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December 3, 2010

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

Re: File No. SR-FINRA-2010-053

Dear Ms. Murphy:

We are law professors who write extensively about the securities arbitration process and serve as chair-qualified arbitrators at FINRA Dispute Resolution. We write in support of FINRA's proposed rule change to amend the Code of Arbitration Procedure for Customer Disputes to provide every customer claimant, in a three-arbitrator case, the option of selecting a panel consisting entirely of public arbitrators. We agree with FINRA that giving customers this option will "enhance customers' perception of the fairness of FINRA's rules and of its securities arbitration process."[1] We also suggest a modification to improve the process.

Perceptions of Fairness

A recent study of participants' perceptions of the securities arbitration process that we co-authored found that investors have a far more negative perception of securities arbitration than all other participants in the process and perceive a strong bias in arbitrators.[2] Many investors approached the arbitration process with concerns about its fairness, and these concerns persisted throughout the process.

When we asked participants about their concerns prior to filing an arbitration claim, 39.1% of those who answered this question and self-identified as customers stated that they were concerned that it would not be a fair process; 33.6% stated they were concerned that the arbitrators would be biased; and 25% stated they were concerned about the composition of the arbitration panel.[3] 47% of customer-survey participants

[1] Notice of Filing of Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes, Exchange Act Release No. 34-63250, 75 Fed. Reg. 69481, 69483 (Nov. 12, 2010).
[2] 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.
[3] *Id.* at 366. The survey directed participants to select all concerns that applied.

knew, prior to the filing of the arbitration, that one arbitrator would be an industry arbitrator.[4]

When we asked customer-participants about their most recent arbitration experience, the questions that generated the most negative customer reactions asked about perceptions of arbitrator impartiality. A majority of customers gave positive assessments of the arbitrators' competence and attentiveness at the hearing.[5] In contrast, 41% of customers disagreed with the positive statement that the "arbitration panel was impartial," and 40% disagreed with the positive statement that the "arbitration panel was open-minded."[6]

Finally, when we asked customer-participants if, based on their overall arbitration experience, given the choice, they would choose arbitration to resolve a customer dispute in the future, 35% of customers said they would not choose arbitration because it is unfair.[7]

Based on these findings, we urged that, because customers' perceptions of fairness are important to the integrity of the dispute resolution process, FINRA should give serious consideration to eliminating the requirement of an industry arbitrator on every three-person panel. We concluded that:

> 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.[8]

Our empirical findings strongly support FINRA's determination that giving customers the option of an all-public panel "will enhance confidence in and increase the perception of fairness in the FINRA arbitration process."[9]

Furthermore, the SEC must approve the proposed rule change if it is "consistent" with the Securities Exchange Act of 1934 and the regulations that are applicable to FINRA.[10] In particular, section 78o-3(b)(6) requires the SEC to ensure that FINRA rules are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The SEC must also ensure that FINRA rules are not designed to permit unfair discrimination among customers, issuers, brokers, or dealers.[11]

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[4] *Id.* at 370.
[5] *Id.* at 383.
[6] *Id.* at 385.
[7] *Id.* at 387.
[8] *Id.* at 400. FINRA subsequently increased the threshold dollar amount for a claim to trigger a three-arbitrator panel from $25,000 to $100,000.
[9] *Supra* note 1.
[10] 15 U.S.C. § 78s(b)(2) (2006).
[11] 15 U.S.C. §§ 78o-3(b)(6) (2006).

Because it is essential for investor confidence in the FINRA arbitration forum that customers can unilaterally select an all-public panel, giving them this right does not constitute impermissible "unfair discrimination" against industry participants. SEC oversight over the arbitration process is directed to ensure that the process is fair and efficient,[12] and the SEC has considerable discretion to use its judgment and knowledge in determining whether a proposed rule complies with the statutory requirements.[13] Moreover, it is clear that SRO rules may make appropriate distinctions between differently situated groups, consistent with the statutory purpose, without running afoul of the prohibition against "unfair discrimination."[14]

Finally, the presence of an industry arbitrator on a three-person panel in every customer case has tainted what we believe otherwise to be a fair process. This proposed rule change would remedy that taint with no adverse consequences, because FINRA has not previously articulated a compelling justification for the industry arbitrator. Accordingly, we support FINRA's proposed rule change to give customers the option of selecting a panel consisting entirely of public arbitrators.

One Suggested Modification

We suggest one modification to the rule proposal that would better implement investors' choice. As proposed, customers can choose between two panel selection options: the Majority Public Panel, which retains the current panel composition method, or the Optional All Public Panel, which would guarantee that any party could select an all-public panel. Customers must affirmatively elect the Optional All Public Panel procedures within 35 days from the service of the statement of claim; otherwise, FINRA would apply the procedures for the Majority Public Panel option. As proposed, customers would lose an important procedural protection -- their ability to select an all-public panel – through inadvertent tardiness in making their election. Such a harsh consequence could create investor resentment toward the FINRA process, exactly the opposite of the intention behind the proposed rule change.

On this point, the interim findings as of June 1, 2010 from FINRA's Pilot Program are instructive. Investors in 485 of a total of 853 cases eligible for the pilot program chose to participate (56.86%). In the 361 cases (of 485) where parties completed arbitrator rankings, the investor chose to rank one or more non-public arbitrators on the list in 187, or 52%.[15] This data indicate that a majority of customers want the option of an all-public panel, even if ultimately they do not strike all the names of industry arbitrators on their list. Moreover, the percentage of customers wanting the option to select an all-public panel is likely to increase as investors become better-informed about its advantages and the restrictions of the Pilot Program are no longer in

[12] Order Approving Proposed Rule Change Relating to Amendments to the Codes of Arbitration Procedure to Require Arbitrators to Provide an Explained Decision Upon the Joint Request of the Parties, Rel. 34-59358, File No. SR-FINRA-2008-051, 74 Fed. Reg. 6928, 6931 (Feb. 4, 2009).
[13] In re Nat'l Ass'n of Sec. Dealers, Inc., Rel. 34-17371, 1980 SEC Lexis 128 (Dec. 12, 1980).
[14] Timpinaro v. SEC, 2 F.3d 453, 456 (D.C. Cir. 1993).
[15] Kenneth L. Andrichik et al., *The Financial Industry Regulatory Authority's Dispute Resolution Activities*, 1829 PRACTISING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 37, 45 (2010).

effect. Accordingly, we believe it would enhance customers' choice, and increase confidence in the arbitration process, if the Optional All Public Panel procedures were made the default choice, so that its procedures would apply unless the customer opted out within 35 days from the service of the statement of claim.

In conclusion, we applaud FINRA for proposing this rule change and strongly support it. In addition, we propose one modification that we believe will further enhance investor choice and confidence in the FINRA arbitration forum.

Sincerely,

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