

VIA ELECTRONIC MAIL

July 11, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number SR-FINRA-2013-023: Proposed Rule Change to Amend FINRA Rule 12403 of the Code of Arbitration Procedure for Customer Disputes to Simplify Arbitrator Selection in Cases with Three Arbitrators

Dear Ms. Murphy:

On June 3, 2013, the Financial Industry Regulatory Authority (FINRA) filed with the Securities and Exchange Commission (SEC), a proposed rule change amending FINRA Rule 12403 of the Customer Code of Arbitration Procedure (Proposed Amendment).¹ The Proposed Amendment would simplify arbitration panel selection in cases with three arbitrators. Under the proposed rule change, FINRA would no longer require a customer to elect a panel selection method (choosing either an all public panel option or majority public panel option), and parties in all customer cases with three arbitrators would get the same selection method. The Financial Services Institute² (FSI) appreciates the opportunity to comment on this important proposal.

Background on FSI Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisers are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

¹ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to the Customer and Industry Codes of Arbitration Procedure To Revise the Public Arbitrator Definition, 78 Fed. Reg. 119, 37267 (June 20, 2013).

² The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 100 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Advisor members.

In the U.S., approximately 201,000 independent financial advisers – or approximately 64% percent of all practicing registered representatives – operate in the IBD channel.³ These financial advisers are self-employed independent contractors, rather than employees of the IBD firms. These financial advisers provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisers are typically “main street America” – it is, in fact, almost part of the “charter” of the independent channel. The core market of advisers affiliated with IBDs is comprised of clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisers are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.⁴ Independent financial advisers get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisers have a strong incentive to make the achievement of their clients’ investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisers. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisers play in helping Americans plan for and achieve their financial goals. FSI’s primary goal is to ensure our members operate in a regulatory environment that is fair and balanced. FSI’s advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments

The Proposed Amendment is the current iteration of the ongoing efforts of FINRA (and its predecessor organization NASD) to cater to perceived flaws in the FINRA Dispute Resolution process that cause a disadvantage to investors. This effort has increasingly focused on panel selection and the perceived bias of industry arbitrators on arbitration panels.⁵ FINRA has proposed a number of rule changes and amendments in an effort to counteract this perceived bias in the past few years.

Changes to the “Public Arbitrator” Definition

FINRA has amended the Arbitration Codes a number of times to narrow the scope of the “public arbitrator” definition. These amendments excluded veteran industry professionals who have ended their industry affiliations,⁶ officers and directors (and their immediate family members) with indirect ties to the securities industry,⁷ and attorneys, accountants, and other professionals who derive a portion of their annual revenue serving firms in the securities industry.⁸ On January 4, 2013, FINRA again proposed to

³ Cerulli Associates at <http://www.cerulli.com/>.

⁴ These “centers of influence” may include lawyers, accountants, human resources managers, or other trusted advisers.

⁵ (“Any lingering perceptions of pro-industry bias [in FINRA Arbitration] appear to stem from rules governing panel composition...”) See Michael A. Perino, Report to the Securities & Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, U.S. Securities & Exchange Commission, November 4, 2002, p.3, available at: <http://www.sec.gov/pdf/arbconflict.pdf>

⁶ Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations, 69 Fed. Reg. 21,8171 (Apr. 22, 2004).

⁷ Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to Amendments to the Classification of Arbitrators Pursuant To Rule 10308 of the NASD Code of Arbitration Procedure, 71 Fed. Reg. 62,026 (Oct. 20, 2006).

⁸ Self-Regulatory Organizations; National Association of Securities Dealers, Inc., Notice of Filing of Proposed Rule Change To Amend the Definition of Public Arbitrator, 72 Fed. Reg. 39,110 (Jul. 17, 2007).

narrow the “public arbitrator” definition by excluding persons associated with a mutual fund or hedge fund from serving as “public arbitrators” for two years after severing those associations.⁹

Evolution of the All Public Panel Option

In addition to these changes to the “public arbitrator” definition, FINRA also evaluated panel composition and selection in customer cases. On February 1, 2011, FINRA implemented a rule change establishing an “all public panel option,” which gives parties the option to exclude all non-public arbitrators from panels.¹⁰ The establishment of the All Public Panel Option (Public Option) in February 2011¹¹ was a major step in this process. With the establishment of the Public Option under current FINRA Rule 12403 (Current Rule), parties in customer FINRA arbitrations were now able to choose an arbitration panel that included only arbitrators that had no experience with the operations and customs of the financial services industry.¹²

Under the Current Rule, a customer may either initially choose between the Public Option or a Majority Public Panel Option (Majority Option) when they file their statement of claim, or within 35 days from the statement of claim being served on the opposing party.¹³ If the filing party selects either the Public Option or the Majority Option, they are placed in the Majority Option by default. Customers who do not select either option are then notified by FINRA that they may select the Public Option within 35 days.¹⁴ All parties then receive randomly generated lists of arbitrators from the Neutral List Selection System (NLSS), including three lists, one with 10 chair-qualified public arbitrators, one with 10 public arbitrators and one with 10 non-public arbitrators.¹⁵ The customer who chooses the Majority Option may strike up to four arbitrators on each of those lists, while the customer who chooses the Public Option may strike up to all 10 arbitrators on the non-public arbitrator list.¹⁶ However, in reality, even after selection the Majority Option or being placed in it by default, the customer may strike all 10 arbitrations on the non-public list. The Proposed Amendment will streamline this process to eliminate FINRA’s requirement to inform customers of the Public Option in writing within 35 days, and essentially will not require customers to initially select either the Public Option or the Majority Option. Instead, the customer will just file their claim and proceed to the ranking and striking arbitrators, striking all the industry arbitrators if they desire the current Public Option.

1. FSI Supports the Proposed Amendment

In general, FSI supports the Proposed Amendment. FSI and its members believe that streamlining this process will allow FINRA staff to eliminate the burdensome requirement of sending out the 35 day notice. The Proposed Amendment will also prevent claimants and attorneys unfamiliar with the process from failing to select the Public Option if that is their intent, by eliminating this step. In sum, FSI and its members see little concern in altering this aspect of the panel selection method.

⁹ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc., Notice of Filing of Proposed Rule Change Relating to Amendments to the Customer and Industry Codes of Arbitration Procedure to Revise the Public Arbitrator Definition, 78 Fed. Reg. 12, 3925 (Jan. 17, 2013).

¹⁰ See Arbitration Panel Composition, Regulatory Notice 11-05 (Feb. 2011); see also U.S. Securities & Exchange Commission, Release No. 34-63799; File No. SR-FINRA-2010-053, *Self Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Relating to the Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes*, January 31, 2011, available at:

<http://www.sec.gov/rules/sro/finra/2011/34-63799.pdf>

¹¹ *Id.*

¹² See FINRA Customer Code of Arbitration, Rule 12403.

¹³ *Id.*

¹⁴ FINRA Dispute Resolution, New Optional All Public Panel Rules, available at:

<http://www.finra.org/ArbitrationAndMediation/Arbitration/Rules/RuleGuidance/NoticestoParties/P123997>

¹⁵ FINRA Dispute Resolution, Arbitrator Selection, Investor Cases, available at:

<http://www.finra.org/ArbitrationAndMediation/Arbitration/Process/ArbitratorSelection/index.htm>

¹⁶ *Id.*

2. FINRA Dispute Resolution Should Continue to Track Claimant Outcomes Between Those that Choose an All Public Panel and Those That Choose a Majority Public Panel

FSI is concerned that, after the adoption of the Proposed Amendment, FINRA Dispute Resolution will no longer track the difference in outcomes between those that select the Public Option as opposed to the Majority Option. As FSI and its membership have previously made clear, there is significant concern that all public panels deliver more favorable outcomes for investors than those panels with non-public arbitrators that understand the financial industry. This is evidenced in the rule filing for the Proposed Amendment where FINRA Dispute Resolution notes: "For the period February 1, 2011 [the start date for the Public Option] through March 31, 2013, investors prevailed 49 percent of the time in cases decided by all public panels and 34 percent of the time in cases decided by majority public panels."¹⁷ This disparity between the two panel types is currently very significant and should continue to be tracked by FINRA Dispute Resolution. This tracking should be carried out in an effort to determine what impact the institution of the Public Option has had on investor outcomes and the overall fairness of the arbitration process.

3. FSI Remains Concerned About the Definition of "Public Arbitrator"

While we support the Proposed Amendment, FINRA should use this opportunity to more uniformly address shortcomings and inconsistencies with the current definition of "public arbitrator." In particular, FINRA should alter the "public arbitrator" definition to also prevent attorneys that spend a significant portion of their time representing investors and claimants in FINRA arbitrations from serving as "public arbitrators" on arbitration panels.

Under federal law, FINRA's rules must be "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."¹⁸ As such, FINRA's rule changes related to arbitration proceedings have addressed concerns regarding the fairness and neutrality of FINRA's public arbitrator roster by reducing the risk that arbitrators have significant affiliation with the securities industry. This has led to exclusions from the "public arbitrator" definition of anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator, and requiring a five years "cooling off" period before transitioning from serving as a non-public arbitrator to a public arbitrator.¹⁹ FINRA rules also exclude from the public arbitrator roster any attorney, accountant, or other professional whose firms' have derived at least \$50,000 or more in annual revenue in the past two years from professional services rendered to clients involved in securities related activities relating to customer disputes concerning an investment account or transaction.²⁰ These same professionals will also be excluded from the definition of "public arbitrator" if their firms derived 10 percent or more of its annual revenue in the prior two years from persons or entities in the securities industry.²¹

While withholding judgment on the appropriateness of every aspect of the current definition of "public arbitrator," we believe FINRA's changes to the arbitration code over the past several years have neglected to observe that the integrity and neutrality of the forum's arbitrator roster may be threatened by individuals who fall within the "public arbitrator" definition of but who are still deriving income and have ties to the securities industry, albeit indirectly. Under the current definition, the Arbitration Codes do not include in the definition of "public arbitrator" any attorney whose firm has derived at least \$50,000

¹⁷ Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to the Customer and Industry Codes of Arbitration Procedure To Revise the Public Arbitrator Definition, 78 Fed. Reg. 119, 37268 (June 20, 2013).

¹⁸ 15 U.S.C. 78o-3(b)(6).

¹⁹ Order Approving Proposed Rule Change To Amend the Definition of Public Arbitrator. 77 Fed. Reg. at 15025.

²⁰ *Id.*

²¹ FINRA Code of Arbitration Procedure for Customer Disputes § 12100(u)(4); FINRA Code of Arbitration Procedure for Industry Disputes § 1300(u)(4).

or more in annual revenue in the past two years from professional services rendered to clients involved in securities related activities relating to customer disputes concerning an investment account or transaction.²² Also in the Arbitration Codes, an attorney whose firm has derived 10 percent or more of its annual revenue in the prior two years from persons or entities in the securities industry is excluded from the definition of “public arbitrator”.²³ Their exclusion from the definition stems from concerns about “individuals serving as public arbitrators when they have business relationships with entities that derive income from broker-dealers.”²⁴ If FINRA and the SEC have determined that these attorneys should be excluded from the definition of “public arbitrators” in order to reduce the risk of impartiality, it would also be appropriate to exclude attorneys whose firms derived \$50,000 or 10 percent or more of their annual revenue from professional services rendered to claimants relating to customer disputes concerning an investment account or transaction in the prior two years.

Perceptions of fairness and neutrality of the arbitration forum cannot be exclusive to claimants. FSI has identified a significant number of “public arbitrators” whose entire legal practice consists of representing claimants against broker-dealers and other entities in securities litigation and FINRA arbitration. These individuals actively serve on arbitration panels as “public arbitrators.” For example, in *Alice J. Potter vs. Lawrence A. Rasche, Tommy D. Bowman and Ameritas Investment Corp.* (Case ID 11-20745), the presiding chairperson of the arbitration panel, an attorney whose “entire legal practice consists of the representation of customers and registered representatives with claims against broker-dealers and other entities,”²⁵ is classified as a “public arbitrator”. In *Alberto Ferrero and Qingwen Li vs. CCO Investment Services Corp.* (Case ID 10-01505) the presiding chair, an attorney whose practice is dedicated to securities arbitration on behalf of individual investor claimants, is classified as a “public arbitrator”. In *Florence Campbell Butts vs. Fifth Third Securities, Inc.* (Case ID: 08-02669), the presiding chair, an attorney whose practice specializes in securities litigation and who mainly represents claimants against broker-dealers, is classified as a “public arbitrator.” In *Penserra Securities, LLC; George Madrigal; Anthony E. Guaimano* (Case ID: 12-01944), one of the arbitration panelists, an attorney whose law firm and legal practice mainly represent claimants in securities disputes before FINRA, state, and federal courts, is classified as a “public arbitrator”.

If attorneys who represent securities firms are to be excluded from the definition of “public arbitrator” for their connections to the securities industry, the preservation of neutrality and integrity in the arbitration process must also require that FINRA address perceptions of fairness and neutrality with regard to practicing attorneys who primarily represent claimants. If FINRA has determined that an attorney’s industry representation and defense work in customer disputes are too closely related to matters they would be deciding in an arbitration proceeding, therefore affecting the arbitrator’s impartiality, the same concern must apply to those attorneys who principally represent claimants in FINRA arbitration proceedings against members of the securities industry. We suggest that this inconsistency be corrected by excluding from the definition of “public arbitrators” any attorney whose firm has derived \$50,000 or 10 percent or more of their annual revenue in the prior two years from professional services rendered to claimants relating to customer disputes concerning an investment account or transaction.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ Information derived from publicly available arbitration awards records.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you on this and other important regulations.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 803-6061.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "D. T. Bellaire". The signature is fluid and cursive, with a large initial "D" and "T" followed by "Bellaire".

David T. Bellaire, Esq.
Executive Vice President & General Counsel