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Securities and Exchange Commission

Re: Release No. 34-51856
File No. SR-NASD-2003-158
Revision of NASD Code of Arbitration Procedure

I am an attorney who represents investors in NASD arbitration in Kansas and Missouri, primarily the Kansas City area. NASD arbitration procedure, as practiced, is inherently biased against public customers and heavily favors the NASD member firms. The proposed changes to the Code of Arbitration Procedure, on balance, do nothing to improve the situation and in some particular instances aggravates the present disadvantage to customers.

In allowing forced arbitration through pre-dispute arbitration agreements, the Supreme Court in Shearson/American Express, Inc. v. McMahon, 482 US 220, 233-34 (1987) relied on the Commission's oversight to ensure the adequacy of arbitration procedures. The Court stated that there was "no reason to assume that arbitrators will not follow the law." Any independent review today would demonstrate that NASD arbitrators routinely and systematically ignore the law, especially state blue sky laws. They do so with the active encouragement of the NASD and to the benefit of the NASD membership. The April issue of NASD Dispute Resolution's *Neutral Corner*, the quarterly arbitrator training newsletter published a section on **Question and Answer: Understanding and Applying the Law in a Case.** The NASD instructed its arbitrator pool that, "Arbitrators are not bound by case precedent or statutory law. . ." Would we have forced arbitration if the Court knew the forum sponsor would encourage arbitrators not to follow the law? The Commission should assert its authority to insure that the NASD Code of Arbitration Procedure is revised to provide some minimal standard of fairness for defrauded public customers.

The following comments suggest areas in which some small movement in the direction of a level playing field for public investors might be made.

Rule 12100: Definitions of "Public" and "Non-Public" Arbitrators

No element of forced industry sponsored arbitration provides more incredulity to defrauded investors than the fact that every panel appointed to hear a case against a broker will include another broker. It fosters intense skepticism of the basic fairness of the process.

A "non-public" arbitrator is a securities industry employee or close associate. The NASD has never provided a satisfactory or even reasonable explanation of why every panel must include a member employee to watch the "public" arbitrators. The lame excuse of a need for prior knowledge of industry customs and practices is without merit. The parties are just as competent to introduce evidence of industry rules, regulations, and practices as they are to present evidence of the applicable law. Yet the NASD does not see the need to place a person knowledgeable concerning state and federal law on each panel. Furthermore, "non-public" arbitrators are not required to have any knowledge concerning the area of dispute. An oft appointed industry arbitrator in my area simply processes securities transactions for a local bank and has never taken a securities qualification exam. She offers no expertise on most issues involving customer accounts or sales practices.

It is widely believed that the general counsels for respondent brokerage firms check with their counterparts at the firm of industry arbitrators to determine if a particular arbitrator can be relied upon to be sympathetic. Some industry arbitrators are believed to consider that their job is to make sure awards are small regardless of the circumstances. Whether either belief can be documented is not relevant. There will never be public confidence in industry sponsored arbitration while it is perceived as being conducted by another broker and two of his golf buddies. As a matter of full disclosure, I am an industry arbitrator because of my affiliation with a NASD member firm. I have, however, only been appointed to two cases in 15 years and I recused myself from one.

There is no excuse for industry arbitrators and the practice should be ended. Of more immediate concern, however, is that industry lawyers and their partners are

routinely included on panels as “public” arbitrators. Rule 12100(n)(3) provides that attorneys and other professionals with 20% of their business from the industry must be classified as industry arbitrators. The problem, of course, is that industry lawyers are always interested in increasing their business, whether its 10% or 50% of their total. This is an outrageous conflict of interest. Industry lawyers must vote against their own economic interest to grant a customer a full return of losses. The securities industry does not hire lawyers who do not support the industry. Furthermore, it is a basic premise of legal ethics that a lawyer has all of the conflicts of all his or her partners. Yet the NASD will appoint a partner or associate of an industry lawyer where it could not appoint the individual lawyer. The system of encouraging industry lawyers and their partners to serve as arbitrators while soliciting industry business does not invite confidence in the process and should be ended. A lawyer or other professional should represent brokerage firms or act as an arbitrator; not both.

Rule 12400: Neutral List Selection System and Arbitrator Rosters

The Neutral List Selection System (NLSS) is neither neutral nor a selection system. Claimants in the Kansas City hearing site are overwhelmingly assigned panels with most arbitrators appointed by NASD staff with at least one favored arbitrator whose appointment has nothing to do with the “rotational” NLSS system. It is arbitrary and capricious. Even if industry bias is not a criteria for selection as a Category 4 arbitrator which brings monthly or more frequent appointment, the favored arbitrators usually believe they work for the industry and act accordingly. That is why approximately 60% of net losses is considered a ceiling for even the most outrageous cases of abuse.

That being said, the suggested changes would make matters worse. Creating a roster of the elite Chair status will appeal to the professional arbitrator. Because the NASD member respondent firms vote, at least indirectly, on the retention and pay of the Dispute Resolution staff it is absolutely foreseeable that those seeking special status will further favor Respondent members. It would also take the selection of the person responsible for oversight of discovery out of the hands of aggrieved investors. Because most panels are appointed and not selected, the NASD staff would decide what documents its members could withhold through the arbitrary selection of the chair.

Even the current flawed choice between two public arbitrators provides some control. It is preferable to the proposed rule.

The added effect is that a non-chair arbitrator will be treated as unqualified and unworthy to influence the decision. He or she is neither industry nor experienced. They would be relegated to the position of going along to get along in the hope of being raised to the exalted status of Chair and possibly Category 4 arbitrator with its guaranteed expense account and opportunity for travel. When the NASD says "experienced arbitrator" the claimant hears industry slug. A basic tenant of arbitrator selection is that claimants do not want "experienced" arbitrators with a long list of awards. They usually, although not always, represent a favored industry arbitrator too biased or jaded to even listen to the evidence. They do not read the pleadings nor have much sympathy for a defrauded investor because they have seen much worse in the past. At one point, prior to the current NASD-DR leadership, arbitrators who were considered customer friendly were routinely purged from the pool. Many highly qualified and truly neutral arbitrators withdrew in disgust (and some still do) or were never appointed and dropped out. The surviving long-time arbitrators were nearly 100% industry friendly when the current NASD-DR President and Executive Vice President were hired. The legacy remains. So while the NASD may prefer "experienced" arbitrators because they will cause fewer problems for staff, public customers in this area prefer novice arbitrators without the baggage.

The amendment to Rule 12403 expanding the number of names on the expanded number of NLSS lists to seven and limiting the number of strikes to five will not benefit public customers. At least half of all arbitrators remain industry friendly, either overtly biased or so jaded they no longer believe defrauded customers should be fully compensated. Giving Respondents five strikes on any list of seven guarantees that industry respondents can strike everyone they believe might harbor some sympathy for defrauded investors. Regardless of how many strikes the public customer is given, all unbiased arbitrators have already been eliminated. It is highly unlikely that a list of seven will have two arbitrators acceptable to both parties. Appointed panels will remain the rule and the NASD is offering only the pretense of reform.

The NASD has only authorized one audit of the NLSS. That study was apparently done by its auditor, an outrageous abuse of corporate governance. The NLSS does not work as the NASD represents it. It is most obvious in the appointed panels. While names may be placed on the arbitrator selection lists equally, most panels do not come from the lists. The same arbitrators are repeatedly appointed off-list or from the "extended list" as the NASD terms it. It is statistically impossible for the same names to be appointed week after week in a "rotational" system. Now the NASD wishes to change it to a "random" system. The only effect is to make it harder to demonstrate that the NASD has a selected corps of super arbitrators which it appoints outside the NLSS. Before any changes are made to the NLSS, there should be a full audit of its operation by a neutral body with no connection to the NASD or the industry. The GAO might be a good choice.

The NASD should also be required to submit rules for approval on how the different categories of arbitrators are selected and the qualifications for each category. The names of arbitrators approved for each hearing site should be available on a continuous basis. There can be no confidence in the system of arbitrator selection while the names, qualifications required, categorization criteria, and selection process is secret. It should be transparent and easily verified by non-industry parties. The system should then be audited on an annual basis to insure that the approved methods are being followed.

Rule 12504: Dispositive Motions

The NASD's obsequious toadying to its member firms on this issue is disgraceful and casts serious doubt on its ability to operate a neutral arbitration forum. There is no provision in the Code to allow summary judgment without a hearing with the opportunity for presenting evidence, offering testimony and the cross examination of witnesses. Nevertheless, the NASD has encouraged the practice for the benefit of its member firms and to the detriment of public customers.

It now pleads that it is only recognizing established practice. But it established the practice contrary to its own rules, state and federal law. One of the few statutory grounds for the vacation of an arbitration award is arbitrator refusal to hear evidence. This is in both the Federal Arbitration Act (9 U.S.C. §10) and the uniform state

arbitration act. The NASD now seeks to remove this basic statutory protection and allow its member firms a free pass prior to any discovery, testimony or evidentiary hearing. It could not be more abusive until it is coupled with the proposal to establish a pool of "experienced" chairs who could be expected to utilize the rule to maximum effect. The NASD would remove by contract, one of the few safeguards provided by statute. The "extraordinary circumstances" requirement is far too vague to offer any protection to customers. If some anecdotal frivolous claims are being brought, it should be the price the industry pays for its own litigation system where thousands of other meritorious claims are discouraged by the appearance of a self-serving system run for and by the brokerage industry for its own protection.

Rule 12506 and 12511: Document Production

Document production is the most flagrant area of abuse by NASD member firms in arbitration. The Discovery Guide, NASD Notice to Members 99-90 was issued almost six years ago and I have not experienced a single instance of a member firm actually complying. All useful documents are routinely withheld, redacted and subject to draconian confidentiality orders that deny the ability to verify their authenticity or completeness. In one instance, a member firm was given four written orders to produce compliance manuals. They simply refused and denied the existence of manuals that were identified in SEC documents. At hearing the Chair was presented with irrefutable evidence that the documents did exist. When asked to order their production and sanction the member firm, he whimpered and groveled to respondent counsel and denied claimant's request on the grounds that he believed the respondent member must surely have some good faith reason to refuse to produce documents (even though they were declared "presumptively discoverable" in the Discovery Guide). He is an "experienced" Category 4 arbitrator and a prime candidate for the chair list if approved. Forgive my cynicism, but the industry will shut down NASD arbitration before it will actually cooperate in discovery that might lead to a fair, expeditious, low cost dispute resolution system that would consistent produce meaningful awards to defrauded investors who are allowed substantive discovery. It is the Commission's responsibility to force compliance or withdraw its approval of the forum.

The most offensive proposal is to provide the industry with yet another excuse for delaying production of documents with the response that they will deliver them at some future date. All documents in the Discovery Guide are required regulatory records which should be readily available. Proposed Rule 12506(b) allows further delay by codifying a second excuse which is already commonly used; we'll send it to you later. The purpose is to see what documents the customer has retained prior to deciding what to produce. Until claimants can receive basic discovery documents without months of motions, counter-motions, confidentiality disputes, and hearings, they can not get a fair hearing. All parties must bear the burden of demonstrating that documents have some legal right to confidentiality. There must be real sanctions for refusal to follow orders.

Investors already bear the ultimate burden. If they do not comply with the code, arbitrators are quick to dismiss their claims at hearing despite evidence of broker misconduct. Respondents bear no such burden. If member firms lie, cheat and withhold documents, they are subject only to an award of what they owed the customer at the start, or some fraction thereof. There is no downside to a member firm for misconduct in NASD arbitration. The instances of serious sanctions are notable because there are so few. Meaningful sanctions for member firms must be devised and implemented. Most "experienced" arbitrators simply do not believe that they will be allowed to sanction member firms and remain a frequently appointed arbitrator.

Thank you for the opportunity to comment. If my comments appear overly negative, that is my experience in NASD arbitration. I am currently appealing an award by a chair who the state has declared unfit to keep his child because he is unemployed and mentally ill. At the NASD, however, he is fully qualified to deny an elderly widow reimbursement for blatant fraud. Arbitrators are removed at the whim of the Respondent members but customer concerns are ignored. The system of arbitrator appointment is not what it is claimed.

To some extent, rule changes are irrelevant because the NASD seldom enforces the rules. As I tell aggrieved investors; this is the National Association of Securities Dealers, not the National Association of Individual Investors. The brokers get to vote on whether to keep the people administering arbitration and we don't. Unless the SEC takes an active role in auditing and inspecting the process, it will continue to be highly

profitable to the securities industry and harmful to the investing public. An industry that professes to support free markets should allow public customers the freedom to file their complaint in state court if the federal courts do not want them. In a free market, informed consumers would not choose an unfair forum sponsored and administered by their adversaries' trade association. The forum would have to reform or die, just like a real business in free enterprise.

Sincerely,

Barry D. Estell