THE IMPORTANCE OF ARBITRATOR DISCLOSURE

A Report By Public Investors Arbitration Bar Association (PIABA) Shows That The Cornerstone of FINRA Arbitration Has Serious Flaws And That The Forum Is Unfair To Investors.[1]

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Foreword

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In 1987, the Supreme Court decided *Shearson/American Express, Inc. v. McMahon*,[5] and held that pre-dispute arbitration agreements in the brokerage industry were fully enforceable. At the time *McMahon* was decided, there were at least ten industry-operated arbitration forums.[6] Since then, pre-dispute arbitration agreements have become pervasive, and customers are compelled to arbitrate virtually every dispute they have with the brokerage industry. Realistically, therefore, arbitration has become the mandatory form of dispute resolution.

Today, FINRA resolves virtually all securities arbitration disputes. As basically the only remaining game in town, FINRA owes the public an even greater duty to ensure a level playing field, which includes providing parties with

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[1] PIABA is an international, not-for-profit, voluntary bar association of lawyers who represent claimants in securities and commodities arbitration proceedings and securities litigation. The mission of PIABA is to promote the interests of the public investor in securities and commodities arbitration, by seeking to protect such investors from abuses in the arbitration process, by seeking to make securities arbitration as just and fair as systemically possible and by educating investors concerning their rights.

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[5] 482 U.S. 220, 107 S. Ct. 2332, 96 L. Ed. 2d 185 (1987).

[6] *See*, GAO, *SECURITIES ARBITRATION HOW INVESTORS FARE*, Rep. No. GAO/GGD 92-74 (May 1992), p. 20.

neutral and impartial arbitrators as well as a transparent arbitrator disclosure process – the cornerstone of the integrity of arbitration. Indeed, because of its virtual monopoly position, the need for independent oversight over FINRA's arbitration forum is even greater today than when multiple competing forums existed.

In 1977, the Securities Industry Conference on Arbitration (SICA) was established to create greater uniformity and clarity in the rules of arbitration at the various SROs. Since its inception, SICA has actively participated to improve the integrity of the SRO arbitration process, detailing its activities since its creation in fourteen publically issued reports.

SICA's independence, as an amalgam of the various constituents of arbitration, has been its strength during almost four decades of existence. That strength has maintained uniformity of procedures and assured independent public participation in conjunction with the government's oversight of the process. This system of checks and balances worked well and resulted in steady and meaningful change that improved the arbitration process, gaining the trust and confidence of the public investor. Public confidence in a securities arbitration forum relies upon independent public participation in the oversight function and rule making process. SICA played a vital role in improving the public's perception of fairness regarding securities arbitration.

Unfortunately, in recent years, FINRA has effectively minimized SICA's role in facilitating independent public participation in the oversight of FINRA's arbitration forum by delegating that role to its own appointed committee, the National Arbitration & Mediation Committee (NAMC). As a result, FINRA's arbitration process has become less transparent.

The public interest in arbitration's fairness should not be solely safeguarded by government oversight and it is doubtful that the NAMC – no matter how talented or well-meaning its members - can be perceived as adequately independent under a system where parties have nowhere else to go. I am not in this Foreword minimizing the contributions of present or former NAMC members to improving the arbitration process. However, all NAMC members are selected by FINRA and NAMC's agenda is set by FINRA.

In contrast to NAMC, SICA has been able to maintain its independence, in part, because it requires that new public members be selected by existing seated and emeritus public members of SICA. This process worked well and it ensured

that the new public members were considered by the remaining public members to be truly public representatives and to be people whom they believe would make a contribution to SICA's deliberations.

It is noteworthy that in 1987 (ten years after the creation of SICA) that the majority opinion in *McMahon* recognized the great strides achieved in arbitration procedures since the Supreme Court's decision in *Wilko* some 24 years earlier.[7] Moreover, Justice Blackman in his dissenting opinion also recognized that of "particular importance has been the development of a code of arbitration by the Commission with the assistance of representatives of the securities industry and the public"[8] – i.e., SICA. Furthermore, after *McMahon*, SICA received a letter from Richard D. Ketchum, the then Director of the division of Market Regulation with the Securities Exchange Commission, encouraging SICA to continue its role as an independent voice in the securities arbitration community.[9]

Without such independent scrutiny, public confidence in arbitration will erode, chipping away at the trust and confidence earned over the last four decades. If securities arbitration were *optional*, perhaps FINRA's current practices of self-evaluation would not be so troublesome; but in the present climate, where FINRA arbitration is effectively *mandatory*, it is disturbing.

I am not in this Foreword taking a position on whether arbitration should be mandatory or voluntary or a hybrid of both. I believe, however, at the very least, that life without an independent group like SICA to provide the public with a meaningful opportunity to critique FINRA's arbitration process will surely energize the movement to make arbitration voluntary again, as it basically was before *McMahon*[10]. Moreover, without such independent scrutiny, the perceived integrity of the present system of resolving securities disputes will suffer to the detriment of all parties involved.

[7] 482 U.S. 220 at 233
[8] 782 U.S. 220 at 258
[9] *See* Letter from Richard G. Ketchum to SICA (September 10, 1987).
[10] *See* C. Katsoris, *Riding the Trojan Horse Back to Wilko?,* 10 SEC. ARB. COMMENTATOR, NO. 7 AT 1 (July 1999); *see also* C. Katsoris*, The Trojan Horse Revisited*, SEC. ARB. COMMENTATOR, NO. 4 AT 1 (Mar. 2013).

Introduction

The question of whether industry-sponsored securities arbitration is fair to investors has been a subject of debate for over three decades. Investor advocates argue that securities arbitration is unfair, inefficient, expensive, and biased towards the securities industry. The securities industry, on the other hand, contends that the arbitration process works well, is faster and less expensive than litigation, and is fair to all the parties involved.[11]

Measuring the fairness of industry-sponsored securities arbitration is difficult. In 1992, just five years after *McMahon*, the United States General Accounting Office ("GAO") conducted a study regarding the fairness of securities arbitration (the "1992 GAO Study"), and issued a report entitled, *Securities Arbitration, How Investors Fare.* The 1992 GAO Study examined results in arbitrations over an eighteen-month period from January 1989 to June 1990. It concluded, among other things, that about 60% of investors who submitted claims to industry-sponsored arbitration forums, such as the NASD and NYSE[12], received an award in some amount, and that the amount awarded averaged about 60% of the amount claimed.[13] Since 1992, the win rates for customers have fallen as low 37% in 2007 and were approximately 42% in 2013.[14] Claimants' percentage recovered has also sharply declined.[15] According to a March 2014 article entitled *So You Think You Know The Worst FINRA Arbitration Venues?*, written by a prominent law firm that represents the securities industry, the most favorable states for respondents are Hawaii, West Virginia, Mississippi, Rhode Island, Iowa, Washington, Nevada, Alabama, Connecticut and Georgia because each have low win rates (e.g. 86% zero rate in Hawaii) and when claimants win, arbitration panels in those states award claimants between 1%-10% of the alleged damages.[16]

The 1992 GAO Study cautioned, however, that a statistical analysis of overall arbitration results indicated little about the fairness of individual cases.[17] The GAO correctly stated that the "fairness of arbitration cases, regardless of the

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[11] Jill Gross, Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, Journal of Dispute Resolution (2008) at 3.
[12] In 2007, the National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) merged to become FINRA.
[13] See GAO Report, *supra*, note 2, p. 7.
[14] http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/; see also Securities Arbitration Commentator (June 2014).
[15] S. Lawrence Polk, *So You Think You Know The Worst FINRA Arbitration Venues?*, Law360 (March 21, 2014)
[16] *Id.*
[17] *Id.*

forum, depends largely on the impartiality and competence of individual arbitrators."[18]

FINRA, today's only remaining SRO arbitration forum, acknowledges and agrees that it has a duty to ensure that its arbitrator roster consists of impartial and neutral arbitrators. In fulfilling that duty, it correctly states in its Arbitrator Guide that "arbitrator disclosure is the cornerstone of FINRA arbitration."[19] FINRA's Code of Arbitration also requires that arbitrators disclose any circumstance which might preclude an arbitrator from rendering an objective and impartial determination in the proceeding. This obligation is a continuing duty that requires an arbitrator who accepts appointment to an arbitration proceeding to disclose, at any stage of the proceeding, any such interests, relationships, or circumstances that arise, or are recalled or discovered.[20]

Therefore, the fairness of FINRA's arbitration forum should be judged on whether FINRA's arbitrator disclosure process adequately protects investors by eliciting complete, meaningful, reliable and timely disclosures about FINRA's arbitrators. Disclosures about potential conflicts of interest or bias are of particular importance.

The importance of arbitrator disclosures becomes even more apparent when one considers that arbitrators' failure to disclose potential and actual conflicts of interests and biases is one of the most common, if not the most common, reason that motions to vacate arbitration awards are filed in courts. Courts are hesitant to grant such motions, however, because of the stringent standard of review and limited legal grounds for vacating arbitration awards.[21] As a result, parties that are harmed by arbitrators' inadequate or even false disclosures realistically are left with no meaningful recourse.[22]

This report analyzes FINRA's arbitrator disclosure process to determine whether it is designed and operates to elicit meaningful, reliable and timely

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[18] *Id.*
[19] FINRA Arbitrators Guide (2014), p. 17.
[20] See Rule 12405, FINRA Code of Arbitration.
[21] See e.g., *Stone v. Bear, Stearns & Co., Inc.*, 872 F. Supp. 2d 435 (E.D. Pa. 2012) *Rosen Capital Partners, LP v. Merrill Lynch Prof'l Clearing Corp.*, 2013 WL 428460 (Cal. Ct. App. Feb. 5, 2013).
[22] Barlyn, Suzanne, Reuters, *Wall St. arbitrator booted for fake credentials heard nearly 40 cases* (March 25, 2014). (FINRA arbitrator falsely represented that he was an attorney and decided approximately 40 arbitration cases. Since the arbitrator's misrepresentations were not discovered until after the deadline to file a motion to vacate, most, if not all, of the parties impacted were time barred under the FAA to vacate the awards).

disclosures, particularly disclosures related to potential conflicts of interest or biases.

FINRA's arbitrator disclosure process begins with FINRA's recruitment of arbitrators. After recruitment, FINRA's process for eliciting information about conflicts and biases from arbitrators begins with the FINRA Arbitrator Application.[23] After an applicant completes the FINRA Arbitrator Application, the FINRA staff screens the applications. The background information from the application is entered into a FINRA database and portions of information from the application is used to create an Arbitrator Disclosure Report for each arbitrator.[24] After Arbitrator Disclosure Reports are created for the applicants, FINRA forwards the Arbitrator Disclosure Form(s) to the Neutral Roster Sub-Committee of NAMC for review and approval.[25] In participating with the approval of an arbitrator applicant, the members of the sub-committee are only provided with the Arbitrator Disclosure Report for each arbitrator applicant.[26] PIABA confirmed that sub-committee members are not provided with copies of the applicants' FINRA Arbitrator Applications. PIABA also confirmed that FINRA does not provide sub-committee members with any information about how applicants are recruited to become arbitrators.

If and when an arbitrator applicant is accepted to FINRA's arbitrator roster, under FINRA rules, parties receive an Arbitrator Ranking List and Arbitrator Disclosure Reports for each arbitrator within thirty days of an answer being filed.[27] The parties are expected to rely on the information contained in the reports to rank and strike the arbitrator candidates. FINRA relies solely on the Arbitrator Disclosure Report(s) to notify the parties of any actual of potential conflicts of interest and biases. FINRA does not allow parties a formal *voir dire* process before selecting arbitrators. FINRA's Code of Arbitration permits parties to request additional information from the arbitrators before the deadline to rank and strike the arbitrator lists.[28] However, the rule does not require arbitrators to answer the questions at all or under oath.[29]

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[23] A copy of FINRA'S Arbitrator Application is attached as Exhibit A to Appendix.
[24] *See* FINRA Arbitrator Application, Ex. A at 4.
[25] *Id*.
[26] An example of an Arbitrator Disclosure Report is attached as Exhibit B to Appendix.
[27] *See* Rule 12403, FINRA Code of Arbitration; An example of an Arbitrator Ranking List is attached as Exhibit C to Appendix.
[28] Rule 12403, FINRA Code of Arbitration.
[29] *Id*.

After FINRA appoints arbitrators to a panel based on the parties' ranking forms, FINRA requires each arbitrator on the panel to complete the FINRA Oath of Arbitrator and accompanying questions that relate to conflicts/biases.[30]

Pursuant to Rule 12405, arbitrators have an on-going duty to disclose conflicts of interest and bias to the parties. In the event that the parties feel the need to seek removal of an arbitrator after appointment on the basis of a conflict of interest and bias, Rule 12406 of the FINRA Code of Arbitration states that any party may ask an arbitrator to recuse himself or herself from the panel for good cause. Requests for arbitrator recusal are decided by the arbitrator who is the subject of the request.[31] Rule 12407 addresses instances in which the Director of Arbitration can remove an arbitrator.[32]

As explained below in more detail, there are critical deficiencies throughout FINRA's arbitrator disclosure process that warrant immediate remedial action. For example, there is a lack of transparency in how arbitrators are initially recruited by FINRA to its arbitrator roster. FINRA does not disclose to the parties how particular arbitrators are recruited even though FINRA collects that information, which could provide parties with valuable information about actual and potential conflicts of interest or biases. PIABA is concerned that FINRA does not have adequate or verifiable procedural safeguards in place to ensure that its targeted recruiting practices result in the recruitment of diverse, neutral arbitrators. Courts

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[30] A copy of FINRA's Oath of Arbitrator is attached as Exhibit D to Appendix.

[31] Rule 12406, FINRA Code of Arbitration.

[32] FINRA Rule 12407 states:

> **(a) Before First Hearing Session Begins**
> Before the first hearing session begins, the Director may remove an arbitrator for conflict of interest or bias, either upon request of a party or on the Director's own initiative.
> (1) The Director will grant a party's request to remove an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has a direct or indirect interest in the outcome of the arbitration. The interest or bias must be definite and capable of reasonable demonstration, rather than remote or speculative. Close questions regarding challenges to an arbitrator by a customer under this rule will be resolved in favor of the customer.
> (2) The Director must first notify the parties before removing an arbitrator on the Director's own initiative. The Director may not remove the arbitrator if the parties agree in writing to retain the arbitrator within five days of receiving notice of the Director's intent to remove the arbitrator.
> **(b) After First Hearing Session Begins**
> After the first hearing session begins, the Director may remove an arbitrator based only on information required to be disclosed under Rule 12405 that was not previously known by the parties. The Director may exercise this authority upon request of a party or on the Director's own initiative. Only the Director or the President of FINRA Dispute Resolution may exercise the Director's authority under this paragraph (b).

have refused to enforce pre-dispute arbitration provisions in contracts when the arbitration forum fails to have adequate procedural safeguards in place to ensure that arbitrators are neutral and impartial.

In preparing this report, PIABA conducted its own demographic research concerning FINRA's arbitrators by reviewing and analyzing Arbitrator Disclosure Reports of 5,375 past and current arbitrators in an effort to gain more clarity about the demographics of FINRA's roster of arbitrators ("PIABA Demographic Study"). PIABA's Demographic Study illustrates that FINRA's recruiting practices have resulted in FINRA's arbitrator roster being homogenous and lacking diversity, which is exactly what the SEC warned against in the 1992 GAO study. The data suggests that FINRA's recruiting practices have resulted in the disproportionate exclusion of quality arbitrators on the basis of age, gender, and socio-economic status. While PIABA did not have adequate data to study the issues, based on the current demographics of FINRA's arbitrator roster, PIABA has no reason to believe that FINRA's targeted recruiting practices do not also exclude minorities.

FINRA collects information related to how each arbitrator is recruited but it chooses not to disclose that information to parties. Parties participating in FINRA arbitrations should be privy to any and all information in the possession of FINRA that could lead to the discovery of information that could detect arbitrators' potential conflicts of interest or biases.

As explained below, PIABA consulted with expert, Dr. Akshay Rao, a tenured professor at the University of Minnesota, who examined FINRA's arbitrator disclosure process and determined that it is illusory and does not elicit meaningful and reliable information regarding potential conflicts of interest and biases. For example, the questions in FINRA's Arbitrator Application, which serves as the primary way that FINRA collects disclosures, are not properly designed to elicit meaningful and reliable information about conflicts of interest and biases. Further, some of the information that is provided by arbitrators during their application process (which could be meaningful in disclosing conflicts of interest and bias) is <u>not</u> disclosed by FINRA to the parties. Additional information about arbitrators' backgrounds is disclosed to parties after the arbitrators have been selected by the parties, and arbitrators are left to determine for themselves whether disclosures are material. The way questions in the arbitrator application are drafted has the potential to lead to misclassification of arbitrators who have industry affiliations as public, depriving customers of their right to have majority public or all public arbitration panels. Arbitrator disclosures are not updated on a regular

basis, making the information parties receive to evaluate arbitrators, outdated. As shown below, PIABA found recent examples where arbitrators had not updated their Arbitrator Disclosure Reports in many years despite representations by FINRA to the contrary. PIABA also identified instances where FINRA included deceased arbitrators on the ranking lists. Dr. Rao concluded that FINRA's arbitrator disclosure process is illusory because while FINRA's Arbitrators Guide and disclosure rules say the right things about disclosure, FINRA's implementation of its arbitrator disclosure process fails to elicit meaningful and reliable information about arbitrators' conflicts of interest and biases.

In short, FINRA's arbitrator disclosure process is flawed at every stage and is implemented backwards – the arbitrators are selected before the parties have the all of the information they need to make an intelligent selection, and when such information is provided, it is not reliable and it is the potentially biased arbitrator who determines whether he/she should be recused. Social science research determined long ago that people cannot accurately assess the nature and the level of their own bias. Yet customers have no choice but to tolerate this system.

Dr. Rao concludes that the flawed arbitrator disclosure process provides respondent broker-dealers with an unfair advantage over public investors in securities arbitration disputes in part, because broker-dealers are repeat participants and, therefore, have more information about arbitrators in the pool than do investors, due to experience.

Something must be done to protect investors. At present, investors have had no choice but to tolerate this flawed system. The securities industry has had almost thirty years to get the arbitrator disclosure process right and has not done so. Since FINRA states that it's arbitrator disclosure process is the cornerstone to the integrity of arbitration, given the findings in this Report, how can investors conclude anything except that FINRA's arbitration forum is unfair? As a result, statutory or regulatory enactments are needed to prompt the changes that should be made to make FINRA's arbitration forum truly fair and impartial.

In contrast to FINRA's system, the jury selection process allows litigants a meaningful opportunity to identify potential bias and to ask that the court excuse prospective jurors who may have a bias. The additional safeguard of peremptory challenges allows litigants to excuse potentially biased jurors without cause if the court declines a challenge for cause. The jury selection system reflects that reality; FINRA's selection system does not.

PIABA believes that arbitration is a valuable forum for investors to resolve disputes with the securities industry. Over the years, PIABA has worked to attempt to level the playing field for investors. Going forward, PIABA will continue to support arbitration as a viable option and participate in improving the process. It is clear, however, that legislative and/or regulatory change appears to be the only way to attempt to ensure investors have access to a dispute resolution forum that is truly fair and impartial, and to attempt to ensure that the entity operating that forum (FINRA) is held accountable when it fails to meet that goal.

PIABA supports investors having the unilateral right to choose between FINRA arbitration and court to resolve their disputes with the securities industry. PIABA encourages Congress to take action and pass *The Investor Choice Act of 2013* (H.R. 2998), which would prohibit the use of mandatory pre-dispute agreements by broker-dealers and investment advisers that force investors to arbitrate disputes or otherwise surrender their right to pursue recourse in a forum of their choosing. PIABA applauds the leadership of the bill's author and member of the House Financial Services Committee Rep. Keith Ellison (D-MN) for introducing the legislation.

The Investor Choice Act of 2013 will level the playing field for retail investors by amending Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to statutorily prohibit the use of mandatory pre-dispute agreements in broker-dealer and financial adviser customer contracts that restrict investors' ability to pursue claims in the lawful forum of their choosing. The Investor Choice Act of 2013 would not in any way prevent investors from voluntarily electing to resolve a dispute through arbitration or mediation after the facts and circumstances of the dispute have been discovered.

Investors need protections now. As a result, PIABA also requests that the SEC use its power under the 1934 Securities Exchange Act as well as the Dodd-Frank to improve FINRA's arbitration forum for the better. Below is a summary of recommended solutions to many of the problems that PIABA identified with FINRA's arbitrator disclosure process.

I. RECOMMENDED SOLUTIONS

Below is a list of proposed recommendations to correct the problems identified in this Report:

1. If investors had a choice to seek justice in a forum other than FIRNA, then many of the problems in this report would be alleviated. Unfortunately, as Professor Katsoris states in the Forward to this Report: FINRA "is basically the only remaining game in town." Right now, investors are forced into FINRA's flawed system to seek justice. PIABA believes that a viable alternative would do much to clean up FINRA's arbitration system and, thus, urges Congress to pass the Investor Choice Act of 2013 making securities arbitration optional for investors.

2. Because a lack of transparency appears to be at the core of many of the problems described in this Report, PIABA recommends that the SEC take action to ensure that an independent group be commissioned to assist in the oversight of FINRA's entire arbitration process. PIABA recommends that, if possible, the SEC require FINRA Dispute Resolution to be governed by a new independent board of directors that it is separate, distinct and that does not report to FINRA's current board of directors. Making the securities arbitration process independent from FINRA's regulatory body would likely improve the fairness of the arbitration forum for investors. It would also likely improve the perception of fairness about FINRA's industry-sponsored dispute resolution process.

3. PIABA recommends that the SEC take action to restore SICA's status as a meaningful participant in the oversight of the securities arbitration process. In the alternative, PIABA recommends that a new independent group with a similar mission as SICA be created. This group should not report to the FINRA Board of Directors. And, this independent group should be given the power to obtain documents and information from FINRA related to its arbitration forum.

4. PIABA recommends that the SEC improve the transparency of FINRA's arbitration forum by making documents relating to its supervision of FINRA arbitration be subject to the Freedom of Information Act (FOIA).

5. PIABA recommends that SEC commission an independent study about how FINRA's past and current arbitrator recruiting practices have impacted the demographics of its arbitration roster and whether these practices have impacted arbitration outcomes.

6. PIABA recommends that the SEC examine FINRA's arbitrator recruitment practices and develop a transparent recruitment process that ensures that FINRA's arbitrator roster is diverse and that it includes neutral and impartial arbitrators.

7. PIABA recommends that the SEC commission an independent study to determine whether requiring two years of college credits or five years of business or professional experience equates to highest quality of arbitrators. PIABA recommends that this study analyze and propose other alternative criteria.

8. PIABA recommends that the SEC require FINRA to take action on the identified problems with the arbitrator application process and other failures of disclosure.

9. PIABA recommends that the SEC ensure that FINRA has adequate and verifiable procedural safeguards in place to ensure that FINRA's arbitrator disclosure process results in the recruitment and selection of quality, neutral and impartial arbitrators.

II. DISCLOSURE PROBLEMS RELATED TO FINRA'S ARBITRATOR ELIGIBILITY STANDARDS AND RECRUITMENT PRACTICES

A. Arbitrator Eligibility Standards And Recruitment Have Been A Problem Since The Beginning.

FINRA's arbitrator disclosure process related to arbitrators' actual and/or perceived conflicts of interest or biases begins with FINRA's recruitment of arbitrators. As discussed above, just five years after the United States Supreme Court issued its landmark decision in *Shearson/American Express, Inc. v. McMahon*[33], the United States General Accounting Office conducted a study regarding the fairness of securities arbitration, the "1992 GAO Study", and issued a report entitled, *Securities Arbitration, How Investors Fare.* The 1992 GAO Study accurately stated:

> The fairness of arbitration cases, regardless of the forum, depends largely on the impartiality and competence of individual arbitrators. The primary ways that industry-sponsored forums can ensure that their arbitration process is as fair as possible are to select arbitrators with appropriate backgrounds and experience and ensure that they are trained to know and understand the arbitration process.[34]

[33] 482 U.S. 220, 107 S. Ct. 2332, 96 L. Ed. 2d 185 (1987).

[34] GAO, SECURITIES ARBITRATION HOW INVESTORS FARE, Rep. No. GAO/GGD 92-74 (May 1992) at 8.

The 1992 GAO Study found that none of the SRO securities arbitration forums at that time including the National Association of Securities Dealers ("NASD"), now FINRA, had established formal standards to initially qualify individuals as arbitrators; they did not verify background information provided by prospective or existing arbitrators; and they had no system to ensure that arbitrators were adequately trained to perform their functions fairly and appropriately.[35] Instead, SROs decided informally on a case-by-case basis whether individuals were qualified, taking into account the individual's employment history, education, any experience as an arbitrator at another forum, and any references from experienced arbitrators, judges, or business associates.[36] However, none of the SROs applied formal standards that specified minimum professional or educational requirements.[37]

The 1992 GAO Study did not discuss whether or how SRO arbitration forums recruited arbitrators. The SEC commented in the study, however, that arbitrators were selected on the basis of referrals, recommendations, membership in civic or professional groups, and general reputation in the community, in addition to the information provided in the arbitrators' applications.[38]

The 1992 GAO Study did not define what constituted appropriate background or experience for SRO arbitrators. The GAO also did not study whether or how SRO arbitrator recruiting practices could cause arbitration to be unfair to investors. Recognizing the importance of quality arbitrators, the 1992 GAO Study recommended that the SEC hold SRO forums responsible for making their arbitration process as fair as possible. In its comments to the 1992 GAO Study, the SEC stated that enhancing procedures to select and train arbitrators could provide industry-sponsored arbitration forums better assurance that arbitrators were independent and competent.[39]

Importantly, the SEC expressed concern that requiring formal standards for arbitrators would either homogenize the pool of arbitrators, and, thus, would result in the loss of the benefits of a diverse pool, or would be meaningless, if the standards were too loose.[40] (Emphasis added). The SEC stated that "standards that might require all arbitrators to have advanced degrees or a minimum number of

[35] *Id.* An SRO is an acronym for self-regulatory organization. Back in 1992, there were multiple SROs that regulated the securities industry. Those SROs also sponsored their own dispute resolution arbitration forums.
[36] *Id.* at 57.
[37] *Id.*
[38] *Id.*
[39] *Id.* at 60-61.
[40] *Id.*

years of experience in certain professions could foreclose investor choice and exclude individuals with expertise, such as individual investors or other capable arbitrators."[41] (Emphasis added).

B. Since the 1992 GAO Study, NASD and FINRA Have Made Arbitrator Eligibility Standards More Stringent And Have Engaged In Targeted Recruiting of Arbitrators.

Despite the SEC's prediction and warning about how investors could be harmed by a homogenized arbitrator pool, in 2003, the NASD raised the arbitrator standard for acceptance to the roster by requiring a minimum of two years of college-level credits.[42] FINRA subsequently raised the eligibility standard again and as a result, the current standards for acceptance to the arbitrator roster is now even more stringent because arbitrators must now have a minimum of five years of paid business and/or professional experience—inside or outside of the securities industry—and at least two years of college-level credits, unless waived by FINRA in its discretion.[43] PIABA is not aware of any studies conducted by the NASD or FINRA that analyzed whether requiring two years of college credits or five years of business or professional experience equates to higher quality arbitrators.

With regard to recruiting arbitrators, FINRA admits that it targets certain categories of individuals. For example, FINRA's website currently states:

> We recruit arbitrators to help resolve disputes from diverse backgrounds including:
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> - lawyers;
> - educators;
> - doctors;
> - accountants;
> - business professionals; and
> - securities professionals.[44]

As explained in more detail below, FINRA's practice of targeting certain categories of individuals to serve as arbitrators has operated to foreclose investor choice and to exclude individuals with expertise, such as individual investors or

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[41] *Id.*
[42] Linda Fienberg, NASD Dispute Resolution, The Arbitration Policy Task Force Report- A Report Card (July 27, 2007) at 8.
[43] http://www.finra.org/ArbitrationAndMediation/Arbitrators/BecomeanArbitrator/FINRAArbitrators/index.htm
[44] *Id.*

other capable arbitrators from serving as arbitrators. This problem is exactly what the SEC warned about in the 1992 GAO Study.

C. Parties That Participate In FINRA Arbitrations Are Entitled To Have Their Cases Decided By Impartial and Neutral Arbitrators.

The United States Supreme Court has long held that the American concept of a jury trial contemplates a jury drawn from a fair cross section of the community.[45] Indeed, the United States Courts website states:

> The Constitution, federal law and a series of Supreme Court rulings guarantee the right to impartial juries, selected at random from a fair cross-section of the community. Increasingly, federal trial courts are seeking to move beyond those legal imperatives and find new ways to maximize jury diversity.[46]

As a result, all ninety-four (94) federal trial courts have written jury plans to assure compliance with constitutional mandates and the federal Jury Selection and Service Act, which for nearly twenty (20) years has prohibited the exclusion from federal jury service of any person "on account of race, color, religion, sex, national origin, or economic status."[47]

The purpose of guaranteeing the right to impartial juries is to achieve justice and to help ensure that the judicial process is perceived to be fair. Judge Reginald Lindsay in the U.S. District Court for the District of Massachusetts aptly stated:

> The perception of fairness counts. A white jury may be fair, but a non-white defendant likely will think 'the jurors can't be fair because they don't understand me.'[48]

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[45] For example, a unanimous Court stated in *Smith v. Texas*, 311 U.S. 128, 130, 61 S Ct 164, 165, 85 L.Ed. 84 (1940), that "(i)t is part of the established tradition in the use of juries as instruments of public justice that the jury be a body truly representative of the community." To exclude racial groups from jury service was said to be "at war with our basic concepts of a democratic society and a representative government." *Glasser v. United States*, 315 U.S. 60, 85-86, 62 S.Ct. 457, 86 L.Ed. 680 (1942), in the context of a federal criminal case and the Sixth Amendment's jury trial requirement, stated that "(o)ur notions of what a proper jury is have developed in harmony with our basic concepts of a democratic system and representative government," and repeated the Court's understanding that the jury "'be a body truly representative of the community' . . . and not the organ of any special group or class."

[46] http://www.uscourts.gov/news/TheThirdBranch/07-07-01/Courts_Try_to_Maximize_Jury_Diversity.aspx

[47] *Id.*

[48] *Id.*

Courts have long overturned criminal convictions when the jury selection system was designed to exclude certain classes of people from serving on a jury.[49] The rationale for this principle was concisely stated in the United States Supreme Court case of *Taylor v. Louisiana*:

> The purpose of a jury is to guard against the exercise of arbitrary power—to make available the commonsense judgment of the community as a hedge against the overzealous or mistaken prosecutor and in preference to the professional or perhaps overconditioned or biased response of a judge. *Duncan v. Louisiana*, 391 U.S., at 155-156, 88 S.Ct. at 1450-1451. This prophylactic vehicle is not provided if the jury pool is made up of only special segments of the populace or if large, distinctive groups are excluded from the pool.[50] (Emphasis added).

Parties in an arbitration do not have a right to have cases decided by arbitration panels selected at random from a fair cross-section of the community.[51] However, those parties do have a right to have cases decided by impartial and neutral arbitrators. FINRA puts it this way:

> Arbitrators must be impartial and neutral throughout a proceeding. Impartiality extends to parties, counsel, agents, witnesses, co-panelists and even the type of case involved. Arbitrators must be impartial in both appearance and in fact. Arbitrators are viewed by parties in an arbitration case much as a judge would be viewed in a court of law. In some ways, arbitrators have greater power than a judge (e.g., except for limited reasons, arbitration awards cannot be overturned). Therefore, it is particularly important in arbitration that the forum be fair and be perceived to be fair.[52] (Emphasis added).

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[49] *Ballard v. United States*, 329 US 187, 67 S.Ct. 261 (1946) (court reversed conviction because women were excluded from the jury pool); *Duncan v. Louisiana*, 391 US 145, 88 S.Ct. 1444 (1968); *Taylor v. Louisiana*, 419 US 522, 95 S.Ct. 692 (1975) (Court reversed criminal conviction because the jury selection system systematically excluded women from the jury pool); *Carter v. Jury Comm'n*, 396 US 320, 90 S.Ct. 518 (1970) (Court observed that the exclusion of Negroes from jury service because of their race "contravenes the very idea of a jury.")

[50] *Taylor v. Louisiana*, 419 US 522, 530 , 95 S.Ct. 692, 698 (1975).

[51] *Hooters of America, Inc. v. Phillips*, 177 F.3d 933, 940-941 (4th Cir. 1999) (arbitral forum need not replicate the judicial forum for arbitration agreement to be enforceable.)

[52] FINRA Arbitrators Guide, p. 14.

Courts have repeatedly held that arbitration provisions are unenforceable if the arbitration forum does not have adequate procedural safeguards in place that provide for impartial arbitrators.[53]

As explained below, PIABA is concerned that FINRA does not have adequate and verifiable procedural safeguards in place to ensure that it is recruiting impartial and neutral arbitrators. FINRA does not disclose the specific ways that it recruits individual arbitrators and, therefore, neither the parties participating in the arbitration forum nor the public have no way of knowing or verifying that FINRA's arbitrator recruiting practices in fact recruit neutral and impartial arbitrators. In addition, FINRA collects information about how individual arbitrators are recruited but it chooses not to disclose that information to parties participating in arbitration even though it could be very important in helping parties to detect arbitrators' potential conflicts of interests and biases.

D. Adequate and Verifiable Procedural Safeguards Must Be In Place To Ensure That FINRA's Opaque Targeted Recruitment Practices Result In The Recruitment Of Impartial, Neutral And Diverse Arbitrators.

FINRA's practice of targeted arbitrator recruitment has the potential to lead to the recruitment of arbitrators who are not neutral or impartial. In a 2012 Reuters news article entitled, *Who Makes A Good Arbitrator?* Barbara Brady, FINRA's Vice President and Director of Neutral Management, stated that FINRA was focused at that time on recruiting real estate professionals and professors of law and economics.[54]

It is unknown why FINRA chose to recruit those very specific categories of individuals and there is no way to know whether FINRA's decision to recruit real estate professionals and professors of law and economics was made by FINRA arbitrarily or whether there was a well-founded and legitimate basis.

Transparency with regard to why and how FINRA recruits arbitrators is critical to the legitimacy and fairness of the entire arbitration forum, given the impact it could have on the composition of the arbitrator roster and the outcomes of cases. In January 1996, a task force assembled by the NASD issued a report entitled, *Report of the Arbitration Policy Task Force to the Board of Governors*

[53] *See e.g. Hooters of America, Inc*. at 940-41, *supra*; see also *McMullen v. Meijer, Inc*., 355 F.3d 485, 493-494 (6th Cir. 2004).
[54] http://www.reuters.com/article/2012/08/22/us-finra-arbitrators-comply-idUSBRE87L0M420120822

National Association of Securities Dealers ("Ruder Report").[55] With regard to arbitrator recruitment, the Ruder Report stated that there was a shortage of qualified arbitrators because the size of NASD's arbitrator pool "was dramatically reduced in 1993, when NASD required, for the first time, all new arbitrators who had not decided a case prior to January 1, 1993 to attend an arbitrator training session."[56] As a result, the number of eligible NASD arbitrators at that time precipitously dropped from 7,000 to 2,600.[57]

In response to that shortage, "the NASD established a nationwide program to identify, recruit, and train potential arbitrators in all of the cities in which it conducts arbitrations."[58] As a result of NASD's recruiting program, during the period of 1993 to 1996, the pool of eligible arbitrators significantly increased from 2,600 to close to 5,000.[59] The Ruder Report noted that the NASD "initiated a new recruitment plan whose goal is to recruit and train 3,000 new arbitrators in 1995 and 1996" and "to assist in attaining this goal, the NASD has established Regional Arbitrator Recruitment Councils."[60]

It is clear from the Ruder Report that the NASD initiated its recruiting campaign to "meet existing demand and projected caseload growth" and appears to have based its recruiting success on hitting a targeted quota, not necessarily on obtaining quality neutral and impartial arbitrators.[61] There is no explanation or indication of how arbitrator candidates were identified or recruited and/or whether procedural safeguards were put in place at that time to ensure that impartial and neutral arbitrators were recruited, which is significant given that about half of the NASD's entire arbitrator roster at that time was obtained through that recruitment process.

The NASD's recruitment practices could be important to arbitration outcomes in FINRA arbitrations today. Since 1992, claimant win rates in

[55] REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (Jan. 1996), reprinted in [1995-1996 TR. BINDER] FED. SEC. L. REP. (CCH) ¶ 85,735, at 87,433. ("Ruder Report")
[56] *Id.* at 101.
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.* at 102.
[61] *Id.*

arbitrations have fallen from 60% to the current rate of 42%.[62] In addition, since 1992, the percentage of claimants' alleged damages recovered has also decreased.[63]

Notably, in 2000, the GAO conducted a follow up study to the 1992 GAO Study ("2000 GAO Study")[64]. The 2000 GAO Report, in part, revisited the issue of fairness in securities arbitration. The 2000 GAO Report identified the declining trend in claimant win and recovery rates but speculated that the decline may have been due a higher percentage of cases settling.[65]

It does not appear from its report, however, that the GAO analyzed the impact of the NASD's Year 1993 loss of 4,400 of its 7,000 arbitrators (a 63% decline of its entire roster) on claimant win and recovery rates during that same time period. It also does not appear that the GAO analyzed the impact of the NASD's recruitment of approximately 2,400 new arbitrators to its existing pool of 2,600 between 1993 and 1996 (a 92% increase in new arbitrators) on claimant win and recovery rates[66] It is certainly plausible that a different composition of NASD arbitrators (post-1992) contributed to the decline in claimant win and recovery rates, not simply an increase in settlements. The likelihood that these new arbitrators impacted the overall SRO arbitration outcomes becomes even greater when one considers that in 1992, the NASD decided 67% of all securities arbitrations and in 2000, 92% of all cases.[67]

The NASD merged with the NYSE in 2007 to become FINRA. Today, FINRA decides 99% all securities arbitrations involving disputes between FINRA members and their customers.[68] The arbitrators who were on the NASD's roster were integrated into FINRA's arbitrator roster. As of September 16, 2014, FINRA has 6,383 arbitrators on its roster. Of those 6,383 arbitrators, FINRA classifies 3,550 as public arbitrators (arbitrators who are supposed to have no ties to the securities industry) and 2,833 as non-public or industry arbitrators (arbitrators with ties to the securities industry.)[69] It is not known how many of the arbitrators on the NASD's arbitrator roster are currently active on FINRA's arbitrator roster. It is

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[62] *See* 1992 GAO Study, *supra*, note 2; see also FINRA statistics on its website at http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.
[63] See note 16, *supra*.
[64] GAO, SECURITIES ARBITRATION, ACTION NEEDED TO ADDRESS PROBLEMS OF UNPAID AWARDS, Rep. No. GAO/GGD 00-115 (June 2000)
[65] *Id*. at 7.
[66] Ruder Report, *supra*, note 23 at 101-102.
[67] *See* 1992 GAO Study, *supra*, note 2 at 24; see also 2000 GAO Report, *supra*, note 30, at 24.
[68] http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@fdr/documents/arbmed/p124105.pdf
[69] http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/

clear, however, that FINRA continues to target certain categories of individuals to become arbitrators.

Targeted recruiting has the possibility to affect arbitration outcomes. There are a myriad of foreseeable problems that could result from such practices. For example, when FINRA targets certain groups, it interjects its own bias into the arbitrator recruitment and selection process.[70] This selection bias has the potential to skew the composition of the arbitrator roster, which certainly could impact arbitration results.

In addition, FINRA's method(s) used to recruit arbitrators could affect the composition of the arbitrator roster and arbitration outcomes. For example, FINRA readily admits on its website that it recruits attorneys as arbitrators. However, not all attorneys are created equal, and if FINRA actively recruits at the meetings of bar associations that are predominated by defense counsel, it logically follows that, if left unchecked, defense attorneys will predominate the arbitrator pool. It is plausible that an arbitrator pool that is predominated by defense-minded attorneys, even if they do not have ties to the securities industry, could negatively impact the outcomes of arbitrations for claimants. The same logic would hold true if FINRA recruited attorneys at meetings of bar associations consisting primarily of plaintiffs' attorneys.

Also, by picking certain groups to recruit, FINRA is choosing not to recruit other groups even though those individuals could be quality arbitrators. Since FINRA does not disclose the specifics of its recruiting practices, there is no way to tell what categories it has chosen to exclude or why. Choosing some groups and excluding others could certainly influence the overall demographics of the arbitrator roster as well as the outcomes of arbitration hearings. Equally important, it also could negatively impact investors' perceptions of fairness about FINRA's arbitration forum.

Finally, as explained in more detail below, FINRA's targeted recruiting practices impact diversity of its arbitrator roster. In preparing this report, PIABA conducted the PIABA Demographic Study concerning FINRA's arbitrators by reviewing and analyzing Arbitrator Disclosure Reports of 5,375 past and current FINRA arbitrators in an effort to gain more clarity about the demographics of

[70] Selection bias is a type of bias that is widely recognized in statistical analysis in which there is an error in choosing the individuals or groups to take part in a scientific study. If selection bias is not taken into account, then some conclusions of that study may not be accurate.

FINRA's roster of arbitrators.[71] The PIABA Demographic Study shows that FINRA arbitrator roster lacks diversity. It also suggests that FINRA's recruiting practices have contributed to that lack of diversity, resulting in a homogenous arbitrator pool, which is exactly what the SEC warned against in the 1992 GAO study.

FINRA's self-appointed sub-committee of the NAMC, the Neutral Roster Sub-Committee, serves as FINRA's procedural safeguard to ensure that neutral and impartial arbitrators are added to the arbitrator roster. The sub-committee includes public members of NAMC. In participating with the approval of an arbitrator applicant, however, the members of the sub-committee are only provided with a Disclosure Report for each arbitrator applicant. PIABA confirmed that sub-committee members are not provided with copies of the applicants' FINRA Arbitrator Applications. PIABA also confirmed that FINRA does not provide sub-committee members with any information about how applicants are recruited to become arbitrators. Sub-committee members do not meet or speak with the applicants. As a result, the NAMC Neutral Roster Sub-Committee is not an adequate procedural safeguard to ensure fairness in FINRA recruiting practices. Also, as explained below, because of disclosure deficiencies in the FINRA Application and Arbitrator Disclosure Report, the sub-committee is also not an adequate procedural safeguard to ensure that neutral and impartial arbitrators are being added to the roster.

Parties participating in FINRA arbitrations should be privy to any and all information in the possession of FINRA that could lead to the discovery of information that could detect arbitrator potential conflicts of interest or bias. PIABA recommends that an independent study be commissioned by the SEC to analyze FINRA's arbitrator recruitment practices. If they do not already exist, the SEC should require FINRA to institute adequate and verifiable procedural safeguards to ensure that the arbitrator pools consist of neutral and impartial arbitrators. Above all, PIABA requests that the SEC require that FINRA's arbitrator recruitment practices be fully transparent.

E. FINRA Does Not Disclose To The Parties Participating In Arbitration How Individuals Are Recruited Even Though FINRA

[71] FINRA provides parties the employment history and other background information for each arbitrator listed. The background information is provided to the parties in a document entitled "Arbitrator Disclosure Report." The parties receive an Arbitrator Disclosure Report for each potential arbitrator before the parties select the panel. PIABA obtained the 5,375 Arbitrator Disclosure Reports from its members who represent parties in FINRA arbitrations.

Collects Much Of That Information In The Arbitrator Application.

FINRA does not disclose to parties participating in its arbitrations the specific ways in which individuals are recruited even though FINRA collects that information. FINRA's Arbitrator Application begins with a survey entitled, *How Did You Hear About Us?* The survey asks applicants to specifically list what prompted them to apply to FINRA's roster and gives applicants choices between FINRA Conference, Business or Recruiting Conference, FINRA Arbitrator Referral, Other Referral, FINRA Recruitment Letter, FINRA Email, FINRA Print Advertisement or FINRA Internet Advertisement. The applicant is also asked to specifically identify the referral source, e.g. name and location of the conference, name of referring arbitrator, name and occupation of referral source, name of publication and URL address of website.

Notwithstanding that virtually all the information that FINRA provides to the parties to help them select arbitrators comes from the arbitrators' applications, FINRA chooses not to disclose arbitrators' survey answers to the parties. It is PIABA's understanding that FINRA does not provide its NAMC sub-committee members with this information either. Such information would be helpful to the parties in identifying potential conflicts of interest and/or bias. In preparing this report, PIABA recently asked FINRA to provide it with statistics on how applicants answered the survey questions. FINRA responded that because supplying the information is voluntary, it did not have complete information. Therefore, it could not provide the requested information.

There is simply no legitimate reason why parties participating in FINRA arbitrations should not be provided with this information at the time of arbitrator selection. This type of information could be crucial in helping parties to identify potential conflicts of interest and bias in arbitrators. PIABA recommends that FINRA should provide this information to parties immediately.

F. FINRA Claims That Its Arbitrator Roster Is Diverse But Also Admits That It Has Not Conducted Any Studies To Measure Diversity.

FINRA maintains that it takes great strides to ensure that the roster is diverse. In 2007, NASD described its arbitrator recruitment efforts:

> NASD carefully selects arbitrator candidates from a broad cross-section of people, diverse in culture, with varying professions and backgrounds. NASD expanded its recruitment team and intensified efforts to provide more arbitrators to handle the caseload in each of NASD's 68 hearing locations.[72]

In 2012, Barbara Brady, FINRA's Vice President and Director of Neutral Management, confirmed to a Reuters reporter that FINRA does not disclose the demographics of its arbitrator pool, but Brady said that FINRA "strives to have a broad selection of people" diverse in culture, professions and background. (Emphasis added). She also said the regulator is "very strongly" focusing on building the roster of minorities and women arbitrators, as well as real estate professionals and professors of law and economics.[73]

With regard to recruiting women and minorities, FINRA recently told PIABA:

> FINRA recruits neutrals using a combined strategy of direct mailings, recruitment ads, broadcast emails, and attendance at business events/conferences to enhance the diversity of the roster. We solicit the help of professional organizations around the country, several of which focus on the recruitment of women and minorities to ensure that we continue to maintain a diverse roster nationwide. (Emphasis added). We work with the following minority and women's organizations to recruit arbitrators, including, but not limited to:
>
> - NAFE (National Association of Female Executives)
> - GA Association of Black Women Attorneys
> - National Hispanic MBA (NSHMBA)
> - ABA – Women in ADR Section
> - California Women Lawyers
> - Black Women Lawyers
> - Puerto Rico Chamber of Commerce
> - Colegio de Contadores Publicos Autorizados de Puerto Rico (CPA group)
> - Colegio de Abogados de Puerto Rico (lawyer group)
> - University of Puerto Rico

[72] Linda Fienberg, *supra* n. 27, at p. 10.
[73] http://www.reuters.com/article/2012/08/22/us-finra-arbitrators-comply-idUSBRE87L0M420120822

- Servicios Integrados De Psicologia, Mediacion Y Arbitraje (Sipma) Inc. (Conflicts Resolution Center, PR)
- National Bar Association (African American lawyers and judges) and
- The Transition Network (community of professional women over age 50).[74]

In July 2014, PIABA asked FINRA for statistics on the breakdown of percentages of minorities and women. FINRA responded that it has not yet studied the issue. However, with regard to a breakdown on the basis of gender, FINRA stated:

> Although the method is not scientific, we can tell that approximately 21-22% of our existing neutral roster consists of women. We do not have estimates for the other categories.[75]

It is unclear how FINRA can legitimately claim that its arbitrator roster is diverse but then admit that it has not studied the issue. As discussed in the next section of this report, contrary to its public statements, FINRA's arbitration roster is anything but diverse.

G. PIABA's Arbitrator Demographic Study

1. Background Information

PIABA's goal of undertaking this research was to better understand the demographics of FINRA's arbitrator roster and to attempt to verify the accuracy of FINRA statements that its arbitrator roster is diverse.[76] PIABA was also interested in better understanding the demographics of arbitrators in FINRA's public pool as a whole as well as the demographics of a subset of public arbitrators that FINRA deems to be chair-qualified. Information about the demographics of the public pool is very important because on February 1, 2011, FINRA permitted claimants to choose arbitration panels consisting of all public arbitrators.[77] Since then, claimants

[74] See Linda Fienberg email to Jason Doss dated July 15, 2014.
[75] *Id*.
[76] PIABA has received complaints from its members about problems related to arbitrators failing to disclose material information about conflicts of interest or facts that would suggest that the arbitrator is biased. PIABA has also received complaints from its members that some arbitrators serving on arbitration panels were having a difficult time effectively participating in arbitration hearings, in large part, because of their advanced age.
[77] http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/. Prior to February 1, 2011, arbitration panels were comprised of two public arbitrators and one industry arbitrator (majority public panels). FINRA changed its procedures to allowing claimants to choose all-public panels in an attempt to

have chosen all-public panels more often than not. As a result, PIABA analyzed the demographic breakdown of the public pool in an effort to determine information about age, gender, and socio-economic factors. PIABA also examined the information to attempt to determine how FINRA recruits public arbitrators.

According to FINRA's website, in 2013 and 2014, claimants chose to have their cases decided by all-public panels approximately 54% of the time.[78] As a result, there is no doubt that public arbitrators are being used to decide customer cases far more often than in the past. For example, prior to 2011 when all cases were decided by majority public panels (two public arbitrators, one industry arbitrator), public arbitrators participated in deciding arbitrations twice as often as industry arbitrators. Now, given the prevalence of all-public panels, public arbitrators participate in deciding customer arbitrations approximately 5.5 times as often as industry arbitrators.[79]

In conducting its demographic research and analysis, PIABA relied on the information that FINRA provides to parties about its arbitrators, which is contained in a document entitled, Arbitrator Disclosure Report. See Exhibit B to Appendix. Arbitrator Disclosure Reports contain information about each arbitrator's employment history and other background information. Under FINRA's Code of Arbitration, FINRA provides parties with an Arbitrator Disclosure Report for each potential arbitrator within thirty days of an answer being filed.[80] The parties are

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eliminate the perception that securities arbitration was unfair to investors due to the participation of the industry arbitrator.

[78] Id. To arrive at the 54% statistic, PIABA used the data from FINRA's chart entitled *Comparison of Results of All-Public Panels and Majority Public Panels in Customer Claimant Cases*. See http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ PIABA took the total number of cases decided by an all-public panel for 2013 and 2014 (128 cases in 2013 and 84 in 2014) and divided those numbers by the total number of cases as stated in FINRA's chart for those same years (235 cases in 2013 and 155 in 2014).

[79] To arrive at this number, PIABA used the data from FINRA's chart entitled *Comparison of Results of All-Public Panels and Majority Public Panels in Customer Claimant Cases.* PIABA took the total number of cases decided by an all public panel in 2013 and 2014 and multiplied those numbers by three to arrive at the number of public arbitrators for those years (384 in 2013 and 252 in 2014). PIABA also took the total number of cases decided by a majority public panel and multiplied by two, because two public arbitrators participated in those cases (214 in 2013 and 142 in 2014). PIABA then added those two figures together for each year to determine the number of public arbitrators that participated in the arbitration cases identified in FINRA's chart (the total number of public arbitrators in 2013 was 598 and 394 in 2014). To determine the number of industry arbitrators that participated in majority public cases, PIABA simply took the total number of cases decided by a majority public panel given that those panels have only one industry arbitrator (the total number of industry arbitrators in 2013 was 107 and 2014 was 71). To complete the analysis to arrive at the multiples used in this report, PIABA divided the total number of public arbitrators by the total number of industry arbitrators in 2013 and 2014. In 2013, public arbitrators participated in customer cases approximately 5.6 times as often as industry arbitrators (598 public arbitrators/107 industry arbitrators). In 2014, public arbitrators participated in customer cases approximately 5.5 times more often than industry arbitrators.

[80] See Rule 12403, FINRA Code of Arbitration.

expected to rely on the information contained in the reports to rank arbitrators in the Arbitrator Ranking List for the case. An example of an Arbitrator Ranking List is attached as Exhibit C to the Appendix.

FINRA relies solely on the Arbitrator Disclosure Report(s) to notify the parties of any actual or potential conflicts of interest and/or biases. The information contained in the Arbitrator Disclosure Reports is derived primarily from the portions of the application completed by the arbitrators before they are approved by FINRA to the arbitrator pool. FINRA represents to the parties that the information in the Arbitrator Disclosure Reports is current as of the time that FINRA provides the report to the parties.

2. Methodology

In compiling the research, PIABA reviewed 5,375 Arbitrator Disclosure Reports. For the period 1991-2006, 1,908 NASD Arbitrator Disclosure Reports are included in PIABA's database. For the period 2007-2014, 3,467 FINRA Arbitrator Disclosure Reports are included in the database. For the period 2013-2014, 2118 Arbitrator Disclosure Reports are included in the database. PIABA collected the Arbitrator Disclosure Reports from PIABA members who were or are representing parties in FINRA arbitration cases.

Because the Arbitrator Disclosure Reports available to PIABA spanned over such a long time period, PIABA determined that its research should, to the extent possible, include a review of arbitrators who are currently on FINRA's roster. For the purposes of this report, PIABA assumed that an arbitrator listed on a 2013 and/or 2014 FINRA Arbitrator Ranking List with a current Arbitrator Disclosure Form is currently on FINRA's arbitrator roster. PIABA reviewed and compiled demographic information for all 5,375 Arbitrator Disclosure Reports in its database. To serve as a check on the research results derived from the 5,375 Arbitrator Disclosure Reports, PIABA also reviewed and compiled demographic information for the 2,118 Arbitrator Disclosure Reports that were provided to parties in 2013 and/or 2014.

As a point of comparison, according to FINRA's website, as of September 16, 2014, FINRA has 6,383 arbitrators in its roster. Of those 6,383 arbitrators, FINRA classifies 3,550 as public arbitrators (arbitrators who are supposed to have no ties to the securities industry) and 2,833 as non-public or

industry arbitrators (arbitrators with ties to the securities industry.)[81] The 2118 arbitrators that were listed on a 2013-2014 FINRA Arbitrator Ranking Lists constitutes approximately 33% of the 6,383 arbitrators that FINRA has stated are currently on its roster. FINRA represents that the lists of arbitrators provided to parties are randomly selected. Based on that representation, PIABA feels confident that the Arbitrator Disclosure Reports on which it relied for the purposes of this research is representative of FINRA's entire arbitrator roster.

The information derived from the 5,375 Arbitrator Disclosure Reports were reviewed at least two times for accuracy. If a newer version of an Arbitrator Disclosure Report was provided to PIABA, it was incorporated into the arbitrator's file and reviewed to ensure that the information in the database remained accurate. If the information on the new Arbitrator Disclosure Report changed, the database was updated to reflect the new information.

Each Arbitrator Disclosure Report was reviewed to extract the following information for this research:

- **Arbitrator Number**
- **CRD Number** (if provided)
- **Full Name** (if provided)
- **Sex** (Male, Female, Unknown)
- **Classification** (Public, Non-Public)
- **Mediator Status** (Yes, None)
- **Chair Status** (Qualified, None)
- **Education**
  -Year of High School Graduation or Year Undergraduate Study Began
  -Degree(s) (Undergraduate education without degree; Associate, Undergraduate, Juris Doctorate or LLB, Masters, PhD, including LLM, MD, DDS, etc.)
- **Estimated Year of Birth** – determined by taking the year stated for high school graduation or the stated year that undergraduate studies began less 18 years. Because ages vary upon completion or High School of beginning undergraduate work, the arbitrator age is an estimate.

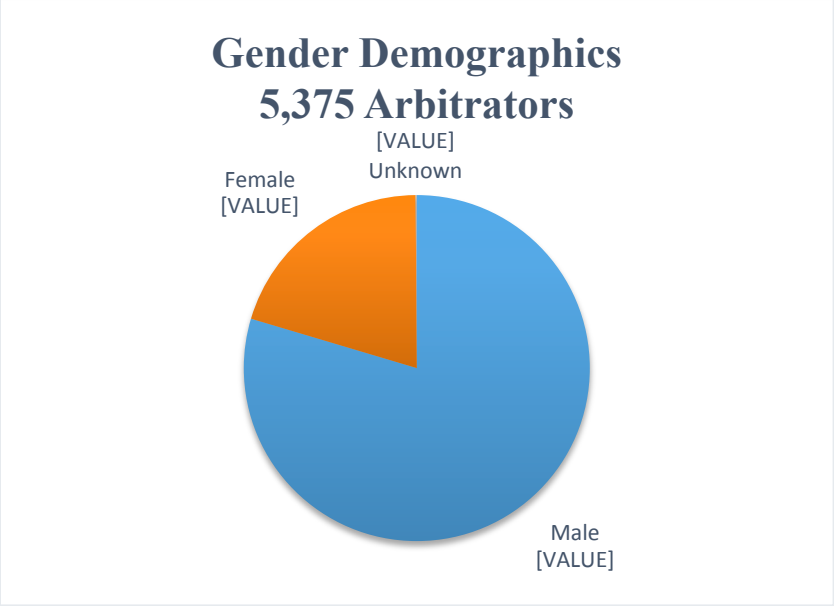
[81] http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/

3. Presentation of Results

As stated above, PIABA's goal of undertaking this research was to better understand the demographics of FINRA's arbitrator roster. Based on all of the above, PIABA presents the following results and commentary.

a. Gender Demographic Breakdown

PIABA's research shows that FINRA's arbitrator pools are comprised primarily of men. Females are underrepresented on arbitration panels. For example, based on a review of all 5,375 arbitrators in PIABA's database, which includes arbitrators categorized by FINRA as public and non-public ("industry"), men comprise approximately 80% of the roster while women comprise 20%.



The gender breakdown is similar when analyzing only Arbitrator Disclosure Reports issued by FINRA in 2013-2014. That data reflects that men comprise approximately 78% of the arbitrator roster and women comprise approximately 22%.

b. Age Demographic Breakdown

PIABA's research shows that FINRA's arbitrator pools consist primarily of elderly men. Based on a review of all 5,375 arbitrators in PIABA's database, the average age is 67 years old, with the public pool having an average age of

approximately 69 years old and the industry pool slightly younger at 65 years old. The charts below provide additional results related to age:

Average Age – Gender

	Male	Female	Unkwn
Total Arbs	4279	1090	6
Av. Age All	**68.58**	**61.24**	**75.92**
2013-2014	1645	472	1
Av. Age 13-14	**66.57**	**59.85**	**80.75**

	Public				Industry			
	All	Male	Female	Unkwn	All	Male	Female	Unkwn
Total Arbs	3327	2612	711	4	2048	1667	379	2
Ave Age All	**68.67**	**70.39**	**62.29**	**76.25**	**64.57**	**65.76**	**59.26**	**75.25**
2013-2014	1336	1021	314	1	782	624	158	0
Ave Age 13-14	**66.66**	**68.29**	**61.3**	**80.75**	**62.38**	**63.74**	**56.98**	**0**

	Chair-Qualified				Non-Chair Qualified			
	Total	Male	Female	Unkwn	Total	Male	Female	Unkwn
All	1760	1435	325	0	3615	2844	765	6
Ave Age All	**69.84**	**71.12**	**64.2**	**0**	**65.77**	**67.3**	**59.98**	**75.92**
2013-2014	927	742	185	0	1191	903	287	1
Ave Age 13-14	**68.62**	**69.85**	**63.67**	**0**	**62.32**	**63.87**	**57.39**	**80.75**

In addition, based on a review of all 5,375 arbitrators in PIABA's database, approximately 40% of the entire pool is 70 years or older and 17% is 80 years or older. The breakdown is similar when analyzing only Arbitrator Disclosure Reports issued by FINRA in 2013-2014. That data reflects that approximately 35% of the pool is 70 years or older and 12% is 80 years or older.

35% - 40% of entire pool is 70 years or older

12% - 17% of entire pool is 80 or older.

PIABA is concerned about the advanced age of FINRA's arbitrator roster. PIABA is particularly concerned that the public arbitrator pool is significantly older than the industry pool. As shown above, the average age of the public pool is 68.67 years old, while the industry pool's average age is 64.57 years. Equally troubling, the average age of the males in the public pool is 70.39 years old and the average age of males serving as chair-qualified public arbitrators is 71.12 years.

The above data, standing alone, confirms that FINRA has a problem with a lack of diversity on its arbitrator roster that needs to be fixed immediately. The above data also strongly suggests FINRA's recruiting practices played a significant role in causing the average age of arbitrators on its roster to be what it currently is.

PIABA has received complaints from its members that some arbitrators serving on arbitration panels were having a difficult time effectively participating in arbitration hearings, in large part, because of their advanced age. PIABA is also aware that this problem is not news to FINRA and that it has received complaints from parties about this issue as well. In the past, FINRA's response to complaints about arbitrators not being able to effectively participate in arbitrations because of their advanced age has been to encourage parties and their attorneys to complete party evaluation forms.[82]

Party evaluation forms have proven ineffective and it is unknown what, if anything, FINRA is doing about the issue. In a February 24, 2014 Reuters article by Suzanne Barlyn, citing to a complaint filed by a former FINRA employee against FINRA, the plaintiff Jill Wile alleged that Manly Ray, a FINRA regional director "frequently joked about FINRA's older arbitrators, saying that he hoped that they would die before he had to go through the trouble of having to track them in a process for problem arbitrators."[83]

c. Socioeconomic Demographic Breakdown

[82] See email from Barbara Brady to Diane Nygaard dated July 23, 2014 with a subject line "male, pale and stale arbitrators."
[83] Barlyn, Suzanne, *New case alleges improprieties at Wall Street watchdog*, Reuters, February 24, 2014.

PIABA's research shows that FINRA's arbitrator pool consists primarily of elderly men who have a socioeconomic status that put them out of touch with the average investor.[84] Based on a review of all 5,375 arbitrators in PIABA's database, approximately 70% of the arbitrators have advanced degree defined as a university degree higher than a bachelors. When analyzing only the Arbitrator Disclosure Reports in PIABA's database that were issued by FINRA in 2013-2014, the data reflects that 73% the arbitrators have advanced degrees.

Importantly, there are very large differences as to which arbitrators have advanced degrees. Seventy-five percent (75%) of public arbitrators have advanced degrees whereas only 25% of industry arbitrators have advanced degrees. Also, of the arbitrators with advanced degrees, approximately 79% are men and 21% are women. The most common advanced degree among the arbitrator roster was the juris doctorate or law degree. Arbitrators with law degrees comprise 73% of all arbitrators with advanced degrees, with 81% of those individuals being classified as public arbitrators, compared to 19% in the industry pool.

These statistics support the conclusion that FINRA's targeted recruiting for public arbitrators significantly impacts the demographics of its arbitrator roster. The data suggests that FINRA targets public arbitrator recruiting efforts at attorneys, which has resulted in the public pool primarily consisting of individuals with advanced degrees, which is exactly what the SEC warned about in 1992. Because FINRA does not disclose its arbitrator recruitment practices about specific arbitrators, it is not known where FINRA found these attorneys or what the attorneys' motivations were for becoming FINRA arbitrators. All of this information is important for parties to know to evaluate conflicts of interest and biases.

II. THE REMAINDER OF FINRA'S ARBITRATOR DISCLOSURE PROCESS IS ILLUSORY AND FAILS TO ELICIT MEANINGFUL AND RELIABLE INFORMATION RELATED TO ARBITRATORS' POTENTIAL CONFLICTS OF INTEREST AND/OR BIASES.

A. There Is No Question That Arbitrators' Disclosures Are Critical.

[84] According to the American Psychological Association, socioeconomic status is commonly conceptualized as the social standing or class of an individual or group. It is often measured as a combination of education, income and occupation. Examinations of socioeconomic status often reveal inequities in access to resources, plus issues related to privilege, power and control.

No matter how diverse the pool of arbitrators, absent full and complete background disclosures from the arbitrator candidates, parties (claimant and respondent alike) are unable to ensure that they are ranking and striking candidates who are most likely to be fair and unbiased. The point is not subject to debate. FINRA's Arbitrator Guide states:

> Arbitrator disclosure is the cornerstone of FINRA arbitration, and the arbitrator's duty to disclose is continuous and imperative. Disclosure includes any relationship, experience and background information that may affect—or even appear to affect—the arbitrator's ability to be impartial and the parties' belief that the arbitrator will be able to render a fair decision. When making disclosures, arbitrators should consider all aspects of their professional and personal lives and disclose all ties between the arbitrator, the parties and the matter in dispute, no matter how remote they may seem. This includes, but is not limited to, lawsuits (even non-investment related lawsuits); any publications (even if they appear only online); professional memberships; service on boards of directors; etc. If you need to think about whether a disclosure is appropriate, then it is: make the disclosure. Failure to disclose may result in vacated awards which undermine the efficiency and finality of our process. Failure to disclose may also result in removal from the roster.[85]

As explained below, FINRA's arbitrator disclosure process is illusory because while FINRA's Arbitrators Guide and disclosure rules say the right things about disclosure, FINRA's implementation of its arbitrator disclosure process fails to elicit meaningful and reliable information about arbitrators' conflicts of interest and biases.

B. Summary of FINRA's Arbitrator Conflict and Bias Disclosure Process

[85] FINRA Arbitrators Guide (2014), p. 17; see also Rule 12405, *Disclosures Required By Arbitrators*, FINRA Code of Arbitration.

After recruitment, FINRA's process for eliciting information about conflicts and biases from arbitrators begins with the FINRA Arbitrator Application.[86] FINRA acknowledges that its application is long and time consuming. The cover letter to the application states:

> We recognize that our arbitrator application is lengthy and requires considerable time to complete. However, the questions we ask are necessary both to maintain the integrity of the roster and to ensure that new arbitrators are properly classified as either public or non-public upon approval. If you are accepted as an arbitrator, you will be under a continuing obligation to update your profile information.[87]

After an applicant completes the FINRA Arbitrator Application, the FINRA staff screens the applications. The background information from the application is entered into a FINRA database and portions of information from the application is used to create an Arbitrator Disclosure Report for each arbitrator.[88]

After Arbitrator Disclosure Reports are created for the applicants, FINRA forwards the Arbitrator Disclosure Form(s) to the Neutral Roster Sub-Committee of NAMC for review.[89] In participating with the approval of an arbitrator applicant, the members of the sub-committee are only provided with the Arbitrator Disclosure Report for each arbitrator applicant. They are not provided with copies of the applicants' FINRA Arbitrator Applications. FINRA does not provide sub-committee members with any information about how applicants are recruited to become arbitrators.

If and when an arbitrator applicant is accepted to FINRA's arbitrator roster, under FINRA rules, parties receive an Arbitrator Disclosure Report for each arbitrator within thirty days of an answer being filed.[90] The parties are expected to rely on the information contained in the reports as they rank and strike the arbitrator candidates. FINRA relies solely on the Arbitrator Disclosure Report(s) to notify the parties of any actual of potential conflicts of interest and biases.

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[86] See FINRA'S Arbitrator Application, Ex. B to Appendix.
[87] *Id* at 1.
[88] *See* FINRA Arbitrator Application, Ex. B at 4.
[89] *Id*.
[90] *See* Rule 12403, FINRA Code of Arbitration.

Arbitrators are encouraged to update their biographical information on a regular basis.[91] FINRA, however, relies in large part on the arbitrators to take the initiative to self-report conflicts and biases.

The next step of FINRA's arbitrator disclosure process relates to the parties' opportunity to ask questions to arbitrators. FINRA does not have a formal *voir dire* process before selecting arbitrators. FINRA's Code of Arbitration permits parties to request additional information from the arbitrators before the deadline to rank and strike the arbitrator lists.[92] However, the rule does not require arbitrators to answer the questions at all or under oath.[93]

After FINRA appoints arbitrators to a panel based on the parties' ranking forms, FINRA requires each arbitrator on the panel to complete the FINRA Oath of Arbitrator and accompanying questions that relate to conflicts/biases. A copy of FINRA's Oath of Arbitrator is attached as Exhibit D to Appendix.

Pursuant to Rule 12405, arbitrators have an on-going duty to disclose conflicts of interest and bias to the parties. In the event that the parties feel the need to seek removal of an arbitrator after appointment on the basis of a conflict of interest and bias, Rule 12406 of the FINRA Code of Arbitration states that any party may ask an arbitrator to recuse himself or herself from the panel for good cause. Requests for arbitrator recusal are decided by the arbitrator who is the subject of the request.[94] Rule 12407 addresses instances in which the Director of Arbitration can remove an arbitrator.[95]

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[91] *See* Arbitrators Guide.
[92] Rule 12403, FINRA Code of Arbitration.
[93] *Id*.
[94] Rule 12406, FINRA Code of Arbitration.
[95] FINRA Rule 12407 states:

> **(a) Before First Hearing Session Begins**
> Before the first hearing session begins, the Director may remove an arbitrator for conflict of interest or bias, either upon request of a party or on the Director's own initiative.
> (1) The Director will grant a party's request to remove an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has a direct or indirect interest in the outcome of the arbitration. The interest or bias must be definite and capable of reasonable demonstration, rather than remote or speculative. Close questions regarding challenges to an arbitrator by a customer under this rule will be resolved in favor of the customer.
> (2) The Director must first notify the parties before removing an arbitrator on the Director's own initiative. The Director may not remove the arbitrator if the parties agree in writing to retain the arbitrator within five days of receiving notice of the Director's intent to remove the arbitrator.

B. PIABA Retained Expert Dr. Akshay R. Rao To Review and Evaluate FINRA's Arbitrator Disclosure Process.

PIABA's research included the retention of Dr. Akshay R. Rao, a tenured professor with the University of Minnesota's Carlson School of Management. Dr. Rao has conducted and published research on a range of marketing topics including Pricing, Brand Management, Channels of Distribution, Consumer Behavior and Information Processing. Dr. Rao's original scholarly research has appeared in a variety of leading journals including the *Harvard Business Review*, the *Journal of Brand Management*, the *Journal of Business*, the *Journal of Consumer Research*, the *Journal of Marketing*, the *Journal of Marketing Research*, *Marketing Science*, *Organizational Behavior and Human Decision Processes, Sloan Management Review*, and other journals. In addition, Dr. Rao has experience in designing and conducting surveys.

Because of Dr. Rao's experience, PIABA retained Dr. Rao to review FINRA's arbitrator disclosure process and to evaluate whether the process is effective in eliciting disclosures from arbitrators that may affect or appear to affect an arbitrator's ability to be impartial and the parties' belief that the arbitrator will be able to render a fair decision, the disclosure standard stated in FINRA's Arbitrator's Guide.

C. Dr. Akshay Rao's Expert Opinion.

Based on his review of FINRA's arbitrator disclosure process, Dr. Rao's opinion is as follows:

> [I]t is my opinion that the process is illusory and especially harms claimant public investors because the system is not designed to elicit meaningful or timely disclosures about actual or potential conflicts of interest and/or biases. FINRA's flawed arbitrator disclosure process provides respondent broker-dealers with an unfair advantage over public investors in securities arbitration disputes in part, because broker-dealers are repeat participants in securities arbitration

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(b) After First Hearing Session Begins
After the first hearing session begins, the Director may remove an arbitrator based only on information required to be disclosed under Rule 12405 that was not previously known by the parties. The Director may exercise this authority upon request of a party or on the Director's own initiative. Only the Director or the President of FINRA Dispute Resolution may exercise the Director's authority under this paragraph (b).

proceedings and therefore have more information about arbitrators in the pool, due to experience.

A complete copy of Dr. Rao's Declaration is attached as Exhibit E to Appendix.

D. Dr. Akshay Rao's Rationale For His Expert Opinion.

In formulating his opinions, Dr. Rao reviewed among other things, the FINRA Arbitrator Application. He concluded that FINRA's application is not designed to elicit meaningful and reliable answers because the questions require respondents to self-define important words in the application, which leads to subjective variance in the answers (unreliable answers). Dr. Rao explained the rationale for his opinions as follows:

1. FINRA's Arbitrator Application Fails To Elicit Meaningful and Reliable Information Related to Actual or Potential Conflicts of Interest and/or Biases.

FINRA's process for eliciting information about conflicts and biases from arbitrators begins with the FINRA Arbitrator Application.[96]

a. *Definitional Issues*

A key requirement in competent questionnaire design is to assure that respondents understand terminology embedded in the questionnaire, validly and reliably. That is, the respondents' understanding of the terms and language used in the questionnaire ought to be consistent with the intent of the questioner (to assure validity) and all respondents should interpret the terms in similar if not identical fashion (to assure reliability). In many instances, it is singularly unclear if these criteria are met in the FINRA application. Consider:

1. Q. 11: In a section entitled *Educational History*, FINRA asks respondents about accreditation. It may be unclear to the respondent whether or not the program or the School/University s/he attended is indeed accredited. It is further unclear who the accrediting agency ought to be. For instance, in the case of Business schools, the default accrediting agency is the AACSB. Is this the accrediting agency to

[96] See FINRA'S Arbitrator Application, Ex. B. to Appendix.

which this question refers? How about Law schools? Or Medical schools? Further, accreditation is an ongoing process. Sometimes schools and programs lose their accreditation and subsequently recover it. What if the program or school did not have accreditation at the time the respondent attended, but received it subsequently? Since the question does not provide temporal specificity, the respondent might very well choose to answer as if the program or school had accreditation when s/he attended, even if it did not have accreditation at that point, but has been subsequently accredited. In short, the question is vague.

2. Q. 13 (d): Question 13 is a set of questions that are used by FINRA to classify arbitrators as public or non-public. In Question 13(d), FINRA employs the word "substantial" in the question, "Have you spent a substantial part of your career engaged in business activities listed in paragraph (a) above?"

   Substantial is an imprecise term, subject to interpretation. Most important, it is subject to different interpretations – some might infer substantial to mean a "majority", some a "plurality", others might think in percentage terms and employ a 75% threshold or higher, and so on. As a consequence, responses to this question are unreliable due to "within subject variance" (a term of art in marketing research).

   In this context, incorrect answers to Question 13 may cause FINRA to misclassify arbitrators by placing arbitrators who, for example, should be in the non-public pool into the public pool. The same concern applies to Q. 14. b).

3. Q. 13 (h): This is another question used by FINRA to classify arbitrators as public or non-public. The question in full reads: "Are you an attorney, accountant, professional whose firm derives 10 percent or more of its annual revenue in the past two years from any persons or entities listed in paragraphs (a) through (c)."

   It would be virtually impossible for an employee of an organization who is not involved with extremely detailed accounting information, to hazard even an educated guess with respect to the sources of revenue that a firm receives. To be able to parse whether a percentage

of revenue comes from a particular sector of the economy is not a reasonable expectation. The same concern applies to item i).

Once again, just like Question 13(d) discussed above, the subjective variances in the responses to Question 13(h) and (i) are unreliable and may cause FINRA to misclassify arbitrators and for example, wrongly place attorneys in the public pool when they should be classified as non-public.

4. Q. 18: This set of questions is entitled *Conflicts/Disclosures*. This entire section is greatly problematic because the term "conflict" is never defined. The best information the respondent has with respect to the meaning of the term is the examples provided. Notice that the examples are largely if not exclusively related to real or potential financial conflicts of interest as a source of bias on the part of the arbitrator. It is essential that the questionnaire provide the respondent a definition of the term about which the respondent is being queried, lest there be a misinterpretation on the part of the respondent (a validity concern) or different interpretations on the part of different respondents (a reliability concern).

   b. *Scope Issues*

   In general, the issue of conflict is, to my understanding, related to actual and potential for bias. FINRA's application wrongly restricts the type of questions primarily to those that relate to economic conflicts of interest even though the underlying drivers of bias are not restricted to economic conflicts of interest.

   Conflicts due to economic interest in the outcome of litigation and/or arbitration is a real and genuine concern, and I do not wish to minimize its importance. I think it is desirable that such conflicts, whether real or potential, be revealed to and by all parties engaged in a dispute.

   However, the questions related to economic conflicts of interest appear to only provide information about arbitrator applicants who may end up being classified as non-public arbitrators. There are very few, if any questions that probe into conflicts of interest and biases for public arbitrators. As a result, parties receive less information about conflicts

of interest and bias from public arbitrators than they might receive about non-public arbitrators.

In addition, a potential arbitrator, however, may be biased against women, men, immigrants, ethnic minorities, people with a different sexual orientation, older people, younger people, poor people, rich people, and the like. There are innumerable sources of bias that are not accounted for and cannot be accounted for in any standard questionnaire.

c. Eliciting bias

There is a considerable literature in Psychology and Marketing that speaks to whether agents have veridical access to their own thoughts. It is quite clear, based on this and related literature that people are unaware of their biases, at least to the extent they can report on those biases in self-reports in response to questionnaires. In fact the literature in Psychology and neuroscience shows how obvious biases exist unbeknownst to the respondent (Nisbett and Wilson 1977), and when they are revealed to the respondent, are corrected for by the respondent (Schwarz and Clore 1983). As Professor V. S. Ramachandran, a distinguished neuroscientist observes in his recent book "A person's verbal response is likely to be inauthentic. It may be contaminated by other areas of the brain" (p. 215).

d. Length of Application and Timing Issues

The length of the application and timing of the questions also increase the likelihood that arbitrators completing the application will not fully disclose conflicts and biases. FINRA acknowledges at the beginning of FINRA's arbitrator application that completing the application process is grueling, which could constitute a barrier to entry for an individual interested in becoming an arbitrator. Furthermore, applicants do not know whether they will ultimately be accepted to FINRA's arbitrator pool and are not informed at the time of completion that the application is the primary way that FINRA obtains information related to actual or perceived conflicts of the arbitrators. All of these factors increase the likelihood that applicants will not fully disclose conflicts and biases.

2. FINRA's Arbitrator Disclosure Process Prior To Appointment To Arbitration Fails To Provide Parties With Meaningful and Reliable Information Related to Actual or Potential Conflicts of Interest and/or Biases.

To assist the parties in selecting arbitration panels, FINRA provides parties with Arbitrator Disclosure Reports to rank and strike the lists of potential arbitrators. The information on the Arbitrator Disclosure Report is derived from the answers in the FINRA Arbitrator Application and is presented only in summary format.

Parties to FINRA arbitrations are not entitled to review the arbitrator applications when selecting arbitrators, which further limits disclosure of information to the parties participating in an arbitration. FINRA also excludes some information contained in the application from disclosure reports. For example and importantly, the answers to question 13 of the FINRA Arbitrator Application, which speaks to disclosure of economic conflicts of interests, are not provided to the parties.

FINRA requires arbitrators to disclose "any relationship, experience and background information that may affect—or even appear to affect—the arbitrator's ability to be impartial and the parties' belief that the arbitrator will be able to render a fair decision."

However, by relying on self-reporting, the FINRA's rules on conflict and bias disclosure are rendered virtually meaningless. As discussed above, research determined long ago that people cannot accurately assess the nature and the level of their own bias. As a result, FINRA's practice of relying of self-reporting causes arbitrators to fail to disclose meaningful and reliable information about conflicts and bias.

Also, FINRA does not have a formal *voir dire* process before selecting the arbitration. FINRA's Code of Arbitration permits parties to request additional information from the arbitrators before the deadline to rank and strike the arbitrator lists. However, the rule does not require arbitrators to answer the questions at all or under oath. The lack of a meaningful *voir dire* process further contributes to the

parties not having full and complete disclosures about conflicts of interest and biases.

3. FINRA's Arbitrator Disclosure Process That Occurs After Arbitrators Are Appointed To Arbitration Panels Fails To Provide Parties With Meaningful and Reliable Information Related to Actual or Potential Conflicts of Interest and/or Biases.

After FINRA appoints arbitrators to a panel based on the parties' ranking and striking forms, FINRA requires each arbitrator on the panel to complete the FINRA Oath of Arbitrator and accompanying questions that relate to conflicts/biases. In large part, the questions are very similar to those contained in the Arbitrator Application. The questions contained in the FINRA Oath of Arbitrator fail to elicit meaningful and reliable information for the same reasons described above related to the problems with FINRA's Arbitrator Application.

Furthermore, the timing of these questions (i.e. post-appointment) make it very likely that the arbitrators will represent to the parties that any additional disclosure will not impact their ability to be impartial even if such disclosure does or will impact that ability.

In addition, parties seeking to remove of an arbitrator based on conflicts of interests and/or biases risk antagonizing an arbitrator that whom they are seeking to remove. This discourages parties from challenging arbitrators and as a result, it could provide an additional disincentive for arbitrators to disclose conflicts and biases.

4. FINRA's Arbitrator Disclosure Process Provides FINRA Member Firms With An Advantage Over Public Investors.

As discussed above, FINRA's arbitrator disclosure process fails to provide parties with meaningful and reliable information about actual or potential conflicts of interest and/or biases. FINRA's flawed arbitrator disclosure process provides respondent broker-dealers with an unfair advantage over public investors in securities arbitration disputes in part, because broker-dealers are repeat participants in

securities arbitration proceedings and therefore have more information about arbitrators in the pool, due to experience.

III. EXAMPLES OF PROBLEMS RELATED FINRA'S ARBITRATOR DISCLOSURE PROCESS

A. Arbitrators With Substantial Ties To The Securities Industry In The Public Pool.

In preparing this Report, PIABA asked its members to provide it with examples of problems that relate to FINRA's arbitrator disclosure process. In response, PIABA received examples of important disclosures of potential conflicts of interest and bias that were made by arbitrators after panels had been selected that would have changed the way claimants' counsel ranked the arbitrators. PIABA also received examples of arbitrators who were misclassified as public arbitrators even though the arbitrators had substantial ties to the securities industry.

In one case, PIABA member, Jeff Sonn, provided PIABA with an example of an arbitrator who was classified as a public arbitrator even though the arbitrator had spent 15 years of his career in the securities industry. In emails between Mr. Sonn and FINRA in May and June 2014, FINRA stated that the arbitrator was properly classified as public because he had not spent a "substantial" part of his career in the securities industry. FINRA stated in an email it for the purposes of classifying arbitrators, it defined internally the term "substantial" as 50%. See email exchange attached as Exhibit F to the Appendix.

Question 13(d) of FINRA's Arbitrator Application entitled *Arbitrator Classification* asks applicants the following question:

> Have you spent a substantial part of your career engaged in business activities listed in paragraph (a) above?

Presumably, a "yes" answer could lead to FINRA classifying him or her as a non-public arbitrator. A "no" answer could lead FINRA to classify the applicant as a public arbitrator. As noted by Dr. Rao, the term "substantial" is not defined in the application and as a result, the question fails to elicit meaningful and reliable information. As a result, FINRA's system could easily misclassify arbitrators simply because applicants define "substantial" differently.

FINRA does not provide parties with copies of the arbitrator applications. FINRA only provides parties with Arbitrator Disclosure Reports and FINRA recently responded to PIABA that the disclosure reports do not include answers to question 13 from the application. According to FINRA, Arbitrator Disclosure Reports only identify arbitrators as "public" or "non-public", which for the reasons stated above could be wrong. In addition, FINRA does not provide parties with an effective way to verify whether an arbitrator is properly classified.

In addition, as discussed above, FINRA considers its self-appointed National Arbitration and Mediation Committee (NAMC), which includes public members, to serve as its procedural safeguard to ensure fairness in approving new arbitrators to its roster. PIABA is concerned about the effectiveness of the NAMC sub-committee because FINRA does not provide sub-committee members with copies of the arbitrator applications either. According to page 5 of FINRA's Arbitrator Application, subcommittee members approve arbitrators based on the information that they receive from FINRA in Arbitrator Disclosure Reports. FINRA's Arbitrator Application states in pertinent part:

> If your application proceeds through Step One, your resulting Disclosure Report will be forwarded to a Subcommittee of the National Arbitration and Mediation Committee (NAMC) for its review and approval.

It is PIABA's understanding that NAMC members do not receive any other information about arbitrator applicants other than what is contained in the Disclosure Reports. Therefore, it does not appear that NAMC is privy to any more information than parties are provided in approving arbitrators to the roster. As a result, PIABA is concerned that there are no meaningful and reliable procedural safeguards in place to ensure that arbitrators are properly classified.

This is a classic example of why independent oversight of FINRA is crucial. At a minimum, PIABA recommends that the SEC investigate whether FINRA has adequate and verifiable procedural safeguards in place to ensure that arbitrators are being properly classified.

B. Deceased Arbitrators Being Placed On Arbitrator Ranking Lists

Two members provided examples in separate cases where deceased arbitrators were included in the Arbitrator Ranking Form. One PIABA member, Diane Nygaard from Kansas City reported that she recently had a case where two

deceased arbitrators were included on an Arbitrator Ranking List in one case. A summary of the situation is as follows:

On or around August 2013, FINRA sent counsel for the parties an Arbitrator Ranking Form and accompanying Arbitrator Disclosure Reports for each potential arbitrator in a case filed earlier that year.

Each Arbitrator Disclosure Report in the packet stated in the top center heading: "Report reflects information provided by the arbitrator through 08/16/2013." Based on the information listed on the Arbitrator Disclosure Reports, Claimants' counsel ranked one of the public arbitrators 2nd on the ranking sheet. It turns out that this arbitrator had died several months earlier in 2013. On the same list, another arbitrator was also deceased.

After discovering this fact, FINRA provided the parties with a new list of arbitrators which caused delay in getting a panel appointed. The fact that they were included suggests that FINRA does not contact the potential arbitrators prior to including them on the list.

C. FINRA Provides Parties With Arbitrator Disclosure Reports That Purport To Be Current When They Are Not.

A systemic problem with all Arbitrator Disclosure Reports is that each document includes a phrase stating, "Report reflects information provided by the arbitrator through [Date]." This language leads parties to believe that the information on the Arbitrator Disclosure Report is current at the time that FINRA sends the information to the parties. As shown below, however, that is not necessarily the case.

In July 2014, the author of this Report, tested whether the information is current. In a case recently filed, each Arbitrator Disclosure Report in the packet that our firm received stated in the top center heading: "Report reflects information provided by the arbitrator through 07/03/2014."

We asked all thirty potential arbitrators to answer the question: "When was the last time you updated your Arbitrator Disclosure Report?" The responses to this question are described below:

Of the thirty arbitrators, four (4) potential arbitrators did not respond at all. This could be the function of the FINRA Code of Arbitration not requiring arbitrators to answer questions from the parties prior to appointment.

Two (2) of the arbitrators responded they were not responding the request because they did not want to serve as arbitrators. Surprisingly, in the case of one of the arbitrators, the FINRA case administrator composed the arbitrator's response and stated:

> "Please be advised that Arbitrator [name omitted] notified FINRA that he will not be replying to the request for additional information."

After we called the case administrator and asked for the arbitrator's original response, the case administrator forwarded the original email response from the arbitrator and it stated as follows:

> "Since I currently am not accepting any new arbitration cases, I will not reply to this inquiry. Thanks[.]"

These two arbitrators should not have been included as potential arbitrators on the Arbitrator Ranking Form at all. An arbitrator's unwillingness to participate as an arbitrator is a material disclosure that all parties need to know before ranking and striking arbitrators. The fact that they were included suggests that FINRA does not contact the potential arbitrators prior to including them on the list.

Furthermore, PIABA is concerned that there may be other instances in which case administrators filter responses from arbitrators. Had our firm not followed up with the case administrator, we would not have known that the arbitrator was not accepting any new arbitration cases. Based on the first email from the case administrator, the parties may have ranked the arbitrator because all the parties would have known is that the arbitrator "will not be replying to the request for additional information."

The remaining responses are as follows:

- One (1) arbitrator stated that he "probably have not changed my disclosure report in 10 yrs."

- One (1) arbitrator stated, “the last time I updated my Arbitrator's Disclosure Report was in May 2010.”

- Two (2) arbitrators stated that they had not updated their Arbitrator Disclosure Form in 18-24 months. Their actual responses are as follows:
    - “18 mos or so ago.”
    - “I don't remember the exact date of the last time I updated my Disclosure Report. I believe it is within the last 18-24 months.”

- Two (2) arbitrators did not remember the last time he updated his Arbitrator Disclosure Report. The arbitrators’ response are as follows:
    - “I update my Arbitrator Disclosure Report whenever something changes. I don't know the last date I did that.”
    - “I am not sure when my arbitration disclosure report was last updated, but I believe it to be accurate.”

- Three (3) arbitrators stated that they had not updated their Arbitrator Disclosure Form approximately a year ago. The arbitrators’ responses are as follows:
    - “My disclosure document was updated about a year ago and nothing has changed.”
    - “I last changed my arbitrator disclosure report one year ago and have reviewed again today and there are no changes that need to be incorporated.”
    - “My arbitrator information was updated in 2013.”

- Three (3) arbitrators stated that they had updated their Arbitrator Disclosure Forms between six months and one year ago. Their responses are as follows:
    - “I updated my resume and disclosures within the last six months.”
    - Further, I have updated my Arbitrator Disclosure Report within the past six months. I’m sure that FINRA records would reflect this requested information in more specific detail.”
    - “I updated my information within the last year.”

- Of the thirty arbitrators included on the Arbitrator Ranking List, only twelve arbitrators (40% of the entire list) stated that they had updated their

Arbitrator Disclosure Reports within the last six (6) months. Their responses are as follows:

- "April 30, 2014. In addition, I just reviewed my Arbitrator Disclosure Report and it is correct."
- "April 2014"
- "Within the past 6 weeks."
- **"I don't recall when I last updated my disclosure. FINRA should have that information. I have reviewed the information [sic] within the last few months, and it is accurate."**
- "…the answer to the second question is 30-60 days ago is my estimate when the last time my arbitrator disclosure was updated."
- "My Disclosure Report should be up to date."
- The answer to the second question is "July 2014."
- "March 2014; Please update the Arbitrator Disclosure Report, to show that I am no longer an active member of the American Bar Association, and that I am inactive as a member of the National Bar Association."
- "My arbitrator disclosure report was updated about a month ago."
- "I updated my Arbitration Disclosure Report about 4 months ago. I have no additional disclosures to report at this time."
- "I believe I last updated my arbitrator profile earlier this year."
- "I do not maintain a log of my Arbitrator Disclosure Report updates, and my last update was done online, so my records do not indicate when my Report was last updated. My recollection is that I updated my Report in June 2014, or in any event fairly recently. As far as I know the Report posted on the FINRA DR-Portal for me is up-to-date and accurate."

IV. CONCLUSION

As shown above, PIABA has illustrated that the cornerstone of the integrity FINRA's arbitration forum, (i.e. its arbitrator disclosure process) is flawed at every stage. FINRA does not disclose how it recruits individual arbitrators. FINRA's recruiting practices have resulted in a pool of arbitrators that is not diverse and is homogenous, which is the very problem that the SEC warned about in 1992. As opined by Dr. Rao, the rest of FINRA's arbitrator disclosure process is illusory and fails to elicit meaningful and reliable information about conflicts of interests and/or biases. The FINRA application fails to elicit the very information that it is supposed to compile. FINRA magnifies the problem caused by the faulty application by withholding important answers in the application that speak to how

arbitrators are recruited and that disclose important information about potential conflicts and/or biases, i.e., Question 13 of application. FINRA also magnifies the disclosure deficiency problems by providing parties only with an Arbitrator Disclosure Report, which is just a summary of some information in the application. As illustrated above, Arbitrator Disclosure Reports incorrectly suggest that the reports are current. FINRA fails to adequately update the information on the Arbitrator Disclosure Reports. FINRA fails to provide the parties with a meaningful *voir dire* process and does not require its arbitrators to answers any questions for additional information. FINRA requires arbitrators to update their information only after they are selected to be on a panel. FINRA relies on the arbitrators to self-report conflicts of interest and biases, which research has long proven to be ineffective. Furthermore, by requiring arbitrators to update their disclosures after appointment increases the likelihood of late disclosures, which puts parties in a difficult position in deciding whether to ask for recusal or removal.

As opined by Dr. Rao, all of the problems described above related to FINRA's flawed arbitrator disclosure process provide respondent broker-dealers with an unfair advantage over public investors in securities arbitration disputes in part, because broker-dealers are repeat participants in securities arbitration proceedings and therefore have more information about arbitrators in the pool, due to experience.

Something must be done to protect investors. The fairness of FINRA's arbitration forum should be judged on whether FINRA's arbitrator disclosure process adequately protects investors by eliciting complete, meaningful, reliable and timely disclosures about FINRA's arbitrators. The securities industry has had almost thirty years to get the arbitrator disclosure process right and has not done so. As a result, given that FINRA's arbitrator disclosure process is flawed for the reasons identified in this Report, investors have no choice but to conclude that FINRA's arbitration forum is unfair.

PIABA supports investors having the unilateral right to choose between FINRA arbitration and court to resolve their disputes with the securities industry. PIABA encourages Congress to take action and pass *The Investor Choice Act of 2013* (H.R. 2998), which would prohibit the use of mandatory pre-dispute agreements by broker-dealers and investment advisers that force investors to arbitrate disputes or otherwise surrender their right to pursue recourse in a forum of their choosing. PIABA applauds the leadership of the bill's author and member of the House Financial Services Committee Rep. Keith Ellison (D-MN) for introducing the legislation.

The Investor Choice Act of 2013 will level the playing field for retail investors by amending Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act to statutorily prohibit the use of mandatory pre-dispute agreements in broker-dealer and investment adviser customer contracts that restrict investors' ability to pursue claims in the lawful forum of their choosing. The Investor Choice Act of 2013 would not in any way prevent investors from voluntarily electing to resolve a dispute through arbitration or mediation after the facts and circumstances of the dispute have been discovered.

Investors need protections now. In addition to legislative action, PIABA requests that the SEC use its power under the 1934 Securities Exchange Act as well as the Dodd-Frank to improve FINRA's arbitration forum for the better.