The Neutral Corner

Volume 2 – 2009

Mission Statement

We publish *The Neutral Corner* to provide arbitrators and mediators with current updates on important rules and procedures within securities dispute resolution. FINRA's dedicated neutrals serve parties and other participants in the FINRA forum by taking advantage of this valuable learning tool.

WHAT'S INSIDE

How Well Do Attorneys and Litigants Evaluate Settlement Offers During Negotiations?

*By Richard Fincher, FINRA Arbitrator and Mediator

Introduction

Many disputes that do not settle in mediation end with the declaration, "We can do better at trial." But as the parties and mediator leave the room, they may ask themselves if that assertion is accurate. Will the reluctant party fare better at trial? Did the client and the attorney accurately assess the value of their case? Was one party smart in rejecting the last offer of settlement?

In the law review article, "Let's Not Make A Deal: An Empirical Study of Decision Making in Unsuccessful Settlement Negotiations,"[1] the authors conclude that settling litigation through negotiations is generally a better decision than taking a case to trial, for both plaintiffs and defendants.[2] The results from the study counter conventional wisdom that attorneys are generally accurate in evaluating settlement value and risk assessment of their cases.

I do not have an opinion on the methodology used by the authors. However, I note that the conclusions are consistent with my own experience mediating commercial and FINRA cases.

The Study

This article, hereinafter "the Study," examines over 2,000 California civil cases in which plaintiffs and defendants conducted settlement negotiations, rejected an opposing proposal and then went to trial or arbitration. The settlement offers were compared to the ultimate award or verdict, revealing decision-making errors. Decision error is defined as a party's failure to achieve a more favorable

continued on page two

Message from the Editor

Comments, Feedback and Submissions

In addition to comments, feedback and questions regarding the material in this publication, we invite you to submit suggestions for articles and topics you would like addressed. We reserve the right to determine which articles to publish.

Please send your comments to:

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How Well Do Attorneys and Litigants Evaluate Settlement Offers During Negotiations? continued

result at trial than could have been achieved by accepting the adverse party's demand or offer. Under this definition, a party errs when the award is the same as or worse than the demand or offer it declined. Decision error was strictly a mathematical calculation and does not suggest attorney negligence.

The Study database consists of cases reported in *Verdict Search California* during the 38-month period from November 2002 – December 2005. *Verdict Search California*, previously titled *California Jury Verdicts Weekly*, obtains information from attorneys about the parties, facts, damages, results and settlement offers. The Study includes cases in which plaintiffs retained counsel on both a contingency and non-contingency basis. Personal injury disputes were the most common type of case in the sample.

In interpreting the data, the authors examined the influence of explanatory variables that might affect the outcomes, such as actor variables and context variables. Actor variables, for example, describe the type of plaintiff or defendant (*e.g.,* corporation, individual, unincorporated business entity) and the attorneys representing them (*e.g.,* gender, law firm size, law school ranking, experience, mediation experience). Context variables represent conditions under which the "actors" make settlement decisions—variables such as the forum in which a case was tried, the type of case or the nature of alleged damages or whether Section 998 offers were served.[3]

Prior to the Study, the historical theory of litigation risk-analysis asserted that trials occur primarily in close cases and that plaintiffs and defendants are equally adept in predicting trial outcomes. Under this historical theory, plaintiffs will win about 50 percent of the cases that proceed to trial, and mistakes about outcomes will be evenly distributed between plaintiffs and defendants. The Study, however, negates the historical theory.

Insights from the Study

The Study provided several key insights concerning risk-analysis during settlement negotiations:

- The majority, or 80 to 92 percent, of litigated cases settle.
- In most cases, the ultimate trial verdict or arbitration award reveals that one of the parties has miscalculated.
- In 61 percent of the cases, plaintiffs made the wrong decision to go to trial, which resulted in a verdict or award that awarded less money than the last settlement offer. This is particularly true for cases in which the plaintiff attorney is retained on a contingency basis.
- In 24 percent, defendants fared worse by proceeding to trial. However, the cost of going to trial is more significant for defendants. The average plaintiff settlement demand was $770,900; although the average verdict was $1.9 million—a difference of more than $1.1 million.
- The presence of punitive damages requested in claims significantly affected decision error rates. Decision error among defendants (defendant error) with punitive claims rose from 20.4 percent to 36.6 percent. In other words, defendants underestimate the potential of a verdict with punitive damages.
- Participation by a party advocate—someone who also serves as a mediator-attorney for other cases—helped reduce decision error rate.
- In general, high rates of decision error among plaintiffs (plaintiff error) were associated with cases in which contingency fee arrangements are common, such as in personal injury and medical malpractice cases. Low decision error rates were associated with cases in which contingency fee arrangements are uncommon, such as in contracts and eminent domain cases.
- In general, high rates of defendant error occurred in cases in which insurance coverage was usually unavailable (for example, contracts and fraud). Low decision error rates were associated with cases in which insurers are more likely to represent defendants, for example, premises liability and personal injury.

Based on these insights, the Study demonstrated two major points for me: first, the ultimate verdict or arbitration award proves that one of the parties has miscalculated during negotiations; second, the use of mediators diminishes decision error during negotiation.

How Well Do Attorneys and Litigants Evaluate Settlement Offers During Negotiations? continued

Forum Variables: Is There a Statistical Difference in Risk Analysis?

In the Study, the three forum variables were jury trials, bench trials and arbitration.[4] I expected decision error rates to be the same regardless of the forum, but the analysis indicates that the forum affects decision error rates.

Decision error rates differed substantially for both plaintiffs and defendants in arbitration cases, compared to their rates in jury cases. Defendant error in arbitration (45.4 percent) was similar to their error rate in bench trials (42.6 percent), but considerably more than in jury trials (22.1 percent). Plaintiff error in arbitration cases (28.9 percent) was notably lower than in either bench trials (42.6 percent) or jury trials (64.0 percent). The total amount of decision error is lower in arbitration than in either bench or jury trials.

Overall, plaintiffs are better at analyzing risk in arbitration than in a jury or bench trial. Defendants are better at analyzing risk in a jury trial than in arbitration or a bench trial. The reasons are not clear, but I would say that variables such as contingency compensation by plaintiff attorneys and the effect of insurance adjusters might play a role in decision-making.

Implications for FINRA Advocates and Mediators

Assuming the broad conclusions of this research are accurate, what is causing decision error during settlement negotiations? Is it the client who will not listen to his or her advocate? Is it the attorney who is blinded by a case and loses perspective? Are the attorney and client unable to objectively discuss litigation risk? Is the attorney overconfident?

Although the data for the Study does not include traditional securities litigation, for me it reaffirms the value of effective mediator practice and the need for representatives to talk candidly with their clients to address:

- **Litigation risk.** Most clients appear with only their perspective and no understanding of trial risk. While settlement value is less than potential trial value, it is a calculated tradeoff when a party considers the risks of motion practice, judicial temperament and potential low damages. Time-value of a settlement now, rather than the chance of a monetary payment years in the future, should also figure into the litigation risk calculus.
- **Reality-testing.** The entire discovery produced prior to the hearing may not be accepted into the record. One also has to consider the possibility that some witnesses may not be as compelling as expected and that cross-examination may damage a witness's credibility. And some evidence is not as convincing in front of a judge or an arbitrator as it is with a jury.

Summary

This research draws several conclusions from one set of data from California cases and other jurisdictions may reveal different insights. In California, the broad conclusion of the research confirms that settling litigation through negotiation is generally a smarter decision than going to trial, for both plaintiffs and defendants.

As a FINRA and commercial mediator, my experience supports this conclusion. The next time I hear a party say, "We can do better at trial," I will renew my efforts to test the reality of their evidence, and question whether both client and counsel have conducted an objective risk analysis.

The views expressed in this article are solely the author's, and do not necessarily reflect FINRA's views or policies.

**Richard Fincher is a full-time attorney-mediator and arbitrator of commercial and employment litigation. He has served as an arbitrator and mediator on FINRA's rosters for several years. He is adjunct faculty with the Scheinman Institute for Conflict Solution (SICR) at Cornell University and the Managing Partner of Workplace Resolutions LLC in Phoenix, Arizona. He can be contacted at* rdf@workplaceresolutions.com.

Endnotes:

1 Randall Kiser, Martin Asher, and Blakely McShane, "Let's Not Make A Deal: An Empirical Study of Decision Making in Unsuccessful Settlement Negotiations," 5 *Journal of Empirical Research* 551 (Cornell Law School September 2008). The article is available also online at ***http://www3.interscience.wiley.com/cgi-bin/fulltext/121400491/PDFSTART***.

See also "Study Finds Settling is Better than Going to Trial," *The New York Times,* Business Section, August 8, 2008.

2 This academic research does not focus on securities litigation, *e.g.,* suitability of investment, failure to supervise, etc., nor reach any conclusions about FINRA arbitrations or mediations.

3 California's Code of Civil Procedure Section 998 allows parties to contractually allocate treatment of attorney's fees and costs in settlement agreements or stipulations.

4 Ninety percent of the cases in the Study were tried by juries; the remaining cases were divided about evenly between bench trials and arbitrations.

Dispute Resolution News

Case Filings

Arbitration case filings from January through April 2009 reflect an 81 percent increase compared to cases filed during the same four-month period in 2008 (from 1,326 cases in 2008 to 2,403 cases in 2009). Customer-initiated claims during this four-month period increased even more, by 106 percent. The increase is being fueled by market fluctuations and by claims involving subprime mortgages (typically claims alleging that mutual funds were over-concentrated in these investment vehicles without adequate disclosure) and "failed auctions" for auction rate securities. Between January and April 2009, parties filed 182 subprime mortgage cases and 103 auction rate securities cases.

Special Arbitration Procedures in Cases Involving Auction Rate Securities

In December 2008, FINRA announced special arbitration procedures for claims of consequential damages involving auction rate securities filed by customers of firms that entered into regulatory settlements with FINRA or the Securities and Exchange Commission (SEC). The most recent FINRA settlements, announced on May 7, involved NatCity Investments, Inc., M&T Securities, Inc., Janney Montgomery Scott LLC and M&I Financial Advisors, Inc. For more information about these latest settlements, please review the news release on our Web site.

Several brokerage firms have also entered, or are expected to enter into, settlements with state securities regulators in cases arising from the sale of auction rate securities by those firms. You may review the special procedures for these cases on the NASAA Web site.

The regulatory settlements define eligibility for the special arbitration procedures. FINRA's Web site shows the special arbitration procedures for claims filed by customers of the firms that have entered into **final** regulatory settlements with FINRA and the SEC.

In accordance with the settlements, public arbitrators will decide the cases. Under the special procedures, firms:

1. will pay all fees related to the arbitration;
2. cannot contest liability related to the illiquidity or sales of the auction rate securities holdings; and
3. cannot use as a defense an investor's decision not to sell the holdings before the relevant settlement date, or the investor's decision not to borrow money from the firm if it made a loan option available to auction rate securities holders.

To expedite the arbitration process under the special procedures, cases claiming consequential damages under $1,000,000 will be decided by a single chair-qualified public arbitrator. Claims for consequential damages of $1,000,000 or greater will also be decided by a single chair-qualified arbitrator, unless both parties agree, in writing, to the appointment of three public arbitrators.

Under the special arbitration procedures, investors now have the option of selling their auction rate securities holdings back to the firms under the regulatory settlements and, at the same time, pursuing claims for consequential damages. If investors do not opt for the special arbitration procedures, they retain the choice of other available remedies, including initiating a FINRA arbitration claim under standard procedures. Investors who wish to seek punitive damages or attorneys' fees have the option to do so under FINRA's standard arbitration procedures.

Please visit our Web site for more information about these special arbitration procedures.

Neutral Workshops

FINRA's New Motion to Dismiss Rules—What You Need to Know

On February 24, 2009, FINRA introduced a pre-recorded neutral workshop to address FINRA's new motion to dismiss rules. The rules significantly limit motions to dismiss filed prior to the conclusion of a party's case-in-chief and impose stringent sanctions against parties for engaging in abusive practices under the rules. In the workshop, senior FINRA staff discussed the new rules and addressed various case scenarios.

Workshop faculty included: Linda D. Fienberg, President, FINRA Dispute Resolution; Rose M. Schindler, Vice President and Regional Director, Southeast Region; and Scott Carfello, Associate Vice President and Regional Director, Midwest Region.

Neutrals can access the audio file on FINRA's Web site.

Here are links to the workshop reference materials:

- FINRA—*Regulatory Notice 09-07*
- FINRA—Motion to Dismiss and Eligibility Rules FAQ

Update on FINRA's Mediation Program

In a future workshop, staff will discuss the restructuring of our mediation program. We plan to deploy a new mediator fee schedule that will become effective July 1. We designed the new fee schedule to secure mediator loyalty, promote our program and simplify the mediation administrative process.

Note: *FINRA's neutral workshops are now pre-recorded and archived on the Arbitration & Mediation section of* www.finra.org.

2009 FINRA Annual Conference

FINRA hosted its securities conference from May 6 – 8 in Boston, Mass. FINRA combined its securities conferences into a single annual event and expanded the program to address complex business and operational challenges firms face in today's regulatory landscape. At the conference, attendees heard from industry leaders and analysts regarding their perspectives on regulatory reform and the future of the financial services industry, and attended a schedule of workshops designed to address their own unique needs.

Dispute Resolution News continued

Dispute Resolution presented a panel discussion on recent and anticipated case filings and trends, rule filings and approvals and how arbitration fits into the changing political landscape. Moderated by Linda Fienberg, the panel included Pat Sadler of the law firm Sadler & Hovdensven, PC and Anne Flannery of the law firm Morgan, Lewis & Bockius, LLP.

SEC Filings

Panel Composition for Claims Involving an Associated Person in Industry Disputes

On March 4, 2009, FINRA filed a proposed rule change with the SEC to amend the Code of Arbitration Procedure for Industry Disputes (Industry Code) to change the criteria for determining the panel composition when the claim involves an associated person in industry disputes. The proposal would require that the parties receive a majority public panel for all industry disputes involving associated persons (excluding disputes involving statutory employment discrimination claims which require a specialized all public panel); clarify that, in disputes involving only member firms, parties will receive an all non-public panel; and provide that if a party amends its pleadings to add an associated person to a previously all member case, parties will receive a majority public panel.

Please visit our Web site for more information about this rule proposal.

Procedures to Expedite the Administration of Promissory Note Cases

On March 24, 2009, FINRA filed a proposed rule change with the SEC to establish new procedures to expedite the administration of promissory note cases. Proposed new Rule 13806 would apply to arbitrations solely involving a member's claim that an associated person failed to pay money owed on a promissory note. In order to proceed under the new rule, a claimant would not be permitted to include any additional allegations in the Statement of Claim. FINRA is also proposing to amend Rules 13214 and 13600 of the Industry Code to make conforming changes.

Please visit our Web site for more information about this rule proposal.

SEC Approvals

Single Arbitrator Threshold Rule

On February 2, 2009, the SEC approved amendments to FINRA Rule 12401 of the Code of Arbitration Procedure for Customer Disputes (Customer Code) and Rule 13401 of the Industry Code to raise the amount in controversy for appointing a single, chair-qualified arbitrator to $100,000, exclusive of interest and expenses. The arbitrator will be selected from the roster of arbitrators who are qualified to serve as chairpersons. Investors' claims for up to $100,000 will be heard by a single public, chair-qualified arbitrator. The rules became effective on March 30, 2009.

You may view *Regulatory Notice 09-13* for more information about this new rule.

Explained Decisions

On February 4, 2009, the SEC approved amendments to Rules 12214, 12514 and 12904 of the Customer Code and Rules 13214, 13514 and 13904 of the Industry Code, which establish procedures for explained decisions. Under the rules, FINRA will require arbitrators to provide an explained decision at the parties' joint request. An explained decision is a fact-based award stating the general reasons for the arbitrators' decision. Parties will be required to submit any joint request for an explained decision at least 20 days before the first scheduled hearing date. The chairperson of the arbitration panel will write the explained decision and will receive an additional honorarium of $400 for doing so. The rules became effective on April 13, 2009.

You may view *Regulatory Notice 09-16* for more information about this new rule.

Tolling Provisions

On May 12, 2009, the SEC approved amendments to Rules 12206 and 13206 of the Customer Code and the Industry Code to clarify that the rules toll the applicable statutes of limitation when a person files an arbitration claim with FINRA.

Please visit our Web site for more information about this new rule.

Amendments to Form U4, Form U5 and FINRA Rule 8312

On May 13, 2009, the SEC approved amendments to the Uniform Application for Securities Industry Registration or Transfer (Form U4) and the Uniform Termination Notice for Securities Industry Registration (Form U5), as well as FINRA Rule 8312 (FINRA BrokerCheck Disclosure). The amendments make significant changes to disclosure questions on the Forms, including the addition of questions about certain regulatory actions. The revised Forms were implemented in the Central Registration Depository (CRD) on May 18, 2009. The effective date for most of these changes (i.e., the Forms changes and the amendment to FINRA Rule 8312)—with the exception of the new regulatory action disclosure questions—was May 18, 2009. The effective date for the new regulatory action disclosure questions will be November 14, 2009.

You may review *Regulatory Notice 09-23* for more information about the amendments to the Form U4 and Form U5 and Rule 8312.

Arbitrator Training

Motion to Dismiss and Eligibility Rules

On December 31, 2008, the SEC approved a proposal to adopt Rule 12504 of the Customer Code and Rule 13504 of the Industry Code to establish procedures that will govern motions to dismiss. The proposal also amends Rules 12206 and 13206 of the Codes to address motions to dismiss based on eligibility grounds. The rules became effective on February 23, 2009, for motions to dismiss filed on or after the effective date.

For details on the amendments, please see *Regulatory Notice 09-07*.

As a result of the new rules, FINRA requests all arbitrators to become familiar with the rules by either:

- Reading the Frequently Asked Questions document (FAQ) that explains the purpose of the new rules addressing motions to dismiss, how they are applied and the procedures arbitrators and parties must follow; or
- Listening to the recording of our latest neutral workshop: FINRA's New Motion to Dismiss Rules—What You Need to Know.

To access either of these training materials, please click the underlined text, which will lead you to the appropriate page on our Web site.

After you study the FAQ or listen to the workshop, please notify FINRA by submitting an email to *FINRAdrnm@finra.org.* We will update your disclosure report with this training information. Be sure to put "Motion to Dismiss Training" in the subject line to ensure that your profile is updated quickly.

If you have already reviewed the Motion to Dismiss rules and notified FINRA, no further action is required. Due to the large number of updates we have received, some records have not yet been updated. Please allow adequate time for your profile to be updated.

Please send an email to *FINRAdrnm@finra.org* if you have any questions about the rule amendments.

Question and Answer: Arbitrators Should Promptly Assess Postponement Fees

Question: Should arbitrators promptly assess postponement fees?

Answer: Yes. FINRA's Code of Arbitration Procedure (Code) authorizes arbitrators to impose postponement fees. Arbitrators may allocate all or part of the fee to the party or parties who requested the postponement. Arbitrators may also assess all or part of the fee against a non-requesting party if they determine that the party contributed to the need for the postponement. The Code also permits arbitrators to waive the fee.

Although circumstances may arise requiring arbitrators to wait until the end of the case to assess these fees, FINRA generally recommends that arbitrators assess fees at the time of postponement.

Arbitrators, parties and staff benefit when postponement fees are assessed promptly because:

- The facts and circumstances of the postponement are fresh in the arbitrators' minds. Arbitrators may not easily recall circumstances surrounding the postponement if they wait until the conclusion of the case.
- Parties are notified immediately about the fees they have incurred. As a result, parties may give careful thought to future postponement requests.
- Staff does not waste valuable time following up on outstanding postponement fees.

In the interest of fairness and efficiency, FINRA encourages arbitrators to assess postponement fees as they occur rather than waiting until the case concludes.

FINRA News Updates

Richard G. Ketchum Named as FINRA's Chief Executive Officer

On March 16, 2009, Richard G. Ketchum assumed the role of Chief Executive Officer for FINRA, replacing Mary L. Schapiro, who resigned her position as FINRA's CEO on January 23 after her confirmation as Chairman of the SEC.

Prior to his appointment as CEO, Mr. Ketchum served as CEO of New York Stock Exchange (NYSE) Regulation and as Chairman of FINRA's Board of Governors. Mr. Ketchum will continue in his role as FINRA's Chairman.

Office of the Whistleblower

FINRA created the Office of the Whistleblower to expedite FINRA senior staff review of high-risk tips and to ensure a rapid response for tips believed to have merit.

Since its inception less than two months ago, FINRA's Office of the Whistleblower has received numerous tips, and completed over a half dozen investigations that have resulted in extensive, well-documented referrals to the SEC—including several potential Ponzi schemes.

Matters that fall outside FINRA's jurisdiction are referred to the appropriate regulatory or law enforcement agency. One referral sent to the SEC has already resulted in a regulatory action in late April.

FINRA's whistleblower initiative does not replace longstanding processes for handling thousands of routine regulatory tips and customer complaints each year.

Please visit our Web site for more information.

Mediation Outreach Efforts

Mediation staff members represented FINRA recently at various speaking engagements, including joint presentations at Fordham Law School Securities Arbitration Clinic, PACE University Securities Arbitration Clinic and Brooklyn Law School. Staff members covered a combination of topics, such as mediation, securities law and ADR issues. FINRA staff also lectured at PACE University Securities Arbitration Clinic.

Regional Updates

NOTE: Participants must successfully complete the online portion of the Basic Arbitrator Training Program before attending an onsite training program. Please visit the Arbitrator Training page at *www.finra.org* for more information. FINRA generally requires a minimum of nine attendees to conduct an onsite session.

Northeast Regional Update

During the next three months, the Northeast Regional Office will conduct the following in-person Basic Arbitrator Training programs:

New York, New York	June 17, 2009
Philadelphia, Pennsylvania	July 22, 2009
Buffalo, New York	August 19, 2009

If you are interested in attending a Basic Arbitrator Training program, please contact Cicely Moise at (212) 858-3963 or Cicely.Moise@finra.org.

Midwest Regional Update

Arbitration Outreach

On April 23, 2009, the Midwest Regional Office gave a presentation on FINRA's arbitration process at an Alternative Dispute Resolution (ADR) seminar sponsored by the Illinois State Bar Association and its ADR Section.

Arbitrator Training

During the next three months, the Midwest Regional Office will conduct the following in-person Basic Arbitrator Training programs:

Cleveland, Ohio	June 17, 2009
Minneapolis, Minnesota	July 15, 2009
Columbus, Ohio	August 12, 2009

If you are interested in attending a Basic Arbitrator Training program, please contact Deborah Woods at (312) 899-4431 or Deborah.Woods@finra.org.

Regional Updates continued

West Regional Update

During the next three months, the West Regional Office will conduct the following in-person Basic Arbitrator Training programs:

San Diego, California	June 9, 2009
Denver, Colorado	June 23, 2009
Los Angeles, California	August 25, 2009

If you are interested in attending a Basic Arbitrator Training program, please contact Hannah Yoo at (213) 229-2362 or Hannah.Yoo@finra.org.

Southeast Regional Update

Arbitration Outreach

On February 24, 2009, the Southeast Regional Office participated in the Lewis B. Freeman & Partners Leadership Luncheon Series hosted by the Center for Ethics and Public Service of the University of Miami School of Law. FINRA staff spoke to law students and faculty about FINRA's arbitration and mediation programs, with special focus on ethics and arbitration procedure.

Arbitrator Training

During the next three months, the Southeast Regional Office will conduct the following in-person Basic Arbitrator Training programs:

Atlanta, Georgia	June 25, 2009
Boca Raton, Florida	July 21, 2009

If you are interested in attending a Basic Arbitrator Training program, please contact Lanette Cajigas at (561) 447-4911 or Lanette.Cajigas@finra.org.

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