SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-70442; File No. SR-FINRA-2013-023)

September 18, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change Relating to Amendments to the Code of Arbitration Procedure for Customer Disputes Concerning Panel Composition

I. Introduction

On February 1, 2013, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change amending the Code of Arbitration Procedure for Customer Disputes ("Customer Code") to simplify arbitration panel selection in cases with three arbitrators. Under the proposed rule change, FINRA would no longer require a customer to elect one of the two existing panel-selection methods. Instead, parties in all customer cases with three arbitrators would use the same selection method. Specifically, FINRA would provide all parties with lists of ten chair-qualified public arbitrators, ten public arbitrators, and ten non-public arbitrators. FINRA would permit the parties to strike four arbitrators on the chair-qualified public list and four arbitrators on the public list. However, any party could select an all-public arbitration panel by striking all of the arbitrators on the non-public list.

The proposed rule change was published for comment in the Federal Register on June 20, 2013.[3] The Commission received fifteen comment letters on the proposed rule change,[4] and, on

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

2 17 CFR 240.19b-4.

3 See Exchange Act Release No. 69762 (June 13, 2013), 78 FR 37267 (June 20, 2013), ("Notice").

August 7, 2013, received FINRA's response to the comments.[5] The text of the proposed rule change is available on FINRA's website at http://www.finra.org, at the principal office of FINRA, on the Commission's website at http://www.sec.gov, and at the Commission's Public Reference Room.

This order approves the proposed rule change.

II. Description of the Proposed Rule Change

A. Current Panel Composition Methods at the Forum

Under the Customer Code, parties in arbitration participate in selecting the arbitrators who serve on their cases. Until January 31, 2011, the Customer Code contained one panel composition method for cases with three arbitrators (generally cases with claims of more than

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4 See Letters from Philip M. Aidikoff, Partner, Aidikoff, Uhl and Bakhtiari, dated July 10, 2013 ("Aidikoff Letter"); Ryan K. Bakhtiari, Aidikoff, Uhl and Bakhtiari, dated July 10, 2013 ("Bakhtiari Letter"); David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, dated July 11, 2013 ("FSI Letter"); Steve A. Buchwalter, Attorney, dated July 10, 2013 ("Buchwalter Letter"); Steven B. Caruso, Esquire, Maddox Hargett Caruso, P.C., dated June 18, 2013 ("Caruso Letter"); George Friedman, Esq., dated June 25, 2013 ("Friedman Letter"); Glenn S. Gitomer, McCausland Keen & Buckman, dated July 11, 2013 ("Gitomer Letter"); Jill I. Gross, Investor Rights Clinic, Pace University School of Law, dated July 11, 2013 ("Pace Law Letter"); Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, dated July 11, 2013 ("PIABA Letter"); Christine Lazaro, Esq., Acting Director, and Pamela M. Albanese, Legal Intern, St. John's University School of Law Securities Arbitration Clinic, dated July 9, 2013 ("St. John's Law Letter"); Seth E. Lipner, Professor of Law, Zicklin School of Business and Deutsch & Lipner, dated July 2, 2013 ("Lipner Letter"); David P. Neuman, Stoltmann Law Offices, dated July 2, 2013 ("Neuman Letter"); Mark E. Sanders, Attorney, dated July 11, 2013 ("Sanders Letter"); Debra G. Speyer, Esq., Law Offices of Debra G. Speyer, dated July 10, 2013 ("Speyer Letter"); and Leonard Steiner, Attorney, dated July 10, 2013 ("Steiner Letter").

5 Letter from Margo A. Hassan, Assistant Chief Counsel, FINRA Dispute Resolution, to Elizabeth M. Murphy, Secretary, Commission, dated August 7, 2013 ("FINRA Letter").

Although the Speyer Letter was dated July 10, 2013, it was submitted on September 13, 2013. Since it supports the proposal, we have not asked FINRA for an additional response.

$100,000).[6] This method provided for a panel composed of one chair-qualified public arbitrator, one public arbitrator, and one non-public arbitrator (the "Majority Public Panel Option"). To begin the selection process, FINRA used its computerized Neutral List Selection System ("NLSS") to generate random lists of ten arbitrators in each of the three categories. The parties selected their panel through a process of striking and ranking the arbitrators on the lists generated by NLSS. The Customer Code permitted the parties to strike the names of up to four arbitrators from each list. The parties then ranked the arbitrators remaining on the lists in order of preference. FINRA appointed the panel from among the names remaining on the lists that the parties returned.[7]

FINRA states that customer advocates argued that the mandatory inclusion of a non-public arbitrator in a three-arbitrator case raised a perception that FINRA Dispute Resolution's forum was not fair to customers. In order to address this perception, FINRA amended the panel composition rule (old FINRA Rule 12402), and related rules, of the Customer Code to, among other things, implement a new panel composition rule (current FINRA Rule 12403) for customer cases with three arbitrators.[8] Under FINRA Rule 12403, customers may choose between two panel composition methods: (1) the Majority Public Panel Option and (2) the all public panel option (the "All Public Panel Option"), which allows any party to select an arbitration panel consisting of three public arbitrators.

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6 See FINRA Rule 12401 which provides that if the amount of a claim is more than $100,000, exclusive of interest and expenses, or is unspecified, or if the claim does not request money damages, the panel will consist of three arbitrators, unless the parties agree in writing to one arbitrator.

7 Under the Majority Public Panel Option, a customer can ensure the participation of a non-public arbitrator.

8 See Exchange Act Rel. No. 63799 (Jan. 31, 2011), 76 FR 6500 (Feb. 4, 2011) ("2011 Order") and Regulatory Notice 11-05 (Feb. 2011).

If a customer choses the All Public Panel Option, FINRA sends the parties the same three lists of randomly generated arbitrators that they would have received under the Majority Public Panel Option (i.e., ten chair-qualified public arbitrators, ten public arbitrators, and ten non-public arbitrators). However, Rule 12403 allows either or both parties to strike any or all of the arbitrators on the non-public arbitrator list. FINRA will not appoint a non-public arbitrator if either party individually or both parties collectively strike all the arbitrators appearing on the non-public list or if all remaining arbitrators on the non-public list are unable or unwilling to serve for any reason. In these situations, FINRA will select the next highest-ranked public arbitrator to complete the panel. In other words, if a customer chooses the All Public Panel Option, any party can ensure that the panel will have three public arbitrators by striking all the arbitrators on the non-public list.

FINRA Rule 12403 provides that a customer may choose a panel composition method in the statement of claim (or accompanying documentation) or at any time up to 35 days from service of the statement of claim. To make the customer aware of his or her available options, FINRA states that it generally notifies the customer in writing that he or she may elect the All Public Panel Option within 35 days from service of the statement of claim. In the absence of an affirmative choice by the customer, the Majority Public Panel Option is the default composition method.

B. Proposal to Use One Panel Composition Method at the Forum

Based on its experience with the two panel composition methods, FINRA is proposing to amend Rule 12403 to use one panel composition method in all customer cases.[9] That method

[9] In the Notice, FINRA represented that from February 1, 2011 (the date the current panel composition rule went into effect) through March 31, 2013, customers in approximately three-quarters of eligible cases have chosen the All Public Panel Option. Of the

would mirror the All Public Panel Option, with one clarifying change relating to striking and ranking arbitrators. Currently, Rule 12403(d)(3)(B)(i) provides that "[e]ach separately represented party may strike up to four of the arbitrators from the chairperson and public arbitrator lists for any reason by crossing through the names of the arbitrators." FINRA is proposing to clarify that provision by amending it to state that "[e]ach separately represented party may strike up to four of the arbitrators from the chairperson list and up to four of the arbitrators from the public arbitrator list for any reason by crossing through the names of the arbitrators."

III. Discussion of Comment Letters and FINRA's Response

As noted above, the Commission received fifteen comment letters on the proposed rule change. Thirteen comment letters expressed support for the proposal, although two of these thirteen also raised specific concerns.[10] Two commenters opposed the proposal in part.[11] The comment letters and FINRA's response are summarized below.

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customers using the Majority Public Panel Option, 77 percent have done so by default rather than by making an affirmative choice (i.e., these customers did not make an election in their statement of claim or accompanying documentation, and did not respond to the follow-up letter FINRA sent). FINRA also represented that over the same time period customers selecting the All Public Panel Option have chosen to strike all of the non-public arbitrators in 66 percent of the cases during the ranking process. Customers have ranked one or more non-public arbitrators in 34 percent of cases and four or more in 13 percent of cases proceeding under the All Public Panel Option. Industry parties have ranked one or more non-public arbitrators in 97 percent of cases and have ranked four or more non-public arbitrators in 90 percent of cases.

10 See FSI Letter and PIABA Letter.

11 See Friedman Letter and Pace Law Letter.

Eleven commenters expressed support for the proposal.[12] In particular, one commenter expressed wholehearted support for the proposal.[13] Other commenters noted their support for making the All Public Panel Option the default option. For example, several commenters stated that making this method the default would relieve customers of the burden associated with affirmatively selecting an all public panel;[14] while others stated that making this method the default would protect investors with arbitration claims.[15] Other commenters expressly noted their support for implementing a single method of panel selection. For example, one commenter stated that implementing a single panel-selection method would benefit public investors and the integrity of the arbitration forum.[16] Another commenter stated that a single method would benefit public investors, particularly pro se claimants.[17]

One commenter generally supported the proposed rule change, but expressed concern that, if it was approved, FINRA would stop tracking the disparity in results between all public panels and those that include non-public arbitrators.[18] This commenter also suggested that

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12 See Aidikoff Letter, Bakhtiari Letter, Buchwalter Letter, Caruso Letter, Gitomer Letter, Lipner Letter, Neuman Letter, Sanders Letter, Speyer Letter, St. John's Law Letter, and Steiner Letter.

13 See Buchwalter Letter.

14 See Gitomore Letter, Lipner Letter, Neuman Letter, Speyer Letter, St. John's Law Letter, and Steiner Letter. See also Pace Law Letter.

15 See Bakhtiari Letter and Sanders Letter.

16 See Caruso Letter.

17 See Aidikoff Letter.

18 See FSI Letter (stating that "all public panels deliver more favorable outcomes for investors than those panels with non-public arbitrators that understand the financial industry.").

FINRA amend the definition of "public arbitrator" to exclude attorneys who spend a significant portion of their time representing investors and claimants in FINRA arbitrations. This commenter's suggestion would effectively prevent those attorneys from serving as "public arbitrators" on arbitration panels.[19]

FINRA responded that it will continue tracking award results separately for all public panels and majority public panels and will consider the cause for any disparity if the data suggest the need to do so. FINRA also stated that it is not proposing to amend its arbitrator definitions, and therefore believes that the commenter's suggestion is outside the scope of the proposed rule change. FINRA noted, however, that it is separately reviewing its non-public and public arbitrator definitions for potential changes, including whether to exclude attorneys who spend a significant portion of their time representing investors and claimants in FINRA arbitrations.

Another commenter also generally supported the proposed rule change.[20] This commenter also suggested that FINRA emphasize in its transmittal letter accompanying the arbitrator ranking form and the arbitrator disclosure reports that each party has the ability and right to have the case heard by an arbitration panel comprised of only public arbitrators. This commenter expressed the view that emphasizing the two alternative types of panels available under the revised rule and the ability and right of the parties to have their cases heard by an all-public panel would be appropriate and beneficial to investors.[21]

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19 Id.

20 See PIABA Letter.

21 Id.

FINRA responded that it will revise the transmittal letter accompanying the arbitrator ranking form and the arbitrator disclosure reports to clarify earlier in the letter that any party has the option of selecting an all public panel.

Two commenters opposed the proposal, in part, because it would eliminate a customer's ability to ensure that a non-public arbitrator is empaneled.[22] Both commenters suggested that there may be circumstances in which a customer may want a non-public arbitrator on his or her panel. For example, one commenter noted that a customer may believe that a non-public arbitrator would be a better arbiter of the professional norms of the broker-dealer activity at issue in an arbitration.[23] Both commenters stated, however, that under the proposal a broker-dealer counterparty could frustrate a customer's objective by striking all ten names on the non-public arbitrators list. Alternatively, these commenters recommended (1) that FINRA retain the two current panel composition methods and (2) if the customer does not affirmatively opt out of the All Public Panel Option within 35 days, the default would be the All Public Panel Option instead of the current Majority Public Panel Option. The commenters expressed the belief that this method would preserve a customer's right to ensure the presence of a non-public arbitrator on his or her panel while addressing FINRA's concern about inexperienced parties inadvertently failing to exercise their right to elect the All Public Panel Option.[24]

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22 See Friedman Letter and Pace Law Letter.

23 See Pace Law Letter.

24 Id.

FINRA acknowledged the commenters' concern that parties would no longer be guaranteed the option of having a non-public arbitrator on their panel.[25] FINRA noted, however, that forum users have not generally raised this concern with FINRA. In addition, FINRA stated that if either party or both parties strike all the names on the non-public arbitrators list, or if the non-public arbitrator they select is not available to serve, the parties can still agree to empanel a non-public arbitrator. In this situation, the parties could ask FINRA to send a supplemental list of non-public arbitrators for the parties' review. FINRA indicated that it would generally accommodate such requests.

FINRA agreed with commenters that the non-public arbitrators on its roster are capable of identifying and judging poor broker conduct.[26] However, FINRA stated that the public arbitrators on its roster are also capable of doing so. FINRA explained that both customer and firm representatives frequently use expert witnesses at a hearing. Accordingly, in FINRA's view, if a customer is concerned about whether an all public panel can properly identify poor broker conduct, he or she will generally already have access to an expert witness to testify about industry practices. FINRA stated that customers will rarely have to incur additional expenses related to the use of expert witnesses because of the proposed rule change. FINRA further indicated that the benefits of simplifying the panel selection method outweigh this potential for additional costs.

In sum, FINRA stated that based on its experience using the two panel selection methods, it believes that a simpler approach to panel selection would benefit all parties using its forum and

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25 See FINRA Letter. As stated above, under the All Public Panel Option, any party can ensure that the panel will have three public arbitrators by striking all the arbitrators on the non-public list.

26 See Friedman Letter and Pace Law Letter.

would improve the efficiency of case administration. Therefore, FINRA declined to amend its proposal as suggested by the commenters.

IV. Discussion and Commission's Findings

The Commission has carefully reviewed the proposed rule change, the comments received, and FINRA's response. Based on its review, the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association.[27] In particular, the Commission finds that the proposed rule change is consistent with the provisions of Exchange Act Section 15A(b)(6),[28] which requires, among other things, that FINRA 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.

More specifically, the Commission believes that the proposal is consistent with the provisions of Exchange Act Section 15A(b)(6) because it would (a) simplify the arbitrator selection process for all parties and FINRA staff while leaving in place the method used by customers in approximately three-quarters of customer cases since the method became effective; and (b) ensure that customers would not inadvertently miss the opportunity to select an all public panel because it would be the default option. In the 2011 Order, we noted commenter concerns that customers without attorneys, or attorneys new to the practice of securities arbitration, might not elect the All Public Panel Option within the prescribed deadline, or might not appreciate the

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

28 15 U.S.C. 78o-3(b)(6).

significance of making such an election.[29] In light of those comments, FINRA implemented the notification procedure discussed earlier. As stated above, the proposed rule change would further ameliorate these concerns by making the All Public Panel Option the default option.

In addition, the Commission believes that the proposed rule change would not increase, and could decrease, the burden parties incur in panel selection. FINRA would continue to send the parties the same three lists of arbitrators. While the parties could choose to continue to review all three lists, they could also choose to strike all of the non-public arbitrators and only review the remaining two lists.

We appreciate the concerns of some commenters, and recognize that some customers may want to empanel a non-public arbitrator in a particular matter. Therefore, we are requesting FINRA to gather statistics for a period of one year from the effective date of this rule change and report to the Commission on the number of cases in which a customer ranking a non-public arbitrator nonetheless receives an all public panel.

For the reasons stated above, the Commission finds that the rule change is consistent with the Exchange Act and the rules and regulations thereunder.

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[29] Supra note 8.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Exchange Act Section 19(b)(2),[30] that the proposed rule change (SR-FINRA-2013-023) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[31]

Kevin M. O'Neill
Deputy Secretary

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30 15 U.S.C. 78s(b)(2).

31 17 CFR 200.30-3(a)(12).