

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-63799; File No. SR-FINRA-2010-053)

January 31, 2011

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes

I. Introduction

On October 25, 2010, 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 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposal to amend the panel composition rule, and related rules, of the Code of Arbitration Procedure for Customer Disputes (“Customer Code”),<sup>3</sup> to provide customers with the option to choose an all public arbitration panel in all cases. The proposed rule change was published for comment in the Federal Register on November 12, 2010.<sup>4</sup> The Commission received 125 comments on the proposed rule change.<sup>5</sup> Of the comments received, 103 commenters support the proposal as filed, 21 commenters support the proposal with suggested modifications, and one commenter opposes the proposal. On December 16, 2010, FINRA responded to comments and filed

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

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

<sup>3</sup> FINRA Manual, Rule 12000, et seq., available on FINRA’s website, <http://www.finra.org>.

<sup>4</sup> See Securities Exchange Act Release No. 63250 (Nov. 5, 2010), 75 FR 69481 (Nov. 12, 2010) (“Notice”).

<sup>5</sup> The comment period ended on December 3, 2010; all comments are posted on the Commission’s website, <http://www.sec.gov/rules/sro.shtml>.

Amendment No. 1 to the proposed rule change.<sup>6</sup> The Commission is publishing this notice and order to solicit comment on Amendment No. 1 and to approve, on an accelerated basis, the proposal as modified by Amendment No. 1.

II. Description of the Proposed Rule Change as Modified by Amendment No. 1

FINRA proposed to amend the panel composition rule, and related rules, of the Customer Code to provide customers with the option to choose an all public arbitration panel in all cases.

A. Background

Under the Customer Code, parties in arbitration participate in selecting the arbitrators who serve on their cases. For customer claims of more than \$100,000, the Customer Code currently provides for a three arbitrator panel<sup>7</sup> comprised of a chair-qualified public arbitrator,<sup>8</sup> a public arbitrator,<sup>9</sup> and a non-public arbitrator (“Majority

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<sup>6</sup> See Response to Comments and Amendment No. 1. The text of the proposal and Response to Comments and Amendment No. 1 are available on FINRA’s website, <http://www.finra.org>, at the principal office of FINRA, and on the Commission’s website, <http://www.sec.gov/rules/sro.shtml>. Amendment No. 1 imposes an additional notice requirement from FINRA to customers, provides minor clarifications regarding FINRA’s original intent for the scope of the rule change, and makes other minor technical edits. FINRA identifies and discusses the particular commenters that support, request modification and oppose the proposal in its Response to Comments and Amendment No. 1. For the purposes of this Order, we will use the same designations for the commenters that are used by FINRA in that response.

<sup>7</sup> Rule 12401 provides for a single, chair-qualified public arbitrator if the amount of the claim is not more than \$100,000. It provides for a three arbitrator panel if the amount of a claim is more than \$100,000, or is unspecified, or if the claim requests non-monetary damages. The parties, in claims of more than \$25,000, but not more than \$100,000, may agree in writing to have a three arbitrator panel.

<sup>8</sup> Rule 12400(c) specifies the criteria for arbitrator inclusion on the chairperson roster.

<sup>9</sup> Rule 12100(u) specifies the criteria FINRA uses to classify arbitrators as public.

Public Panel”).<sup>10</sup> FINRA uses its computerized Neutral List Selection System (“NLSS”) to generate random lists of 10 arbitrators from each of these categories.<sup>11</sup> The parties select their panel through a process of striking and ranking the arbitrators on the lists generated by NLSS. The Customer Code permits the parties to strike the names of up to four arbitrators from each list. The parties then rank the arbitrators remaining on the lists in order of preference. FINRA appoints the panel from among the names remaining on the lists that the parties return.

#### B. FINRA’s Public Arbitrator Pilot Program

In order to address the perception that FINRA’s mandatory inclusion of a non-public arbitrator (often referred to as the “industry” arbitrator) in the Majority Public Panel is not fair to customers, FINRA launched a pilot program (“the Pilot”) that allows parties to choose a panel of three public arbitrators instead of two public arbitrators and one non-public arbitrator (“Optional All Public Panel”).

FINRA designed the Pilot to run for two sequential years (“Year One” and “Year Two”), beginning October 6, 2008, and ending October 5, 2010. In Year One, 11 brokerage firms volunteered to participate in the Pilot, each contributing a set number of cases to the Pilot per year for two years. In Year Two, FINRA expanded the number of participating brokerage firms to 14 firms. In addition, several of the original participants increased their respective case commitments for Year Two. Participating firms agreed to extend the Pilot for a third year at the same case levels as Year Two, while FINRA proceeds with the current rulemaking process. Year Three of the Pilot began October 6,

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<sup>10</sup> Rule 12100(p) specifies the criteria FINRA uses to classify arbitrators as non-public.

<sup>11</sup> Rule 12400.

2010, and ends October 5, 2011, or upon implementation of this proposed rule change, whichever comes first.

Under the Pilot, only a customer may decide whether his or her case should proceed under Pilot rules; the participating firms cannot select the Pilot cases. Under the Pilot rules, the parties receive the same three lists of proposed arbitrators that parties in non-Pilot cases receive. However, in the Pilot cases, any party can strike up to four arbitrators on the chair-qualified public arbitrator list, up to four arbitrators on the public arbitrator list, as well as all of the arbitrators on the non-public list. After striking arbitrators from the lists, the parties will rank the remaining arbitrators in order of preference and FINRA will appoint the panel from among the names remaining on the lists that the parties return. By striking all the arbitrators on the non-public list, any party may ensure a panel of three public arbitrators.

FINRA stated that reactions from participants in the Pilot indicate that customer representatives strongly support the right of customers to decide whether to exclude any non-public arbitrator.<sup>12</sup> That feedback led FINRA to propose amending the panel composition rule for customer cases to follow the Pilot model, and to allow the customer party to choose between the existing panel selection method and the method used in the Pilot. Unlike the Pilot, however, the proposed rule would apply to all customer disputes against any firm and any registered representative.

### C. Details of the Proposed Rule Change

FINRA based the proposed rule change on its experience with the Pilot. Under the proposed rule change, a customer could elect either arbitrator selection method within

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<sup>12</sup> During the Pilot FINRA conducted surveys, focus groups, and met with customer representatives from the Securities Industry Conference on Arbitration and FINRA's National Arbitration and Mediation Committee.

35 days from service of the Statement of Claim. If the customer declined to make an affirmative election by the 35-day deadline, FINRA would apply the composition rule for the existing Majority Public Panel.

Under either panel selection option, the parties would receive three lists – one with 10 chair-qualified public arbitrators, one with 10 public arbitrators, and one with 10 non-public arbitrators. The parties would select their panel through a process of striking and ranking the arbitrators on the lists. Under the Majority Public Panel method, FINRA would permit each party to strike up to four arbitrators on the chair-qualified public, public, and non-public lists, leaving at least six arbitrator names remaining on each party’s list. Under the Optional All Public Panel, any party may strike up to four arbitrators on the chair-qualified public and public lists, but may also strike all proposed non-public arbitrators and thereby effectively choose a panel of three public arbitrators.

Currently, six rules enumerate the procedures for selecting, appointing, and replacing arbitrators.<sup>13</sup> FINRA proposed to consolidate these six rules into two new rules: new Rule 12402 relating to customer cases with one arbitrator, and new Rule 12403 relating to customer cases with three arbitrators.<sup>14</sup> New Rule 12402 would describe the procedures for selecting, appointing, and replacing the arbitrator in a single arbitrator case. New Rule 12403 would describe the two options that customers have for

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<sup>13</sup> Rule 12402 (Composition of Arbitration Panels) specifies the panel composition for all customer cases. Rules 12403 (Generating and Sending Lists to the Parties), 12404 (Striking and Ranking Arbitrators), 12405 (Combining Lists), 12406 (Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List), and 12411 (Replacement of Arbitrators) enumerate the procedures for selecting, appointing, and replacing arbitrators.

<sup>14</sup> FINRA would delete current Rules 12402, 12403, 12404, 12405, 12406, and 12411 in their entirety. FINRA would renumber the remaining rules in the 12400 series so that the numbering would remain consecutive after FINRA consolidated the rules.

selecting arbitrators and would include the procedures for appointing and replacing arbitrators. The proposed rule change would apply to all customer cases.

### III. Summary of Comments

#### A. Customer Election of Panel Composition Method

Some commenters suggested that the Optional All Public Panel method of panel composition should be the default instead of the Majority Public Panel method.<sup>15</sup>

Commenters also raised concerns that customers without attorneys (“pro se” claimants), or attorneys new to the practice of securities arbitration, might not elect the Optional All Public Panel method within the prescribed deadline, or might not appreciate the benefit of electing this method.<sup>16</sup> One commenter stated that pro se claimants may be confused by receiving a list of non-public arbitrators after making the election for the Optional All Public Panel method.<sup>17</sup> Another commenter suggested that, if a customer elects to proceed with the Optional All Public Panel method of panel composition, the parties should only receive lists of public arbitrators (i.e., they should not receive a list of non-public arbitrators).<sup>18</sup> Finally, two commenters asked FINRA to clarify whether

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<sup>15</sup> See Haigney comment, Sutherland comment, Black and Gross comment, Berg comment, PIABA comment; St. John’s comment; and NASAA comment.

<sup>16</sup> See Haigney comment.

<sup>17</sup> See NASAA comment. The comment also suggests that FINRA change the “majority public panel” option label to “mixed affiliation” and that FINRA describe the term “non-public arbitrator” as “industry-affiliated.” In its response to comments, FINRA stated that the Majority Public Panel label clearly describes the panel composition and that changing the term “non-public” at this point would cause confusion.

<sup>18</sup> See Berg comment.

customers may make their panel composition election at the time of filing the Statement of Claim.<sup>19</sup>

FINRA responded to these comments by stating that it believes it is appropriate to have customers elect the Optional All Public Panel method rather than having that option as the default.<sup>20</sup> During the Pilot, a substantial percentage of customers opted for a Majority Public Panel. From launch of the Pilot in October 2008, until December 1, 2010, in 74 percent of cases eligible for the Pilot, customers accepted a non-public arbitrator on their panel either by choosing not to participate in the Pilot or by ranking one or more non-public arbitrators.<sup>21</sup> FINRA stated that there were very few complaints from customers that they were not aware of the Pilot and that it is appropriate to have customers elect, rather than be defaulted to, the Optional All Public Panel method.<sup>22</sup>

While FINRA indicated that the percentage of pro se claimants that file arbitration claims over \$100,000 at FINRA is very small, to respond to the commenters' concerns relating to pro se claimants and to attorneys new to the practice of securities arbitration, FINRA is proposing to amend the proposed rule change to state that FINRA will notify the customer in writing that the customer has 35 days from service of the Statement of Claim to elect the Optional All Public Panel method. Further, FINRA will highlight the rule change in its case filing instructions, website information, and other materials, as applicable. FINRA stated that it believes that amending the proposed rule change to add a customer notification provision and highlighting in its written materials how the panel

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<sup>19</sup> See the Haigney comment and the PIABA comment.

<sup>20</sup> See Response to Comments and Amendment No. 1, supra, note 6.

<sup>21</sup> Id.

<sup>22</sup> Id.

composition methods work will ensure that customers understand how to elect the Optional All Public Panel method and are aware of the applicable deadlines for election. FINRA also stated that during the Pilot, a substantial percentage of customers opted for a majority public panel and for this reason did not change the selection process in the proposal.

With regard to the comment that customers electing the Optional All Public Panel receive three lists of public arbitrators, FINRA stated that given the data FINRA compiled from the Pilot, it did not at this time find persuasive the comments requesting that customers receive a list only of public arbitrators.<sup>23</sup>

FINRA also stated that it intends to allow customers to make their election of the Optional All Public Panel in the Statement of Claim (or correspondence accompanying the Statement of Claim) in instances when the customers are claimants.<sup>24</sup> Therefore, FINRA is proposing to amend the proposed rule change to state that the customer may elect in writing to proceed under either the composition rules for the Majority Public Panel or the composition rules for the Optional All Public Panel in the customer's Statement of Claim, if the customer is a claimant, or at any time up to 35 days from service of the Statement of Claim, whether the customer is a complainant or respondent.

In addition, FINRA is proposing to correct an error in the title of proposed Rule 12403(b) which, as proposed, states "Customer Claimant Election." FINRA proposes to amend the title to eliminate the reference to "Claimant" because a customer may be a respondent in FINRA arbitration and FINRA intends the proposed rule change to apply to all customer disputes regardless of whether customers are claimants or respondents.

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<sup>23</sup> See Response to Comments and Amendment No. 1, *supra*, note 6.

<sup>24</sup> *Id.*

B. Effect of Proposed Rule Change on Individually Named Registered Representatives

The proposed rule change would apply to all firms and all registered representatives. One commenter opposed applying the proposed rule change to individually named registered representatives.<sup>25</sup> According to the commenter, FINRA should provide registered representatives with the procedural protection of having a non-public arbitrator on their arbitration panel. FINRA stated that it believes that the commenter's suggestion is unworkable.<sup>26</sup> If FINRA does not apply the proposed rule change to individually named registered representatives, customers that wish to proceed under the Optional All Public Panel method for their claims against firms would be compelled to bifurcate their claims against firms from their claims against registered representatives. Moreover, if the firm wishes to assert a third party claim against a registered representative in a customer case where a customer elected the Optional All Public Panel composition method, the firm's claim could interfere with the customer's election of the Optional All Public Panel. Finally, FINRA believes that bifurcation of customers' claims is likely to result in higher overall arbitration costs for customers. FINRA, thus, concluded that the consequences of the commenter's suggestion would make the suggestion inefficient and impractical.

C. Inclusion of a Non-Public Arbitrator

Two commenters stated that inclusion of a non-public arbitrator would benefit all the parties to a dispute, as well as the public arbitrators on the panel, by appropriately

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<sup>25</sup> See SIFMA comment.

<sup>26</sup> See Response to Comments and Amendment No. 1, supra, note 6.

educating them about industry-related issues.<sup>27</sup> One commenter stated that the non-public arbitrator may also reduce costs for the parties by limiting the need for the parties to call expert witnesses.<sup>28</sup>

In contrast, a number of commenters stated that parties frequently use expert witnesses in cases with majority public panels, which limits the need for the non-public arbitrator's industry expertise and any potential cost savings.<sup>29</sup>

Under the Pilot and the amended rules, customers who do not elect the Optional All Public Panel selection method, will continue to have a panel that includes a non-public arbitrator. FINRA stated that it received feedback on the Pilot from both investor and industry attorneys that indicates that panel composition made no difference in how parties used experts to try their cases.<sup>30</sup> In addition, a number of commenters expressed concerns about the non-public arbitrator offering expert opinions to the other arbitrators where those opinions would not be subject to cross-examination.<sup>31</sup> Regarding the comments that a non-public arbitrator may act as an expert witness not subject to cross-examination, FINRA stated that it believes that the proposed rule mitigates the concern

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<sup>27</sup> See SIFMA comment and Wacht comment.

<sup>28</sup> See SIFMA comment.

<sup>29</sup> See Neuman comment, Shewan comment, Banks comment, and Rosenberg comment.

<sup>30</sup> See Response to Comments and Amendment No. 1, supra, note 6.

<sup>31</sup> See Aidikoff comment, Coleman comment, Amato comment, Eccleston comment, Goldstein comment, Karen comment, Fogel comment, Cornell comment, Mihalek comment, PIABA comment, and NASAA comment.

because any customer that shares this concern may elect the Optional All Public Panel.<sup>32</sup> Therefore, FINRA did not amend the proposal as it relates to the non-public arbitrator.

#### D. Request to Reject the Proposed Rule Change

One commenter requested that the Commission reject the proposed rule change as contrary to the public interest.<sup>33</sup> The commenter stated that FINRA has other tools to correct the public's perception that FINRA arbitration is not fair to investors. FINRA stated that it believes that the results of the Pilot, the public's feedback on the program, and the overwhelming support reflected in the comments submitted on the proposed rule change support the need to provide customers with the choice of whether to select an Optional All Public Panel or a Majority Public Panel.<sup>34</sup>

#### E. Comments Outside the Scope of the Proposed Rule Change

Commenters raised a number of additional issues, including concerns regarding mandatory arbitration of investor disputes;<sup>35</sup> the definition of "public arbitrator";<sup>36</sup> investor arbitration fees;<sup>37</sup> the discovery process at FINRA;<sup>38</sup> the NLSS; and blue sky

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<sup>32</sup> See Response to Comments and Amendment No. 1, supra, note 6.

<sup>33</sup> See Wacht comment.

<sup>34</sup> See Response to Comments and Amendment No. 1, supra, note 6.

<sup>35</sup> See: Layne comment, Steiner comment, Chalmers comment, Gladden comment, Estell comment, Sutherland comment, Furgison comment, Healy comment, Samson comment, Berg comment, Miller comment, Ilgenfritz comment, Rosenfield comment, Bleacher comment, Mihalek comment, and NASAA comment.

<sup>36</sup> See Goldstein comment.

<sup>37</sup> See Layne comment.

<sup>38</sup> See Layne comment and Estell comment.

laws.<sup>39</sup> Stating that all of these comments are outside of the scope of the proposed rule change, FINRA declined to make changes to address them.<sup>40</sup> FINRA also stated that it believes its arbitration forum is fair, and highlighted that it does not require firms to use pre-dispute arbitration clauses.<sup>41</sup>

#### IV. Discussion and Finding

After carefully reviewing the proposed rule change, the comment letters, and FINRA's Response to Comments and Amendment No. 1, 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.<sup>42</sup> In particular, the Commission believes that the proposed rule change, as amended, is consistent with the provisions of Section 15A(b)(6) of the Act, 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.<sup>43</sup> The Commission believes the proposed rule change, as amended, will enhance the public's perception that the FINRA securities arbitration process and rules are fair and would promote just and equitable principles of trade by giving investors additional choices regarding the composition of panels that will hear their cases. This, in

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<sup>39</sup> See Estell comment.

<sup>40</sup> See Response to Comments and Amendment No. 1, supra, note 6.

<sup>41</sup> Id.

<sup>42</sup> 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).

<sup>43</sup> See 15 U.S.C. 78o-3(b)(6).

turn, should help enhance public confidence in, and perception of, the fairness of the FINRA arbitration forum. We understand that FINRA plans to implement this rule change as soon as possible to provide this option to as many customers as possible.

V. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>44</sup> for approving the proposed rule change, as amended, prior to the 30<sup>th</sup> day after the date of publication in the Federal Register. The changes proposed in Amendment No. 1 do not raise novel regulatory concerns. Moreover, accelerating approval of this proposal should benefit investors by providing customers with the immediate option to select an all public arbitration panel for all cases. Accordingly, the Commission finds that good cause exists to approve the proposal, as modified by Amendment No. 1, on an accelerated basis.

VI. 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-FINRA-2010-053 on the subject line.

Paper Comments:

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<sup>44</sup> 15 U.S.C. 78s(b)(2).

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

All submissions should refer to File Number SR-FINRA-2010-053. 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 website (<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 website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. 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-FINRA-2010-053 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>45</sup> that the proposed rule change (SR-FINRA-2010-053), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>46</sup>

Cathy H. Ahn  
Deputy Secretary

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<sup>45</sup> 15 U.S.C. 78s(b)(2).

<sup>46</sup> 17 CFR 200.30-3(a)(12).