PACE INVESTOR RIGHTS PROJECT

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Jonathan G. Katz
Secretary, Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549-2001

Re: File No. SR-NASD-2005-094

To Whom It May Concern:

The Pace Investor Rights Project (PIRP) at Pace University School of Law welcomes the opportunity to comment on NASD's proposal to amend Rule 10308 relating to the classification of arbitrators to further ensure that individuals with significant ties to the securities industry do not serve as public arbitrators. PIRP's mission is to advocate on behalf of investor justice, particularly with regard to the rights of small investors.

PIRP supports the proposed amendment. Making certain that "public arbitrators" are independent of the securities industry enhances the perceived and actual fairness of the NASD arbitration forum. Moreover, the amendment accomplishes its stated purpose of ensuring that individuals with significant ties to the securities industry do not serve as public arbitrators.

Public arbitrators should not have significant ties to the securities industry because of the critical role they play in the arbitration process. A public arbitrator either decides a claim (where it is for $50,000 or less) or comprises two out of three constituents of a panel that decides such a claim (where it is for more than $50,000).[1] The perception and reality that a public arbitrator hearing a claim brought against a member of the securities industry is independent of the industry is therefore critical to the legitimacy of the arbitral decision.[2]

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[1] *See* NASD Code of Arbitration Procedure Rule 10308(b)(1). The parties may agree to a different panel composition. *Id.*

[2] This is not to say that a person with significant ties to the securities industry is *ab initio* incapable of deciding a claim fairly. However, in particular, such ties may lend themselves to the perception that the process is biased. *See, e.g.*, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations* (November 4, 2002), at 19 ("Critics of SRO arbitrations consistently point to the presence of industry arbitrators on arbitration panels and the classification of arbitrators as public or non-public as the primary sources of potential pro-industry bias."), available at http://www.sec.gov. This is especially true given the contested nature of arbitration

NASD has made significant changes to its method of selecting arbitrators in order to limit the perception of pro-industry bias.[3] PIRP believes that the proposed amendment follows logically from and enhances these changes.

Specifically, the proposed exclusion of persons who are employed by entities in a control relationship with a broker/dealer, and the proposed exclusion of directors and officers of such entities will further enhance the perceived and objective independence of public arbitrators.[4] Permitting such persons to serve as public arbitrators, especially where their economic interest closely aligns with the securities industry as a whole, would readily give rise to an inference of pro-industry bias. The example provided of a person working for a real estate firm under common control with a broker/dealer and perhaps sharing the same corporate name aptly illustrates the need for the proposed exclusion. While one can envision instances in which such persons, particularly directors chosen to serve on boards precisely because of their independence, would have a compelling claim to be free from bias, these instances in PIRP's judgment are likely to be far fewer than those where an inference of pro-industry bias would be plausible. Likewise, the proposed exclusion of spouses and immediate family members of persons in the aforementioned control relationships similarly, and on balance, is a wise approach in seeking to ensure the further independence of public arbitrators.[5]

The proposed revision to the definition of non-public arbitrator clarifying that persons registered with a broker/dealer may not be classified as public arbitrators[6] is also a sensible refinement of Rule 10308 because it makes clear that a person associated with a broker/dealer includes a person registered through a broker/dealer (and therefore that such person should be classified as a non-public arbitrator).

In its statement of the purpose of the proposed rule change, NASD rests the proposed exclusion of employees, directors and officers of entities in a control relationship with a broker/dealer on the basis that "investors may feel that [such] an

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proceedings. *See, e.g.*, NASD Notice to Members 04-61, *Arbitration Chairperson Selection* (August 2004), at 670 (noting that, in nearly 80 percent of cases, the parties to an arbitration proceeding are unable to agree upon a chairperson for the arbitration panel).

[3] See, e.g., Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations, Exchange Act Release No. 34-49573, 69 Fed. Reg. 21,871 (April 22, 2004); Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3 and 4 to Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40555, 63 Fed. Reg. 56,670 (October 22, 1998). For instance, in its 2004 Order, the Commission among other things provided for an increase to five years from three in the period for transitioning from a non-public to a public arbitrator, and clarified the term "retired."

[4] Proposed Rule 10308(a)(5)(A)(v) and (vi).

[5] Again, one can envision instances in which a spouse, parent or a child of an employee, director or officer of an entity in a control relationship with a broker/dealer would be both subjectively and objectively free from pro-industry bias; but again, these instances seem likely to be fewer than those where an inference of bias would be plausible.

[6] Proposed Rule 10308(a)(4)(A)(i).

arbitrator … is not truly 'public'."[7] In PIRP's view, the stated justification for the proposed exclusion should extend beyond investors' subjective view of independence to include an objective search for such independence; in other words, investors may *justifiably* feel that such an arbitrator is not truly public.

PIRP's support for the proposed amendment is not an endorsement of Rule 10308's public/non-public classification scheme in its entirety at this time. As a broad matter, employing bright-line, objective criteria to achieve a potentially subjective outcome (arbitral decision free from bias) can lead to anomalous results.[8] For instance, the current scheme would, in theory, permit a professional who, within the last three years, had devoted 100 percent of her professional work to securities industry clients (and whose firm had derived 100 percent of its annual revenue from such clients) to serve as a public arbitrator.[9] Thus, the criteria set forth elsewhere in the classification scheme may require further review.[10]

Thank you for providing us with the opportunity to comment on this proposed amendment. Please do not hesitate to contact us if you have any questions regarding these comments.

Respectfully submitted,

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[7] 70 Fed. Reg. at 51,396.

[8] In its 1998 Order, the Commission noted that "a small group of persons" would continue to be excluded from serving as either public or non-public arbitrators. 63 Fed. Reg. at 56,673, n. 11.

[9] Rule 10308(a) (5)(A)(i) excludes as a public arbitrator any person who is engaged in the activities described in paragraphs (a)(4)(A) through (D) of the Rule; included in these paragraphs at (C) is "an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, *in the last two years*, to [securities industry] clients." (emphasis supplied) Rule 10308(a)(5)(A)(iv) excludes as a public arbitrator any person "whose firm derived 10 percent or more of its annual revenue in the past 2 years" from securities industry clients. As a practical matter, time spent is unlikely precipitously to have dropped from 100 percent in year three to less than 20 percent in year two; but, if 20 percent in year two is taken as the necessary cut off, then why not, for instance, a further amplification of the definition to include 30 percent in year three, and so forth?

[10] An extensive discussion of potential problems in the operation of the arbitrator selection rules is provided in Cheryl Nichols, *Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias*, 15 OHIO ST. J. ON DISP. RESOL. 63 (1999).