FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS
AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

July 24, 2014

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

Re: Release No. 34-72491; File No. SR-FINRA-2014-028

Dear Ms. Murphy:

On June 18, 2014, FINRA filed a proposed rule change with the SEC that would redefine the definitions of "non-public arbitrator" and "public arbitrator" in FINRA's Code of Arbitration for Customer Disputes and Code of Arbitration Procedure for Industry Disputes (Proposed Amendments).[1] The Proposed Amendments would make several significant changes. They would provide that persons who worked in the financial industry for any duration during their careers would always be classified as non-public arbitrators, and persons who represent investors or the financial industry as a significant part of their business would also be classified as non-public, but could become public arbitrators after a cooling-off period. Importantly, the Proposed Amendments would reclassify investor advocates as non-public arbitrators which FSI supports.

The Financial Services Institute[2] (FSI) appreciates the opportunity to comment on this important proposal. FSI applauds FINRA for advancing amendments that will address perceptions about the fairness and neutrality of the public arbitrator roster. However, FSI believes that the Proposed Amendments can be further improved. Specifically, the removal of the five-year cooling-off provision for persons who work in the financial industry will lead to unintended consequences, particularly due to the fact that other professionals categorized as non-public arbitrators are provided a cooling-off period. FSI encourages FINRA to reevaluate this portion of the 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 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

[1] Notice of Filing of Proposed Rule Change Relating to Revisions to the Definitions of Non-Public Arbitrator and Public Arbitrator, [79 Fed Reg. 38,080 (July 3,2014).

[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.

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. 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

FSI continues to support FINRA's efforts to improve the arbitration process. The Proposed Amendments are effectively designed to achieve these goals, and FINRA should be commended for pursuing these changes. While we support the majority of the changes advanced in the proposal, we have concerns with FINRA's removal of a five-year cooling-off period for persons who worked in the financial industry for any duration during their careers. We believe this is unnecessary and does not give equal treatment to other professionals under the Proposed Amendments. We expand upon these concerns below:

- **FSI Applauds FINRA Expansion of "Non-Public" Arbitrator Definition:**

  The Proposed Amendments would classify as non-public any attorney, accountant, or other professional who has devoted 20 percent or more of their professional time, within the prior

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

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

five years, to serving parties in investment or financial industry disputes. These individuals could serve as public arbitrators five years after their business mix changes, unless the person accumulated 15 calendar years of providing the qualifying services over the course of their career, in which case they would be permanently classified as non-public. FSI applauds FINRA for making these changes. Absent the amendments, some arbitrators would continue to serve as public arbitrators when they arguably have the comparable bias as industry arbitrators. This creates an asymmetry in the application of FINRA's rules. This important change makes significant progress in returning the perception of fairness and neutrality to the arbitration process.

- **The Proposed Removal of the Five-Year Cooling-Off Period for Industry Participants Is Unnecessary:**

  Under current rules, after a five year "cooling off period," an individual who was affiliated with a securities industry entity can qualify to serve as a "public arbitrator," with some exceptions. The Proposed Amendments would eliminate the "cooling off period" and would permanently classify persons who are, or were, affiliated with a securities industry entity at any point in their careers, for any duration, as "non-public." Under the Proposed Amendments, once FINRA classifies an arbitrator as non-public, FINRA would never reclassify the arbitrator as public. FSI believes this approach to addressing perceptions of fairness and neutrality of the arbitration panel is unnecessary and would have significant unintended consequences.

  - **Impact of All-Public Panels:** In early 2011, the Securities and Exchange Commission (SEC) approved a FINRA-proposed rule allowing investors a choice between an all-public panel instead of a majority public panel.[5] As parties in arbitration increasingly exercise this option, it has increased the risk of an arbitration involving no arbitrators with extensive securities industry knowledge or experience. Often, the operational, supervision, or investment issues involved in FINRA arbitrations are complex. Arbitrators with even modest industry experience can explain difficult concepts and issues in order to bring clarity to the process. Given the high number of all-public panels selected by participants, FINRA could effectively be eliminating the chance for arbitrators with industry experience to assist with cases by eliminating the cooling-off period. This becomes particularly troublesome with large or complex cases. Because these cases involve higher monetary stakes, the importance of panel composition is consequently magnified. Arbitrators with industry experience can significantly benefit the process and all parties involved. They can educate other panelists with regard to industry practices and procedures, and can easily identify sales practice violations and other unfair practices. In addition, it is inaccurate to assume that these individuals harbor a bias that will cause them to rule in favor of the industry in disputes. In fact, in instances where a member of industry has engaged in particularly egregious behavior, arbitrators with industry experience have an interest in ensuring that these individuals are properly held accountable.

    Furthermore, the exclusion applies no matter how much or little time the individual worked in the industry. Arbitrators who served as entry-level employees, despite their short working tenure, have acquired important knowledge about the industry which would make them a valuable panelist. Because these individuals lack longstanding ties or allegiance to the industry, concerns or perceptions of bias are substantially

[5] Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes, 76 Fed. Reg. 6500 (Feb. 4, 2011).

reduced. Another unintended consequence would be a reduction in supply of available public arbitrators. At of the end of 2013, 44% of FINRA arbitrators were classified as non-public.[6] With the expected changes to the definition, the result will likely be many public arbitrators being reclassified as non-public, decreasing the number of public arbitrators in the pool. FSI is concerned about the impact this proposed change might have on the availability of qualified public arbitrators to meet demand, either now (at historically low levels of new claims)[7] or when new claims escalate upon a market correction. Eliminating additional potential arbitrators by reclassifying them as non-public will further reduce the supply of arbitrators available to serve.

- **Regulatory Asymmetry:** The removal of the cooling-off period also reintroduces the issue of asymmetry with regard to application of FINRA's rules. The proposed amendments eliminate a cooling-off period for industry participants while simultaneously providing for a cooling-off period for investor advocates. This inconsistency is not explained in the rule filing. The proposed rule presumes that after a five year cooling-off period investor representatives will regain their perceived ability to be neutral while there is no amount of time that will allow an industry participant to regain neutrality. Rather than eliminating any chance for these individuals to ever serve as public arbitrators, FSI suggests a cooling-off period equal to the amount of time an arbitrator worked for a member firm or as an investor advocate. For example, if an arbitrator was employed by a member firm for five years, then the cooling-off period would be five years following the last date of industry employment, after which the arbitrator could be reclassified as public. Longer-tenured industry employees, who are more likely to be perceived as biased, would have longer cooling-off periods. The same standard would apply to investor advocates as well. Under this framework, an individual who has spent an entire career engaging in the work that may create a bias would likely never be reclassified as public. FSI believes that this is a more effective approach to eliminating concerns with the perception of bias among arbitrators.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with FINRA and the SEC on this and other important regulatory efforts. Thank you for your consideration of our comments. Should you have any questions, please contact me at [redacted].

Respectfully submitted,

David T. Bellaire, Esq.
Executive Vice President & General Counsel

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[6] Mason Braswell, *FINRA approves rule to redefine public arbitrators*, InvestmentNews, Feb. 13, 2014, *available at* http://www.investmentnews.com/article/20140213/FREE/140219936.

[7] See FINRA Dispute Resolution Statistics, *available at http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/* (last accessed July 11, 2014).