FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

February 7, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number SR-FINRA-2013-003: Proposed Rule Change Relating to Amendments to the Customer and Industry Codes of Arbitration Procedure to Revise the Public Arbitrator Definition

Ms. Murphy:

On January 4, 2013, the Financial Industry Regulatory Authority (FINRA) filed with the Securities and Exchange Commission (SEC), a proposed rule change amending the Customer and Industry Codes of Arbitration Procedure (Arbitration Codes) in regard to the "public arbitrator" definition (Proposed Amendments).[1] The Proposed Amendments would revise the definition of "public arbitrator" in FINRA arbitration proceedings to exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators and require individuals to wait for two years after ending certain affiliation before they may be permitted to serve as public arbitrators. The Financial Services Institute[2] (FSI) appreciates the opportunity to comment on this important proposal.

Background on FSI Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The

[1] Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to the Customer and Industry Codes of Arbitration Procedure To Revise the Public Arbitrator Definition, 78 Fed. Reg. 3925 (Jan. 17, 2013).

[2] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 100 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Advisor members.

IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisers are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 independent financial advisers – or approximately 64% percent of all practicing registered representatives – operate in the IBD channel.[3] These financial advisers are self-employed independent contractors, rather than employees of the IBD firms. These financial advisers provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisers are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisers affiliated with IBDs is comprised of clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisers are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[4] Independent financial advisers get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisers have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisers. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisers play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to ensure our members operate in a regulatory environment that is fair and balanced.

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[3] Cerulli Associates at http://www.cerulli.com/.

[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisers.

FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments

This proposed rule change continues the ongoing efforts of FINRA (and its predecessor organization NASD) to ensure the integrity and neutrality of FINRA's public arbitrator roster by addressing the classification of arbitrators.[5] To this end, FINRA has amended the Arbitration Codes a number of times to narrow the scope of the "public arbitrator" definition, excluding veteran industry professionals who have ended their industry affiliations,[6] officers and directors (and their immediate family members) with indirect ties to the securities industry,[7] and attorneys, accountants, and other professionals who derive a portion of their annual revenue serving firms in the securities industry.[8] In addition to these changes, on February 1, 2011, FINRA implemented a rule change establishing an "all public panel option," which gives parties the option to exclude all non-public arbitrators from panels.[9]

We share FINRA's goal to ensure the integrity and neutrality of the forum's arbitrator roster, however, we are troubled by trends we have observed resulting from some of these changes. Many recent rule changes that were intended to make the arbitration process more equitable, in fact pose serious risks to the impartiality and integrity of current and future arbitration proceedings.

While few FSI members are likely to be captured by the proposed amendments to the Arbitration Codes, which narrow the definition of "public arbitrator" by excluding persons associated with a mutual fund or hedge fund, we believe FINRA should use this opportunity to more uniformly

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[5] *See* Self-Regulatory Organizations; National Association of Securities Dealers, Inc. (n/k/a Financial Industry Regulatory Authority, Inc.); Order Approving Proposed Rule Change To Amend the Definition of Public Arbitrator, 73 Fed. Reg. 15,025, 15,026 (Mar. 20, 2008).

[6] Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations, 69 Fed. Reg. 21,8171 (Apr. 22, 2004).

[7] Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to Amendments to the Classification of Arbitrators Pursuant To Rule 10308 of the NASD Code of Arbitration Procedure, 71 Fed. Reg. 62,026 (Oct. 20, 2006).

[8] Self-Regulatory Organizations; National Association of Securities Dealers, Inc., Notice of Filing of Proposed Rule Change To Amend the Definition of Public Arbitrator, 72 Fed. Reg. 39,110 (Jul. 17, 2007).

[9] *See* Arbitration Panel Composition, Regulatory Notice 11-05 (Feb. 2011).

address shortcomings and inconsistencies with the current definition of "public arbitrator." FINRA's rules "must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest."[10] As such, FINRA's rule changes related to arbitration proceedings have addressed concerns regarding the fairness and neutrality of FINRA's public arbitrator roster by reducing the risk that arbitrators have significant affiliation with the securities industry. This has led to exclusions from the "public arbitrator" definition of anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator, and requiring five years to pass before transitioning from serving as a non-public arbitrator to a public arbitrator.[11] The Arbitration Codes also exclude from the public arbitrator roster an attorney, accountants, or other professional whose firms have derived at least $50,000 or more in annual revenue in the past two years from professional services rendered to clients involved in securities related activities relating to customer disputes concerning an investment account or transaction.[12] These same professionals will also be excluded from the definition of "public arbitrator" if their firm derived 10 percent or more of its annual revenue in the prior two years from persons or entities in the securities industry.[13]

While withholding any judgment on the appropriateness of every aspect of the current definition of "public arbitrator," we believe FINRA's changes to the arbitration code over the past several years have neglected to observe that the integrity and neutrality of the forum's arbitrator roster may be threatened by individuals who fall within the definition of public arbitrators but who are still deriving income and have ties to the securities industry, albeit indirectly. Under the current definition, the Arbitration Codes exclude from the definition of "public arbitrator" an attorney whose firm has derived at least $50,000 or more in annual revenue in the past two years from professional services rendered to clients involved in securities related activities relating to customer disputes concerning an investment account or transaction.[14] Also in the Arbitration Codes, an attorney whose firm has derived 10 percent or more of its annual revenue in the prior two years from persons or entities in the securities industry is excluded from the definition of "public arbitrator".[15] Their exclusion from the definition stems from

[10] 15 U.S.C. 78o-3(b)(6).
[11] Order Approving Proposed Rule Change To Amend the Definition of Public Arbitrator. 77 Fed. Reg. at 15025.
[12] *Id*.
[13] FINRA Code of Arbitration Procedure for Customer Disputes § 12100(u)(4); FINRA Code of Arbitration Procedure for Industry Disputes § 1300(u)(4).
[14] *Id*.
[15] *Id*.

concerns about "individuals serving as public arbitrators when they have business relationships with entities that derive income from broker-dealers."[16] If FINRA and the SEC have determined that these attorneys should be excluded from the definition of "public arbitrators" in order to reduce the risk of impartiality, it would also be appropriate to exclude attorneys whose firms derived $50,000 or 10 percent or more of their annual revenue from professional services rendered to claimants relating to customer disputes concerning an investment account or transaction in the prior two years.

Perceptions of fairness and neutrality of the arbitration forum cannot be exclusive to claimants. FSI has identified a significant number of "public arbitrators" whose entire legal practice consists of representing claimants against broker-dealers and other entities in securities litigation and FINRA arbitration. These individuals actively serve on arbitration panels as "public arbitrators." For example, in *Alice J. Potter vs. Lawrence A. Rasche, Tommy D. Bowman and Ameritas Investment Corp.* (Case ID 11-20745), the presiding chairperson of the arbitration panel, an attorney whose "entire legal practice consists of the representation of customers and registered representatives with claims against broker-dealers and other entities,"[17] is classified as a "public arbitrator".[18] In *Alberto Ferrero and Qingwen Li vs. CCO Investment Services Corp.* (Case ID 10-01505) the presiding chair, an attorney whose practice is dedicated to securities arbitration on behalf of individual investor claimants, is classified as a "public arbitrator".[19] In *Florence Campbell Butts vs. Fifth Third Securities, Inc.* (Case ID: 08-02669), the presiding chair, an attorney whose practice specializes in securities litigation and who mainly represents claimants against broker-dealers, is classified as a "public arbitrator".[20] In *Penserra Securities, LLC; George Madrigal; Anthony E. Guaimano* (Case ID: 12-01944), one of the arbitration panelists, an attorney whose law firm and legal practice mainly represent claimants in securities disputes before FINRA, state, and federal courts, is classified as a "public arbitrator".[21] If attorneys who represent securities firms are to be excluded from the definition of "public arbitrator" for their connections to the securities industry, the preservation of neutrality and integrity in the arbitration process must also require that FINRA address perceptions of fairness and neutrality with regard to practicing attorneys who primarily represent claimants. If FINRA has determined that an attorney's industry representation and defense work in customer disputes

[16] *Id*.
[17] Information derived from publicly available arbitration awards records.
[18] *See id.*
[19] *See id.*
[20] *See id.*
[21] *See id.*

are too closely related to matters they would be deciding in an arbitration proceeding, therefore affecting the arbitrator's impartiality, the same concern must apply to those attorneys who principally represent claimants in FINRA arbitration proceedings against members of the securities industry. We suggest that this inconsistency be corrected by excluding from the definition of "public arbitrators" any attorney whose firm has derived $50,000 or 10 percent or more of their annual revenue in the prior two years from professional services rendered to claimants relating to customer disputes concerning an investment account or transaction.

Another concern regarding the current arbitration process is the recent establishment of the optional all-public arbitration panel. A review of available data, provided by a number of sources including FINRA, indicates that out of the 174 cases that exercised the all-public panel option, 86 cases were decided by an all public panel, while 88 of cases that were eligible (including cases that did not opt into the program) were decided by a mixed panel which included an industry arbitrator. The all public panels appear to have delivered a 51% "win" rate" (44 cases out of 86) for claimants while the mixed panels only delivered a 32% "win rate" (28 cases out of 88). This was a difference of over 19% in 2012. This suggests that all public panels are disproportionately favoring claimants in their decisions. This may be due to several factors, however the presence of claimant attorneys on these panels may partially explain these recent trends.

The increasingly prevalence of claimants choosing the "all public panel" option since its availability in February 2011 (currently 76% of all claimants in new arbitrations have been selecting it since it became available) only exacerbates the fact that attorneys who predominately represent claimants in FINRA arbitration are eligible to serve on these all public panels as they are not considered "industry" arbitrators. This shift is likely to create an imbalance and poses a serious risk to the impartiality, neutrality, and integrity of arbitration proceedings.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you on this and other important regulations.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 803-6061.

Respectfully submitted,

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