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Via Electronic Filing

Ms. Nancy M. Morris
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: SR-FINRA-2007-021
Proposed Rule Change and Amendment No. 1 Relating to Amendments to the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes to Address Motions to Dismiss and to Amend the Eligibility Rule Related to Dismissals

Dear Ms. Morris:

The Cornell Securities Law Clinic (the "Clinic") welcomes the opportunity to comment in support of the above-referenced rule proposal (the "Rule Proposal"). The Clinic is a Cornell Law School curricular offering in which second and third-year law students have the opportunity to provide representation of public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. *See* http://securities.lawschool.cornell.edu.

The Proposed Rule (the "Proposed Rule") will amend NASD Rules 12206 and 12504 of the Code of Arbitration Procedure for Customer Disputes (the "NASD Code") and NASD Rules 13206 and 13504 of the Code of Arbitration Procedure for Industry Disputes.[1] The Proposed Rule will prohibit arbitrators from acting upon a motion to dismiss prior to the completion of the non-moving party's case in chief unless 1) the non-moving party previously released the claims in dispute by a signed settlement agreement, 2) the moving party was not associated with the accounts, securities, or conduct at issue, or 3) the moving party seeks dismissal on eligibility grounds.

Despite some concerns, the Clinic supports the Proposed Rule for several reasons. First, the Proposed Rule will reduce the current abuses of dispositive motion practice in which securities industry respondents collectively use repetitive and frivolous dispositive

[1] While this comment letter addresses only the Proposed Rule as it affects customer cases, we believe our comments are equally applicable to industry cases.

motions to harass public customers. Second, the securities industry will not lose a protectable interest if the Proposed Rule is adopted, since the law has been clear for decades that claimants in FINRA (formerly NASD) arbitration are not limited to legal "causes of action." Third, the Proposed Rule is a neutral rule that treats customers and the securities industry equally. Fourth, because the grounds on which an arbitration award can be overturned are extremely narrow and do not include error of law, it is in the public interest to require that arbitrators, at a minimum, hear the evidence supporting a claim before ruling. Fifth, the Proposed Rule will facilitate settlement by reducing legal fees currently wasted on frivolous and wasteful dispositive motion practice. Finally, the risk that the Proposed Rule will lead to harmful mid-hearing delays can be mitigated through strict enforcement of NASD Code Rule 12303(a)'s answer requirements and FINRA's Initial Pre-Hearing Conference procedures.

A. There is a Need for a Rule Change

It is beyond reasonable dispute that dispositive motion practice has become highly abusive in securities arbitration. Respondents, typically broker-dealers and registered representatives, routinely move to dismiss claims prior to a hearing despite a paltry success rate.[2] Further, many motions are filed prematurely and sometimes are even filed as substitutes for answers.[3] Because these motions have little chance for success, it is evident the motions are being used as a mechanism to delay the proceedings,[4] drive up the costs of opposing parties, and to intimidate public customers who almost always have fewer financial resources than broker-dealers.

Not only is the current use of dispositive motions abusive, the practice is increasing.[5] In 2004, 10% of arbitration respondents filed a motion to dismiss. In 2006 this percentage rose to 28%.[6] Some law firms are even counseling their attorneys to file multiple dispositive motions during the course of an arbitration as a useful litigation

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[2] "FINRA is aware that parties increasingly are filing motions to decide claims before a hearing (commonly referred to as dispositive motions) in arbitration cases. Even though nearly 90% of these motions are denied...." FINRA, *Notice to Parties on Motions to Dismiss Claims Prior to Award (Dispositive Motions) under the Code of Arbitration Procedure for Customer Disputes and Industry Disputes*, http://www.finra.org/ArbitrationMediation/ResourcesforParties/NoticestoParties/p037078.

[3] Constantine N. Katsoris, *Have Pre-Hearing Motions To Dismiss Become Abusive in SRO Arbitrations?*, Securities Arbitration Commentator Vol. 2006, No. 5 at 2-3.

[4] "FINRA is concerned, however, that dispositive motions often result in delay of the hearing on the merits." – *See* note 2, *supra.*

[5] *See* note 1, *supra.*

[6] SAC Awards Survey, Securities Arbitration Commentator Vol. 2006, No. 5 at 3.

tactic.[7] Clearly, the use of dispositive motions as a weapon to drive up costs and overburden public investors is an abusive practice that must be curtailed.

B. The Proposed Rule Appropriately Addresses the Problem

1) The Securities Industry is Not Losing a Protectable Interest

The Proposed Rule does not deprive securities industry respondents of a protectable interest. Respondents in FINRA arbitration have never had the right to limit arbitration to legal "causes of action." In claiming such a right in opposition to the Rule Proposal,[8] the securities industry fails to acknowledge the fundamental difference between arbitration and court litigation. As discussed below, because arbitration is a creature of contract, FINRA arbitrators are empowered to hear claims that would be barred in court.

The Uniform Submission Agreement, which must be signed by all parties,[9] is an unlimited submission by which the parties agree to submit the entire "matter in controversy… to arbitration in accordance with the Constitution, By-Laws, Rules, Regulations, and/or Code of Arbitration Procedure."[10] FINRA's Conduct Rules prohibit an industry member from narrowing the scope of the submission, or attempting to limit the scope of claims which arbitrators may hear.[11] Moreover, nothing in FINRA's by-laws, rules, regulations, or NASD Code limits arbitrators to hearing legal "causes of action." In fact, a statement of claim need only contain the "relevant facts and remedies requested."[12] In light of the Uniform Submission Agreement and the NASD Code, courts

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[7] FINRA learned through various constituent and focus groups that some respondents' attorneys were being counseled by their law firms that an acceptable and useful tactic was to file multiple dispositive motions at various stages of an arbitration proceeding. *See* Securities and Exchange Commission, Release No. 34-57497; File No. SR-FINRA-2007-021, http://www.sec.gov/rules/sro/finra/2008/34-57497.pdf.

[8] *See* SIFMA, Comment to FINRA File No. SR-FINRA-2007-021 at 4-5 (April 7, 2008) (stating that the Proposed Rule should be modified to allow dispositive motions seeking dismissal on legal impossibility and statute of limitations grounds), http://www.sec.gov/comments/sr-finra-2007-021/finra2007021-32.pdf.

[9] NASD CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES § 12100(u), http://finra.complinet.com/finra/display/display_content.html?rbid=1189&element_id=1159006799

[10] FINRA Arbitration, Uniform Submission Agreement, http://www.finra.org/web/groups/med_arb/documents/mediation_arbitration/p009438.pdf

[11] NASD Conduct Rule 3110(f)(4)(A-D), http://finra.complinet.com/finra/display/display.html?rbid=1189&element_id=1159000466

[12] NASD CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES § 12302(a)(1), http://finra.complinet.com/finra/display/display.html?rbid=1189&element_id=1159000927

have repeatedly ruled that arbitration panels are empowered to resolve claims and provide remedies unavailable in courts.

For example, in Freeman v. Arahill, No. 111119-01, slip op. (Sup. Ct. N.Y. County 2001) (copy attached), the Court refused to overturn an arbitration award in favor of the claimant even though the underlying claim, a violation of a self-regulatory organization's rule, may have been impermissible in federal court. In Shearson Hayden Stone, Inc. v. Liang, 653 F.2d 310 (7th Cir. 1981), the 7th Circuit determined that the arbitration panel was contractually empowered to grant a claimant's wrongful termination claim, even though the claimant was employed on an "at will" basis which would have barred the claim in court. Also, in Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, (1995), the Supreme Court allowed punitive damages in a securities arbitration, even though awarding punitive damages was prohibited by governing state law. Significantly, the Court held that unlimited contractual submissions to arbitration preempt state law rules that otherwise would limit the arbitrators: "[T]he FAA ensures that their agreement [to arbitrate] will be enforced according to its terms even if a rule of state law would otherwise exclude such claims from arbitration." Mastrobuono, 514 U.S. at 58.

In light of the case law and the NASD Code and Conduct Rules, it is frivolous for the securities industry to claim that the limitations in the Proposed Rule on pre-hearing motions to dismiss will deprive industry members of a protectable interest. Due to the contractual nature of arbitration, arbitration panels have always been empowered to hear claims and provide remedies that are barred in courts. It is ironic that the securities industry now seeks to limit the scope of arbitration when it was the securities industry that imposed the FINRA arbitration forum on the investing public. If the securities industry truly wants to limit disputes to legal "causes of action," the securities industry should simply stop imposing arbitration on its customers and allow public investors the choice of suing in court.

2) The Proposed Rule is Neutral

The Proposed Rule's restriction on the filing of dispositive motions applies equally to investors and the securities industry. The investing public will also be prevented from filing abusive dispositive motions when responding to claims or counter-claims by industry members.

3) Given the Narrow Review of Arbitration Awards it is in the Public Interest to Require Arbitrators to Hear Evidence Before Ruling on a Claim

It has long been the case that "[t]he grounds for overturning an arbitration award are extremely limited."[13] For instance, mistake of law has never been an accepted ground for vacating arbitration awards.[14] In the recent case of Hall Street Associates v. Mattel, 2008 U.S. LEXIS 2911 (U.S.), the Supreme Court further limited the available grounds for vacating an arbitration award. The Court ruled that manifest disregard of the law is not a ground to vacate an arbitration award separate from the narrow statutory grounds listed in section 10 of the Federal Arbitration Act.

In light of this severely limited judicial review, it is imperative that arbitration panels do not prematurely dismiss a claimant's claim before hearing the evidence. Because a claimant has essentially no recourse for an unjust dismissal, it is in the public interest and reasonable for FINRA to require an arbitration panel to hear a claim except under the very specific exceptions set forth in the Proposed Rule. Thus, FINRA is acting appropriately in creating a presumption in favor of hearing a claim by establishing a framework that discourages and limits dispositive motions.

4) Dispositive Motions Hinder Settlement by Driving Up Costs

It is mutually beneficial to parties in a dispute to reach settlement early through mediation or other means because doing so is relatively inexpensive.[15] In fact, one of the primary reasons parties settle is to avoid legal costs.[16] Under the current dispositive motion practice, funds that could potentially be used as part of a settlement are instead wasted on legal fees, driving up costs early in a case and making settlements less likely to

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[13] Halim v. Great Gatsby's Auction Gallery, Inc., 516 F.3d 557, 563 (7th Cir. 2008).

[14] "...legal error, no matter how gross, is insufficient to support overturning an arbitration award." Halim, 516 F.3d at 563 (citing IDS Life Ins. Co. v. Royal Alliance Associates, Inc., 266 F.3d 645, 650 (7th Cir.2001)).

[15] Howard Aibel, *Mediation Works... Opting for Interest-Based Solutions to a Range of Business Needs*, DISPUTE RESOLUTIONS JOURNAL, April/September 2006 (stating that "reaching resolution through mediation is relatively inexpensive... [and] is typically a small fraction of the cost of litigation"); Joan Stearn Johnsen, *Mediation Advocacy: Yes, Lawyers Are Important If You Mediate* (stating that "[t]here are many advantages to mediating... [t]he most obvious advantage is the cost savings to party as well as the attorney if the case is resolved early"), http://jsjmediate.com/pdf/Mediation%20Advocacy.pdf.

[16] John S. Monical and Kent Lawrence, *Mediation of Securities Disputes: Views from the Advocate and the Mediator*, SECURITIES LITIGATION JOURNAL, Vol. 16, No. 3 Spring 2006, http://lksu.com/images/42%20Mediation%20of%20Securities%20Disputes.pdf

occur.[17] In addition, accumulating legal fees cause parties to entrench themselves, making settlement more difficult, as both sides will seek to recover on their legal investment.

Settling a dispute as early as possible often requires that attorneys not "overlawyer." Commentators warn that legal counsel should "not spend so much on preparation that any recovery has to include thousands of dollars spent on trial preparation."[18] Additionally, legal counsel should "[a]void creating a situation where a settlement offer that is fair based on the various damage analyses is insufficient due to the expenses already expended."[19]

Dispositive motions in securities arbitration are a form of "overlawyering." Respondents' legal counsel waste significant time and money researching and drafting dispositive motions which are almost never granted.[20] The end result of this practice is wasted time, money, and a decreased probability of reaching settlement.

5) FINRA Must Enforce the Answer and Pre-Hearing Conference Requirements to Avoid Mid-Hearing Delays

Some commentators have argued that the Proposed Rule will not end the abusive use of dispositive motions. Rather, if the Proposed Rule is implemented, respondents will simply wait until the end of the claimant's case in chief before presenting their frivolous dispositive motions.[21] One distinguished commentator suggests that the middle of an evidentiary hearing is the worst possible time to first raise and confront the legal issues in a case.[22] Mid-hearing dispositive motions may cause harmful delays if the arbitrators adjourn the hearings for briefing.

We agree with other commentators that mid-hearing is not the time for dispositive motions which result in hearing delays, and the Proposed Rule may open the door to such potentially abusive delaying tactics. We take such concerns very seriously.

FINRA arbitration rules, however, provide the framework for avoiding a significant risk of mid-hearing delays. Rule 12303(a), 'Answering the Statement of Claim,' requires a respondent to specify "the relevant facts and available defenses to a

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[17] James D. Knotter, *Securities Mediation Works: Why and How* (1998), http://www.mediationnow.com/communal/Articles/knotter.htm
[18] Joan Stearn Johnsen, *The Dreaded Impasse: Possible Ways of Avoiding It*, *available at* http://jsjmediate.com/pdf/Impasse%20Article.pdf
[19] *Id.*
[20] *See* note 1 *supra.*
[21] Seth Lipner, Comment to FINRA Rule Making, Release No. 34-57497; File No. SR-FINRA-2007-021, http://www.sec.gov/comments/sr-finra-2007-021/finra2007021-4.hml
[22] *Id.*

statement of claim."[23] Any potential grounds for dismissal should be included within the respondent's Answer. The parties are then afforded an opportunity to request briefing on unique legal issues as part of the Initial Prehearing Conference. Requirement L of the Arbitrator's Script for Initial Pre-Hearing Conferences requires the arbitrators to ask whether "there are any unique legal issues that would warrant the filing of briefs in this case."[24] If either party has a substantial legal issue that warrants briefing, the arbitrators are to set deadlines for submission of the briefs.[25]

NASD Code Rule 12303(a), in concert with the Initial Pre-Hearing Conference procedures, provides ample opportunity, prior to the hearing, for a respondent to state and brief the legal grounds for its defense, including any unique legal issues that would warrant dismissal at the close of claimant's case in chief. If a respondent forgoes this opportunity, an arbitrator can fairly deny the respondent's request to brief a mid-hearing dispositive motion. In addition, because the grounds for dismissal should already be briefed, orally argued motions to dismiss at the close of the claimant's case should not cause significant delay.

While we do not discount the likelihood that respondents will attempt mid-hearing delay (much as the securities industry as a collective tactic abused pre-hearing motions to dismiss), we believe that it would be a mistake for FINRA not to address the current problem of pre-hearing dispositive motions for fear of a potential problem that need not arise if current procedures are enforced. If mid-hearing delays become a significant problem, FINRA should address the problem when it arises.

Finally, under the Proposed Rule, arbitrators are not under an affirmative duty to consider a mid-hearing dispositive motion. The language of the Proposed Rule simply states that "[a] motion to dismiss made after the conclusion of a party's case in chief is not subject to the procedures set forth in subparagraph (a)."[26] Nothing in the Proposed Rule prohibits arbitrators from declining a party's application to submit a motion to dismiss in the middle of the hearing. Accordingly, arbitrators can prevent harmful mid-hearing delays through the exercise of their fully authorized discretion.

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[23] NASD CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES § 12303(a), http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159001229&element_id=1159001237&highlight=answer#r1159001229

[24] NASD Dispute Resolution, Initial Prehearing Conference Arbitrator's Script, http://www.finra.org/web/groups/med_arb/documents/neutral_corner/p009937.pdf

[25] *Id.*

[26] Securities Exchange Commission, Notice of Filing of Proposed Rule Change and Amendment No. 1 Relating to Amendments to the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes to Address Motions to Dismiss and to Amend the Eligibility Rule Related to Dismissals at 5, Release No. 34-57497; File No. SR-FINRA-2007-021(March 14, 2008), http://www.sec.gov/rules/sro/finra/2008/34-57497.pdf

C. The SEC Should Approve the Proposed Rule Now, and Address Systemic Issues in the Near Future

Some commentators have argued against the Proposed Rule on the ground that the Proposed Rule is another example of FINRA allowing dispositive motion practice into the arbitration process when the NASD Code currently has no provision for such motion practice. This process, some argue, is yet another step towards FINRA arbitration becoming a more complicated motion-intensive proceeding in which investors receive neither efficiency nor fairness, while at the same time having no meaningful avenue for judicial review.

We acknowledge such comments and agree that the simplest answer to the problem of abusive dispositive motion practice may be for FINRA to counsel arbitrators not to permit such practice. However, because arbitrators have the ultimate authority to interpret the NASD Code (*see* NASD Code, Rule 12413) and routinely allow pre-hearing dispositive motion practice on an *ad hoc basis*, we believe it makes sense to create some uniformity of practice which recognizes this reality. Moreover, the decline of FINRA arbitration as an investor-friendly forum does not mean that the current Rule Proposal should be rejected. The Rule Proposal, in our estimation, has many present benefits, even if it were to contribute to the further complication of the arbitration process.

After approving the Rule Proposal, we urge the SEC to take a hard look at implementing systemic changes, such as requiring securities firms to allow investors the choice among multiple arbitration forums and the choice to file in court The lack of investor choice, and the feeling that investors are trapped in a securities industry-sponsored forum, causes numerous substantive and perceptual problems which need to be addressed.

Conclusion

The Clinic greatly appreciates the opportunity to comment on this Rule Proposal. As set forth above, the Clinic supports the Rule Proposal and urges its implementation as soon as possible because the current state of pre-hearing dispositive motion practice is highly abusive and must be curtailed.

Very truly yours,

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Clinton Becker
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SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: **HON. WALTER B. TOLUB** **PART 15**
Justice

MARC BENNETT FREEMAN,

Petitioner,

-V-

DAMIAN ARAHILL,

Respondent.

INDEX NO. **111119/01**

MOTION DATE 8/8/01

MOTION SEQ. NO. **001**

MOTION CAL. NO.

The following papers, numbered 1 to _____ were read on this motion to/for _____

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits _____	_____
Answering Affidavits — Exhibits _____	_____
Replying Affidavits _____	_____

Cross-Motion: [ ] Yes [x] No

Upon the foregoing papers, it is ordered that the petition for an order vacating the April 30, 2001 decision and award rendered in an arbitration proceeding is denied.

The underlying arbitration award concerned the alleged breach of two rules of the National Association of Securities Dealer, Inc. In seeking to vacate the arbitration award, the petitioner contends that the arbitrator ignored the rule of law that an alleged violation of a self-regulatory organization rule does not provide an investor with a private right of action. A party seeking to vacate an arbitration award faces a heavy burden of proof (Artists & Craftsmen Builders, Ltd. v Schapiro, 232 AD2d 265, 266 [1st Dept 1996]). "The showing required to avoid summary confirmation of an arbitration award is high" (Areca, Inc. v Oppenheimer & Co., Inc., 960 FSupp 52, 54 [SDNY 1997]), and "[a]rbitration awards are subject to very limited review in order to avoid undermining the twin goals of arbitration, namely, settling disputes efficiently and avoiding long and expensive litigation" (Folkways Music Publishers v Weiss, 989 F2d 108, 111 [2d Cir 1993]). The cases cited by the petitioner denied private rights of action in federal court based on violation of self-regulatory organization rules. The petitioner has not cited any case law for the proposition that a private right of action based on the violation of self-regulatory organization rules cannot be brought in arbitration. Accordingly, it is ordered that the petition is denied and the proceeding is dismissed.

This constitutes the decision and judgment of the Court.

Dated: 10/18/01

WALTER B. TOLUB, *J.S.C.*

Check one: **[x] FINAL DISPOSITION** **[ ] NON-FINAL DISPOSITION**