Financial Industry Regulatory Authority

September 18, 2014

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Notice of Filing of a Proposed Rule Change To Amend the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes To Increase Arbitrator Honoraria and Increase Certain Arbitration Fees (File No. SR–FINRA–2014–026); Response to Comments

Dear Mr. Fields:

On June 13, 2014, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend the Code of Arbitration Procedure for Customer Disputes ("Customer Code") and the Code of Arbitration Procedure for Industry Disputes ("Industry Code") (together, "Codes") to increase arbitration filing fees, member surcharges and process fees, and hearing session fees for the primary purpose of increasing arbitrator honoraria. Specifically, the proposed rule change would amend Rules 12214 (Payment of Arbitrators), 12800 (Simplified Arbitration), 12900 (Fees Due When a Claim is Filed), 12901 (Member Surcharge), 12902 (Hearing Session Fees, and Other Costs and Expenses), and 12903 (Process Fees Paid by Members) of the Customer Code. The proposed rule change would also amend Rules 13214 (Payment of Arbitrators), 13800 (Simplified Arbitration), 13900 (Fees Due When a Claim is Filed), 13901 (Member Surcharge), 13902 (Hearing Session Fees, and Other Costs and Expenses), and 13903 (Process Fees Paid by Members) of the Industry Code.[1]

The SEC received eight comment letters on the proposed rule change.[2]

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[1] See Securities Exchange Act Rel. No. 72479 (June 26, 2014), 79 FR 37786 (July 2, 2014) (File No. SR-FINRA-2014-026).

[2] Comments on the proposed rule change were submitted by: Steven B. Caruso, Esq., Maddox Hargett & Caruso, P.C., July 1, 2014 ("Caruso Comment"); Ryan K. Bakhtiari, Aidikoff, Uhl and Bakhtiari, July 2, 2014 ("Bakhtiari Comment"); Phillip M. Aidikoff, Esq., Aidikoff, Uhl and Bakhtiari, July 2, 2014 ("Aidikoff Comment"); Jason Doss, President, Public Investors Arbitration Bar Association (PIABA), July 22, 2014 ("PIABA Comment"); Ellen Liang, Student Intern; Elissa Germaine, Supervising Attorney; and Jill Gross, Director; Pace Investor Rights Clinic, July 23, 2014 ("Pace Comment"); David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, July 23, 2014 ("FSI Comment"); Andrea Seidt, President, North American Securities Administrators Association (NASAA) and Ohio Securities Commissioner, July 23, 2014 ("NASAA Comment"); and Michael J. Quarequio, Esq., July 23, 2014 ("Quarequio Comment").

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Their positions break down as follows: three support the proposed rule change;[3] three support the proposed rule change, but suggest further modifications;[4] and two support the proposed rule change in part and oppose it in part.[5] FINRA is hereby responding to the comments received on the proposed rule change.

The commenters support the increase in the arbitrator honoraria,[6] support the goal of such an honoraria increase[7] or do not oppose raising the honoraria.[8] A majority of the commenters acknowledge that, as it has been 15 years since the last increase, the proposed increase is long overdue and critical to the forum in recruiting and retaining a roster of high quality arbitrators.[9] In support of the proposed honoraria increase, one commenter believes that the proposed rule change would increase the likelihood of attracting and retaining competent, engaged arbitrators to serve on panels, which would achieve fair outcomes for participants in arbitration cases.[10]

The majority of commenters who support the proposed increase in arbitrator honoraria also support FINRA's proposed approach for funding these increased payments.[11] Specifically, these commenters believe that the plan to fund the increases generally through increased member fees and hearing session fees for claims over $500,000 would allocate fairly fee increases among the parties, as larger claims usually require more time and labor.[12] One commenter noted that FINRA's economic impact analysis helped FINRA strike an effective balance between assessing fees and surcharges and increasing the honoraria.[13]

While a majority of commenters support the proposed increase in arbitrator honoraria, two commenters oppose the plan to increase the filing fees that customers would pay to help fund the honoraria increases.[14] Further, some of the commenters who support the proposed rule change, nevertheless, raise concerns or suggested modifications for FINRA to consider. The remainder of FINRA's response addresses the opposition to the proposed rule change as well as the additional concerns and suggested modifications raised by the commenters.

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[3] Caruso Comment, Bahktiari Comment, and Aidikoff Comment.

[4] Quarequio Comment, FSI Comment, and PACE Comment.

[5] NASAA Comment and PIABA Comment.

[6] Caruso Comment, Bahktiari Comment, Aidikoff Comment, FSI Comment, PACE Comment, and Quarequio Comment.

[7] NASAA Comment.

[8] PIABA Comment.

[9] See, e.g., Caruso Comment, Bahktiari Comment, and Aidikoff Comment.

[10] FSI Comment.

[11] Caruso Comment, Bahktiari Comment, Aidikoff Comment, FSI Comment and PACE Comment.

[12] See, e.g., PACE Comment, Bahktiari Comment, and Aidikoff Comment.

[13] FSI Comment.

[14] PIABA Comment and NASAA Comment.

Members should pay any fee increases

Two commenters oppose the part of the proposed rule change that would increase the filing fees that customers would pay to help fund the honoraria increases.[15] One commenter suggests that such an increase could deny investors access to the forum, and, therefore, members should pay all of the increased filing fees.[16] The other appreciates FINRA's effort to mitigate costs for investors under the proposed rule change, but suggests that if investors suffer losses that would result in a claim of more than $500,000, they could not afford the large fees to file a claim under the proposed rule change.[17] This commenter contends that investors would prefer to pursue claims in state court as the filing fees are less there than the proposed filing fees.[18]

FINRA notes that as claimants and respondents utilize the arbitration facilities to resolve disputes, it would be inequitable for industry members to pay 100 percent of the filing fee increase. Further, FINRA disagrees with the PIABA assertion that an increase in filing fees for investors could serve to deny access to the forum for investors, because the filing fee increases begin for claims over $500,000 and a majority of the increases are added to the refundable portion of the fee to help minimize the impact of the increases on claimants.[19]

In response to the concern that investors could not afford the proposed filing fees after having suffered a financial loss, FINRA notes that an inability to pay the filing fees would not foreclose an investor's ability to seek redress in the forum. If an investor demonstrates financial hardship, FINRA will waive the filing fees.[20]

Finally, whether a claim goes to court or to arbitration is not the subject of the rule filing and is, therefore, outside the scope of the filing. FINRA believes, however, that while the filing fees in the forum may not be comparable to those in state courts, investors experience substantial savings in arbitration compared to litigation.[21] For example, claims in arbitration are typically resolved more quickly than claims in litigation. Further, in arbitration, appeals of awards are rare and are based on narrower grounds under the Federal Arbitration Act.[22] Moreover, investors in arbitration avoid the expense

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[15] Id.

[16] PIABA Comment.

[17] NASAA Comment.

[18] Id.

[19] See supra note 1 at 37791-37792.

[20] See FINRA, Arbitration & Mediation, Fee Waivers, at http://www.finra.org/ArbitrationAndMediation/Arbitration/Fees/FeeWaivers/index.htm.

[21] See FINRA, Arbitration & Mediation, What to Expect, at http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p117486.pdf.

[22] An award may be vacated upon the application of any party to the arbitration—

(1) where the award was procured by corruption, fraud, or undue means;

(2) where there was evident partiality or corruption in the arbitrators, or either of them;

(3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy, or of any other misbehavior by which the rights of any party have been prejudiced; or

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of depositions and similar costs associated with discovery in litigation. For these reasons, FINRA believes that the benefits and cost savings of arbitration make filing an arbitration claim a less costly option for investors.

For these reasons, FINRA declines to modify the proposed rule change to assign all filing fee increases to members, and requests that the SEC approve the proposed rule change as proposed.

Use of predispute arbitration agreements

The commenters who oppose the proposed increase in the filing fees that customers would pay also cite the use of predispute arbitration agreements ("PDAAs") by members as additional rationale for their opposition.[23] Specifically, the commenters believe that as PDAAs require parties to arbitrate their disputes in the forum, investors do not have a choice of forum, and, thus, should not be required to pay the increase in filing fees.[24]

The issue of whether the use of PDAAs by members is appropriate is not the subject of this rule filing.[25] Rather, the issue, FINRA believes, is whether the proposed fee increases provide for the equitable allocation of reasonable dues, fees and other charges among members and issuers and other persons using any facility or system that FINRA operates or controls.[26] Specifically, the proposed rule change allocates the proposed fee increases among users of the forum by spreading them through the higher claim amounts. In particular, the filing fee and hearing session fee increases for customers begin for claim amounts of more than $500,000, which minimizes the impact of the increases on smaller claims and keeps the arbitration forum accessible for the small investor. Moreover, to further mitigate the impact of the filing fee increases, most of the increases would be added to the refundable portion of the filing fee. Conversely, the proposed rule change would increase the member surcharge and process fees – the fees that only members pay in arbitration - for claim amounts of more than $250,000. FINRA believes that the proposed fee increases are reasonable and represent an equitable allocation of the costs of the forum among the users of the forum and are, therefore, consistent with the requirements of the Securities Exchange Act of 1934.[27]

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(4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

See 9 U.S.C. §10(a).

[23] PIABA Comment and NASAA Comment.

[24] Id.

[25] See Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987); see also Rodriquez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989) (finding expressly that predispute arbitration agreements mandating arbitration of customer and broker dealer disputes are consistent with the purposes of the federal securities laws).

[26] 15 U.S.C. § 78o-3(b)(5).

[27] 15 U.S.C. § 78s (b)(1).

Allocation of forum fees

One commenter contends that members should pay all of the proposed increased filing fees, because arbitration panels rarely assess forum fees against respondents even when they find the respondents liable for the claimants' losses.[28]

Arbitrator training materials and the Award Information Sheet guide arbitrators on making allocation decisions. The training materials indicate that the arbitrators have the discretion to assess forum fees among the parties in any fashion. Some of the factors that they might consider include, but are not limited to, a determination that a case was frivolous, party behavior at the hearing, party responsibility for delaying or prolonging hearings, and a party's perceived ability to pay forum fees. Further, FINRA gives the arbitrators an Award Information Sheet to guide them on how to complete each section of the arbitration award.[29] FINRA notes that the arbitrators make allocation decisions on a case by case basis depending on what happened during the hearings.

However, FINRA reviewed the customer claimant cases closed by award from 2011 through 2013. In only four of these cases (less than one percent), the respondent was found liable for claimants' losses, but was not assessed any fees. Three of the cases were pursued by claimants under the default[30] proceedings. In these cases, arbitrators assessed forum fees of $300, $300, and $1,425 respectively against the claimants. The fourth case was not a default proceeding but only the claimant appeared at the hearing. In that case, the arbitrators assessed the claimant a total of $4,500 for two hearing sessions and four prehearing conference sessions. However, FINRA waived the claimant's filing fees in that matter and the arbitrators awarded the claimant more than 160 percent of the compensatory damages claimed plus $15,000 in sanctions from the respondent firm.

Based on these data, FINRA concludes that the commenter's assertion is inaccurate and misleading.

Add statistical modeling to file

One commenter contends that the proposed rule change does not provide sufficient information to assess the reasonableness or anticipated effectiveness of the increases that FINRA is proposing.[31] The commenter suggests that FINRA produce the statistical model it created to develop the proposed rule change and make it a part of the rule filing.[32]

FINRA believes that the information provided in the rule filing is sufficient to elicit meaningful comment. Moreover, FINRA's financial systems and the data they generate are used only by FINRA staff when conducting FINRA business and operations. Because of the proprietary nature of these systems and their data, FINRA believes the information should remain non-public.

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[28] PIABA Comment.

[29] The Award Information Sheet provides the same guidance as the training materials.

[30] See Rules 12801 and 13801.

[31] NASAA Comment.

[32] Id.

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Enhance recruitment to expand arbitrator rosters

One commenter opines that it cannot assess whether there is a need for an increased arbitrator honoraria because the proposed rule change does not provide information concerning the current size or quality of FINRA's existing arbitrator pool.[33] The commenter suggests that FINRA should use different arbitrator recruiting methods to expand its outreach and geographical presence.[34] The commenter believes that FINRA may have greater flexibility in setting honoraria amounts by expanding its geographical presence, which could result in reduced travel expense reimbursements for many participants.[35]

FINRA relies on a diverse roster of over 6,300 arbitrators to maintain its fair, impartial and efficient system of dispute resolution. (The exact number of arbitrators, broken down by public and non-public classifications, is updated monthly and published on our website.[36]) The roster consists of arbitrators from various backgrounds, including educators, accountants, medical professionals and others, as well as lawyers and securities professionals. Unless waived by FINRA at its discretion, arbitrator applicants must have a minimum of five years of paid, business and/or professional experience and at least two years of college-level credits.

After thoroughly completing the arbitrator application, which consists of twenty multiple-part questions, the resulting Disclosure Reports of new arbitrator applicants are forwarded to a Subcommittee of the National Arbitration and Mediation Committee[37] for its review and approval, as all applications are subject to approval to determine if the applicant's credentials match FINRA's needs.

Additionally, applicants are subject to an extensive background verification conducted by FINRA's third-party vendor. The areas covered by the background verification include the applicant's employment, education, social security number verification, professional licenses, and civil/criminal records. In order to maintain the quality of the roster, FINRA periodically re-verifies, at its own expense, the backgrounds of existing roster members.

Finally, after completing the lengthy application process, and before serving on a case, arbitrators must successfully complete FINRA's comprehensive Basic Arbitrator Training Program ("Program"). The Program covers each stage of the arbitration

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[33] NASAA Comment.

[34] Id.

[35] Id.

[36] See FINRA, Arbitration & Mediation, Dispute Resolution Statistics, at http://www.finra.org/ArbitrationAndMediation/Arbitrators/Responsibilites/OathofArbitrator/index.htm.

[37] The NAMC is a Board-appointed advisory committee on arbitration matters and includes representatives from the public, the securities industry and arbitrators and mediators serving in FINRA's Dispute Resolution forum. The majority of the NAMC's members, including its Chair, are public representatives. Under the Codes of Arbitration Procedure, the NAMC shall have the authority to recommend rules, regulations, procedures and amendments relating to arbitration, mediation, and other dispute resolution matters to the Board. The NAMC shall also establish and maintain rosters of neutrals composed of persons from within and outside of the securities industry. See Rules 12102 and 13102.

process and reviews the procedures that arbitrators must follow to successfully complete an arbitration case. The Program consists of three parts: (1) basic arbitrator training; (2) expungement training, and (3) live video or classroom training.

Once approved to the roster, FINRA arbitrators may be required to respond to mandatory surveys to ensure proper classification as either public or non-public, and to ensure eligibility under the Codes. Arbitrators are also subject to evaluation by FINRA staff, the parties, and fellow arbitrators at the conclusion of each case. The evaluation process is an essential part of FINRA's continuous efforts to ensure the quality of our administrative services and the arbitrators on our roster. FINRA encourages parties and arbitrators to complete their respective evaluation forms because we believe there is no better way to assess an arbitrator's dedication, attentiveness, and objectivity than to review the feedback from the parties and from arbitrator's fellow panelists.

As the commenter suggests, FINRA already focuses on areas of the country where there is a lower number of available arbitrators. In its effort to recruit arbitrators from a diverse group of professionals, FINRA continues to conduct outreach activities in underserved locations, including attending business and recruitment conferences, initiating direct marketing and ad campaigns, publishing articles in *The Neutral Corner*[38] and soliciting applicant referrals in a monthly email that is distributed to FINRA neutrals. FINRA also tracks the success of its recruitment initiatives by asking in its application how applicants learned of the arbitrator opportunity. It also asks them to provide names of individuals whom they recommend for the roster. As the number of available arbitrators increases in these areas, FINRA agrees that fewer resources would be necessary to pay arbitrator expenses to travel to remote hearing locations.

FINRA notes that the increased honoraria would be helpful in its recruiting efforts, as staff has received feedback from prospective applicants who have declined to apply when they learn of the current pay structure. Similarly, it would also support our retention objective, as current arbitrators express their concerns to FINRA staff regularly about the honoraria levels.

Apply the increased honoraria retroactively

One commenter expressed concern that applying the increased honoraria prospectively would create a two-tier pay structure for arbitrators – one for arbitrators assigned before the effective date and another for those assigned after the effective date.[39] For cases filed prior to the effective date, the commenter's concern is that if hearings are not scheduled for 12 months or more after the initial prehearing conference,[40] the arbitrators would be compensated under the current honoraria levels.[41]

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[38] See FINRA, The Neutral Corner, Vol. 1, 2011 at http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p123215.pdf.

[39] Quarenquio Comment.

[40] An initial prehearing conference is a hearing session that is conducted telephonically and is held before any hearings are conducted. See Rules 12100(t) and 12500; see also Rules 13100(t) and 13500.

[41] Quarenquio Comment.

The commenter suggests making the honoraria increase partially retroactive to pending cases.[42]

FINRA understands the commenter's concern; however, the suggestion, if implemented, would have a negative impact on the forum's resources. The stated purpose of the proposed rule change is "to increase arbitration filing fees, member surcharges and process fees, and hearing session fees for the primary purpose of increasing arbitrator honoraria."[43] If FINRA were to extend the honoraria increases to pending cases, the honoraria payments would not be properly funded, as the fees in these cases would be based on the current fee structure. Further, FINRA must program its technology platforms to effectively implement the honoraria and fee changes. To simplify the technology programming and to ensure consistent application of the honoraria and fee changes, FINRA believes the increased honoraria should apply to cases filed on or after the effective date.

Increased arbitrator honoraria could create conflicts of interest

One commenter suggests that FINRA consider the effect that increased arbitrator compensation could have on an arbitrator's impartiality.[44] The commenter believes that the increased payments could make arbitrators reluctant to grant a motion to dismiss[45] because doing so would eliminate potential compensation they would receive from serving on panel.[46] To eliminate this concern, the commenter suggests paying a "set" honorarium.[47]

First, FINRA does not believe that increasing the honoraria would prevent arbitrators from performing their duties and deciding disputes in a fair manner, as they must agree to do by executing the arbitrator oath.[48] Further, arbitrators must comply with the ethical standards in the Code of Ethics for Arbitrators in Commercial Disputes ("Code of Ethics"),[49] when conducting FINRA arbitrations. FINRA believes the overarching tenet of Canon I – an arbitrator should uphold the integrity and fairness of the arbitration process[50] – guides the actions of arbitrators as they make decisions in a case. In particular, Canon I(D) requires that arbitrators conduct themselves in a way that is fair to all parties and should not be swayed by outside pressure, public clamor, and fear of criticism or self-interest.[51] Moreover, if arbitrators deny a motion to dismiss, it would

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[42] Id.

[43] See supra note 1 at 37786.

[44] FSI Comment.

[45] See Rules 12504 and 13504.

[46] FSI Comment.

[47] Id.

[48] See FINRA, Arbitration & Mediation, Oath of Arbitrator, at http://www.finra.org/ArbitrationAndMediation/Arbitrators/Responsibilites/OathofArbitrator/index.htm.

[49] See FINRA, Arbitration & Mediation, Code of Ethics for Arbitrators in Commercial Disputes, at http://www.finra.org/ArbitrationAndMediation/Arbitrators/Responsibilites/CodeofEthics/index.htm.

[50] See Code of Ethics, Canon I at 5.

[51] Id.

be because they believe that the grounds for dismissing a claim prior to the conclusion of a claimant's case in chief have not been met.[52]

Second, the commenter suggests that FINRA pay a set honorarium, but does not define what "set" means.[53] For purposes of FINRA's response, FINRA interprets the suggestion to mean a fixed amount, regardless of the number of motions decided or hearings held during a case. Based on this interpretation, FINRA believes that paying a set honorarium to arbitrators would present some challenges to the forum. The current honoraria structure pays arbitrators for certain tasks or activities they perform in a case, such as paying for the number of hearing session held.[54] This structure gives parties some control over the process and, in some cases, the fees, by permitting the parties to settle the arbitration.[55] A set honorarium would negate these benefits. Further, FINRA believes such a payment structure would be unfair to parties whose arbitration case requires a minimal number of hearing sessions as well as to those arbitrators who sit on cases with a large number of hearing sessions. Moreover, FINRA believes more cases would go to hearing, as there would be no incentive to settle, which would result in an increase in forum expenses. For these reasons, FINRA declines to amend the proposed rule change as suggested.

Calculate hearing session fees based on an hourly rate

A commenter suggests that FINRA should consider calculating hearing session fees based on an hourly rate.[56] The commenter explains that, in its experience, the length of hearing sessions vary and most last less than the four-hour allotment, as defined by the Codes.[57] Thus, arbitrators are compensated the same amount, whether they hold a hearing session that lasts two or four hours. The commenter believes that a change to an hourly rate would help FINRA recruit and retain high-quality arbitrators who have an incentive to manage arbitration cases efficiently and consider all issues thoroughly.[58]

FINRA notes that the structure of hearing session payments is not the subject of this rule filing. Thus, as this subject is outside the scope of the proposed rule change, FINRA declines to respond at this time.

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[52] See Rules 12504(a)(6) and 13504(a)(6).

[53] FSI Comment.

[54] See Rules 12902 and 13902.

[55] See Rules 12701 and 13701.

[56] PACE Comment.

[57] The term "hearing session" means any meeting between the parties and arbitrator(s) of four hours or less, including a hearing or a prehearing conference. Rules 12100(n) and 13100(n).

[58] PACE Comment.

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FINRA believes that the foregoing responds to the issues raised by the commenters. If you have any questions, please contact me on 202-728-8151 or mignon.mclemore@finra.org.

Sincerely,

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Mignon McLemore
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FINRA Dispute Resolution, Inc.