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Florence Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2008-051

Dear Ms. Harmon:

We are law professors who have written extensively about the securities arbitration process and conducted a survey on investors' perceptions of the securities arbitration process on behalf of the Securities Industry Conference on Arbitration (SICA).[1] In addition, we have served as arbitrators at FINRA Dispute Resolution. We are writing in response to the SEC's request for comments concerning the proposed rule change to require arbitrators to provide an explained decision upon the joint request of the parties.[2]

When FINRA proposed in 2005 to amend the Code of Arbitration Procedure to require the arbitration panel to write an explained decision at the request of the customer in customer disputes or the associated person in intra-industry disputes,[3] we expressed our ambivalence towards the proposal. We wrote:

> We support NASD's efforts to improve the arbitration process and find it difficult to oppose a rule designed to increase transparency and options available to investors participating in that process. We observe that the stated purpose for the proposed rule change is to increase investor confidence in the fairness of the process. We are not convinced that adoption of the proposed rule will improve the process itself, but merely claimants' *perceptions* of the arbitration process. Furthermore, in instances where an investor is denied recovery or is awarded only a small percentage of his claimed damages, we doubt that an explanation would obviate investors' concerns about the process. Nevertheless, while courts do not require arbitrators to write opinions on the policy ground that such a requirement

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[1] *See* Jill I. Gross & Barbara Black, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (Feb. 6, 2008), http://ssrn.com/abstract=1090969 [hereinafter *Fairness Study*].

[2] FINRA, Notice of Filing of Proposed Rule Change Relating to Amendments to the Codes of Arbitration Procedure to Require Arbitrators to Provide an Explained Decision Upon the Joint Request of the Parties, 73 Fed. Reg. 64995 (Oct. 27, 2008) [hereinafter *2008 Proposed Rule Change*].

[3] *See* NASD, Notice of Filing of Proposed Rule Change to Provide Written Explanations in Arbitration Awards Upon the Request of Customers or Associated Persons in Industry Controversies, 70 Fed. Reg. 41,065 (proposed July 11, 2005; withdrawn Oct. 14, 2008).

would undermine the speed and thrift sought to be obtained by arbitration,[4] we do acknowledge several benefits to NASD's proposed rule change.[5]

Since that time, SICA published the results of our Fairness Study, which found that over seventy percent of customers were dissatisfied with the outcome in their most recent arbitration case[6] and over fifty-five percent of customers stated that they would be more satisfied if they had an explanation of the award.[7] These findings demonstrate that investors want more transparency in the process and a better understanding of how the arbitrators arrived at their decisions. As a result, although we continue to have concerns about the consequences of explained awards,[8] we support this revised proposal as a reasonable compromise that addresses investors' desires for written explanations of an arbitration panel's decision.

Written Explanations Offer Benefits to Investors

First and foremost, the reason for requiring written explanations in some circumstances is that many customers have stated that they would be more satisfied if they had an explanation of the award. This desire for explained outcomes is consistent with procedural justice theorists who value transparency in decision-making.[9] Written explanations will provide insight into the arbitrators' reasons for the award and may

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[4] *See* Eljer Mfg., Inc. v. Kowin Dev. Corp., 14 F.3d 1250, 1254 (7th Cir. 1994); Sargent v. Paine Webber Jackson & Curtis, Inc., 882 F.2d 529 (D.C. Cir. 1989).

[5] Letter from Jill Gross, Barbara Black & Melanie Serkin, Pace Investor Rights Project, to Jonathan Katz, Secretary, Securities and Exchange Commission, Aug. 5, 2005; *see also* Barbara Black & Jill I. Gross, *The Explained Award of Damocles: Protection or Peril in Securities Arbitration*, 34 SEC. REG. L.J. 17 (2006) [hereinafter *Explained Award of Damocles*].

[6] *See* Gross & Black, *Fairness Study, supra* note 1, at 38.

[7] *Id*. at 39.

[8] In particular, we remain concerned that explained decisions may increase judicial review under a manifest disregard of the law standard. *See* Dawahare v. Spencer, 210 F.3d 666, 669 (6th Cir. 2000) (noting that if arbitrators do not explain their award, it is all but impossible to determine whether they acted with manifest disregard for the law); Fellus v. AB Whatley, Inc., 2005 WL 9756090 (N.Y. Sup. Ct. Apr. 15, 2005) (in the absence of a reasoned decision supporting an arbitration award, there was no basis for court to decide whether arbitrator manifestly disregarded the law); *see also* H & S Homes v. McDonald, 2004 WL 291491 (Ala. Dec. 17, 2004) (in the absence of an explanation of damages awarded by the arbitrator, court had no basis to determine whether arbitrator manifestly disregarded the law). *But see* Rich v. Spartis, 516 F. 3d 75 (2d Cir. 2008) (vacating award and acknowledging that, while arbitration panels generally do not have to provide reasons for their awards, where a reviewing court cannot determine whether the panel manifestly disregarded the law or exceeded its powers, the court has authority to remand the award to the panel for clarification); *see also* Raymond James Finl. Svc., Inc. v. Bishop, 2007 WL 4531964 (E.D. Va. Dec. 18, 2007) (remanding award for clarification because the explanation provided by arbitration panel was too confusing to permit sufficient judicial review). This can lead to prolonged and expensive litigation, subverting arbitration's goal of providing an efficient, low-cost and final dispute resolution mechanism. DOMKE ON COMMERCIAL ARBITRATION § 34:6 (3d ed. 2003) ("The general view is that a detailed opinion written by a layman might expose the award to challenge in the courts, jeopardizing both the speed and finality of arbitration."). The small investor, in particular, could be overwhelmed by attorneys' fees and a long, drawn-out court battle.

[9] *See* Richard C. Reuben, *Democracy and Dispute Resolution: The Problem of Arbitration,* 67 LAW & CONTEMP. PROBS. 279, 289, 301 (2004) (identifying transparency as a value in democratic processes and stating that "[t]ransparency is generally not an animating value of arbitration" because arbitrators are not required to include reasons in their awards).

provide the investor with "psychological satisfaction." In addition, because explained awards will provide parties with some insight into how arbitrators resolve controversies, they may provide valuable information for parties to use when ranking and striking arbitrators during arbitrator selection in future cases.

Moreover, requiring arbitrators to explain their decisions makes them directly accountable for their conclusions. Thus, they may be more likely to carefully evaluate all the evidence and reason through their conclusions rather than decide based on compassion, bias, or instinct.[10] Knowing that an explanation might be reviewed by a judge in a post-award review proceeding[11] is also likely to encourage the panel to be more thoughtful in its decision-making.

The Proposal Correctly Designates the Chairperson as the Author

In our 2005 comment letter, we expressed concerns that the rule proposal required the entire panel of arbitrators to write the decision, did not provide sufficient time to the panel to draft an explanation, and did not take into account the potential that some arbitrators might be philosophically opposed to written explanations since parties could request an explanation after the panel was constituted.[12] We also expressed doubt as to whether an arbitration panel could write short, clear explanations that would preclude vacatur through judicial review.

The new version of the proposed rule change addresses these concerns to some extent by designating the panel Chairperson as the sole author of the written explanation.[13] First, the Chairperson eligibility requirements increase the likelihood that the arbitrator is competent to write an explanation.[14] Second, any person accepting this role as Chairperson automatically will be on notice that parties could request an explanation. Third, assigning this responsibility to the Chairperson eliminates any

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[10] *See* Sarah Rudolph Cole, *Fairness in Securities Arbitration: A Constitutional Mandate?*, 26 PACE L. REV. 73, 104-110 (2005)

[11] Barbara Black & Jill I. Gross, *Making it Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1034 (2002) (explaining that written explanations will increase the chance of judicial review).

[12] Letter from Gross, Black & Serkin, *supra* note 5, at 4; *see also* Black & Gross, *Explained Award of Damocles, supra* note 5, at 23-24.

[13] NASD CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES [hereinafter CUSTOMER CODE], Proposed Rule 12904(g)(4); NASD CODE OF ARBITRATION PROCEDURE FOR INDUSTRY DISPUTES [hereinafter INDUSTRY CODE] 13904(g)(4).

[14] To be Chair-eligible, an arbitrator must be a public arbitrator, must complete FINRA's Chairperson training, and must either (a) have a law degree and be a member of one bar of at least one jurisdiction with experience in serving through award on at least two arbitrations administered by a self-regulatory organization in which hearings were held; or (b) have served as an arbitrator through award on at least three arbitrations administered by a self-regulatory organization in which hearings were held. CUSTOMER CODE 12400(c) (eff. Apr. 15, 2007). FINRA amended this rule, effective September 22, 2008, to eliminate an alternative means previously available to satisfy the Chairperson training requirement – that the arbitrator have "substantially equivalent" experience as a Chair. *See* FINRA, Order Approving Proposed Rule Change to the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes To Amend the Chairperson Eligibility Requirements, 73 Fed. Reg. 36,579 (June 23, 2008).

confusion over who is responsible for drafting the explanation and streamlines the decision-writing process. Designating one arbitrator to draft the explained award after the panel has deliberated together will reduce the time required to complete the award. Once the award is drafted, each arbitrator still would be required to sign it as provided in Customer Code 12904(a) and Industry Code 13904(a). For these reasons, we support this aspect of the rule proposal.

The Proposed Rule Limits Compensation to the Chairperson

Under the 2005 proposal, each arbitrator would be paid an additional $200.00 honorarium for writing an explained decision, and half of the additional cost would be allocated to the parties, as determined by the arbitrators. In contrast, this proposed rule change provides for a slightly lower cost for writing the explained award – at least for a three-arbitrator panel. FINRA will pay the Chairperson $400.00 for each requested decision since only the Chairperson will write the opinion.[15] Although this will add extra cost to the arbitration process, we believe the payment fairly compensates the Chairperson for the effort extended in drafting the explained decision. In addition, the panel may allocate the cost of the honorarium to one party or between or among both parties and this may help minimize the cost to the parties.[16]

Explained Decisions Will Have No Precedential Value

By requiring arbitrators to explain their decisions, FINRA runs the risk of imbuing awards with precedential value. In our 2005 Comment Letter, we wrote:

> It is well established that arbitration awards do not have precedential value because they are so fact-specific, and the addition of a few reasons for the award should not change this view. Attorneys, however, with their training to search for and apply legal precedent will find the temptation to cite awards as authority nearly irresistible, and arbitrators may accede to this practice. We believe this would be an undesirable development. Arbitrators are tasked with the responsibility of deciding the dispute before them on its own facts, not with deciding disputes based on precedent. Some argue that giving arbitration awards precedential effect will lead to development of the law in the securities industry, making future cases more predictable and allowing investors to make informed decisions. However, creation of law is a legislative and judicial function; it is not the role of arbitrators.[17]

Thus, in that letter, we urged FINRA to strengthen the language of the rule or the award template to make it clear and unambiguous that arbitration awards have no precedential value.

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[15] Proposed CUSTOMER CODE 12214 (e)(1) and (g)(5); Proposed INDUSTRY CODE 13214(e)(1) and (g)(5).
[16] *Id.* Also, under the proposed rule change, if the panel decides on its own to write an explained decision, FINRA would not pay an additional honorarium to any panel member. Proposed CUSTOMER CODE 12214 (e)(1); Proposed INDUSTRY CODE 13214(e)(1).
[17] Letter from Black, Gross & Serkin, *supra* note 5, at 4 (citations omitted).

This proposed rule change explicitly states FINRA's intention that, as with current arbitration awards, explained decisions will have no precedential value in other cases.[18] FINRA also plans to revise the template for all awards to include the following sentence: "If the arbitrators have provided an explanation of their decision in this award, the explanation is for the information of the parties only and is not precedential in nature."[19] We support this language as it addresses our original concern.

Parties May Not Require Explained Decisions in Some Arbitrations

We also support the proposed rule change to the extent that it does not apply to simplified arbitrations. Simplified arbitrations, which involve claims under $25,000 and are decided solely upon the pleadings and evidence filed by the parties,[20] should not require an explanation since the outcome should be simple and straightforward and the parties seek an expedited, inexpensive resolution of their small dispute.[21]

We also support the proposed rule change to the extent that it excludes from its scope arbitrations that are conducted under the default procedures in Rules 12801 and 13801. In these cases, explained decisions would not be appropriate because of the nature of these arbitration proceedings.

Specific Concerns About the Proposal

Despite our support for the proposal, we still have a few reservations as to specific aspects of the proposed rule. The original proposal in 2005 permitted a customer, or an associated person in an intra-industry controversy, to require an explained decision. In contrast, under this proposed rule change, all parties to a case must agree to request an explained decision because some commenters objected to the "one-sided" nature of the provision.[22] Although this revision respects arbitration as a process valuing all parties' consent, we have concerns that this change does not adequately address the apprehension investors have over the fairness of the process.[23] Securities arbitration is, as a practical matter, mandatory, and every three-person arbitration panel must include an industry arbitrator. As a consequence, investors who request a written explanation in a case where brokers and/or firms decline to request one may believe they have little control over the process. If those investors are unhappy with the outcome of the hearing, their perceptions of unfairness will only increase.

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[18] *2008 Proposed Rule Change*, 73 Fed. Reg. 64995, 64997, n.10 ("While Rules 12604 and 13604 provide that the panel decides what evidence to admit and is not required to follow state or federal rules of evidence, FINRA intends that, as with current arbitration awards, explained decisions will have no precedential value in other cases. Thus, arbitrators will not be required to follow any findings or determinations that are set forth in prior explained decisions.")

[19] *Id.*

[20] *See* CUSTOMER CODE 12800.

[21] *See* Black & Gross, *Explained Award of Damocles, supra* note 5, at 24-25.

[22] *2008 Proposed Rule Change,* 73 Fed. Reg. 64995, 64996.

[23] *See* Gross & Black, *Fairness Study, supra* note 1, at 45.

Additionally, we are concerned that the proposed rule change will not further FINRA's goal of improving the arbitration process because it does not provide sufficient guidance to arbitrators. More specifically, the proposed rule defines an explained decision as merely a "fact-based award stating the general reason(s) for the arbitrators' decision. Inclusion of legal authorities and damage calculations is not required."[24] However, the rule is ambiguous concerning the extent of fact-based detail sufficient to constitute an explanation. For example, it is unclear whether a statement such as "we awarded Mrs. Smith $24,000 because we felt sorry for her" would be an adequate explanation under the proposed rule. Furthermore, the proposed rule change is silent on whether the explanation would have to address each and every legal theory or theories presented by the claimant as well each affirmative defense presented by respondent(s). Without further clarity in the rule's requirements, the panel's "explanation" might not increase investor confidence in the process.[25]

Conclusion

Whether the explained awards proposal will enhance the substantive fairness of the arbitration process is far from clear. However, it is evident that many investors want explained awards. Thus, this proposed rule may increase investors' *perceptions* of the fairness of the process because – at least in cases where all parties request an explained award -- it will make arbitrators' decision-making more transparent and will encourage higher-quality, more thoughtful awards. For this reason, we support the proposed rule change.

Thank you for your consideration of these comments.

Sincerely yours,

Jill I. Gross
Barbara Black

Deborah Sommers
Student Intern

[24] Proposed CUSTOMER CODE 12904(g)(2).
[25] *See* Black & Gross, *Explained Award of Damocles, supra* note 5, at 24.