SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69297; File No. SR-FINRA-2013-003)

April 4, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change to Amend the Customer and Industry Codes of Arbitration Procedure to Revise the Public Arbitrator Definition

I. Introduction

On January 4, 2012, 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 to amend FINRA's Customer and Industry Codes of Arbitration Procedure (collectively, the "Codes") to revise the definition of "public arbitrator" in the Codes. Specifically, the proposed rule change would (a) exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators and (b) require individuals to wait for two years after ending certain affiliations before they may be permitted to serve as public arbitrators. The proposed rule change was published for comment in the Federal Register on January 17, 2013.[3] The Commission received 45 comment letters on the proposed rule change,[4] and a response to comments from FINRA.[5] This order approves the proposed rule change.

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

2 17 CFR 240.19b-4.

3 See Exchange Act Release No. 68632 (Jan. 11, 2013), 78 FR 3925 (Jan. 17, 2013) ("Notice"). The comment period closed on February 7, 2013.

4 See Letter from Steven B. Caruso, Maddox Hargett & Caruso, dated Jan. 16, 2013 ("Caruso Letter"); letter from David Neuman, Stoltmann Law Offices, dated Jan. 16, 2013 ("Neuman Letter"); letter from Richard M. Layne, Law Office of Richard M. Layne, dated Jan. 28, 2013 ("Layne Letter"); letter from Seth E. Lipner, Professor of

Law, Zickloin School of Business, Baruch College, and Member, Deutsch & Lipner, dated Jan. 29, 2013 ("Lipner Letter"); letter from Carl J. Carlson, Tousley Brain Stephens, dated Jan. 29, 2013 ("Carlson Letter"); letter from David Harrison, Law Offices of David Harrison, dated Jan. 29, 2013 ("Harrison Letter"); letter from Philip M. Aidikoff, dated Jan. 29, 2013 ("Aidikoff Letter"); letter from Scott L. Silver, Silver Law Group, dated Jan. 30, 2013 ("Silver Letter"); letter from Robert A. Uhl, Adjunct Professor of Law, Securities Arbitration and Director, Pepperdine Investor Advocacy Clinic, and Partner, Aidikoff, Uhl & Bakhtiari, dated Jan. 30, 2013 ("Uhl Letter"); letter from Andrew A. Lipkowitz, Student Intern, and Christine Lazaro, Acting Director, St. John's University School of Law Securities Arbitration Clinic, dated Feb. 4, 2013 ("St. John's Letter"); letter from Robert C. Port, Cohen Goldstein Port & Gottlieb, dated Feb. 5, 2013 ("Port Letter"); letter from Lisa A. Catalano, dated Feb. 5, 2013 ("Catalano Letter"); letter from Scott R. Shewan, Pape & Shewan, dated Feb. 6, 2013 ("Shewan Letter"); letter from Jon C. Furgison, Law Offices of Jon C. Furgison, dated Feb. 6, 2013 ("Furgison Letter"); letter from Steven J. Gard, Reznicsek Fraser White & Shaffer, dated Feb. 6, 2013 ("Gard Letter"); letter from Jonathan W. Evans and Michael S. Edmiston, Jonathan W. Evans & Associates, dated Feb. 6, 2013 ("Evans and Edmiston Letter"); letter from Robert Savage, Visiting Assistant Clinical Professor, Florida International University College of Law, dated Feb. 7, 2013 ("Savage Letter I"); letter from Robert Savage dated Feb. 7, 2013 ("Savage Letter II"); letter from James A. Dunlap, Jr., James A. Dunlap Jr. & Associates, dated Feb. 7, 2013 ("Dunlap Letter"); letter from Diane Nygaard, Kenner, Schmitt & Nygaard, dated Feb. 7, 2013 ("Nygaard Letter"); letter from W. Scott Greco, Greco & Greco, dated Feb. 7, 2013 ("Greco Letter"); letter from A. Heath Abshure, NASAA President and Arkansas Securities Commissioner, dated Feb. 7, 2013 ("NASAA Letter"); letter from Robert S. Banks, Jr., Banks Law Office, dated Feb. 7, 2013 ("Banks Letter"); letter from Dale Ledbetter, Esq., Ledbetter and Associates, dated Feb. 7, 2013 ("Ledbetter Letter"); letter from Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, dated Feb. 7, 2013 ("PIABA Letter"); letter from Elizabeth Zeck, Willoughby & Hoefer, dated Feb. 7, 2013 ("Zeck Letter"); letter from James A. Sigler, dated Feb. 7, 2013 ("Sigler Letter"); letter from Robert W. Goehring, dated Feb. 7, 2013 ("Goehring Letter"); letter from William S. Shepherd, Shepherd Smith Edwards & Kantas, dated Feb. 7, 2013 ("Shepherd Letter"); letter from Leonard Steiner, Beverly Hills, California, dated Feb. 7, 2013 ("Steiner Letter"); letter from Joseph Fogel, Fogel & Associates, dated Feb. 7, 2013 ("Fogel Letter"); letter from Richard A. Lewins, dated Feb. 7, 2013 ("Lewins Letter"); letter from Jenice L. Malecki, Malecki Law, dated Feb. 7, 2013 ("Malecki Letter"); letter from Mark E. Sanders, Halling & Cayo, dated Feb. 7, 2013 ("Sanders Letter"); letter from Jeffrey Sonn, Sonn & Erez, dated Feb. 7, 2013 ("Sonn Letter"); letter from Thomas C. Costello, dated Feb. 7, 2013 ("Costello Letter"); letter from Barry D. Estell, dated Feb. 7, 2013 ("Estell Letter"); letter from Royal Lea, dated Feb. 7, 2013 ("Lea Letter"); letter from Peter Mougey, Levin, Papantonio, Thomas, Mitchell, Rafferty & Proctor, dated Feb. 7, 2013 ("Mougey Letter"); letter from William A. Jacobson, Associate Clinical Professor, Cornell Law School, and Director, Cornell Securities Law Clinic, and Malavika Rao, Cornell Law School '14, dated Feb. 7, 2013 ("Cornell Letter"); letter from David T. Bellaire, Executive Vice President and General

II. Description of the Proposal

As stated in the Notice, FINRA classifies arbitrators under the Codes as either "non-public" (otherwise known as "industry" arbitrators) or "public." Arbitrators are generally considered non-public if they are affiliated with the securities industry either because they (1) are currently or were formerly employed in a securities business; or (2) provide professional services to securities businesses. Arbitrators are generally considered public if they (1) do not have any significant affiliation with the securities industry; and (2) are not related to anyone with a significant affiliation with the securities industry.

To improve investor confidence in the neutrality of FINRA's public arbitrator roster, FINRA has amended its arbitrator definitions a number of times over the years.

In 2004, FINRA amended the definitions of "public arbitrator" and "non-public arbitrator" to:

- Increase from three years to five years the amount of time necessary after leaving the securities industry to transition from a non-public to public arbitrator;
- Clarify that "retired" from the industry includes anyone who spent a substantial part of his or her career in the industry;

Counsel, Financial Services Institute, dated Feb. 7, 2013 ("FSI Letter"); letter from Theodore M. Davis, dated Feb. 8, 2013 ("Davis Letter"); letter from Nicholas J. Guiliano, dated Feb. 8, 2013 ("Guiliano Letter"); letter from Mitchell Ostwald, dated Feb. 8, 2013 ("Ostwald Letter"); letter from Charles Michael Tobin, The Tobin Law Firm, dated Feb 22, 2013 ("Tobin Letter"). Comment letters are available at http://www.sec.gov.

[5] See Letter from Margo A. Hassan, Assistant Chief Counsel, FINRA Dispute Resolution, to Elizabeth M. Murphy, Secretary, Commission, dated Mar. 11, 2013 ("Response Letter"). The text of the proposed rule change and a copy of FINRA's Response Letter are available on FINRA's website at http://www.finra.org, at the principal office of FINRA, and at the Commission's Public Reference Room. A copy of the Response Letter is also available on the Commission's website at http://www.sec.gov.

- Prohibit anyone who has been associated with the industry for at least twenty years from ever becoming a public arbitrator, regardless of how long ago the association ended;
- Exclude from the definition of "public arbitrator" attorneys, accountants, or other professionals whose firms have derived ten percent or more of their annual revenue in the previous two years from clients involved in securities-related activities ("Ten-Percent Rule"); and
- Provide that investment advisers may not serve as public arbitrators, and may only serve as non-public arbitrators if they otherwise qualify as non-public.[6]

In 2007, FINRA again revised the definition of "public arbitrator" to:

- Exclude individuals who were employed by, or who served as an officer or director of, a company in a control relationship with a broker-dealer.
- Exclude individuals with a spouse or immediate family member who was employed by, or who served as an officer or director of, a company in a control relationship with a broker-dealer; and
- Clarify that people registered through a broker-dealer could not be public arbitrators even if they are employed by a non-broker-dealer (such as a bank).[7]

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6 See Exchange Act Rel. No. 49573 (April 16, 2004), 69 FR 21871 (Apr. 22, 2004) (File No. SR-NASD-2003-95) (Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations). The changes were announced in Notice to Members 04-49 (June 2004).

7 See Act Rel. No. 54607 (Oct. 16, 2006), 71 FR 62026 (Oct. 20, 2006) (File No. SR-NASD-2005-094)(Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to Amendments to the Classification of Arbitrators Pursuant to Rule 10308 of the NASD Code of Arbitration Procedure). The changes were announced in Notice to Members 06-64 (Nov. 2006).

Finally, in 2008, FINRA revised the public arbitrator definition to add a dollar limit to the Ten-Percent Rule. The amended definition was designed to preclude an attorney, accountant, or other professional from serving as a public arbitrator if the individual's firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to certain industry entities relating to customer disputes concerning an investment account or transaction.[8]

The proposed rule change is designed to improve investor confidence in the neutrality of FINRA's public arbitrator roster. In particular, the proposed rule change would (a) exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators and (b) require individuals to wait for two years after ending certain affiliations before they may be permitted to serve as public arbitrators.

FINRA has indicated that it would announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval, and that the effective date would be no later than 30 days following publication of the Regulatory Notice announcing Commission approval.

III. Discussion of Comment Letters

As stated above, the Commission received 45 comment letters on the proposed rule change in response to the Notice. Thirty-eight of those commenters (represented by 39 comment letters) generally supported FINRA's proposal to revise the definition of "public arbitrator" to

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8 See Exchange Act Rel. No. 57492 (Mar. 13, 2008), 73 FR 15025 (Mar. 20, 2008) (File No. SR-NASD-2007-021) (Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator). The changes were announced in Regulatory Notice 08-22 (May 2008).

exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators.[9] Of those commenters, however, many stated that while they agreed with the proposed rule change, they thought FINRA should exclude additional categories of persons from the definition of "public arbitrator." Moreover, some otherwise supportive commenters thought that FINRA should lengthen the proposed cooling off period.

A. Exclusions

Three commenters suggested that the definition of "public arbitrator" should be further narrowed to expressly exclude from ever acting as a public arbitrator persons associated with issuers or sponsors of private placements, publicly offered non-traded REITs, variable insurance products, and other investment products.[10] These commenters also suggested that the definition of "public arbitrator" should exclude persons who have ever worked for more than a de minimis time as a stockbroker or investment advisor, as well as persons with more than a de minimis time of affiliation with a FINRA member firm, an investment advisory firm, a hedge fund, a mutual fund, or an issuer, sponsor, marketer, or seller of securities or investment products with embedded securities.[11] Similarly, two commenters suggested that anyone who has been licensed to do business in the securities industry or depended on the industry for more than a de minimis

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9 See Caruso Letter; Neuman Letter; Layne Letter; Lipner Letter; Carlson Letter; Aidikoff Letter; Silver Letter; Uhl Letter; St. John's Letter; Port Letter; Catalano Letter; Shewan Letter; Furgison Letter; Evans and Edmiston Letter; Savage Letter I; Savage Letter II; Dunlap Letter; Nygaard Letter; Greco Letter; NASAA Letter; Banks Letter; Ledbetter Letter; PIABA Letter; Zeck Letter; Sigler Letter; Goehring Letter; Shepherd Letter; Fogel Letter; Lewins Letter; Malecki Letter; Sanders Letter; Sonn Letter; Costello Letter; Estell Letter; Cornell Letter; Davis Letter; Guiliano Letter; Ostwald Letter; Tobin Letter.

10 See PIABA Letter; Sanders Letter; Cornell Letter.

11 Id.

amount of his or her livelihood for any appreciable length of time should be excluded from the definition of "public arbitrator."[12]

One commenter suggested that the definition of "public arbitrator" should exclude any attorney whose firm has derived $50,000 or ten percent or more of its annual revenue in the prior two years from professional services rendered to claimants in customer disputes concerning an investment account or transaction.[13] Another commenter suggested that individuals who have been employed by securities industry trade organizations such as FINRA should be barred from being classified as public arbitrators.[14]

One commenter generally approved of the proposed rule change but maintained that, in the context of customer disputes, FINRA's current definition of "non-public arbitrator" must be broadened to include the entire securities industry, particularly if FINRA plans to open up its forum to non-members.[15]

Finally, another commenter believed the proposed rule change should exclude additional categories of individuals from the definition of "public arbitrator" but ultimately disapproved of the proposed rule change on the grounds that it would continue to permit individuals who previously worked in and have financial interests connected to the securities industry to be classified as public arbitrators.[16] This commenter also expressed the view that the amended rule

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12 See Lewins Letter; Cornell Letter.

13 See FSI Letter.

14 See Davis Letter.

15 See NASAA Letter.

16 See Gard Letter.

would continue to give FINRA staff too much discretion in classifying arbitrators. Another commenter expressed the same concern.[17]

B. Cooling-Off Period

Fourteen commenters suggested that FINRA's proposal to require individuals to wait for two years after ending certain affiliations before they may be permitted to serve as public arbitrators should be amended to increase the proposed "cooling off" period from two years to at least five years.[18] Five commenters suggested that the proposed cooling off period should generally be longer than two years.[19] Three commenters generally disapproved of the length of the proposed two-year cooling off period on the grounds that it would not serve the interests of investors.[20] Two commenters suggested expanding the proposed cooling off period from two years to ten.[21] One commenter suggested that no individual who has spent ten years or more in the securities industry should ever be classified as a public arbitrator.[22] Another commenter suggested that anyone associated with the industry for twenty or more years should be prohibited from ever becoming a public arbitrator.[23] Eleven commenters suggested that no cooling off

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17 See Gard Letter; Estell Letter.

18 See Caruso Letter; Neuman Letter; Layne Letter; Harrison Letter; Silver Letter; St. John's Letter; Catalano Letter; Zeck Letter; Shepherd Letter; Malecki Letter; Costello Letter; Estell Letter; Cornell Letter; Guiliano Letter.

19 See Greco Letter; PIABA Letter; Fogel Letter; Lewins Letter; Sanders Letter.

20 See Dunlap Letter; Nygaard Letter; Goehring Letter.

21 See Carlson Letter; Evans and Edmiston Letter.

22 See Uhl Letter.

23 See Harrison Letter.

period is sufficient and that only individuals who have never had an affiliation with the financial services industry should be eligible to serve as public arbitrators.[24]

In its Response Letter, FINRA stated that the purpose of the proposed rule change is to respond to investor representatives' concerns that certain arbitrators on the public roster were not perceived as public because of their background and experience. Specifically, FINRA stated that the proposed rule change would affect certain persons whose job precludes them from being classified as a public arbitrator but does not qualify them as a non-public arbitrator. In addition, FINRA stated that the proposed rule would require persons precluded by their job from being classified as a public arbitrator to wait two years before being eligible to join the public roster after moving to a job that would not otherwise disqualify them for service. FINRA maintained that the proposed two-year cooling off period responds to the concerns raised by investor representatives and would be a positive step toward enhancing investors' perception of fairness in FINRA's arbitration forum. FINRA also stated that it intends to further review, under the auspices of the National Arbitration and Mediation Committee, both the public and non-public arbitrator definitions with a view towards clarifying the definitions and reviewing additional issues such as those raised in comment letters on the proposed rule change. Therefore, FINRA declined to amend the proposed rule change.

IV. Commission's Findings

The Commission has carefully reviewed the proposed rule change, the comments received, and FINRA's Response Letter. Based on its review of the record, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules

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[24] See Lipner Letter; Aidikoff Letter; Silver Letter; Port Letter; Shewan Letter; Furgison Letter; Evans and Edmiston Letter; NASAA Letter; Sonn Letter; Davis Letter; Ostwald Letter.

and regulations thereunder applicable to a national securities association.[25] In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,[26] 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 finds that the proposed rule change to exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators and require individuals to wait for two years after ending certain affiliations before they may be permitted to serve as public arbitrators would benefit investors and other participants in the forum by improving investor confidence in the neutrality of FINRA's public arbitrator roster. While the Commission appreciates the suggestions regarding exclusions from the definition of "public arbitrator" and the proposed two-year cooling off period, we believe that FINRA has responded adequately to comments. We also agree with the Response Letter's position that the proposed rule change should improve investors' perception about the fairness and neutrality of FINRA's public arbitrator roster, particularly given the Response Letter's representation that FINRA intends to conduct a comprehensive review of both the public and non-public arbitrator definitions with a view towards further clarifying the definitions and reviewing additional issues such as those raised in comment letters on the proposed rule change.

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

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

26 15 U.S.C. 78o–3(b)(6).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[27] that the proposed rule change (SR-FINRA-2013-003) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[28]

Kevin M. O'Neill
Deputy Secretary

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[27] 15 U.S.C. 78s(b)(2).

[28] 17 CFR 200.30-3(a)(12).