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**Re: Letter of January 12, 2007 Regarding the Proposed Consolidation of the NASD and NYSE Regulation Arbitration Programs**

Dear SICA Public Members:

This letter responds to your January 12, 2007[1] letter (letter) to SEC Chairman Christopher Cox sent in your capacities as past and present members[2] of the Securities Industry Conference on Arbitration (SICA). The letter, while reflecting your keen interest in the arbitration process, contains many conclusory statements that have no evidentiary basis. NASD would like to address these potentially misleading statements.

Single Dispute Resolution Forum

Your letter states: "The prospect of a single securities arbitration forum maintained and funded by the securities industry will only heighten the suspicion long held by many public investors that the system they are compelled to use is less than independent and hence less than fair."

[1]Although a SICA meeting was planned for and held on Tuesday, January 16th, you sent the letter without prior consultation with SICA's other members.
[2] The letter was signed by the three current public SICA members, Theodore G. Eppenstein, Constantine N. Katsoris, and J. Pat Sadler, and the three past public members, Peter R. Cella, Thomas R. Brady, and Thomas J. Stipanowich.


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First, we must challenge any notion that NASD's arbitration program is unfair; this is not the case. In 1999, NASD engaged the United States Military Academy at West Point to conduct an independent analysis of surveys submitted by our forum's constituents. The West Point report stated:

> Based upon the analysis of the data collected, we are able to conclude that participants to ODR[3] sponsored arbitrations believe their case was handled fairly and without bias. The data we have analyzed shows the parties to ODR arbitrations are overwhelmingly satisfied with the fairness of the forum. For example, at the conclusion of their arbitration case, 93.49% of those responding indicated that their case "appears to have been handled fairly and without bias." [4]

That study found the same strong and overwhelmingly positive results when parties evaluated the arbitrators who heard their case.

In 2002, the SEC commissioned a study and report by Professor Michael A. Perino[5] on the adequacy of arbitrator conflict disclosure requirements at NASD and NYSE. Professor Perino's report also touched on user perceptions of fairness, finding that "[a]vailable empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair."[6] The report also suggested that, to resolve any doubts about investor perceptions regarding the fairness of self-regulatory organization (SRO) arbitration programs, the SROs should sponsor an independent user survey. This survey is about to be conducted under SICA's auspices by the Pace Investor Rights Project (affiliated with the Pace University School of Law).

NASD believes that it is the quality of the forum that dictates fairness rather than an investor's ability to select one dispute resolution forum over another. As shown by SICA's reported statistics, there has been a steady migration by investors to NASD's arbitration forum even without consolidation; the result is that NASD already administers over 94 percent of the investor-broker disputes filed every year.[7] We note also that the Commission has approved the consolidation of arbitration programs at several SROs with NASD over the past decade with no adverse effects.[8]

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[3] Prior to July 2000, NASD's dispute resolution program was part of NASD Regulation and was known as the "Office of Dispute Resolution" (ODR).

[4] G. Tidwell, K. Foster, and M. Hummel, Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations, at 3 (Aug. 5, 1999) http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_009528.pdf>.

[5] Visiting Professor of Law, Columbia Law School when the report was issued; currently Professor of Law, St. John's University School of Law.

[6] M. Perino, Report to the SEC Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, at 51 (Nov. 4, 2002) <http://www.sec.gov/pdf/arbconflict.pdf>.

[7] The SICA 13th Report (2005) shows that NASD's share of total arbitration cases received by SROs increased from 65 percent in 1988 to nearly 89 percent in 2004. Using statistics on the NASD and NYSE Regulation Web sites, NASD estimates that its share for 2006 will be over 94 percent.

[8] The NASD Code of Arbitration Procedure applies not only to NASD firms and their associated persons, but also to members and associated persons of the following SROs pursuant to agreements under which NASD administers their arbitration processes: Municipal Securities Rulemaking Board (MSRB), the Philadelphia Stock Exchange (Phlx), the American Stock Exchange (Amex), the International Securities Exchange (ISE), and The NASDAQ Stock Market LLC (Nasdaq). Exchange Act Release No. 39378 (Dec. 1, 1997), 62 Fed. Reg. 64417 (Dec. 5, 1997) (MSRB); Exchange Act Release No. 40517 (Oct. 1, 1998), 63 Fed. Reg. 54177 (Oct. 8, 1998) (Phlx); Exchange Act Release No. 40622 (Oct. 30, 1998), 63 Fed. Reg. 59819 (Nov. 5, 1998) (Amex); Exchange Act Release 45094 (Nov, 21, 2001), 66 Fed. Reg. 60230 (Dec. 3, 2001) (ISE), and Exchange Act Release No. 53128 (Jan. 13, 2006), 71 Fed. Reg. 3550 (Jan. 23, 2006) (Nasdaq).

Customer Case Results

Your letter states: "[C]ustomers' chances of winning an award had substantially dwindled to around forty-three percent by 2006." The conclusion that outcome rates over a specific period of time define the fairness of the forum is empirically dubious. There are many factors that influence particular outcomes. Publicity about a regulatory crackdown on a particular practice can cause an increase in claims, including some without merit. For example, investors filed hundreds of claims after regulatory actions regarding misleading analyst reports, but arbitrators dismissed many of those claims due to lack of a relationship between the claimant and the analyst. Similar outcomes occurred where investors took these cases to court.[9] Moreover, as an impartial forum, NASD cannot ensure that a particular side will win more cases than another. Certainly, the court system is not evaluated in this manner.

As a regulated SRO, NASD is proactive in ensuring that its rules and procedures are fair and understandable to investors. NASD does not require customers to arbitrate. Rather, under NASD rules, brokerage firms and their associated persons have a duty to arbitrate upon the demand of a customer, whether or not there is a predispute arbitration agreement.[10] Moreover, NASD's rules provide that, if broker-dealers elect to use predispute arbitration agreements, those agreements must contain enumerated safeguards and disclosures to protect investors. Customers already have the right to take their claims against defunct firms directly to court. A 2001 amendment to the rules prohibits a firm that has been terminated, suspended, or barred from the NASD, or that is otherwise defunct, from enforcing a predispute arbitration agreement against a customer in the NASD arbitration forum,[11] but, importantly, does not preclude a customer from filing a claim in the NASD arbitration forum.

Your letter draws a sweeping conclusion in note 6: "NASD's statistics also show a drop of around 20% in the customer's chances from 2000 levels to 2005 levels." In fact, over the last six years, the percentage of customers awarded damages has fluctuated between 43 and 54 percent. (With regard to the reported outcome rates in particular, we also note that NASD changed retroactively the method of calculating the so-called "win" rate in 2005, resulting in a slight drop in the numbers.) Numerous factors can cause changes in recovery statistics. For example, arbitrators awarded damages in less than one third of the analyst cases described above.

The United States General Accounting Office (GAO)[12] in a 2000 report recognized that one should not draw conclusions about the fairness of the arbitration process based on case outcome statistics, stating that "GAO could not reach conclusions about the fairness of the arbitration process from

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[9] *See, e.g.*, In re Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 2003 U.S. Dist. LEXIS 11005 (SDNY 2003); *aff'd in part and rev'd in part sub nom.* Lentell v. Merrill Lynch & Co., 396 F.3d 161 (2d Cir. 2005) (holding that plaintiffs failed to plead loss causation); *cert. denied*, 126 S. Ct. 421, 163 L. Ed. 2d 321, 2005 U.S. LEXIS 7318 (Oct. 11, 2005).

[10] NASD Code of Arbitration Procedure Rule 10301(a).

[11] See Exchange Act Release No. 43998 (Feb. 23, 2001), 66 Fed. Reg. 13362 (Mar. 5, 2001) (File No. SR-NASD-2001-08).

[12] Now the Government Accountability Office.

case outcome statistics." The report also noted that a declining investor win rate "could indicate little or no change in the fairness of the arbitration process."[13]

Seth Lipner, former president of the Public Investors Arbitration Bar Association (PIABA), wrote in his article entitled: *Study of Arbitration Recovery Statistics:*[14]

> Because risk-willing investors generally have weaker cases than risk-averse investors, the pool of suitability cases going to award is abundant with relatively weak cases. By studying awards in those cases, we learn little about how the average or good suitability case will fare at a hearing.

In addition, experienced respondents' attorneys tend to settle the strongest cases filed by investors. The fact remains, however, that an individual investor's chances of prevailing in arbitration depend primarily on the strength of the investor's case as presented by the investor or the investor's counsel, and not on the results of other cases.

Finally, the above statistics on results of customer cases reflect only cases that were resolved by award. Such cases represent only a small fraction (approximately 25 to 30 percent) of all arbitrations. Investors settle or withdraw more than half of their cases prior to hearing. In most of these cases, the investor receives compensation. Thus, the overall recovery rate for investors is much higher than that reflected in the table on results of customer awards, a point noted by the GAO in its 2000 report.

Independent Arbitration Forum

Your letter states that the proposed single arbitration forum "maintained and funded by the securities industry" is less than independent. This statement distorts the nature of NASD's dispute resolution forum, which is not "maintained and funded by the industry." NASD's arbitration program is financially self-sufficient, and is funded by fees paid by the forum's users: firms, individual brokers, and investors. The fees are structured such that investors bear about 25 percent of the overall fees, with the balance borne by the industry. And, as noted below, we are subject to extensive regulatory oversight, and we invite significant investor and public input in shaping our program.

Referring to a supposed investor fear of unjust outcomes, your letter suggests that the Commission consider a new organization: "A single, independent securities arbitration forum, with SEC oversight and public investor and securities industry participation, [that] would serve to contribute to the reduction of this negative perception." The goal of the NASD-NYSE Regulatory consolidation, and indeed the trend in all of NASD's actions, has been to create a regulator completely independent from the commercial concerns of markets and broker-dealers.

There is strong public representation on all internal advisory and governing bodies impacting NASD's dispute resolution program. The NASD Dispute Resolution Board contains a majority of

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[13] Actions Needed to Address Problem of Unpaid Awards, at 4-5 (GAO/GGD-00-115, June 2000) ("2000 GAO Report").

[14] The article appeared in *The Neutral Corner*, NASD's newsletter for arbitrators and mediators - June 2006, page 3.

public directors. Sharon Smith,[15] our present chairperson, and John Sexton,[16] our immediate past chairperson, are both academics and public representatives. The National Arbitration and Mediation Committee (NAMC), a standing committee that proposes rule and policy changes to the NASD Dispute Resolution Board, is comprised of fourteen members. Eight of the fourteen NAMC members are public representatives, including the current chair who is also a former president of PIABA. In fact, five of PIABA's presidents have served as Chair or members of the NAMC. Finally, as you know, NASD actively participates as a member of SICA, and supports it financially by absorbing, along with the other SRO members, the public members' travel and other expenses. You are also aware that, in addition to voting members representing the public, the SROs, and industry organizations, SICA has several "invitee"[17] member organizations such as the SEC, the North American Securities Administrators Association, the National Futures Association, the Commodity Futures Trading Commission, and the American Arbitration Association.

NASD's dispute resolution program is subjected to extensive regulatory oversight. The SEC must approve all arbitration and mediation rules. NASD must file with the Commission proposed changes to the rules, as well as significant changes to our processes. After publication in the *Federal Register*, there follows an extensive period for comments by the public, and NASD must address the issues raised by the commenters. We often amend rule filings in response to comments from the public. SEC's Office of Compliance Inspections and Examinations conducts periodic inspections of our dispute resolution program. The GAO also conducts reviews of our program from time to time. A new combined NASD-NYSE arbitration entity would presumably operate under the same or a heightened level of scrutiny, because regulators would be able to focus their resources on one rather than two arbitration programs.

Finally, it is worth noting that the GAO in a 1992 report[18] observed that there was no statistically significant difference in award outcomes in SRO and non-SRO arbitration forums:

> Our statistical analysis of case results and comparison of results between arbitration forums showed no evidence of pro-industry bias at industry-sponsored forums. Investors received awards in more than half the disputes they initiated, and the awards received in industry-sponsored forums were not statistically different from awards at AAA or NFA.[19]

The GAO repeated this observation in its 2000 report.[20]

In sum, NASD already is an independent forum; there is no need to create another forum.

Allowing Investors to Choose Another Forum

Your letter states: "Another alternative to compulsory SRO arbitration would be to again provide the public investor with the right to choose to bring grievances to court or to arbitration. While not

[15] Provost and Vice Chancellor of Academic Affairs, National University; formerly Dean of Fordham University Graduate School of Business Administration.
[16] President of New York University, formerly Dean and Professor of Law, New York University School of Law.
[17] As you know, SICA invitees attend meetings and actively participate in discussions, although they do not have voting rights.
[18] Securities Arbitration: How Investors Fare (GAO/GGD-92-74, May 11, 1992)
[19] Id. at 60
[20] 2000 GAO Report at 4-5.

all cases would be susceptible to resolution in court (for example, claims under $25,000), it would permit the public investor the choice as was their right prior to 1987." This proposal seeks to overturn federal case law dating back 20 years, as articulated by the United States Supreme Court.

In the 1987 case of *Shearson/American Express, Inc. v. McMahon*[21] the Court held that the use of predispute arbitration clauses in customer-broker agreements did not violate the Securities Exchange Act of 1934. Two years later, the Court ruled in *Rodriguez de Quijas v. Shearson/American Express*[22] that the use of predispute arbitration clauses in customer-broker agreements did not violate the Securities Act of 1933. Two years thereafter, in *Gilmer v. Interstate Johnson/Lane Corp*[23] the Supreme Court again supported SRO arbitration programs. Although this last case involved an employment dispute between a broker and his former employer, the Court's views of arbitration in an SRO forum (in this case the NYSE) are nonetheless instructive:

> In arguing that arbitration is inconsistent with the ADEA, Gilmer also raises a host of challenges to the adequacy of arbitration procedures. Initially, we note that, in our recent arbitration cases, we have already rejected most of these arguments as insufficient to preclude arbitration of statutory claims. Such generalized attacks on arbitration "res[t] on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants," and, as such, they are "far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes." [citing *Rodriguez*].

When investors (and other parties) were offered a choice of another arbitration forum under the 2000 SICA Pilot, there was little interest. In 2002, SICA concluded a two-year pilot program, in which seven major brokerage firms agreed to allow investors the choice of having their arbitration dispute administered by a non-SRO arbitration forum (either JAMS or the American Arbitration Association, depending on the participating brokerage firm). The SICA *Twelfth Report* sums up the pilot's results this way: "From its inception few investors (or their attorneys) elected to proceed at a non-SRO forum." Based upon responses to a survey of investors, SICA reported that investors' main reasons for not using the alternative forums were the higher fees at non-SRO forums, and a general degree of comfort with existing and more familiar SRO procedures. [24]

Improvements to the NASD Code of Arbitration Procedure

NASD continues to make significant improvements to the dispute resolution forum to make the process more transparent, fair, and efficient for investors and others who use the forum. On January 24, 2007, the SEC approved a complete reorganization of the NASD Code of Arbitration Procedure[25] that included simplification of the Code language. To eliminate confusion regarding which rules apply to which disputes, NASD separated the Code into three parts: the Customer Code, the Industry Code, and the Mediation Code. The rules now follow the sequential order of a typical case making them more logical and user-friendly.

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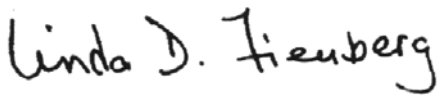
[21] 482 U.S. 220 (1987).
[22] 490 U.S. 477 (1989).
[23] 500 U.S. 20 (1991).
[24] SICA Twelfth Report at 5-6 (2003).
[25] See Exchange Act Release No. 34-55158.

The new rules incorporate improvements to the discovery process, including codifying the power of arbitrators to sanction parties for non-compliance with the rules, which should significantly reduce the number of discovery disputes in NASD arbitrations. We also established uniform procedures for filing, responding to, and ruling on motions in NASD arbitrations. The new code refines the arbitrator selection process by creating a new roster of public arbitrators who are qualified to serve as chairpersons in cases involving investors. Arbitrators must have a specific amount of training and experience to qualify to serve as a chairperson. These and other revisions codify best practices and provide more guidance to parties and arbitrators in the NASD DR forum.

Conclusion

The consolidation of the NASD and NYSE dispute resolution forums will continue to serve the interests of the investing public. The combined entity would continue to be subject to full SEC oversight and inspections, and its rules subject to approval by the Commission as at present. The economies of scale and increased efficiencies will make it more efficient to recruit, train, and maintain a unified roster of neutrals; there will be better coordination on disciplinary referrals arising out of arbitrations, and on suspending or terminating firms for non-payment of awards; and the single set of rules will reduce confusion for investors.

Very truly yours



Linda D. Fienberg

cc: The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Kathleen L. Casey
The Honorable Annette L. Nazareth

The Honorable Max Baucus
The Honorable Christopher J. Dodd
The Honorable Daniel K. Inouye
The Honorable Chuck Grassley
The Honorable Richard C. Shelby
The Honorable Ted Stevens

The Honorable Rick C. Boucher
The Honorable John Conyers, Jr.
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