

## FINRA PROPOSED RULE CHANGE WOULD GIVE CUSTOMERS OPTION OF ALL-PUBLIC ARBITRATION PANELS

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Brokerage firms customarily include in their customers' agreements a predispute arbitration agreement requiring that investors arbitrate their disputes before an arbitration panel of the Financial Industry Regulatory Authority (FINRA). Current rules governing customers' claims over \$100,000<sup>1</sup> require each three-person panel to include one non-public, or industry, arbitrator in addition to one public arbitrator and one chair-qualified public arbitrator.<sup>2</sup> Investor advocates long have argued that the mandatory inclusion of an arbitrator with ties to the securities industry was unfair to investors and gave the securities industry one decision-maker who would be sympathetic to its position.<sup>3</sup> Indeed, a recent study of participants' perceptions of the securities arbitration process that I co-authored found that investors have a far more negative perception of securities arbitration than all other participants in the process and perceive a strong bias in arbitrators.<sup>4</sup>

On October 25, 2010, FINRA filed a proposed rule change with the Securities and Exchange Commission (SEC) to respond to these negative perceptions.<sup>5</sup>

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<sup>1</sup> FIN. INDUS. REGULATORY AUTHORITY, FINRA MANUAL r. 12401 (2009), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4139](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4139). Claims under \$100,000 are heard by a single arbitrator.

<sup>2</sup> FINRA MANUAL r. 12100(p) (2010), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4099](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4099).

<sup>3</sup> NASAA Pro-Investor Legislative Agenda for the 111th Congress, N. Am. Sec. Adm'rs Ass'n (Jan. 2009), [http://www.nasaa.org/issues\\_\\_\\_answers/legislative\\_activity/10147.cfm](http://www.nasaa.org/issues___answers/legislative_activity/10147.cfm).

<sup>4</sup> Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349.

<sup>5</sup> Notice of Filing of Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes, Exchange Act Release No. 34-63,250, 75 Fed. Reg. 69,481 (Nov. 12, 2010), available at <http://www.gpo.gov/fdsys/pkg/FR-2010-11-12/pdf/2010-28419.pdf>.

FINRA's proposed rule change would give customers the option to choose an arbitration panel consisting entirely of public arbitrators. FINRA stated that giving customers this option would "enhance customers' perception of the fairness of FINRA's rules and of its securities arbitration process."<sup>6</sup> The proposed rule change requires SEC approval; the period for public comment will expire on December 3, 2010.<sup>7</sup>

Under the proposed rule change, customers can choose between two panel selection options: the Majority Public Panel, which retains the current panel composition method, or the Optional All Public Panel, which would guarantee that any party could select an all-public panel. Customers must affirmatively elect the Optional All Public Panel procedures early in the process; otherwise, FINRA would apply the procedures for the Majority Public Panel option.

The Majority Public Panel option retains the current three-arbitrator panel. The parties select their panel by striking names from three lists of ten arbitrators (one list per arbitrator type) and then ranking the remaining arbitrators. Each party may strike up to four names from each list. FINRA appoints the panel from among the names remaining on the lists that the parties return.

The process for striking non-public arbitrators, however, is different under the Optional All Public Panel approach. Instead of limiting strikes to four non-public arbitrators (the current approach, which would continue under the Majority Public Panel option), each party could strike all ten names. Taking this option would guarantee that no non-public arbitrator would be appointed to the panel. In that case, FINRA would appoint the next highest-ranked public arbitrator to complete the panel.

In October 2008, FINRA launched a voluntary pilot program with a number of brokerage firms that allowed eligible claimants to select all public panels.<sup>8</sup> FINRA designed the program to run for two years, from Oct. 6, 2008 through Oct. 5, 2010. Participating firms recently agreed to extend the pilot program for a third year.<sup>9</sup> FINRA reported interim findings as of June 1, 2010. Investors in 485 of a total of 853 cases eligible for the pilot program chose to participate. In the 361 cases (of 485) where parties completed arbitrator rankings, the investor chose to rank one or more non-public arbitrators on the list in 187, or 52%.<sup>10</sup> Panels have not yet issued a sufficient number of awards to enable accurate statistical analysis of the effect of

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<sup>6</sup> *Id.* at 69483.

<sup>7</sup> *Id.* at 69484.

<sup>8</sup> See *Public Arbitrator Pilot Program Frequently Asked Questions*, FINRA, <http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P116995> (last visited Oct. 29, 2010).

<sup>9</sup> *Id.*

<sup>10</sup> Kenneth L. Andrlichik et al., *The Financial Industry Regulatory Authority's Dispute Resolution Activities*, 1829 PRACTISING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 37, 45 (2010).

the alternative panel structure.<sup>11</sup> However, FINRA cited the positive reaction from participants in the pilot program as a motivating factor for its proposed rule change.<sup>12</sup>

The SEC must approve the proposed rule change if it is “consistent” with the Securities Exchange Act of 1934 and the regulations that are applicable to FINRA.<sup>13</sup> In particular, section 78o-3(b)(6) requires the SEC to ensure that FINRA rules are 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; and also that they are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.<sup>14</sup>

Previously, the Securities Industry and Financial Markets Association (SIFMA) strongly defended the mandatory inclusion of an industry arbitrator, asserting that the industry arbitrator’s expertise benefits both parties<sup>15</sup> and that there is no evidence that the presence of an industry arbitrator “somehow infuses pro-industry bias into the process.”<sup>16</sup> SIFMA and other leaders in the securities industry have not yet publicly commented on FINRA’s proposed rule change, and it is not certain that the industry will speak with a united voice on this issue. At least some in the industry may object that the proposed rule change unfairly discriminates against brokerage firms and registered representatives.

The proposed rule change will not satisfy the critics who continue to doubt the fairness of requiring customers to agree *ex ante* to FINRA securities arbitration. I personally would prefer a rule that made the All Public Panel approach the default choice. The experience with the pilot program indicates that a majority of customers want the option of an all-public panel, even if ultimately they do not strike all the names of industry arbitrators on their list. Nevertheless, adoption of the proposed rule change should help to improve investors’ perceptions of FINRA arbitration’s fairness. Such a result will advance the goals of protecting investors and increasing investor confidence in the capital markets.

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<sup>11</sup> *Id.*

<sup>12</sup> Proposed Rule Change Relating to Amendments to the Panel Composition Rule, 75 Fed. Reg. at 69,482.

<sup>13</sup> 15 U.S.C. § 78s(b)(2) (2006).

<sup>14</sup> §§ 78o-3(b)(6).

<sup>15</sup> SEC. INDUS. & FIN. MKTS. ASS’N, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY 36 (2007), available at <http://www.sifma.org/issues/item.aspx?id=21334>.

<sup>16</sup> *Id.* at 35.