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July 24, 2014

VIA ELECTRONIC SUBMISSION

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

Re: File No. SR-2014-028, Proposed Rule Change Relating to Revisions to the Definitions of Non-Public Arbitrator and Public Arbitrator

Dear Ms. Murphy:

The Investor Rights Clinic at Pace Law School ("PIRC"),[1] operating through John Jay Legal Services, Inc., welcomes the opportunity to comment on the proposed rule change relating to the Financial Industry Regulatory Authority's ("FINRA") definitions of public and non-public arbitrators. PIRC generally supports the rule proposal to the extent that it accurately classifies arbitrators into public and non-public categories. These changes will increase neutrality and perceptions of fairness in the arbitral forum.

However, as discussed more fully below, PIRC proposes three revisions to the rule proposal: (1) define a non-public arbitrator as an "industry-funded" arbitrator; (2) define "professional work" through annual revenue; and (3) implement a proportional cooling-off period for professionals who worked in the securities industry and for professionals who provided services to the industry before they can be placed on the public roster.

I. FINRA Should Continue to Define Non-Public Arbitrators as Industry-Funded and Public Arbitrators as Independent of the Industry

FINRA should define non-public arbitrators as disputants always have considered them: industry-funded arbitrators. The term "non-public arbitrator" has historically been and is currently used synonymously with "industry arbitrator."[2] "Public arbitrator," on the other hand,

[1] PIRC opened in 1997 as the nation's first law school clinic in which J.D. students, for academic credit and under close faculty supervision, provide pro bono representation to individual investors of modest means in arbitrable securities disputes. *See* Barbara Black, *Establishing A Securities Arbitration Clinic: The Experience at Pace*, 50 J. LEGAL EDUC. 35 (2000); *see also* Press Release, Securities Exchange Commission, *SEC Announces Pilot Securities Arbitration Clinic To Help Small Investors- Levitt Responds to Concerns Voiced At Town Meetings* (Nov. 12, 1997), available at http://www.sec.gov/news/digest/1997/dig111297.pdf.

[2] *See* Stephen J. Choi, Jill E. Fisch & A. C. Pritchard, *Attorneys as Arbitrators*, 39 J. LEGAL STUDS. 109, 113 (2010); Jill I. Gross, McMahon *Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 101,

has historically been and is currently used to describe arbitrators who have no connection to the securities industry and receive no revenue from industry entities. PIRC agrees with Richard A. Stephens' comment that FINRA and the general public considered attorneys, accountants, and other professionals who regularly represent investors as public from the inception of the rules up until this notice.[3]

FINRA has always distinguished between public and non-public arbitrators to preserve the perception of fairness.[4] Empirical evidence demonstrates that investors perceive that arbitrators and the arbitration forum are biased against them.[5] Because investors are forced into the arbitral forum through contracts of adhesion with their brokers, these investors should be afforded fair and unbiased adjudicators. Additionally, the empirical evidence demonstrates that professionals associated with the industry do favor the industry, while there is no evidence that claimant professionals favor claimants.[6] Amendments from 2004-2013 broadened the definition of non-public arbitrator to fight the perception of unfairness.[7] All of the prior amendments focused on properly classifying individuals associated with the industry as non-public arbitrators.

Consistent with the principle that non-public arbitrators are financially connected to the industry, PIRC supports adding additional categories of individuals subject to Rules 12100(p)(1) (defining non-public arbitrator) and 12100(u)(1) (defining public arbitrator) to the extent they are consistent with the Rules' current meaning.[8] FINRA should have always characterized individuals associated with hedge funds and mutual funds as non-public. It would be arbitrary to treat individuals associated with hedge funds or mutual funds any differently than individuals associated with broker-dealers; therefore, PIRC supports their inclusion in the definitions. By excluding these individuals from the public roster, FINRA and the SEC are satisfying their mission to protect investors.

Inconsistent with the principle that non-public arbitrators are connected to the industry, the proposed rule targets professionals who represent claimants in an attempt to reclassify them as non-public arbitrators. Claimant-side professionals have not been barred from being public arbitrators in the past and should not be barred now. The sudden change of course appears to be

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105 n.36 (2008); Letter from Richard A. Stephens, to Securities and Exchange Commission (July 6, 2014) (on file with SEC), *available at* http://www.sec.gov/comments/sr-finra-2014-028/finra2014028-4.pdf (supporting this proposition with case law). PIRC agrees that it is commonly understood by investors, the industry, FINRA, and the SEC that non-public means industry.

[3] Letter from Richard A. Stephens, *supra* note 2.

[4] *See, e.g.*, Philip M. Aifikoff, Robert A. Uhl, Ryan K. Bakhtiari & Chantal Francois, *Arbitrators Misclassified: Looking Back to Move Forward*, 18 PIABA BAR J. 1, 3 (2011).

[5] *See* Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349.

[6] Professors Stephen J. Choi, Jill E. Fisch, and A. C. Pritchard found that attorney-arbitrators who have represented brokerage firms in prior arbitrations are more likely to give lower arbitration awards; attorney-arbitrators who represent investors or both investors and brokerage firms did not show this same bias. *See generally* Choi *et al. supra* note 2.

[7] *See generally* Aifikoff *et al.*, *supra* note 4; Securities Exchange Act Release No. 34-68632 (Jan. 11, 2013), 78 FR 3925 (Jan. 17, 2013) (Notice of Filing of SR-FINRA-2013-003).

[8] This comment letter only addresses the Consumer Code. However, the Rules 13100(p) and 13100(u) of the Industry Code are identical to the rules discussed above.

due to one comment letter submitted to the SEC in 2013.[9] Forty-two comment letters, however, focused on the well-founded and well-documented fears that improperly categorized public arbitrators (associated persons of mutual funds or hedge funds) were either biased or were perceived to be biased against investors.[10] Not only does the non-public definition historically apply only to arbitrators who have represented or been associated with industry firms, but the FINRA website itself distinguishes the two definitions based on the arbitrator's "connection" to the industry.[11] This "connection" is employment or funding by the industry. Therefore, a more accurate definition of non-public arbitrator is an arbitrator whose professional activities are funded in whole or in part by the securities industry.

The empirical evidence demonstrates that professionals associated with the industry do favor the industry, but there is no evidence that customer professionals favor customers.[12] The purpose behind barring from the public roster professionals who are tangentially related to and funded by the industry is to prevent bias or the appearance of bias based on a financial interest. For instance, an attorney-arbitrator might be influenced to find in the industry's favor if s/he has represented industry clients in the past to ensure being hired by those firms in the future. Attorney-arbitrators who represent industry clients are also more likely to favor their former clients because industry firms are repeat players in arbitration, while customers typically are not. Therefore, FINRA should continue to classify industry-funded arbitrators as non-public arbitrators and maintain arbitrators independent of the industry as public arbitrators.

II. FINRA Should Define "Professional Work" Through Annual Revenue, Not Professional Time

PIRC does not support redefining "professional work" to mean "professional time," as suggested by FINRA in proposed Rules 12100(p)(2)-(3) and 12100(u)(2)-(3), (6)-(7). Rather, FINRA should quantify "professional work" through annual revenue of twenty percent for both professionals (such as attorneys and accountants) servicing the industry and for other professionals in the firm (colleagues). While, as FINRA suggests, "professional time" may be an easier measure to apply than "professional work," measuring work through time misinterprets the understanding behind the definition of non-public arbitrator. Since FINRA should define a non-public arbitrator accurately as an arbitrator whose professional activities are funded in whole or in part by the industry, as discussed above, the proper measure of professional work is annual revenue rather than "professional time." Colleagues in a firm reap the same financial benefits and, therefore, have the same interests. If the originally-barred professional has the tendency to

[9] Letter from David T. Bellaire, Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Feb. 7, 2013) (on file with SEC), *available at* http://www.sec.gov/comments/sr-finra-2013-003/finra2013003-41.pdf.

[10] FINRA compiled this number. *See* Letter from Margo A. Hassan, Assistant Chief Counsel, FINRA Dispute Resolution, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Mar. 11, 2013) (on file with SEC), *available at http://www.sec.gov/comments/sr-finra-2013-003/finra2013003-46.pdf.* There were forty-five comment letters: forty-two supported the proposal and three opposed, with one comment letter suggesting adding customer professionals to the non-public roster. *Id.*

[11] *Resources for Investors Representing Themselves in FINRA Arbitrations and Mediations*, FINRA, http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/OverviewofArbitrationMediation/P230280 (last visited July 15, 2014).

[12] *See generally* Choi *et al.*, *supra* note 2.

rule in favor of the industry to ensure lucrative business in the future, then so does his or her business colleague.

Additionally, the "professional time" quantification may not be appropriate for every professional who might qualify as an arbitrator. For instance, while attorneys often quantify their work through billable hours, accountants and other professionals (and some attorneys) may quantify their work based on revenue. FINRA should require that professionals quantify "professional work" through annual revenue to minimize the chance of inconsistency among professionals. Firms can easily manage using annual revenue as the measure for all potential arbitrators.

III. FINRA Should Implement A Proportional "Cooling-Off" Period

PIRC recommends adopting a proportional cooling-off period for both individuals who worked in the financial industry (*e.g.*, an associated person of a broker-dealer) and for professionals providing services to the industry (*e.g.*, a lawyer representing a broker-dealer) before they can serve on the FINRA roster as public arbitrators. In the alternative, industry-associated individuals should be permanently barred from serving as public arbitrators, while professionals serving the industry should be barred after providing fifteen years of service to the industry. Additionally, in the alternative, those industry professionals should have a lengthened cooling-off period of five years. PIRC supports imputing the conflict across all colleagues in a firm.

For those individuals who fall within the 12100(p)(1) rule – individuals associated with companies within the industry – PIRC recommends that FINRA consider implementing a cooling-off period equal to the time an associated person has worked for the companies listed in Rules 12100(p)(1) and 12100(u)(1). Under the current rules, a former associated person to a broker-dealer for his or her entire career is eligible to become a public arbitrator after five years of inactivity. This individual would continue to carry his or her knowledge and experience along with any biases associated with the experience. For this individual, five years is not long enough to be impartial in appearance and in fact, and this individual would likely grant awards as an industry arbitrator as described by Choi *et al.* However, being permanently barred may be inappropriate for an individual who worked in the industry for a single year. The proportional cooling-off period would effectively eliminate life-long associated persons from the public arbitrator roster while incorporating short-term associated persons onto the roster.

The proportional cooling-off period would bar an individual from being classified as a public arbitrator on a one-to-one scale – one year of exclusion from the public roster for each year an individual was associated with the securities industry. Under this method, an individual who worked in the industry or a professional who provided services to the industry for a single year could be registered on the public roster in just one year, while someone entrenched with firms for twenty years would be barred for two full decades.

In the alternative, if the proportional cool-down period is not adopted, PIRC supports FINRA's proposal to permanently bar the industry-associated individuals listed in Rules 12100(p)(1) and 12100(u)(1) from being classified as public arbitrators. Under this method, there may be individuals who are barred from serving as public arbitrators who worked in the

industry for a fraction of their careers; however, should FINRA not adopt the proportional method, this is a fair price to pay to ensure that investors are protected from former industry employees who currently masquerade as public arbitrators. Under these circumstances, the rule can be partially remedied by clarifying the word "worked" to apply only to associated persons as defined in Section 3(a)(18) of the Securities and Exchange Act of 1934[13] – as suggested by Mr. Stephens[14] – and exclude individuals working in clerical and ministerial functions from being permanently barred.

If FINRA does not adopt a proportional cooling-off period, then it should lengthen the cooling-off period for professionals being funded by the industry, such as attorneys and accountants. A professional who has worked for the industry, through representation as an attorney or by providing other professional services, for nineteen years will not be perceived as neutral after two years out of service to the industry and will likely continue giving awards in the manner described in the Choi *et al.* study. While five years, as the proposed rules recommend, may not cure this problem completely, it gets closer to remedying the lack of neutrality. PIRC questions FINRA's proposed distinction in cooling-off periods between professionals providing services to the industry and their colleagues working in the same firm. PIRC recommends that these arbitrators be barred from the public roster for the same time period as the professional with the direct conflict. As discussed above, professionals providing services to the industry and their colleagues are influenced by the same forces. If FINRA believes these professionals need a cooling-off period to avoid the appearance or fact of lack of neutrality, then the same should hold true for their business colleagues.

Similarly, if FINRA does not adopt the proportional cooling-off period, then PIRC supports the permanent bar being decreased to fifteen years for professionals providing services to the industry as proposed in the new rules. Professionals who have derived a significant amount of business – twenty percent – for fifteen years will be inclined to give awards favoring the industry, as indicated in the Choi *et al.* study. By decreasing the permanent bar, the number of public arbitrators with this disposition will be minimized, therefore leading to a more fair and neutral forum for investors.

IV. Conclusion

PIRC supports the proposed rule change to the extent it broadens the definition of non-public arbitrator and provides additional protection to investors. In particular, PIRC supports the expansion of the non-public arbitrator roster to include individuals associated with hedge funds or mutual funds. However, PIRC does not support including customers' representatives in that definition. FINRA has intended the purpose and language of the rules to exclude customers' representatives from being public arbitrators and, for the reasons set forth above, should not now.

Additionally, in accordance with the definition of non-public arbitrator as industry-funded, PIRC recommends defining "professional work" through annual revenue. Finally, PIRC recommends that FINRA implement a proportional cooling-off period for individuals who have

[13] 15 U.S.C. § 78c(a)(18) (2012).
[14] *See* Letter from Richard A. Stephens, *supra* note 2.

worked in the industry and for professionals servicing the industry and their colleagues. If FINRA does not adopt this proportional standard, then PIRC supports permanently barring individuals who have worked in the industry and lengthening the cooling-off periods for professionals servicing the industry and their colleagues. Statistics show that having an all-public panel makes a difference in the outcome of an arbitration,[15] and having a truly public panel will make a greater difference.

Respectively submitted,

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[15] *See* Financial Industry Regulatory Authority, *Dispute Resolution Statistics*, http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/?utm_source=MM&utm_medium=email&utm_campaign=DR_Monthly_070314_FINAL (last updated June 16, 2014).