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October 30, 2014

Via Email Only
rule-comments@sec.gov

Office of the Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: SR-FINRA-2014-028
Notice of Filing of Proposed Rule Change Relating to Revisions to the Definitions of Non-Public Arbitrator and Public Arbitrator

To the Office of the Secretary:

I am a partner at Aidikoff, Uhl and Bakhtiari, a law firm devoted to the representation of individuals and institutions in disputes with Wall Street and the financial service industry. I am a former President of the Public Investors Arbitration Bar Association (PIABA) and the current Chairman of FINRA's National Arbitration and Mediation Committee (NAMC).

The purpose of this letter is to provide the Securities and Exchange Commission with comments on the above referenced rule proposal. My original comment was filed on or about July 2, 2014.

The proposed rule represents an important step forward in leveling the playing field of securities arbitration for investors. After a decade of changes attempting to eliminate customers' perceptions that some industry arbitrators are biased, customers were given the option to choose an all public panel. Despite ties to the financial industry, some arbitrators continue to be misclassified as part of the public pool. Therefore, a customer's choice to have an all public panel can be nullified by the improper classification of arbitrators. Finra's letter dated September 30, 2014 responding to the various publicly filed comments states that 374 of 3,567 public arbitrators or 10.4% of the public pool has a CRD number. The 10% of the public pool that has served the securities industry should be immediately and permanently classified as "non-public."

In 2011, the Public Investors Arbitration Bar Association Bar Journal published an article that I co-authored titled "Arbitrators Misclassified: Looking Back to Move Forward", a copy of

which is attached. The article explains the importance of eliminating loopholes by which a professional in the securities industry or those that worked on behalf of the industry are classified as public arbitrators by establishing a bright line classification standard.

In material part, the proposed rule eliminates the most troubling loophole in the existing classification rules which permit members of the securities industry from serving as public arbitrators.

The proposed rule is an important step towards protecting the investing public. I urge the Commission to approve the proposed rule.

Very truly yours,

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ARBITRATORS MISCLASSIFIED: LOOKING BACK TO MOVE FORWARD

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The Financial Industry Regulatory Authority (FINRA) regulates its member firms who compel their customers to arbitrate any future claim they may have against the firm.[1] Prior to 2008, in claims exceeding $100,000, an arbitration panel was composed of three arbitrators, two public and one industry (i.e., one with ties to the securities industry). After a decade of changes attempting to eliminate customers' perceptions that some industry arbitrators are biased, customers were given the option to choose an all public panel. However, despite ties to the financial industry, some arbitrators continue to be misclassified as part of the public pool. Therefore, a customer's choice to have an all public panel can be nullified by the improper classification of arbitrators. FINRA rules should be amended to resolve this problem.

Defining Public v. Non-Public Arbitrators

The FINRA Code of Arbitration Procedure (Code) sets forth the definition of public and non-public arbitrators. A non-public arbitrator, also known as an industry arbitrator, is deemed non-public due to his or her ties to the securities industry.[2] The public arbitrators must be qualified to serve as

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1. FINRA Code of Arbitration Procedure § 12200.

2. FINRA Code of Arbitration Procedure § 12100(p) defines a non-public arbitrator as one who is qualified and:

> (1) is, or within the past five years, was:
>
> (A) associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or municipal securities dealer);
>
> (B) registered under the Commodity Exchange Act;

arbitrators and must not be personally engaged in certain activities that would make them non-public, or have the immediate family member of a person engaged in such activities.[3]

(C) a member of a commodities exchange or a registered futures association; or

(D) associated with a person or firm registered under the Commodity Exchange Act;

(2) is retired from, or spent a substantial part of a career engaging in, any of the business activities listed in paragraph (p)(1);

(3) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in paragraph (p)(1); or

(4) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities future or options or supervises or monitors the compliance with the securities and commodities laws of employees who engage in such activities.

For purposes of this rule, the term "professional work" shall not include mediation services performed by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.

3. FINRA Code of Arbitration Procedure § 12100(u) defines a public arbitrator as one who is qualified and:

(1) is not engaged in the conduct or activities described in paragraphs (p)(1)-(4);

(2) was not engaged in the conduct or activities described in paragraphs (p)(1)-(4) for a total of 20 years or more;

(3) is not an investment advisor;

(4) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past two years from any persons or entitled listed in paragraphs (p)(1)-(4);

(5) is not an attorney, accountant, or other professional whose firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1) relating to any customer disputes concerning an investment account or transaction, including but not limited to, law firm fees, accounting firm fees, and consulting fees;

(6) is not a director or officer of, and is not the spouse or an immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business;

These distinctions were created to preserve the perception of fairness. Over the last decade, amendments to the definitions of public and non-public arbitrators, as well as to the composition of the arbitration panel have been made, but as a result of significant pressure from the industry, these amendments have fallen short of the mark.

2004 Amendment to the Definitions of Public and Non-Public Arbitrator

In 2003, changes to rules 10308 and 10312 were made to modify the definitions of public and non-public arbitrators, which required potential arbitrators to disclose any relationships or financial interests they may have that are likely to affect impartiality or that might reasonably create an appearance of partiality or bias.

These amendments followed the 2002 Perino Report assessing the adequacy of the National Association of Securities Dealers' (NASD now FINRA) arbitrator disclosure requirements.[4] The Perino Report made several recommendations which were incorporated into the 2003 revisions to the classification rules. The purpose of the Perino Report recommendations was to reduce the appearance of partiality customers' may have of public arbitrators.

The 2002 Perino Report proposed:

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(7) is not a director or officer of, and is not the spouse or immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business; and

(8) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (p)(1)-(4). For purposes of this rule, the term immediate family member means:

(A) a person's parent, stepparent, child, or stepchild;

(B) a member of a person's household;

(C) an individual whom a person provides financial support of more than 50 percent of his or her annual income; or

(D) a person who is claimed as a dependent for federal income tax purposes.

For purposes of this rule, the term "revenue" shall not include mediation fees received by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.

4. The Perino Report, November 4, 2002, available at http://www.sec.gov/pdf/arbconflict.pdf.

- An increase from three years to five years the period for transitioning from a non-public to public arbitrator after leaving the securities industry.
- Clarified that the term "retired" from the industry includes anyone who spent a substantial[5] part of his or her career in the industry.
- Prohibited anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator, regardless of how long ago the association ended.
- Excluded from the public arbitrator roster attorneys, accountants, or other professionals whose firms have derived 10 percent or more of their annual revenue in the previous two years from clients involved in securities-related activities.

In response to industry objections to the proposed changes being overly restrictive, NASD took the position that it preferred the definition of public arbitrator to be more restrictive rather than overly permissive in order to protect investors' confidence in the integrity of the forum.[6]

Public Investors Arbitration Bar Association's (PIABA) September 11, 2003 comment letter supported these amendments to the definition of public arbitrator, but argued that the NASD and Securities and Exchange Commission (SEC) should eliminate all banking and insurance personnel from the public arbitration pool, as well as all partners of those that are deemed non-public, regardless of the 10% threshold.[7]

The 2003 recommendations were adopted by the NASD and approved by the SEC in April of 2004.[8]

2006 Amendment to the Definition of Public Arbitrator

On July 22, 2005 the NASD proposed further amendments relating to the classification of arbitrators to prevent individuals with certain indirect ties to the securities industry from serving as public arbitrators. The NASD

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5. The term "substantial" appears to be undefined.

6. NASD Comment Letter to the SEC, February 2, 2004. http://www.sec.gov/rules/sro/nasd/nasd200395/srnasd200395-10.pdf.

7. PIABA Comment Letter to the SEC, September 11, 2003. http://www.sec.gov/rules/sro/nasd/nasd200395/srnasd200395-5.pdf.

8. Federal Register Vol. 69, No. 78, April 16, 2004. Release No. 34-49573. http://edocket.access.gpo.gov/2004/pdf/04-9163.pdf.

proposed to amend the definition of public arbitrator to exclude individuals who work for, or are officers or directors of an entity that controls, is controlled by, or is under common control with, a broker-dealer or 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 broker-dealer. The NASD also proposed an amendment to clarify that individuals registered through broker-dealers may not be public arbitrators, even if they are also employed by a non-broker-dealer.

PIABA's September 9, 2005 comment letter stressed the importance of excluding industry professionals from classification as public arbitrators in order to limit industry influence on the panel. PIABA argued that this potential for two or even three arbitrators with industry connections on the panel "presents an unacceptable appearance of pro-industry partiality or bias."[9]

Despite industry comments that the proposed amendments were not necessary, NASD supported the rule change, stating the change was important to promote the appearance of impartiality. The SEC approved the amendments on October 16, 2006 and they became effective January 15, 2007.

2008 Amendment to the Definition of Public Arbitrator

Concurrent with the 2004 amendment, NASD also had a proposal pending with the SEC to amend the Code to reorganize the rules into a Customer Code, Industry Code and a separate mediation code. These changes were approved on January 24, 2007 and became effective April 16, 2007. Due to continuing concerns, FINRA proposed a 2008 amendment to the definition of public arbitrator. Many commentators sought to eliminate all professionals who received any compensation from the industry from the definition, whereas the industry opposed this. The result of this debate was a compromise which set limits of compensation at $50,000 in annual revenue in the past two years that an attorney, accountant or other professional firm could receive from the securities industry.

The North American Securities Administrators Association's (NASAA) August 2, 2007 comment letter approved the proposal, yet believed it did not go far enough. NASAA criticized the piecemeal changes to the definition of public arbitrator and noted that "[i]f the NASD is willing to acknowledge

9. PIABA Comment Letter to the SEC, September 5, 2005. http://www.sec.gov/rules/sro/nasd/nasd2005094/rjshockman090905a.pdf.

that the receipt of this type of revenue creates conflicts or an appearance of bias, then logic dictates that the receipt of any form of revenue from the brokerage industry would be equally problematic."[10]

PIABA's July 23, 2007 comment letter supported the proposed amendment, although it also voiced concerns that the amendment did not go far enough, noting that the type of services rendered should be irrelevant because it is the receipt of funds that creates the perception of bias that the arbitrator is beholden to the industry.[11] FINRA's response letter dated January 17, 2008, found that forty-one out of sixty-four comment letters contended that the proposal did not go far enough.[12] The proposal was adopted in March of 2008.

FINRA's 2008 Pilot Program

Originally, the FINRA rules provided for the "Majority Public Panel" method for choosing an arbitration panel.[13] A panel was composed of two public (two arbitrators out of three) and one industry arbitrator.

The Pilot Program was a proposed solution to long-standing complaints about the unfairness of requiring an industry arbitrator to sit on a panel deciding the merits of a customer complaint against a brokerage firm. The Pilot Program allowed investors with claims against a limited number of participating firms to select an all public panel. FINRA collected data on the Pilot Program to help better understand the role of the industry arbitrator and parties' perceptions.

The results of the Pilot Program demonstrated that 29% of participating customers accepted the presence of an industry arbitrator and 96% of brokerage firms accepted an industry arbitrator. (See charts below).[14]

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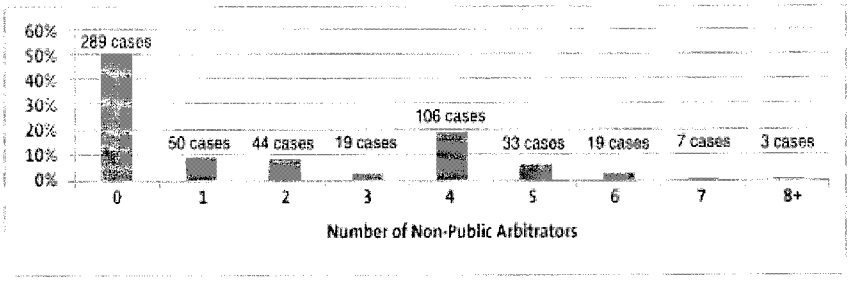
10. NASAA Comment Letter to the SEC, August 2, 2007. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-20.pdf.

11. PIABA Comment Letter to the SEC, July 23, 2007. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-3.pdf.

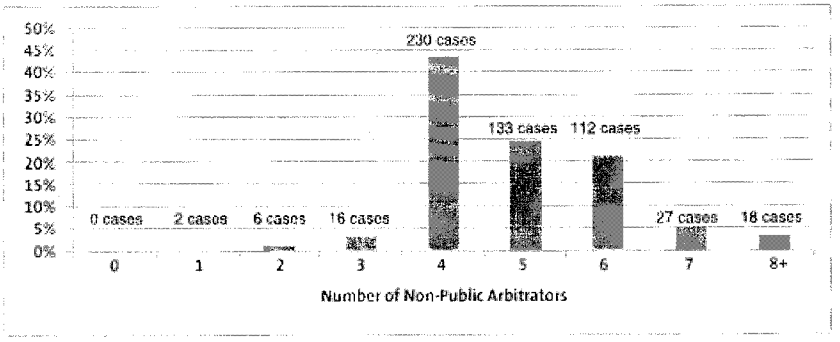
12 FINRA Comment Letter to the SEC, January 17, 2008. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-65.pdf.

13. FINRA Code of Arbitration Procedure § 12403(c), which provides for a panel of one chair-qualified public arbitrator, one public arbitrator and one non-public arbitrator in every customer case.

Investors' rankings:



Firms' rankings:



This stark difference demonstrates that aggrieved investors prefer public arbitrators to industry arbitrators. Contrariwise, brokerage firms overwhelmingly prefer an industry arbitrator likely because they believe that the presence of an industry arbitrator favors the firm in customer disputes.

The 2008 Securities Industry Conference on Arbitration (SICA) survey revealed that investors viewed the FINRA arbitration process as biased and unfair. One of the reasons for this is that almost half of the investors who participated in the survey believed that their arbitration panel was biased against their position. The survey questions that generated the highest

14. Public Arbitrator Pilot Program Summary Sheet With Interim Results http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P122535.

negative customer responses concerned perceptions of arbitrator impartiality.[15]

FINRA proposed the amendment to allow for an optional all public panel. The amendment was approved by the SEC and adopted in January 2011.[16] Despite this amendment, however, customers still face arbitrators with industry backgrounds or ties on their panels due to a lax definition of the public arbitrator under FINRA Code §12100(u) and equally problematic definitions under section 12100(p).

For example, a Texas arbitrator with a CRD number listed on his disclosure form who describes himself as having retired from the investment management industry after thirty one years of managing institutional equity portfolios for publically traded mutual funds and private pensions funds is nonetheless classified as a public arbitrator. This arbitrator appears to have been classified as public because only 12 of his 31 years of work experience in the industry were at a licensed broker dealer. Clearly, the "substantial part" clause in Rule 12100 (p)(2) did not account for the 18 years that this arbitrator worked managing portfolios. The arbitrator's classification as "public" presents questions about the integrity of the process.

Moving Forward

Despite numerous attempts to tailor the definition of public arbitrator to improve the appearance of impartiality, the incremental changes of the last decade have been inadequate and the problem remains unsolved.[17] The present classification allows arbitrators with significant ties to the industry to remain in the public pool.

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15. 36.5% of customers perceived that the industry arbitrator favored at least one securities party. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration* (2008) 2008 J. Disp. Resol. 349, 385.

16. FINRA Code of Arbitration Procedure § 12403(d), which provides for an all-public arbitration panel or majority public panel depending on how the parties exercise their strikes. The rule allows each separately represented party to strike up to all ten arbitrators on the non-public list. If all are stricken, FINRA will appoint the next highest ranked public arbitrator.

17. NASAA Comment Letter to the SEC regarding proposed 2008 Amendment to the definition of public arbitrator, August 2, 2007. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-20.pdf.

Under the current Code section 12100(u), an arbitrator can be classified as public immediately after leaving a law, accounting, or other professional firm that has received revenue from the securities industry.[18] This means that a person who would be classified as non-public one day, can terminate their employment and the very next day be re-classified as public. Despite terminating the employment relationship, customers still perceive bias because of the relationships that the now public arbitrator may still have to other industry members and firms. Thus, partners and associates of large defense firms who for years have represented the industry can become public arbitrators the day after they leave their firm. FINRA's classification system also fails to alert parties if an industry arbitrator is later reclassified as public.

New revisions must close this loophole. Some might propose a "cooling off" period, a time out, or a look back, for an attorney, accountant or other professional formerly employed by a firm with a significant securities practice following his/her termination of employment is a start similar to that in section 12100(p), but is not sufficient to solve the problem. Some may argue that firms employed by the industry are not part of the industry and therefore do not carry the same perceptions. However, when a firm derives ten percent or more of its annual revenue from the industry, it is impossible to remove the association between the firm and the industry. A bright line rule disqualifying anybody who has worked in the industry or on behalf of the industry must be implemented. No formal audit process to determine the scope of the work performed or relationship with the industry exists. Instead FINRA relies on the individual applicant and their good faith determination of revenues in determining whether a candidate will be classified as industry or public.

Lawyers and other professionals who have worked for firms providing services to the securities industry are apparently able to qualify for the public pool the day after they terminate their employment irrespective of how long they were at the firm. For example, a New York arbitrator was employed for 33 years at a law firm that derived significant revenues representing Wall Street. He retired as a partner and continues to receive benefits from this firm but is classified as public. Similarly, a Midwest based arbitrator was for more

18. Under the Code § 12100(u)(4), arbitrators are excluded from serving as public arbitrators if they are professionals whose *current* firm derived ten percent or more of its annual revenue in the past two years from any persons or entities listed in paragraphs (p)(1)-(4). Section 12100(5) excludes individuals from serving as public arbitrators if their *current* firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1).

than 10 years the General Counsel of one of the world's largest exchanges. No "cooling off" period could possibly cleanse the perception of bias of these two arbitrators.

Other members of the industry, including persons employed by or associated with registered investment advisors, mutual funds, and hedge funds fall through loopholes and are classified as public arbitrators. The five year time out provision of section 12100(p) is also problematic. Suggesting that working for less than twenty years in the industry and having been out for five years somehow eliminates the perception of bias is illogical. Changes that remove potential bias and perceived unfairness are essential.

If a claimant has a hearing in a mandatory arbitration with an arbitrator who has been misclassified as public, the claimant has little chance of being able to overturn the result. This is because courts are hesitant to vacate an arbitration award and give arbitrators great deference. Courts have interpreted the grounds for reversal of an arbitration award narrowly and the misclassification of an arbitrator does not fit into any of the statutory grounds enumerated in Section 10 of the FAA. In fact, in Bulko v. Morgan Stanley DW, Inc., the 5th Circuit held that the arbitrator's misclassification was a "trivial departure not warranting vacatur."[19]

Conclusion

Despite the long history of concern and amendments over the definition of public arbitrator and the perception of partiality, the time has come to solve the problem. The current definition must be amended to eliminate the loopholes through which professionals in the industry or those who worked on behalf of the industry are classified as public arbitrators. Public should mean public.

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19. *Bulko v. Morgan Stanley DW, Inc.*, No. 05-10242, 2006 U.S.App. LEXIS 13322 (5th Cir. May 30, 2006).