

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62480; File No. SR-FINRA-2010-022)

July 9, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change Relating to Amending the Codes of Arbitration Procedure to Increase the Number of Arbitrators on Lists Generated by the Neutral List Selection System

On April 29, 2010, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change. The proposed rule change was published for comment in the Federal Register on May 26, 2010.³ The Commission received six comments on the rule proposal.⁴

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Rel. No. 62134 (May 19, 2010), 75 FR 29594 (May 26, 2010) (File No. SR-FINRA-2010-022).

⁴ See Submission via SEC WebForm from A. M. Miller, dated May 6, 2010 (“Miller comments”); Submission via SEC WebForm from Steven B. Caruso, Maddox Hargett Caruso, P.C., dated May 27, 2010 (“Caruso comments”); Letter to Elizabeth M. Murphy, Secretary, Commission from Patricia Cowart, Chair, Arbitration Committee, Securities Industry and Financial Markets Association, dated May 27, 2010 (“SIFMA letter”); Submission via SEC WebForm from Leonard Steiner, Steiner & Libo, P.C., dated May 27, 2010 (“Steiner comments”); Letter to Elizabeth M. Murphy, Secretary, Commission from Scott R. Shewan, President, Public Investors Arbitration Bar Association, dated June 14, 2010 (“PIABA letter”); and Letter to Elizabeth M. Murphy, Secretary, Commission from Jill I. Gross, Director, Ed Pekarek, Clinical Law Fellow, and Jeffrey Gorenstein, Student Intern, Pace Law School Investor Rights Clinic, dated June 16, 2010 (“PIRC letter”).

I. Description of the Proposed Rule Change

FINRA proposed to amend Rules 12403 and 12404 of the Code of Arbitration Procedure for Customer Disputes (“Customer Code”) and Rules 13403 and 13404 of the Code of Arbitration Procedure for Industry Disputes (“Industry Code”) to increase the number of arbitrators on each list generated by the Neutral List Selection System (“NLSS”).

The NLSS is a computer system that generates, on a random basis, lists of arbitrators from FINRA’s rosters of arbitrators (i.e., public, non-public, and chair rosters) for each arbitration case. The parties select their panel through a process of striking and ranking the arbitrators on the lists. Currently, FINRA sends the parties lists of available arbitrators, along with detailed biographical information on each arbitrator. In a three-arbitrator case, other than one involving a dispute among members, the parties receive three lists of eight arbitrators each – one public, one chair-qualified and one non-public. Each party is permitted to strike up to four of the eight names on each list and ranks the remaining names in order of preference. FINRA appoints the panel from among the names remaining on the lists that the parties return.⁵

When there are no names remaining on a list, or when a mutually acceptable arbitrator is unable to serve, a random selection is made to “extend the list” by generating names of additional arbitrators to complete the panel. Parties may not strike the

⁵ In an arbitration between members, the panel consists of non-public arbitrators, and so the parties receive a list of 16 arbitrators from the FINRA non-public roster, and a list of eight non-public arbitrators from the FINRA non-public chairperson roster. See FINRA Rules 13402 and 13403. Each separately represented party may strike up to eight of the arbitrators from the non-public list and up to four of the arbitrators from the non-public chairperson list. See FINRA Rule 13404.

arbitrators on the extended lists, but they may challenge an arbitrator for cause (e.g., on the basis of conflict of interest).

Prior to 2007, FINRA permitted parties unlimited strikes of proposed arbitrators on lists. This often resulted in parties collectively striking all of the arbitrators on each list generated through NLSS. When this occurred, staff would use NLSS to “extend the list” by generating names of additional arbitrators to complete the panel. Parties expressed concern about extended list arbitrator appointments because they could not strike arbitrators from an extended list. In response to this concern, in 2007, FINRA changed the arbitrator appointment process through a rule change that limited the number of strikes each party may exercise to four, in an effort to reduce the frequency of extended list appointments.⁶ Under the current rule, FINRA permits each party to strike up to four arbitrators from each list of eight arbitrators generated through NLSS and up to eight arbitrators from each list of 16 arbitrators generated through NLSS. The rules limiting strikes have significantly reduced extended lists and thus increased the percentage of cases in which FINRA initially appoints arbitrators from the parties’ ranking lists. However, after each side exercises its strikes, typically only one or two persons remain eligible to serve on a case. Therefore, when FINRA grants a challenge for cause or an arbitrator withdraws, FINRA often must appoint the replacement arbitrator using an extended list. Forum users, including both investor and industry parties, continue to express concerns about extended list appointments.⁷

⁶ Exchange Act Release No. 55158 (January 24, 2007), 72 FR 4574 (January 31, 2007) (File No. SR-NASD-2003-158).

⁷ The rationale for the proposed rule change was confirmed in a telephone conversation between Margo Hassan, FINRA Dispute Resolution, and Joanne Rutkowski, Division of Trading and Markets, Commission, May 18, 2010.

As a result of these concerns, FINRA proposed to amend Rule 12403 of the Customer Code to expand the number of arbitrators on each list (public, non-public, and public chairperson) generated through NLSS from eight arbitrators to 10 arbitrators. Thus, in every two party case, at least two arbitrators would remain on each list after strikes.⁸ FINRA stated that the additional number of arbitrators will increase the likelihood that the parties will get panelists they chose and ranked, even when FINRA must appoint a replacement arbitrator. FINRA also stated that, in cases with more than two parties, expanding the lists from eight to 10 arbitrators should significantly reduce the number of arbitrator appointments needed from extended lists.⁹

FINRA also proposed to amend Rule 13403 of the Industry Code to expand the number of arbitrators on lists generated through NLSS.¹⁰ For disputes between members, FINRA would expand the number of arbitrators on the non-public chairperson list generated through NLSS from eight arbitrators to 10 arbitrators and the number of arbitrators on the non-public list from 16 arbitrators to 20 arbitrators. For disputes between associated persons, or between or among members and associated persons, FINRA would expand the number of arbitrators on each list (public, non-public, and public chairperson) generated through NLSS from eight arbitrators to 10 arbitrators.

⁸ FINRA did not propose to expand the number of allowable strikes for each party.

⁹ Under the rules, each “separately represented” party is entitled to strike four arbitrators from an eight arbitrator list. If, for example, a case involves a customer, a member and an associated person, and each party is separately represented, even with 10 arbitrators there is a chance that all of the arbitrators will be stricken from the list.

¹⁰ Again, FINRA did not propose to expand the number of allowable strikes for each party.

FINRA considered whether increasing each list of arbitrators would be unduly burdensome for parties since parties would be reviewing the backgrounds of additional arbitrators during the ranking and striking stage of the arbitrator appointment process. In instances where FINRA appoints arbitrators by extended lists, parties still need to review arbitrators' backgrounds to determine, for example, whether to challenge an extended list arbitrator for cause. FINRA staff discussed expanding the lists with both investor and industry representatives, and asked the representatives to address the potential burden of reviewing additional arbitrators. The representatives uniformly stated that they would prefer to review additional arbitrators at the ranking and striking stage of the arbitrator appointment process in order to reduce the incidences of extended list appointments.

II. Summary of Comments

The Commission received six comments regarding the proposed rule change. On June 21, 2010, FINRA submitted a response to the comments.¹¹

All of the commenters support the proposed rule change, either in whole or with certain modifications. The PIABA letter states that “this rule change is important because it will reduce the number of instances in which an arbitrator is appointed with no input from or approval by the parties.” The SIFMA letter states that the proposal “will increase the likelihood that all arbitrators appointed to a case will have been selected by the parties, result in fewer administrative ‘extended list’ appointments, and enhance party choice and satisfaction with the selection process.” Likewise, PIRC supports the proposal “because it increases the parties’ ability to present their dispute to an arbitrator

¹¹ See Letter to Elizabeth M. Murphy, Secretary, Commission from Margo A. Hassan, Assistant Chief Counsel, FINRA Dispute Resolution, Financial Industry Regulatory Authority, dated June 21, 2010 (“FINRA response”).

of their own choosing,”¹² and the Caruso comments state that the proposed rule change “would provide investors with greater control and choice over the individuals who will ultimately be appointed to serve on the arbitration panels” and urges the Commission to approve the proposal on an expedited basis.

The Steiner comments suggest limiting the current proposal to cases in which there is only one respondent or multiple respondents being represented by only one attorney.¹³ The Steiner comments also ask that: (1) FINRA be ordered to effectuate immediately additional modifications to eliminate the portions of Rule 12404 that give each separately represented respondent a separate set of strikes, and to replace those portions with provisions that the amount of strikes that may be exercised by respondents in total cannot exceed the amount of strikes that can be exercised in total by the claimant; (2) that FINRA be ordered immediately to rescind its interpretation of Rule 12404 that permits even non-appearing respondents from participating in the arbitrator selection process; and (3) that FINRA be ordered to immediately propose a rule change providing that instead of appointing a cram down arbitrator that a new selection list be sent to the parties. FINRA notes that it is not proposing to amend its rules relating to party strikes, participation in arbitrator selection, or extended list appointments and that, therefore, the comments are outside the scope of the proposed rule change.¹⁴

¹² See PIRC letter.

¹³ PIRC supports the proposed rule change, and advocates a further rule revision that would give four strikes per side, rather than to each “separately represented party.” See id.

¹⁴ See FINRA response.

III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.¹⁵ In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,¹⁶ in that it is designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

The Commission believes that the proposed rule change will protect investors and the public interest by providing investors greater control in the arbitrator selection process. Forum users have criticized extended list appointments and asked FINRA to reduce the number of arbitrators appointed in this way. Expanding the number of arbitrators on lists generated through NLSS should help to reduce extended list appointments and so increase the likelihood that arbitrators from each initial list would remain on the list after the parties complete the striking and ranking process. This, in turn, should enhance investor and industry participants' confidence in the arbitration process. Concerning the requests in the Steiner comments that FINRA be ordered to take certain actions, the Commission finds that requested actions are beyond the scope of the current rulemaking.

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

¹⁶ 15 U.S.C. 78o-3(b)(6).

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities association.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁷ that the proposed rule change (SR-FINRA-2010-022) be and hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Florence E. Harmon
Deputy Secretary

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 17 CFR 200.30-3(a)(12).