Financial Industry Regulatory Authority

May 19, 2014

Ms. Lourdes Gonzalez
U. S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. SR-FINRA-2014-005 – Proposed Rule Change to Amend Rules 12104 and 13104 to Broaden Arbitrators' Authority to Make Referrals During an Arbitration Proceeding; Response to Comments

Dear Ms. Gonzalez:

The Financial Industry Regulatory Authority, Inc. (FINRA) hereby responds to the comment letters received by the Securities and Exchange Commission (SEC) with respect to the above rule filing. In this rule filing, FINRA is proposing to amend Rule 12104 of the Code of Arbitration Procedure for Customer Disputes (Customer Code) and Rule 13104 of the Code of Arbitration Procedure for Industry Disputes (Industry Code) (together, Codes) to broaden arbitrators' authority to make referrals during an arbitration proceeding.[1]

History of the Mid-case referral proposed rule change

On July 12, 2010, FINRA filed a proposed rule change to amend Rules 12104 and 13104 of the Codes to permit arbitrators to make referrals during an arbitration case ('original proposal'). The SEC published the original proposal in the Federal Register on September 23, 2010.[2] It would have provided arbitrators with express authority to alert FINRA's Director of Arbitration during the prehearing, discovery, or hearing phase of a case when they learned of what they believed to be fraudulent activity that required immediate action. The original proposal also would have required the Director to disclose the mid-case referral to the parties, and would have required the entire panel to withdraw upon a party's request that a referring arbitrator withdraw. The SEC received eleven comments, all of which opposed the original proposal.[3]

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[1] See Securities Exchange Act Rel. No. 71534 (Feb. 12, 2014), 79 FR 9523 (Feb. 19, 2014) (File No. SR-FINRA-2014-005).

[2] See Securities Exchange Act Rel. No. 62930 (Sept. 17, 2010), 75 FR 58007 (Sept. 23, 2010) (SR-FINRA-2010-036).

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On July 7, 2011, in response to the comments, FINRA filed Amendment No. 1 ("Amendment"), which replaced the original proposal in its entirety.[4] Under the Amendment, an arbitrator would have been permitted to make a mid-case referral if an arbitrator became aware of any matter or conduct, which the arbitrator had reason to believe posed a serious ongoing or imminent threat that was likely to harm investors. A mid-case referral could not have been based solely on allegations in the pleadings. Also, the Amendment would have instructed the arbitrator to wait until the arbitration concluded to make a referral, if investor protection would not have been materially compromised by the delay. Further, if an arbitrator made a mid-case referral, the Director of Arbitration ("Director") would have disclosed the act of making the referral to the parties, and a party would have been permitted to request recusal of the referring arbitrator. The Amendment would have required either the President of FINRA Dispute Resolution ("President") or the Director to evaluate the referral and determine whether to forward it to other divisions of FINRA for further review. Finally, the Amendment would have retained the provision in Rule 12104(b) of the Customer Code and Rule 13104(b) of the Industry Code which permits an arbitrator to make a post-case referral.

The SEC received five comments[5] on the Amendment.[6] Several commenters supported proposed part (e) of Rule 12104,[7] which makes minor changes to current Rule 12104(b)[8] governing post-case referrals. Specifically, under proposed Rule 12104(e), FINRA would have removed the term "disciplinary" as a qualification on the type of investigation FINRA may conduct once the arbitrators make a post-case referral. Further, FINRA would have expanded the type of activity that could be the subject of a referral to include "conduct." These commenters believed that broadening the scope of potential post-case referrals by arbitrators would "efficiently promote investor protections."[9] All of the commenters, however, opposed the Amendment as it related to mid-case referrals, and recommended withdrawing those provisions.[10]

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[4] See Securities Exchange Act Rel. No. 64954 (July 25, 2011), 76 FR 45631 (July 29, 2011) (File No. SR-FINRA-2010-036, Notice of Filing of Proposed Rule Change and Amendment No. 1 to Amend the Codes of Arbitration Procedure to Permit Arbitrators to Make Mid-Case Referrals).

[5] Comments on Amendment No. 1 were submitted from: Peter J. Mougey, President, Public Investors Arbitration Bar Association, Aug. 18, 2011 ("PIABA Comment"); Richard P. Ryder, Esquire, Securities Arbitration Commentator, Inc., Aug. 27, 2001 ("Ryder Comment"); William A. Jacobson, Esq., Director, Cornell Securities Law Clinic, Aug. 22, 2011 ("Cornell Comment"); Seth E. Lipner, Professor of Law, Baruch College, Sept. 8, 2011 ("Lipner Comment"); and Barry D. Estell, Attorney at Law, Sept. 12, 2011 ("Estell Comment").

[6] See note 3, supra.

[7] PIABA Comment, Cornell comment (citing support for PIABA Comment), and Estell comment (citing support for Cornell Comment).

[8] Amendment No. 1 proposed changes to Rule 12104 of the Customer Code and Rule 13104 of the Industry Code.

[9] See note 7, supra

[10] See note 5, supra.

On January 29, 2014, FINRA withdrew SR-FINRA-2010-036[11] without responding to the comments submitted on the Amendment. On the same day, FINRA filed a proposed rule change, under a new rule filing number SR-FINRA-2014-005, to replace the withdrawn proposed rule change ("current proposal"). The current proposal responds to the comments submitted on Amendment No. 1; however, FINRA did not make any changes to the rule language filed in the Amendment.

The SEC received ten comment letters[12] on the current proposal.[13] Their positions break down as follows: two commenters support the current proposal;[14] three support the concept and the goal of the current proposal, but condition their support on changes to the current proposal;[15] and five oppose.[16] FINRA's response to these comments follows.

Response to Comments

FINRA's mission is to ensure that the interests of public investors are protected. In recent years, public investors have been the victims of schemes that have resulted in significant financial harm. In keeping with its mission, FINRA reviewed the Codes and determined that investors' interests would be better protected if FINRA were alerted to serious threats and wrongdoing as early as possible. FINRA determined that one of the ways to do this was to amend its rules on arbitrator referrals, so that arbitrators would be permitted, under narrowly defined circumstances, to make referrals during an arbitration proceeding, rather than solely at the conclusion of a matter as is currently the case.

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[11] See SR-FINRA-2010-036, Withdrawal of Proposed Rule Change, available at http://www.finra.org/Industry/Regulation/RuleFilings/2010/P121722.

[12] Comments on the current proposal were submitted from: Gary Berne, Stoll Berne, Feb. 6, 2014 ("Berne Comment"); Jason Doss, President, Public Investors Arbitration Bar Association, Feb. 28, 2014 ("PIABA Comment"); Steven B. Caruso, Esq., Maddox Hargett & Caruso, P.C., March 4, 2014 ("Caruso Comment"); George H. Friedman, Esquire, George H. Friedman Consulting, LLC, March 5, 2014 ("Freidman Comment"); William A. Jacobson, Clinical Professor of Law, Cornell Law School, and Director, Cornell Securities Law Clinic, March 11, 2014 ("Cornell Comment"); William D. Nelson, Partner, Lewis Roca Rothgerber LLP, March 11, 2014 ("Nelson Comment"); Nicole G. Iannarone, Esq., Assistant Clinical Professor, Georgia State University College of Law Investor Advocacy Clinic, March 11, 2014 ("GSU Comment"); Elissa Germaine, Supervising Attorney and Michelle N. Robinson, Student Intern, Pace Investor Rights Clinic, Pace Law School, March 12, 2014 ("Pace Comment"); Ryan Jennings, Christian Corkery, and Daniel Coleman, Legal Interns, St. John's University School of Law Securities Arbitration Clinic, March 12, 2014 ("St. John's Comment"); and Richard P. Ryder, Esquire, President, Securities Arbitration Commentator, March 12, 2014 ("Ryder Comment").

[13] See Comments on FINRA Rulemaking, Notice of Proposed Rule Change to Amend the Codes of Arbitration Procedure to Permit Arbitrators to Make Mid-case Referrals, available at http://www.sec.gov/comments/sr-finra-2014-005/finra2014005.shtml.

[14] Caruso Comment and Friedman Comment.

[15] GSU Comment, PACE Comment, and Cornell Comment.

[16] PIABA Comment, Berne Comment, Nelson Comment, St. John's Comment, and Ryder Comment.

If an arbitrator or panel makes a mid-case referral as the current proposal would permit, it would be based on evidence or testimony from a hearing on the wrongdoing of a party to the arbitration. FINRA acknowledges that such a referral might cause delays in the arbitration and increase an investor party's costs. FINRA is sensitive to these concerns and, as a result, would implement procedures, detailed in the response, to mitigate some of the delays and increased costs that an investor party could incur. FINRA's procedures cannot mitigate all of these costs, but for the reasons explained below, the forum cannot assume the costs and expenses that an investor party may incur as a result of a mid-case referral. However, if an arbitrator or panel makes a mid-case referral and the effect of the referral increases an investor party's costs, the investor may request that the arbitrator or panel assign to the respondent liability for such consequential costs. Further, the Codes currently allow investors to seek reimbursement of all costs associated with bringing a claim and to ask arbitrators to allocate fees to other parties.

FINRA has carefully considered the impact that its proposed rules could have on an individual investor claimant. However, its obligations as a regulator require that it also weigh the potential effect that inaction could have on a large group of investors. In developing the proposed rule change, FINRA weighed the risk of potentially increasing the costs of an individual investor against the harm of significant losses to a larger group of investors. In balancing the potential outcomes, FINRA determined that the current proposal would help FINRA detect serious, ongoing or imminent threats to investors at an earlier stage than would otherwise occur; this early warning could help curb financial losses of a potentially large group of investors. FINRA believes, therefore, that providing additional protection to public investors generally by strengthening its regulatory structure outweighs the potential increased costs to an investor party.

Comments that Support the Current Proposal

The Caruso and Friedman comments support the current proposal, believing that authorizing arbitrators to make mid-case referrals would be "critical for public investors and the integrity of the arbitration forum,"[17] and would provide a benefit to the markets "if it more quickly terminates one massive fraud."[18] The Caruso letter also suggested that FINRA amend proposed Rule 12104(b)[19] to state that during the pendency of an arbitration, any arbitrator may refer to the Director any matter or conduct that has come to the arbitrators' attention during an evidentiary hearing, which the arbitrator has reason to believe poses an ongoing or imminent serious threat, that is likely to harm investors unless immediate action is taken.[20] This suggestion would remove two elements of the current proposal that FINRA believes should remain.

First, the proposed Caruso amendment would remove the requirement that

[17] Caruso Comment.

[18] Friedman Comment.

[19] References throughout the response to comments focus on the Customer Code rule, but the explanations and findings apply to the Industry Code rule as well.

[20] Caruso Comment.

arbitrators should not make mid-case referrals during the pendency of an arbitration based solely on allegations in the statement of claim or other claims, and, instead, would require that the referral be based on any matter or conduct that has come to the arbitrators attention during an *evidentiary* hearing (emphasis added). The suggestion would truncate the proposed rule. Specifically, it would remove the requirement that a mid-case referral should not be based solely on allegations raised in the statement of claim, counterclaim, cross claim, or third party claim. FINRA believes the term "evidentiary" in the Caruso amendment is meant to replace this criterion in the proposed rule language.

FINRA believes the current wording provides arbitrators with more guidance on how the rule should be applied. Under proposed Rule 12104(b), arbitrators may make a mid-case referral based on any matter or conduct that has come to an arbitrator's attention during a hearing, which, under the Codes, means a hearing on the merits.[21] The proposed rule emphasizes the point further by providing the criterion that the Caruso amendment would remove. FINRA believes this requirement would ensure that arbitrators have reviewed or heard actual evidence to support a decision to make a mid-case referral. Dispute Resolution routinely provides copies of arbitration claims and pleadings to other FINRA divisions for analysis; so, FINRA has knowledge of the facts and circumstances raised therein. The purpose of this requirement is to ensure that a mid-case referral is based on facts or circumstances that may not already be known to FINRA.

Second, the suggestion would remove the option for the arbitrator to wait until the case concludes to make a mid-case referral, if the case is nearing completion and investor protection would not be materially harmed by the delay. FINRA included this option for arbitrators to permit them to protect a party from the effects that a mid-case referral could have on a person's case, if the facts and circumstances support waiting until the case concludes. Thus, under this element of the current proposal, the arbitrators would consider for example, when they learned of the serious threat, whether the threat is ongoing or imminent, and how many scheduled hearing sessions[22] remain, in deciding whether to make a mid-case or a post-case referral. As FINRA believes these elements provide added protections to investors, FINRA declines to amend the proposed rule as suggested.

Five commenters also support of the goal of the current proposal which is to protect the investing public from future harm or to mitigate ongoing harm from widespread, serious activity that may not have been revealed in a complaint.[23] PACE

[21] A hearing is the hearing on the merits of an arbitration under Rule 12600. Rules 12100(m) and 13100(m).

[22] A hearing session is 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).

[23] GSU Comment, PACE Comment, Cornell Comment, Caruso Comment and Freidman Comment.

and Cornell[24] agree with FINRA that the current proposal would strengthen its regulatory structure and provide additional protection to investors and securities markets by helping to detect and address such widespread schemes before they can harm more investors. However, three of these commenters believe that the current proposal would have a negative impact on the investor-claimant if a mid-case referral could be used as grounds for recusal of an arbitrator[25] or to challenge the arbitration award.[26] FINRA appreciates these commenters' recognition of the importance of the current proposal in furthering its regulatory goals. FINRA acknowledges that a mid-case referral could affect an investor claimant's arbitration case; however, as explained in more detail below, FINRA believes the current proposal, as drafted, effectively balances the risk of potentially increased costs to an individual investor against the harm of significant losses to a group of investors, and, therefore, declines to amend the current proposal as suggested.

Comments that Oppose the Current Proposal

As noted above, five commenters oppose[27] the current proposal. The following is a list of concerns raised by these commenters and FINRA's response to each.

Purpose of current proposal not defined

St. John's letter states that the current proposal does not define clearly the problem it is trying to solve.[28] Further, PIABA suggests that current proposal is based on an assumption that mid-case referrals would have a positive effect on investor protection, and that FINRA should supply statistical data to prove that the current proposal is necessary to further investor protection.[29] Another commenter argues that he does not believe that there would be a set of facts in an arbitration where a mid-case referral would apply.[30]

In the Purpose section of the rule filing, FINRA expressed concern that the current rule governing referrals would require arbitrators in all instances to wait until a case is concluded before making a referral, which could hamper FINRA's efforts to uncover threats to investors as early as possible.[31] In an effort to address this limitation in the current rule, FINRA is proposing to broaden the arbitrators' authority under the Codes to make referrals during the hearing phase of an arbitration in those extremely rare circumstances in which investor protection requires that the referral not be

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[24] See William A. Jacobson, Clinical Professor of Law, Cornell Law School, and Director, Cornell Securities Law Clinic, October 14, 2010 (submitted on FINRA-2010-036); see also note 3, supra.

[25] PACE Comment, GSU Comment, and Cornell Comment.

[26] Cornell Comment.

[27] See note 16, supra.

[28] St. John's Comment.

[29] PIABA Comment.

[30] Nelson Comment.

[31] Notice of Filing of Proposed Rule Change Relating to Broadening Arbitrators' Authority to Make Referrals During an Arbitration Proceeding, 79 FR 9523, 9524 (Feb. 19, 2014).

delayed.[32] These statements indicate that FINRA has assessed its regulatory structure and determined that its rules would be strengthened by closing this gap – the primary goal of the current proposal, described above, which five commenters support.[33]

When an issue is quantifiable, FINRA strives to support its rule filings with statistical data. In this instance, however, there is no meaningful statistical data to prove the value of the current proposal, because the current rule permits post-case referrals only and the criteria that such referrals must meet is not as stringent as the criteria for making a mid-case referral. Even in the absence of statistical data, however, FINRA's mandate to protect public investors (e.g., from illegal conduct that can result in significant financial losses), as well as its decision to strengthen its regulatory structure by expanding arbitrators' authority to make referrals, provides, strong support for the current proposal.

Finally, certain securities market schemes would obviously support an arbitrator making a mid-case referral, such as Ponzi schemes. There could also be other situations in which a mid-case referral would be warranted, where the serious threat could have a broad impact on the financial markets. For example, if evidence or testimony during a hearing indicated that someone was engaged in money laundering, this action could warrant an arbitrator making a mid-case referral. Although FINRA believes that mid-case referrals would be an extremely rare occurrence in the forum, arbitrators should, nevertheless, have the authority to make such a referral, if evidence or testimony from a hearing dictates such an action.

Expand Enforcement's role

Two commenters suggest that instead of implementing the current proposal, FINRA should increase its enforcement activities[34] by developing procedures to monitor brokerage firms' accounts and assess the costs of increased fraud protection on clearing firms and exchanges.[35] Another commenter suggests that FINRA expand Central Review Group's (CRG) review of statements of claims and pleadings, and mandate referral to FINRA Enforcement Division ("Enforcement") when appropriate.[36]

FINRA disagrees with the commenters' premise that enforcement procedures conducted prior to an arbitration hearing would be an effective substitute for arbitrator action taken during a hearing based on evidence presented. Analysis by Enforcement employees conducted on the claims and pleadings permit FINRA to monitor and analyze volumes of data through various market data systems to detect evidence of wrongdoing. The current proposal would provide FINRA with another tool to detect wrongdoing. By permitting arbitrators, through their assessment of evidence presented during a hearing to act swiftly on their concerns about a serious threat to the investing public, FINRA

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[32] Id.

[33] See note 23, supra.

[34] Berne Comment.

[35] St. John's Comment.

[36] PIABA Comment.

would be given notice earlier than under the present procedures, thereby enabling FINRA to respond sooner to fulfill its mission of investor protection. Mid-case referrals would provide an additional layer of investor protection occurring in real time. Thus, expanding Enforcement's procedures, would not, in FINRA's view, necessarily address the same concerns discovered by arbitrators, who learn of a serious threat during a hearing after consideration of evidence. Moreover, mid-case referrals would provide FINRA with an additional tool in its arsenal to investigate abuses against investors based on the most current information available.

As to the last point, the CRG's current procedures allow it to refer a case to Enforcement if its initial review of a statement of claim and pleadings determines that further investigation is necessary. It would be impractical, FINRA believes, to expand this process to require all cases reviewed by CRG to be forwarded to Enforcement. The current process is efficient and ensures that FINRA's resources are allocated to those cases that indicate violations of the securities laws or that could pose a threat to public investors.

For these reasons, FINRA declines to expand its enforcement procedures as recommended.

A mid-case referral based on the reasonable belief standard

Two commenters express concern that the reasonable belief standard in proposed Rule 12104(b) would be difficult to apply.[37] The Nelson letter also suggests that, as the forum allows parties to select all public panels, the reduction of industry arbitrators on panels to identify situations in which referrals may be warranted, raises concerns about the quality of mid-case referrals.[38]

FINRA notes that the reasonable belief standard for proposed Rule 12104(b) is the same standard used in current Rule 12104(b). Rule 12104(b) states that, only at the conclusion of an arbitration, any arbitrator may refer to FINRA for disciplinary investigation any matter that has come to the arbitrator's attention during and in connection with the arbitration, either from the record of the proceeding or from material or communications related to the arbitration, which the arbitrator has reason to believe may constitute a violation of NASD or FINRA rules, the federal securities laws, or other applicable rules or laws. FINRA is proposing to apply the same reasonable belief standard that exists in the current rule,[39] which most commenters support. FINRA does not believe the current proposal provides an impetus to change from the current reasonable belief standard. FINRA's arbitration forum is a forum of equity which means that arbitrators are committed to serve justice as they deem appropriate for particular factual situations. FINRA believes the reasonable belief standard is appropriate for arbitrators to use in its forum because it would allow them to use their judgment, based on their assessment of the facts, evidence, and testimony, when making decisions during

[37] Ryder Comment and Nelson Comment.

[38] Nelson Comment.

[39] The current reasonable belief standard would remain in the post-case referral rule, which would be re-labeled as Rule 12104(e).

an arbitration. Thus, FINRA believes this standard should also apply if arbitrators encounter facts and circumstances that would warrant a mid-case referral.

FINRA disagrees with the assertion in the Nelson letter that mid-case referrals made by all public panels would not meet the standards set forth in the proposed rule because there would be no industry arbitrator on the panel to identify situations in which such referrals may be warranted. In the forum's experience, public arbitrators have the training, knowledge, and understanding to recognize the difference between a common industry practice and conduct that poses a serious threat to public investors. Public arbitrators could apply effectively the elements of the proposed rule to the evidence and arguments presented by both sides without this additional guidance.

Exempt certain customer cases from mid-case referrals

One commenter suggested that the current proposal should exempt from the mid-case referral rule cases that have only one or a few hearing dates scheduled consecutively because the current proposal does not provide them with additional protection.[40]

The last element of proposed Rule 12104(b) would instruct the arbitrators to delay their referral until the conclusion of a case if, in the arbitrator's judgment, investor protection would not be materially compromised by a short delay in making the mid-case referral. FINRA contemplates that the mid-case referral rule would typically be used in those circumstances where hearings are scheduled for many days, or even weeks, and, in particular, when the hearing days are not scheduled consecutively. If, as the commenter suggests, a customer's case has one scheduled hearing, then a post-case referral would likely be appropriate. FINRA would prefer that arbitrators determine, based on their judgment and the facts and circumstances of the case, whether a mid-case or post-case referral is more appropriate, and, thus, declines to expressly exempt these cases from the proposed rule.

Remove the notice requirement and ability to request recusal

Four commenters[41] oppose proposed Rule 12104(c), which would require the Director to disclose to the parties when an arbitrator makes a mid-case referral, and would permit a party to request recusal of the referring arbitrator. These commenters contend that the proposed rule would permit counsel for the party that is the subject of the referral to request recusal of the referring arbitrator based solely on the act of making the referral.[42] Two commenters believe that the respondent would always seek recusal of the referring arbitrator.[43]

FINRA strongly encourages its arbitrators to make a wide variety of disclosures. When an arbitrator is appointed on a FINRA case, the arbitrator must complete an Arbitrator Disclosure Checklist (Checklist), which contains questions intended to help the

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[40] Cornell Comment.

[41] Cornell Comment, GSU Comment, St. John's Comment and PACE Comment.

[42] Id.

[43] GSU Comment and St. John's Comment.

arbitrator comply with the disclosure requirements pursuant to Rule 12405.[44] The obligation to disclose interests, relationships, or circumstances that might preclude an arbitrator from rendering an objective and impartial determination is a continuing duty.[45] This duty 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.[46] In addition to the forum's current rules and practices, case law has established a broad requirement that arbitrators make full disclosures.[47] For these reasons, FINRA believes that if an arbitrator makes a mid-case referral, this information must be disclosed to the parties, and therefore, declines to remove the notice requirement from proposed Rule 12104(c).

FINRA acknowledges that disclosure of a mid-case referral would likely prompt a party to make a recusal motion which a party currently may do under the Codes.[48] As noted, two commenters suggest that FINRA amend the current proposal to provide that making a mid-case referral would not be grounds for recusal of an arbitrator or panel.[49] The recusal rules of the Codes state that an arbitrator who is the subject of a recusal request has the discretion to decide whether to withdraw from the case.[50] FINRA rules do not currently dictate the grounds for granting recusal requests and do not require specific decisions by arbitrators in response to such requests. Consistent with any other recusal request, an arbitrator challenged because of a mid-case referral would be required to make that decision in accordance with the Codes.[51] Further, courts have found that arbitrators are expected to form opinions based on the evidence presented to them after they are appointed, and such an expression of those views prior to the conclusion of the case would not be considered proof of bias.[52] Thus, pursuant to the Codes and case law, an arbitrator would not be required to withdraw from the case because of a mid-case referral under the current proposal.

Therefore, FINRA does not believe the proposed rule should change this authority to decide recusal requests, nor the right of a non-moving party to oppose the request. The language of the current proposal clearly demonstrates FINRA's view that recusal of arbitrators making a mid-case referral is not mandated. For these reasons, FINRA is not proposing to amend proposed Rules 12104 (b) and (c) to eliminate the recusal request option as suggested.

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[44] See also Rule 13408.

[45] See The Neutral Corner, "Disclosure: The Cornerstone of Integrity and Fairness in Arbitration," Ruth V. Glick, Volume 4-2011.

[46] Id.

[47] See Commonwealth Coatings Corp. v. Continental Casualty Corp., 393 U.S. 145, 89 S. Ct. 337 (1968), reh. den. 393 U.S. 1112, 89 S. Ct. 848 (1969).

[48] Rules 12406 and 13409.

[49] PACE Comment and Cornell Comment.

[50] Id.

[51] Rules 12406 and 13409.

[52] See Ballantine Books Inc. v. Capital Distributing Company, 302 F.2d 17, 21 (2nd Cir. 1962). See also Health Services Management Corp. v. Hughes, 975 F.2d 1253, 1267 (7th Cir. 1992).

Mid-case referral requires removal of entire panel

Two commenters believe that a mid-case referral should be attributed to the entire panel and require its removal.[53] The Ryder Comment indicated that the original proposal would have required the entire panel to withdraw upon a party's request that the referring arbitrator withdraw.[54] The commenter argues, however, that the current proposal does not address the concern that a mid-case referral compromises the panel.[55]

FINRA considered the comments on the original proposal[56] and our rules concerning arbitrator recusal, and re-filed the language of Amendment No. 1 as the current proposal. The current proposal would not include the requirement that the entire panel withdraw upon a request that the referring arbitrator withdraw. Further, under the current proposal, unless the other panelists join in the mid-case referral, FINRA believes the referring arbitrator alone should be the subject of any recusal request. While arbitrators on three-person panels often collaborate on decisions involving the case, it is difficult to ascribe one person's thinking to the remaining arbitrators, unless each arbitrator expressly affirms participation in the decision.

Require moving party to pay all costs of recusal request

One commenter notes that the current proposal does not require costs and fees, such as postponement fees, associated with a recusal request to be borne exclusively by the moving party.[57] The commenter argues that requiring an investor to pay the costs associated with arbitrator recusals made because of a mid-case referral is unfair, inequitable and inconsistent with Section 15A(b)(6) of the Securities Exchange Act of 1934 ("the Act").[58] Further, the commenter suggests replacing proposed Rule 12104(b), and, instead, amending current Rule 12104(a)[59] to require that all costs associated with an arbitrator's compliance with the rule be borne by either the industry respondent or FINRA as an advancement of its mandate to detect fraud.[60]

FINRA rules do not currently require a moving party to pay all parties' costs that result from a recusal request.[61] Instead, the Code permits the panel to determine the amount of costs and expenses incurred by the parties, and which party or parties will pay the costs and expenses.[62] Thus, if an investor party incurs costs and expenses as a

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[53] Nelson Comment and Ryder Comment.

[54] See note 2, supra.

[55] Ryder Comment.

[56] See note 3, supra.

[57] PIABA Comment.

[58] 15 U.S.C. 78o-3(b)(6).

[59] Rule 12104(a) currently states that submitting a dispute to arbitration under the Code does not limit or preclude any right, action or determination by FINRA that it would otherwise be authorized to adopt, administer or enforce.

[60] PIABA Comment.

[61] See note 48, supra.

[62] Rule 12902(c). See also Rule 13902(c).

result of a mid-case referral, the investor can request that the arbitrator or panel assign liability for the investor's costs and expenses to the respondent.

The Codes also give an arbitrator or the panel the ability to allocate postponement fees against the party that contributed to the need for the postponement. For example, if a party requests a postponement as a result of an arbitrator's recusal based on a mid-case referral request, the panel could also assess part or all of any postponement fees against a party that did not request the postponement, if the panel determines that the non-requesting party caused or contributed to the need for the postponement.[63]

FINRA does not support the commenter's suggestion that FINRA pay to mitigate an investor's costs and expenses that could arise as a result of a mid-case referral. FINRA does not believe that it would be appropriate for the forum that administers the arbitration process to bear the costs for any party. FINRA provides an arbitration forum that is neutral and fair for all parties to a dispute. If the forum were to agree to pay for one party's costs and expenses, this action would raise questions about the forum's neutrality and its role in administering the arbitration process. For these reasons, FINRA believes the current proposal meets the statutory requirements under the Section 15A(b)(6)[64] of the Act and, therefore, declines to amend the current proposal as suggested.

Finally, FINRA notes that the current proposal does not create the arbitrator recusal request option. Prior to the approval of the Codes in 2007,[65] it had been forum practice to permit a party to request that an arbitrator recuse himself or herself at any time. To provide guidance to the parties and to codify this practice, FINRA included a rule in the Codes, which provided that any party may ask an arbitrator to recuse himself or herself from the panel for good cause.[66] In the context of the current proposal, if an arbitrator or panel makes a mid-case referral, any party may request that the referring arbitrators recuse themselves. However, pursuant to the recusal rule, the subject of such a recusal request would be allowed to decide whether making a mid-case referral, as would be permitted under the Codes, qualifies as good cause for making such a request.[67] FINRA reiterates that the current proposal would neither create nor change the application of the recusal rule.

Effect of arbitrators granting recusal request

Most of the five commenters contend that investors would incur increased costs and delays if an arbitrator makes a mid-case referral under the proposed rule.[68] They

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[63] Rule 12601(b)(1). See also Rule 13601(b)(1).

[64] See note 58, supra.

[65] See Securities Exchange Act Rel. No. 55158 (Jan. 24, 2007), 72 FR 4574 (Jan. 31, 2007) (File Nos. SR-NASD-2003-154 and SR-NASD-2004-011).

[66] See note 48, supra.

[67] Id.

[68] PIABA Comment, GSU Comment, St. John's Comment, PACE Comment, and Ryder Comment.

believe that if an arbitrator grants a recusal request based on such a referral, the individual investor would bear the costs, such as lost income, lost time of parties and witnesses, and the cost of a delay in finding a replacement arbitrator.[69] Two commenters suggest that if an arbitrator in a single-arbitrator case or the full panel makes a mid-case referral and grants recusal, then the parties could not continue with the remaining arbitrators, which would result in additional costs and delays for the individual investor.[70] One commenter also argues that if an arbitrator grants the recusal request, the replacement arbitrator would be an extended list appointment.[71]

Under the current proposal, upon disclosure of the mid-case referral to the parties, the parties would be permitted to request recusal of the referring arbitrator. The referring arbitrator may, in his or her discretion, decide to continue as an arbitrator on the case. If so, this means that a single arbitrator or the entire panel could remain after a party's recusal motion, and the case would proceed as normal. Under this scenario, the investor would be less likely to experience procedural disadvantages, significant delays, and increased costs, because the arbitrator recusal rules would minimize the possibility that the arbitration will start anew.

A referring arbitrator, in his or her discretion, may grant a recusal request. If the referring arbitrator were part of a three-person panel, the parties may agree to proceed with the remaining two arbitrators to limit additional expenses and to avoid delays in selecting a replacement arbitrator.

If a referring arbitrator agrees to a recusal request after making a mid-case referral and the parties request a replacement arbitrator, FINRA would appoint a replacement arbitrator[72] and the case would proceed from where it left off. FINRA's rules and policies would help expedite the replacement arbitrator's selection, which would minimize delays that could occur. FINRA notes that, if the parties seek a replacement arbitrator, FINRA would first attempt to replace the arbitrator by reviewing the lists that the parties previously returned, and inviting any arbitrators previously ranked by the parties to serve. However, where no ranked arbitrators remain from the parties' initial lists, or no remaining arbitrators are able to serve, parties would have the option to agree to review a "short list" of potential arbitrators to find a replacement, rather than accept an extended list appointment.[73]

FINRA would pay the replacement arbitrator to review the hearing record (e.g. listen to the digital recording or review a transcript, when available, of the prior hearing sessions) and learn about the arbitration case up to the point at which it was stopped.

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[69] Id.

[70] Ryder Comment and St. John's Comment.

[71] PIABA Comment.

[72] Rules 12403(c)(6) and 12403(d)(6)(A), 12403(d)(7)(A) and 12403(d)(8)(A) and 13411 .

[73] See, Short List Option to Reduce Extended List Appointments, FINRA, Arbitration and Mediation, available at http://www.finra.org/ArbitrationAndMediation/Arbitration/SpecialProcedures/ShortListOption/index.htm.

Pursuant to forum policy, the parties would not be assessed any fees for this review time. The parties may also agree to other methods of saving time and cost, such as rehearing only one or two key witnesses, stipulating to summaries of prior testimony or continuing additional hearings by video conference for parties and witnesses.[74] Regardless of whether the parties agree to additional cost saving measures, the investor could request additional consequential damages[75] and fees from the party or parties that caused the delays to the hearings.[76]

If the single arbitrator or the entire panel makes the referral and grants a recusal request,[77] the Director has the discretion to make any decision that is consistent with the purposes of the Code to facilitate the appointment of arbitrators and the resolution of arbitrations.[78] Thus, the Director could use a combination of its short list policy and list selection procedures to expedite the selection of the replacement arbitrators. Further, as noted above, FINRA would pay them to review the hearing record and learn about the arbitration up to the point where the case was interrupted. These actions do not preclude the parties from agreeing to additional cost and time saving measures, including mediation and settlement.[79]

FINRA acknowledges the commenters' concerns that these remedies may not provide complete compensation to the party who might incur increased costs and delays. Yet, FINRA cannot eliminate all of the attendant costs or potential delays that may arise as a result of a mid-case referral. FINRA believes, however, that its cost and time mitigation strategies could alleviate many of the impacts the current proposal might have on an investor party. Contrary to the commenters' assertions, however, FINRA believes that, under circumstances which would warrant a mid-case referral, the referral itself could save a substantial number of non-party investors from losses or costs. FINRA believes this overarching goal of the current proposal, on balance, outweighs the risk of potential increased costs for an individual party.

Effect of arbitrators declining recusal request

The majority of commenters believe that an arbitrator who does not grant a recusal request, under the current proposal, increases the likelihood that a respondent would file a motion to vacate the award.[80] The commenters suggest that by not granting the recusal request, the referring arbitrator would give industry members grounds to file a motion to vacate,[81] which would increase the prevailing customer's costs by having to

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[74] Rules 12105 and 13105.

[75] These damages are caused by an injury, but are not a necessary result of the injury. Steven H. Gifis, Barron's Law Dictionary 117(3rd ed. 1991).

[76] See note 62, supra.

[77] GSU Comment.

[78] Rule 12408. See also Rule 13412.

[79] Rules 12701 and 13701.

[80] Berne Comment, PIABA Comment, GSU Comment, PACE Comment, Nelson Comment, St. John's Comment, and Ryder Comment.

[81] Ryder Comment, Nelson Comment, and Berne Comment.

defend against the motion.[82] Two commenters contend that regardless of whether a motion proves successful, filing the motion would delay restitution or force the customer to settle for less than what could have been received.[83] Another commenter also suggests amending Rule 12104(b) among other things to add language that states that a referral under the rule would not be grounds for recusal or removal of an arbitrator or panel, and would not be a ground to challenge the arbitration award.[84]

FINRA acknowledges a possible increase in motions to vacate as an outcome if a referring arbitrator does not grant a recusal request. However, FINRA disagrees that a denied recusal request would provide the respondent with valid bias grounds on which to challenge an award, as two commenters suggest.[85] The Federal Arbitration Act ("FAA") establishes four grounds for vacating an arbitration award.[86] Arbitrator evident partiality encompasses both an arbitrator's explicit bias toward one party and an arbitrator's inferred bias when an arbitrator fails to disclose relevant information to the parties.[87] "The party alleging evident partiality must establish specific facts which indicate improper motives" on the part of the arbitrators.[88] The appearance of impropriety, standing alone, is insufficient.[89] And the arbitrators' decision has also been deemed insufficient to constitute a showing of evident partiality.[90] If it were, the court said, "any dissatisfied party could allege evident partiality whenever an unfavorable decision is rendered."[91]

Moreover, courts have not found that a situation in which an arbitrator forms an

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[82] St. John's Comment, PIABA Comment, GSU Comment, and PACE Comment.

[83] PIABA Comment and St. John's Comment.

[84] Cornell Comment.

[85] Nelson Comment and Ryder Comment.

[86] 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

(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).

[87] Windsor, Kathryn A. (2012) "Defining Arbitrator Evident Partiality: The Catch-22 Of Commercial Litigation Disputes," *Seton Hall Circuit Review*: Vol. 6: Iss. 1, Article 7, p. 192. Available at: http://erepository.law.shu.edu/circuit_review/vol6/iss1/7.

[88] Sheet Metal Workers International Association Local Union 420 v. Kinney Air Conditioning Co., 756 F.2d 742, 746 (9th Cir. 1985).

[89] Kinney, 756 F.2d at 746 (citing International Produce, Inc. v. Rosshavet, 638 F.2d 548, 551 (2d Cir.), *cert. denied*, 451 U.S. 1017 (1981)).

[90] Stanley J. Mical, et al. v. Phillip J. Glick, et al., No. 13 C 6508 (N.D. Ill. filed Jan 28, 2014).

[91] Id.

opinion using evidence presented during a hearing and then acts on that evidence rises to the level of evident partiality.[92] Courts expect that after an arbitrator has heard considerable testimony, the arbitrator will have some view of the case.[93] As long as that view is one that arises from the evidence and the conduct of the parties, it cannot be fairly claimed that some expression of that view amounts to bias.[94] Based on case law, FINRA believes that, as arbitrators are expected to form opinions based on evidence presented to them after they are appointed, a prevailing investor's award would not likely be vacated because arbitrators acted on their views, in the form of a mid-case referral, prior to the conclusion of the proceedings.[95]

One commenter notes that even if FINRA eliminated the mid-case referral as an explicit ground to request recusal, respondents would likely still file a motion to vacate.[96] The commenter suggests that FINRA could mitigate the effect of such motions with arbitrator and party guidance about the courts' findings on what constitutes grounds for evident partiality.[97] FINRA agrees and believes the better approach would be to provide training for parties and arbitrators as suggested.

A majority of the five commenters argue that regardless of the success in defending a motion to vacate, the investor would incur increased costs to defend against such a motion and experience further delays in receiving restitution.[98] FINRA does not dispute these potential outcomes. However, the industry respondent would also incur costs in filing such a motion as well as the financial risk of an unfavorable court decision. For example, if the award assesses monetary damages against the respondent, then interest would accrue on that amount until the amount is paid.[99] Further, when the prevailing customer responds to the respondent's motion to vacate, the customer may request attorney's fees or sanctions as appropriate. Thus, if the motion to vacate is denied, the customer could recover some or all of its expenses.

Moreover, courts have imposed sanctions to discourage parties from "defeating the purpose of arbitration by bringing such [motions] based on nothing more than dissatisfaction with the tribunal's conclusions."[100] "Where parties agree to arbitration as an efficient and lower-cost alternative to litigation, both the parties and the system itself have a strong interest in the finality of those arbitration awards."[101] Thus, the court found

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[92] Ballantine Books Inc., 302 F.2d at 21. See also Bell Aerospace Co. v. Local 516, UAW, 500 F.2d 921, 923 (2nd Cir. 1974).

[93] Ballantine, 302 F.2d at 21.

[94] Id. See also Health Services Management Corp., 975 F.2d 1253at 1267.

[95] Health Services Management Corp., 975 F.2d at 1267.

[96] PACE Comment.

[97] Id.

[98] See note 80, supra.

[99] Rule 12904(j). See also Rule 13904(j).

[100] DigiTelCom, Ltd. v. Tele2 Sverige AB, 2012 U.S. Dist. LEXIS 105896, 18-19 (S.D.N.Y. July 25, 2012).

[101] Id. at 18.

that sanctions were appropriate when the motion "serves only to cause the parties to incur unnecessary expense and delay the implementation of the award."[102] It is, therefore, possible that filing a motion to vacate an award on the basis of an arbitrator making a mid-case referral could expose the attorney and the party to fees and sanctions.

Last, the Cornell Comment that suggests that FINRA amend proposed Rule 12104(b) to provide that a mid-case referral would not be grounds to challenge an arbitration award.[103] As an initial matter, FINRA does not believe it has the authority to expand the interpretation of the FAA; that is reserved for the courts. Based on case law, FINRA believes such a provision would contradict a finding that the statutory grounds in the FAA are the exclusive grounds for vacating an arbitration award. Specifically, in Hall Street Associates, L.L.C. v. Mattel, Inc., the United States Supreme Court held that Sections 10[104] and 11[105] of the FAA are the exclusive grounds for vacating and modifying an arbitration award.[106] In Hall Street, the Court made it clear that adding vacature grounds would contradict Section 9 of the FAA, which "carries no hint of flexibility in unequivocally telling courts that they "must" confirm an arbitral award, "unless" it is vacated or modified "as prescribed" by Sections 10 and 11."[107] Thus, in light of the Supreme Court's ruling, FINRA declines to amend the proposal as suggested.

FINRA realizes these measures do not fully mitigate the increased costs that an investor could incur to defend against a motion to vacate. However, FINRA believes that remedies available to a prevailing investor under the Code and in court, combined with the standard for vacature under the FAA and established case law, make it unlikely that a motion to vacate would succeed under these circumstances. Additionally, since it is anticipated that situations involving mid-case referrals will be extremely rare, it follows that instances of arbitrators declining recusal requests based on mid-case referrals will be infrequent. Thus, FINRA anticipates that the number of prevailing investors subject to a motion to vacate based on a failure to recuse after a mid-case referral would be minimal.

Other Issues Raised by the Commenters

Referral should be allowed in prehearing phase

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[102] Id. at 19-20. See also B.L. Harbert Int'l v. Hercules Steel Co., 441 F.3d 905, 913 (11th Cir. Ala. 2006) (suggesting that courts cannot prevent parties from trying to convert arbitration losses into court victories, but it may be that we can and should insist that if a party on the short end of an arbitration award attacks that award in court without any real legal basis for doing so, that party should pay sanctions).

[103] Cornell Comment.

[104] See note 86, supra.

[105] Section 11 of the FAA allows a court to modify an arbitration award to correct non-substantive matters that do not affect the merits of the case. 9 U.S.C. §11.

[106] Hall Street Associates, L.L.C. v. Mattel, Inc., 552 U.S. 576, 583 (2008).

[107] Id. at 577.

One commenter believes that arbitrators should also be permitted to make referrals in the prehearing phase of an arbitration based solely on parties' pleadings, and suggests an amendment to implement this change.[108]

FINRA believes that a mid-case referral should be based on evidence presented by the parties during a hearing. The goal of the current proposal is to permit arbitrators to act on information that may not be apparent until an arbitration hearing occurs and the parties and their witnesses testify and introduce evidence about relevant events. Moreover, as the CRG analyzes all statements of claims and related pleadings for fraudulent activity, this suggestion would duplicate regulatory functions. For these reasons, FINRA declines to amend the current proposal as suggested.

Compromises to arbitrators' neutrality and the arbitration process

Four commenters suggest that the current proposal would compromise arbitrators' neutrality and ability to maintain confidentiality by requiring that they make a decision on the merits during a case without having received all of the evidence, which inappropriately affects the arbitration deliberative process and violates due process.[109]

FINRA rules require that its arbitrators are impartial and free of conflicts that could hinder their ability to decide a case fairly.[110] When arbitrators are initially appointed to a case, they must complete a Checklist, which contains questions intended to help the arbitrator comply with the disclosure requirements. Further, the arbitrators take an oath to maintain confidentiality of all matters relating to the arbitration proceeding and decision, including but not limited to any information, documents, evidence, or testimony presented.[111] FINRA believes these tenets are the foundation of what it means to be an arbitrator, and they should be adhered to during the proceedings.

FINRA does not believe that arbitrators would compromise their duties to maintain neutrality or confidentiality by making a mid-case referral. To the first point about compromising an arbitrator's neutrality, FINRA has noted that courts expect arbitrators to form opinions about a case, based on evidence and testimony presented to them after they are appointed.[112] FINRA does not believe, therefore, that making a mid-case referral would compromise arbitrators' neutrality, as the arbitrators would be performing one of the duties that is expected of arbitrators.

With respect to the duty of confidentiality, FINRA does not believe making a mid-case referral, pursuant to the forum's rules, would constitute a breach of an arbitrator's duty to maintain confidentiality. Pursuant to Canon I of the Code of Ethics for Arbitrators

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[108] Cornell Comment.

[109] Berne Comment, Nelson Comment, Ryder Comment, and St. John's Comment.

[110] Rules 12405 and 13408.

[111] See, Oath of Arbitrator, FINRA, Arbitration and Mediation, available at http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p009442.pdf.

[112] See note 93 and discussion under "Effect of arbitrators declining recusal request," supra.

in Commercial Disputes ("Code of Ethics"),[113] an arbitrator should uphold the integrity and fairness of the arbitration process. One of the ways that an arbitrator can accomplish this is by complying with an agreement of the parties which provides the rules and procedures to be followed when conducting an arbitration. Specifically, Canon I(E) states, in relevant part that, "[w]hen an arbitrator's authority is derived from the agreement of the parties, an arbitrator should neither exceed that authority nor do less than is required to exercise that authority completely. Where the agreement of the parties sets forth procedures to be followed in conducting the arbitration or refers to rules to be followed, it is the obligation of the arbitrator to comply with such procedures or rules."[114] Based on these criteria, the parties to a FINRA arbitration are subject to the rules and procedures of the forum either through the FINRA Submission Agreement or by membership. FINRA rules and procedures provide arbitrators with the authority to conduct an arbitration, and require them to do so, pursuant to those rules and procedures. Thus, if an arbitrator makes a mid-case referral pursuant to the rules of the Code, the arbitrator would have made such a referral in compliance with the arbitration rules. In complying with the rules of the forum,[115] therefore, FINRA does not believe making a mid-case referral would be a breach of the duty of confidentiality under the Code of Ethics.

An attorney's duty to client would conflict with duty to public good

One commenter suggests that the current proposal would put an attorney's duty to his client and the duty to the public good at odds.[116] The commenter believes that attorneys may wait to present evidence of a serious threat until later scheduled hearing sessions to avoid the possibility of a mid-case referral, which, the commenter believes could hurt the client.

FINRA notes that the current proposal is not intended to dictate case strategy. An attorney must decide how to present a client's case in a manner that benefits the client and meets the attorney's ethical obligations.

FINRA believes, however, that the concern raised by the commenter illustrates the need for arbitrators to have the authority to alert FINRA during an arbitration to a possible threat that could harm investors. An attorney's obligation is to represent a single client in a manner that would achieve the best results possible for that client (of course, within ethical bounds). This obligation could conflict with the purpose of the current proposal, which is for FINRA to be alerted to serious threats and wrongdoing as early as possible. Thus, FINRA believes that the current proposal is necessary to ensure

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[113] The Code of Ethics for Arbitrators in Commercial Disputes http://www.finra.org/ArbitrationMediation/Rules/RuleGuidance/P009525 (last visited May 12, 2014).

[114] See The Code of Ethics for Arbitrators in Commercial Disputes, Canon I(E).

[115] Similarly, if the arbitrators learned of a threat that could result in physical harm to a person or group or of an ongoing criminal act, it would be reasonable for arbitrators to refer these under the current proposal.

[116] St. John's Comment.

that arbitrators have the authority to alert FINRA during an arbitration, if evidence or testimony during a hearing reveals a serious threat that could result in harm to investors.

Director's review after referral

Three commenters question the need for the Director's review of the mid-case referral after the arbitrators make the referral.[117] One commenter believes that such review would only delay any benefit gained from the arbitrators making a mid-case referral.[118] Another suggests that if the Director thinks referral is unwarranted and does not refer it to Enforcement, this action would only add to a bias challenge and determination.[119]

FINRA modeled this provision after the current practice used when an arbitrator makes a post-case referral.[120] The purpose of the Director's review would not be to second-guess the arbitrators, but, rather, to determine which FINRA division should receive the referral, and whether other divisions or regulators should be notified.

The current proposal would authorize only the President or Director to forward the mid-case referral to other divisions, but does not obligate the President or Director to do so. However, in practice, FINRA believes that if the President or Director receives a mid-case referral, the person would likely forward it to the appropriate divisions. FINRA notes that if the arbitrators refer a serious threat to FINRA during an arbitration, the parties are likely to know the outcome of the referral by any subsequent response by a regulatory body. FINRA does not believe, however, that the action the Director takes concerning a mid-case referral would be sufficient grounds to support a showing of bias by the arbitrators.[121]

Arbitrator training and guidance

Two commenters suggest that arbitrators would benefit from training and guidance on how to apply the proposed mid-case referral rule to minimize frequent referrals and to ensure that referrals made under the rule are consistent.[122]

FINRA agrees that there should be training for arbitrators on the mid-case referral rule and how it should be applied. FINRA also believes parties would benefit from guidance on the rule, which would include a reminder about the courts' findings on what constitutes grounds for evident partiality. If the current proposal is approved, FINRA would publish a Regulatory Notice to explain the mechanics of the rule. The Regulatory Notice would emphasize that arbitrators are not required to grant a recusal request based on making a mid-case referral. Courts have consistently found that arbitrators are

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[117] Nelson Comment, Cornell Comment, and Ryder Comment.

[118] Cornell Comment.

[119] Ryder Comment.

[120] See, The Neutral Corner, "What Happens After Arbitrators Submit a Disciplinary Referral?," Jeffrey Smith, Volume 4 – 2012.

[121] See note 93 and discussion under "Effect of arbitrators declining recusal request," supra.

[122] PACE Comment and St. John's Comment.

expected to form opinions based on evidence presented to them after they are appointed, and that some expression of that view, made during a case, would not be considered bias. Moreover, the Regulatory Notice would remind attorneys and parties that courts are willing to impose sanctions to discourage frivolous litigation over arbitration awards.[123]

* * *

Conclusion

Mid-case referrals would provide FINRA with another important tool to protect investors by alerting FINRA to potentially serious wrongdoing earlier than is possible under the current rules. The current proposal contains stringent criteria for making mid-case referrals, which should make them an extremely rare occurrence in our forum. If the arbitrators make a mid-case referral, the current proposal's other protections as well as the Director's authority under the Codes would help ameliorate some of the potential negative effects that a mid-case referral could have on a customer's case. These protections would help minimize delays, costs and administrative procedures, as well as reduce the potential for a finding of arbitrator bias, which would help a prevailing investor defend against a motion to vacate. Despite these measures, some individual investors may incur delays and costs. However, FINRA's investor protection mission leads us to believe that the Codes permit an arbitrator who has reason to believe that there is a serious, ongoing, or imminent threat to other investors to make a referral without waiting until a case is over. FINRA believes, therefore, that the current proposal could save a substantial number of other investors from incurring losses, the benefit of which, on balance, outweighs the risk of potential increased costs for an individual investor. For these reasons, FINRA requests that the SEC approve the current proposal to help protect investors and the public interest.

If you have any questions, please contact me on (202) 728-8151 or at mignon.mclemore@finra.org.

Very truly yours,

/mm/

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[123] See discussion under "Effect of arbitrators declining recusal request," supra.