Public Investors Arbitration Bar Association

VIA E-MAIL To: rule-comment@sec.gov

December 3, 2010

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. SR-FINRA-2010-053
Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Relating Rules, of the Code of Arbitration Procedure for Customer Disputes

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"), I thank the Commission for the opportunity to comment on the proposed rule change which would give investors the choice to proceed with an all public panel of arbitrators in cases heard before FINRA Dispute Resolution ("FINRA-DR") in which the amount in controversy exceeds $100,000.[1] The FINRA rule proposal essentially proposes that the claimants in investor securities arbitration disputes be given the choice to decline the presence of an industry arbitrator on panels that hear and decide their cases.

PIABA is a national, not-for-profit bar association comprised of attorneys, including law school professors and regulators, both former and current, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. Virtually every broker-dealer customer account agreement provides for mandatory arbitration before FINRA-DR of any dispute arising between the investors and the firm; our clients have no meaningful choice of judicial forums. Accordingly, our members and their clients have a strong interest in FINRA's rules which govern the way in which the arbitration process is administered.

PIABA supports any changes that make the process fairer for investors, both in perception and reality. PIABA supports the current rule proposal to the extent that it provides investors with choice; however, we take contention with the fact that an investor must opt-in within 35 days from the service of the Statement of Claim to be given the opportunity to proceed with the all public panel option.

[1] See, Proposed Rule Change – Elimination of FINRA-DR Mandatory Industry Arbitrator, Commission Rulemaking Proposal 4-586, available at http://sec.gov/rules/petitions/2009/petn4-586.pdf. PIABA submitted a similar rule petition to the Commission in June of 2009 pursuant to Rule 192 (17 CFR 201.192).

We believe this should be the default choice and that an investor should given the opportunity to opt-in to proceed with the majority public panel option.

I. Synopsis of the Proposed Rule Change

FINRA's current arbitration rules provide that a panel of three arbitrators must hear all arbitration claims whenever the amount in controversy exceeds $100,000. FINRA Code of Arbitration Procedure, Rule 12401(c). The rules further provide that one of the panel members must be a "non-public" (i.e., industry) arbitrator. FINRA Code of Arbitration Procedure, Rule 12402(b). The rules define a "non-public" arbitrator as any individual who currently works in the securities industry, who has worked in the securities industry within the past five years, or retired individuals who have spent a substantial amount of their career employed in the securities industry. Code of Arbitration Procedure, Rule 12100(p)(1), (2). The rules also provide that any lawyer, accountant, or other professional who has devoted more than twenty percent of his or her work to the securities industry within the past two years is also deemed an industry arbitrator. Code of Arbitration Procedure, Rule 12100(p)(3). In addition, certain individuals are deemed ineligible to be public arbitrators, such as spouses of securities industry personnel, investment advisers, and professionals whose firms do a certain amount of work for the securities industry. Code of Arbitration Procedure, Rule 12100(u).

The proposed rule change provides investors with the option to choose whether an industry arbitrator sits on their particular case. Such a rule would be a significant improvement to the current system wherein FINRA requires that an industry arbitrator sit on every case where the amount of damages claimed exceeds $100,000.

II. The Need for Reform

In 1953, the Supreme Court of the United States ruled, in *Wilko v. Swan*, 346 U.S. 427 (1953), that disputes involving the statutory investor protections set forth in the Securities Act of 1933 could not be forced into arbitration pursuant to pre-dispute arbitration agreements. In deciding the case, the U.S. Supreme Court recognized several inadequacies of arbitration as compared to court proceedings in resolving investment disputes. Following the *Wilko* decision, securities arbitration for investor claims arising under the Securities Act of 1933 and the Securities Exchange Act of 1934 was viewed as strictly voluntary on the part of the investor.

In 1987, the Supreme Court again considered the issue of whether investors could be compelled to arbitrate claims involving statutory violations of the Securities Exchange Act of 1934[2] pursuant to pre-dispute arbitration agreements in the landmark case *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220

[2] The *Wilko* decision did not specifically address claims under the Securities Exchange Act of 1934. However, it had widely been believed that the reasoning of the *Wilko* decision concerning the 1933 Act also applied to the 1934 Act. Additionally, the SEC had indicated that broker-dealers could not seek to enforce pre-dispute arbitration agreements for claims alleging violations of the Securities Acts (See NASD Notice to Members 83-73 regarding the adoption of SEC Rule 15c2-2).

(1987). In reversing the long held position that investors could not be compelled to arbitrate these statutory claims, the Supreme Court issued a 5-4 decision ruling that pre-dispute arbitration agreements could be enforced with respect to these claims. However, the dissenting opinion in *McMahon* raised serious concerns regarding the fairness of the industry-sponsored securities arbitration process. The concerns raised in the dissenting opinion have largely proven prescient.

Partially dissenting in the *McMahon* case, Justice Blackmun called into question the basic fairness of the arbitration forums operated by the securities industry. In particular, Justice Blackmun, joined by Justices Brennan and Marshall, questioned whether the promised oversight by the Commission of the SRO sponsored arbitral forums adequately ensured that investors' claims could be fairly heard. The opinion specifically referenced the presence of the industry arbitrator in connection with the fairness of the arbitration process:

> Furthermore, there remains the danger that, at worst, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the market professional. The Uniform Code [of Arbitration] provides some safeguards, but, despite them, *and indeed because of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry, and not drawn from the public* . . . The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be *some* truth to the investors' belief that the securities industry has an advantage in a forum under its own control." *See N.Y. Times*, Mar. 29, 1987, Section 3, p. 8., col. 1 (Statement of Sheldon H. Eisen, Chairman, American Bar Association Task Force on Securities Arbitration: "The houses basically like the present system because they own the stacked deck.").

482 U.S at 260-261 (emphasis added) (footnotes omitted). The dissenting justices were critical of the fact that the Commission had not conducted a study of the perceived inadequacy of the SRO arbitration system as it existed in 1987. *Id*., at 265. The *McMahon* dissent also suggested that studies of the mandatory arbitration system would likely reveal evidence as to the fairness (or lack thereof) of the process. *Id.* at 265 and fn. 20 (After noting the industry's use of statistics to support its claim of fairness, noting further that "[s]uch statistics, however, do not indicate the damages received by customers in relation to the damages to which they believed they were entitled. It is possible for an investor to 'prevail' in arbitration while recovering a sum considerably less than the damages he actually incurred.")

Since *McMahon*, a number of statistical studies have, in fact, been conducted to evaluate the fairness of industry sponsored mandatory arbitration. Not surprisingly, the studies have confirmed the long held belief that industry sponsored securities arbitration is not perceived as fair to investors and that recovery rates favor the securities industry.

A. The SICA Study

In 2005, The Securities Industry Conference on Arbitration ("SICA") undertook to perform an academic study of fairness in arbitration based upon empirical evidence. Specifically, the study sought to determine whether participants in securities arbitration believe that the process is conducted simply, fairly, economically, and without bias by the arbitrators. In February of 2008, SICA published the results of the study (Barbara Black, Jill I. Gross, "*Perceptions of Fairness of Securities Arbitration: An Empirical Study*," (2008)).[3]

The SICA study found a strong perceived bias with respect to industry sponsored securities arbitration. Nearly half of responding investors believed that arbitration panels were biased. Sixty-two percent of public investors felt that the arbitration process was unfair. Seventy percent of public investors were dissatisfied with the outcome of their securities arbitration cases. Seventy-five percent of public investors found securities arbitration to be "very unfair" or "somewhat unfair" as compared to court. Of particular note, the SICA study specifically probed issues relating to the mandatory industry arbitrator. Thirty-six and one half percent of the responding public investors found the industry arbitrator to be biased in favor of the industry respondents.

After publishing the results of the SICA empirical study, the authors published a paper discussing the results of the report, wherein they set forth the following conclusion[4]:

> Accordingly, based on the findings of our Report, we urge the SEC and FINRA to give serious consideration to eliminating the requirement of an industry arbitrator on every three-person arbitration panel. Rightly or wrongly, investors are simply suspicious of a mandatory process with an opaque outcome that is sponsored by the regulatory arm of the securities industry and that includes an industry representative on every three-arbitrator panel hearing a claim greater than $25,000. The frequently-made argument – that no one can prove that the presence of an industry arbitrator harms the investor – misses the point. Given the widespread distrust of the industry arbitrator, it would seem that the presence of an industry arbitrator would have to contribute great value to the process—which no one can establish either—to justify the continuation of this practice.

Following the release of the SICA study, the North American Securities Administrators Association (NASAA), a group composed of state securities

[3] http://www.law.pace.edu/files/finalreporttosica.pdf.
[4] Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. Disp. Resol. 349, 400.

regulators from all fifty states, issued a statement calling for immediate reforms to the system. Karen Tyler, the president of NASAA, encouraged FINRA to take immediate action by stating[5]:

> The first step toward improving the integrity of the arbitration system must be the *removal of the mandatory industry arbitrator* and a prohibition on ties to the industry on the part of the public arbitrator. NASAA has long held that a choice between arbitration and the courts for resolving disputes should be a fundamental right for investors. Because the arbitration system has evolved into a mandatory condition imposed by the industry, it is imperative that the system of dispute resolution be fair, transparent and free from bias.

(Emphasis added.) Thus, NASAA recognizes the importance of eliminating the mandatory industry arbitrator from the current system.

B. The O'Neal-Solin Study

In 2007, an independent study was conducted to analyze investor recoveries in securities arbitration.[6] The study examined all arbitration awards rendered in NASD and NYSE arbitral forums between 1994 and 2004. In light of the *McMahon* dissent's suggestion that customer "win" rates might not be as meaningful as data showing damages awarded versus damages sustained, the study focused primarily on the amount a public investor could expect to recover in securities arbitration. The numbers were discouraging, ultimately finding that the percentage of the amount awarded to public investors compared to the amount sought significantly decreased from 68% in 1998 to 50% in 2004. Through extrapolation, it was found that investors bringing securities arbitration claims could expect to recover only 20% of the amount sought. Shockingly, the expected recovery percentage of a claim of over $250,000 (claims which would involve a three person panel and include an industry arbitrator) against one of the three largest brokerage firms was a paltry 12%.

Since the publication of the O'Neil-Solin Study, investors' chances of recovery have continued to decline. In 2006, the win rate for public investors in FINRA arbitrations declined to 42% and plummeted to 37% in 2007, before rebounding to a still dismal 42% rate in 2008 with a slight increase to 45% in 2009.[7] Moreover, the experience of our members, who routinely represent investors in arbitration cases, is that full recoveries of statutory damages such as

---

[5] NASAA News Release, February 6, 2008, available at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/8081.cfm.

[6] J. O'Neal and D. Solin, "Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimants Fare," (2007). Hereinafter the "O'Neal-Solin Study," available at http://www.slcg.com/pdf/news/Mandatory%20Arbitration%20Study.pdf.

[7] A "win" is not always a win. If a panel were to make a small award to a public investor, then assess forum fees in excess of the amount awarded, this would still be counted as a "win" in FINRA's statistics. The statistics are available at http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm

those provided under state securities acts are usually the exception, even when liability is established.

III. The All Public Panel Should be the Norm, the Industry Arbitrator Should be the Exception

The traditional justification for the inclusion of industry arbitrators on panels is that they provide needed expertise and guidance to the public arbitrators on matters involving the securities industry. This justification is unwarranted; the opinions of industry arbitrators should be given no greater weight than those of the public arbitrators. The significance of the "expert" role of the industry arbitrator cannot be underestimated. Not only are they one of only three votes, but at FINRA, industry arbitrators are also given a significantly disproportionate voice in the process. For years, FINRA explicitly advised arbitrators that in determining liability, "[w]hen the case is highly technical, the industry arbitrator might begin the discussion to help clarify industry terminology or practices."

Ironically, the undue influence of the industry arbitrator is further highlighted in the "*White Paper on Arbitration in the Securities Industry*" published in October 2007 by the Securities Industry and Financial Markets Association ("SIFMA").[8] SIFMA, which is the securities industry's trade association, describes the following as a particular *virtue* of the industry arbitrator: "'Industry' arbitrators also benefit the public panelists as they can serve to educate them about financial products and services, industry customs and practices and other legal industry-related issues." (SIFMA White Paper, at 35). The SIFMA White Paper goes so far as to suggest that because of the presence of industry arbitrators on panels "parties need not call expert witnesses in order to educate a panel about certain products or industry practices." (SIFMA White Paper, at 35-36).

The suggestion that industry arbitrators serve as *de facto* expert witnesses should be deeply troubling for not only investors but also regulators overseeing the process. Importantly, the influence of the industry arbitrator is not counter-balanced by any requirement that one of the other arbitrators have the qualifications to offer not only a more investor friendly perspective, but also not even an objective perspective of securities industry products and practices. Furthermore, industry arbitrators who offer their opinions on these topics are not subject to cross-examination about any errors or biases that could make their opinions unreliable. As a result, investors may lose their cases on the basis of "expert opinions" that they never have an opportunity to address or even hear.

The frequently assumed role of the industry arbitrator as the panel's appointed "expert" on industry products and practices has become increasingly problematic for investors who have been injured by industry-wide illegal and unethical practices that have come to light in recent years. The list of Wall Street scandals relating to products and practices that have caused investors unwarranted

[8] SIFMA White Paper, pp. 36-37, available at http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf.

losses of billions of dollars over the last decade is distressing and lengthy, but must include, even in abbreviated form:

- (a) pervasive conflicts of interest of Wall Street research and recommendations on "tech" stocks in favor of brokerage firms' investment banking clients;[9]
- (b) abuses in the trading and sales of mutual funds;[10]
- (c) deceptive seminars and marketing schemes aimed at the elderly and newly retired;[11]
- (d) fraudulent and unsuitable sales of variable annuities, especially to seniors and for tax-deferred accounts;[12]
- (e) dishonest and deceptive practices in connection with the conduct of auctions of "auction rate securities" ("ARS") and the mismarketing of such securities as money market or CD equivalents;[13] and
- (f) fraudulent practices in connection with the securitization and retail sales of products backed by subprime loans.[14]

---

[9] In 2002, Bear Stearns & Co., CS First Boston, Deustche Bank, Goldman Sachs, J.P. Morgan Chase & Co., Lehman Brothers, Inc., Merrill Lynch & Co., Morgan Stanley, Salomon Smith Barney, Inc., and UBS settled charges by state and federal agencies concerning the undue influence of investment banking relationships on favorable stock research reports. *See*, http://www.sec.gov/new/press/2002-179.htm.

[10] In 2004, fifteen firms settled NASD and SEC charges relating to unfairly depriving customers of mutual fund breakpoints. The firms included: American Express Financial Advisors; Bear Stearns; Legg Mason; Lehman Brothers; Raymond James; Linsco Private Ledger; UBS; and Wachovia. See, http://www.sec.gov/news/press/2004-17.htm. In 2005, the NASD fined American Express, Chase Investment Services and Citigroup for improper sales of Class B and C shares of mutual funds. See: http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/p013648.

[11] A joint report by the SEC, NASAA and FINRA found a pervasive pattern of misleading, fraudulent, and unsuitable sales practices in investment seminars sponsored by securities firms for senior citizens. *See*, "*Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars*" (Sept. 2007), available at http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.

[12] *See*, "*Joint SEC/NASD Report On Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*" (June, 2004), available at http://www.sec.gov/news/studies/secnasdvip.pdf.

[13] Firms that have been implicated in ARS misconduct include: TD Ameritrade; Banc of America Securities; Bear Stearns & Co., Inc.; Citigroup Global Markets; Deutsche Bank; A.G. Edwards, Inc.; E-Trade; Goldman Sachs & Co.; H&R Block; Lehman Bros. Inc.; J.P. Morgan Securities, Inc.; Merrill Lynch Pierce Fenner & Smith, Inc.; Morgan Keegan & Company, Inc.; Morgan Stanley; Oppenheimer; Piper Jaffray & Co.; Raymond James; RBC Dain Rauscher, Inc.; SunTrust Capital Markets, Inc.; UBS; Wachovia Capital Markets, Inc.; and Wells Fargo & Co. The SEC's 2006 Consent Order against 15 firms for fraudulent practices in connection with ARS can be found at: http://www.sec.gov/litigation/admin/2006/33-8684.pdf.

[14] The SEC, FINRA, Justice Department and the states have initiated dozens of investigations relating to subprime securitization and sales. *See*, *"Prosecutors Widen Probes Into Subprimes" Wall Street Journal* (Feb. 8, 2008); The Bureau of National Affairs, Inc., *In Three Dozen Subprime Investigations SEC Is Asking 'Who Knew What, When'*, 40 Securities Regulation & Law 7 (Feb. 18, 2008); David Scheer and Jesse Westbrook, *Brokers Probed by FINRA on Mortgage Securities Sales, Person Says*, Bloomberg.com (Jan. 4, 2008), available at http://www.bloomberg.com/apps/news?pid=20601087&sid=apNYRLoCVcUk&refer=home; Edward Hayes, *FINRA Joins Mortgage Storm*, Wolters Kluwer Financial Services (Feb., 4, 2008), available at http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=02-04-08; *USA*

The major Wall Street firms and many lesser known ones have been named in class actions, investigated, and/or sanctioned for misconduct in one or more of these areas, many of which were accepted as "business as usual" in the securities industry. Yet the victims of these wrongs may have to select arbitrators who were employed, or are even still employed, by broker-dealers who engaged in similar practices. These arbitrators are likely to be reluctant to find another firm liable for conduct that may be the subject of litigation or regulatory proceedings against their own employers. This conflict of interest creates at the least the appearance of bias. Worse still, if, as SIFMA points out, industry arbitrators serve to "educate" other panel members, the so-called "education" may consist of persuading them that the practices at issue are acceptable because "everyone does it." Thus, conduct that a judge or jury might remedy with a recovery of full damages may be excused altogether, or minimized with "compromise" awards.

In addition, the on-going consolidation of brokerage firms within the securities industry has compounded potential conflicts for industry arbitrators. In recent years, such well-known firms as Dean Witter, Prudential Securities, A.G. Edwards, PaineWebber, Bear Stearns, Wachovia, and Merrill Lynch have been taken over by other firms. Faced with this consolidation trend, industry arbitrators may be reluctant to award substantial damages against firms that could well become their future employers. The same economic considerations may influence lawyers or accountants who serve as industry arbitrators, since their clientele may include brokerage firms that could be acquired by the firm whose conduct is at issue in the case before them.[15] Against this backdrop it should not be surprising that statistically an investor's expected recovery rate (i.e., win rate times recovery rate) of substantial damages in a large claim against a major brokerage firm is far less than against smaller firms.[16] This disparity suggests, at least in part, that some arbitrators are reluctant to antagonize major firms.

While PIABA unquestionably supports the proposed rule, it should be modified so that the all public panel option is the default option applicable to all customer cases. As currently drafted, too many *pro se* claimants, and even attorneys who do not regularly practice in this area, will not comprehend the potential impact of ranking an industry arbitrator, or even worse, they may simply overlook the deadline to select the all public panel option. Similarly, adopting the

---

Today, *Regulators' Subprime Mortgage Cases* (Feb. 18, 2008), available at: http://www.usatoday.com/money/economy/2008-02-18-4194118666_x.htm; "*Morgan Keegan Fraud Alleged; SEC, States Aim at $2 Billion Loss*" Memphis Commercial Appeal, (April 7, 2010); "*Banks in Talks to End Bond Probe*" Wall Street Journal (Dec. 2, 2010) (noting that after Goldman Sachs' $550 billion settlement with the SEC concerning sale of CDOs, other investment banks including Deutsche Bank, J. P. Morgan, Morgan Stanley, UBS, and Citigroup were negotiating with the SEC).

[15] Additionally, lawyer-industry arbitrators may be hard pressed to accept certain theories of recovery or reject certain brokerage defenses while serving as "impartial" arbitrators, knowing that they will present the opposite positions on behalf of their industry clients.

[16] As previously noted, according to the O'Neal-Solin Study, the expected recovery percentage of a claim of over $250,000 against one of the three largest brokerage firms was a paltry 12%, versus over 37% for claims under $10,000 against smaller firms.

all public panel option as the default option would eliminate notification deadlines for customers while simultaneously lessening the burden of the FINRA-DR case administrators with respect to following up on the application of the rule. An investor should not be deprived of the ability to exclude an industry arbitrator from a panel due to missing a deadline.[17]

In addition, the proposed rule is vague as to whether a claimant can request that the all public panel option be elected at the time of filing a Statement of Claim. The rule appears to preclude the ability of an investor to request it be applied to a case at the time of filing, forcing the claimant to wait until the Statement of Claim has actually been served. To the extent that there may be any uncertainty on the part of investors, they should be given the benefit of the doubt and be permitted to proceed with an all public panel unless they opt otherwise.

Conclusion

PIABA urges the Commission to adopt the rule proposed by FINRA. We request, however, that the rule be amended so that the all public panel option is the default option, and not require that investors opt-in. Thank you for your kind consideration in advancing the interests of investor protection.

Respectfully submitted,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
/s/
Peter J. Mougey
President

Mr. Mougey's Contact Information:

Peter J. Mougey
Shareholder/Chair, Securities Department
Levin, Papantonio, Thomas, Mitchell, Rafferty & Proctor, P.A.
316 S. Baylen Street, Suite 600
Pensacola, FL 32502
Telephone: (850) 435-7068
Facsimile: (850) 436-6068

[17] It should be noted that FINRA-DR's procedures for serving notices of claim can vary slightly between regional offices. Due to deficiency letters and other procedural matters that hold up the service of a statement of claim, it is sometimes difficult to ascertain when a claim has actually been served.