Public Investors Arbitration Bar Association

August 18, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: **File No. SR-FINRA-2010-036 – Amendment No. 1**, **Effect of Arbitration on FINRA Regulatory Activities; Arbitrator Referral During or at Conclusion of Case**

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Association[1], I thank you for the opportunity to comment on the above-referenced rule proposal filed by the Financial Industry Regulatory Authority ("FINRA"). The currently proposed rule is reflected in Amendment No.1 to SR-FINRA-2010-036. It replaces and supersede FINRA's initial 2010 proposal on this topic.

FINRA seeks to amend FINRA Rule 12104 of the Code of Arbitration Procedure for Customer Disputes ("Customer Code") so as to broaden the power of arbitrators to make mid-case referrals to FINRA Dispute Resolution. The proposal also allows for recusals, and cost assessments against the parties, including apparently the innocent investors, when an arbitrator makes a mid-case referral due to his belief that a "threat, whether ongoing or imminent, is likely to harm investors unless immediate action is taken". Proposed Amendment No.1 provides that: 1) mid-hearing referrals be allowed only after evidentiary hearings have begun (Rule 12104(b)); 2) referrals be made only to the Director of Arbitration, who would inform the parties of the fact of referral, and advise the parties they may then seek recusal of the referring arbitrator under existing [Arbitration] Code provisions, with added costs and expenses assessed pursuant to traditional recusal situations (Rule 12104(c)); 3) the President and

[1] PIABA is a bar association whose member attorneys are devoted to representing the interests of investors in disputes with the securities industry. PIABA was established in 1990 as an educational organization for securities arbitration attorneys who represent the public investor in securities disputes. PIABA members are involved in promoting the interests of the public investor in securities and commodities arbitration

Director of Dispute Resolution will determine whether the referral needs to be forwarded to appropriate FINRA divisions; and 4) post-hearing referrals may be made not only for disciplinary proceedings, but also for conduct that arbitrators believe may violate the rules of FINRA.

PIABA commends FINRA's efforts to address the investor protection concerns identified by PIABA and others who objected to FINRA's initial 2010 proposal. Most notably, FINRA's current proposal eliminates the "new panel" option of the initial proposal that would have allowed any party to demand dismissal of the entire panel upon the referral of even a single arbitrator. In addition, FINRA properly proposes to limit mid-case referrals to only those cases where an arbitration hearing is underway, and even then, such referrals should be delayed if the conclusion of the case is near and other stated concerns are satisfied. While PIABA supports these improvements to FINRA's initial 2010 proposal, it objects to the currently proposed rule 12104(c), which states, among other things, that the parties will be advised if an arbitrator has made a referral and that the parties may seek to recuse the arbitrator under existing procedure. According to FINRA's discussion, assessment of costs associated with replacing and educating a newly appointed arbitrator would be at the discretion of the panel. Under such a rule, an aggrieved investor involved in an arbitration could be assessed the costs associated with replacing the arbitrator. This is unfair. An investor already victimized should not be required to pay these additional costs in cases where recusal invariably would arise through the likely past conduct of a member firm respondent. Furthermore, the proposed rule will invite recusal motions, as well as appeals, however frivolous, to the detriment of investors. Thus, the current proposal is not sufficiently tailored to address investor protection concerns, and would likely negatively impact investors.

FINRA should not require public investors who are forced into the industry arbitration forum to be saddled with any unnecessary delays or added costs when an arbitrator finds that an industry party or non-party is posing a "serious threat" likely to harm investors on a massive scale. These burdens should be borne by industry respondents, or by FINRA as part of its mission to better to detect fraud. These and other procedures in FINRA's current proposals are inconsistent with the provisions of Section 15A(b)(6) of the Act[2] and should be rejected.

The Purpose of the Proposed Rule

At the outset, we note that the proposed rule generally appears to be a solution without a problem, the implementation of which would pose penalties on investors who have been harmed by the conduct of FINRA members. The purpose for the proposed rule, as set forth in Amendment No. 1, is vaguely referenced as the detection of "well

[2] 15 U.S.C. 78o-3(b)(6).

publicized securities frauds that resulted in harm to investors" as justification.[3] While overall goals of investor protection are laudable, the rule proposal fails to identify those frauds. Nor does the proposal illustrate how mid-hearing referrals in customer cases (followed by disclosure of the referral, likely recusal motions, and added costs to investors), might have protected public investors in the past.

FINRA should be required to set forth specifics relating to the background and context of this rule proposal, as opposed to generalizations, before imposing new burdens or delays on investors involved in arbitration. Indeed, operation of the proposed rule may discourage claimant investors from presenting information that may implicate widespread fraud. Arbitrators similarly may be reluctant to refer matters than might lead to recusal motions and inability to be selected for future arbitrations. Such anomalous results do not serve FINRA's core purpose of protecting investors.

Proposed Rule 12104(b), Grounds For Mid-Case Referrals

While FINRA's purpose stems from recent well-publicized securities frauds, FINRA later states that the threshold for mid-hearing referrals is lower than that of concluding there has been fraud. The arbitrator need only have reason to believe a matter or conduct "poses a serious threat, whether ongoing or imminent, that is likely to harm investors unless immediate action is taken". FINRA states that by establishing this threshold, which is lower than requiring a conclusion of fraud, a prevailing investor will be less prone to appeals. PIABA believes the threshold basis for mid-referrals is sufficiently ominous. The proposed threshold for referral clearly implicates serious wrongdoing, on a widespread scale. Appeals would be no less likely under the proposed threshold, than it would be if the threshold required detection of widespread fraud. While the referral may be important, PIABA cannot support mid-hearing referrals that require disclosure to the parties, either of which may file consequent appeals, however frivolous. Moreover, the provisions for recusal and subsequent activity are onerous and unnecessary as discussed below.

Proposed Rule 12104(c) – Recusal

Rule 12104(c) would require that the parties be informed of the "fact" of referral. The proposal goes on to highlight that any party could then seek to recuse the arbitrator under existing rules in the Code. Put another way, if an arbitrator observes a 'serious

[3] FINRA does not identify specific examples where such disasters could have been alleviated through arbitrator referrals. Moreover, FINRA could and should already urge any person with information suggesting such horrific scandals to contact FINRA's ombudsman, the SEC or other authority immediately, on an anonymous basis if needed. PIABA speculates that the well-publicized securities fraud refers to the Bernie Madoff matter. Our research indicates that there were no arbitration claims commenced against Mr. Madoff's 'investment advisory arm' prior to his surrender to the authorities.

threat' likely to harm investors if immediate action is not taken, (almost certainly against the member firm or associated person), counsel for that industry party could attempt to recuse the arbitrator for that reason, and potentially bring frivolous appeals whether or not recusal is granted. It is fairly well presumed that counsel for the respondents will always make such a recusal motion. Some arbitrators may also be bullied into recusal by counsel, thereby imposing undue burdens on the investor who has to cope with delays and costs incurred to resume arbitration with a new arbitrator.

FINRA should amend this section of the rule proposal to emphasize that mid-hearing referrals do not support independent, new grounds for recusal. Furthermore, FINRA should consider including in its Arbitrator Training Manuals and Reference Guides those authorities, including those cited in it proposed rule filing, which explain that arbitrators formation of views concerning evidence during the course of hearing does not give rise to bias requiring recusal.

Customers Likely Will Suffer Prejudice And Unjustified Costs Upon Application of Proposed Rule 12104(c)

Although FINRA's proposed rule may only come into play in cases where an arbitration hearing is scheduled over weeks or months, with gaps between hearing dates, the prejudice and costs to those investors could be devastating. For example, FINRA proposes that in three person panels, the parties may stipulate how evidence will be presented to the replacement arbitrator and to the structure of new hearing dates. However, in the probable event that the parties cannot so stipulate, particularly as to materials concerning the scandalous issues referred, FINRA would allow the arbitrators, including the replacement arbitrator, to decide what evidence will be reviewed and how to proceed. The investor would thus forfeit the ability to present his case as he would otherwise be entitled to do, had there not been a mid-case recusal. The new panel may shy away from considering evidence that led to the recusal, even if highly relevant to the case. In one arbitrator cases, the replacement arbitrator similarly would dictate what evidence to accept from the prior proceeding if the parties do not stipulate.

In addition, recusal and replacement of arbitrators often result in delayed hearing dates, with herculean efforts needed to re-schedule according to availability of the parties, witnesses, counsel, and the new panel. Existing arbitrators and counsel may already have full schedules for the immediate future, causing unnecessary delay. In any case, whether a hearing can be rescheduled, resumed quickly or not, the costs to counsel and the parties can be significant. Experts and lay witnesses will likely have to travel yet again to the new hearing dates. Claimants may have to take off from work, again. Counsel will have to expend many hours to effectively re-start the hearing, potentially many months in the future, on a matter they were prepared to try and complete earlier in time. Counsel may be already committed to other matters for an extended time

beyond the original hearing dates, leaving claimants with the burden, stress and expense of needing to retain new counsel. We appreciate fully that FINRA does not intend to create avenues for these added, unnecessary costs, or to interfere with the parties' ability to continue with counsel. Nevertheless, the proposed rule presents real risk of these added burdens. Over time, investors may decide arbitration is too costly and skewed to undertake in the first instance.

There is also the concern that regardless of whether the recusal is granted, respondents will use the fact that an arbitrator made a referral as grounds to file a motion to vacate if an award is not in their favor. Whether or not courts are likely to grant such a motion, investors will incur additional delay and expenses related to defending the motion. Arbitration, which is meant to be a speedy and efficient means of resolving disputes, will become even less so than it is now.

The Proposed Provisions For Recusal Are Unworkable and Unnecessary

In addition to the unfair burden and significant expense the proposed rule would impose upon investors, the procedures may create new and potentially never-ending problems. For instance, what happens if the replacement arbitrator, or existing arbitrators, come upon the same information and make the same referral? Is another recusal possible? Would the member firm or associated person likely implicated in the referral be able to challenge the entire panel on the basis that all the arbitrators heard the same evidence as the referring arbitrator? Would Claimants' counsel be able to argue that the non-referring arbitrators should recuse themselves if they did not see or agree with the 'threat' reported by the referring arbitrator? Would not replacement arbitrators be able to review the record (though not executive sessions) and also identify the same "serious threat" that led to the mid-case referral? Will any of the arbitrators know that the previous arbitrator(s) was recused under either of the Code's provisions for recusal, because he saw a serious threat likely to harm investors unless immediate action was taken? In all likelihood, the non-referring arbitrators will have at least some idea of the circumstances and evidence. Should an investor be prevented from presenting the scandalous evidence to the replacement arbitrator, once those questions are placed in the hands of the arbitrators? And, for the arbitrators to answer these questions, would they not have to review at least a proffer concerning the 'serious threat'? In short, the rule proposal raises more questions than answers.

PIABA also submits that there is no showing of any kind that the proposed rule would benefit investors. On the other hand, it is very likely that the proposal would unfairly and unnecessarily prejudice investors, unlucky enough to have a case where the industry wrongdoing extends beyond their case. The extra costs, expenses, rescheduling and potential inability to present evidence to the replacement arbitrator if it implicates the basis for the mid-case referrals outweighs the vaguely stated benefits of the

proposed rule. Such a doubly aggrieved investor would be subjected to costs and time needed to educate replacement arbitrators at a minimum. The proposed rule would also effectively foster frivolous appeals.

Text of Proposed Section 12104(e) Should be Approved

FINRA's proposed Rule 12104(e) governing post-hearing referrals is substantially identical to current Rule 12104(b), with minor, positive changes. The Proposed Rule 12104(e) slightly expands the grounds for arbitrator's post-hearing referrals. At the conclusion of an arbitration, arbitrators may refer matters or "conduct" that came to their attention during the course of the hearing, and which may violate the rules of FINRA or other applicable laws and rules. The referral need not be limited to one for disciplinary investigation; it may be referred generally for any FINRA investigation. PIABA supports these particular changes which will efficiently promote investor protections.

FINRA expends considerable resources in training its arbitrator pool to be the fair and impartial triers of arbital disputes. An arbitrator must always maintain an appearance of neutrality and lack of bias until all of the evidence has been presented in a particular case. Although laudable in trying to prevent harm to the investor public, the proposed rule serves to transform neutral arbitrators into police officers. FINRA employs scores of investigators and auditors to regulate the financial industry - it's the job of these employees to ferret out widespread fraud, not the independent arbitrators appointed to fairly determine cases. With this in mind, consideration should be given to withdrawing the proposed rule change as it relates to mid-hearing referrals.

Conclusion

Existing FINRA Rule 12104 requires a panel to wait until after they have issued an award before making a disciplinary referral. We are unaware of any situation where the public at large was harmed by waiting until the hearing is concluded. FINRA does not adequately explain or illustrate how mid-case referrals could have prevented widespread harm in the past, or how the proposed procedures are best tailored to meet the important goals of fraud detection.

The proposed Rule 12104(c) would cause more harm than good to public investors who practicably may be unable to ever present the full extent of their case, should it implicate imminent harm to others as well as to themselves. FINRA's proposed manner of dealing with mid-case referrals is misguided. The proposed rule invites recusal motions, delayed arbitration hearings, possible relinquishment of investor claims, and frivolous appellate activity, all at the expense of investors who were compelled to arbitration by the same member firms whose conduct likely caused the arbitrator referral.

PIABA believes the proposal can and should be further improved. Alternatively, the current rule should be left substantially intact[4], with adoption only of the minor changes reflected in proposed 12104(e).

We thank you again for the opportunity to comment upon this rule proposal, and welcome further dialogue as the SEC or FINRA may desire. At present, we urge the SEC to either reject this rule, or to require further amendment as suggested by our comments herein.

Respectfully submitted,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

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[4] Arbitrators could alternatively be permitted to make anonymous referrals. FINRA Enforcement could then investigate the arbitrator referral and determine whether violations are occurring. However, FINRA Enforcement should not be confused with FINRA Dispute Resolutions. These are two separate functions, both of which are necessary to protect the investing public. They should not be combined to the benefit of the arbitrating member firm and the detriment of the arbitrating customer. Anonymous referrals would provide the desired benefit without the unacceptable collateral damage.