Thursday, April 10, 2008

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: Proposed Revisions to Rules 12206 and 12504 of the FINRA Code of Arbitration Procedure—Motions to Dismiss
SR-FINRA-2007-021

Dear Ms. Morris:

The Securities Arbitration Clinic at St. John's University School of Law is very pleased to accept this opportunity to comment on the proposed rule changes concerning Motions to Dismiss in FINRA arbitrations. The Clinic strongly supports these rule changes, however, we believe that the rule changes could go further.

The Securities Arbitration Clinic gives law students the opportunity to learn the arbitration process while representing aggrieved investors that otherwise cannot obtain legal representation. Our practice is generally limited to FINRA arbitrations because our clients are contractually bound by pre-dispute arbitration agreements to arbitrate their disputes with their broker-dealers and their employees and registered representatives. As a result, the Clinic and its clients have a strong interest in the rules governing the arbitration process at FINRA.

Experience Demonstrates The Need For A Change

The Clinic has first-hand experience dealing with Motions to Dismiss, which cause unnecessary work and delay without much benefit. Recently, in a pending case, we received a Motion to Dismiss from a Respondent firm in lieu of an answer. Respondent asserted the full range of imaginable, yet meritless, defenses and objections, including standing, improper venue, failure to state a claim, statutes of limitation, contributory negligence, ratification, waiver, and estoppel. The Respondent also made several substantive arguments that could not be properly addressed without an opportunity for discovery and an evidentiary hearing to address the factual issues which are in dispute. Without guidance from FINRA's Code of Arbitration Procedure (the "Code") , the Clinic was forced to respond to every point in a more than thirty page reply that was subsequently followed by a sur-reply from the Respondent which is not permitted under the Code. This extensive motion practice all occurred before the parties began the very basic preliminary steps in the arbitration process, such as selecting arbitrators and exchanging discovery. Respondent has yet to provide a proper answer. Needless to say, the Respondent's extensive motion practice has greatly complicated this arbitration in direct contravention to the purposes of arbitration – that is to provide a procedure that is more informal, cost-effective and expeditious than litigation.

This situation was further complicated because the Respondent is a Clearing Firm, and had also argued that dismissal is appropriate based simply on that fact. While a clearing firm may not be liable for the actions of its introducing brokerage firms in the ordinary course of business, they may be and have been held liable under certain circumstances.[1] In our case, we had reasonable grounds for believing that the Clearing Firm had acted improperly, however, we were unable to allege many specific facts bearing on the Clearing Firm's liability in our Statement of Claim. The facts that were alleged were sufficient to state a cause of action, and it is essential that our client be permitted to engage in discovery and make her case at an evidentiary hearing on the issue. Since we have begun discovery, we have already uncovered facts which further implicate the Clearing Firm. This illustrates a core problem with allowing pre-hearing Motions to Dismiss: many Claimants simply will not have the documentary evidence necessary to prove meritorious claims at such early stages. Fortunately, in our case, we learned crucial information before the arbitration panel has ruled on the Motion to Dismiss, and therefore will rely on it to argue against the Clearing Firm's dismissal. The costs to the Clearing Firm of defending its allegedly wrongful actions are outweighed by the injustice to our client if her claims are dismissed without an opportunity to present her case.

Fortunately for our client, our situation is somewhat unique. The Clinic was able to devote significant time and effort to responding to the Motion to Dismiss, without regard to the relatively small amount of the claim. However, the legal work involved would have been prohibitively expensive for a similar Claimant who could not avail themselves of free legal representation. It is the Clinic's position that the proposed rule change may help investors with smaller claims to obtain counsel that they may not otherwise have been able to by limiting the work required to get to a hearing.

The Motion To Dismiss Has No Place In Arbitration

We appreciate that the rule revisions which are the subject of this filing attempt to strike a balance between the right of Respondents to be free of frivolous claims and the right of Claimants to present their evidence in support of their claims. In our experience, the vast majority of client's claims involve factual disputes which can only be resolved by the panel after permitting discovery and conducting an evidentiary hearing. Thus, there is a very strong argument that, pre-hearing motions to dismiss should not be permitted or granted in securities arbitrations. While FINRA's effort to reconcile these competing interests is commendable, the resulting rule, while trying to reach a fair compromise, is far from perfect.

As previously mentioned, our clients have no choice but to arbitrate their securities disputes. It is therefore of utmost importance that the arbitration tribunal identified within the pre-dispute agreement preserve basic due process protections to the users of the system. For a Claimant, this includes the right to develop and present all of

[1] *See Kostoff v. Fleet Securities, Inc.*, 506 F.Supp.2d 1150 (M.D. Fla. 2007).

his or her evidence in support of the claim; for a respondent, it includes the right to notice of the claim and a hearing to determine the validity of the claim.

By stark contrast to the rules governing claims that are filed in a court action, arbitrations at FINRA have limited discovery, and limited appeal mechanisms. There are no depositions. Nor are there any discovery responses under oath. When a Respondent makes a "motion to dismiss," the motion nearly always presents issues of fact. Yet the Claimant lacks the usual discovery record, which might be required to establish the need for an evidentiary hearing. This situation is magnified when panels, at the request of Respondents, stay discovery until after the hearing on the motion to dismiss. As discussed above, discovery is often necessary to, at the very least, resolve some of the factual disputes and may be necessary for a Claimant to establish his or her right to proceed. Finally, a procedure does not exist for providing evidence or testimony in opposition to a motion to dismiss. The panel has wide discretion in determining what information, if any, it needs to decide the motion.

Moreover, unlike a plaintiff in a court action who would have an opportunity to challenge the granting of a motion to dismiss or for summary judgment by way of an appeal, there is no right to appeal a wrongly decided motion in arbitration. This is true despite the fact that such motions are purportedly made on legal grounds to arbitrators who often are not all lawyers. Not only can an investor be deprived of his or her "day in court" on the basis of a telephone call attended only by the lawyers and arbitrators, but the investor will have no recourse if the dismissal is legally incorrect. Although the investor retains the right to file a motion to vacate an arbitration award, this presupposes that the granting of the motion was memorialized in an award and not an order. Further, the standard for vacating an award is quite high, and it is rare that there would be a record memorializing how and why the motion to dismiss was granted. Additionally, as noted earlier, our clients tend to have small cases and limited means, and may not be financially capable of pursuing the costly and drawn out process of moving to vacate an award. Quite simply, dispositive motions are simply inappropriate in the arbitration process.

<u>The Proposed Rule Provisions</u>

The proposed rule provisions permit pre-hearing dismissals in three narrow circumstances: (1) where the claim is ineligible for arbitration under the six-year eligibility rule; (2) where there is a settlement agreement or release signed by the Claimant which previously released the claim; or (3) where the named Respondent was not associated with the account(s), security(ies) or conduct at issue.

There are parts of the two rules which we find problematic. As previously stated, the Clinic believes that pre-hearing motions to dismiss should not be permitted in any circumstance. Even the three enumerated narrow grounds for dismissal will require fact-oriented motion practice. For example, there may be tolling provisions applicable to motions made under the eligibility rule; these issues require an evidentiary hearing. Similarly, motions made under the third circumstance will by definition involve factual presentations, which will require the Claimant to establish a factual basis for including

the moving Respondent in the claim. Faced with any of these motions, the Claimant will have to invest significant time to marshal and present evidence to establish to the panel's satisfaction the need for an evidentiary hearing. None of this is consistent with the stated objectives of arbitration, to streamline procedures and provide a cost-effective dispute resolution mechanism.

We are particularly disturbed by the second circumstance in which a Respondent may move to dismiss a claim, that is where there is a settlement agreement or release signed by the Claimant which previously released the claim. Our concern is well-founded as the Clinic represented a client who had signed a release and settlement agreement without the benefit of counsel and was paid an amount that represented a very small fraction of the client's losses. The circumstances under which our client signed the release were very suspect and unconscionable. The Clinic was fortunate to have settled the case and recovered additional losses for the client prior to having filed an arbitration claim against the Respondents. If we were unable to settle the matter, we would have argued that the arbitration panel should render the release void in light of the suspect and unconscionable circumstances under which our client signed the release. However, under the second proposed ground for a motion to dismiss, the case may have been dismissed prior to an evidentiary hearing, despite that there were clearly factual issues as to the validity and enforceability of the release. We suggest that the language of the second provision be reconsidered. For example, rather than the language reading: "where there is a settlement agreement or release signed by the Claimant which previously released the claim", the language could read as follows: "where there is a valid settlement agreement or release signed by the Claimant which previously released the claim."

In addition, although both proposed Rule 12206 and proposed Rule 12504 do provide for an in-person or telephonic prehearing conference, there is no guidance in the rules as to what exactly would satisfy that requirement. There is no requirement that the parties be present or even that their counsel be given the opportunity to present factual evidence. The rules as written imply that the panel may grant the motion solely on the basis of the submissions of the parties. There is some concern that, if the motion is made on one of the enumerated bases, the panel may feel it is appropriate to simply go through the formalities of the pre-hearing conference and then grant the motion, without any opportunity given to the Claimant to effectively challenge the appropriateness of the grounds for dismissal. Moreover, with the lack of guidance on what that pre-hearing conference should encompass, there is the risk that the pre-hearing conferences will not be handled consistently.

We do support that portion of the eligibility rule, Rule 12206(b)(7), which requires that a panel specifically state its grounds for granting a motion to dismiss on eligibility grounds, and refrain from deciding on any other ground. Under current practice, panels sometimes fail to specify the ground for their decision to grant the motion. This is problematic because a Claimant whose case is dismissed on eligibility grounds still has the right to pursue their claim in court under the current Rule 12206(b). When panels fail to set forth the reason for their decision, the parties are unable to

determine whether the case could be re-filed in court, or is barred on *res judicata* grounds. The revision to Rule 12206(b)(7) resolves this issue.

Conclusion

Faced with the reality that motions to dismiss may not be entirely abolished in arbitration proceedings, and despite our concerns, we are generally in support of the proposed provisions. We believe that the delineation of only three very narrow grounds for motions to dismiss should vastly reduce the number of motions that are now made. Additionally, there are very critical safeguards in the proposed rules such as the panel being prohibited from considering or acting upon a motion to dismiss not brought under one of the three grounds. Thus, the rules provide that the granting of a motion to dismiss on a ground other than the specified grounds would be in excess of the panel's jurisdiction and, thus, would probably be successfully challenged in a motion to vacate.

Other very critical safeguards are those relating to sanctions and cost-shifting. The rule *mandates* that forum fees be assessed against the Respondent who unsuccessfully makes a motion to dismiss—a key change from the current practice. Moreover, the panel is authorized to assess attorney's fees or any other appropriate sanctions against a Respondent who files a frivolous motion to dismiss. These provisions will certainly have a prophylactic effect on the filing of weak and frivolous motions, which investors routinely see under the current state of affairs.

We ask that the Commission approve these rules on an accelerated basis, thereby helping to level the playing field in FINRA arbitrations. Additionally, we ask that FINRA continue to consider other changes that may be made to the rules to address the on-going concerns of counsel for the Claimants. Thank you for your consideration of this important matter.

Respectfully,

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