FINRA
Financial Industry Regulatory Authority

November 24, 2014

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-FINRA-2014-028 – Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change Relating to Revisions to the Definitions of Non-Public Arbitrator and Public Arbitrator; Response to Comments

Dear Mr. Fields:

On June 17, 2014, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC") a proposed rule change to amend the Customer and Industry Codes of Arbitration Procedure to refine and reorganize the definitions of "non-public" and "public" arbitrator. The amendments would, among other matters, provide that persons who worked in the financial industry for any duration during their careers would always be classified as non-public arbitrators, and persons who represent investors or the financial industry as a significant part of their business would also be classified as non-public, but could become public arbitrators after a cooling-off period. The amendments would reorganize the definitions to make it easier for arbitrator applicants and parties, among others, to determine the correct arbitrator classification.[1] The SEC received 316 comment letters on the proposed rule change.[2] On September 30, 2014 FINRA responded to the comments.[3] On October 1, 2014, the SEC published its Order Instituting Proceedings ("Notice") to Determine Whether to Approve or Disapprove Proposed Rule Change Relating to Revisions to the Definitions of Non-Public Arbitrator and Public Arbitrator.[4]

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[1] See Securities Exchange Act Rel. No. 72491 (June 27, 2014), 79 FR 38080 (July 3, 2014) (File No. SR-FINRA-2014-028).

[2] See Comments on FINRA Rulemaking, Notice of Filing of a Proposed Rule Change Relating to Revisions to the Definitions of Non-Public Arbitrator and Public Arbitrator (http://www.sec.gov/rules/sro/finra/2014/34-72491.pdf)

[3] See letter from Margo A. Hassan, Assistant Chief Counsel, FINRA Dispute Resolution, to Brent Fields, Secretary, SEC, dated September 30, 2014 ("FINRA letter").

[4] See Securities Exchange Act Rel. No. 73277 (October 1, 2014), 79 FR 60556 (October 7, 2014)(file No. SR-FINRA-2014-028).

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10006-1404
t 212 858 4000
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In its Notice, the SEC solicited views, data, and arguments with respect to the issues raised by the proposed rule change and asked whether the proposed rule change is inconsistent with Sections 15A(b)(6) and 15A(b)(9) of the Securities Exchange Act of 1934.[5] The SEC received 13 comment letters on its Notice.[6] FINRA is hereby responding to the comments received on the Notice. The 13 commenters' positions break down as follows: five support the proposal;[7] four object to the proposal;[8] and four raised concerns about specified aspects of the proposal.[9] The following is FINRA's response, by topic, to the commenters' concerns.

Impact of the Proposed Rule Change on the Public Arbitrator Roster

FINRA classifies persons who are, or were, associated with the industry as non-public arbitrators. However, FINRA permits these persons to serve as public arbitrators five years after they leave the industry, provided they have not retired from, or spent a substantial part of their careers in the industry.[10] Investor advocates raised concerns about the neutrality of the public arbitrator roster because they believe that these persons should not serve as public arbitrators. To address this concern, FINRA proposed eliminating the five-year cooling-off period, thereby providing that FINRA would classify persons who worked in the industry, at any point in their careers, for any duration, as non-public. Once classified as non-public, FINRA would not reclassify them as public. If the SEC approves the proposed rule change, FINRA will reclassify, as non-public, any public arbitrators on the roster who worked in the industry. In response to the Notice, several commenters affirm that the proposal would address longstanding perceptions about the fairness and neutrality of the public arbitrator roster thereby enhancing the interests of public investors.[11]

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[5] Id. at 60560.

[6] Comments on the Notice were submitted by: John A. Bender, Esq., Ryan Swanson, October 10, 2014 ("Bender"); George H. Friedman, Esquire, George H. Friedman Consulting, LLC, October 20, 2014 ("Friedman"); Richard P. Ryder, Esquire., President, Securities Arbitration Commentator, Inc., October 26, 2014 ("Ryder"); Steven B. Caruso, Esq., Maddox Hargett & Caruso, P.C., October 29, 2014 ("Caruso"); Ryan K. Bakhtiari, Aidikoff, Uhl and Bakhtiari, October 30, 2014 ("Bakhtiari"); Glenn S. Gitomer, Esquire, McCausland Keen & Buckman, November 5, 2014 ("Gitomer"); Daniel Wolfe, Legal Intern, and Teresa Verges, Esquire, Professor of Law, University of Miami School of Law Investor Rights Clinic, November 6, 2014 ("UMIRC"); CJ Croll and Jefferey P. Valacer, Student Interns, Elissa Germaine, Supervising Attorney, and Jill I. Gross, Director, Pace Investor Rights Clinic, November 6, 2014 ("PIRC"); Kevin M. Carroll, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, November 6, 2014 ("SIFMA"); Ryan Corbin, Kori Eskridge, and Kristina Ludwig, Student Interns, and Nicole Iannarone, Assistant Clinical Professor, Georgia State University College of Law Investor, Advocacy Clinic, November 6, 2014 ("GIAC"); Greg Curley, Senior Litigation Counsel, American International Group, Inc., November 6, 2014 ("Curley"); William A. Jacobson, Clinical Professor of Law, Cornell Law School, and Director, Cornell Securities Law Clinic, November 6, 2014 ("CSLC"); and William Beatty, President, North American Securities Administrators Association, Washington Securities Administrator, November 6, 2014 ("NASAA").

[7] See the Caruso, Bakhtiari, Gitomer, SIFMA, and Curley letters.

[8] See the Ryder, PIRC, GIAC, and NASAA letters.

[9] See the Bender, Friedman, UMIRC, and CSCC letters.

[10] See current FINRA Rules 12100(p)(1) and (p)(2) and 13100(p)(1) and (p)(2).

[11] See the Caruso, Bakhtiari, Gitomer, SIFMA, and CSCC letters.

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FINRA classifies attorneys and other professionals who regularly represent or provide services to investors in disputes concerning investment accounts or transactions as public arbitrators. Industry constituents raised concerns about the neutrality of the public arbitrator roster because they believe that these persons should not serve as public arbitrators. To address this concern, FINRA proposed removing these persons from the public arbitrator roster, and reclassifying them as non-public arbitrators. FINRA proposed reclassifying these arbitrators as non-public – instead of removing them from arbitrator service altogether – because FINRA believes that they have knowledge and experience that benefits forum users. By moving them to the non-public roster, FINRA would eliminate the industry's perception of investor bias in the public roster, while affording parties in customer cases with the option of ranking these persons during the arbitrator selection process.[12]

Several commenters object to the proposed reclassifications outlined above, because they believe that the reclassifications would substantially reduce the number of arbitrators on the public roster.[13] Commenters argue that the SEC should not approve the proposed rule change because FINRA did not conduct an in-depth analysis of the number of arbitrators whom FINRA would reclassify as non-public.[14] Two commenters raised a concern that FINRA might find the impact of the reclassifications unsupportable – necessitating a subsequent rule change to return arbitrators to the public roster.[15]

As stated in its September 30, 2014 correspondence, FINRA agreed that a cost-benefit analysis would be helpful. Therefore, FINRA conducted a review of its public arbitrator roster to ascertain a preliminary estimate of the number of arbitrators whom FINRA might reclassify as non-public under the proposed rule change. In connection with the proposal to classify persons who worked in the financial industry permanently as non-public, a search of the arbitrator database revealed that 374 public arbitrators out of 3,567 were likely to be affected by the proposed rule change. Concerning the proposal to reclassify attorneys and other professionals who regularly represent or provide services to investors as non-public, a search of the arbitrator database revealed that the proposal might impact approximately 100 public arbitrators. While it is useful to have an estimate of the impact of the proposed reclassifications for planning purposes, FINRA believes that users' perceptions of neutrality of the public arbitrator roster are imperative to maintaining the integrity of the forum, and that fairness requires FINRA to address the concerns of all forum users. The proposed rule change is the culmination of extensive dialogue with FINRA constituents and FINRA filed the proposed rule change at the urging of its constituents. These proposed changes will shift arbitrators to another part of the roster but will not reduce the total number of arbitrators available for selection. Several commenters argued that the affected

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[12] Under the Code of Arbitration Procedure for Customer Disputes, one arbitrator hears customer claims up to $100,000 and three arbitrators hear customer claims of more than $100,000 or unspecified claims (FINRA Rule 12401). In cases with three arbitrators, FINRA sends the parties three randomly generated lists of arbitrators – a list of 10 chair-qualified public arbitrators, a list of 10 public arbitrators, and a list of 10 non-public arbitrators. The parties select their panel through a process of striking and ranking the arbitrators on the lists. FINRA limits the parties to four strikes on the chair-qualified public list and four strikes on the public list. However, FINRA gives parties unlimited strikes on the non-public arbitrator list.

[13] See the Bender, Friedman, Ryder, UMIRC, PIRC, and GIAC letters.

[14] See the Friedman, Ryder, PIRC letters.

[15] See the Ryder and PIRC letters.

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arbitrators have considerable talents and experience. The parties will see those arbitrators and a complete description of each person's background and experience on the non-public lists.

FINRA recognizes that the proposed rule change will necessitate aggressive arbitrator recruitment and it is committed to ensuring that the forum has a sufficient number of public arbitrators to serve the needs of forum users in each of its hearing locations. For example, in the case of the Puerto Rico bond fund disputes, FINRA staff conducted recruitment activities in Puerto Rico and also asked arbitrators in hearing locations in the Southeast Region[16] and Texas if they would be willing to serve in Puerto Rico. Our recruitment efforts have resulted in almost 200 applications from Puerto Rico residents to serve on our roster, and we have approximately 800 arbitrators who have agreed to hear cases in Puerto Rico.

In addition, one commenter hypothesizes that FINRA may not currently have enough public arbitrators, and questions whether a lack of arbitrators may be contributing to an increase in overall case turnaround time.[17] FINRA monitors turnaround time, and believes that there are several factors that might affect it. FINRA has not heard from forum users that arbitrator availability is causing delays in processing cases. However, based on our review, FINRA staff believes that the following factors affect turnaround times.

- **Party Initiated Postponements:** Over the last ten years, the average number of postponed hearing days per case closed more than doubled (from 3.84 to 7.98 days). Postponed hearings require parties and arbitrators to find mutually agreeable replacement dates – a process that can delay the hearing by days, weeks, or even months.

- **Increased Hearing Sessions:** Over the last ten years, the average number of hearing sessions per case closed has increased by 29 percent from 7.6 to 9.8 hearing sessions (meaning the average hearing now lasts nearly five days). Cases with more hearing sessions often require scheduling on non-consecutive days or non-consecutive weeks to accommodate all parties' schedules.

- **Concentration of Parties' Counsel:** A concentration of law firms representing the majority of parties in product cases increases turnaround time. For example, in the Puerto Rico bond fund cases, two firms represent 67 percent of Respondents, and five firms represent 71 percent of Claimants. The concentration of party representatives creates scheduling delays whereby party representatives are scheduling hearings months, or even years, into the future.

- **Efforts to Verify Arbitrator Disclosures**: Since June 2013, FINRA staff has been conducting internet searches on arbitrators prior to assigning them to cases. During the third quarter of 2014 alone, FINRA conducted research on 2,905 arbitrators. While this effort protects parties from undisclosed arbitrator conflicts, it increases case processing times, which has an impact on overall turnaround times.

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[16] The Southeast Region includes Atlanta, GA; Baltimore, MD; Birmingham, AL; Boca Raton, FL; Charlotte, NC; Columbia, SC; Jackson, MS; Jacksonville, FL; Little Rock, AR; Memphis, TN; Miami, FL; Nashville, TN; New Orleans, LA; Norfolk, VA; Orlando, FL; Raleigh, NC; Richmond, VA; San Juan, PR; Tampa, FL; Washington, DC; and Wilmington, DE.

[17] See the Ryder letter.

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Expansion of the Non-Public Arbitrator Definition to Include Investor Representatives

Two commenters express their support for expanding the definition of non-public arbitrator to include attorneys and other professionals who regularly represent or provide services to investors in disputes concerning investment accounts or transactions.[18] These commenters assert that the proposal is both necessary and appropriate, and that the reasons for eliminating perceived arbitrator bias for both investors and industry parties in the forum are the same. They believe that the current distinction between the non-public and public arbitrator definitions developed because FINRA rules used to require the presence of an industry arbitrator on the panel. Since FINRA amended its rules to allow any party in a customer case to select an all public panel, the historical distinction should yield to the proposed enhancements to the non-public arbitrator definition.

Several commenters object both to the reclassification of investor representatives as non-public and, more generally, to FINRA's expansion of the non-public roster to persons who are not affiliated with the industry.[19] A few commenters argue that the distinctions between the public and non-public arbitrator definitions were designed to address the bias concerns of investor representatives,[20] with one commenter asserting that any proposed rule change should focus on mitigating investor perceptions of bias, not industry perceptions.[21] One commenter believes that the reclassification will cause confusion and will complicate investors' ability to select non-public arbitrators with industry experience.[22] FINRA has implemented many changes to the arbitrator definitions in recent years. Each change requires some educational efforts on our part and some adjustments to selection strategies for parties and counsel. We have successfully implemented these changes. Parties also adapted quickly when FINRA implemented a major change in the selection process by allowing parties to select all public panels.

FINRA respectfully disagrees with these views. As explained above, FINRA believes that to ensure the integrity of the forum, FINRA must address both investor and industry perceptions of bias in the public arbitrator roster. By expanding the scope of the non-public arbitrator definition as proposed, FINRA can respond to constituents' needs while providing parties in customer cases with a greater ability to address their own perceptions of bias through the use of their unlimited strikes on the list of non-public arbitrators. If the SEC approves the proposed rule change, FINRA intends to issue a Regulatory Notice detailing the changes to the arbitrator definitions. Parties will continue to receive extensive disclosure statements on each proposed arbitrator which describe in detail that arbitrator's background. This enables the parties to make an informed decision when selecting arbitrators. FINRA staff believes that the Regulatory Notice, along with the arbitrator profile reports, will provide the information investors need during the arbitrator selection process.

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[18] See the SIFMA and Curley letters.

[19] See the Friedman, UMIRC, PIRC, GIAC, CSCC, and NASAA letters.

[20] See the UMIRC, CSCC, and NASAA letters.

[21] See the CSCC letter.

[22] See the UMIRC letter.

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Permanent Classification of Industry Employees as Non-Public

One commenter suggests that FINRA prohibit persons with industry experience from arbitrator service at some point after they end their industry involvement.[23] The commenter also asserts that FINRA should not permit certain classes of industry employees, such as clerical workers, to serve as arbitrators. FINRA disagrees with these assertions. Former industry employees have valuable knowledge and experience, and FINRA staff believes that removing them from arbitrator service would not benefit forum users. Concerning the capacity in which an industry employee serves, FINRA believes that if an industry affiliate meets FINRA's qualifications for service as an arbitrator, FINRA should appoint the person to the non-public arbitrator roster. Any party in a customer case may strike any or all of the arbitrators on the non-public list if the party determines that an arbitrator is too far removed from the industry or is not sufficiently knowledgeable. In the case of an intra-industry dispute, parties may exercise their limited strikes if they do not want a particular arbitrator to serve on a case.

Eliminating Arbitrator Classifications

One commenter suggests that FINRA consider eliminating arbitrator classifications, and allow parties to choose from a single pool of arbitrators.[24] In FINRA's most recent discussions with the National Arbitration and Mediation Committee (NAMC) and other forum constituents on the arbitrator definitions, we encouraged interested persons to raise their concerns about the definitions and to make suggestions on how to improve them. During this series of discussions, the NAMC did not suggest that FINRA eliminate arbitrator classifications altogether. In addition, in light of the positive feedback that FINRA received on the rule amendments that ensure that any party may select an all public arbitration panel, FINRA does not believe that eliminating arbitrator classifications is a good approach to panel selection. Since the selection lists are populated randomly, eliminating classifications could lead to investors having a choice of only arbitrators with industry affiliations in a particular case. This would undermine many of FINRA's recent changes to the arbitrator selection rules.

Use of the Term "Professional Time"

Under the proposed rule change, FINRA uses the term "professional time," as opposed to the term "professional work," in provisions relating to specified professional services because FINRA believes that time would be more easily quantified by professionals applying to serve as arbitrators, and by arbitrators checking their business mix periodically to determine whether their current classification is appropriate. One commenter requests that FINRA use revenue in the proposal relating to classifying attorneys and other professionals who regularly represent or provide services to investors as non-public instead of professional time, because under the proposed provision, FINRA might classify professors and supervisors who work in law school investor advocacy clinics as non-public.[25] The commenter states that while the clinics provide services to investors with small claims, the primary function of the clinics is to teach legal skills to law students. Given the purpose of the proposed amendment – to address the perception that professionals who regularly provide services to investors might be biased in favor of investors –

[23] See the Friedman letter.

[24] See the PIRC letter.

[25] See the UMIRC letter.

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FINRA does not believe that it would be appropriate to carve out an exception for employees of law school investor advocacy clinics.

Dispute Resolution Task Force

In July 2014, FINRA formed a new Dispute Resolution Task Force ("Task Force") to consider possible enhancements to its arbitration and mediation forum.[26] Two commenters suggest that FINRA withdraw the proposed rule change and refer it to the Task Force for consideration.[27] The proposed rule change is the culmination of FINRA's comprehensive review of the arbitrator definitions. As stated in its rule filing, FINRA met with the NAMC and interested groups several times to discuss the definitions. FINRA believes that the proposed rule change reflects a balanced approach on classifying arbitrators that will enhance forum users' perceptions of fairness of the forum now. While the Task Force is setting its own agenda, and is free to discuss the arbitrator definitions, it does not expect to complete its review and make recommendations to the NAMC until fall of 2015. FINRA would not be likely to file any proposed rule change resulting from a Task Force recommendation until at least 2016. Therefore, FINRA does not believe that it would be in the best interest of forum users to delay action on this thoroughly vetted proposed rule change.

Conclusion

FINRA believes that the foregoing, along with its September 30, 2014 letter, responds to the issues raised by the commenters. If you have any questions, please contact me on [redacted] or by email at [redacted]

Very truly yours,

Margo A. Hassan
Assistant Chief Counsel
FINRA Dispute Resolution

[26] Information on the Dispute Resolution Task Force can be found on the FINRA website at http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/MoreonFINRADisputeResolution/P600966

[27] See the Friedman and Ryder letters.

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