. PNC started with the same thesis, he said, but then changed course a decade or so ago to become more of a fee-based business, acquiring a large share of New York money management firm BlackRock and PFPC, a mutual-fund processing firm. Both generated fees based on the level of business they did. At the same time, PNC started selling off parts of its lending division and whittling down its portfolio.

Its strategy wasn't all that unusual. A number of banks in the 1990s pursued fee businesses such as fund processing and management as a way to lessen the volatility of cyclical swings on the lending side of the business. Fees were thought to be steadier and a growing source of income amid Wall Street's meteoric rise in the '90s. Indeed, neighboring Mellon went so far on the fee front as to sell its retail banking operations to Citizens.

In retrospect, however, the approach taken by PNC "was a huge mistake," Bove said. When the stock market collapsed in 2000 and continued to falter for the next two years, profits dissolved on the fee side of the business and exploded on the traditional banking side.

Neighboring Mellon was hurt, too, but by then, it had become so big in the money management fee business by virtue of its acquisitions years earlier of mutual fund giant Dreyfus and mutual funds service firm The Boston Co.

that it was better able to weather the storm.

Mellon "zigged when it should have zagged," Bove said. "It got out of retail banking at the exact moment it should have been expanded. And "it paid the price." Mellon, the world's fifth-largest bank in 1946, is now No. 33.

But it was not hurt nearly as much as PNC. Bove nonetheless credits PNC for moving quickly to right itself over the past five years by pushing retail banking services and working harder to promote lending to individuals and businesses.

PNC "took this ship and completely turned it around," Bove said. "That is a significant change. It is no longer attempting to be the best fee-based bank or emulate Mellon. They are now trying to emulate what Citizens is doing."

With the focus back on traditional banking and the competition for new customers tightening, PNC knows that it has to get its costs down to survive and fend off larger rivals in its backyard.

The amount it spends to generate a dollar of revenue -- 63 cents -- is well above industry rivals. Tuesday's announcement, which will include cuts and strategies for new revenue, is about improving the bank's efficiency and improving earnings.

Analysts applaud the move but note that such an initiative is common among financial institutions. Thomas, the Miami banking expert, said the announcement may be a way for PNC to soften criticism that it paid too much this year to acquire Riggs Bank.

"Banks do this all the time," he said. "A lot of times they do this after major expansions, especially one that may have been questioned. 'Now we have an opportunity to justify to investors and Wall Street that we are still bottom line conscious regardless of what we paid for the bank.' "

Some within PNC also view the initiative as a way to make the bank stronger and perhaps position it for future acquisitions.

Analysts, though, said that PNC is only big enough to acquire smaller banks that improve PNC's existing position -- as opposed to an industry-shattering acquisition that would catapult PNC to the upper tier.

Danielson, the analyst based in Maryland, sees PNC looking to the Northeast, especially after its foray this year into the highly competitive Washington, D.C., market. But he believes such a strategy is misguided. PNC, he said, should focus on the areas it dominates -- such as Pittsburgh.

"I think there is more money to be made in Pittsburgh," he said. Expanding to the East instead of westward into Ohio and other markets is "probably a mistake."

(Len Boselovic can be reached at **lboselovic@post-gazette.com** *or 412-263-1941. Dan Fitzpatrick can be reached at* **dfitzpatrick@post-gazette.com** *or 412-263-1752.)*

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