SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57492; File No. SR-NASD-2007-021)

March 13, 2008

Self-Regulatory Organizations; National Association of Securities Dealers, Inc. (n/k/a Financial Industry Regulatory Authority, Inc.); Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator

On March 12, 2007, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. (n/k/a FINRA Dispute Resolution, Inc.) filed with the Securities and Exchange Commission ("Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),[1] and Rule 19b-4 thereunder,[2] a proposed rule change to amend the definition of "public arbitrator" in the NASD's Code of Arbitration Procedure for Customer Disputes ("Customer Code") and Code of Arbitration Procedure for Industry Disputes ("Industry Code").[3] The proposed rule change was published for comment in the Federal Register on July 17, 2007.[4] The Commission received 62 comments on the proposed rule change[5] and FINRA's response to the comments.[6]

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Release No. 56146 (July 26, 2007). In connection with this name change, NASD Dispute Resolution became FINRA Dispute Resolution, Inc. ("FINRA Dispute Resolution").

4 See Securities Exchange Act Release No. 56039 (July 10, 2007), 72 FR 39110 (July 17, 2007).

5 Comment letters were submitted by Philip M. Aidikoff, Esq., Attorney, dated July 17, 2007 ("Aidikoff Letter"); Professor Seth E. Lipner, Zicklin School of Business, Baruch College, dated July 23, 2007 ("Lipner Letter"); Steven B. Caruso, Esq., President, Public Investors Arbitration Bar Association, dated July 23, 2007 ("PIABA Letter"), William S.

Shepherd, Esq., Founder, Shepherd, Smith & Edwards, LLP, dated July 24, 2007 ("Shepherd Letter"); Richard Layne, dated July 25, 2007 ("Layne Letter"); Dale Ledbetter, Ledbetter Associates, dated July 25, 2007 ("Ledbetter Letter"); Jeffrey B. Kaplan, Esq., Dimond Kaplan Rothstein, P.A., dated July 25, 2007 ("Kaplan Letter"); Charles C. Mihalek, Esq., dated July 25, 2007 ("Mihalek Letter"); Daniel A. Ball, Esq., Ball Law Offices, dated July 25, 2007 ("Ball Letter"); Stuart D. Meissner, Esq., Law Offices of Stuart D. Meissner LLC, dated July 25, 2007 ("Meissner Letter"); Adam S. Doner, Esq., dated July 25, 2007 ("Doner Letter"); Jay H. Salamon, Esq., Hermann Cahn & Schneider LLP, dated July 25, 2007 ("Salamon Letter"); Robert W. Goehring, Esq., dated July 25, 2007 ("Goehring Letter"); Barry D. Estell, dated July 25, 2007 ("Estell Letter"); Steve A. Buchwalter, Esq., Law Offices of Steve A. Buchwalter, P.C., dated July 25, 2007 ("Buchwalter Letter"); Charles W. Austin, Jr., dated July 25, 2007 ("Austin Letter"); Les Greenberg, Esq., Law Offices of Les Greenberg, dated July 27, 2007 ("Greenberg Letter"); Jeffrey A. Feldman, Esq., Law Offices of Jeffrey A. Feldman, dated July 27, 2007 ("Feldman Letter"); Frederick W. Rosenberg, Esq., dated July 30, 2007 ("Rosenberg Letter"); W. Scott Greco, Esq., Greco & Greco, P.C., dated July 31, 2007 ("Greco Letter"); Bryan J. Lantagne, Esq., Director, Massachusetts Securities Division and Chair, NASAA Arbitration Working Group, dated August 2, 2007 ("NASAA Letter"); Peter J. Mougey, Esq., Beggs & Lane, dated August 3, 2007 ("Mougey Letter"); Andrew Stoltmann, Esq., Stoltman Law Offices, P.C., dated August 6, 2007 ("Stoltman Letter"); Robert C. Port, Esq., Cohen Goldstein Port & Gottlieb, LLP, dated August 6, 2007 ("Port Letter"); James D. Keeney, Esq., James D. Keeney, P.A., dated August 6, 2007 ("Keeney Letter"); Herb Pounds, Esq., Herbert E. Pounds, Jr., P.C., dated August 6, 2007 ("Pounds Letter"); John Miller, Esq., Swanson Midgley LLC, dated August 6, 2007 ("Miller Letter"); Janet K. DeCosta, Esq., dated August 6, 2007 ("DeCosta Letter"); Milton H. Fried, Jr., Esq., dated August 6, 2007 ("Fried Letter"); Laurence S. Schultz, Esq., Driggers, Schultz & Herbst, dated August 6, 2007 ("Schultz Letter"); Mark A. Tepper, Esq., President, Mark A. Tepper, P.A., dated August 6, 2007 ("Tepper Letter"); Leonard Steiner, dated August 6, 2007 ("Steiner Letter"); William P. Torngren, Esq., dated August 6, 2007 ("Torngren Letter"); Richard A. Lewins, Esq., Special Counsel, Burg Simpson Eldredge Hersh & Jardine P.C., dated August 7, 2007 ("Lewins Letter"); Jonathan W. Evans, Esq., Jonathan W. Evans & Associates, dated August 7, 2007 ("Evans Letter"); Kathleen H. Gorr, Esq., dated August 7, 2007 ("Gorr Letter"); Martin L. Feinberg, Esq., dated August 8, 2007 ("Feinberg Letter"); Dave Liebrader, Esq., dated August 8, 2007 ("Liebrader Letter"); Steven M. McCauley, Esq., dated August 8, 2007 ("McCauley Letter"); David Harrison, dated August 8, 2007 ("Harrison Letter"); Rob Bleecher, Esq., dated August 8, 2007 ("Bleecher Letter"); Thomas C. Wagner, Esq., Van Deusen & Wagner L.L.C., dated August 8, 2007 ("Wagner Letter"); Carl J. Carlson, Esq., Carlson & Dennett, P.S., dated August 8, 2007 ("Carlson Letter"); Robert S. Banks, Jr., Esq., The Banks Law Office, P.C., dated August 8, 2007 ("Banks Letter"); Jeffrey S. Kruske, Esq., Law Office of Jeffrey S. Kruske, P.A., dated August 8, 2007 ("Kruske Letter"); Mitchell S. Ostwald, Esq., The Law Offices of Mitchell S. Ostwald, dated August 8, 2007 ("Ostwald Letter"); Debra G. Speyer, Esq., Law Offices of Debra G. Speyer, dated August 8, 2007 ("Speyer Letter"); Dawn R. Meade, Esq., The Spencer Law Firm, dated August 9, 2007 ("Meade Letter"); Scott C. Ilgenfritz, Esq., dated August 8, 2007 ("Ilgenfritz Letter"); Eliot Goldstein, Esq., Partner,

I. Description of the Proposed Rule Change

FINRA Dispute Resolution, Inc. proposes to amend the Customer Code and the Industry Code to amend the definition of public arbitrator to add an annual revenue limitation. In discussing the proposed rule change, FINRA stated that it and its predecessor NASD had taken numerous steps in recent years to ensure the integrity and neutrality of the forum's arbitrator roster by addressing classification of arbitrators. For example, in August 2003, NASD proposed changes to Rules 10308 and 10312 of the Code of Arbitration Procedure ("Code") to modify the definitions of public and non-public arbitrators to further prevent individuals with significant ties to the securities industry from serving as public arbitrators.[7] The 2003 proposal:

Law Offices of Eliot Goldstein, LLP, dated August 9, 2007 ("Goldstein Letter"); Howard Rosenfield, Esq., Law Offices of Howard Rosenfield, dated August 10, 2007 ("Rosenfield Letter"); Scott R. Shewan, Esq., Born, Pape & Shewan LLP, dated August 13, 2007 ("Shewan Letter"); Joseph Fogel, Esq., Fogel & Associates, dated August 14, 2007 ("Fogel Letter"); Donald M. Feferman, Esq., Donald M. Feferman, P.C., dated August 16, 2007 ("Feferman Letter"); Gail E. Boliver, Esq., Boliver Law Firm, dated August 19, 2007 ("Boliver Letter"); Stephen P. Meyer, Esq., Meyer & Ford, dated August 20, 2007 ("Meyer Letter"); Jan Graham, Esq., Graham Law Offices, dated August 20, 2007 ("Graham Letter"); John E. Sutherland, Esq., dated August 20, 2007 ("Sutherland Letter"); Ronald M. Amato, Esq., Shaheen, Novoselsky, Staat, Filipowski & Eccleston, P.C, dated August 21, 2007 ("Amato Letter"); James J. Eccleston, Esq., Shaheen, Novoselsky, Staat, Filipowski & Eccleston, P.C, dated August 21, 2007 ("Eccleston Letter"); J. L. Spray, Esq., Mattson, Ricketts, Davies, Stewart & Calkins, dated August 21, 2007 ("Spray Letter"); Randall R. Heiner, Esq., Heiner Law Offices, dated August 23, 2007 ("Heiner Letter").

The public file for the proposal, which includes comment letters received on the proposal, is located at the Commission's Public Reference Room located at 100 F Street, NE, Washington, DC 20549. The comment letters are also available on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml).

6 See Letter from Mignon McLemore, Assistant Chief Counsel, FINRA Dispute Resolution, to Nancy M. Morris, Secretary, Commission, dated January 17, 2008 ("FINRA Response").

7 In July 2002, the Commission retained Professor Michael Perino to assess the adequacy of arbitrator disclosure requirements at the NASD and at the New York Stock Exchange ("NYSE"). Professor Perino's report ("Perino Report") concluded that undisclosed

- Increased from three years to five years the period for transitioning from a non-public to public arbitrator after leaving the securities industry.

- Clarified that the term "retired" from the industry includes anyone who spent a substantial part of his or her career in the industry.

- Prohibited anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator, regardless of how long ago the association ended.

- Excluded from the public arbitrator roster attorneys, accountants, or other professionals whose firms have derived 10 percent or more of their annual revenue in the previous two years from clients involved in securities-related activities.

The proposal was approved by the Commission on April 16, 2004, and became effective on July 19, 2004.[8]

On July 22, 2005, NASD proposed further amendments to Rule 10308 of the Code relating to arbitrator classification to prevent individuals with certain indirect ties to the securities industry from serving as public arbitrators. Specifically, NASD proposed to amend the definition of public arbitrator to exclude individuals who work for, or are officers or directors of, an entity that controls, is controlled by, or is under common control with, a broker-dealer, or who have a spouse or immediate family member who works for, or is an officer or director of, an entity that is in such a control relationship with a broker-dealer. NASD also proposed to amend

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conflicts of interest were not a significant problem in arbitrations sponsored by self-regulatory organizations ("SROs"), such as NASD and the NYSE. However, the Perino Report recommended several amendments to SRO arbitrator classification and disclosure rules that might ''provide additional assurance to investors that arbitrations are in fact neutral and fair.'' This proposal implemented the recommendations of the Perino Report and made several other related changes to the definitions of public and non-public arbitrators that were consistent with the Perino Report recommendations. The Perino Report is available at http://www.sec.gov/pdf/arbconflict.pdf.

[8] See Securities Exchange Act Release No. 49573 (April 16, 2004), 69 FR 21871 (April 22, 2004) (SR-NASD-2003-95) (approval order). The changes were announced in Notice to Members 04-49 (June 2004).

Rule 10308 to clarify that individuals registered through broker-dealers may not be public arbitrators, even if they are also employed by a non-broker-dealer (such as a bank). This rule filing was approved by the Commission on October 16, 2006, and became effective on January 15, 2007.[9]

During the time that the changes discussed above were being made, NASD also had pending at the Commission a 2003 proposal to amend the Code to reorganize the rules into the Customer Code, the Industry Code, and a separate code for mediation. The final provisions of this proposal were approved by the Commission on January 24, 2007, and became effective on April 16, 2007.[10] Several substantive changes to the Customer and Industry Codes affected the classification of arbitrators[11] and how they are selected for panels.[12]

Despite these changes to the arbitrator classification rules, some users of the forum continued to voice concerns about individuals serving as public arbitrators when they have

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9 See Securities Exchange Act Release No. 54607 (October 16, 2006), 71 FR 62026 (Oct. 20, 2006) (SR-NASD-2005-094) (approval order). The changes were announced in Notice to Members 06-64 (November 2006).

10 See Securities Exchange Act Release No. 51856 (June 15, 2005), 70 FR 36442 (June 23, 2005) (SR-NASD-2003-158) (notice); Securities Exchange Act Release No. 51857 (June 15, 2005), 70 FR 36430 (June 23, 2005) (SR-NASD-2004-011) (notice); and Securities Exchange Act Release No. 51855 (June 15, 2005), 70 FR 36440 (June 23, 2005) (SR-NASD-2004-013) (notice). The changes were announced in Notice to Members 07-07 (February 2007).

11 FINRA believes the new codes have improved the arbitrator selection process by creating and maintaining a new roster of arbitrators who are qualified to serve as chairpersons. The chair roster consists of more experienced arbitrators available on FINRA's public arbitrator roster for all investor cases and for certain intra-industry cases. For other industry cases, the Customer Code and Industry Code also create a chair roster of experienced non-public arbitrators. See Rules 12400(b) and (c) of the Customer Code and Rules 13400(b) and (c) of Industry Code.

12 The Customer Code and Industry Code also change how arbitrator lists are generated and how arbitrators are selected for a panel. See Rules 12403 and 12404 of the Customer Code and Rules 13403 and 13404 of the Industry Code.

business relationships with entities that derive income from broker-dealers. For example, an arbitrator classified as public might work for a very large law firm that derives less than 10% of its annual revenue from broker-dealer clients, but still receives a large dollar amount of such revenue. Concern focuses primarily on a law firm's defense of action (in arbitration or litigation) by customers of broker-dealers, and not on its representation of broker-dealers in underwriting or other activities. Some recommended that there be an annual dollar limitation of $50,000 on revenue from broker-dealers relating to customer disputes with a brokerage firm or associated person concerning an investment account.

In response to these recommendations, FINRA proposed to amend the definition of public arbitrator in Rule 12100(u) of the Customer Code and Rule 13100(u) of the Industry Code to add a provision that would prevent an attorney, accountant, or other professional from being classified as a public arbitrator, if the person's firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in Rule 12100(p)(1) of the Customer Code or Rule 13100(p)(1) of the Industry Code relating to any customer disputes concerning an investment account or transaction, including but not limited to, law firm fees, accounting firm fees, and consulting fees.[13]

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[13] Rule 12100(p) defines "non-public arbitrator." Paragraph (1) of the rule states, in relevant part, that the term "non-public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and is or, within the past five years, was: (A) associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer); (B) registered under the Commodity Exchange Act; (C) a member of a commodities exchange or a registered futures association; or (D) associated with a person or firm registered under the Commodity Exchange Act. Rule 13100(p) is the same as Rule 12100(p).

FINRA stated that the proposed amendment, in conjunction with the existing 10 percent revenue limitation,[14] would further improve its public arbitrator roster by ensuring that arbitrators whose firms receive a significant amount of compensation from any persons or entities associated with or engaged in the securities, commodities, or futures business are removed from the public roster.[15]

II. Summary of Comments and FINRA's Response

The Commission received 62 comment letters.[16] Many of the commenters raised common issues and shared the same views on these issues, regardless of whether they supported or opposed the proposal overall. In particular, a majority of the commenters argued that arbitrators should not be classified as public arbitrators under the rule if they are attorneys, accountants or other professionals whose firms receive any compensation or revenue from the securities industry.[17] FINRA responded that the proposed $50,000 annual revenue limitation would reasonably narrow the definition of public arbitrator, removing from the public arbitrator pool those arbitrators whose firms derive substantial revenue from providing professional

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14 See supra note 4. Under the July 2004 amendments, a public arbitrator cannot be "an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past 2 years from any persons or entities listed in Rules 12100(p)(1) and 13100(p)(1) of the new Codes."

15 FINRA will survey its public arbitrators to determine which arbitrators will be removed from the roster for appointment to new cases upon the effective date of the proposed rule.

16 See supra, note 5.

17 See Speyer, Goehring, Doner, Ledbetter, Aidikoff, Meissner, Boliver, Meyer, Lewins, Harrison, McCauley, Torngren, Ball, Feinberg, Tepper, Sutherland, Fogel, Bleecher, Steiner, Miller, Mihalek, Kaplan, Lipner, Shepherd, Layne, Salamon, Buchwalter, Feldman, Shewan, and Mougey Letters.

services to members of the securities industry involving customer disputes, while simultaneously maintaining the integrity of the public arbitrator roster.[18]

Many commenters also argued that the proposed $50,000 annual revenue limitation should not be limited to professional services related to customer disputes concerning an investment account or transaction and instead should include all professional services rendered by the arbitrator's firm to a firm or associated person.[19] FINRA responded that the annual revenue limitation should be restricted to the provision of those services, such as defense work in a customer dispute, that are closely related to matters that arbitrators would be deciding in an arbitration proceeding and, therefore, might affect the arbitrator's impartiality.[20] Moreover, FINRA stated that expanding the proposed annual revenue limitation to include all services could result in the removal of experienced, competent public arbitrators from their roster.[21]

Several commenters expressed doubt regarding FINRA's ability to monitor and enforce the $50,000 annual revenue limitation.[22] FINRA responded that because arbitrators must continually update their disclosure reports and, when selected to serve on a case, must complete a checklist and take an oath confirming that the arbitrator's disclosures are true and complete, the procedures are sufficient.[23]

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18 See FINRA Response.

19 See NASAA, PIABA, Meade, Ilgenfritz, Liebrader, Gorr, Pounds, Keeney, Fried, Estell, Heiner, DeCosta, Schultz, Evans, Wagner, Ostwald, Kruske, Carlson, Port, Stotman, Graham, Feferman, and Rosenfield Letters.

20 See FINRA Response.

21 See id.

22 See PIABA, Speyer, Liebrader, Heiner, Goldtein, Schultz, Evans, Wagner, Ostwald, Feinberg, Tepper, Graham, Feferman, and Feldman Letters.

23 See FINRA Response.

One commenter suggested that a "cooling off" period be implemented after the annual revenue limitation no longer applies and before a person can serve as a public arbitrator.[24] The commenter noted that this concept is applied to individuals who have been out of the securities industry for fewer than five years by assigning them to the non-public arbitrator pool.[25] FINRA responded that there is a distinction between individuals who work in the securities industry and individuals whose firms receive revenue for providing services to members of the industry.[26] In the case of individuals who worked in the industry, FINRA indicated that a five-year "cooling off" period is appropriate, as such individuals might maintain close relationships with staff at their former firms.[27] FINRA stated that the potential for such bias is less likely to exist for individuals whose firms receive a de minimis amount of annual revenue for providing services to members of the securities industry and, therefore, that a similar "cooling off" period should not be required.[28]

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24 See Feinberg Letter.

25 See id.

26 See FINRA Response.

27 See id. (citing Rule 12100(p)(1) of the Customer Code and Rule 13100(p)(1) of the Industry Code).

28 See id.

Finally, numerous commenters argued that the requirement that a non-public arbitrator be a member of a three-person panel involving a customer dispute should be eliminated.[29] FINRA indicated that these comments are outside the scope of the rule filing because it is not amending the provisions of the Codes that address this issue.

III. Discussion

After careful review, and consideration of commenters' views and the FINRA Response, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[30] In particular, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission believes that the proposed rule change meets this standard by removing from the pool of public arbitrators those individuals whose firms receive a significant amount of compensation for service on matters closely related to those that arbitrators consider during arbitration proceedings.

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29 See NASAA, Pounds, Fried, Estell, Goldstein, Banks, Harrison, McCauley, Torngren, Feinberg, Sutherland, Spray and Salamon Letters.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[31] that the proposed rule change (SR-NASD-2007-021) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[32]

Florence E. Harmon
Deputy Secretary

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30 In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

31 15 U.S.C. 78s(b)(2).

32 17 CFR 200.30-3(a)(12).