

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-56039; File No. SR-NASD-2007-021)

July 10, 2007

Self-Regulatory Organizations; National Association of Securities Dealers, Inc., Notice of Filing of Proposed Rule Change to Amend the Definition of Public Arbitrator

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 12, 2007, the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. (“NASD Dispute Resolution”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD Dispute Resolution proposes to amend the Code of Arbitration Procedure for Customer Disputes (“Customer Code”), and the Code of Arbitration Procedure for Industry Disputes (“Industry Code”) to amend the definition of public arbitrator to add an annual revenue limitation. The text of the proposed rule change is available at NASD, [www.nasd.com](http://www.nasd.com), and the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change. The text of these statements may be examined at the

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

places specified in Item IV below. NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

NASD has taken numerous steps in recent years to ensure the integrity and neutrality of its 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.<sup>3</sup> The 2003 proposal:

- 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

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<sup>3</sup> In July 2002, the SEC retained Professor Michael Perino to assess the adequacy of arbitrator disclosure requirements at NASD and at the New York Stock Exchange (NYSE). Professor Perino’s report (Perino Report) concluded that undisclosed 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>.

revenue in the previous two years from clients involved in securities-related activities.

The proposal was approved by the SEC on April 16, 2004, and became effective on July 19, 2004.<sup>4</sup>

On July 22, 2005, NASD proposed a further amendment 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 Rule 10308 to clarify that individuals registered through broker-dealers may not be public arbitrators, even if they are employed by a non-broker-dealer (such as a bank). This rule filing was approved by the SEC on October 16, 2006, and became effective on January 15, 2007.<sup>5</sup>

Finally, during the time that the above changes 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.<sup>6</sup> Several of the substantive changes to the Customer and Industry Codes will

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<sup>4</sup> See Securities Exchange Act Rel. 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).

<sup>5</sup> See Securities Exchange Act Rel. No. 54607 (Oct. 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).

<sup>6</sup> See Securities Exchange Act Rel. No. 51856 (June 15, 2005), 70 FR 36442 (June 23, 2005) (SR-NASD-2003-158) (notice); See Securities Exchange Act Rel. No.

affect the classification of arbitrators<sup>7</sup> and how they are selected for panels.<sup>8</sup>

Despite these many initiatives amending the arbitrator classification rules, some users of the forum continue to voice concerns about individuals serving as public arbitrators when they have business relationships with entities that derive income from broker-dealers. The concern is that, for example, an arbitrator classified as public might work for a very large law firm that derived less than 10% of its annual revenue from broker-dealer clients, but still receives a large dollar amount of such revenue. The concern focused primarily on the law firm's defense of action (in arbitration or litigation) by customers of broker-dealers, and not on representing broker-dealers in underwriting or other activities. Therefore, those concerned with the amount of annual revenue 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.

NASD supports these recommendations and is, therefore, proposing 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

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51857 (June 15, 2005), 70 FR 36430 (June 23, 2005) (SR-NASD-2004-011) (notice); and See Securities Exchange Act Rel. 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).

<sup>7</sup> NASD 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 will consist of more experienced arbitrators available on NASD's public arbitrator roster for all investor cases and for certain intra-industry cases. For other industry cases, the Code also creates 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.

<sup>8</sup> The new Codes 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.

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.<sup>9</sup>

NASD believes the proposed amendment, in conjunction with the existing 10 percent revenue limitation,<sup>10</sup> will further improve NASD's 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.<sup>11</sup>

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must 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. NASD believes

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<sup>9</sup> 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).

<sup>10</sup> 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."

<sup>11</sup> NASD 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.

that the proposed rule change will enhance investor confidence in the fairness and neutrality of NASD's arbitration forum, by providing further assurance to parties that persons who have a relationship with those who receive a significant amount of compensation from the securities industry are not able to serve as public arbitrators in NASD arbitrations.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2007-021 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2007-021. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of NASD. All comments received will be posted without change; the Commission does

not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2007-021 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>12</sup> 17 CFR 200.30-3(a)(12).