Michael R. Weissmann
Tel: 617-951-8705
Fax: 617-951-8736

April 10, 2008

Nancy M. Morris
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: FINRA Rule Proposal -- SR-FINRA-2007-021

Dear Ms. Morris:

I write to comment on the rule proposal submitted by the Financial Industry Regulatory Authority ("FINRA"), SR-FINRA-2007-021 (the "Proposal"), seeking the Commission's approval to adopt a new rule and amend related rules pertaining to motions to dismiss in FINRA arbitrations. Now in its third iteration, the Proposal is far too restrictive and FINRA has given inadequate consideration to the costs and burdens imposed by the new rule. Limiting dismissals to instance in which the claims have been settled or where the broker-dealer or associated person "was not associated with the account(s), security(ies), or conduct at issue" would unfairly force broker-dealers to bear the expense of participating in an evidentiary hearing, at least through the end of the claimant's case-in-chief, even when the law clearly bars the claims or provides no basis for the claimant to recover damages. In attempting to deal with supposed abuses in current motion practice, FINRA has gone too far and proposes rules that will complicate, rather than simplify, the arbitration process by allowing cases without merit to proceed at least until the claimant has completed the presentation of his or her case.

Three particular situations illustrate the overly restrictive nature of the Proposal. In each instance the law requires dismissal based on facts that are available at the outset of the proceeding, without the need for discovery, pre-hearing conferences, or for the panel to hear evidence. In these instances, Proposed Rule 12504 will actually undermine FINRA's objective of promptly and efficiently resolving arbitration cases.

First, the rule makes no accommodation to dismiss and, therefore, provides no finality to claims that have already been tried and decided in an earlier proceeding. Under the law, the principle of *res judicata*, states that once a claim or issue has been adjudicated by a suitable tribunal, the parties are entitled to rely on the decision. While they may appeal the decision, the parties are not permitted to "collaterally attack" the tribunal's decision by starting a new action in which they seek to relitigate the same claim or facts. *See* BLACK'S LAW DICTIONARY 1305 (6th ed. 1990) (res judicata defined as the "[r]ule that a final judgment rendered by court of competent jurisdiction on the merits is conclusive as to the rights of the parties and their privies, and, as to them, constitutes an absolute bar to a subsequent action involving the same claim, demand or cause or action."); *Bear, Stearns & Co., Inc., v. 1109580 Ontario, Inc.*, 409 F.3d 87, 91 (2d Cir. 2005) (holding that an arbitration award can have preclusive effect) (*citing Postlewaite v. McGraw-Hill, Inc.*, 333 F.3d 42, 49 (2d Cir.2003). This principle promotes efficiency, by eliminating

Boston
Hartford
Hong Kong
London
Los Angeles
New York
Orange County
San Francisco
Santa Monica
Silicon Valley
Tokyo
Walnut Creek
Washington

Bingham McCutchen LLP
150 Federal Street
Boston, MA 02110-1726

T 617.951.8000
F 617.951.8736
bingham.com

the need to expend resources trying the same case multiple times, and finality to the tribunal's decisions.

By allowing motions to dismiss when the claims alleged have been the subject of a prior settlement, the rule proposal recognizes that resolved cases should not be litigated. There is no reason in logic or law for claims that already have been litigated and decided not to be similarly dismissed at the pleading stage without requiring the parties to go through an evidentiary hearing. Where a customer and his broker-dealer have already arbitrated a set of facts or a particular claim and an award has been rendered, the case should be over. Under the Proposal, if the claimant elects to bring the same or similar claims again, he or she could do so. The broker-dealer, unable to show that it is not associated with the accounts, securities, or conduct, would have no recourse but to wait until the end of the claimant's case to move for dismissal. This is fundamentally unfair, a waste of resources, and contrary to universally accepted legal norms.

Second, the rule proposal does not allow motions to be filed based on statutes of limitations. Like the six-year eligibility rule -- regarding which prehearing motions to dismiss are expressly allowed -- statutes of limitations bar claims that are filed after the limitations period has run. Like *res judicata*, statutes of limitation promote efficiency and fairness in that they require claimants to assert their claims promptly, making it more likely that witnesses will still be available, documents will still be in existence, and memories of relevant events will be clearer. Courts routinely dismiss cases that are filed after the statute of limitations has lapsed, and FINRA's rules recognize statutes of limitations. *See,* FINRA Code of Arbitration Procedures Rule 12206(c) (stating that the eligibility rule "does not extend applicable statutes of limitations"). Nonetheless, under the Proposal, a case that is untimely when filed would have to be defended, at least through the claimant's case-in-chief. It is unfair and inefficient to require a firm to bear the expense of defending a claim where the Panel could have determined, based on the pleadings, that the claim was not timely. It is also unfair and expensive for the claimant to go through the expense of a hearing where the Panel is ultimately going to dismiss the case as untimely. To the extent that there are issues in particular cases as to when a claim arose or if it was tolled, the panel could convene an evidentiary hearing solely on that issue.

Third, the position of clearing firms raises special considerations. As you know, the relationship between an introducing broker-dealer and a clearing firm is defined by NASD Rule 3230 and NYSE Rule 382, which specify the tasks to be divided between the two firms in their clearing agreement. Once the parties to the clearing agreement agree on this division of functions, each party is solely responsible for fulfilling the functions it has agreed to undertake. Typically the clearing firm is responsible for back office tasks (*e.g.* clearing the trade, generating confirmations and statements) and the introducing firms are responsible for all customer facing tasks (*e.g.* opening and approving accounts, meeting with customers, making investment recommendations, placing trades, supervising the registered representatives who deal with the customer, maintaining an adequate compliance system).

By far the most common claims brought in FINRA arbitrations involve suitability of recommendations and misrepresentations and omission in connection with the purchase or sale of securities. These claims almost always arise out of the point of sale duties that are the responsibility of the introducing firms, not the clearing firms. Indeed courts routinely recognize that clearing firms are not liable for these types of claims and dismiss them. *See, e.g., Mars v. Wedbush Morgan Secs., Inc.*, 231 Cal. App. 3d 1608, 1614 (Cal. Ct. App. 1991) (affirming summary judgment for clearing broker, holding that clearing broker owed customer no duty other than those it undertook to perform as clearing broker, and was not liable for any fraud the securities company may have committed); *Denson v. Bear Stearns Secs. Corp.*, 682 So. 2d 69, 71 (Ala. 1996) (affirming summary judgment for clearing broker, holding that clearing broker, which had performed no more than bookkeeping functions, was not liable for fraud of introducing broker or its agents); *Warren v. Tacher*, 114 F.Supp.2d 600, 601-03 (W.D. Ken. 2000) (confirming NASD arbitration award dismissing claims against clearing firm prior to discovery and evidentiary hearing, where customers received a Rule 382 notice that the introducing broker would be exclusively responsible for supervising all activity and signed a customer agreement stating that they understood and agreed that the clearing broker had no liability for acts or omissions of introducing broker, its officers, employees and agents). The courts have also recognized that a clearing broker does not control the introducing firm and cannot be held liable on a claim based on control person liability. *See, e.g., Carlson v. Bear, Stearns & Co.*, 906 F.2d 315, 318 (7th Cir. 1990) ("Under federal securities law, clearing agents performing operational or ministerial duties have not been considered controlling persons nor subject to liability"); *Baum v. Phillips, Appel & Walden, Inc.*, 648 F. Supp. 1518, 1533 n.18 (S.D.N.Y. 1986) (clearing broker not a control person); *Damato v. Merrill Lynch, Pierce, Fenner & Smith*, 878 F. Supp. 1156 (N.D. Ill. 1995) (clearing broker not a control person).

Under the Proposal, a clearing firm will rarely be able to obtain pre-hearing dismissal of a claim, even where, under the clearing agreement, it clearly bears no responsibility for the alleged misconduct at issue. Since the clearing firm carries the customer's account, it will be impossible to assert that it is not "associated with the account(s)." Although the clearing firm has no responsibility to review the recommendations an introducing firm makes to its customers or to supervise the representations made by the introducing firm's brokers, the clearing firm will be unable to seek early dismissal.

Forcing broker-dealers to defend cases in these circumstances will cause both the claimants and the firms to incur unnecessary cost and expense that FINRA has not accounted for in its rule proposal. FINRA has conducted no analysis to determine either the burden on competition or the real costs to both broker-dealers and the investing public that the Proposal will impose. Such considerations should not be ignored or swept aside with a conclusory statements that FINRA "does not believe that the proposed rule change would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended." If the intent of the proposed rule is to do away with frivolous motions, there are other more appropriate and effective means for doing so, including awarding attorneys fees if a motion is brought that the panel determines is frivolous.

Specifically, the cost and expense of proceeding through to the close of the claimants case-in-chief before considering a motion to dismiss can easily be 3 to 5 times the cost of considering dismissal at an early stage. This can be the difference between $5,000 or $8,000 in attorneys' fees to prepare and argue a motion, and $15,000 or $25,000 in attorneys' fees to prepare for and appear at the first two or three days of an arbitration hearing while the parties make opening statements and the claimant presents his or her case. Those amounts, moreover, do not include the costs incurred by the firm to have corporate representatives and other witnesses away from the office. Nor do the costs all fall on the respondent clearing firm, as the claimant will also incur additional expense and costs in prosecuting a claim that is not supported by the law and that will, therefore, ultimately be dismissed. There has been no evaluation in the Proposal of whether these costs are necessary or appropriate to address the concerns that have prompted these proposed rules.

Having a firm against whom there is no legally cognizable claim participate in the arbitration hearing through the claimant's case-in-chief, will also unnecessarily lengthen the hearing. The firm will be forced to make an opening statement and cross-examine the claimant's witnesses. Indeed, there is no basis for the Proposal's assertion that waiting until the end of the claimant's case-in-chief strikes a suitable "balance" between the rights of the claimant to a hearing and the respondent's right to challenge the legal merits of the claim in a way that will "minimize the moving parties' incurring unnecessary additional attorneys' fees and forum fees." If, based on the pleadings, the claim is legally barred (by *res judicata* or the statute of limitations) or legally untenable, bearing <u>any</u> expense to participate in the arbitration hearing should be unnecessary. Moreover, as it is common for claimants to call many of the respondents' witness in their case-in-chief, waiting to move for dismissal until the end of the claimant's case, generally means the movant will be required to participate in well more than half of the hearing.

In addition, if this proposal makes it more difficult for clearing firms to be dismissed and, therefore, it becomes more common for claimants to name the clearing firm as a party, it will likely increase the costs to the investing public of doing business through introducing firms. Any significant increase in the cost of doing business is likely to be passed directly on to the introducing firm by the clearing firm. These costs will, inevitably be passed on to the customer in the form of higher commissions or other fees. Again, the Proposal has not given adequate consideration to these potential costs, and, in particular, the burden on competition it may impose on introducing firms as compared with those firms that are self-clearing.

In considering whether a proposed rule change is "necessary or appropriate in the public interest," the Commission is required to consider whether it will aid in "protection of investors, [and] whether the action will promote efficiency, competition, and capital formation." Securities Exchange Act of 1934 § 3(f). Given these additional costs, we cannot agree with FINRA's conclusion that forcing firms to defend arbitrations in which there is no legal basis for the claims lodged against them meets these requirements. Investors are not protected by being allowed to prosecute claims that are destined to be dismissed. Forcing both claimants and respondents to bear the costs of engaging in discovery and conducting evidentiary hearings on these types of claims also does not promote efficiency, competition, or capital formation.

Finally, even when the Proposal allows a motion to dismiss to be heard, it requires that it be granted only if the Panel unanimously agrees. This proposed supermajority is unnecessary and could greatly add to the cost and expense of arbitrations. If two of the panel members decide after a pre-hearing motion to dismiss that the claim should be dismissed, what possible reason would there be to make all the parties proceed to an evidentiary hearing where, at the close of the claimant's case, those same two arbitrators could dismiss the case by a simple majority? FINRA's explanation for the supermajority -- that granting a motion to dismiss is an integral part of the arbitration process -- is not persuasive. The culmination of the arbitral process after an evidentiary hearing is the issuance of the award, where a unanimous decision is not required.

We urge the Commission not to approve the Proposal as it is currently drafted.

Sincerely yours,

Michael R. Weissmann

cc: David C. Boch, Esq.