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October **8,** 2003

Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Dear Secretary:

File No. SR-NASD-2003-95 – Amendments to Rules 10308 and 10312 of the NASD Code of Arbitration Procedure Governing Arbitrator Classification - - Submission bv James Dolan

Last week I discovered that the National Association of Securities Dealers filed on June 12, 2003 a proposed rule change relating to arbitrator classification and disclosure in NASD arbitration. Arbitrators were not previously informed of the proposed rule change, nor **was** the filing announced in the June 2003 **NASD** publication 'The Neutral Corner' which was mailed to arbitrators. The filing of the proposed rule change (without text) was announced in the August 2003 issue of 'The Neutral Corner' which was posted on the NASD website, but not mailed or e-mailed to arbitrators. The proposed rule was published in the Federal Register, Vol. ***68,*** No. 162 dated August 21, 2003. The **SEC** requested that comments be submitted by September 11, 2003. During August and September I was engaged in other matters, on vacation, and attending an ADR workshop with the result that I did not become aware of the proposed rule change until I accessed the NASD website last week. To my knowledge, neutrals on the NASD panel have not been consulted either for their opinions on the proposed rule change or on the effect it would have on their classification as public arbitrators. I **spoke**

to other public arbitrators who are not aware that a proposed rule re-defining the term "immediate family member" had been submitted to the SEC. I have been informed that non-public/industry arbitrators have been consulted and that a survey indicates that the proposed rule change will disqualify 200 or more of them.

By way of background, in addition to an **active** court litigation practice, I have served **as** a neutral and have represented parties in commercial and securities arbitrations for more than 30 years. I have been a member of the American Arbitration Association commercial panel since 1972, the **NASD** and NYSE panels since 1982, and I serve on the Eastern District of New York ADR panel, I have arbitrated some 250 cases to hearing and award as **a** neutral and as counsel for parties. I have served as a neutral on many NASD cases, initially on five-member and later on three-member panels, and as chairperson in 90% of the cases. I have served on large and complex cases in all forums and I am qualified by **the NASD** to serve as chairperson in statutory employment cases. I have lectured on securities arbitration on **NASD,** Practising **Law** Institute **and** bar association panels. I am Vice-Chair of the ADR Committee of the **Nassau** County Bar Association.

NASD proposes a substantial rule change despite the statement in SEC Release 2002-**16** that the Perino report indicates that current SRO conflict disclosure requirements generally appear **adequate.** Professor Perino states:

> "This Report concludes that there is little **if** any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations. Available empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair." **(Report,** p. 48)

Also: "Definitive recommendations are inappropriate at this time because I have insufficient data on the effect that these changes may have on the depth of the arbitrator pool or on any additional administrative costs that such amendments would entail." (Report, p. 19) Although

the report is "only recommending that the SROs evaluate the advisability of these changes," the **NASD,** without carrying out independent research, is proposing a substantial and unwarranted change in public arbitrator classification.

The proposed rule (the text of which is annexed) re-defines the term "immediate family member" elevating it from a matter of disclosure to ***per se*** disqualification. In the June **12,** 2003 submission to the SEC **(p.** 3), the **NASD** stated: "The proposed rule change would also significantly amend the definition of 'immediate family member' in Rule 10308(a)(5)(B) to further ensure that individuals with significant, albeit indirect, ties to the securities industry may not serve as public arbitrators." (The words "significant" and "indirect" appear to be contradictory.) I believe this change **will** adversely affect the depth of the arbitrator pool because it will disqualify a significant number of well-qualified public arbitrators who have emancipated sons and daughters engaged in securities industry related work, many of whom have given years of service to the process. Financial services constitute upwards of 30% of gross domestic product, so that it is highly probable that a significant number of neutrals will be barred from future service because of the re-definition of "immediate family member." I might be affected because my son worked for a broker-dealer for several years **prior** to August 2002; this relationship has been disclosed when I submitted my oaths and I have not been challenged because of it.

The proposed re-definition of "immediate family member" is a capitulation to the demands of the claimants' bar who do not want experienced arbitrators on their cases, preferring instead persons without any knowledge of evidence, securities law and regulations, and industry customs. It's common knowledge that claimants' attorneys have been striking from arbitrator lists those neutrals whose biographical data indicate prior experience. At **a**

June 2000 program sponsored by the Association of the Bar (Securities Arbitration : Hot Topics 2000) with panelists from NASD, **NYSE** and PIABA, the **PIABA** representative stated that claimants' attorneys do not want experienced arbitrators on their panels. He said Claimants' attorneys want the first three persons who walk in the room to decide their cases. Further, **he said** claimants' attorneys want inexperienced arbitrators so that they can more easily persuade them of the justice of their clients' cases. **He** also complained that claimants' attorneys were having problems with arbitrators who cannot control the process, who do not know the rules of evidence, **as** a result of which hearings last days longer than they should. Just **as** it is improper for an arbitrator to favor one party or the other, it is not appropriate for an SRO arbitration forum to adopt a rule favoring a discrete class of litigant without the empirical data justifying the rule change.

My comments are directed to the definition of public arbitrator in Rule 10308(a)(5)(A)(v) and (B)(i) and (ii), and more specifically to the re-definition of the term "immediate family member". Preliminarily, I note that the proposed rule (as well **as** the existing rule) is inherently ambiguous. The definition of "immediate family member" is not **a** model of clarity. The proposed rule **is** susceptible of alternative interpretations. One interpretation of the words "a person engaged in the conduct or activities described in paragraphs (a)(4) **(A)** through (D)," indicates that the "person" must be presently – at the time of selection - engaged in the conduct or activities described, regardless of whether the "person" had been so engaged during **a** prior period within the past five years. For **example,** if one **is** the "parent" of a "person" who was engaged in the conduct or activities described during the period January 2002 to December 2002, but is not engaged when the parent is selected, there is no disqualification. An alternative interpretation would disqualify the

"parent" of the "person" if the "person" was engaged in the listed activities at **any** time, however brief, within the past five years, but not so engaged when the parent is selected.

For the purpose of this letter, I will assume that the **NASD** will apply the alternative interpretation, namely that the "parent" **of** a "person" engaged in the conduct or activities described at any time for any period within the **past five years,** even if not ***so*** engaged at time of selection, cannot serve as a public arbitrator. This ***per se*** disqualification does not mean that the parent **can** serve as a non-public/industry arbitrator because if the parent qualifies **as** a non-public/industry arbitrator, he or she cannot be classified as a public arbitrator in the first place. This effectively removes the parent from serving as an arbitrator altogether until passage of a five-year 'cleansing' period.

The proposed rule is a radical departure from well-established **law** and practice of early resolution of partiality issues by disclosure and post-award judicial policing of awards, and will have an adverse impact on the integrity and professionalism of the securities arbitration process because a significant number of competent neutrals will be barred from future service merely because of a family relationship that in **and** of itself does not constitute evident partiality. Professor Perino's concern about the adverse impact this rule change **may** have on the depth of the arbitrator pool will be fully realized.

I submit that the proposed rule is not just a radical departure from existing practice, but **as** well conflicts with federal and state arbitration statutes and the AAA/ABA Code of Ethics for Arbitrators in Commercial Disputes which binds neutral arbitrators selected to hear and decide cases filed with the NASD. *See* Perino Report, pp. 41-44. The AAA/ABA Code **was** prepared in 1977 by joint committees of the American Arbitration Association and American Bar Association. The Code reflects **the prevailing** principle that arbitrators will

disclose the existence of interests or relationships that are likely to affect their impartiality or might reasonably create an appearance that they are biased against one party or favorable to another. These provisions favor early resolution of partiality issues by informed parties who frequently choose parties on the basis of prior professional or pertinent subject matter expertise. They are intended to be applied realistically so that the burden of detailed disclosure does not become so great that it is impractical or impossible for persons in the business world to be arbitrators, thereby depriving parties of the services of those who might be best informed and qualified to decide particular types of cases. I daresay a trial judge would not recuse himself or herself from a securities case merely because an emancipated son or daughter is or was employed by a firm not involved in the case; the relationship is a matter for disclosure.

The provisions of the AAA/ABA Code relating to partiality are rooted in the Supreme Court decision in *Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145 (1968) which held that an arbitrator's undisclosed business relationship with one of the parties constituted evident partiality. The Court held that arbitrators "should err on the side of disclosure" because "it is better that the relationship be disclosed at the outset when the parties are free to reject the arbitrator or accept him with knowledge of the relationship." At the same time, the Court noted that it must be recognized that "an arbitrator's business relationships may be diverse indeed, involving more or less remote commercial connections with great numbers of people." An arbitrator "cannot be expected to provide the parties with his complete and unexpurgated business biography." Justices White and Marshall, in their concurring opinion, would not require disclosure of interests or relationships that are merely "trivial."

The AAA/ABA Code allows parties to choose whomever they wish to serve as an arbitrator. When parties with knowledge of a person's interests and relationships desire that individual to serve as an arbitrator, that person may properly serve. Canon II of the Code *(An* Arbitrator Should Disclose Any Interest or Relationship Likely to Affect Impartiality or Which Might Create an Appearance of Partiality of Bias) provides in pertinent part as follows:

> **A.** Persons who are requested to serve as arbitrators should, before accepting, disclose (a) any direct or indirect financial or personal interest in the outcome of the arbitration; (2) any existing or past financial, business, professional, **family** or social relationships which are likely to affect impartiality or which might reasonably create an appearance or partiality or bias. Persons requested to serve as arbitrators should disclose **any** such relationships which they personally have with any party or its lawyer, or with any individual whom they have been told will be a witness. They should also disclose any such relationships involving members of their families or their current employers, partners or business associates.
>
> B. Persons who are requested to accept appointment as arbitrators should make a reasonable effort to inform themselves of any interests or relationships described in the preceding paragraph **A.**
>
> C. **The** obligation to disclose interests or relationships described in the preceding paragraph **A is a** continuing duty which requires a person who accepts appointment **as** an arbitrator to disclose, at any stage of the arbitration, any such interests or relationships which may arise, or which are recalled or discovered.
>
> D. Disclosure should be made to all parties unless other procedures for disclosure are provided in the rules or practices of **an** institution which is administering the arbitration. Where more than one arbitrator has been appointed, each should inform the others of the interests and relationships which have been disclosed.

It cannot be gainsaid that the securities arbitration process has been subjected to criticism, both fair and biased. Courts have shown such confidence in arbitration as an alternative to court litigation, however, that courts repeatedly hold that arbitrators do not have to explain their awards. Despite the criticisms, which can be leveled as well at formal court litigation, the integrity and professionalism of decision-making by independent neutrals has reached such **a** point that the courts have granted arbitration panels great deference and

subjected arbitration awards to very limited review in order to avoid undermining the twin goals of arbitration, namely, settling disputes efficiently and avoiding long and expensive litigation. *See, Duferco Int'l Steel Trading v. T. Klaveness Shipping*, 333 F.3d 383 (2d Cir. 2003); *Willemihjn Houdstermaatschappij, BV v. Standard Microsystems Corp.*, 103 F.3d 9 (2d Cir. 1997). Depriving parties of the services of well-qualified neutrals who might be the best informed and competent to decide particular types of cases will undermine the twin objectives of arbitration. Two recent cases illustrate the consequences of selecting inexperienced arbitrators.

In *Sawtelle v. Waddell & Reed, Inc.*, 304 A.D.2d 103 (1st Dep't 2003), the Appellate Division (the intermediate New York appellate court) vacated and remanded to the original panel for reconsideration a $25-million punitive damages award on the grounds of manifest disregard of the constitutional law of punitive damages proportionality in *BMW v. Gore*, 517 U.S. 559 (1996). On remand, the original panel ignored the Appellate Division's instructions and adhered to its prior decision awarding $25-million punitive damages, furnishing reasons justifying the award, many of which had been recited in the court decision vacating the award. This six-year old 1997 NASD case will no doubt be reviewed again and this time it is likely the court will vacate and remand to a new panel. In another recent case, *Tripi v. Prudential Securities, Inc.*, NYLJ 10/2/03, p. 23 (SDNY 2003), NASD arbitrators awarded claimant $25,000 damages, 3% of an $800,000 loss. Claimant asked the panel to clarify the award; the request for clarification was denied. District Judge Scheindlen reviewed the record and remanded to the original panel for clarification, with instructions that it explain its allocation of losses, 97% to claimant and 3% to Prudential. The judge was troubled by the fact that the claimant's losses were sustained at a time when the market experienced significant growth

(DJIA rose 1,700 points) during the period January-November 1999. Judge Scheindlen commented that "it is hard to imagine any justification for the arbitrators' award which holds Prudential responsible for only three percent of Tripi's losses. The arbitrators have provided no clue as to how they arrived at a 97/3 percent split. In fact, when questioned about the arbitrariness of the apportionment . . . the panel specifically declined to provide an explanation. . . ." Finally, noting that there was strong evidence in the record of Prudential's liability, Judge Scheindlin stated that "such a meager award shocks the conscience of this Court" and said "I would not hesitate to set aside such an incomprehensible award if it were a jury verdict."

If it ain't broke, don't fix it. The overall conclusion of the Perino report is that participants in NASD arbitrations overwhelmingly believed that cases are handled fairly and without bias. In his executive summary, Professor Perino states:

> "This Report concludes that there is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations. To be sure, some critics, particularly lawyers that represent investors, continue to suggest that SRO-arbitrations have a distinct pro-industry bias. But, available data on arbitration outcomes do not suggest that industry members fare better than investors. Investors generally appear to believe that arbitrators are fair and impartial. A miniscule percentage of arbitral awards are vacated on the basis of arbitrator bias. There is thus little evidence than an overhaul of current conflict disclosure rules is needed."

As I stated above, early disclosure of potential conflicts, coupled with post-award judicial review, are more than adequate mechanisms to ensure the fairness of the process. My own experience is consistent with the conclusions of the Perino report **(p. 37)** that, because of the early disclosure requirements, very few awards are challenged on the ground of arbitrator bias or prejudice. There are an increasing number of post-award cases challenging decisions for "manifest disregard of the law," or the award is "arbitrary and capricious" or "irrational". "Manifest disregard of the law" and its siblings "arbitrary and capricious" and "irrational" are

now the mantra of unsuccessful parties challenging awards. A number of these cases are the result of inexperienced arbitrators hearing cases beyond their competence to handle. Although judicial review of an award for "manifest disregard of the law" (knowingly ignoring controlling legal principles) is limited and the party challenging the award on that ground bears a heavy burden of proof, nevertheless there is heightened scrutiny of awards challenged on that ground which are reviewed *de novo* as a question of law. "Manifest disregard of the law" and its siblings are much greater and more serious problems than the selection of a panelist who has an emancipated son or daughter employed in the financial services industry.

I agree with the recommendations in the Perino report that there should be continuing independent research to ensure that, as an alternative to formal court litigation, basic principles of justice are maintained in arbitration so that the goal of fairness in each venue is achieved. I do not believe, however, that the arbitration forum should adopt any rule that favors one class of party over any other class. As stated in the Perino report, empirical evidence does not support the re-definition of "immediate family member" and, in my opinion, the proposed re-definition skews arbitrator selection standards in favor of claimants.

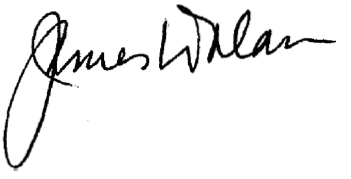
Although the Federal Register indicates that comments should be submitted by September 11, 2003, I respectfully request that this submission be accepted by the Commission. By separate letter, I am sending a copy of this submission to the NASD with a request that the proposed rule change be withdrawn. In addition, I respectfully ask the Commission not to approve the proposed rule change. Alternatively, I request that the proposed rule change be held in abeyance pending independent research and evaluation of the effect the proposed rule will have on the integrity of the arbitration process and the depth and

professional competence of the arbitrator pool. **As** Professor Perino stated in his Executive

Summary:

> "Changing current rules to define potential conflicts more broadly may deter well-qualified arbitrators from serving or may disqualify those with significant expertise from hearing a case. The net result may **well** be less accurate case resolutions and more **judicial** challenges to arbitral **awards."**

Sincerely,



JD:ss
cc: **NASD** Dispute Resolution

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October 10, 2003

Secretary
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450 Fifth Street, NW
Washington, DC 20549-0609

Dear Secretary:

File No. SR-NASD-2003-95 – Amendments to Rules 20308 and 10312 of the NASD Code of Arbitration Procedure Governing Arbitrator Classification - - Submission by James Dolan

I submitted my comments on the NASD's proposed amendment to Rule **10308** by letter dated October 8, 2003. In that letter I referred to the attached **copy** of the proposed rule. I forgot to attach the copy to my letter.

Attached to this letter **is** a copy of the proposed rule. Please attach one of these **six** copies of this letter and proposed rule to **each** copy of my October **8,** 2003 submission.

Thank you for your courtesy.

Sincerely,

JD/dg
Enclosures

Rule 10308. Selection of Arbitrators

This Rule specifies how parties may select or reject arbitrators, and who can be a public arbitrator.

(a) Definitions

(1)-(3) Unchanged

* * *

(4) "non-public arbitrator"

The term "non-public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and:

(A) is, or within the past 5 [three] years, was:

(i) associated with a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer);

(ii) registered under the Commodity Exchange Act;

(iii) a member of a commodities exchange or a registered futures association; or

(iv) associated with a person or firm registered under the Commodity Exchange Act;

(B) is retired from, or spent a substantial part of a career, engaging in any of the business activities listed in subparagraph (4)(A);

(C) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last 2 years, to clients who are engaged in any of the business activities listed in subparagraph (4)(A); or

(D) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities futures or options or supervises or monitors the compliance with the securities and commodities laws of employees who engage in such activities.

(5) "public arbitrator"

(A) The term "public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and [is not]:

(i) is not engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D); [or]

(ii) was not engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D) for a total of 20 years or more;

(iii) is not an investment adviser;

(iv) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past 2 years from any persons or entities listed in paragraph (a)(4)(A); and

(v) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D).

(B) For the purpose of this Rule, the term "immediate family member" means:

(i) the parent, stepparent, child, or stepchild, of a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);

(ii) a member of the household of [family member who shares a home with] a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);

(iii) a person who receives financial support of more than 50 percent of his or her annual income from a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D); or

(iv[iii]) a person who is claimed as a dependent for federal income tax purposes by a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D).

* * *

Remainder of (a) through (c) unchanged.

* * *