PETITION TO THE SECURITIES AND EXCHANGE COMMISSION

by

The Public Investors Arbitration Bar Association

The undersigned officers and directors of the Public Investors Arbitration Bar Association (PIABA) hereby respectfully petition the Commission pursuant to §19(c) of the Securities Exchange Act, 15 U.S.C. §78s(c), to amend the Code of Arbitration Procedure of the National Association of Securities Dealers (NASD) in accordance with the proposed rules set forth herein. These rules would:

1) Establish an unambiguous "NASD Window" giving customers the right to arbitrate before the American Arbitration Association in a venue set by the AAA using traditional guidelines;

2) Provide for a new concept in panel compositions: (a) one public arbitrator for claims up to $35,000; (b) for claims over $35,000, a panel of three public arbitrators (designated as a Public panel) or (c) a panel designated as Experienced, consisting of one Public member, one Industry member and one Investor arbitrator; the NASD administrator would have authority to designate an Experienced panel in appropriate cases;

3) Provide for "rotational" selection of arbitrators to better carry out the recommendations of the Ruder Commission Report and re-establish a more level playing field for public investors.

In support of this petition, PIABA would show unto the Commission as follows:

I

THE PROPOSED "NASD WINDOW" RULE

Preliminary Background Information

A. Since 1990 the number of customer arbitration complaints filed with the SROs has risen from 5,332 to 6,510 in 1996. The overwhelming majority of

these cases have been filed with the NASD (5,631). Of the 6,510 arbitrations filed in 1996, the NASD and NYSE accounted for all but 3 1/2% or 230 cases. The NYSE in 1996 accounted for 10% of new filings. Of the combined 1996 total filed at NASD and NYSE (6,279), only 648 or 11.5% were filed with the NYSE. In short, nearly 9 new cases were filed with the NASD in 1996 for every case filed with the NYSE. The filing figures published by the *Securities Arbitration Commentator* show a steady rise in the NASD's share of total SRO filings: 1988 (65%), 1989 (68%), 1990 (68%), 1991 (71%), 1992 (80%), 1993 (83%), 1994 (85%), 1995 (83%) and 1996 (86%). [1]

Various factors account for the NASD's growing share of new filings — including such empirical considerations as an increased sophistication of the claimants' bar and a concomitant dissatisfaction with other SROs. Over the same period, the AAA filings have steadily decreased. These statistics cannot, however, be read as a sign that customers' attorneys prefer the NASD over a neutral forum such as the AAA.

B. In a September 1987 letter to the Securities Industry Conference on Arbitration (SICA), the Commission urged that organization to request its members to include in standard customer agreements a provision allowing customers to arbitrate before the American Arbitration Association. However, instead of more broker-dealers adding the AAA choice to their standard arbitration provisions, broker-dealers continued to eliminate the AAA forum. As of January 1, 1997, none of the twenty largest full-service broker-dealers afforded customers the right to arbitrate before the American Arbitration Association. In June 1997 Schwab Securities unilaterally changed all account agreements to eliminate the AAA option.

C. In its amicus brief in Roney v. Goren, 875 F. 2d 1218 (6th Cir. 1989), the Commission noted the importance of customer choice of arbitration forums and the competitive benefit to both parties derived from such choices. See pages 16-21 of the amicus brief. However, any competitive effect of arbitration before "competing" SRO forums would seem to be greatly diminished by the persistently

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[1]In 1980 only 318 cases were filed with the NASD and 367 with the NYSE. Two years later filings at the NASD exceeded filings at the NYSE (606 vs. 558). And by 1985 the imbalance grew to 1400 vs. 1095.

large share of filings with the NASD (17,256 for the 1994-1996 period alone, compared to 2,169 for the same period with the NYSE).

D. Beginning in 1988, a very few customers tried to arbitrate before the American Arbitration Association pursuant to what is known as the "Amex Window." This is a provision of the Constitution of the American Stock Exchange whose Article VIII seemingly gives customers the option to arbitrate before the AAA if that customer had not agreed to arbitrate solely before the American Stock Exchange. Section 2(c) of this Article VIII provides that

> "...the customer may elect to arbitrate before the American Arbitration Association in the City of New York, unless the customer has expressly agreed, in writing, to submit only to the arbitration procedures of the Exchange."

To PIABA's knowledge there were never any standard form customer agreements limiting arbitration only to the American Stock Exchange.

Irrespective of the language of Article VIII, customer elections to arbitrate before the AAA pursuant to the Amex Window inevitably resulted in litigation, with mixed results. While the lower courts divided on this issue, two federal courts of appeal held the Amex Window available only if there is no customer agreement requiring arbitration before one or more of the SROs. See, Luckie v. Smith Barney, Harris Upham & Co., 999 F. 2d 509 (11th Cir. 1993), and PaineWebber, Inc. v. Rutherford, 903 F. 2d 106 (2d Cir. 1990). These decisions, however, contained no critical analysis of Article VIII, the Commission's present arbitration policy or SRO arbitration rules in general. Notably, lower court decisions supporting the customer choice of AAA arbitration generally set forth a solid analysis of the issue. See, e.g., Shearson Lehman Brothers, Inc. v. Brady, 783 F. Supp. 1490 (D.Mass. 1992); Prudential Sec. Inc. v. Thomas, 793 F. Supp. 764 (W.D. Tenn. 1992); Wade v. Prudential Sec. Inc., CCH Fed. Sec. L. Rep. ¶ 98,117 (N.D. Cal. Feb. 11, 1994), and Joseph v. Prudential Bache Sec. Inc., CCH Fed. Sec. L. Rep. ¶ 96,184 (Or. Cy Fla 1991). Understandably, the Commission took no public stance with respect to this litigation. The lone appellate decision supporting the Amex Window seems to be Cowen & Co. v. Anderson, 559 N.Y.S. 2d 225 (N.Y. 1990).

As result of a few customers trying to arbitrate before the AAA pursuant to the Amex Window, the American Stock Exchange in 1989 petitioned the Commission to shut the Window by limiting the AAA option only to those situations where there was no signed customer agreement requiring arbitration before one of the SROs. See the American Stock Exchange filing of Proposed Rule in 54 Federal Register (No. 229 at 49374, Nov. 30, 1989). There were three cogently-worded objections to the closure of the Amex Window, including one by Representative Markey. Eventually the Commission requested the Exchange to withdraw its proposed rule amendment. On June 2, 1994, the Exchange formally withdrew its filing.

Thus, there is no presently reliable method by which a customer can invoke the right to arbitrate before a non-industry forum if that customer signed any arbitration agreement currently utilized by major broker-dealers.

Even for those customers with no arbitration agreement, their right to arbitrate before the AAA has been fraught with great difficulty due to the unabashed position of the securities firms, viz., that all such arbitrations must take place "in the City of New York." Both the Amex and the AAA consider the Article VIII phrase, "in the City of New York," as a reference to the AAA home office: the Amex properly considers venue an issue to be decided by the AAA; and the AAA decides Amex Window venue disputes in accordance with its common sense, traditional guidelines. But all such Amex Window cases start out in court; and, again, the courts are split on the issue, with the decision turning on whether the 'court or the AAA' should decide the meaning of the phrase "in the City of New York." To date only one appellate decision has dealt expressly with this issue. Fahnestock v. Dean Witter Reynolds, Inc., 691 So.2d 509 (Fla. 4th DCA 1997) (the arbitrators make the venue decision). A recent decision with the same holding, McCullagh v. Dean Witter Reynolds, Inc., ____ F. Supp. ____ (MD Fla. 1997), is now on appeal to the Eleventh Circuit.

E. As the number of arbitration filings steadily increased, and the availability of the AAA forum steadily decreased, an accurate public perception arose that SRO arbitration was not always fair to the customer. The GAO Report on securities arbitration in May 1992 did not arrest this perception. In fact, this perception reflects the views of most PIABA members and is based on actual experience centering on arbitrator selection methods, parsimony in calculation of damages and a discouraging record on the practice of seldom awarding full costs

or any attorneys' fees even where called for by statute. In short, the acute perception is that the felt hand of the securities industry needs to be lifted to vindicate the belief expressed in Shearson/American Express v. McMahon, 482 U.S. 220, 96 L.Ed. 2d 185, 107 S.Ct. 2332 (1987), viz., that arbitration generally leads to results parallel to judicial resolution.

F. The ground swell for significant improvements in the fairness of SRO arbitration led to the appointment of the Ruder commission and its January 1996 NASD Task Force Report on Securities Arbitration Reform. The report listed more than 100 suggested improvements in the SRO arbitration process, nearly all of them non-controversial. The more controversial recommendations came down to three proposed rules: a rule significantly limiting the incidence and the amount of punitive damages by SRO panels; a rule for a controversial six-year eligibility period, and a random-type arbitrator selection rule, intended to implement in part the panel selection procedure of the AAA by the use of two lists of arbitrators, and more importantly to cure the unfair bias in the present selection process.

Neutrality of the American Arbitration Association

G. The Commission's Oversight Committee annually submits a report to Congress. Apparently nothing has come to the Committee's attention suggesting in any significant way that arbitration before the AAA is inherently unfair to either broker-dealers or customers.

Although the Commission's committee on arbitration oversight would have no direct, regulatory avenue to investigate and oversee AAA arbitration, PIABA believes this should be no barrier to the proposed NASD Window Rule:

(1) The public has always considered the AAA as party-neutral;

(2) Much litigation, particularly class actions, puts securities firms in court, which are a fortiori viewed as party-neutral;

(3) Until the 1987-1990 period, many firms gave customers the choice of AAA arbitration and there has never been a Commission study identifying AAA arbitration was anything but neutral;

(4) The GAO Report, supra, found no significant difference between the results of SRO and AAA arbitration;

(5) The Commission in its Roney v. Goren amicus brief , supra, urged the court to consider the importance of fostering competition between arbitration forums (as ultimately benefitting both parties);

(6) In September 1987 the Commission wrote SICA requesting it to urge its members to accord customers the choice of AAA as a forum (at the time the Commission's objective was, inter alia, to reduce the budget of the two SROs handling nearly all the arbitrations);

(7) The claimants' bar is far more sophisticated than even a decade ago and can be counted on to make the choice between SRO and AAA arbitration based upon traditional factors such as geography, the arbitrator pool, the nature of the case and estimated costs (all of which should greatly lessen oversight concerns); and

(8) It can be expected that a very significant number of new filings will be with the AAA, thereby materially reducing the NASD's arbitration budgetary problems which have apparently reached alarming heights, leading to a recent proposal for imposition on customers of large fee increases. Peradventure the NASD would welcome another forum sharing the economic burden of compulsory arbitration, much of which is now passed on to its industry members.

H. The Oversight Committee's actual procedures for watching over SRO arbitrations do not include following an arbitration from filing of the complaint through discovery and attendance at the actual hearing. Its work consists largely of statistical analyses of completed arbitrations. Much of this can be accomplished with respect to AAA arbitration, should the Commission so desire, because most AAA arbitration awards are sent to, inter alia, the *Securities Arbitration Commentator* for its award data base.

As noted above, the past ten years have seen an increasingly active and specialized claimants' bar develop, which will more than likely insure careful deliberation in the initial decision to select AAA arbitration and in monitoring the arbitration process itself, thereby easing any concerns for the customer the Commission may have felt in the past. It is believed that broker-dealers will not

be prejudiced by a neutral forum, particularly since the AAA Securities Arbitration Rules adopted in 1987 require an industry representative on three-member panels.

Purpose of the NASD Window Rule

I. The purpose of the proposed rule providing for an "NASD Window" is therefore as follows:

> To insure that all customers of member broker-dealers have the right to elect the non-industry AAA arbitration forum for controversies arising out of the members' business and to arbitrate that controversy pursuant to the AAA's arbitration rules in effect at the time of the election.

Petitioner notes that the AAA arbitration rules

1) Do not provide any strictures on arbitrator remedies;

2) Grant arbitrators broad authority in fashioning remedies (including punitive damages); and

3) Contain no arbitration eligibility rules.

J. In all such cases where the customer elects to arbitrate before the AAA, that arbitration will take place in the locale chosen by the AAA pursuant to its internal guidelines for selecting venue. Those guidelines employ traditional criteria for determining the situs of an arbitration hearing.

Text of Proposed NASD Window Rule

K. The proposed text of the Amendment to be added to the Code of Arbitration Procedure of the NASD is as follows:

10107 Submission to the American Arbitration Association.

(a) Any customer of a member firm may elect to arbitrate all controversies arising out of that member's business before the American Arbitration Association (AAA) in accordance with the arbitration rules of the AAA then in effect.

(b) The provisions of subsection (a) shall apply in all cases where the customer makes an election to arbitrate before the AAA whether or not the customer previously consented in writing to submit only to the arbitration procedures of securities industry self-regulatory organizations.

(c) The provisions of this rule may not be waived by any customer and any contractual provision, agreement or unilateral notice of a change to the contrary shall be void.

(d) Every member of this Association employing customer agreements containing arbitration provisions shall include in those agreements a notice of the substantive provisions of this rule beginning July 1, 1998. In addition, a separate notice of the substantive provisions of this rule shall be provided to all customers within 60 days from the effective date of this rule.

(e) The customer-agreement provision shall be in the same size print used in the members' heretofore standard arbitration provisions and shall be printed in close proximity on the same page as the members' standard arbitration provisions.

II

PROPOSED PANEL COMPOSITION AND ARBITRATION SELECTION RULES

Background and Purpose

A. Historically arbitration panels have been comprised according to two basic formats: neutral, or representational. A neutral panel is one where all the arbitrators are neutral to all parties. A representational panel is one in which each of the two parties appoints an arbitrator and these two agree upon and select a third arbitrator who hopefully is neutral. Securities arbitration today is the only known form of arbitration on a significant scale in which one of the parties is entitled to a representative arbitrator, with the remaining two arbitrators being neutral. In order to remedy this obviously unfair bias against the customer, the below rule is being proposed. This rule of course depends 100% upon a neutral, rotational selection rule for constituting these two different panels.

B. In securities arbitration the standard three-member arbitration panel has been comprised of one "industry" arbitrator, and two "public" arbitrators. The rationale given for including the industry person is that there is often a need for specialized expertise not thought to be possessed by the public arbitrators. PIABA does not agree to the universality of this need. But if this specialized expertise is desired, that expertise should be supplied by two arbitrators, each of whom understands the broader policy considerations of the respective sides.

C. Three-member securities arbitration panels will under the proposed rule be designated as either Public or Experienced. A Public panel will be composed of three Public arbitrators. An Experienced panel shall be composed of three arbitrators: a Public arbitrator, an Industry arbitrator and an Investor arbitrator.

D. If the securities industry's concern is truly focused on the need for specialized expertise in given cases, then it should have no objection to the Experienced panel because a majority of the panel members will be deemed to

have specialized knowledge and understanding of the policy considerations of each party.

E. As noted in the discussion of the proposed NASD Window rule, attorneys representing customers are now significantly more knowledgeable in selecting arbitration forums, panels and panel members than they were a decade ago. This stems in part from the availability of awards and background data on arbitrators, but mostly it is due to an increase in attorneys specializing in "retail securities," accelerated in part by former defense lawyers moving to the customer side. Indeed, the public seems more attuned to the issues of fairness in securities arbitration. It is for these reasons, inter alia, that PIABA proposes giving the customers and only the customers the choice of selecting AAA arbitration or NASD arbitration, and if the latter, the right to a Public panel, or to an Experienced securities arbitration panel (if the NASD deems it more appropriate). This choice of AAA or NASD would usually be made with the help of an attorney. PIABA believes that this choice represents minimum fairness in an arbitration system universally imposed upon the customer by form contracts, a system that has in the past four years been characterized, in PIABA's opinion, by a marked industry bias.

F. It is believed that a large percentage of customers and their attorneys would choose to arbitrate before the AAA if the NASD Window rule were adopted. It is further believed that a much larger percentage of customers (who for one reason or another file their claim with the NASD) will prefer a Public panel if the mechanics of arbitrator selection are fair and unbiased and made in strict accordance with PIABA's proposed rotational selection rule. However, PIABA acknowledges that in certain cases, especially those involving esoteric securities, the NASD can serve both sides by designating an Experienced panel.

G. The true rotational method of selecting Public as well as Experienced panels is crucial to containing the growing cancer on the present system, which sees all too many so-called public arbitrators act in a pro-industry fashion. This problem was throughly explored both statistically and anecdotally by Stuart Goldberg, PIABA's General Counsel, in his June 19, 1995 analysis. See Mr. Goldberg's "Preliminary Study: SRO Securities Arbitration and 'Evident Partiality.'" His study focused on 69 similar limited partnership cases submitted to single arbitrators at the Pacific Stock Exchange.. This inherent industry bias results in many so-called public arbitrators being invited to sit time and time

again, while other public arbitrators are seldom or never invited to sit on panels. These regularly-sitting arbitrators show as a group a pro-industry bent by almost any statistical and empirical analysis. They can best be described as quasi-professional arbitrators and keepers of the dike. In this most sensitive area of selection of public arbitrators it has often been said that "The hand that feeds is the hand that leads." Certainly no one knowledgeable in this field doubts that the hope of being invited back is a powerful rein on doing justice.

H. Fortunately, all interest groups recognize the necessity if not the desirability of carrying out the Ruder Commission mandate and adopting a workable, neutrally-administered rotational selection rule. PIABA believes its proposed rule is fair and can be administered with the least amount of discretion accorded the NASD case administrators. This rule would thus materially ease the case administrator's burden of selecting arbitrators, which presently leads to sharp criticism and frequent exchanges of correspondence with counsel for both sides as they attempt to remove one of the NASD's appointments for cause.

I. The very use of lists of arbitrators will of necessity eliminate most challenges for cause; and, concomitantly, the more neutral the panel selection, the greater the chance for a fair settlement short of the hearing itself.

Text of Proposed Rules on Panel Compositions and Definitions

J. The proposed text of this Amendment to be added to the Code of Arbitration Procedure of the NASD is as follows:

10108 Single Arbitration Cases.

(a) Customers filing claims for up to $35,000 shall have their claims heard by a single Public arbitrator.

(b) Customers may elect to have their claims decided upon the claim and such evidentiary material as the parties furnish the Public arbitrator.

10109 Panel Compositions.

(a) Customer claims for more than $35,000 shall be heard by a three-member panel and unless otherwise agreed to by the customer the claim shall be decided by a panel selected in accordance with the applicable rotational selection procedure of Rule 10111.

(b) Within 60 days after receipt of a customer complaint in arbitration, the NASD may determine that the case should be submitted to an Experienced panel; this determination shall be based upon consideration of the claims made, the securities involved and other apparent factors supporting the desirability for an Experienced panel. The Experienced panel shall be selected in accordance with the applicable rotational selection procedure of Rule 10111.

10110 Arbitrator Definitions.

(a) Public Arbitrator. An arbitrator who is not within the definition of a securities Industry arbitrator or Investor arbitrator, will be deemed a Public arbitrator. A person will not be classified as a Public arbitrator if the person:

* is employed by a bank, insurance company or other financial institution that is engaged in securities activities; or

* has a spouse or other member of the household who is associated with:
    * a member,
    * broker/dealer,
    * government securities dealer,
    * municipal securities dealer,
    * registered investment advisor, or

* registered under the Commodity Exchange Act, a futures association or commodity exchange, or
* is employed in securities activities by a bank or other financial institution.

(b) Industry Arbitrator. An arbitrator will be deemed as being an Industry arbitrator if that person:

(1) is associated with either:
* a member,
* broker/dealer,
* government securities broker or dealer,
* municipal securities dealer,
* registered investment adviser,
* registered futures association or commodity exchange or

(2) has been associated with any of the organizations under number (1) within the last 7 years; or

(3) has retired from or spent a substantial part of their career with any of the organizations under number (1); or

(4) is an attorney, accountant, or other professional who devoted 20 percent or more of their time to securities industry clients within the last 2 years, and has not devoted a larger percentage of their time, in the same period, on behalf of clients adverse to the securities industry; or

(5) is registered under the Commodity Exchange Act or is a member of a registered futures association or any

commodity exchange, or is associated with such person.

(c) Investor Arbitrators. An Investor arbitrator is a person who is not a Public or Industry arbitrator and who belongs to one or more of the following groups:

(1) Government official: for purposes of this rule a "government official" shall be a person who is or has in the past 7 years been employed by the government (federal, state or other public or quasi-public body, university or college) in any capacity, which functions include the administration, teaching, regulation, investigation, prosecution, or adjudication of broker-dealer registrations, securities registrations, or securities fraud adjudications.

(2) Investor Advocate: for purposes of this rule an "investor advocate" is a person (including an attorney) who devotes a substantial portion of his or her time to representing public investors in their disputes with broker-dealers.

Proposed NASD Arbitrator Selection Rule

10111 Rotational Selection of Arbitrators in Customer Disputes.

(a) The NASD shall assemble three separate pools of arbitrators on a regional basis and prepare "rotational lists" of the arbitrators in each pool: 1) a pool of Public arbitrators, 2) a pool of Industry arbitrators and 3) a pool of Investor arbitrators. A complete list of the arbitrators from each pool shall initially be prepared on

a fully random basis: the arbitrators on each rotational list shall then be assigned a permanent number. Arbitrators added to the pools thereafter shall be assigned the next available number on the appropriate rotational list.

(b) Unless otherwise agreed, a single Public arbitrator shall be selected by the parties as follows:

(1) Within 30 days after the arbitration claim is filed, the NASD will send each party a list of 10 Public arbitrators selected in numerical order from the Public rotational list;

(2) Each party may strike up to three names from this Public list.

(3) Each party shall number the remaining arbitrators on its list in order of preference and return the list to the NASD within 20 days from receipt; if a party does not return the list within this time period, all arbitrators on the list shall be deemed acceptable by that party.

(4) The NASD shall prepare a consolidated preference ranking list by combining the rankings of the arbitrators made by the parties on their lists.

(5) The NASD shall contact in writing the arbitrator with the highest preference ranking to see if that arbitrator can serve; if that arbitrator cannot serve, the NASD will contact the next arbitrator.

(c) Unless otherwise agreed by the parties, a three-member Public panel will be selected as follows:

(1) Within 40 days after the arbitration claim is filed the NASD will send each party a list of 12 Public arbitrators selected in numerical order from the public rotational list.

(2) Each party may strike up to three names from this Public list.

(3) Each party shall number the remaining arbitrators on its list in order of preference and return the list to the NASD within 20 days; if a party does not return the list within this time period, all arbitrators on that list shall be deemed acceptable by that party.

(4) The NASD shall prepare a consolidated preference ranking by combining the rankings of the arbitrators made by the parties on their lists.

(5) The NASD shall contact in writing those three arbitrators with the highest preference rankings to see if that arbitrator can serve. If one or more of the arbitrators contacted cannot serve, the NASD will contact in writing the next arbitrator or arbitrators on the preference ranking list in order to complete a three-member Public panel.

(d) If the NASD determines that the case should be submitted to an Experienced panel, the parties shall select the panel as follows:

the next numbered arbitrator from the appropriate regional rotational list until the panel is completed. An arbitrator selected from any of the three rotational lists and included on the arbitrator lists sent to the parties shall be eligible for selection to another list only after all other arbitrators from the appropriate regional lists have been selected and included on an arbitrator list for a claim in arbitration.

(f) In the event an arbitrator is disqualified or resigns after appointment the NASD shall select another arbitrator in accordance with the procedures under paragraphs (b), (c) and (d) above.

(g) In the event of a tie in the preference rankings on any list under this rule, the next arbitrator from the list will be decided alphabetically by last name.

(h) For each arbitrator selected and named on an arbitrator list sent to the parties, the NASD shall provide the parties with the arbitrators' employment history for the preceding ten years, the information disclosed to the NASD by the arbitrator pursuant to Rule _____ of the Code and a list of the known awards where the arbitrator sat as a panel member.

(i) The parties may by mutual agreement select one of the arbitrators to be chairperson of the panel. If the parties cannot agree within ten days after being notified of the composition of the panel the NASD shall appoint one of the Public or Investor members as chairperson with preference given to the most senior attorney should one or more of those members be an attorney.

(j) In the event the NASD determines on the basis of any information coming to its attention from any source, including a party, that any member of the panel is disqualified from service, the parties shall be informed

The Public Arbitration Bar Association

/s/
Rosemary Shockman, Esq.
President

/s/
Stuart Goldberg, Esq.
General Counsel

/s/
Robert Dyer, Esq., Chairman
SEC Petition Committee
James E. Beckley, Esq.
Joseph C. Long, Esq.