September 20, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, DC 20549-9303

Re: Proposed Rule Change Relating to Amendments to the Classification of Arbitrators Pursuant to Rule 10308 of the NASD Code of Arbitration
Release No 34-52332; File No. SR-NASD-2005-094

Dear Secretary Katz:

The Massachusetts Securities Division (the "Securities Division") appreciates this opportunity to comment on proposed changes to the rules of the National Association of Securities Dealers ("NASD") to amend the NASD Code of Arbitration Procedure (SR-NASD-2005-094) to revise the current system of classifying arbitrators as "public" or "non-public" (industry affiliated) arbitrators.

The Massachusetts Securities Division is a department within the Office of the Secretary of the Commonwealth of Massachusetts. The Securities Division is charged with the responsibility to implement and enforce the Massachusetts securities laws. As such, the Secretary of the Commonwealth is the chief securities regulator for Massachusetts.

The Securities Division does not participate in the NASD arbitrations or in any other self-regulatory organization's dispute resolution process. However, the Securities Division has received a stream of complaints from brokerage customers who assert they received unfair treatment in securities arbitration. We write on behalf of those customers with the aim of protecting their interests.

The Proposed Rule Change: Narrowing the Definition of Public Arbitrator.

The Securities Division supports the proposed rule change, because it incrementally improves the current definition of "public arbitrator" by excluding persons with relationships to entities controlling or controlled by securities or commodities firms.[1]

[1] New Rule sections 10308(a)(5)(A)(v) and (vi).

This change represents some progress toward improving arbitration panels. However, we urge the NASD and the Securities and Exchange Commission to make fundamental changes in the arbitration system to help make it more even-handed and fairer to investors.

Attorneys and Other Professionals with Industry Ties Should Be Excluded from the Definition of Public Arbitrator.

If the NASD limits its rule changes to reforming the definition of public arbitrator, we urge that the section definition of "public arbitrator" be further narrowed to exclude attorneys and other professionals who represent securities firms.

Under NASD Rule 10308(a)(4)(C), the term "non-public arbitrator" includes 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 clients who are engaged in the securities or commodities business. Similarly, the definition of "public arbitrator" under NASD Rule 10308(a)(5)(A)(iv) excludes a person who is otherwise qualified to serve as an arbitrator and 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 person or entities in the securities or commodity business.

These conflict of interest standards for attorneys and other professionals are far too liberal, and they fail to address the conflicts professionals with ties to the investment industry are subject to.   Pursuant to the standards cited above, professionals who receive substantial streams of business from the investment industry would be categorized as non-industry arbitrators.

We urge that the standard for professionals should instead be that public arbitrators have no role in representing securities or commodity firms. The NASD's current "percentage test" approach to excluding professionals from the definition of public arbitrator allows some professionals to claim public arbitrator status even if they are likely to be beholden to the industry.

Abolish the System of Requiring An Industry Arbitrator on Arbitration Panels.

The proposed rule change fails to address the fundamental unfairness that NASD Rule 10308(b) builds into arbitration panels. Under Rule 10308(b), for the majority of disputes, which are heard by a three-member arbitration panel[2], one arbitrator must be a

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[2] Pursuant to NASD Rule 10308(b), for claims of $50,000 or less, the Director of Arbitration shall appoint an arbitration panel composed of one public arbitrator, unless the parties agree to the appointment of a non-public arbitrator; if the amount of a claim is $25,000 or less and an arbitrator appointed to the case requests that a panel of three arbitrators be appointed, the Director shall appoint an arbitration panel composed of one non-public arbitrator and two public arbitrators, unless the parties agree to a different panel composition; and if the amount of a claim is greater than $25,000 and not more than $50,000 and a party in its initial filing or an arbitrator appointed to the case requests that a panel of three arbitrators be appointed, the Director shall appoint an arbitration panel composed of one non-public arbitrator and two public

non-public (industry affiliated) arbitrator. The effect of NASD Rule 10308(b) is that arbitration panels have a pro-industry, anti-investor bias, because they must include a member who is tied to the securities industry.

Investors who have disputes with their brokers deserve to have their complaints heard in an impartial and unbiased forum. We note that investors are typically at a severe disadvantage in disputes with their brokers. Disputes that go to arbitration often involve small investors with limited sophistication confronting large and sophisticated firms. In view of this imbalance of power, fairness requires that such complaints be heard by a panels of impartial decision makers, panels that do not include industry representatives.

Problems Arising from Including Industry Arbitrators on Arbitration Panels.

Arbitration panels that include industry arbitrators can perpetuate problems in the securities industry, particularly bad sales practices, rather than creating pressure to eliminate them.

For example, it is difficult to conceive of an industry arbitrator penalizing overly aggressive sales practices in the sale of variable annuities if his or her own firm uses similar practices. Such an arbitrator is likely to adopt the view that those practices reflect the way that annuity products are customarily sold, and that it would be unfair to sanction another firm for such practices.

Furthermore, requiring an industry arbitrator on arbitration panels creates a distinct appearance that the arbitration process is unfair. While this may not be apparent to those who are habituated to the current arbitration system, many investors are dismayed to learn that the panel that will hear their complaint must include a member from the securities industry. Based on this, investors sensibly conclude that the system is stacked against them and in favor of the brokerage.

THE SEC AND NASD SHOULD TAKE FURTHER STEPS TO IMPROVE THE ARBITRATION PROCESS.

Give Investors the Choice Whether to Arbitrate and a Choice of Forum.

Proponents of arbitration urge that it is superior because it offers speed, simplicity and lower cost. However, none of these advantages is meaningful if customers see the arbitration process as unfair.

Virtually every brokerage includes in its new customer agreement form language requiring that customer disputes with the brokerage must go to NASD arbitration. This requirement is part of a contract of adhesion that is offered on a take-it-or-leave-it basis.

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arbitrators, unless the parties agree to a different panel composition. If the amount of a claim is more than $50,000, the Director shall appoint an arbitration panel composed of one non-public arbitrator and two public arbitrators, unless the parties agree to a different panel composition.

Retail customers are not given the option to delete the requirement to arbitrate, or to select the forum for arbitration. The Securities Division has encountered many instances of investors who were shocked to learn that they cannot take their claims to court, because they had already agreed to go to arbitration. Investors should be given the choice to elect or not elect arbitration of disputes.

When an arbitrable dispute arises, customers should be given a choice of arbitration forums, and not be locked into NASD arbitration. Giving investors these choices will create a healthy pressure for the arbitration forums to perform fairly and to appear fair. If customers believe their complaints will not be fairly heard in a given forum, customers will avoid that forum. If a forum operates fairly and is seen to have fair procedures, investors will be attracted to that forum, particularly if that forum also provides simplicity, speed and cost savings.

The current NASD arbitration system operates as a monopoly, and many of the current features of NASD arbitration reflect the fact that the NASD system does not have to meet the desires of customers. For instance, the requirement for industry arbitrators and the lack of explained decisions in most cases show that the current NASD arbitration system is a creature of the securities industry.

Explained Decisions Promote Fairness in Arbitration.

We fully support the NASD's recent proposal to permit customers and associated persons to receive explained decisions in arbitrations.[3] Common sense and fairness require this change and we urge that explained decisions should be provided in all cases.

Explained decisions foster careful decision making and promote the appearance that claims are being heard and evaluated fairly. Also, written explanations will also have the important benefit of assisting courts in correcting bad decisions, again promoting fairness.

Arbitration decisions should also include the legal authorities relied upon and damage calculations, along with the fact-based reasons for the award. This change will bring fairer outcomes, enhance investor confidence, and provide a meaningful basis for appeal.

Improve the NASD Information and Statistics on Arbitration Outcomes.

The NASD has so far provided only limited information about the outcomes of customer arbitrations. We are concerned that this limited information gives only a limited picture of how the system performs.

The NASD asserts that investors receive at least some compensation in over half of the arbitrations that result in a decision. This statement suggests that investors "win" more than half the time. This would be a misleading conclusion because the arbitration process commonly grants investors only partial recoveries for their losses. An investor who

[3] SEC Release 34-52009, SR-NASD-2005-32

recovers only a small fraction of his or her losses through arbitration can hardly be described as a "winner," especially when attorneys' fees and costs are considered.

Because the NASD is a federally registered self-regulatory organization and because arbitration is typically the only means of recovery available to small investors, the process should be as transparent as possible and information about the process should be openly disclosed. Clear data and statistics regarding the arbitration process will permit the SEC, the NASD, the states, the industry, and customers to evaluate how well the system works and to determine whether reforms are needed.

If you have any questions about this letter, or we can assist you in any way, please contact me or Bryan Lantagne, Director of the Massachusetts Securities Division, at (617) 727-3548.

Sincerely,

<signed>
William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts