

To the Commission:

I write to oppose the NASD's request for accelerated approval of the sweeping changes embodied in Amendment Number 5 to the NASD's proposed rewrite of the Code of Arbitration Procedure, originally filed as SR 2003-158. Numerous problems with certain of the changes have been discussed at length by others who have posted comments regarding earlier versions, and I will not address them again here. Instead, I will devote this letter to a change that may seem innocuous at first blush but which, when examined quantitatively, reveals some serious and highly problematic consequences. While several comment letters objected to the change, I am told that none of them explored its quantitative aspects. It is in that detail that the devil can be found.

The innocuous-sounding wrinkle in Amendment Number 5 to the proposed Code is the NASD's proposal to combine its chair-qualified arbitrators with the non-chair-qualified arbitrators for purposes of selecting the non-chair public arbitrator. If the NASD's proposal is approved, the SEC will have permitted the NASD to divide its public arbitrator pool into two groups and to unbalance list-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 justifiably cynical about both arbitration and the securities industry.

I thought this issue was sufficiently important that, rather than simply write a letter, I have written an article about the problem. A final draft of that article is pasted below my signature.

Early in the article, you will find a brief table of sample outcomes showing the greatly increased frequency with which chair-qualified arbitrators will be appointed and the greatly reduced frequency with which non-chair-qualified arbitrators will be appointed under the NASD's proposed rule. The article also discusses some of the consequences of the resulting disparity. Finally, the article provides formulas that will enable any reader, using any combination of pool sizes, to determine the quantitative impact of the NASD's proposed rule.

Here is an immediate look at the table of sample outcomes that appears in the article below:

| Number of Chair-Qualified Arbitrators<br>"x" | Number of <b>Non-Chair-Qualified</b> Arbitrators<br>"y" | 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 |
|--|---|---|---|
| 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   |

Why should this skewing of arbitrator selection be permitted? Will dividing the public arbitrator pool and giving strong preference to one subgroup enhance investors' trust in an arbitration system about which the public already has serious doubts? Will it enhance the reputation of American capital markets generally?

From an analytical perspective, I appreciate situations in which I can divide the universe of possibilities into two mutually exclusive, exhaustive sets. Here is one: either

(a) the NASD was aware of the extent of the skewing of list-selection that would be brought about by its decision to include chair-qualified arbitrators in the non-chair-qualified pool for list selection purposes, or

(b) it was not.

If it was, and it did not disclose the extent of that skewing in its filing with the SEC, that demonstrates the need for an extended comment period to assure that the final version of the revised Code of Arbitration Procedure will provide adequate protection for the investing public. And if the NASD itself did not know the extent of the skewing problem it created, that underscores all the more the need to extend the public comment period to flesh out this and other unintended consequences of the changes in the latest filing.

The SEC should simply deny approval to the NASD's proposed skewing of the list-selection process. At the very least, the fact that the matters set forth in this letter just now may be coming to light in a quantitative way is a vivid illustration of the need to reopen the public comment period for this massive rule rewrite which for years will define investors' sole redress for misconduct by their brokers.

Respectfully submitted,

Scot Bernstein

## **Tampering with List Selection by Enhancing the Appointment Frequency of "Chair-Qualified" Arbitrators**

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In the NASD's recently-filed fifth amendment to its proposed rewrite of the Code of Arbitration Procedure,<sup>[1]</sup> the NASD continues previous amendments' proposals to divide all "public" arbitrators<sup>[2]</sup> into two separate pools: those who are "chair-qualified" and those who are not.<sup>[3]</sup> That recent amendment, however, adds a new wrinkle that may seem innocuous at first blush but, when examined quantitatively, 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. This conclusion is not empirical in nature and is not based on assumptions that are arguable. Rather, it is knowable *a priori* based solely on the NASD's proposed selection rules. Proof of this proposition is simple and will be provided in this article.

The innocuous-sounding wrinkle in the fifth amendment to the proposed Code is the new use the NASD has found for its pool of "chair-qualified" arbitrators. If the NASD gets its way, that pool will not just be used to select the individual who will chair the arbitration panel (the original proposal); in addition to that use, the NASD now wants to add those "chair-qualified" arbitrators into the public non-chair pool temporarily for list selection in each case, so that chair-qualified arbitrators frequently will serve as both panel chairs and public non-chairs.

Thus, if the NASD's proposal 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.

I will begin this discussion with a brief table of sample outcomes showing the greatly increased frequency with which chair-qualified arbitrators will be appointed and the greatly reduced frequency with which non-chair-qualified arbitrators will be appointed under the NASD's proposed rule. A brief discussion of the consequences of that disparity will follow. I then will provide sample calculations that will demonstrate the disparity for a hypothetical hearing location with specified pool-sizes. Finally, at the end of the article, I will demonstrate the skewing in algebraic terms and derive formulas that will enable the reader, using any combination of pool sizes, to calculate the corresponding frequencies and chair dominance.

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<sup>[1]</sup> 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.

<sup>[2]</sup> 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.

<sup>[3]</sup> 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.

First, here are some sample outcomes:

| Number of Chair-Qualified Arbitrators<br>“x” | Number of <i>Non</i> -Chair-Qualified Arbitrators<br>“y” | Chair vs. Non-Chair Relative Odds of Serving if Selection Is <b>Untampered</b> | Chair vs. Non-Chair Relative Odds of Serving if Selection is <b>Tampered</b> to Boost Chairs’ Odds |
|--|--|--|--|
| 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 – 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 in arbitrator appointments – is the public perception that chairs with substantial numbers of closed cases 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; and shunned punitive damage awards and similar remedies which 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 that “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.<sup>[4]</sup> Indeed, the dramatically reduced odds of

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<sup>[4]</sup> Imagining really isn’t necessary. The calculations below will yield an obvious way to estimate the percentage increase in the time required.

being appointed can be expected 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 at their expenditure of time and money to become arbitrators in the first place; and (3) prospective arbitrators who hear from those who have experienced the problems identified in “(1)” and “(2)” will not even apply.

### **Quantifying Skewing and Deriving a Formula**

Finally, here is the derivation of the formula. To make this more approachable I will start with a straight numerical calculation that assumes each pool – chair-qualified and non-chair-qualified – has 40 arbitrators. I have done this with the idea that seeing actual numbers makes the concepts more accessible and intuitive.

I then will generalize the formulas so that they will apply to any combination of pool sizes. The resulting formulas will enable anyone with knowledge of the number of arbitrators in the chair-qualified pool and the non-chair-qualified pool to determine the consequences of the tampering for which the NASD is seeking accelerated approval.

The mathematics of this is simple. 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. Also, I have made it a point to show every step in the calculations and derivations.

With regard to probability, the only probability concepts in this paper are as follows:

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 of being picked.
2. The sum of the probabilities of all possible outcomes, taken together, must equal 1.0. For example, if you will either be late or not be late and there is no other possibility, then if you have a 30% chance of being late, 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  $\frac{1}{2} \times \frac{1}{2} \times \frac{1}{2}$ .

The calculations and the derivations of formulas below assume application of the NASD’s 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-chairs 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 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*, as stated previously.

### A. Calculations Assuming 40 Arbitrators in Each Pool

For purposes of these calculations,

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

#### A1. Average Probability of Chair-Qualified Arbitrator Serving as Chair:

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

(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 below.)

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

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

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

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

(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.)

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

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

**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.)

**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.)

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

$$\text{Increase} = \frac{4}{360} - \frac{9}{360} = 44\%$$

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

$$\text{Decrease} = \frac{4}{360} + \frac{9}{360} = 44\%$$

**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 (see A1 and A5)

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

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

#### **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 (see A4 and A6)**

$$\text{Ratio} = \frac{19}{360} + \frac{5}{360} = 2.6$$

*(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**

In this section, I 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. Using the formulas will require only that you know the sizes of the chair-qualified and non-chair-qualified pools at the hearing location in question. For these purposes,

Let x = number of arbitrators in chair-qualified pool  
 Let y = number of arbitrators in non-chair-qualified pool  
 Let P<sub>described event</sub> = probability of that event

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

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

(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:**

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

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

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

(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.)

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

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

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

**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.)

**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 – 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.)

**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 added probability of serving as a non-chair.)

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

(This is the added probability divided by the initial probability in an untampered system. To express it as a percentage, multiply by 100.)

**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.)

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

(This is the reduction in probability divided by the initial probability in an untampered system. To express it as a percentage decline, multiply by 100.)

**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)

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

(Thus, when they come from pools of equal size, the chair-qualified arbitrators and non-chair-qualified arbitrators have chances of serving that vary inversely with the sizes of their respective pools.)

**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 understanding all of this because it shows that the increase over the untampered odds always will be equal to  $2 - \frac{16}{x}$ . 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 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.

**Conclusion**

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

*© 2006 by Scot Bernstein. Scot Bernstein practices law in California. His law firm – Law Offices of Scot Bernstein – is located at 10510 Superfortress Avenue, Suite C, Mather Field, California, near the City of Sacramento. Mr. Bernstein can be reached at 916-447-0100. His email address is [swampadero@sbernsteinlaw.com](mailto:swampadero@sbernsteinlaw.com).*

Scot Bernstein  
Law Offices of Scot Bernstein  
10510 Superfortress Avenue, Suite C  
Mather Field, California 95655

Telephone: 916-447-0100  
Fax: 916-933-5533

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