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March 10, 2005

Secretary Jonathan G. Katz  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Re: File Number SR-NASD-2004-164

Dear Mr. Katz:

Thank you for this opportunity to comment.

The SEC should reject the NASD's proposed rule change from a "rotational to a random selection function" because there is no evidence that it would be an improvement over the current system. Additionally the change fails to address one of the most serious problems with the current system and would introduce at least one new problem.

The NASD offers two reasons in support of the change. The first is that other arbitration systems use a random selection system. This is irrelevant. The change should be judged on its intrinsic merits and not on its popularity.

The second reason is that a "large amount of computer code is required to manage and maintain arbitrator rotation" and the NASD cites the cause as the changing database of arbitrator information. This is both weak and superficial. The change should be judged on a cost-benefit analysis, yet the NASD presented no such analysis.

Additionally, the NASD's proposal offers no proof that the current system is more difficult to implement than the new system. The proposal refers to the difficulty in maintaining a database in order to implement the current system, yet both systems require a database.

In this era of sophisticated computer power, it is incomprehensible that maintaining a database is a problem unique to the NASD. Moreover, maintaining an easily useable database of arbitrator information would be useful in performing other analysis related to checking the integrity of the NASD arbitration system.

The NASD praises the random selection system, yet the new system would fail to correct a significant problem with the current system. The rotational selection system fails to consider arbitrator experience and other historical data, so it frequently generates potential arbitrator lists containing many or all arbitrators with a history of ruling in favor of the broker/dealer. A random selection system would suffer from the same flaw.

Finally, moving to the random selection system would introduce new problems. A purely random selection would select some arbitrators more frequently than others. The difference in frequency is significant. This uncertainty in an arbitrator being selected to a panel would discourage the best arbitrators from investing the time and other resources to become arbitrators. Additionally, the added variability in the selection of arbitrators would further mask any problems with the NASD's arbitrator selection process.

The NASD downplays the problem that some arbitrators would be selected more frequently than others stating that “a statistical comparison of one arbitrator’s selection to another, using a large sample of eligible arbitrators and lists generated, should show that one arbitrator is not being selected for lists more frequently than any other.” But this is wrong. Simple probabilistic analysis shows that the differences in the frequency with which arbitrators are selected are significant.<sup>1</sup>

The NASD’s has not made a strong case for changing the current system and has ignored other problems. In particular, they have not shown any benefit to the customer or employee of broker/dealers. So while the current system is flawed,<sup>2</sup> it would be imprudent to rush to implement a new system. Before considering any change, the SEC should request that the NASD make a rigorous assessment of both systems.

Thank you.

Sincerely,



Richard Skora

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<sup>1</sup> Elementary probabilistic analysis shows that the distribution of the number of times that an arbitrator is selected would be a binomial distribution with  $p = 1/(\text{number of arbitrators})$  and  $N = \text{number of slots for an arbitrator on a potential arbitrator list}$ . With both the *number of arbitrators* and the *number of slots for an arbitrator* large, it is almost certain that some arbitrators will be chosen multiple times more than other arbitrators.

<sup>2</sup> Another flaw with a purely rotational selection system is that it could select the same arbitrators for more than one potential arbitration panel list. This would be even more likely in regions where the number of arbitrators is small. Such a lack of diversity would intensify any biases in favor of the broker/dealer.