Financial Industry Regulatory Authority

Mary L. Schapiro
Chief Executive Officer

April 22, 2008

Mr. Erik R. Sirri
Director, Division of Trading and Markets
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Petition for Rulemaking, File No. 4-502

Dear Erik:

Thank you for providing a copy of your March 27 letter to Mr. Les Greenberg, along with a copy of the Commission's order denying his petition for rulemaking. The petition reflects Mr. Greenberg's concerns regarding, among other things: the training available for arbitrators in applicable substantive law; the ability of arbitrators to conduct independent legal research; the use of party and peer evaluations (on a mandatory basis); the language in predispute arbitration agreements; and the role of the industry arbitrator in investor disputes.

In your letter, you request that FINRA: 1) examine the Petition; 2) examine the recently released report, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (the Survey Report);[1] and 3) review FINRA's arbitration forum's rules and procedures with a view to considering additional actions we can take to improve the fairness of our forum, and constituent perceptions of fairness. We will conduct a careful analysis of both documents, and plan to get back to you shortly concerning our recommendations going forward.

Sincerely,

Mary

Mary L. Schapiro

cc: Chairman Christopher Cox, SEC

[1] J. Gross and B. Black, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (2008), at http://www.law.pace.edu/files/finalreporttosica.pdf.

1735 K Street, NW
Washington, DC
20006-1506

t 202.728.8140
f 202.728.8075
mary.schapiro@finra.org
www.finra.org

Financial Industry Regulatory Authority

Linda D. Fienberg
President, Dispute Resolution
and Chief Hearing Officer

July 22, 2008

Mr. Erik R. Sirri
Director – Division of Trading and Markets
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: *Petition for Rulemaking, File No. 4-502*

Dear Mr. Sirri:

This letter addresses issues raised in your March 27, 2008 letter to Les Greenberg, Esq., regarding his May 2005 Petition for Rulemaking (Petition). We appreciate your providing a copy of the letter to Mary L. Schapiro, FINRA's Chief Executive Officer, as well as a copy of the Securities and Exchange Commission's (SEC) denial of Mr. Greenberg's petition. On April 22, Ms. Schapiro wrote to acknowledge receipt of your letter and advised that FINRA would conduct a careful analysis of the issues raised in it.

In your letter, you requested that FINRA examine the Petition and the recently released report, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (the Survey Report).[1] You also asked us to review our arbitration rules and procedures and consider additional actions we could take to improve the fairness of our forum, as well as constituent perceptions of fairness.

The Petition for SEC Rulemaking

We start with a brief chronology relating to the Petition.

- In 2005 the SEC received from Mr. Greenberg a Petition for Rulemaking dated May 13.

- On August 19, 2005, Catherine McGuire, then SEC's Chief Counsel, Division of Market Regulation, wrote to Constantine Katsoris, Chairman of the Securities Industry Conference on Arbitration (SICA),[2] asking that SICA consider the proposals.

[1] J. Gross and B. Black, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (2008), at http://www.law.pace.edu/files/finalreporttosica.pdf.

[2] SICA was formed in 1977 to develop nationwide uniform rules governing the arbitration of disputes between broker/dealers and customers at Self Regulatory Organizations (SRO). SICA is composed of representatives of SROs with extant arbitration programs, three public members, the North American Securities Administrators Association, and the Securities Industry and Financial Markets Association. In addition, representatives of the SEC, the Commodity Futures

1735 K Street, NW
Washington, DC
20006-1506

t 202.728.8407
f 301.527.4756
linda.fienberg@finra.org
www.finra.org

- At the October 2005 SICA meeting, Chairman Katsoris appointed a subcommittee to review the Petition and to recommend a response. The subcommittee met several times during 2005 and 2006, periodically reporting to SICA on its progress.

  The subcommittee presented its recommendations to SICA in fall 2006. SICA adopted the subcommittee's proposals; in some instances (discussed below), SICA recommended to the SROs that they make certain changes in their arbitration programs.

- SICA endorsed some of the Petition's proposals but rejected others.

  Chairman Katsoris wrote to Ms. McGuire on November 2, 2006, advising her of SICA's recommendations.

SICA's Recommendations and Subsequent FINRA Actions

FINRA implemented each of the Petition's proposals that SICA endorsed; it did not implement the ones SICA rejected. We discuss these below, and describe subsequent actions taken by FINRA.

Proposal that arbitrators should be allowed to conduct independent legal research

The Petition suggested that arbitrators be permitted to conduct independent legal research and was critical of SRO policies that discourage arbitrators from conducting such research. SICA determined to take the following actions:

- *The Arbitrator's Manual (Manual),* a SICA publication used by the SROs in their arbitration programs, should be updated to include in the appendix the revised 2004 AAA/ABA *Code of Ethics for Commercial Arbitrators* (*Code of Ethics*), thereby replacing the older version that was in the *Manual.* SICA implemented this recommendation in April 2006. The revised *Manual* can be found on FINRA's Web site.[3]

- The *Manual* and perhaps the *Arbitration Procedures (Guide),* a SICA publication that describes the SRO arbitration process for the parties, should be changed to clarify when research would be permitted (for example, looking up cases cited in briefs) and to refer to Canon VI (B) of the revised *Code of Ethics* which provides

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Trading Commission, the National Futures Association, the American Arbitration Association, law schools with securities arbitration clinics, and former public members are invited to attend SICA meetings.

[3] See http://www.finra.org/web/groups/med_arb/documents/mediation_arbitration/p009668.pdf.

that some limited research may be appropriate.[4] SICA completed these changes in August 2007.

- Also, since there was no analogous section in the *Guide*, SICA approved placing the same language in the *Guide's* "What if I Don't Get Paid?" section (where the arbitrators' decision-making authority is discussed). SICA amended the *Guide* in January 2007; it can be found on FINRA's Web site.[5]

SICA also noted that it had been several years since there had been comprehensive reviews of both the *Manual* and the *Guide* and decided to conduct such reviews. Chairman Katsoris appointed a subgroup to undertake this effort. As a result of the NASD and NYSE consolidation,[6] however, FINRA subsequently agreed to assume responsibility for both publications. We currently are in the midst of that review and will complete the project this fall.

Proposal that SROs with arbitration programs conduct party and peer evaluations on a mandatory basis

The SROs all reported that they already had voluntary party and peer evaluation programs. SICA believed that, while parties and arbitrators should be strongly encouraged to complete survey forms, a mandatory program was not necessary or appropriate. FINRA agrees with SICA's view.

SICA recommended the following changes to promote a better response rate for evaluations:

- **Include return postage:** Providing return postage encourages some responders to return survey forms. FINRA has provided return postage for party and peer evaluations for at least ten years.

- **Put surveys online:** Because the Web has become an accepted tool for completing surveys, offering this additional means of evaluating the SRO arbitration process should increase response rates. FINRA has provided parties with the option to submit evaluations via the Web since January 2005 and arbitrators with the ability to download the peer evaluation forms since July 2003.

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[4] This provision of the *Code of Ethics* provides: "The arbitrator should keep confidential all matters relating to the arbitration proceedings and decision. An arbitrator may obtain help from an associate, a research assistant or other persons in connection with reaching his or her decision if the arbitrator informs the parties of the use of such assistance and such persons agree to be bound by the provisions of this Canon."

[5] See http://www.finra.org/ArbitrationMediation/Arbitration/ArbitrationProcedures/index.htm.

[6] In mid-2007, NASD and NYSE Regulation consolidated their member regulation, enforcement, and arbitration operations to form FINRA.

- **Remind arbitrators to complete and return peer evaluations when they receive their compensation:** SICA believed that receipt of compensation would be a good time to remind arbitrators to complete peer evaluations. In April 2008 we amended the thank you letter we send to arbitrators at the close of the case to include a reminder to complete the forms.

- **Encouraging settling parties to return surveys:** SICA noted that some SRO arbitration programs only send user surveys in cases in which arbitrators issue awards. SICA believed there also is value in asking parties who settle to complete the surveys; in many of those cases, arbitrators may have held initial or evidentiary hearings or decided motions. In April 2008, FINRA amended the party settlement letters to encourage parties to complete the evaluation forms.

Proposal that SROs be required to train arbitrators in applicable substantive law

SICA determined that this proposal should not be adopted for several reasons: 1) it would not be feasible or appropriate to train arbitrators on the law of over 50 jurisdictions; 2) keeping abreast of changes in substantive law would be very difficult; 3) it would likely be very difficult to obtain a consensus on the content of such training; 4) it is generally up to the parties to present their case to the arbitrator, including addressing substantive law; and 5) strict application of the law in many instances would be harmful to investors. FINRA concurs with SICA's view.

Proposal that SROs include in their predispute arbitration agreements whether their arbitrators are trained in the law and are required to follow it

The SROs do not have predispute agreements; nor do they require or encourage brokerage firms to use them; any such agreements are between the customer and the broker-dealer.[7] Further, SICA believed that the Petition's training proposal should not be

[7] FINRA, however, does have a Conduct Rule specifying certain disclosures that must be made if a firm chooses to use a predispute arbitration agreement, Rule 3110(f). This rule was amended in 2005 to provide enhanced disclosure about the arbitration process.

The 2005 changes were aimed at ensuring that investors know when there is an arbitration agreement contained in their customer agreement and highlights key elements of the arbitration clause. This rule also establishes greater protections for investors by requiring members to provide copies of predispute arbitration agreements and relevant arbitration forum rules to customers upon request, clarifying the use of certain provisions, and requiring firms seeking to compel arbitration of claims initiated in court to arbitrate all of the claims contained in the complaint if the customer so requests. Finally, Rule 3110(f) specifically bars an arbitration agreement that: a) limits or contradicts the rules of any self-regulatory organization; b) limits the ability of a party to file any claim in arbitration; c) limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement; and d) limits the ability of arbitrators to make any award. See *Notice to*

adopted. FINRA provides parties with extensive information about prospective arbitrators. When sending a list of potential arbitrators to parties, FINRA encloses a biographical description of each listed arbitrator.[8] The description, known as the Arbitrator's Disclosure Report, assists the parties in determining which arbitrators to select.

The arbitrator's training history is included in the Arbitrator's Disclosure Report. All FINRA arbitrators must complete FINRA's comprehensive basic arbitrator training program before serving on arbitration cases. Completion of FINRA arbitrator training programs appears on the Arbitrator's Disclosure Report.

Proposal that the SROs should be required to disclose their arbitrator evaluation process

SICA believed that this proposal was moot, since the SROs do disclose their arbitrator evaluation processes. FINRA's Web site provides parties with a convenient way to give feedback on the arbitration process. As noted, the arbitration evaluation form is available on FINRA's Web site,[9] and our letters to parties at the end of their cases describe the arbitrator evaluation process and provide the Web site link to the form. The letters advise parties that FINRA will send hard copies of the form to those that request it. FINRA also encourages parties to complete the form by including it in the Party Reference Guide (a comprehensive guide to the FINRA arbitration process). Finally, the hearing script that arbitrators read to the parties encourages them to complete evaluations.

Proposal that SEC specifically oversee whether SROs are following the other proposals

SICA believed this proposal was premature because the SEC had not acted on the Petition at the time SICA was considering it. It also believed that it was clear that the SEC does oversee the SRO arbitration programs. FINRA's dispute resolution program is subject to extensive regulatory oversight. The SEC must approve all FINRA's arbitration and mediation rules and any significant changes to our processes, after the public has an opportunity to comment. FINRA must respond to those comments, and, where appropriate, will amend the rule proposal in response to comments. In addition, SEC's Office of Compliance Inspections and Examinations conducts periodic examinations of our programs.

Members 05-09 (January 2005), available at: http://www.finra.org/RulesRegulation/NoticestoMembers/2005NoticestoMembers/P013208.

[8] See Rules 12403(b) and 13402(c) of the Code of Arbitration Procedure (Code). The Code was amended in 2007 to rewrite the arbitration rules in plain English and to separate the rules into two parts: rules applicable to customer disputes (the Rule 12000 Series), and those applicable to intra-industry disputes (the Rule 13000 Series). The mediation rules are now contained in the Rule 14000 Series. See *Notice to Members* 07-07 (February 2007), available at: http://www.finra.org/RulesRegulation/NoticestoMembers/2007NoticestoMembers/P018656.

[9] See http://www.finra.org/arbevaluation.

Proposal to eliminate the non-public arbitrator or that, in the alternative, the non-public arbitrator be required to disclose to the parties any information he or she presents to the other arbitrators in deliberations

SICA discussed to what extent arbitrator deliberations should be disclosed. SICA did not support this proposal because it would compromise arbitrator independence, and very likely cause less candid deliberations.

SICA deferred consideration of Mr. Greenberg's proposal that the non-public arbitrator be eliminated in arbitration cases involving investors, in light of recent SRO efforts to improve arbitrator classification.

FINRA divides its arbitrators into two categories – those with a present or past connection to the securities industry, and those without connections to the securities industry. Arbitrators who have a connection to the securities industry are referred to as "non-public" arbitrators,[10] and those without as "public" arbitrators.[11] Regardless of category, all FINRA arbitrators are neutral and must observe our Code of Arbitration Procedure (Code) and the *Code of Ethics*.

The number of arbitrators appointed to a case differs based on the amount of the claim. Customer cases with damages claims of $50,000 or less are heard by a single public arbitrator. Larger cases are heard by three arbitrators – two public and one non-public.[12]

We introduced the Neutral List Selection System in November 1998, implementing an Arbitration Policy Task Force[13] recommendation that the parties be able to select their panel from lists of proposed arbitrators.[14] The lists, together with detailed reports on each arbitrator's background, are sent to the parties for their review. As amended in

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[10] See Code Rules 12100(p) and 13100(p).

[11] See Code Rules 12100(u) and 13100(u).

[12] See Code Rules 12401 and 12402 for panel composition in customer cases, and Code Rules 13401 and 13402 for panel composition in intra-industry cases.

[13] In 1994 NASD assembled a group of outside experts, led by former SEC Chairman David S. Ruder, to conduct a thorough examination of NASD arbitration. NASD's Board of Governors asked this group, the Arbitration Policy Task Force, to review the entire NASD securities arbitration process. In January 1996, NASD released the Arbitration Policy Task Force Report, containing more than 70 recommendations for change. This Report set forth comprehensive proposals to revamp securities industry arbitration. Details on the actions taken in response to those recommendations can be found in *The Arbitration Policy Task Force Report – A Report Card*, a July 2007 publication available on FINRA's Web site at: http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p036466.pdf.

[14] See *Notice to Members* 98-90 (November 1998), available at: http://www.finra.org/RulesRegulation/NoticestoMembers/1998NoticestoMembers/P004265.

2007, the system randomly generates three separate lists of eight proposed arbitrators – public, public chair qualified, and non-public. The parties may strike up to four names on each list and rank the remaining arbitrators in order of their preference.[15] This process gives all of the parties a role in the selection of their arbitrators.

Over the past few years, FINRA has instituted a series of changes to the arbitrator classification rules to tighten the definition of public arbitrator, by excluding individuals with even minor or indirect ties to the securities industry.

- In July 2004, we implemented a rule change[16] that: 1) increased from three to five years the period for transitioning from a non-public to public arbitrator; 2) clarified that the term "retired" from the industry includes anyone who spent a substantial part of his or her career in the industry; 3) prohibited anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator; 4) excluded from the definition of public arbitrator attorneys, accountants, and other professionals whose firms have derived 10 percent or more of their annual revenue, in the last two years, from clients involved in the activities defined in the definition of non-public arbitrator; and 5) provided that investment advisers may not serve as public arbitrators.

- Effective January 15, 2007, FINRA amended the definition of public arbitrator to exclude individuals who work for, or are officers or directors of, an entity that has a control relationship with any entity engaged in the securities business.[17]

- Effective June 9, 2008, FINRA amended the definition of public arbitrator to exclude attorneys, accountants, or other professionals whose firm derived $50,000 or more in annual revenue in the past two years from defined professional services rendered to securities industry clients.[18]

In each instance of a Code amendment redefining public or nonpublic arbitrators, FINRA surveyed its roster to ensure that the arbitrators were properly classified under the amended Code.

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[15] See the Code Rule 12400 and 13400 Series.

[16] See *Notice to Members* 04-49 (June 2004), available at: http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p002727.pdf.

[17] See *Notice to Members* 06-64 (November 2006), available at: http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p017901.pdf. The revision to the rule also applies to individuals who have a spouse or immediate family member who works for, or is an officer or director of, an entity that is in such a control relationship with a partnership, corporation, or other organization that is engaged in the securities business. Lastly, FINRA revised the definition of non-public arbitrator to clarify that persons who are registered through a broker-dealer may not be classified as public arbitrators.

[18] See *Regulatory Notice* 08-22(June 2008), available at: http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p038472.pdf.

Perceptions of Fairness of Securities Arbitration: An Empirical Study

In your letter, you also requested that FINRA examine the recently released report, *Perceptions of Fairness of Securities Arbitration: An Empirical Study.*

In July 2002, the SEC retained Professor Michael Perino[19] to assess the adequacy of NASD and NYSE arbitrator disclosure requirements, and to evaluate the impact of the then recently adopted California Ethics Standards on the SRO's conflict disclosure rules.

The November 2002 Perino Report[20] found that the current SRO conflict disclosure requirements generally appeared adequate, but recommended several minor enhancements to disclosure and other related rules that might "provide additional assurance to investors that arbitrations are in fact neutral and fair." In a January 24, 2003 letter, we advised the SEC that we would follow each of the Perino Report recommendations.

As described above, FINRA acted on each of the Report's recommendations to improve the rules for arbitrator classification and disclosure. However, Professor Perino also recommended that, to improve investor perceptions of fairness, the SROs should sponsor an independent survey to gauge user perceptions of the arbitration process.

SICA's Action

In 2003, SICA members considered Professor Perino's survey recommendation and determined that:

1) the survey would be conducted under SICA's auspices;
2) the survey would be paid for by NASD and NYSE; and
3) editorial control over the final questions would repose in SICA to assure that the results would be perceived as independent.

SICA selected the Pace Investor Rights Project, an affiliate of the Pace University School of Law, to conduct the survey. Pace used the services of the Cornell University Survey Research Institute to help develop the survey and to compile responses. Pace mailed the survey to almost 30,000 participants (parties and counsel) in investor-initiated arbitration cases conducted at the NASD and NYSE[21] in 2005 and 2006. Cornell processed approximately 3,100 survey responses and, after factoring out bad address returns, concluded the return rate to be approximately 12 to 13 percent of the total

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[19] Visiting Professor of Law, Columbia Law School when the report was issued; currently Professor of Law, St. John's University School of Law.

[20] M. Perino, Report to the SEC Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, at 51 (Nov. 4, 2002), available on the Web at http://www.sec.gov/pdf/arbconflict.pdf.

[21] Although several other SROs maintained an arbitration forum, the NASD and NYSE administered approximately 99 percent of all securities arbitration cases in 2005 and 2006.

number mailed. Pace submitted its report on the survey results to SICA in February 2008.[22]

FINRA's Reaction to the Survey Findings

FINRA is committed to providing a fair and efficient process for resolving disputes, and is encouraged that survey participants "overwhelmingly agreed that the arbitration panel listened to the parties, their representatives, and the witnesses and gave the parties enough time to present their evidence and argue the merits of their cases."[23] We are also pleased that parties believed that FINRA arbitrators understand the factual and legal issues in their cases and appeared to be qualified to handle the dispute and related prehearing issues, and that the discovery process permitted the parties to obtain necessary information for their hearing.

That said, the survey's finding are mixed – and in some cases inconsistent.

- We are troubled that the survey participants rated positively several *objective* standards – such as arbitrator competence, arbitrator understanding of the issues and legal arguments, the efficiency of the process, and the arbitrators' willingness to listen – while at the same time evaluating the process negatively from the *subjective* standpoint of fairness. As the Survey Report's authors note, these findings "shed light on *subjective* perceptions by arbitration participants and do not address *objective* standards of substantive or procedural fairness" (emphasis in original).

- Many of the same people who cited the thoroughness and openness of the process and praised the competence of the arbitrators also questioned their impartiality. FINRA is concerned about this clear disconnect in the Survey Report's findings.

- A sizeable percentage of investors – about 40 percent of those responding – held negative views of the process prior to even filing their case, indicating to us that, because of factors such as having lost their investment, investors might be predisposed to have negative perceptions of our forum. As the Survey Report's authors note, "A myriad of factors, unrelated to the fairness of the arbitration process, could explain customers' perceptions."

- Investors and others indicated that they would be more satisfied with the outcome of their case if they had an explanation of the award. We are considering further changes to our proposed rule on explained awards[24] because

[22] The report has been posted on the Pace Law School website and can be downloaded at: http://www.law.pace.edu/files/finalreporttosica.pdf.

[23] Id at 3.

[24] See SR-NASD-2005-032, available at: http://www.finra.org/RulesRegulation/RuleFilings/2005RuleFilings/P013542

of the SICA Survey results and the numerous comment letters submitted during the rule filing process.

FINRA also notes that responses were received from only 13 percent of those to whom the survey was sent. Further, the pattern of responses did not match the mailing list since 33 percent of the surveys were sent to investors while 46 percent of the returns were from investors. In numerous instances, multiple parties on the same side of a case received surveys, allowing the possibility that the results of just a few cases could have skewed the results. In addition, Pace reported that thousands of individuals received more than one survey and the methodology provided no way to detect how many returned more than one survey. The combination of these factors means that the survey results are informational, but we are cautious about drawing conclusions based on the survey results alone.

FINRA also is concerned that investors do not fully understand the FINRA arbitration process or know about the many improvements we have made to the process in the past twelve years, such as arbitrator list selection, narrowing the definition of public arbitrator, updating the arbitration and mediation codes to simplify and streamline processes for investors, inaugurating an improved, free Web-based arbitration awards retrieval system, and changing the forum's subpoena procedures to protect investors. And there is more to come, such as our proposals to limit motions to dismiss filed before the investors rest their case and to update the discovery guidelines. The survey results indicate that investors may need additional education about the many FINRA procedures designed to protect and assist them.

We also acknowledge the importance of perceptions of fairness. After suffering losses and then participating in a dispute resolution process, individual investors understandably might be dissatisfied with their overall situation.

Together with other input from the users of our forum, gathered through focus group meetings and FINRA constituent surveys, we will use the Survey Report to develop further changes and enhancements. We will continue to review the results, explore ways to educate the consumers about our services, and improve the forum through appropriate changes to rules and procedures.

FINRA's Arbitration Forum is Fair and Responsive

In your letter, you also requested that we review our arbitration rules and procedures to consider additional actions we could take to enhance the fairness of our forum.

In his introduction to the 2007 article *The Arbitration Policy Task Force Report – A Report Card*, former SEC Chairman David S. Ruder stated that "...the present NASD securities arbitration system is greatly improved over the 1996 system for resolving disputes involving public investors, securities industry firms, and firm employees." In

identifying the enhancements, Ruder cited the independent governance of the system, dramatic and positive improvement to arbitrator selection, quality and training, effective responses to discovery problems, and other procedural advances.

In addition to the key changes covered above, the changing needs of forum users led us to many other investor-friendly modifications and enhancements over the past decade. Among the most important changes have been:

launching the FINRA Dispute Resolution Web site in 2000 as a resource tool available to forum customers, neutrals, and staff;

- developing a Web-based case administration system (MATRICS) that enables online filing of mediation and arbitration claims and facilitates communication among staff, parties, counsel and neutrals;
- launching an online arbitration awards system in 2001, and enhancing it with greatly expanded search capabilities in 2007; and
- expanding the available number of hearing locations to 73 to provide dispute resolution services in all 50 states, Puerto Rico, and London.

In addition, FINRA implemented numerous other pro-investor initiatives such as:

- publishing FINRA Dispute Resolution materials in Spanish;
- adopting a streamlined arbitration process for claimants filing claims against defaulting, suspended, or terminated industry respondents;[25]
- amending the Code to prohibit a firm that has been terminated, suspended, or barred from FINRA, or that is otherwise defunct, from enforcing a predispute arbitration agreement against a customer in the FINRA arbitration forum;[26] and
- creating a special program to expedite proceedings for elderly or seriously ill parties.

Constituent Perception of Fairness

Finally, in your letter you requested that we review constituent perceptions of fairness. FINRA understands the current concerns about the fairness of other consumer arbitration programs as outlined in several bills that have been introduced in Congress. FINRA, however, prohibits unfair procedures and conduct in its arbitration program, and

[25] See *Notice to Members* 02-58 (September 2002), available at: http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003483.pdf.

[26] See *Notice to Members* 01-29 (June 2001), available at: http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003875.pdf.

has taken disciplinary action against firms that have engaged in them.[27] We discuss below the many ways in which FINRA's arbitration program is quite investor-friendly.

FINRA's Governance is Investor-Friendly

There is strong representation from the public on all advisory bodies related to FINRA's dispute resolution program.

- **FINRA's Board of Governors:** FINRA's Board contains a majority of directors who are not affiliated with the securities industry.

  National Arbitration and Mediation Committee (NAMC): Eight of the fifteen members of FINRA's NAMC are public representatives, including the current chair.[28] This diverse composition ensures a neutral approach in the administration of FINRA's dispute resolution forum, promoting fairness to all parties. The NAMC is a standing committee that proposes rule and policy changes. The NAMC actively participates in all aspects of Dispute Resolution's business including:

  - recruiting, qualifying, training, and evaluating arbitrators and mediators;
  - evaluating existing rules, regulations, and procedures; and
  - recommending to the staff appropriate changes to our rules, regulations, and procedures to govern FINRA's conduct of all arbitration, mediation, and other dispute resolution matters.

FINRA Prohibits Unfair Arbitration Clauses

FINRA does not require investors to arbitrate or firms to include a predispute arbitration agreement in customer agreements. This is a matter of contract between firms and their customers. We do, however, regulate the content and notice requirements of the arbitration agreement if firms do include them in their contracts. FINRA has disciplined firms for attempting to restrict investor rights and remedies in arbitration clauses, and

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[27] For example, in 2004, FINRA censured and fined three firms for failing to comply with their discovery obligations, and imposed procedures and reporting obligations. See http://www.finra.org/PressRoom/NewsReleases/2004NewsReleases/P009925.

Also in 2004, FINRA censured and fined a firm for frivolously pursuing legal action against an elderly couple who won an arbitration award against the firm. See http://www.finra.org/PressRoom/NewsReleases/2004NewsReleases/P012750.

In 2007, FINRA entered into a settlement agreement with a firm that agreed to pay $12.5 million ($9.5 million in a restitution fund and $3 million in fines) to resolve FINRA charges that it failed to provide e-mail documents to claimants in arbitration proceedings, as well as to regulators. See http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P037071.

[28] For a list of NAMC members see http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/WhatisDisputeResolution/NationalArbitrationMediationCommittee/index.htm.

has brought cases against firms for improper, restrictive terms (such as use of inappropriate choice-of-law provisions or limitations on the arbitrators' authority to award damages).[29]

FINRA rules also require industry parties to arbitrate at the request of a customer.[30] Thus, whether or not there is an arbitration clause in the customer agreement, firms and associated persons are required to arbitrate at FINRA at the request of a customer.

FINRA's Fee Structure is Consumer-Friendly

FINRA's fee structure favors investors, as compared with non-SRO arbitration systems. To begin with, on average the industry bears about 75 percent of fees charged in a typical arbitration. Filing fees for investors under FINRA's arbitration fee structure are low, and the arbitrators may include in their eventual award reimbursement of filing fees. Also, FINRA has a financial hardship program ensuring that no investor will be denied access to the arbitration program because of an inability to pay.[31]

In addition, investors do not have to advance on a "pay as you go basis" half the arbitrator compensation, as they typically must do at private dispute resolution providers.[32] In FINRA's forum, arbitrator compensation is not paid until the conclusion of a case, and forum fees (which in part fund arbitrator compensation) are not assessed until the case concludes.

In sum, investors pay a relatively low initial fee and do not pay other fees until the conclusion of a case, if at all. The total of these fees is much less at FINRA than at private providers, and thus makes our forum very accessible to investors who have been unable to resolve a dispute with their broker. Of course, the vast majority of arbitrations – over 70 percent – are settled, meaning that the existence of and relatively easy access to our forum offers parties an expeditious, fair, and economical means to resolve disputes.

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[29] See Conduct Rule 3110(f). See also http://www.finra.org/web/groups/enforcement/documents/monthly_disciplinary_actions/p007551.pdf.

[30] See Code Rule 12200.

[31] In 2007 FINRA Dispute Resolution granted 94 percent of all customer hardship applications.

[32] Compensation rates at private providers can run $1,000 per day per arbitrator, or more. And with FINRA arbitrator per diems of $400 a day ($475 for the chair), individuals are generally not motivated to join the FINRA roster for financial reasons, and have no financial interest in the outcome of a case, or a financial interest in FINRA. See Rules 12214 and 13214.

FINRA's Rules are Investor-Friendly

FINRA's arbitration rules are investor friendly, as the examples we have cited and those below indicate.

- FINRA rules allow investors to proceed in court instead of in SRO arbitration if they participate in a class action.[33]

- FINRA serves the claim for the investor. FINRA will locate the brokerage firm and broker, and then serve the claim.

- The arbitration hearing is set where the investor lived when the claimed events

- FINRA's rules for customer disputes require the use of a comprehensive *Discovery Guide*, which contains lists of presumptively discoverable documents.[35]

- FINRA will suspend firms or brokers who don't pay arbitration awards (or file a motion to vacate the award) within 30 days.[36]

Conclusion

FINRA currently is evaluating three significant changes to enhance its arbitration program further.

First, FINRA is talking with constituents about other ways to address concerns surrounding the non-public arbitrator. This week we will issue a press release announcing a two year voluntary pilot program in which investors can choose, in a set number of cases, to have an all public panel. To date, six firms, including the five largest in our forum, have agreed to participate in the two year pilot with a total of 210 cases each year.

Second, we are reviewing the current $50,000 threshold for three arbitrators, which has been in place since 1998. Increasing this threshold would result in a greater proportion of cases being heard by a single public arbitrator.

Last, we are evaluating the comments received on our proposed rule to provide an explained award in certain cases. We expect to file a response to comments this fall.[37]

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[33] See Code Rule 12204. This right also extends to employees and firms in intra-industry cases; see Code Rule 13204.

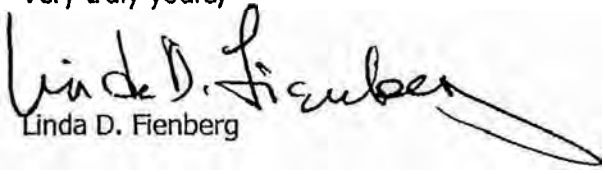
[34] See Code Rule 12213.

[35] See Code Rule 12506.

[36] See Code Rule 12904(i) and Article VI, Section 3 of the FINRA By-Laws.

Consolidating the NASD and NYSE arbitration programs created a forum with a shared background of more than 100 years of experience in arbitration and mediation. Over the past 10 years alone, FINRA Dispute Resolution has helped resolve over 72,000 disputes and returned billions of dollars to investors through settlements and arbitration awards. As described above, we have significantly improved our program over the years, and will continue to work with you and our constituents to make further enhancements in the future.

Very truly yours,



Linda D. Fienberg

cc: Mary L. Schapiro, FINRA
James A. Brigagliano, SEC
Paula Jensen, SEC

[37] FINRA already has filed a proposed rule on dispositive motions which, among other things, would require arbitrators to write an explanation for granting a dispositive motion prior to the conclusion of the claimant's case in chief. See Release No. 34-57497, published in the *Federal Register* on March 20, 2008 (Vol. 73, No. 55, p. 15019). We also filed an expungement procedures proposal which would require arbitrators to draft a brief explanation for granting an expungement request under Conduct Rule 2130. See Release No. 34-57572, published in the *Federal Register* on April 3, 2008 (Vol. 73, No. 65, p. 18308).