Public Investors Arbitration Bar Association

June 11, 2009

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Proposed Rule Change- Elimination of FINRA-DR Mandatory Industry Arbitrator Pursuant to Commission Rule of Practice 192(a)*

Dear Ms. Murphy:

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission ("SEC"), the Public Investors Arbitration Bar Association ("PIABA") submits this rule change petition to the SEC to eliminate the requirement that an arbitrator affiliated with the securities industry sit on all public investor cases arbitrated before the Financial Industry Regulatory Authority ("FINRA")[1] in which the amount in controversy exceeds $100,000. PIABA proposes that investors and industry parties be given the choice to decline to have an industry arbitrator sit on panels that hear and decide their cases.

PIABA's petition seeks to revise the FINRA Code of Arbitration Procedure for Customer Disputes. PIABA believes Rule 12402 of the Customer Code, requiring industry arbitrators to serve in arbitration proceedings between public investors and industry members, unfairly and systemically shifts the

[1] FINRA (formerly the NASD) was established pursuant to the Maloney Act amendments to the Securities Exchange Act of 1934. FINRA is the only organization permitted to be registered with the Securities and Exchange Commission as a national securities association. (*See* Maloney Act, 52 Stat. 1070 (1938), 15 U.S.C. §§ 78o-3, et seq., amending the Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq.) FINRA is required to promulgate and enforce rules "to protect investors and the public interest," 15 U.S.C. § 78o-3(b)(6).

balance of justice against investors. Requiring investors who believe they have been wronged by the securities industry to have claims decided by panels that must include a representative of that securities industry creates at the least the appearance of bias, if not actual bias. In proposing the rule, PIABA draws attention to the fact that virtually all broker-dealer account agreements provide for mandatory arbitration before FINRA Dispute Resolution ("FINRA-DR"); there is accordingly no meaningful choice for wronged public investors. The doors to the federal and state judicial systems have been slammed shut on investors. In compelling investors to arbitrate their disputes, broker-dealers force them to give up significant substantive and procedural rights. For example, investors are deprived of complete and full discovery including the right to depositions, interrogatories and requests for admission, as well as procedural safeguards including meaningful *voir dire* and effective access to appellate review.

If investors were to have access to the courts, it is doubtful that they would be forced to try their cases before a jury comprised of four stockbrokers or their counsel out of twelve jurors (*i.e.*, one third of the triers of fact). Public investors who are compelled to arbitrate in a forum which is controlled by FINRA and heavily influenced by its securities industry members should not also be further compelled to have a member of that industry sit in judgment of their claims. PIABA further notes that while FINRA rules require the presence of an industry arbitrator on panels, there is no parallel requirement that investor advocates sit as arbitrators.

The details of the proposed changes and the reasons in support thereof are set forth below. The relevant revised rules are attached as Exhibit One to this petition.

I. PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

PIABA is a bar association whose member attorneys are devoted to representing the interests of investors in disputes with the securities industry.[2] PIABA was established in 1990 as an educational organization for securities arbitration attorneys who represent the public investor in securities disputes. PIABA members are involved in promoting the interests of the public investor in securities and commodities arbitration by:

1. Protecting public investors from abuses in the arbitration process; and
2. Making securities and commodities arbitration as just and fair as possible through reforms to arbitration forum providers such as FINRA.

As part of our on-going effort to "level the playing field" in arbitration, PIABA has frequently *commented* upon proposed rules involving arbitration. In this instance, however, we believe that the public interest is served by PIABA *submitting* a rule proposal directly to the SEC rather than awaiting action that FINRA may never take on its own. FINRA's efforts at reform in this area, including setting up a pilot program wherein some firms in some cases volunteer not to require an industry panelist, are the proverbial example of too little, offered too late.

[2] PIABA's website may be accessed at www.piaba.org.

The need for permanent and meaningful reform has never been more urgent. In April of 2009, FINRA reported that investor arbitration filings increased 81% versus the same time period in 2008.[3] In the wake of the recent market collapse, many of these claims involve the loss of financial assets that retirees will never be able to replace. Accordingly, investors are flocking to FINRA with arbitration claims and can no longer afford to wait for FINRA to act to remedy what amounts to institutional unfairness. PIABA is therefore compelled to bring the instant proposed rule change directly to the SEC for its consideration.

II. STANDING

PIABA brings this rule change petition before the SEC pursuant to Commission Rule of Practice 192(a), which provides that, "Any person may request that the Commission issue, amend or repeal a rule of general application."

III. CURRENT RULES REGARDING THE INDUSTRY ARBITRATOR

FINRA's arbitration rules provide that all arbitration claims must be heard by a panel of three arbitrators whenever the amount in controversy exceeds $100,000. FINRA Code of Arbitration Procedure Rule 12401(c). The rules further provide that one of the panel members must be a "non-public" (i.e., industry) arbitrator. FINRA Code of Arbitration Procedure Rule 12402(b). The rule defines "non-public" arbitrator as any individual who currently works in the securities industry, worked in the securities industry within the past five years, or retired individuals who spent a substantial amount of their career employed in the

[3] http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm

securities industry. Code of Arbitration Procedure, Rule 12100(p)(1), (2). The rules also provide that any lawyer, accountant, or other professional who has devoted more than twenty percent of his or her work to the securities industry within the past two years is also deemed an industry arbitrator. Code of Arbitration Procedure Rule 12100(p)(3). In addition, certain individuals are deemed ineligible to be public arbitrators, such as spouses of securities industry personnel, investment advisers and professionals whose firms do a certain amount of work for the securities industry. Code of Arbitration Procedure Rule 12100(u).[4]

IV. SYNOPSIS OF PROPOSED RULE CHANGE

The instant rule proposal provides the parties with claims administered before FINRA-DR the option to choose whether an industry arbitrator sits on their particular case. Such a rule would be a significant improvement to the current system wherein FINRA requires that an industry arbitrator sit on every case where the amount of damages claimed exceeds $100,000.

PIABA proposes that all separately represented parties be given the option of striking any or all industry arbitrators generated through the list selection system at FINRA-DR in all cases involving a public investor. In the event that no industry arbitrators remain on the 'non-public arbitrator' list after submission by both sides, the third arbitrator appointed would be selected from the 'public

[4] Industry arbitrators are no longer permitted to sit on single arbitrator cases where the amount in controversy is less than $100,000, unless a party requests a three member arbitration panel. Code of Arbitration Procedure Rule 12402 (b). Additionally, industry arbitrators are prohibited from serving as the chair of an arbitration panel to hear investor arbitration claims. Code of Arbitration Procedure Rule 12400(c). These prohibitions, while well meaning, do nothing more than perpetuate the conflicted industry arbitrator's presence on all other investor arbitration panels on claims in which the investors losses are significant and possibly life altering.

arbitrator' list, or, in some instances, from the 'chair qualified' list. The ability to strike all arbitrators essentially gives parties the option to choose not to have an industry arbitrator to decide their claims. The proposed rule change essentially mirrors the FINRA pilot program with respect to the industry arbitrator discussed more fully below.[5] If, as some securities industry members claim, industry arbitrators are beneficial to investors, investors should be entitled to make that determination for themselves on a case-by-case basis rather than having it forced upon them in all arbitration proceedings.

V. HISTORY OF MANDATORY INDUSTRY ARBITRATOR

In 1953, the Supreme Court of the United States ruled, in *Wilko v. Swan,* 346 U.S. 427 (1953), that disputes involving the statutory investor protections set forth in the Securities Act of 1933 could not be forced into arbitration pursuant to pre-dispute arbitration agreements. In deciding the case, the U.S. Supreme Court recognized several inadequacies of arbitration as compared to court proceedings in resolving investment disputes. Following the *Wilko* decision, securities arbitration for investor claims arising under the Securities Act of 1933 and the Securities Exchange Act of 1934 was viewed as strictly voluntary on the part of the investor.

After *Wilko*, public investors essentially had the option of selecting SRO arbitration. Thus, the determination of whether a securities industry arbitrator was deemed a plus or a minus was for the public investor to decide.

[5] The FINRA-DR press release regarding the public arbitrator pilot program may be found at http://www.finra.org/Newsroom/NewsReleases/2008/P038958.

In 1987, the U.S. Supreme Court again considered the issue of whether investors could be compelled to arbitrate claims involving statutory violations of the Securities Exchange Act of 1934[6] pursuant to pre-dispute arbitration agreements in the landmark case *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987). In reversing the long held position that investors could not be compelled to arbitrate these statutory claims, the Supreme Court issued a 5-4 decision ruling that pre-dispute arbitration agreements could be enforced with respect to these claims. Since the decision in *McMahon,* it has become generally accepted that the securities industry may compel individual investors to file claims in the industry's arbitral forums by pre-dispute arbitration clauses contained in brokerage account agreements. As the result of the *McMahon* decision, securities arbitration transformed from a largely voluntary process to a mandated forum for most aggrieved investors. It is often overlooked, however, that the dissenting opinion in *McMahon* raised serious concerns regarding the fairness of the industry-sponsored securities arbitration process. The concerns raised in the dissenting opinion have largely proven prescient.

Partially dissenting in the *McMahon* case, Justice Blackmun called into question the basic fairness of the arbitration forums operated by the securities industry. In particular, Justice Blackmun, joined by Justices Brennan and Marshall, questioned whether the promised oversight by the SEC of the SRO

[6] The *Wilko* decision did not specifically address claims under the Securities Exchange Act of 1934. However, it had widely been believed that the reasoning of the *Wilko* decision concerning the 1933 Act also applied to the 1934 Act. Additionally, the SEC had indicated that broker-dealers could not seek to enforce pre-dispute arbitration agreements for claims alleging violations of the Securities Acts (See NASD Notice to Members 83-73 regarding the adoption of SEC Rule 15c2-2).

sponsored arbitral forums adequately ensured that investors' claims could be fairly heard. The opinion specifically referenced the presence of the industry arbitrator in connection with the fairness of the arbitration process:

> Furthermore, there remains the danger that, at worst, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the market professional. The Uniform Code [of Arbitration] provides some safeguards, but, despite them, *and indeed because of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry, and not drawn from the public* . . . The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be *some* truth to the investors' belief that the securities industry has an advantage in a forum under its own control." *See N.Y. Times*, Mar. 29, 1987, Section 3, p. 8., col. 1 (Statement of Sheldon H. Eisen, Chairman, American Bar Association Task Force on Securities Arbitration: "The houses basically like the present system because they own the stacked deck."). 482 U.S at 260-261 (footnotes omitted). (emphasis added)

Writing for the majority in the *McMahon* case, Justice O'Connor noted that the decision was based, in large part, on the expectation that the SEC would oversee the rules of the SRO arbitration forums. *Id.* at 233-234. Beyond overseeing the rules of the forums, Justice O'Connor also indicated that the SEC should mandate the adoption of any rules that it deemed necessary to advance investor protection:

> [T]he Commission has the power, on its own initiative, to "abrogate, add to and delete from" any SRO rule. . . . In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights. 482 U.S. at 233-234.

The dissenting justices were critical of the fact that the SEC had not conducted a study of the perceived inadequacy of the SRO arbitration system as it existed in 1987. *Id.*, at 265. The *McMahon* dissent also suggested that studies of the mandatory arbitration system would likely reveal evidence as to the fairness (or lack thereof) of the process. *Id.* at 265 and fn. 20 (After noting the industry's use of statistics to support its claim of fairness, noting further that "[s]uch statistics, however, do not indicate the damages received by customers in relation to the damages to which they believed they were entitled. It is possible for an investor to 'prevail' in arbitration while recovering a sum considerably less than the damages he actually incurred.")

Since *McMahon*, a number of statistical studies have, in fact, been conducted to evaluate the fairness of industry sponsored mandatory arbitration. Not surprisingly, the studies have confirmed the long held belief that industry sponsored securities arbitration is not perceived as fair to investors and that recovery rates favor the securities industry.

VI. STUDIES SHOWING THE UNFAIRNESS OF SECURITIES ARBITRATION

The Securities Industry Conference on Arbitration ("SICA") was formed with the encouragement of the SEC to report on the various arbitration forums sponsored by the SROs.[7] In 2005, SICA undertook to perform an academic study of fairness in arbitration based upon empirical evidence. Specifically, the study sought to determine whether participants in securities arbitration believe that it is

[7] The SICA Arbitrator's Manual 3 provides that "Since arbitration is the primary means of resolving disputes in the securities industry, the public perception of its fairness is of paramount importance." (January 2001).

conducted simply, fairly, economically, and without bias by the arbitrators. Pace University School of Law conducted the study on behalf of SICA, with the assistance of the Cornell University Survey Research Institute. The study sought the opinions of nearly 30,000 individuals involved in the securities arbitration process, including investors, securities representatives and lawyers. Approximately 3,100 individuals returned responses to the detailed questionnaire. In February of 2008, SICA published the results of the study (Barbara Black, Jill I. Gross, "*Perceptions of Fairness of Securities Arbitration: An Empirical Study*," (2008).[8]

The SICA study found a strong perceived bias with respect to industry sponsored securities arbitration. Nearly half of responding investors believed that arbitration panels were biased. Sixty-two percent of public investors felt that the arbitration process was unfair.[9] Seventy percent of public investors were dissatisfied with the outcome of their securities arbitration cases. Seventy-five percent of public investors found securities arbitration to be "very unfair" or "somewhat unfair" as compared to court.

The SICA study specifically probed issues relating to the mandatory industry arbitrator. Thirty-six and one half percent of the responding public investors found the industry arbitrator to be biased in favor of the industry respondents.

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[8] http://www.slcg.com/pdf/news/Mandatory%20Arbitration%20Study.pdf).

[9] The industry may point out that *only* forty percent of the non-customers indicated that arbitration was unfair. That number is indicative of the serious problems associated with mandatory securities arbitration relating to fairness.

Following the release of the SICA study, the North American Securities Administrators Association (NASAA),[10] a group composed of state securities regulators from all fifty states, issued a statement calling for immediate reforms to the system. Karen Tyler, the president of NASAA, encouraged FINRA to take immediate action by stating:

> The first step toward improving the integrity of the arbitration system **must be the removal of the mandatory industry arbitrator** and a prohibition on ties to the industry on the part of the public arbitrator. NASAA has long held that a choice between arbitration and the courts for resolving disputes should be a fundamental right for investors. Because the arbitration system has evolved into a mandatory condition imposed by the industry, it is imperative that the system of dispute resolution be fair, transparent and free from bias.[11]

In 2007, an independent study was conducted to analyze investor recoveries in securities arbitration. J. O'Neal and D. Solin, "Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimants Fare," at 17 (2007).[12] The study examined all arbitration awards rendered in NASD and NYSE arbitral forums between 1994 and 2004. In light of the *McMahon* dissent's suggestion that customer "win" rates might not be as meaningful as data showing damages awarded versus damages sustained, the study focused primarily on the amount a public investor could expect to recover in securities arbitration. The numbers were discouraging, ultimately finding that the percentage of the amount awarded to public investors compared to the amount sought significantly

[10] NASAA's web site is located at www.nasaa.org

[11] http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9081.cfm

[12] Hereinafter the "O'Neal-Solin Study," accessible at:

http://www.slcg.com/pdf/news/Mandatory%20Arbitration%20Study.pdf.

decreased from 68% in 1998 to 50% in 2004. Through extrapolation, it was found that investors bringing securities arbitration claims could expect to recover only 20% of the amount sought. And as discussed *infra* at note 25, recovery rates for large claims against major brokerage firms are shockingly small.

Since the publication of the O'Neil-Solin Study, investors' chances of recovery have continued to decline. In 2006, the win rate for public investors in FINRA arbitrations declined to 42% and plummeted to 37% in 2007, before rebounding to a still dismal 42% rate in 2008.[13] Moreover, the experience of our members, who routinely represent investors in arbitration cases, is that full recoveries of statutory damages such as those provided under state securities acts are very much the exception, even when liability is established.

VII. CONSOLIDATION OF ARBITRAL FORUMS

The landscape of securities arbitration forums has also changed dramatically since the *McMahon* decision. The arbitration departments sponsored by the American Stock Exchange, Municipal Securities Rulemaking Board and the New York Stock Exchange no longer exist, having been merged into FINRA-DR and its predecessor, NASD-DR. Likewise, at the time of the *McMahon* decision, some investors had the option to pursue claims before the American Arbitration Association, without a mandatory industry arbitrator. This option no longer exists. Today, FINRA-DR, with its mandatory industry arbitrator requirement, holds a virtual monopoly on the hearing of investor claims, with no

[13] A "win" is not always a win. If a panel were to make a small award to a public investor, then assess forum fees in excess of the amount awarded, this would still be counted as a "win" in FINRA's statistics.

competitive incentive to provide better procedural options to wronged public investors.

Although not directly germane to the current rule change petition, the near monopolistic grasp of FINRA-DR over securities arbitration proceedings should raise serious concerns with the SEC. Subsequent to the *McMahon* decision, the Commission itself stressed the importance of public investor choice of arbitration forums and the competitive benefit to all parties derived from such choices. *See* SEC *amicus* brief in *Roney v. Goren,* 875 F.2d 1218 (6th Cir. 1989), at pages 16-21. Today only one arbitral forum remains for hearing the claims of public investors. Indeed, if FINRA obtains jurisdiction over investment advisors, even more claims could be swept under its umbrella. Thus, it is imperative that this forum provide a fair opportunity for claims to be heard before truly impartial arbitrators.

VIII. FINRA PILOT PROGRAM

On July 24, 2008, FINRA announced that it was launching a two year pilot program that allows a limited number of public investor claimants to choose to have cases heard before panels without a public arbitrator. [14] FINRA did not give any reason for adopting the proposed pilot program, besides stating that, "This pilot will give investors greater choice when selecting an arbitration panel," and that, "Additionally, this program will allow us to see if a change in the way

[14] The Public Arbitrator Pilot Program is a two-year pilot, whereby eleven FINRA member firms have agreed to have a limited number of cases each year administered under the Pilot Program. In order for a case to be eligible, the case must name one of these eleven firms, and there can be no other named Respondent. Thus, in a case where an associated person is named as a party, the case is ineligible for the Pilot. For eligible cases, the procedure is described at:

http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P116995.

arbitration panels are selected is a better way to serve and protect the interests of investors."[15] Only eleven firms are participating in the pilot program and some firms which are facing hundreds of claims and major exposure have declined to participate, thereby indicating their unwillingness to have their liability determined by panels that do not include an industry arbitrator.

At the time the pilot program was announced, NASAA President Karen Tyler stated on behalf of her members, "FINRA's pilot program, while a positive step, does not go far enough toward resolving immediate investor harm." [16] According to NASAA, "the *immediate* removal of the mandatory industry arbitrator is a *critical* step toward restoring investor confidence in the fairness of the securities arbitration process." *Id.* PIABA agrees, and sees no reason why the pilot program should not be made permanent and apply to all securities firms and their registered representatives.

IX. NO SOUND ARGUMENTS SUPPORT THE MANDATORY INDUSTRY ARBITRATOR REQUIREMENT

The traditional justification for the use of industry arbitrators is that they provide needed expertise and guidance to the panel on matters involving the securities industry. While no empirical evidence exists substantiating this assertion, it is entirely possible, and indeed consistent with the experience of many of PIABA's members, that in years past industry arbitrators could be

[15] Comments of FINRA's then-Chairwoman, Mary Schapiro, FINRA News Release dated July 24, 2008. Available at the following link:

http://www.finra.org/Newsroom/NewsReleases/2008/P038958

[16] http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9081.cfm

helpful to investors particularly when the misconduct at issue was isolated, rather than indicative of systemic, industry-wide abuses. However, the nature of problems in the securities industry and the make-up of the industry itself have changed in ways which makes the mandatory presence of an industry member on panels a net detriment to investors.

The significance of the role of the industry arbitrator can not be underestimated. Not only are they one of only three votes, but, at FINRA, industry arbitrators are given a significantly disproportionate voice in the process. FINRA's arbitrator training materials have explicitly advised arbitrators that in determining liability, "[w]hen the case is highly technical, the industry arbitrator might begin the discussion to help clarify industry terminology or practices."

Ironically, the undue influence of the industry arbitrator is further highlighted in the "*White Paper on Arbitration in the Securities Industry*" published in October 2007 by the Securities Industry and Financial Markets Association ("SIFMA").[17] SIFMA, which is the securities industry's trade association, describes as a particular *virtue* of the industry arbitrator:

> 'Industry' arbitrators also benefit the public panelists as they can serve to educate them about financial products and services, industry customs and practices and other legal industry-related issues. (SIFMA White Paper, at 35).

[17] SIFMA White Paper, pp. 36-37. The White Paper is available at:

http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf

The SIFMA White Paper goes so far as to suggest that because of the presence of industry arbitrators on panels, "parties need not call expert witnesses in order to educate a panel about certain products or industry practices." (SIFMA White Paper, at 35-36). The suggestion that industry arbitrators serve as *de facto* expert witnesses should be deeply troubling for public investors. In the first place, as previously noted, the influence of the mandatory industry arbitrator is not counter-balanced by any requirement that one of the other arbitrators have the qualifications to offer a more investor or regulatory-oriented analysis of securities industry products and practices. Second, industry arbitrators who offer their opinions on these topics are not subject to cross-examination about any errors or biases that make their opinions unreliable. As a result, public investors may lose their cases on the basis of "expert opinions" that they never have an opportunity to confront or even hear.

The role of the industry arbitrator as the panel's FINRA-appointed expert on industry products and practices has become increasingly problematic for public investors who have been injured by industry-wide illegal and unethical practices that have come to light in recent years. The list of Wall Street scandals relating to products and practices that have lost investors billions of dollars over the last decade is distressing and lengthy, but must include, even in abbreviated form:

> (a) pervasive conflicts of interest of Wall Street research and recommendations on "tech" stocks in favor of brokerage firms' investment banking clients;[18]

[18] In 2002, Bear Stearns & Co., CS First Boston, Deustche Bank, Goldman Sachs, J.P. Morgan Chase & Co., Lehman Brothers, Inc., Merrill Lynch & Co., Morgan Stanley, Salomon Smith Barney, Inc., and USB settled charges by state and federal agencies concerning the undue

(b) abuses in the trading and sales of mutual funds;[19]

(c) deceptive seminars and marketing schemes aimed at the elderly and newly retired;[20]

(d) fraudulent and unsuitable sales of variable annuities, especially to seniors and for tax-deferred accounts;[21]

(e) dishonest and deceptive practices in connection with the conduct of auctions of "auction rate securities" ("ARS") and the mismarketing of such securities as money market or CD equivalents;[22] and

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influence of investment banking relationships on favorable stock research reports. *See*, http://www.sec.gov/new/press/2002-179.htm.

[19] In 2004, fifteen firms settled NASD and SEC charges relating to unfairly depriving customers of mutual fund breakpoints. The firms included: American Express Financial Advisors; Bear Stearns ; Legg Mason ; Lehman Brothers; Raymond James; Linsco Private Ledger; UBS; and Wachovia. *See*, http://www.sec.gov/news/press/2004-17.htm. In 2005, the NASD fined American Express, Chase Investment Services and Citigroup for improper sales of Class B and C shares of mutual funds. *See*:

http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/p013648

[20] A joint report by the SEC, NASAA and FINRA found a pervasive pattern of misleading, fraudulent, and unsuitable sales practices in investment seminars sponsored by securities firms for senior citizens. *See*, "*Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars*" (Sept. 2007), available at:

http://www.sec.gov/spotlight/seniors/freelunchreport.pdf

[21] *See*, "*Joint SEC/NASD Report On Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*" (June, 2004), available at http://www.sec.gov/news/studies/secnasdvip.pdf. As stated in *Money Magazine* (January, 2000 ed), *"variable annuities come with plenty of drawbacks: their fees are high, they're brain-numbingly complicated...they're often pushed on investors for inappropriate uses, such as IRA rollovers...*" Variable annuities often have large surrender fees and tax penalties that can tie up an investor's money for many years. However, they also generate some of the highest commissions of any products brokers sell. Thus, annual sales in 2007 were over $160 billion and net assets invested in variable annuities exceed $1.35 trillion dollars. Insurance Information Institute, Facts and Statistics,
http://www.iii.org/media/facts/statsbyissue/annuities/?table_sort_761676=3

[22] Firms that have been implicated in ARS misconduct include: TD Ameritrade; Banc of America Securities; Bear Stearns & Co., Inc.; Citigroup Global Markets; Deutsche Bank; A.G. Edwards, Inc.; E-Trade; Goldman Sachs & Co.; H&R Block; Lehman Bros. Inc.; J.P. Morgan Securities, Inc.; Merrill Lynch Pierce Fenner & Smith, Inc.; Morgan Keegan & Company, Inc.; Morgan

(e) fraudulent practices in connection with the securitization and retail sales of products backed by subprime loans.[23]

The major Wall Street firms and many lesser known ones have been named in class actions, investigated, and/or sanctioned for misconduct in one or more of these areas, many of which were accepted as "business as usual" in the securities industry. Yet the victims of these wrongs must select the arbitrators who will decide their claims from lists that include industry members whose own firms may have engaged in similar practices. These arbitrators are likely to be reluctant to find another firm liable for conduct that may be the subject of litigation or regulatory proceedings against their own employers. This conflict of interest creates at the least the appearance of bias. Worse still, if, as SIFMA points out, industry arbitrators serve to "educate" other panel members, this so-called "education" may consist of persuading them that the practices at issue are

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Stanley; Oppenheimer; Piper Jaffray & Co.; Raymond James; RBC Dain Rauscher, Inc.; SunTrust Capital Markets, Inc.; UBS; Wachovia Capital Markets, Inc.; and Wells Fargo & Co. The SEC's 2006 Consent Order against 15 firms for fraudulent practices in connection with ARS can be found at: http://www.sec.gov/litigation/admin/2006/33-8684.pdf.
A number of class actions brought on behalf of ARS purchasers are identified at http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080422/REG/323114373/1010/rss01&rssfeed=rss01 and http://www.girardgibbs.com/auctionrate.html

[23] The SEC, FINRA, Justice Department and the states have initiated dozens of investigations relating to subprime securitization and sales. *See, "Prosecutors Widen Probes Into Subprimes" Wall Street Journal* (Feb. 8, 2008); The Bureau of National Affairs, Inc., *In Three Dozen Subprime Investigations SEC Is Asking 'Who Knew What, When'*, 40 Securities Regulation & Law 7 (Feb. 18, 2008); David Scheer and Jesse Westbrook, *Brokers Probed by FINRA on Mortgage Securities Sales, Person Says*, Bloomberg.com (Jan. 4, 2008) available at: http://www.bloomberg.com/apps/news?pid=20601087&sid=apNYRLoCVcUk&refer=home; Edward Hayes, *FINRA Joins Mortgage Storm*, Wolters Kluwer Financial Services (Feb., 4, 2008), available at: http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=02-04-08; *USA Today, Regulators' Subprime Mortgage Cases*, Feb. 18, 2008 available at: http://www.usatoday.com/money/economy/2008-02-18-4194118666_x.htm,; Memphis Commercial Appeal, Feb. 28, 200, *"Morgan Keegan CEO Is Leaving : SEC Seeks Facts On Losing Mutual Funds"* http://www.commercialappeal.com/news/2008/Feb/28/morgan-keegan-ceo-is-leaving/ (investigation of Morgan Keegan mutual funds tied to subprime).

acceptable because "everyone does it." Thus, conduct that a judge or jury might remedy with a recovery of full damages may be excused altogether, or minimized with "compromise" awards.

The on-going consolidation of brokerage firms within the securities industry has compounded potential conflicts for industry arbitrators. In recent years, such well-known firms as Dean Witter, Prudential Securities, A.G. Edwards, Paine Webber, Bear Stearns, Wachovia and Merrill Lynch have been taken over by other broker-dealers. Faced with this consolidation trend, industry arbitrators may be reluctant to award substantial damages against firms that could well become their future employers. The same economic considerations may influence lawyers or accountants who serve as industry arbitrators, since their clientele may include brokerage firms that could be acquired by the firm whose conduct is at issue in the case before them.[24] Against this backdrop it should not be surprising that statistically an investor's expected recovery rate (i.e., win rate times recovery rate) of substantial damages in a large claim against a major brokerage firm is far less than against smaller firms.[25] This suggests that some arbitrators are reluctant to antagonize major firms.

As the securities industry continues to consolidate, the pressure on industry arbitrators to avoid antagonizing the few remaining mega-firms will only increase. At the same time, it will be all the more imperative that the clients of

[24] Additionally, lawyer-industry arbitrators may be hard pressed to accept certain theories of recovery or reject certain brokerage defenses while serving as "impartial" arbitrators, knowing that they will present the opposite positions on behalf of their industry clients.

[25] According to the O'Neal-Solin Study, the expected recovery percentage of a claim of over $250,000 against one of the three largest brokerage firms was a paltry 12%, versus over 37% for claims under $10,000 against smaller firms.

those firms who have suffered substantial losses be afforded access to a forum whose arbitrators are truly impartial and disinterested.

X. CONCLUSION

Given the reservations and concerns expressed in the *McMahon* decision over twenty years ago, the time is ripe to review the adequacy of the SRO arbitration system with respect to the mandatory industry arbitrator requirement. At the time the initial rules requiring the presence of a mandatory arbitrator in investor arbitration claims were drafted by the SROs, the SEC exercised very limited oversight in connection with the rules of industry sponsored arbitration forums. Likewise, securities arbitration was largely viewed as voluntary at the time the mandatory industry arbitrator rules were adopted. Additionally, the landscape and rulemaking approval process today, including notice and the ability to comment on proposed rule changes, has become more transparent, allowing investors and their advocates a voice in the process. Most importantly, a number of empirical studies conducted in the wake of *McMahon* show that the use of mandatory industry sponsored arbitration has resulted in a substantial decrease in the percentage of arbitration awards rendered in favor of investors, and that the arbitration system is perceived as being unfair to investors.

In the final analysis, the requirement of a mandatory industry arbitrator is antithetical to the integrity of the arbitration process and to the fundamental principle that finders of fact should be disinterested in the outcome of the cases they decide.[26] If panels need expertise to decide cases, the parties are free to

[26] The importance of avoiding the appearance of bias in arbitrations was hammered home in Justice Black's opinion, writing for the majority in *Commonwealth Coatings Corp. v. Continental*

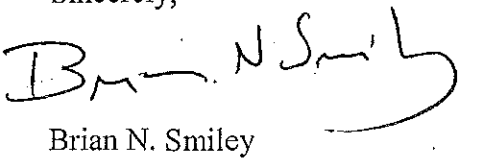
retain expert witnesses and are, in fact, likely to do so in cases in which losses exceed six figures. These experts are subject to thorough and sifting cross-examination by all parties so that their biases and the validity of their opinions may be thoroughly explored. That is fair; allowing an industry arbitrator to opine on industry standards and practices behind closed doors is unfair.

We strongly urge the SEC to take a step that FINRA has been unwilling to take on its own. If, as the Supreme Court has said, the SEC has broad authority to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect investors, *Shearson/American Express v. McMahon,* 482 U.S. 220, 234-35 (1987), this is a propitious time for the Commission to act.

PIABA expects that the securities industry's opposition to this rule proposal will be fierce--thereby revealing the inherent unfairness of the industry arbitrator and member firms' strong desire to maintain the *status quo*.

Thank you for your kind consideration in advancing the interests of investor protection.

Sincerely,



Brian N. Smiley
PIABA President

Casualty Co., 393 U.S. 145, 150 (1969): "[A]ny tribunal permitted by law to try cases and controversies not only must be unbiased, but also must avoid even the appearance of bias. We cannot believe that it was the purpose of Congress to authorize litigants to submit their cases and controversies to arbitration boards that might reasonably be thought biased against one litigant and favorable to another."

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• PART IV APPOINTMENT, DISQUALIFICATION, AND AUTHORITY OF ARBITRATORS

• 12402. Composition of Arbitration Panels

(a) If the panel consists of one arbitrator, the arbitrator will be a public arbitrator selected from the public chairperson roster, unless the parties agree in writing otherwise.

(b) If the panel consists of three arbitrators, one will be a non-public arbitrator and two will be public arbitrators, one of whom will be selected from the public chairperson roster, unless the parties agree in writing otherwise. The parties may, however, choose to have a panel consisting of three non-public arbitrators pursuant to the rules governing strikes contained in Rule 12404.

• 12403. Generating and Sending Lists to the Parties

(a) Generating Lists

(1) If the panel consists of one arbitrator, the Neutral List Selection System will generate a list of eight public arbitrators from the FINRA chairperson roster.

(2) If the panel consists of three arbitrators, the Neutral List Selection System will generate:

- A list of eight arbitrators from the FINRA non-public arbitrator roster;
- A list of eight arbitrators from the FINRA public arbitrator roster; and
- A list of eight public arbitrators from the FINRA chairperson roster.

(3) If the panel consists of three arbitrators, the Neutral List Selection System will generate the chairperson list first. Chair-qualified arbitrators who were not selected for the chairperson list will be eligible for selection on the public list. An individual arbitrator cannot appear on both the chairperson list and the public list for the same case.

(4) The Neutral List Selection System will exclude arbitrators from the lists based upon current conflicts of interest identified within the Neutral List Selection System.

(b) Sending Lists to Parties

(1) The Director will send the lists generated by the Neutral List Selection System to all parties at the same time, within approximately 30 days after the last answer is due. The parties will also receive employment history for the past 10 years and other background information for each arbitrator listed.

(2) If a party requests additional information about an arbitrator, the Director will request the additional information from the arbitrator, and will send any response to all of the parties at the same time. When a party requests additional information, the Director may, but is not required to, toll the time for parties to return the ranked lists under Rule 12404(c).

12404. Striking and Ranking Arbitrators

(a) Each separately represented party may strike up to four of the arbitrators from ~~each~~ the Chair-qualified arbitrator list and four arbitrators from the public arbitrator list for any reason by crossing through the names of the arbitrators. At least four names must remain on ~~each list~~the chair--qualified arbitrator list and four names must remain on the public arbitrator list.

(b) Each separately represented party may strike up to all eight names on the non-public arbitrator list.

(c~~b~~) Each separately represented party shall rank all remaining arbitrators on the lists in order of preference, with a "1" indicating the party's first choice, a "2" indicating the party's second choice, and so on. Each list of arbitrators must be ranked separately.

(d~~c~~) The ranked lists must be returned to the Director no more than 20 days after the date upon which the Director sent the lists to the parties. If the Director does not receive a party's ranked lists within that time, the Director will proceed as though the party did not want to strike any arbitrator or have any preferences among the listed arbitrators.

12405. Combining Lists

For each arbitrator classification (public, non-public, and chairperson), the Director will prepare combined ranked lists of arbitrators based on the parties' numerical rankings, as follows:

- The Director will add the rankings of all claimants together, and the rankings of all respondents together, to produce separate combined ranked lists for the claimants and the respondents.

- The Director will then add the combined rankings of claimants and the respondents together, to produce a single combined ranking number for each arbitrator, excluding all arbitrators stricken by a party.

- The Director will create separate combined ranked lists for each arbitrator classification in cases with both public and non-public arbitrators.

12406. Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List

(a) If the panel consists of one arbitrator, the Director will appoint the highest-ranked available arbitrator from the combined chairperson list.

(b) If the panel consists of three arbitrators, the Director will appoint:

• The highest-ranked available non-public arbitrator from the combined non-public arbitrator list;

• The highest-ranked available public arbitrator from the combined public arbitrator list, and

• The highest-ranked available public arbitrator from the combined chairperson list, who will serve as chairperson of the panel.

(c) If the number of arbitrators available to serve from the combined list(s) is not sufficient to fill an initial panel, the Director will appoint one or more arbitrators of the required classification to complete the panel from names generated randomly by the Neutral List Selection System. If the Director must appoint a non-public arbitrator, the Director may not appoint a non-public arbitrator as defined in Rule 12100(p)(2) or (3), unless the parties agree otherwise. The Director will provide the parties information about the arbitrators as provided in Rule 12403 and the parties will have the right to challenge the arbitrators as provided in Rule 12410.

(d) In the event no names remain on the non-public arbitrator list, or none of the remaining non-public arbitrators are available to serve for any reason, the Director will not randomly appoint a non-public arbitrator to the panel. The Director will select the next highest ranked available public arbitrator to complete the panel. In the event no ranked arbitrators remain on the public list, or if all remaining ranked arbitrators on the public list are not available to serve for any reason, then the Director will select the next highest ranked available arbitrator on the chair qualified list to complete the panel. In the event no ranked arbitrators remain on the chair qualified list, or if all remaining arbitrators on the chair qualified list are not available to serve, then the Director will randomly appoint a public arbitrator.

(ed) Appointment of arbitrators occurs when the Director sends notice to the parties of the names of the arbitrators on the panel. Before making any decision as an arbitrator or attending a hearing session, the arbitrators must execute FINRA's arbitrator oath or affirmation.