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April 4, 2008

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

**Re: SR-FINRA-2008-009
FINRA's Proposed Amendment to
Customer Code Rule 12400(c) Chairperson Eligibility Requirements**

Dear Ms. Morris:

Thank you for the opportunity to comment on FINRA's proposed amendment to Customer Code rule 12400(c), which addresses the requirements for inclusion in FINRA's roster of "chair-qualified" arbitrators.

The SEC should reject the proposed rule change. It is bad enough that FINRA, an association in which all broker-dealers are members, has been given a monopoly over the resolution of disputes between its members and the investing public. Allowing it to extend that monopoly to give itself absolute control over the training of arbitrators who will serve as chairpersons of arbitration panels only makes the problem worse.

The only positive thing about the rule proposal is that it provides the SEC with a valuable opportunity to revisit the rules it approved regarding chair-qualified arbitrators. The SEC should seize that opportunity. Specifically, the SEC should revisit its decision to allow the deck to be stacked in the arbitrator-selection process so that arbitrators whom FINRA defines to be "chair-qualified" will have their names put into the hat twice for list-selection purposes, rather than just once like all other arbitrators. Most anyone who looks at this issue can see the absurdity of allowing a membership organization to stack the deck in selecting the people who will decide disputes between its own members and the public.

Before the SEC approved the deck-stacking rule, the absurdity of the proposal was addressed at length in public comments filed and posted on the SEC's website in both May and October of 2006. Those rule comments and the SEC's regulatory failure on this important issue are discussed in detail in the attached chapter from the Practising

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Law Institute's 2007 program on Securities Arbitration.¹ The SEC's approval of FINRA's deck-stacking rule in the face of what it knew at the time was both palpably wrong and an embarrassment to the SEC and to our capital markets as a whole.

But both the wrong and the embarrassment can be rectified. The SEC should view its examination of SR-FINRA-2008-009 and its re-examination of the deck-stacking issue as an opportunity to re-examine its initial decision to allow FINRA to define a separate sub-pool of public arbitrators whom it deems to be "chair-qualified." Given that the investor and consumer comments were nearly uniform in their opposition to that step, it is jarring indeed that the SEC chose to approve that division of the arbitrator pool in the first place.

I encourage the Commission to take a careful look at the attached PLI chapter, which can be accessed both through Westlaw and at www.sbernsteinlaw.com.

As recent events emphasize, America's savers, investors and retirees – and our capital markets and our economy as a whole – deserve better. They deserve a Securities and Exchange Commission that will return to its proud past and once again serve as the regulator it is supposed to be.

Thank you once again for this opportunity to comment on SR-FINRA-2008-009.

Very truly yours,

Scot Bernstein

SDB:msw
Attachment

¹ See Scot Bernstein, "Stacking the Deck in Arbitrator List Selection: A Study in Regulatory Failure and A Practical Look at the Consequences," *PLI Securities Arbitration 2007* (August 2007), copies of which are available through Westlaw and at www.sbernsteinlaw.com. An earlier version of Appendix B to that PLI chapter, containing the algebraic proof that quantified the problem that would arise as a result of the NASD's proposed deck-stacking rule, was submitted to the SEC by the author in May 2006 as a public comment in response to the NASD's May 4, 2006, Partial Amendment Number 5, Amendments to the NASD Code of Arbitration Procedure for Customer Disputes, File Number SR-NASD-2003-158. The same proof appeared as an attachment to a public comment letter submitted to the SEC by the author and C. Thomas Mason III in October 2006 in response to the NASD's Partial Amendment No. 7, Amendments to the NASD Code of Arbitration Procedure for Customer Disputes, File Number SR-NASD-2003-158.

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STACKING THE DECK IN
ARBITRATOR LIST SELECTION: A
STUDY IN REGULATORY FAILURE
AND A PRACTICAL LOOK AT THE
CONSEQUENCES

Scot Bernstein

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INTRODUCTION¹

If you have an appetite for the absurd, imagine the following:

- An industry association sets up an arbitration system for resolution of disputes that arise between its members and their clients.
- As part of a sweeping set of rule changes, the association touts a proposed selection system that will give every arbitrator an equal chance to serve on arbitration panels. The proposed system provides for random selection, involving, in essence, the drawing of names from a hat.
- Late in the game, in its sixth version of the proposed rules, the industry's association changes its proposed arbitrator selection rule. It now proposes that certain selected arbitrators in a subgroup the association has defined should have their names placed in the hat twice, instead of just once like all other arbitrators! The association's rule filing does not point out that it has suddenly abandoned its long-vaunted principle of giving every arbitrator an equal chance to serve on arbitration panels.
- You provide the governing regulatory agency with a mathematical proof that quantifies the inevitable skewing of results that must occur as a result of stacking the deck in this way. Confronted with your proof, the industry association doesn't claim to be able to disprove your math. Instead, it tries to duck the issue by calling your mathematical proof a "statistical study." Then it then gilds the lily by denouncing the proof as "speculative" – as though there could be something "speculative" about algebra.²
- You point out the absurdity of the industry association's position to the regulatory agency. The agency is, after all, in charge of the largest capital markets in the history of the world. The agency's duties include the obligation to oversee the industry association's arbitration system and assure that it is fair. You believe that such an agency should have the mathematical wherewithal to know the difference between a mathematical proof and a "statistical study."
- The regulatory agency approves the deck-stacking rule, giving the industry association and its members what they want. To your utter

1. The author is an attorney in private practice in California. The views expressed in this chapter are those of the author and do not necessarily reflect the views of PLI or of any bar association or other organization to which the author belongs.

2. See section A2, below, for a brief discussion of the mathematical absurdity of the industry association's position.

amazement, the agency's approval statement refers to the mathematical proof as "statistical models."³

Absurd as it is, what you have just read is a short synopsis of what happened with the NASD's proposed (and now operational) deck-stacking rule. The SEC actually approved a rule that allows the NASD, the securities industry's membership association, to define a special subgroup of arbitrators and to place their names in the hat twice. How can the Commission expect the investing public to believe that this stacked deck is "fair"?

The deck-stacking rule is described in part B of this chapter. That discussion has been kept brief to avoid restating the more complete analysis of the rule's ramifications contained in Appendices A and B, the comment letter and article that were in the SEC's possession for several months by the time it approved the rule.

Part C of this chapter describes the sequence of communications leading up to the SEC's approval of the rule. It puts appendices A, B and C in their chronological context. It is interesting as a study in regulatory failure because it shows exactly what the SEC knew and when the SEC knew it. Those who read part C may come away with serious misgivings about the SEC's discharge of its duties as the agency sworn to protect the investing public.

Part D is this chapter's practical side, giving arbitrators and practitioners a quantitative look at a future shaped by the deck-stacking rule. The SEC, apparently acting on a statement in an October 2006 comment letter⁴, sent the NASD an inquiry regarding arbitrator pool sizes. To respond to the SEC's inquiry, the NASD was forced to reveal, for the

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3. It is astonishing that the NASD thought it could prevail by trying to convince the SEC that an algebraic proof was a "speculative" "statistical study." More amazing still: the NASD was correct in thinking it could prevail by trying to convince the SEC that an algebraic proof was a "speculative" "statistical study."
 4. The October 2006 comment letter to the SEC (Appendix A) contains the following statement:

"Here is the ultimate absurdity: the NASD is being permitted to claim that pool sizes are driving its latest proposal without providing any information about pool sizes venue by venue. For all its public pronouncements about favoring transparency [footnote omitted], the NASD continues to cloak the operations of its arbitration program in dark secrecy. How can the public evaluate the current proposal and the NASD's current excuse for it without being provided with the relevant information? A fair and reasonable opportunity for public comment cannot be had without disclosure of that information by the NASD. This is especially true now that the attached article has provided a formula for determining the precise impact of the

first time, city-by-city data regarding the sizes of its arbitrator pools. Appendix C is the NASD's letter to the SEC providing that data.

This newly-revealed information makes possible Part D's real-world application of the formulas provided by Appendix B, an article that was submitted to the SEC along with Appendix A. No longer limited to examples based on hypothetical pool sizes, we now can make precise predictions based on the actual pool sizes disclosed by the NASD. As a result, practitioners will be able to predict the arbitrator mix that they will see on the strike-and-rank lists they receive in their cases. Arbitrators, too, will gain some predictability in their lives, because they will be able to predict the frequency with which their names will be sent to the parties for striking and ranking. And non-chair-qualified arbitrators will be able to see how much longer it will take to be appointed to panels as a result of the deck-stacking provided by the new rule.

But first, part A.

A. Two Preliminary Matters Before We Get Started In Earnest

1. A Very Short Preview

Readers may have detected some irritation on my part regarding the SEC's decision to allow the NASD to stack the deck in the arbitrator selection process. That irritation arises not just from the SEC's decision but also from the apparent lack of candor in the SEC's communications announcing its decision. So here is a very short preview of what readers will see in more detail later in the chapter.

In its release approving the deck-stacking rule, the SEC states as follows:

Applying the formulas provided in the letter [Appendix B], the Commission staff determined that NASD's proposal to include chair-qualified arbitrators with non-chair public arbitrators in the non-chair public roster would not in all circumstances increase the frequency of chair-qualified arbitrators being appointed to panels.

So perhaps you're wondering what the phrase "*not in all circumstances*" means. Fortunately, the NASD was forced to provide arbitrator pool sizes for all 66 of its hearing locations, so

proposal when the sizes of the chair-qualified and non-chair-qualified sub-pools are known. What possible excuse can the NASD give for flouting the transparency it purports to favor and continuing to pretend that its pool sizes must be kept from the public?"

it is possible to determine exactly what that phrase means. By saying “not in all circumstances,” the SEC means **98% of the time**. That’s right. 98%. The SEC thinks that a mathematically provable consequence of a rule that allows deck-stacking can be ignored because it only results in a skewing of the arbitrator selection process **98% of the time**. There will be more about this further on, but doesn’t the SEC’s use of a phrase like “not in all circumstances” to cloak a meaning like “98% of the time” suggest at least the possibility that it knows its decision is not in the best interests of the investing public? Does it sound like the SEC is being forthcoming with the public that it is supposed to protect?⁵

2. The Absurdity of the NASD’s “Position”

Those who read the article in Appendix B – the article that was submitted to the SEC in opposition to the proposed deck-stacking rule – will see that the mathematical statements it contains are not statistical in nature and cannot be deemed speculative. Rather, they are necessarily true independent of fact or experience, derived purely by reasoning from self-evident propositions. They are algebra.

Thus, the NASD’s assertion that the statements in the article were a “speculative” “statistical study” is no different from saying that the statement

$$a(b + c) = ab + ac$$

is a “speculative” “statistical study.” The principle that a times the sum of b and c is equal to the sum of a times b and a times c (for example, that 5 times the sum of 3 and 7 is equal to the sum of 5 times 3 and 5 times 7) is necessarily and inescapably true whether or not the NASD tries to argue against it by calling it names.⁶

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5. The reason the skewing occurs 98% of the time rather than 100% of the time is explained in section C6 of this chapter. Briefly, the reason is that the NASD has cities where its pools contain eight or fewer chair-qualified public arbitrators, and thus none left to pour over into the non-chair pool for striking and ranking.
 6. The NASD is not alone in attempting to create doubt where none legitimately exists. The practice of insisting, in the face of overwhelming evidence, that the jury is still out as to matters of science has become all too common. As a Brown & Williamson tobacco executive said in a 1969 memo, “Doubt is our product since it is the best means of competing with the ‘body of fact’ that exists in the mind of the general public.” In describing algebra as a “speculative” “statistical study,” the NASD was taking a leaf from big tobacco’s playbook.

B. A Brief Description of the Deck Stacking Rule

The recently rewritten Code of Arbitration Procedure⁷ divides all “public” arbitrators⁸ into two separate groups: those who meet the NASD’s definition of “chair-qualified arbitrators” and those who do not.⁹ Briefly, “chair-qualified” public arbitrators are those arbitrators who are either (a) lawyers and have seen two or more cases through hearing to an award, or (b) non-lawyers who have seen three or more cases through hearing to an award. All other public arbitrators are non-chair-qualified arbitrators.

But the new Code amplifies the dominance of the chair-qualified arbitrators by infusing members of that favored group into the

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7. Unless otherwise specified, the term “Code” refers to the NASD’s new Code of Arbitration Procedure, which was approved by the SEC on January 24, 2007, and became effective on April 16, 2007. The initial version of the new Code was filed with the SEC as SR 2003-158 on October 15, 2003.
 8. The term “public” is a commonly-used shorthand way of referring to arbitrators who meet the Code’s definition of arbitrators who are not affiliated with the securities industry, *i.e.*, who are not “industry arbitrators.” Active controversies regarding the deep industry ties of some arbitrators who qualify as “public” under the definition, whether the definition needs further tightening, and the lack of policing which has allowed industry arbitrators to be and remain misclassified as “public” for extended periods of time are beyond the scope of this chapter.
 9. Thus, under the new Code, panel chairs, public non-chairs and industry arbitrators will be chosen separately by striking and ranking three separate lists instead of the previous two. Rule 12400(c) defines “chair-qualified” arbitrators as follows:

(c) Eligibility for Chairperson Roster

In customer disputes, chairpersons must be public arbitrators. Arbitrators are eligible for the chairperson roster if they have completed chairperson training provided by NASD or have substantially equivalent training or experience and:

- Have a law degree and are a member of a bar of at least one jurisdiction and have served as an arbitrator through award on at least two arbitrations administered by a self-regulatory organization in which hearings were held; or
- Have served as an arbitrator through award on at least three arbitrations administered by a self-regulatory organization in which hearings were held.

“non-chair-qualified” group for list selection purposes.¹⁰ Thus, arbitrators from the “chair-qualified” group will serve both as panel chairs and as public non-chairs in many cases. This newest wrinkle might seem innocuous at first blush. When examined quantitatively, however, it reveals a serious and problematic consequence: the arbitrators who are in the chair-qualified group will serve far more frequently than those who are not. The quantitative impact is far from trivial, as was proven in the article attached as Appendix B.

C. The Sequence Of Events Culminating In The Sec’s Approval Of Deck-stacking

1. The NASD’s Fifth Amendment Filing. The NASD filed the initial version of its new code of arbitration procedure for customer claims on October 15, 2003. Over the next twenty months, four amendments followed. The controversy that is the focus of this chapter began when the NASD filed its fifth amendment to its proposed new code (“Amendment 5”) on May 4, 2006 – more than two and a half years after the initial filing.

In Amendment 5, the NASD suggested for the first time that “chair qualified” arbitrators not included in the “chair-qualified” list sent out to the parties should be injected temporarily into the non-chair-qualified pool for selection purposes – the result being that the arbitrators deemed “chair-qualified” would have a greatly enhanced probability

10. Rule 12400(b) states as follows:

“NASD maintains the following roster of arbitrators:

- A roster of non-public arbitrators as defined in Rule 12100(p);
- A roster of public arbitrators as defined in Rule 12100(u); and
- A roster of arbitrators who are eligible to serve as chairperson of a panel as described in paragraph (c). **Arbitrators who are eligible to serve as chairperson will also be included in the roster of public arbitrators, but will only appear on one list in a case.** [Emphasis added.]

Consistent with this, Rule 12403(a)(3) provides the sequence for the process as follows:

“(3) If the panel consists of three arbitrators, the Neutral List Selection System will generate the chairperson list first. **Chair-qualified arbitrators who were not selected for the chairperson list will be eligible for selection on the public list.** An individual arbitrator cannot appear on both the chairperson list and the public list for the same case.” [Emphasis added.]

of appearing on strike-and-rank lists and that those not deemed “chair qualified” would have a greatly reduced probability of being included on strike-and-rank lists.

2. The May 2006 Comment Letter. It was immediately obvious that such a rule would have a quantitative impact that would be predictable *a priori* from the application of pure algebra, with none of the uncertainty inherent in data gathering and empirical observation – that is, no need to wait and observe how the rule worked in practice. Thus, on May 26, 2006, I submitted a comment letter to that effect.¹¹ The May 2006 comment letter was just one among many that addressed various aspects of Amendment 5, but was the only one that focused on the quantitative problem with the deck-stacking proposal.

3. The NASD’s Response: Amendment Number 7. After filing a sixth amendment addressing issues unrelated to arbitrator selection, the NASD filed Partial Amendment No. 7, Amendments to the NASD Code of Arbitration Procedure for Customer Disputes, File No. SR NASD-2003-158 (“Amendment 7”). It was in Amendment 7 that the NASD avoided addressing the quantitative problems with its proposed rule and instead decided to call them names. Specifically, the NASD said that the algebraic proof in the May 2006 comment letter was a “statistical study” and that it was “speculative.” The NASD’s statements were ridiculous on their face: the May 2006 comment letter clearly contained no “statistical study”; and there is nothing “speculative” about algebra.

4. The October 2006 Comment Letter. Feeling the need to respond to the NASD’s statements, and to address other purported justifications for the NASD’s deck-stacking proposal that had come to our attention through other sources, C. Thomas Mason III and I wrote a comment letter to the SEC in response to Amendment 7. That letter is Appendix A to this chapter. We submitted that letter on October 20, 2006, attaching the article that is Appendix B to this chapter.

The October 2006 letter makes for instructive reading because, when combined with its attached article, it provides a full measure of the evidence available to the SEC regarding the inevitable quantitative impacts and general unseemliness and illogic of the NASD’s deck-stacking proposal. The letter and the attached article are useful, therefore, to anyone attempting to evaluate the appropriateness of mandatory arbitration of investor claims or the comfort that should or should not

11. The May 2006 submission was an earlier draft of the article that appears in Appendix B.

be derived from the SEC's oversight of the NASD's dispute resolution process. They also are useful to anyone wishing to understand the new deck-stacking rule and its ramifications, because the rule that was the subject of the October 2006 letter and its attached article is the rule that was approved by the SEC.

Highlights of the October 2006 letter included the following:

1. The letter made it clear to the SEC that, by attempting to call an algebraic proof a "speculative" "statistical study," the NASD had utterly failed or refused to address the quantitative problems described in the May 2006 comment letter.
2. The letter pointed out the irony inherent in the fact that some of the biggest abuses by the industry "self-regulated" by the NASD involve large sales of mutual fund B shares, fee-based accounts for people who are not trading actively, and sales of full-cost variable annuities – abuses made possible by the failure to disclose an honest mathematical analysis of the consequences of purchasing the offered product. And here was the industry's self-regulatory organization doing the same thing: misrepresenting material facts about its rule proposal by not honestly addressing the math.
3. The letter drew attention to the NASD's unannounced abandonment of a position it had been touting since very early in its efforts to promote the revised code of arbitration procedure. In Amendment 5, at page 22, NASD stated proudly,

"NASD believes that eliminating the ability to select an arbitrator based on expertise and implementing the random selection function of NLSS will expand use of the full arbitrator pool, **so that all arbitrators on the lists will have the same chance of being selected for any case.**"
[Emphasis added.]

By deciding to adopt a deck-stacking list-selection formula, the NASD had abandoned its long-touted principle. But it never admitted to it. Instead, it attempted to cover itself with a new rationalization that was directly contrary to its previously-advanced principled position, and indeed suggested a tacit admission by the NASD that the predictions in the article were correct:

"NASD believes that if chair-qualified arbitrators are found to be serving on panels more frequently than other public arbitrators, this result would be in the public interest"

4. The letter emphasized the NASD's failure to provide anything besides arm-waving to support its position that increased service

by “chair-qualified” arbitrators would be in the public interest; and it made the SEC aware of studies suggesting the contrary, *i.e.*, that a key problem in arbitration is that “repeat players” are favored by the process.

5. The letter addressed the NASD’s claim that the deck-stacking rule was necessary because there might not be sufficient numbers of non-chair-qualified arbitrators in certain hearing locations to make list-selection practical without stacking the deck. Among the absurdities of the NASD’s claim, the letter pointed out the following:
 - a. The NASD was proposing to stack the deck everywhere, not just in locations where the non-chair-qualified pool was small;
 - b. The NASD was not proposing to do the reverse – infuse non-chair-qualified arbitrators into the chair-qualified pool – in locations where it was the chair-qualified pool that was small;¹²
 - c. The better solution, if pools were too small, would be not to split the public pool at all. It was not investors who wanted the “public arbitrator” pool split into “chair-qualified” and “non-chair-qualified” sub-pools in the first place. In fact, investors opposed the change from the inception.
 - d. The NASD was claiming that pool sizes were driving its deck-stacking proposal without providing any information about the actual pool sizes. The NASD’s penchant for cloaking its arbitration operations in a shroud of secrecy was depriving the public of a reasonable opportunity to comment. The formulas provided by the article made the disclosure of pool sizes all the more imperative in that they would make it possible to predict with precision the impact of the NASD’s deck-stacking proposal.¹³

12. The NASD subsequently was forced to disclose that the chair-qualified pool is smaller than the non-chair-qualified pool in nearly 90% of its hearing locations - 58 out of 66! Detailed pool-size information will appear later in the chapter.

13. The SEC acted on this latter point, forcing the NASD to cast secrecy aside and reveal the sizes of its arbitrator pools and sub-pools. The NASD’s response letter and its city-by-city pool-size data appear in Appendix C.

6. The letter asked the SEC why it was that, if deck-stacking in arbitrator selection truly would be *better* for investors as the NASD claimed, the letters favoring it were coming from industry commenters and their membership association rather than from investors.
7. The letter pointed out the potential for embarrassment to the SEC if it approved the deck-stacking proposal, embarrassment that would come from two sources: (a) the simplicity of the mathematics that formed the basis for the article predicting the quantitative impact of the proposed rule; and (b) any failure by the SEC to perform an investigation of its own to determine whether the dramatic favoring of “chair-qualified” arbitrators that would be brought about by the rule would be harmful to investors.¹⁴
8. The letter reminded the SEC of its representations to federal courts that it carefully reviews all rules under which self-regulatory organizations conduct their arbitration systems and has the authority to mandate the adoption of additional rules that it deems necessary in the public interest.

5. The November 2006 Correspondence between the SEC and the NASD. On November 1, 2006, the SEC sent an inquiry to the NASD regarding the issues raised by the article. I do not have a copy of that letter. It ought to be made available to the public, by the use of a Freedom of Information Act request if that is what it takes.

The NASD replied to the SEC’s inquiry on November 9, 2006. I was able to obtain a copy of that letter, and have included it in this chapter as Appendix C. In it, the NASD was forced to provide city-by-city data on arbitrator pool sizes, information that theretofore had been a closely-guarded secret. The figures contained in that letter will be used in part D of this chapter and Appendix D as the basis for predictions of the city-by-city impact of the deck-stacking rule.

6. The SEC’s Decision. On January 24, 2007, the SEC approved the revised code of arbitration procedure, *including* the deck-stacking rule. In so doing, the SEC stated as follows:

Subsequent to the filing of Amendment 5 with the Commission, one commenter expressed opposition to NASD’s proposal to include chair-qualified arbitrators with non-chair public arbitrators on the non-chair public roster [footnote omitted].¹⁵ This commenter included statistical models in support of

14. If the SEC performed any such investigation, the author is unaware of it.

15. Footnote number 84 was a reference to the May 2006 comment letter.

his position that chair-qualified arbitrators would be selected more frequently than non-chair public arbitrators. This commenter also asserted that chair-qualified arbitrators would become “professional” arbitrators.

In Amendment 7, NASD declined to comment on the statistical analysis provided by the commenter, stating that the hypothesized outcome was speculative. NASD explained that it believes having arbitrators with the most experience serving more frequently on panels would be in the public interest. Moreover, NASD stated that the proposed standards to become eligible to serve as chair-qualified arbitrators are reasonable and necessary to provide investors with access to well-qualified arbitrators. NASD believes this proposal will enhance the efficiency of the arbitration process. Therefore, NASD declined to amend the proposed rule on this issue.

Subsequent to Amendment 7, this commenter submitted a second letter reiterating his arguments and providing additional information [footnote omitted].¹⁶ The Commission staff obtained data from NASD relating to the number of arbitrators at each NASD hearing location, including the number of arbitrators who are classified as “public” under the definition found in rule 10308(a)(5) of the current Code, and who would be classified as chair-qualified under Proposed Rule 12100(u) of the Customer Code [footnote omitted]. Applying the formulas provided in the letter, the Commission staff determined that NASD’s proposal to include chair-qualified arbitrators with non-chair public arbitrators in the non-chair public roster would not in all circumstances increase the frequency of chair-qualified arbitrators being appointed to panels. Moreover, even assuming that the odds would increase in certain circumstances, the staff could not find empirical evidence to indicate that the increased odds would result in bias in the NASD arbitration forum or otherwise outweigh the benefit of the increased training and experience among arbitrators.

It is hard to imagine how the SEC’s discussion of the deck-stacking issue could have been shallower. Its first paragraph lists a total of two points out of the extensive materials submitted. Worse, like the NASD, the SEC characterized the algebraic proof in the article as “statistical models.”

Then, after describing, in its second paragraph, the NASD’s non-response to the quantitative problem, the SEC’s third paragraph sets forth its own response to the quantitative problem. In it, the SEC states that it obtained data from the NASD relating to the number of arbitrators classified as “public” who would be classified as chair-qualified under the proposed rule.¹⁷ Let’s take a close look at the SEC’s next sentence:

16. Footnote 85 was a reference to the October 2006 comment letter.

17. That NASD data is provided in Appendix C and is the subject of Appendix D.

Applying the formulas provided in the letter [Appendix C], the Commission staff determined that NASD's proposal to include chair-qualified arbitrators in the non-chair public roster would *not in all circumstances* increase the frequency of chair-qualified arbitrators being appointed to panels." [Emphasis added.]

The SEC's phrase begs the question of just how often the deck-stacking effect would occur. The article that the SEC had before it [Appendix B] answers that question in a precise way: specifically, it shows that if there are eight or fewer chair-qualified arbitrators in a chair-qualified pool, there will be no deck-stacking effect because, after chair-qualified arbitrators' names are pulled out and placed on the chair-qualified strike-and-rank list, there will be none left to infuse into the non-chair-qualified pool for inclusion on the non-chair-qualified strike-and-rank list.

One would expect this to be a rare occurrence. And one would be right. The pool-size data revealed by the NASD show that, out of 66 hearing locations, there are only *six* in which there are fewer than eight chair-qualified arbitrators.

Thus, when the SEC said that the deck-stacking rule would "*not in all circumstances*" increase the frequency of chair-qualified arbitrators being appointed, it meant that the rule would have the deck-stacking effect in *91% of the cities where the NASD has hearing locations*. In other words, the only places where the rule would *not* have the predicted skewing effect on arbitrator selection would be in the NASD's hearing locations in Anchorage, Cincinnati, Little Rock, Norfolk, Omaha and Reno. We'll call these cities with eight or fewer chair-qualified arbitrators the "small-pool cities."

The SEC's review is supposed to be about protecting investors, not cities. Thus, the focus should be upon the predictable impact on investors. Looking at that, we will find that far more than a mere 91% of investors' cases are impacted by the deck-stacking effect. The NASD's data shows that only 45 strike-and-rank lists were generated in the first ten months of 2006 in all six of the small-pool cities *combined*. This compares with 2,888 strike-and-rank lists generated during that time period nationally.¹⁸ Thus, only 1.6 percent of strike-and-rank lists

18. Looking at the number of cases *filed* by location during the first ten months of 2006 yields a similar result: the six cities received 1.8 percent – 50 out of 2,711 – of the cases filed during that time period. Thus, more than 98% of cases *filed* during that time period also would be impacted by the deck-stacking rule if they proceeded to the panel selection stage.

would *not* have been impacted in the way the article predicts, and only because there were fewer than eight chair-qualified arbitrators in those locations.

What does this mean to investors? This means that that your SEC, the agency that is supposed to be protecting you, decided that a mathematically proven deck-stacking effect in arbitrator selection did not matter because the predicted impact would occur only ***98% of the time in the sample presented by the NASD.*** For the SEC to say ‘not in all circumstances’ in this context is like calling King Kong a monkey – while it may be literally true, it understates matters so severely as to be tantamount to a lie.

Determining an agency’s motives can be difficult at times. But it isn’t difficult here. The SEC had to perform a city-by-city application of the article’s formulas to the NASD’s pool-size data to determine that, by the article’s predictions, the deck-stacking effect would not occur everywhere. So the SEC presumably was able to apply the formulas, to ‘do the math.’

The SEC should have disclosed that math to the public it is sworn to protect. Its brushing the matter off as something that would not happen “in all circumstances” looks like nothing so much as a cover-up when it knows that the skewing would occur ***98% of the time.***

The SEC then casts further doubt on its viability as a protector of investors by stating as follows:

“Moreover, even assuming that the odds would increase in certain circumstances, the staff could not find empirical evidence to indicate that the increased odds would result in bias in the NASD arbitration forum or other wise outweigh the benefit of the increased training and experience among arbitrators.”

Did the SEC even look for empirical evidence? One would think that it would do so before approving something as bizarre and unseemly as stacking the deck, the placing of two copies of selected arbitrators’ names in the hat in what is supposed to be a random process for selecting arbitrators. It’s not as though data did not exist. Tens of thousands of arbitration awards are available to the SEC. Arbitrator biographical information is available to the SEC. Did the SEC study the issue? Did it study customer win and loss rates before arbitration panels with one arbitrator who would meet the chair-qualified definition at the time of appointment and compare them with customer win and loss rates before arbitration panels with two such arbitrators? Did it require the NASD to provide that data and perform that analysis? Or is its statement just its attempt to brush the issue away, a complete dereliction of its duties of investor protection?

D. On to the Practical – A Table of Sixty-Six Cities

The NASD’s November 9, 2006, Letter. The lone useful result of the SEC’s efforts on the deck-stacking issue is that the NASD was forced to cough up one of its closely-guarded secrets: the sizes of its arbitrator pools, city-by-city. The NASD’s letter is Appendix C to this chapter.

The table in Appendix D picks up where the NASD’s table leaves off. After providing the total number of public arbitrators and the numbers of chair-qualified and non-chair-qualified public arbitrators in each city (columns B, C and D, respectively), the table provides a number of calculations based on the NASD’s pool-size data.¹⁹ Those calculations ought to be disturbing to anyone who thinks that decks should not be stacked or who believed that the NASD’s long-vaunted equal chance for all arbitrators to serve was a laudable goal.

Column E of the table compares the relative probabilities of chair-qualified and non-chair-qualified arbitrators having their names sent out for striking and ranking in any given case when the deck is stacked as provided in the new rule. It does this by providing the ratio of those two probabilities using the formula derived in Appendix B – *i.e.*, $y/x+2-16/x$.²⁰ Thus, for example, the ratio in Column E for New York City is 3.5. This means that, under the new rule, an arbitrator in the New York “chair-qualified” pool is three and a half times as likely as an

19. While the calculations are based on pool sizes as though they are static, pool sizes will change through time. Arbitrators will leave the pools. New arbitrators will be added. Due to the dramatically reduced opportunities for non-chair-qualified arbitrators to become chair-qualified, however, any growth in the sizes of the chair-qualified pools can be expected to be quite slow.

In any event, changes in pool sizes are not a problem from a predictive standpoint because the formulas can be applied to any combination of pool sizes. All that is necessary is to know those pool sizes on an ongoing basis – something that will happen only if the SEC acts on behalf of the investing public and requires the NASD to provide updated pool-size data frequently.

20. The result has been corrected for the six cities that have fewer than eight chair-qualified arbitrators in the chair-qualified pool. This is because, if there are fewer than eight individuals in that pool, it is not possible to pour a negative number of arbitrators into the non-chair-qualified pool for selection purposes. While I was writing the original article on this subject (the May 2006 article that was the predecessor to the article in Appendix B), it occurred to me that accuracy might be best served by using the expression “Max {(x-8),0}” instead of (x-8) to account for the possibility of pools smaller than eight arbitrators. I elected not to do that, both because I thought that the understandability of the article would suffer as a result and because I thought it unlikely that there would be *any* chair-qualified pools with fewer than eight arbitrators. It seemed absurd to think that the NASD would be

arbitrator in the non-chair-qualified pool to be included on a strike-and-rank list in any given New York arbitration case. Looking at the inverse, we could say with equal accuracy that an arbitrator in the New York non-chair-qualified pool is just under 29% as likely as an arbitrator in the chair-qualified pool to have a chance at being selected.

Column F provides the average number of chair-qualified arbitrators that one can expect to see on strike-and-rank lists of eight public arbitrators for the non-chair public seat. This is equal to eight times the fraction of arbitrators on the non-chair strike-and-rank list who will be chair-qualified – *i.e.*, $(x-8)/(x+y-8)$, where “*x*” is the number of chair-qualified arbitrators in the pool and “*y*” is the number of non-chair qualified arbitrators.²¹ In New York City, for example, one can expect the average eight-arbitrator non-chair list to contain the names of three chair-qualified arbitrators.

Column G provides the average total number of chair-qualified arbitrators whose names will be included on both public lists for a case. This is obtained by simply adding eight to the result in Column F because, in addition to the number of chair-qualified arbitrators whose names will be included on the non-chair-qualified list for a given case, another eight will appear on the chair-qualified list.²² Thus, in the average New York City case under the new rule, the names of eleven chair-qualified arbitrators will be included on the two lists – eight on the chair-qualified list and three on the non-chair-qualified list.

Column H provides the average number of *non*-chair-qualified arbitrators that one can expect to see on strike-and-rank lists of eight public arbitrators for the non-chair public seat. This is equal to eight times the fraction of arbitrators on the non-chair strike-and-rank list who will be non-chair-qualified – *i.e.*, $(y/(x+y-8))$, where “*x*” is the

promoting a new list-selection system that required a splitting of public arbitrator pools if the resulting pools really would be that small.

But promote it the NASD did. In any event, the fix is relatively simple. In the three cities with fewer than eight chair-qualified arbitrators – Anchorage, Norfolk, and Reno – the results have been corrected to reflect the fact that *zero* chair-qualified arbitrators will be poured over into the non-chair-qualified pool for list-selection purposes. As discussed previously, this correction affects about nine percent of hearing locations and fewer than two percent of cases.

21. Once again, a correction is required to reflect the fact that, in those cities where there are fewer than eight chair-qualified arbitrators, the number who will appear on the non-chair lists will be zero. See footnote 20.
22. Obviously, the number to be added will be fewer than eight in Anchorage, Norfolk and Reno, where there are fewer than eight chair-qualified arbitrators. See footnote 20.

number of chair-qualified arbitrators in the pool and “y” is the number of non-chair-qualified arbitrators. Equivalently, it is equal to eight minus the result in Column F.²³ In New York City, for example, one can expect the average eight-arbitrator non-chair list to contain the names of only five chair-qualified arbitrators. In Los Angeles, the number is less than four.

Column I shows the average number of arbitration panels that can be expected to have chair-qualified arbitrators occupying both public seats, *i.e.*, both the chairperson position and the public non-chair position.²⁴ This column will be of particular concern to those who believe that arbitrators who have served frequently are more likely to favor the industry in these disputes. In New York City, for example, 38 percent of arbitration panels can be expected to have two chair-qualified arbitrators, with only 62 percent having even one non-chair qualified public arbitrator. In Los Angeles, more than half of the arbitration panels can be expected to have chair-qualified arbitrators occupying both public seats.

Finally, Column J quantifies the percentage increase in the time it will take an arbitrator in the non-chair-qualified pool to be included in strike-and-rank lists with deck-stacking versus without deck-stacking. The analysis begins by computing the ratio of the number of people who will be included in the non-chair-qualified pool for selection purposes (*i.e.*, the total number of public arbitrators in that city minus eight) to the number of non-chair-qualified arbitrators in that city. In mathematical terms, the ratio is equal to $(x+y-8)/y$; the *increase* in time is that ratio minus one; and the percentage is obtained by multiplying the increase in time by 100. Thus, the percentage increase is equal to $100 ((x+y-8)/y-1)$.²⁵

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23. Once again, a correction is required to reflect the fact that there are cities with fewer than eight chair-qualified public arbitrators. In addition, in one city, Anchorage, there are fewer than eight *non*-chair-qualified public arbitrators, so the total in Column H for Anchorage is 7 rather than 8. See footnote 20.
 24. This computation assumes that arbitrators from the two pools, once their names are included on a public non-chair strike-and-rank list, have the same average probability of being selected. Obviously, in cities with eight or fewer chair-qualified arbitrators, the percentage must be zero because none will appear on the non-chair strike-and-rank lists. See footnote 20.
 25. Once again, a correction is required to reflect that, in Anchorage, Norfolk and Reno, where there are fewer than eight chair-qualified arbitrators, the number who will appear on the non-chair lists will be zero and the percentage increase, likewise, will be zero. See footnote 20.

In New York City, for example, it will take more than 60 percent longer for non-chair-qualified arbitrators' names to appear on strike-and-rank lists than would be the case if the deck were not stacked; in Newark, nearly 90 percent longer; in Los Angeles, more than twice as long; and in Philadelphia, nearly two and a half times as long. As stated previously, if the chair-qualified pools grow, the pace can be expected to be glacial.

The table provides some jarring numbers. It merits study. Readers are encouraged to look at Appendix D not only with regard to the cities where they practice or hear cases, but with regard to the nation as a whole, and to think about the policy implications of the stacked deck that the NASD proposed and the SEC approved.

As pointed out above, pool sizes will change with time. But if the SEC permits the NASD to revert to its pattern of aggressive secrecy, this will be the last table that is published. That would be grossly inappropriate. The NASD should be required to provide city-by-city pool size information on a continuing basis on its website. The NASD should be required to live up to its public proclamations about "transparency."

CONCLUSION

Viewed narrowly, this chapter is about a regulatory failure: the NASD's proposal and the SEC's approval of a single rule that will produce a quantifiable and unseemly skewing of the arbitrator selection process and, in the process, give further reason to doubt the fairness of the securities industry's mandatory arbitration system. More broadly, the failure this chapter explores is emblematic of a far more encompassing problem: some of the entities responsible for protecting the public have simply lost their way.

The sense that the NASD is motivated more by the interests of its members than by the protection of the investing public is nothing new. But in recent times the SEC increasingly has gone in that direction as well. Perhaps this is the result of a misguided belief that cutting regulation and hence costs will make capital markets more competitive. People can harbor that belief only if they fail to account for the inevitable and time-tested outcome of such excursions: an increase in frauds and scandals that erode investors' willingness to entrust their money to an industry and markets perceived as undeserving of trust.

Sometimes the lessons of the past are forgotten too quickly. Investor trust is what makes capital markets possible. Those who forget that lesson are doomed to repeat it.

All is not lost. Investors are fortunate that state securities regulators, by and large, have not lost sight of their goal and purpose of investor protection. They are fortunate as well that Congress is showing increasing interest in investor protection issues, in the performance of the NASD and the SEC, and in the issue of whether it is appropriate – or anything other than nonsensical, for that matter – to force investors into an arbitration monopoly owned and operated by the very industry with which they have a dispute. These beacons give reason for hope that the capital markets might once again deserve the investor trust they seek.

APPENDIX "A"

THE OCTOBER 2006 COMMENT LETTER

20 October 2006

From: Scot D. Bernstein, Esq. and C. Thomas Mason III, Esq.¹

Re: Response to and Comments on NASD's Partial Amendment No. 7, Amendments to the NASD Code of Arbitration Procedure for Customer Disputes, File No. SR-NASD-2003-158

To the Commission:

We write to oppose an aspect of the NASD's proposed rewrite of the Code of Arbitration Procedure that has received far too little attention: the NASD's innocuous-looking proposed rule that will stack the deck in arbitrator selection. The NASD's proposal in Amendments 5 and 7 will rig the selection system so that "chair-qualified" arbitrators will serve several times as often as they otherwise would and "non-chair-qualified" arbitrators will serve a fraction as often as they would serve in an untampered system. This problem is sufficiently important to merit both a comment letter and a bar journal article. That article is attached.²

The attached article and its predecessor are, to our knowledge, the only publicly-disclosed quantitative treatment of the problem. The NASD had an obligation to investigate what its rule would do before proposing it. The NASD either did not analyze the consequences of its proposed rule, or chose to conceal what it found. The analysis requires only first-year algebra. If the NASD even looked at the issue before its Amendment 5 filing, it did not reveal its findings. Indeed, *Investment News* reported in early July that when it confronted the NASD about this matter, the NASD's spokeswoman "didn't respond directly to that issue."³

In Amendment 7, the NASD purports to respond—but in reality refuses to respond—to Scot Bernstein's May 26, 2006 comment, which contained the predecessor to the attached article. The NASD refers to a "statistical study" that it denigrates as "speculative."⁴ But Mr. Bernstein's May 26 comment letter and its attached article contained no "statistical study." The mathematics in the article was plain algebra. There is nothing speculative about algebra. The NASD mischaracterized the analysis and criticisms, evidently hoping that this would make this problem go away and that the SEC would not be able tell the difference.

¹ Scot Bernstein and C. Thomas Mason are lawyers in private practice in Sacramento, California, and Tucson, Arizona, respectively. Both are members of PIABA's board of directors. The views expressed are the authors' and not necessarily those of PIABA or its board of directors.

² The attached article, substantially revised from the draft article attached to Scot Bernstein's May 26, 2006 comment letter, provides a thorough discussion of the problem and its policy implications.

³ Jamieson, Dan, "PIABA cries foul over arbitration proposal," *Investment News*, July 7, 2006, <http://www.investmentnews.com/article.cms?articleId=55339&fromTopic=18>

⁴ NASD, Response to Comments and Partial Amendment 7, dated Aug. 15, 2006, File SR-NASD-2003-158, at p. 8.

After failing to address the issues raised by Mr. Bernstein's May 26 comment letter and its attached article, the NASD reverted to empty boilerplate that it "believes the proposed standards ... are reasonable and necessary ... [and] will enhance the efficiency of the arbitration process." False platitudes are not a substitute for reasoned discussion. NASD has presented no data, no analysis, no evaluation, and no logical or empirical support of any of those contentions.

The way to counter a mathematical argument is to show why the argument is wrong. If the NASD had anything to counter the quantitative analysis in Mr. Bernstein's May 26 comment letter and article, it would have shown what it had. NASD provided nothing. But rather than concede the mathematical point and preserve a shred of credibility, the NASD chose instead to mischaracterize the mathematics in the article and to substitute groundless platitudes to salvage its proposal.

The NASD owes a genuine response to criticisms of its proposal to stack the deck in arbitrator selection. It is inconceivable that the entity that "self-regulates" the nation's capital markets is incapable of understanding the difference between a "speculative" "statistical analysis" and basic algebra. The NASD cannot plausibly claim that it has no employee, and cannot find anyone among all the mathematicians, engineers, and physicists employed by its member firms, who can confirm that Mr. Bernstein's algebra is correct.

The only logical conclusion that the NASD is not being honest. Whether the NASD is being dishonest in an attempt to save face or some other reason does not matter.⁵ The lack of honesty itself is unacceptable. The public deserves, the NASD is obligated to provide, and the SEC should demand more than vacuous boilerplate.

Looking at the larger picture, many of the securities industry's abuses of American investors have come in the form of products and services where honest mathematical analysis would have revealed the ugly truth. The SEC has participated in enforcement actions involving many of them. Examples include large sales of mutual fund B shares, fee-based accounts for people who are not trading actively, and sales of full-cost variable annuities to practically anyone. Those abuses are accomplished by securities industry members misrepresenting material facts by not disclosing the math. And now, in Amendment 7, what is the industry's "self-regulatory" association doing? *Misrepresenting material facts by not disclosing the math.*

The mathematics of the NASD's stacked deck proposal is sufficiently straightforward to create public embarrassment for the SEC if it falls for the NASD's argument and provides the approval that the NASD has requested. Given that simplicity, there will be no excuse for a failure by the SEC to give this matter the closer look that the NASD wants to avoid.

⁵ We have heard it suggested that part of the NASD's resistance to admitting that there are problems with its deck-stacking proposal is that it already has paid to develop the software necessary to implement that proposal. But if doing away with the proposed deck stacking would necessitate any change to its software, that is only because NASD paid for software to implement a rule that had not yet been approved by the SEC. If the NASD argues that the rule should be approved because it already has developed the necessary software, it is asking the SEC to be nothing more than a rubber stamp of a fait accompli.

The disingenuousness of the NASD's arguments is apparent when we compare its previous story in Amendment 5 with its new story in Amendment 7. For instance, in Amendment 5, at page 22, NASD stated proudly,

“NASD believes that eliminating the ability to select an arbitrator based on expertise and implementing the random selection function of NLSS will expand use of the full arbitrator pool, **so that all arbitrators on the lists will have the same chance of being selected for any case.**” [Emphasis added.]

Equal chance in random selection has been the hallmark of the NASD's move away from the existing flawed system. The NASD has touted equal chance as the central benefit of the new random selection function.

However, when NASD introduced the proposal to favor “chair-qualified” arbitrators with multiple bites at the apple, it destroyed any possibility that “all arbitrators on the lists will have the same chance of being selected for any case.” The NASD chose to remain silent about this material change in its advertised program. Mr. Bernstein's May 26 comment letter and article demonstrated that consequence unequivocally and quantified it precisely.

Now, in Amendment 7, without honestly telling anyone that it has abandoned such a fundamental principle, the NASD quietly discards the objective of equal chances in random selection. On page 8 of its Amendment 7 filing, the NASD tacitly admits the accuracy of the May 26 comment letter and tries to cover itself with a new rationalization that is diametrically opposed to its previous purportedly principled position:

NASD believes that if chair-qualified arbitrators are found to be serving on panels more frequently than other public arbitrators, this result would be in the public interest....

The NASD is speaking out of both sides of its mouth. From one side, it claims that straightforward algebra is a “speculative” “statistical study.” From the other, it accepts the math that chair-qualified arbitrators will indeed serve disproportionately often – and then claims, for the first time, that that's a good thing. The NASD apparently will say whatever it thinks will get its deck-stacking proposal approved, and will freely abandon purported “principles” that helped it get other components of its Code rewrite accepted.

The NASD has neither rational nor empirical bases for its purported “belief” that this new skewing will be in the public interest rather than in its members' interest. In fact, relevant studies show that the NASD's “belief” is wrong. The “repeat player” phenomenon has been analyzed repeatedly and shown to be often harmful to the non-repeat player.⁶ Here, the investors are the non-repeat players who are harmed.

⁶ See, e.g., MARCUS NIETO & MARGARET HOSEL, ARBITRATION IN CALIFORNIA MANAGED HEALTH CARE SYSTEMS (California Research Bureau, Dec. 2000) (finding that where a small group of repeat arbitrators handled many of Kaiser Permanente's arbitration claims, 75% of those arbitrators ruled in favor of the defense in 80% of the cases; overall, after surmounting other systemic disadvantages, plaintiffs' chances of winning an award were 15%-25% better with an infrequent arbitrator than with a repeat player arbitrator); Lisa B. Bingham, *On Repeat Players*,

Making repeat player arbitrators more equal than others exacerbates the problem of structural bias in arbitration. It highlights “the question of the incentives that so often operate on arbitrators—that is, of their self-interest in trying to secure and expand prospects of future arbitral appointments. This is a dynamic that is well-understood, if rarely discussed with any frankness.”⁷

Chair-qualified arbitrators are by definition repeat players. The NASD’s proposal to stack the deck by increasing how often they serve increases the perverse incentives and structural bias problems. Empirical studies and statements by arbitrators themselves reveal that, to continue being seated on panels, repeat player arbitrators are more likely to give awards favorable to the industry respondents than to one-shot public consumers.⁸ As a noted observer wrote, a compromise award “rendered so that the arbitrator may keep his job” is “totally unacceptable in any decent system of justice.”⁹

Adhesive Contracts, and the Use of Statistics in Judicial Review of Employment Arbitration Awards, 29 McGeorge L. Rev. 223 (1998); Marc Galanter’s classic study, *Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal Changes*, 9 Law and Society Rev. 95 (1974).

⁷ Alan Scott Rau, *Integrity in Private Judging*, 38 S. Tex. L. Rev. 485, 521 (1997). See also Michelle Andrews, *For Patients, Unpleasant Surprises in Arbitration*, New York Times, March 16, 2003 (the California Research Bureau report, cited above, found that none of the few arbitrators who awarded patients more than \$1 million from April 1999 to March 2000 were selected by health care providers to serve again).

⁸ In addition to the authorities already cited, the former Chief Justice of the West Virginia Supreme Court wrote recently of his personal experience as an arbitrator for the National Arbitration Forum:

In my case I did not award the bank the litigation-related fees. Those fees are tantamount to an award of attorneys’ fees and such fee shifting in a contract of adhesion is “unconscionable.” I never got another case! And that is entirely understandable because banks are *professional litigants*. When a mega-bank gets a list of possible arbitrators, it knows that old Richard here ain’t much for giving the single mom that extra \$450 screwing. So ... the bank knows to strike Richard as unacceptable.

Richard Neely, *Arbitration and the Godless Bloodsuckers*, WEST VIRGINIA LAWYER (Sept/Oct. 2006), at p. 12.

Concerns about getting appointed to another case have been echoed by NASD arbitrators. Indeed, at the PIABA Annual Meeting in 2005, arbitrators in a panel discussion revealed that arbitrators generally do not award investors their remedies under state securities laws, even when they find liability, because they’re concerned that the industry respondents will consider the amounts too high. One panelist said that state blue sky damages are seen as “draconian.” Securities regulators are right to be concerned that arbitrators are denying investors the statutory relief that their legislatures established for public protection.

⁹ PAUL R. HAYS, LABOR ARBITRATION: A DISSIDENTING VIEW 66 (1966). Also Paul R. Hays, *The Future of Labor Arbitration*, 74 Yale L.J. 1019, 1034-35 (1965) (“[a] system of adjudication in which the judge depends for his livelihood, or for a substantial part of his livelihood or even for substantial supplements to his regular income, on pleasing those who hire him to judge is per se a thoroughly undesirable system.”). Judge Hays was a longtime arbitrator and professor of law at Columbia University before being appointed to the U.S. Court of Appeals for the 2nd Circuit.

The NASD would be more accurate and honest if it admitted that “if chair-qualified arbitrators are found to be serving on panels more frequently than other public arbitrators, this result would be in the securities industry’s interest.” Of course, NASD can’t admit that publicly because it is obviously contrary to the NASD’s statutory mandate to protect public investors.¹⁰

We recently learned that the NASD is using small pools of arbitrators as an excuse for stacking the deck in the manner proposed in Amendment 5. The NASD claims it needs to include chair-qualified arbitrators in the non-chair-qualified pool because the total number of available arbitrators is small in some hearing locations and it fears it might not have enough non-chair-qualified arbitrators otherwise. The absurdities of the NASD’s position flood the mind:

1. If the NASD’s proposal to stack the deck truly is motivated by its concern about venues with small pools, then why is the NASD proposing to stack the deck everywhere, even in venues where pools are large? The nationwide character of the proposal puts the lie to any claim the NASD might make that small pools are its concern.
2. Why isn’t the NASD proposing to do the reverse – to infuse the *non*-chair-qualified arbitrators into the *chair-qualified* pool – in those locations where it is the chair-qualified pool that is under-populated? The NASD can scarcely be heard to complain that “non-chair-qualified” arbitrators are not capable of chairing arbitration panels. After all, the arbitrators who will be classified as “non-chair-qualified” under the revised code have been permitted to serve as chairpersons all along. In fact, they are doing so to this day.
3. If some pools are too small, why should the NASD be permitted to split them into still smaller sub-pools? The NASD’s deck-stacking proposal is a bad solution to a problem that the NASD itself is attempting to create by splitting the public pool in the first place. If the sub-pools really are so small that the NASD needs to skew the arbitrator selection process by way of its current proposal, the better answer is not to split the public arbitrator pool at all. The public arbitrator pool has been a single pool for many decades. The SEC should consider the fact that investors – who are supposed to be protected by the securities laws and the NASD – are not the ones clamoring to have it split.
4. If the problem is small arbitrator pools, the remedy is to recruit more arbitrators, not to stack the deck so that a favored group of arbitrators defined by the NASD gets multiple bites at the apple.
5. Here is the ultimate absurdity: the NASD is being permitted to claim that pool sizes are driving its latest proposal without providing any information about pool sizes venue by venue. For all its public pronouncements about favoring transparency,¹¹ the NASD

¹⁰ 15 U.S.C. § 78o-3.

¹¹ NASD declared to Congress that it “believes that transparency should be a hallmark of securities arbitration as well.” Testimony of Linda D. Fienberg, President, NASD Dispute Resolution, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, U.S. House of Representatives, March 17, 2005. NASD’s actual conduct, including its efforts to limit access to arbitration awards for empirical studies that likely would reveal the untruth of many of its assertions about its arbitration forum, are wholly contrary to what Ms. Fienberg assured members of Congress.

continues to cloak the operations of its arbitration program in dark secrecy. How can the public evaluate the current proposal and the NASD's current excuse for it without being provided with the relevant information? A fair and reasonable opportunity for public comment cannot be had without disclosure of that information by the NASD. This is especially true now that the attached article has provided a formula for determining the precise impact of the proposal when the sizes of the chair-qualified and non-chair-qualified sub-pools are known. What possible excuse can the NASD give for flouting the transparency it purports to favor and continuing to pretend that its pool sizes must be kept from the public?

Looking at this in the broader context, members of the investing public, state securities regulators, and members of Congress will be asking themselves this question: If skewing the system to favor repeat player arbitrators is *better* for investors' claims, why are the industry commentators and their membership association the ones who are in favor of it? If repeat player arbitrators are *worse* for investors than arbitrators who serve less often, why is the NASD seeking to elevate its favored players to serve even more frequently – indeed, several times as often?

Why should this skewing of arbitrator selection be permitted? Dividing the public arbitrator pool and giving strong preference to one subgroup defined by the NASD will not enhance investors' trust in an arbitration system about which the public and state regulators already have well-founded serious doubts. The appearance of a stacked deck will not enhance the reputation of American capital markets generally.

Notwithstanding that the analysis requires only simple algebra, the NASD, with all its resources and all its duties of thoroughness in connection with filings of this kind, never touched on this issue. NASD has an affirmative duty to propose rules only after determining—based on facts and knowledge, not empty platitudes and speculation—that they are consistent with investor protection. If the NASD cannot provide real answers to the questions above based on empirical facts, instead of a boilerplate statement of unfounded “belief,” it has no business submitting the proposal at all. All this makes one wonder if the NASD did as poor a job of thinking through the rest of its code rewrite as it did with this issue.

The NASD's “chair-qualified” deck-stacking proposal has the potential to embarrass the SEC. Part of the embarrassment will come from the fact that the math necessary to understand this problem is so basic. Part will come if the SEC does no investigation of its own to determine whether the dramatic favoring of “chair-qualified” arbitrators will be deleterious to investors. The SEC cannot claim that it relied on the NASD to make that determination, because the NASD's analysis of its proposed rule is so demonstrably inadequate and its response comments are so baseless, so false and so contrary to the NASD's prior pronouncements.

The SEC has assured U.S. federal courts that it reviews SRO arbitration rules and rule proposals carefully and thoroughly.

[The SEC] has been entrusted ... with comprehensive oversight of self-regulatory organizations (SROs) such as the NASD and the NYSE. As part of that function,

the Commission carefully reviews and must approve all rules under which the SROs conduct their arbitration systems, as well as any changes to those rules. The Commission also inspects the NASD and NYSE arbitration systems on a periodic basis in order to “identify areas where procedures should be strengthened, and to encourage remedial steps either through changes in administration or through the development of rule changes.” ... The Commission, in short, has full supervisory authority over the rules adopted by SROs, including the power to mandate the adoption of additional rules it deems necessary in the public interest.¹²

The SEC has successfully argued that its careful scrutiny of NASD arbitration rules thereby justifies granting those rules the effect of federal regulation and the power to preempt duly enacted state laws.

The ultimate approval of a proposed SRO rule reflects the Commission's determination that the proposed rule is consistent with the purposes of the Exchange Act. 15 U.S.C. § 78s(b)(2); *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 233, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987) (“No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act....”).¹³

In *McMahon*, as the SEC wrote to the federal district court,

The Court relied on the fact that the Commission had in fact exercised its regulatory authority to specifically approve the arbitration procedures of the NASD and the NYSE, along with those of the American Stock Exchange, in upholding pre-dispute agreements to arbitrate certain securities claims, on the view that Commission oversight assured the arbitration systems would be fair to investors.¹⁴

In view of these repeated representations to federal courts at all levels, including the U.S. Supreme Court, that the Commission gives careful and critical scrutiny to all SRO arbitration rule proposals, the SEC cannot approve the NASD's “chair-qualified” proposals as submitted.

Indeed, the SEC must take a hard look at the NASD's other anti-investor arbitration rule proposals in the code rewrite, including—especially—the proposal to permit summary

¹² SEC amicus brief in *NASD Dispute Resolution, Inc. v. Judicial Council of California*, C-02-3486 (N.D.Cal.), submitted Sept. 18, 2002, at pp. 1, 9. Also, SEC amicus briefs in *Mayo v. Dean Witter Reynolds Inc.*, C-01-20336 (N.D.Cal.), and *Jevne v. Superior Court of California*, No. B167044 (Cal.App. 2 Dist.), submitted Sept. 11, 2003, 2003 WL 23140037.

¹³ *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119, 1130 (9th Cir. 2005). The SEC submitted an amicus brief in this case also, again arguing that its careful review of SRO rules justified giving them preemptive power. The Court of Appeals accepted that argument and held that the NASD arbitration code preempted California's law mandating arbitrator disclosures to protect consumers. The court concluded, “Specifically, we hold that the NASD arbitration procedures in dispute here have preemptive force over conflicting state law.” *Id.* at 1132.

¹⁴ SEC amicus brief in *NASD Dispute Resolution, Inc. v. Judicial Council of California*, at p. 11.

disposition by motion practice so that investors are deprived of an evidentiary hearing on the merits of their complaints.¹⁵ As obnoxious as the present deck-stacking proposal is, the NASD's dispositive motion proposal is even more toxic to investors who expect a fair and just forum for resolving disputes with securities industry members.

The NASD's proposals regarding chair-qualified arbitrators are contrary to the NASD's statutory mandate to protect public investors. The SEC should not approve the deck-stacking proposal under any circumstances. Further, the SEC should deny the NASD's request to divide the public arbitrator pool into "chair-qualified" and "non-chair-qualified" subgroups, as the NASD has not demonstrated that such a split will not be harmful to investors. At a minimum, the split of the public pool should not be permitted in any location in which the NASD claims it would need to stack the deck in list selection in order to have its random system work.

Approving the NASD's proposal would be an inexcusable affront to an investing public entitled to some semblance of justice from a system for which it is forced to give up the age-old right to a judge and jury. And it would be an abrogation of the SEC's promises to the federal courts and to the public.

Respectfully submitted,

Scot Bernstein and C. Thomas Mason III

¹⁵ See SR-NASD-2006-088, Motions to Decide Claims Before a Hearing on the Merits (Proposed NASD Rule 12504), Release No. 34-54360 (Aug. 24, 2006).

APPENDIX “B”

ARTICLE THAT ACCOMPANIED OCTOBER 2006 COMMENT LETTER: “TAMPERING WITH LIST SELECTION BY ENHANCING THE APPOINTMENT FREQUENCY OF ‘CHAIR-QUALIFIED’ ARBITRATORS”

Appendix B: © 2006 Scot Bernstein

This article was written *before* the SEC approved the NASD’s Customer Code in early 2007. While the article is critical of one of the new rules in that Code, it nevertheless provides context for that rule and a discussion of its predictable consequences.
David E. Robbins

OVERVIEW

In the recently-filed “Amendment 5” to its proposed rewrite of the Code of Arbitration Procedure,² the NASD continues previous versions’ division of all “public” arbitrators³ into two separate groups: those who meet the NASD’s definition of “chair-qualified arbitrators” and those who do not.⁴ But Amendment 5 amplifies the dominance of the chair-qualified arbitrators by infusing members of that favored group into the “non-chair qualified” group for list selection purposes.⁵ Thus, arbitrators from the “chair-qualified” group will serve both as panel chairs and as public non-chairs in many cases. This newest wrinkle might seem innocuous at first blush. When examined quantitatively, however, it reveals a serious and problematic consequence: the arbitrators who are in the chair-qualified group will serve far more frequently than those who are not. The impact is far from trivial, as will be proven in this article.

The irony of this is that it is contrary to at least one reasonable interpretation of the NASD’s own representations to the SEC regarding what the new arbitrator selection system will achieve. At page 22 of its Amendment 5 filing, the NASD states as follows:

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2. Unless otherwise specified, the term “Code” refers to the NASD’s new Code of Arbitration Procedure as set forth in its fifth amendment to that proposed code, originally filed with the Securities and Exchange Commission as SR 2003-158.
 3. The term “public” is a commonly-used shorthand way of referring to arbitrators who meet the Code’s definition of arbitrators who are not affiliated with the securities industry, *i.e.*, who are not “industry arbitrators.” Active controversies regarding the deep industry ties of some arbitrators who qualify as “public” under the definition, whether the definition needs further tightening, and the lack of policing which has allowed industry arbitrators to be and remain misclassified as “public” for extended periods of time are beyond the scope of this article.
 4. Thus, under the new Code, panel chairs, public non-chairs and industry arbitrators will be chosen separately by striking and ranking three separate lists instead of the current two.
 5. Proposed Rule 12400(b) states:
“NASD maintains the following roster of arbitrators:
 - A roster of non-public arbitrators as defined in Rule 12100(n);
 - A roster of public arbitrators as defined in Rule 12100(r); and
 - A roster of arbitrators who are eligible to serve as chairperson of a panel as described in paragraph (c). Arbitrators who are eligible to serve as chairperson will also be included in the roster of public arbitrators, but will only appear on one list in a case.

“NASD believes that eliminating the ability to select an arbitrator based on expertise and implementing the random selection function of NLSS will expand use of the full arbitrator pool, **so that all arbitrators on the lists will have the same chance of being selected for any case.**” [Emphasis added.]

If the NASD’s proposal to give chair-qualified arbitrators two bites at the apple is approved, different public arbitrators will have very different chances of being selected for any given case.

It is unclear whether the NASD has considered the quantitative problems with its proposal. What is clear, however, is that those concerns are not addressed in its rule filing. While the quantitative problems make approval of the NASD’s proposal inappropriate, the NASD’s failure to address them makes its request for accelerated approval doubly so.⁶

This article’s conclusions about the proposed rule’s quantitative impacts on list selection are not based upon speculation or arguable assumptions. They are not empirical in nature and do not await experimental confirmation. Rather, they are knowable *a priori* based solely on a straightforward application of algebra to the NASD’s proposed selection rules.

If the proposed rule is approved, the SEC will have permitted the NASD to divide its public arbitrator pool into two groups and to tamper with arbitrator selection so that members of one group will sit in judgment of customer claims far more often than members of the other. Arrangements of that kind have the look of a fixed race and can be expected to erode confidence on the part an investing public that already is weary of securities industry scandals and justifiably cynical about arbitration.

It is a rare instance when the quantitative consequences of a rule filing are calculable with algebraic precision. But this is one such instance. It would be unfortunate for the investing public and an embarrassment to the SEC if the rule were to be approved on an accelerated basis, without the SEC and the public even having an opportunity to consider its clearly provable consequences.

THIS ARTICLE IS DIVIDED INTO TWO SECTIONS.

The first section addresses briefly the policy concerns raised by the NASD’s proposed skewing of list-selection. That section begins with a brief table of sample outcomes to give a preview of the greatly increased frequency with which chair-qualified arbitrators will be appointed and the dramatically reduced frequency with which non-chair-qualified arbitrators

6. As of this writing, the NASD is seeking accelerated approval of this aspect of Amendment 5. Therefore, readers opposed to this tampering with list selection should file their comments with the SEC quickly.

will be appointed under the NASD’s proposed rule. It then discusses non-quantitatively the potential adverse impacts on investors of a rule that makes chair-qualified arbitrators far more likely than non-chair-qualified arbitrators to sit in judgment of investors’ claims.

The next section quantifies the problem. It begins with a straightforward series of numerical calculations demonstrating the skewing that would occur in a hypothetical hearing location with 40 chair-qualified public arbitrators and 40 non-chair-qualified public arbitrators. Following that series of calculations is the derivation of a parallel series of formulas describing the skewing algebraically. The formulas derived in that part will enable the reader, using any combination of pool sizes, to calculate the precise impact of the NASD’s proposed rule.

SECTION 1: SAMPLE OUTCOMES AND POLICY CONSIDERATIONS

First, here are some sample outcomes. In this table, “tampered” refers to the arbitrators’ relative odds of sitting on an arbitration panel if members of the chair-qualified group are favored with “two bites at the apple” as the NASD proposes; “untampered” refers to their odds if each group stands alone on equal footing with the other, as list selection would have been conducted under the revised code prior to Amendment 5.

Number of Chair-Qualified Arbitrators	Number of Non-Chair-Qualified Arbitrators	Chair vs. Non-Chair Relative Odds of Serving if Selection is Untampered	Chair vs. Non-Chair Relative Odds of Serving if Selection is Tampered to Boost Chairs’ Odds
“x”	“y”		
100	100	1 to 1	2.84 to 1
40	40	1 to 1	2.60 to 1
50	100	2 to 1	3.68 to 1
100	50	0.5 to 1	2.34 to 1

Perhaps the biggest problem with this tampering with the arbitrators’ odds of serving on panels – aside from the failing of the “smell test” inherent in allowing the NASD to divide public arbitrators into two groups and then hugely favor one group over the other – is the public perception that arbitrators with substantial numbers of closed cases, all of whom will

be “chair-qualified” under the revised code, are particularly lacking in independence.

To serve frequently, arbitrators must be mutually ranked – that is, they must not receive a “strike” from either party during the strike-and-rank process. Thus, as a practical matter, the arbitrators who serve most frequently will be those who have succeeded in keeping their balance of customer victories and customer losses reasonably close to the 50-50 mark; avoided awarding attorneys’ fees or even interest, notwithstanding the fact that many state securities acts expressly provide for those remedies; and shunned punitive damage awards and similar remedies that would make them stand out as an obvious strike for industry defense counsel. Issuing split-the-baby awards may help those arbitrators as well. What this often means is that arbitrators can enhance their odds of being appointed by nullifying laws enacted for the protection of investors.

In short, arbitrators who want to be appointed will benefit by exhibiting a lack of the judicial independence that the Founding Fathers recognized as so clearly important when they built protection of federal judges’ tenure and salaries into Article III of the U.S. Constitution. The “arbitral dependence” that comes about as a result of arbitrators’ desire to serve and serve again is well known. Exacerbating the problem by inviting those most proficient in displaying a “split-the-baby” mentality to sit far more often than they otherwise would does not qualify as appropriate stewardship of American capital markets.

And that is not the only problem. Imagine how long it will take new non-chair-qualified public arbitrators to try the two cases to award (or for non-lawyers, three cases) that are required to become chair-qualified.⁷ Indeed, the dramatically reduced odds of being appointed can be expected

7. Imagining really isn’t necessary. Dividing the result in “B5” (below) by the result in “B6” (also below) reveals that it can be expected to take $(x + y - 8)/y$ times as long to be appointed to any given number of cases. It will take still longer to carry the required number of cases through to award, given that only 22% of filed cases go all the way to award. As the NASD stated at page 22 of its Amendment 5 filing:

“Last, NASD believes that the requirement that an arbitrator serve on at least three arbitrations through award to be eligible for the chair roster is an objective standard that is easily measured. **While this standard is easy to measure, it is not easy to meet. Of the arbitration cases filed in the past four years, approximately 22% went to hearing.**”

As stated previously, the NASD has given no indication that it understands the quantitative implications of its rule. The difficulty it describes in becoming chair-qualified did not even account for the further lengthening of the required time described in this article. This suggests a future in which chair-qualified arbitrators are firmly entrenched, and entry into that favored group will be rare indeed.

to have a number of negative impacts on the non-chair-qualified public pool and on recruitment of new arbitrators. To name three that come quickly to mind, (1) for many new arbitrators, arbitrator training will be a distant memory by the time they finally get to serve for the first time; (2) some new arbitrators will simply lose interest and give up, irritated that they spent time and money to become arbitrators in the first place; and (3) potential arbitrators who hear from those who have experienced the problems identified in “(1)” and “(2)” may not even complete an application.

Other problems arise out of the increased frequency with which chair-qualified arbitrators will be mutually ranked and asked to serve if the NASD’s proposal is approved. This inevitably will increase the frequency with which arbitrators decline appointments to panels. The already-disturbing problem of last-minute resignations can be expected to worsen as well. Either way, whether early in the case or on the eve of hearing, there will be more administrative appointments. Thus, with the new rule in place, the parties will lose some of the control over their disputes that list selection was supposed to enhance.

Those who are not convinced by the practical arguments above regarding the differences between chair-qualified and non-chair-qualified arbitrators can come to similar conclusions by taking what might be called a “black box” approach to the problem. For this purpose, forget about what it means to be “chair-qualified.” Instead, suppose only that the NASD has been permitted to divide an arbitrator pool into two groups and to determine, by rule or roster, which arbitrators will be in each group. Next, you learn that the NASD seeks permission to implement a rule that will cause arbitrators in one group to decide disputes far more often than those in the other group. Faced with this stripped-down black box scenario, which of the following seems more likely: (1) that the rule favoring one group of arbitrators over the other will be absolutely neutral in its impact, or (2) that the rule somehow will work to the benefit of the NASD’s member firms? Allowing the NASD’s proposed change will create, at the very least, the appearance of a stacked deck.

It is not as though chair-qualified arbitrators would be disenfranchised in the absence of the NASD’s latest wrinkle. There already will be one on every panel, even without the proposed rule. And that arbitrator, by serving as panel chair, will have a heightened opportunity to influence the outcome of the case. Further, the chair-qualified arbitrator will be the only arbitrator in a one-arbitrator case.⁸ So the question is not whether

8. See Proposed rule 12403(a).

chair-qualified arbitrators will have a voice in the outcome of arbitration proceedings. The question is whether the NASD should be permitted to adopt a rule that frequently will cause members of the chair-qualified group to have still greater influence by occupying both public seats instead of one.⁹

SECTION 2: QUANTIFYING SKEWING AND DERIVING A FORMULA

This section quantifies the skewing of list selection that will be brought about by the proposed rule. To make this more approachable, Part “A” of this section works through a series of ten simple numerical calculations based on a hypothetical hearing location with 40 chair-qualified public arbitrators and 40 non-chair-qualified public arbitrators. The benefit of beginning the quantitative discussion with actual numbers instead of the variables “x” and “y” is that doing so will make it easier to see what is happening to the quantities involved and may help to impart a more intuitive feel for the size of the problem.

Part “B” of this section then will generalize the analysis, replacing each numerical calculation with an algebraic formula. Using the resulting formulas, anyone with knowledge of the number of arbitrators in the chair-qualified pool and the non-chair-qualified pool will be able to determine the precise consequences of the tampering for which the NASD is seeking accelerated approval.

The derivation of formulas in Part “B” is not the product of complicated mathematics. It should be accessible to anyone who has had a year of algebra. While the expressions may look daunting at first, you will see that, when boiled down, the resulting formulas are simple and elegant. To make this more approachable, the article shows each step in the calculations and derivations and, in addition, provides plain-English explanations where they will be helpful.

Readers who are good at algebra will find all of this quite easy. It is my hope that those whose algebra skills are a bit rusty will find them less rusty after working through Part “B.” The key to reading Part A and especially Part B (or any other mathematical discussion, for that matter) is to read them slowly and to think about each step until you are sure

9. If there are x chair-qualified arbitrators and y non-chair-qualified arbitrators in a hearing location, chair-qualified arbitrators will occupy both public seats on three-arbitrator panels $(x - 8)/(x + y - 8)$ of the time. For example, if $x = y = 50$ (so that there are 50 chair-qualified arbitrators and 50 non-chair-qualified arbitrators), chair-qualified arbitrators can be expected to occupy both public seats on $42/92$, or approximately 46%, of three-arbitrator panels.

you understand why it is correct (or can show why it is in error). The plain-English explanations accompanying each mathematical statement may prove helpful in this regard.

While probability concepts also figure in this analysis, the knowledge of probability theory required for an understanding of the quantitative discussion below is minimal. That may seem surprising at first, given that arbitrators will be selected at random¹⁰, rather than by “rotation,” under the revised code of arbitration procedure.^{11,12,13} Nonetheless, the only probability concepts needed for an understanding of this paper are those which many readers probably understand intuitively:

10. See Rule 12400(a):

“12400. Neutral List Selection System and Arbitrator Rosters

(a) Neutral List Selection System

The Neutral List Selection System is a computer system that generates, on a random basis, lists of arbitrators from NASD’s rosters of arbitrators for the selected hearing location for each proceeding. The parties will select their panel through a process of striking and ranking the arbitrators on lists generated by the Neutral List Selection System.”

11. The current “rotational” system is not a rotation at all. Rather, it employs an algorithm that attempts to match what a true rotation would do. It does this without complete success. For more about this, see Bernstein, Scot, “Understanding NLSS or How I Learned To Stop Worrying and Love List Selection,” *PIABA Ninth Annual Meeting*, October 2000.

A number of public comments filed in response to prior amendments to the revised code of arbitration procedure called for annual audits of the NASD’s new “random” system for generating lists of arbitrators for striking and ranking purposes. The comments sought to inject a bit of transparency into the arbitrator selection process. Here is the relevant text from the NASD’s Amendment 5 filing, at page 20:

“Neutral List Selection System and Arbitrator Rosters (Rule 12400(a))

Nineteen commenters suggest that NASD hire a neutral third party, not connected to NASD or the securities industry, to conduct an annual audit of the Neutral List Selection System (NLSS), and make the results of the audit publicly available on NASD’s Web site.

NASD is committed to ensuring that the NLSS operates as described in the Customer Code. Thus, NASD plans to hire an independent auditor to conduct an initial audit of the system and will make public the results of the audit. Thereafter, NASD will conduct an audit on an as needed basis.”

See NASD Amendment Number 5 to SR-NASD-2003-158, May 4, 2006, page 20 (footnote omitted).

Apparently, the NASD thinks that having a one-time independent audit at the inception of a system that will select arbitrators for thousands of disputes each year

for many years is sufficient because it will conduct further audits on its own (it doesn't say whether those results will be made public) whenever it wants (what else could "as needed" mean, given that the NASD gets to decide when an audit is "needed"?).

12. As long as we're discussing other problems with the NASD's proposal, here's another: ties during the process of consolidating rankings will be handled in a less desirable manner under the proposed rule. The proposed approach is described in footnote 63 to the NASD's Amendment 5 filing, at page 23:

"63 The system will select randomly one name at a time for each list (i.e., chair, public, non-public), and list the names in the order in which they were selected. The first arbitrator selected would be Arbitrator #1; the second would be Arbitrator #2, etc. After the parties have made their selections and the lists have been consolidated, in the unlikely event of a tie among arbitrators, the system will break the tie based on the order in which the arbitrators were placed on the list. So, for example, if Arbitrators 3 and 5 are "tied" after the public lists are consolidated, the system will select Arbitrator 3 for the public non-chair position, because the system selected him or her before Arbitrator 5."

Previously, ties were broken based on the lowest difference between the parties' rankings. For example, if your #1-ranked arbitrator were my #3-ranked arbitrator, and if your #2-ranked arbitrator were my #2-ranked arbitrator, both arbitrators would tie for top-ranked with the same sum: 4. But two minus two is less than three minus one, so the arbitrator ranked as both parties' second choice would be chosen. The greater fairness inherent in using the lowest difference as the tie-breaker is self-evident. The NASD's proposal, while it may make things administratively easier for the NASD, comes at some cost in terms of fairness. The NASD's "order of selection" approach should be used only when two arbitrators are tied in both sums and differences.

13. Other list-selection problems arise in connection with "strikeouts" – situations in which the joint selection process leaves no one standing. While the limited strikes in the proposed rule will make strikeouts less common, they still will occur. An example would be the situation in which the lone mutually-ranked arbitrator could not or would not agree to serve. Proposed rule 12406(c) will handle strikeouts as follows:

"12406. Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List

...

(c) If the number of arbitrators available to serve from the combined list(s) is not sufficient to fill an initial panel, the Director will appoint one or more arbitrators of the required classification to complete the panel from names generated randomly by the Neutral List Selection System. If the Director must appoint a non-public arbitrator, the Director may not appoint a non-public arbitrator as defined in Rule 12100 (p)(2) or (3), unless the parties agree otherwise. The Director will provide the parties information about the

1. If you are in a group of ten people out of which one person will be picked at random, you have a 10% chance – or equivalently, a probability of 1/10 – of being picked.
2. The sum of the probabilities of all possible outcomes, taken together, must equal 1.0 or, equivalently, 100%. For example, if you will either be late or not be late and there is no other possibility, and if you have a 30% chance of being late, then you must have a 70% chance of not being late.
3. The probability of a sequence of independent events occurring is the product of the probabilities of the individual events. For example, if the probability of “heads” is $\frac{1}{2}$, the probability of tossing “heads” three times in three tosses is $\frac{1}{2} \times \frac{1}{2} \times \frac{1}{2}$, or one in eight. Indeed, each of the eight possible sequences that can occur in three tosses of a coin has this same probability; and, consistent with item 2 above, $8 \times \frac{1}{8} = 1$.

The calculations and the derivations of formulas below assume application of the NASD’s proposed rules that (1) a list of 8 potential chairs will be drawn randomly from the chair-qualified pool; (2) all *other* arbitrators in the chair-qualified pool will be combined with the arbitrators in the non-chair-qualified pool and a list of 8 potential non-chair public arbitrators will be drawn randomly from that combined pool; and (3) the parties then will proceed with striking and ranking. The illustrative numerical calculations in Part “A” assume, in addition, that there are

arbitrators as provided in Rule 12403 and the parties will have the right to challenge the arbitrators as provided in Rule 12410.”

The first sentence of this text could be interpreted to give the Director the right to pull a number of randomly-selected names from the system and to make the choice from among them to fill the vacancy. That would be unfair to investors, who should not have to vest discretion to choose arbitrators in an organization that is, after all, a membership association of the investors’ opponents. A better and fairer approach, one that would enhance rather than detract from the parties’ control over their dispute, would be to fill all vacant seats (whether they occur by strikeout, by later resignation of an arbitrator, or by any other means) in the following order of preference: (1) If there are arbitrators in the same classification who were mutually ranked by the parties (*i.e.*, not stricken by either party), then the highest ranked among those arbitrators shall be appointed to fill the vacancy; (2) if there is no mutually-ranked arbitrator in the appropriate classification to fill the vacancy, then the next randomly-selected arbitrator in that classification shall be appointed to fill the vacancy.

exactly 40 chair-qualified arbitrators and exactly 40 non-chair-qualified arbitrators.

That's it. The calculations and formula derivations below are not based on assumptions that are controversial or the subject of argument. Rather, they are knowable *a priori*, the result of a straightforward application of algebra to the NASD's proposed rule.

A. Calculations Assuming 40 Arbitrators in Each Pool

For purposes of these calculations,

Let $P_{\text{described event}}$ = probability of that event.

A1. Average Probability¹⁴ of Chair-Qualified Arbitrator Serving as Chair:

$$P_{\text{chair-qualified arbitrator serving as chair}} = \frac{8}{40} \cdot \frac{1}{8} = \frac{1}{40} = \frac{9}{360}$$

In plain English, a chair-qualified arbitrator in a pool of 40 has, on average, 8 chances in 40 of being placed on a chair strike-and-rank list and 1 chance in 8 of being selected as chair. A chair-qualified arbitrator's chances of serving as chair are, of course, independent of and unaffected by any tampering with the selection of the non-chair. And a chair-qualified arbitrator's chances of serving in any capacity in the absence of tampering are equal to that individual's chances of serving as chair because, without tampering, chair is the only available position. I have provided the conversion of 1/40 to 9/360 for reasons that will become apparent in A3, below.

14. "Different arbitrators will be differently ranked. Thus, their individual probabilities of serving cannot be determined. But, in a group of eight arbitrators of which one must serve as chair, the *average* probability of serving for the eight arbitrators is 1/8. Similarly, when the groups of chair-qualified and non-chair-qualified arbitrators are mixed for public non-chair selection purposes as the NASD has proposed, we cannot say whether there is any difference between an average chair-qualified arbitrator's and an average non-chair-qualified arbitrator's probabilities of being mutually ranked and selected as the public non-chair. The calculations and derivations in this article assume that arbitrators from the two groups, once their names are included on a public non-chair strike-and-rank list, have the same average probability of being selected.

A2. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$$P_{\text{chair-qualified arbitrator serving as non-chair if selection untampered}} = 0$$

This is simply a mathematical way of expressing the idea that, absent the tampering inherent in the NASD's proposed rule, a chair-qualified arbitrator would have no chance of serving as a public non-chair.

A3. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs' Odds:

$$P_{\text{chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{32}{40} \cdot \frac{8}{72} \cdot \frac{1}{8} = \frac{1}{90} = \frac{4}{360}$$

A chair-qualified arbitrator in a pool of 40 has, on average, 32 chances in 40 of *not* being placed on a chair strike-and-rank list and instead being added into the 40-arbitrator non-chair roster to create a 72-arbitrator combined roster; eight chances in 72 of being placed on a non-chair strike-and-rank list; and 1 chance in 8 of being selected as the non-chair public arbitrator. The reason for expressing the results in 360ths is now clear: that figure serves as a common denominator that will make it possible to add the results of A1 and A3.

One further comment is in order here, because it will be useful in A4 and A7, below: this probability of a chair-qualified arbitrator serving in an additional capacity (*i.e.*, as a public non-chair) represents the *increase* in the chair-qualified arbitrator's probability of serving in *any* capacity.

A4. Average Probability of Chair-Qualified Arbitrator Serving In Any Capacity if Selection Tampered to Boost Chairs' Odds (see A1 and A3):

$$P_{\text{chair-qualified arbitrator serving on panel in any capacity if selection tampered}} = \frac{9}{360} + \frac{4}{360} = \frac{13}{360}$$

This is just the sum of A1 and A3 – the average probabilities of serving as the chair and as the public non-chair, respectively.

A5. Average Probability of Non-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection untampered}} = \frac{8}{40} \cdot \frac{1}{8} = \frac{1}{40} = \frac{9}{360}$$

A non-chair-qualified arbitrator in a pool of 40 has, on average, 8 chances in 40 of being placed on a non-chair strike-and-rank list and 1 chance in 8 of being selected as non-chair – the same as a chair-qualified arbitrator’s chances of being selected as chair out of a 40 arbitrator chair-qualified roster. Note that a non-chair-qualified arbitrator’s chances of serving in any capacity are equal to that individual’s chances of serving as public non-chair because non-chair is the only position available to non-chair-qualified arbitrators.

A6. Average Probability of Non-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs’ Odds:

$$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{8}{72} \cdot \frac{1}{8} = \frac{1}{72} = \frac{5}{360}$$

A non-chair-qualified arbitrator in a combined pool of 72 has, on average, 8 chances in 72 of being placed on a non-chair strike-and-rank list and 1 chance in 8 of being selected as non-chair – a 44% reduction in the non-chair-qualified arbitrator’s likelihood of being appointed.

Note that the non-chair’s chances of serving are now 5/360, a decrease of 4/360 from the untampered figure of 9/360 shown in A5. As must be the case, this 4/360 reduction is equivalent to a chair-qualified arbitrator’s chances of serving as a public non-chair if the system is tampered. In other words, the tampering has the effect of *transferring* a 4-in-360 chance of serving as a public-non-chair from the non-chair-qualified arbitrators to the chair-qualified arbitrators.

A7. Average Percentage Increase in Probability of Chair-Qualified Arbitrator Serving In Any Capacity as a Result of Tampering (see A1 through A4):

$$\text{Average Percentage Increase} = \frac{4}{360} \div \frac{9}{360} = 44\%$$

This is A3 divided by A1 or, equivalently, (A4 minus A1) divided by A1.

A8. Average Percentage Decrease in Probability of Non-Chair-Qualified Arbitrator Serving as a Result of Tampering (see A5 and A6):

$$\text{Average Percentage Decrease} = \frac{4}{360} \div \frac{9}{360} = 44\%$$

This is (A5 minus A6) divided by A5. Note that the non-chair qualified arbitrator's 44% decrease equals the chair-qualified arbitrator's 44% increase (see A7).

A9. Ratio Without Tampering of

-Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity to

-Average Non-Chair Qualified Arbitrator's Probability of Serving in Any Capacity (i.e., A1 divided by A5)

$$\text{Ratio} = \frac{9}{360} \div \frac{9}{360} = 1.0$$

Thus, when they come from pools of equal size, the chair-qualified arbitrator has no advantage over the non-chair-qualified arbitrator in the absence of tampering.

A10. Ratio With Tampering of

- Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity to

- Average Non-Chair Qualified Arbitrator's Probability of Serving in Any Capacity (i.e., A4 divided by A6)

$$\text{Ratio} = \frac{13}{360} \div \frac{5}{360} = 2.6$$

(Thus, chair-qualified arbitrators have gone from being on equal footing with non-chair-qualified arbitrators (based on equal pool size) to being selected, on average, 2.6 times as often.)

Let me expand a bit on this last calculation. To make probabilities more approachable and intuitive, it sometimes helps to replace them with something more concrete. Suppose you and I each have ten dollars. We both have the same amount of money. Next, suppose I get an extra five dollars. Now I have one and a half times as much money as you have, right? Well, it depends. If I got that extra five dollars from some third-party source, the answer is "yes." But if I got the five dollars by taking it from you, I now have three times as much money as you have.

The probability situation is much the same. To simply the example, if I am one of ten chair-qualified arbitrators and you are one of ten non-chair-qualified arbitrators, each of us has an equal one-in-ten chance of serving on any given panel. But if all ten of the chair-qualified arbitrators suddenly are injected into the non-chair qualified arbitrators' selection process, I now have not only my one chance in ten of being selected as chair, but an additional chance in twenty of being selected as a public non-chair. So now I have three chances in twenty of being selected. You, in contrast, now have only one chance in twenty of serving, down from your previous one in ten. And I now have three times the chance to serve that you have.

B. Deriving a General Formula

Arbitrator pool sizes vary from one hearing location to the next. Thus, this section will derive a general formula for the skewing described in this article. A formula will be developed corresponding to each calculation in A1 through A10 above. To use the formulas, the reader will need to know the sizes of the chair-qualified and non-chair qualified pools at the hearing location in question – nothing more. For these purposes,

Let x = number of arbitrators in chair-qualified pool

Let y = number of arbitrators in non-chair-qualified pool

Let $P_{\text{described event}}$ = probability of that event

B1. Average Probability of Chair-Qualified Arbitrator Serving as Chair:

$$P_{\text{chair-qualified arbitrator serving as chair}} = \frac{8}{x} \cdot \frac{1}{8} = \frac{1}{x}$$

In plain English, a chair-qualified arbitrator in a pool of x arbitrators has, on average, 8 chances in x of being placed on a chair strike-and-rank list and 1 chance in 8 of being selected as chair. A chair-qualified arbitrator's chances of serving as chair are, of course, independent of and unaffected by any tampering with the selection of the non-chair. And the chair-qualified arbitrator's chances of serving in any capacity in the absence of tampering are equal to that individual's chances of serving as chair because, without tampering, chair is the only available position.

B2. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$$P_{\text{chair-qualified arbitrator serving as non-chair if selection untampered}} = 0$$

As in A2, absent the tampering inherent in the NASD's proposed rule, a chair-qualified arbitrator would have no chance of serving as a public non-chair.

B3. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs' Odds:

$$P_{\text{chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{x-8}{x} \cdot \frac{8}{x+y-8} \cdot \frac{1}{8} = \frac{x-8}{x(x+y-8)}$$

A chair-qualified arbitrator in a pool of x has, on average, $(x - 8)$ chances in x of *not* being placed on a chair strike-and-rank list and instead being added into the y -arbitrator non-chair roster to create an $(x+y-8)$ -arbitrator combined roster; 8 chances in $(x+y-8)$ of being placed on a non-chair strike-and-rank list; and 1 chance in 8 of being selected as the non-chair public arbitrator.

Just as in A3, this probability of a chair-qualified arbitrator serving in an additional capacity (*i.e.*, as a public non-chair) represents the *increase* in the chair-qualified arbitrator's probability of serving in any capacity.

B4. Average Probability of Chair-Qualified Arbitrator Serving In Any Capacity if Selection Tampered to Boost Chairs' Odds (see B1 and B3):

$$P_{\text{chair-qualified arbitrator serving on panel in any capacity if selection tampered}} =$$

$$\frac{1}{x} + \frac{x-8}{x(x+y-8)} = \frac{(x+y-8)}{x(x+y-8)} + \frac{x-8}{x(x+y-8)} = \frac{2x+y-16}{x(x+y-8)}$$

This is just the sum of B1 and B3 – the average probabilities of serving as the chair and as the public non-chair, respectively.

B5. Average Probability of Non-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection untampered}} = \frac{8}{y} \cdot \frac{1}{8} = \frac{1}{y}$$

A non-chair-qualified arbitrator in a pool of y has, on average, 8 chances in y of being placed on a non-chair strike-and-rank list and

1 chance in 8 of being selected as non-chair. In the special case where $x = y$ (in other words, where the pools are of equal size) chair-qualified arbitrators and non-chair-qualified arbitrators have, on average, equal chances of being selected as long as the system is untampered.

B6. Average Probability of Non-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs' Odds:

$$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{8}{(x+y-8)} \cdot \frac{1}{8} = \frac{1}{(x+y-8)}$$

A non-chair-qualified arbitrator in a combined pool of $(x+y-8)$ has, on average, 8 chances in $(x+y-8)$ of being placed on a non-chair strike-and-rank list and 1 chance in 8 of being selected as non-chair. This is a substantial reduction from the previous $1/y$ chance that the average non-chair-qualified arbitrator would have of being appointed in the absence of an infusion of chair-qualified arbitrators into the non-chair pool. This is the general case of the calculated numerical reduction seen in A6.

B7. Average Increase in Probability of Chair-Qualified Arbitrator Serving In Any Capacity as a Result of Tampering (see B1 through B4):

$$\text{Increase} = \frac{x-8}{x(x+y-8)}$$

This is simply the chair-qualified arbitrator's added probability of serving as a non-chair. It therefore is equivalent to B3.

$$\text{Relative Increase} = \frac{x-8}{x(x+y-8)} \div \frac{1}{x} = \frac{x(x-8)}{x(x+y-8)} = \frac{(x-8)}{(x+y-8)}$$

This is the chair-qualified arbitrator's added probability of serving divided by the chair-qualified arbitrator's initial probability of serving if the system were untampered – *i.e.*, B3 divided by B1. To express it as a percentage, multiply by 100. This is the general version of the numerical result reached in A7.

B8. Average Decrease in Probability of Non-Chair-Qualified Arbitrator Serving as a Result of Tampering (see B5 and B6):

$$\text{Decrease} = \frac{1}{y} - \frac{1}{(x+y-8)} = \frac{(x+y-8)}{y(x+y-8)} - \frac{y}{y(x+y-8)} = \frac{(x-8)}{y(x+y-8)}$$

This is simply the non-chair-qualified arbitrator's reduction in probability of serving as a non-chair – *i.e.*, B5 minus B6.

$$\text{Relative Decrease} = \frac{(x-8)}{y(x+y-8)} \div \frac{1}{y} = \frac{(x-8)}{y(x+y-8)} \cdot \frac{y}{1} = \frac{(x-8)}{(x+y-8)}$$

This is the reduction in a non-chair's probability of serving divided by the initial probability of serving in an untampered system – *i.e.*, (B5 minus B6) divided by B5. To express it as a percentage decline, multiply by 100. Note that the non-chair-qualified arbitrator's relative decrease equals the chair-qualified arbitrator's relative increase (see B7).

B9. Ratio Without Tampering of

- Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity to
- Average Non-Chair Qualified Arbitrator's Probability of Serving in Any Capacity (see B1 and B5)

$$\text{Ratio} = \frac{1}{x} \div \frac{1}{y} = \frac{1}{x} \cdot \frac{y}{1} = \frac{y}{x}$$

Thus, in the absence of tampering, the chair-qualified arbitrators and non-chair-qualified arbitrators have chances of serving that vary inversely with the sizes of their respective pools. In the special case where they come from pools of equal size, they have equal chances of serving.

B10. Ratio With Tampering of

- Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity to
- Average Non-Chair Qualified Arbitrator's Probability of Serving in Any Capacity (see B4 and B6)

$$\text{Ratio} = \frac{2x+y-16}{x(x+y-8)} \div \frac{1}{(x+y-8)} =$$

$$\frac{2x+y-16}{x(x+y-8)} \cdot \frac{(x+y-8)}{1} = \frac{2x+y-16}{x} = \frac{2x}{x} + \frac{y}{x} - \frac{16}{x} = 2 + \frac{y}{x} - \frac{16}{x} = \frac{y}{x} + 2 - \frac{16}{x}$$

This final expression $\frac{y}{x} + 2 - \frac{16}{x}$ is particularly helpful to understand all of this because it shows that the *increase* over the untampered odds (which were y/x , as shown in B9) *always* will be equal to $2 - \frac{16}{x}$. This simple formula can be applied to any combination of pool sizes to determine the precise effect of the NASD's proposed skewing.

Thus, for example, in a situation where the chair-qualified arbitrators and the non-chair-qualified arbitrators have an equal chance of serving in an untampered system (that is, where the pools are of equal size and y/x therefore is equal to 1) and the pool size is 80, the chair-qualified arbitrators benefiting from the NASD's proposed rule will have **2.8 times** the chance of serving that the non-chair-qualified arbitrators will have – that is, $1 + 2 - 16/80 = 3 - 0.2 = 2.8$.

To take an example from the table that appeared early in this article, suppose there are 50 chair-qualified arbitrators and 100 non-chair-qualified arbitrators. In an untampered system, the chair-qualified arbitrators would be twice as likely to serve as the non-chair-qualified arbitrators, because there are half as many of them. But with the NASD's proposed tampering, the chair-qualified arbitrators will have **3.68 times** the likelihood of serving that the non-chair-qualified arbitrators will have – that is, $2 + 2 - 16/50 = 4 - 0.32 = 3.68$.

CONCLUSION

The NASD's proposed inclusion of chair-qualified arbitrators in the non-chair-qualified arbitrators' pool for public non-chair list selection purposes may look innocuous at first blush. But it is far from innocuous when its real effects are quantified. The devil is in the details. One can only hope that the SEC will display an understanding of the mathematics of list selection by denying the NASD's request.

APPENDIX “ C”

THE NASD’S NOVEMBER 9, 2006, LETTER TO THE SEC REVEALING POOL-SIZE DATA

Appendix C: © 2007 National Association of Securities
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Linda D. Fienberg
President, Dispute Resolution
Executive Vice President and Chief Hearing Officer, Regulatory Policy and Oversight



November 9, 2006

Catherine McGuire
Associate Director and Chief Counsel
Securities and Exchange Commission
Division of Market Regulation
100 F Street, N.E.
Washington, DC 20549-1001

Dear Ms. McGuire:

On November 1, 2006, you asked NASD Dispute Resolution to provide you with information on the arbitrator pool for customer cases in various hearing locations. In the interest of full disclosure, we have provided this information for all United States hearing locations.

We have produced the attached report with data current as of today, showing:

1. Each hearing location (HLC) in the 50 states and the District of Columbia.
2. The number of arbitrators in that HLC who are classified as "public" under the definition found in Rule 10308(a)(5) of the NASD Code of Arbitration Procedure (Code) and in proposed Rule 12100(u) of the pending Code for Customer Disputes.¹
3. The number of arbitrators in each HLC who will be designated as chair-qualified under proposed Rule 12400(c) of the pending Code revision.
4. The number of public (customer) arbitration cases that we received in the first ten months of 2006 in that HLC. This list includes both hearing and "paper" (no hearing) cases.
5. The number of public cases in which arbitrator lists were generated in that HLC in the first ten months of 2006. Please note that this includes some cases received prior to January 1, 2006 in which lists had not yet been generated.
6. The number of public cases that were closed by award in that HLC in the first ten months of 2006. Please note that some of these cases would have been filed prior to January 1, 2006.

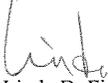
¹ We are preparing to conduct a survey of arbitrators to determine any changes in their classification that might occur as a result of a change to Rule 10308 approved by the SEC on October 16, 2006, which will become effective on January 15, 2007 (Exchange Act Release No. 54607, File No. SR-NASD-2005-094).

Catherine McGuire
November 9, 2006
Page 2

In reviewing this report, please note that the number of arbitrators in columns two and three may include some duplicates. An arbitrator may have volunteered to serve in more than one hearing location (such as New York and New Jersey), and would then appear in more than one location on this chart.

I hope this information is helpful. Please feel free to contact me if you have additional questions.

Very truly yours,



Linda D. Fienberg

Enclosure: Arbitrator Pool Information by Hearing Location

NASD Dispute Resolution
Public Arbitrator Information

Hearing Location	Available Public Arbitrators	Available Public Chairpersons	Public Cases Received		* Public Cases - Lists Generated		Public Cases Closed by Award	
			Jan-1-06	Oct-31-06	Jan-1-06	Oct-31-06	Jan-1-06	Oct-31-06
Albany, NY	52	17	17		28		8	
Albuquerque, NM	24	14	6		6		4	
Anchorage, AK	11	4	3		1		0	
Atlanta, GA	88	34	61		64		12	
Augusta, ME	40	17	7		5		0	
Baltimore, MD	140	46	22		29		10	
Birmingham, AL	69	30	33		43		6	
Bismarck, ND	44	22	1		0		0	
Boca Raton, FL	309	129	227		237		61	
Boise, ID	46	20	3		2		1	
Boston, MA	117	40	47		53		29	
Buffalo, NY	37	16	35		41		16	
Charleston, WV	28	9	23		26		3	
Charlotte, NC	49	22	48		62		17	
Cheyenne, WY	45	26	6		8		0	
Chicago, IL	202	70	85		114		37	
Cincinnati, OH	19	8	13		10		6	
Cleveland, OH	43	18	57		58		17	
Columbia, SC	58	26	16		26		4	
Columbus, OH	58	15	21		19		10	
Dallas, TX	101	40	67		81		38	
Denver, CO	90	38	28		32		14	
Des Moines, IA	138	56	15		11		5	
Detroit, MI	104	39	85		85		27	
Hartford, CT	113	45	40		43		8	
Helena, MT	43	20	5		4		0	
Honolulu, HI	21	9	7		8		4	
Houston, TX	110	44	90		94		36	
Indianapolis, IN	33	11	41		41		7	
Jackson, MS	42	13	8		10		2	
Kansas City, MO	52	19	34		40		10	
Las Vegas, NV	35	13	19		13		9	
Little Rock, AR	24	8	8		7		2	
Los Angeles, CA	219	116	178		170		75	
Louisville, KY	26	14	24		29		11	
Manchester, NH	54	22	9		8		0	
Memphis, TN	23	10	12		16		5	
Milwaukee, WI	49	18	35		31		8	
Minneapolis, MN	73	24	53		40		8	
Montpelier, VT	42	14	5		3		0	
Nashville, TN	30	14	12		16		7	
New Orleans, LA	45	14	83		65		20	
New York, NY	677	262	260		294		106	
Newark, NJ	209	102	114		111		21	
Norfolk, VA	21	7	6		8		1	
Oklahoma City, OK	38	15	59		19		6	
Omaha, NE	21	8	7		12		4	
Orlando, FL	109	68	44		51		17	
Philadelphia, PA	149	67	101		131		24	

* This column includes lists that were generated for cases filed prior to Jan-1-06

NASD Dispute Resolution
Public Arbitrator Information

Hearing Location	Available Public Arbitrators	Available Public Chairpersons	Public Cases	* Public Cases - Lists	Public Cases Closed
			Received Jan-1-06 - Oct-31-06	Generated Jan-1-06 - Oct-31-06	by Award Jan-1-06 - Oct-31-06
Phoenix, AZ	100	44	49	55	20
Pittsburgh, PA	55	10	29	38	16
Portland, OR	60	27	11	9	8
Providence, RI	69	28	6	6	1
Raleigh, NC	46	21	37	32	6
Rapid City, SD	46	21	3	4	0
Reno, NV	17	5	13	7	0
Richmond, VA	48	17	16	16	5
Salt Lake City, UT	29	12	37	36	6
San Diego, CA	84	42	38	37	19
San Francisco, CA	163	74	109	126	50
Seattle, WA	73	30	26	38	19
St. Louis, MO	52	26	47	57	16
Tampa, FL	156	84	61	64	22
Washington, DC	178	52	24	33	4
Wichita, KS	64	23	10	7	2
Wilmington, DE	123	53	15	18	1

* This column includes lists that were generated for cases filed prior to Jan-1-06

APPENDIX "D"

A TABLE OF 66 CITIES

A. Hearing Location	B. Available Public Arbitrators	C. Available Public "Chair-Qualified" Arbitrators ("x")	D. Available Public Non-Chair-Qualified Arbitrators ("y")	E. An arbitrator in the chair-qualified pool benefiting from deck-stacking is this many times as likely as an arbitrator in the non-chair-qualified pool to be included in a strike-and-rank list for any given case ($y/x + 2 - 16/x$)	F. Average number of chair-qualified arbitrators on a strike-and-rank list of eight public arbitrators for a non-chair seat with a deck-stacking rule ($8(x-8)/(x+y-8)$)
Albany, NY	52	17	35	3.1	1.6
Albuquerque, NM	24	14	10	1.6	3.0
Anchorage, AK	11	4	7	1.8	0.0
Atlanta, GA	88	34	54	3.1	2.6
Augusta, ME	40	17	23	2.4	2.3
Baltimore, MD	140	46	94	3.7	2.3
Birmingham, AL	69	30	39	2.8	2.9
Bismarck, ND	44	22	22	2.3	3.1
Boca Raton, FL	309	129	180	3.3	3.2
Boise, ID	46	20	26	2.5	2.5
Boston, MA	117	40	77	3.5	2.3
Buffalo, NY	37	16	21	2.3	2.2
Charleston, WV	28	9	19	2.3	0.4
Charlotte, NC	49	22	27	2.5	2.7
Cheyenne, WY	45	26	19	2.1	3.9
Chicago, IL	202	70	132	3.7	2.6
Cincinnati, OH	19	8	11	1.4	0.0
Cleveland, OH	43	18	25	2.5	2.3
Columbia, SC	58	26	32	2.6	2.9
Columbus, OH	58	15	43	3.8	1.1
Dallas, TX	101	40	61	3.1	2.8
Denver, CO	90	38	52	2.9	2.9
Des Moines, IA	138	56	82	3.2	3.0
Detroit, MI	104	39	65	3.3	2.6
Hartford, CT	113	45	68	3.2	2.8
Helena, MT	43	20	23	2.4	2.7
Honolulu, HI	21	9	12	1.6	0.6
Houston, TX	110	44	66	3.1	2.8
Indianapolis, IN	33	11	22	2.5	1.0
Jackson, MS	42	13	29	3.0	1.2
Kansas City, MO	52	19	33	2.9	2.0
Las Vegas, NV	35	13	22	2.5	1.5
Little Rock, AR	24	8	16	2.0	0.0

A. Hearing Location	G. Average total number of chair-qualified arbitrators on both strike-and-rank lists of public arbitrators with a deck-stacking rule (Col. F + 8)	H. Average number of non-chair-qualified arbitrators on a strike-and-rank list of eight public arbitrators for a non-chair seat with a deck-stacking rule (8 – Col. F)	I. Percentage of cases that will have two arbitrators from the chair-qualified pool if all public arbitrators on a non-chair list have an equal chance of being appointed $(100(x-8)/(x+y-8))$	J. Percentage increase in the time it will take an arbitrator in the non-chair-qualified pool to be included in strike-and-rank lists with a deck-stacking rule versus without a deck-stacking rule $(100((x+y-8)/y-1))$
Albany, NY	9.6	6.4	20	26
Albuquerque, NM	11.0	5.0	38	60
Anchorage, AK	4.0	7.0	0	0
Atlanta, GA	10.6	5.4	33	48
Augusta, ME	10.3	5.8	28	39
Baltimore, MD	10.3	5.7	29	40
Birmingham, AL	10.9	5.1	36	56
Bismarck, ND	11.1	4.9	39	64
Boca Raton, FL	11.2	4.8	40	67
Boise, ID	10.5	5.5	32	46
Boston, MA	10.3	5.7	29	42
Buffalo, NY	10.2	5.8	28	38
Charleston, WV	8.4	7.6	5	5
Charlotte, NC	10.7	5.3	34	52
Cheyenne, WY	11.9	4.1	49	95
Chicago, IL	10.6	5.4	32	47
Cincinnati, OH	8.0	8.0	0	0
Cleveland, OH	10.3	5.7	29	40
Columbia, SC	10.9	5.1	36	56
Columbus, OH	9.1	6.9	14	16
Dallas, TX	10.8	5.2	34	52
Denver, CO	10.9	5.1	37	58
Des Moines, IA	11.0	5.0	37	59
Detroit, MI	10.6	5.4	32	48
Hartford, CT	10.8	5.2	35	54
Helena, MT	10.7	5.3	34	52
Honolulu, HI	8.6	7.4	8	8
Houston, TX	10.8	5.2	35	55
Indianapolis, IN	9.0	7.0	12	14
Jackson, MS	9.2	6.8	15	17
Kansas City, MO	10.0	6.0	25	33
Las Vegas, NV	9.5	6.5	19	23
Little Rock, AR	8.0	8.0	0	0

A. Hearing Location	B. Available Public Arbitrators	C. Available Public "Chair-Qualified" Arbitrators ("x")	D. Available Public Non-Chair-Qualified Arbitrators ("y")	E. An arbitrator in the chair-qualified pool benefiting from deck-stacking is this many times as likely as an arbitrator in the non-chair-qualified pool to be included in a strike-and-rank list for any given case ($y/x + 2 - 16/x$)	F. Average number of chair-qualified arbitrators on a strike-and-rank list of eight public arbitrators for a non-chair seat with a deck-stacking rule ($8(x-8)/(x+y-8)$)
Los Angeles, CA	219	116	103	2.8	4.1
Louisville, KY	26	14	12	1.7	2.7
Manchester, NH	54	22	32	2.7	2.4
Memphis, TN	23	10	13	1.7	1.1
Milwaukee, WI	49	18	31	2.8	2.0
Minneapolis, MN	73	24	49	3.4	2.0
Montpelier, VT	42	14	28	2.9	1.4
Nashville, TN	30	14	16	2.0	2.2
New Orleans, LA	45	14	31	3.1	1.3
New York, NY	677	262	415	3.5	3.0
Newark, NJ	209	102	107	2.9	3.7
Norfolk, VA	21	7	14	2.0	0.0
Oklahoma City, OK	38	15	23	2.5	1.9
Omaha, NE	21	8	13	1.6	0.0
Orlando, FL	109	68	41	2.4	4.8
Philadelphia, PA	149	67	82	3.0	3.3
Phoenix, AZ	100	44	56	2.9	3.1
Pittsburgh, PA	55	10	45	4.9	0.3
Portland, OR	60	27	33	2.6	2.9
Providence, RI	69	28	41	2.9	2.6
Raleigh, NC	46	21	25	2.4	2.7
Rapid City, SD	46	21	25	2.4	2.7
Reno, NV	17	5	12	2.4	0.0
Richmond, VA	48	17	31	2.9	1.8
Salt Lake City, UT	29	12	17	2.1	1.5
San Diego, CA	84	42	42	2.6	3.6
San Francisco, CA	163	74	89	3.0	3.4
Seattle, WA	73	30	43	2.9	2.7
St. Louis, MO	52	26	26	2.4	3.3
Tampa, FL	156	84	72	2.7	4.1
Washington, DC	178	52	126	4.1	2.1
Wichita, KS	64	23	41	3.1	2.1
Wilmington, DE	123	53	70	3.0	3.1

A. Hearing Location	G. Average total number of chair-qualified arbitrators on both strike-and-rank lists of public arbitrators with a deck-stacking rule (Col. F + 8)	H. Average number of non-chair-qualified arbitrators on a strike-and-rank list of eight public arbitrators for a non-chair seat with a deck-stacking rule (8 – Col. F)	I. Percentage of cases that will have two arbitrators from the chair-qualified pool if all public arbitrators on a non-chair list have an equal chance of being appointed $(100(x-8)/(x+y-8))$	J. Percentage increase in the time it will take an arbitrator in the non-chair-qualified pool to be included in strike-and-rank lists with a deck-stacking rule versus without a deck-stacking rule $(100((x+y-8)/y-1))$
Los Angeles, CA	12.1	3.9	51	105
Louisville, KY	10.7	5.3	33	50
Manchester, NH	10.4	5.6	30	44
Memphis, TN	9.1	6.9	13	15
Milwaukee, WI	10.0	6.0	24	32
Minneapolis, MN	10.0	6.0	25	33
Montpelier, VT	9.4	6.6	18	21
Nashville, TN	10.2	5.8	27	38
New Orleans, LA	9.3	6.7	16	19
New York, NY	11.0	5.0	38	61
Newark, NJ	11.7	4.3	47	88
Norfolk, VA	7.0	8.0	0	0
Oklahoma City, OK	9.9	6.1	23	30
Omaha, NE	8.0	8.0	0	0
Orlando, FL	12.8	3.2	59	146
Philadelphia, PA	11.3	4.7	42	72
Phoenix, AZ	11.1	4.9	39	64
Pittsburgh, PA	8.3	7.7	4	4
Portland, OR	10.9	5.1	37	58
Providence, RI	10.6	5.4	33	49
Raleigh, NC	10.7	5.3	34	52
Rapid City, SD	10.7	5.3	34	52
Reno, NV	5.0	8.0	0	0
Richmond, VA	9.8	6.2	23	29
Salt Lake City, UT	9.5	6.5	19	24
San Diego, CA	11.6	4.4	45	81
San Francisco, CA	11.4	4.6	43	74
Seattle, WA	10.7	5.3	34	51
St. Louis, MO	11.3	4.7	41	69
Tampa, FL	12.1	3.9	51	106
Washington, DC	10.1	5.9	26	35
Wichita, KS	10.1	5.9	27	37
Wilmington, DE	11.1	4.9	39	64

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