

June 12, 2000

Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001  
Mail Stop 10-1

Re: File No. SR-NASD-00-34 - Amendments to Rules 10308 and 10312 Concerning  
the Authority of the Director of Arbitration to Remove Arbitrators for Cause

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Jean I. Feeney, Special Advisor, Office of Dispute Resolution, NASD Regulation, Inc., at (202) 728-6959; e-mail [jean.feeney@nasd.com](mailto:jean.feeney@nasd.com). The fax number is (202) 728-8833.

Very truly yours,

Joan C. Conley  
Senior Vice President  
and Corporate Secretary

Attachment

File No. SR-NASD-00-34  
Consists of 31 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

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Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rules 10308 and 10312 to provide authority for the Director of Arbitration (“Director”) to remove arbitrators for cause after hearings have begun. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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**10000. CODE OF ARBITRATION PROCEDURE**

\* \* \*

**10308. Selection of Arbitrators**

(a) - (c) Unchanged.

(d) Disqualification and Removal of Arbitrator Due to Conflict of Interest or Bias

(1) Disqualification by Director

After the appointment of an arbitrator and prior to the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, if the Director or a party objects to the continued service of the arbitrator, the Director shall determine if the arbitrator should be disqualified. If the Director sends a notice to the parties that the arbitrator shall be disqualified, the arbitrator will be disqualified unless the parties

unanimously agree otherwise in writing and notify the Director not later than 15 days after the Director sent the notice.

(2) [Authority of Director to Disqualify Ceases] Removal by Director

After the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, the Director[~~'s authority to~~] may remove an arbitrator from an arbitration panel [~~ceases~~] based on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

(3) Unchanged.

(e) Unchanged.

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**10312. Disclosures Required of Arbitrators and Director's Authority to Disqualify**

(a) Each arbitrator shall be required to disclose to the Director of Arbitration any circumstances which might preclude such arbitrator from rendering an objective and impartial determination. Each arbitrator shall disclose:

(1) Any direct or indirect financial or personal interest in the outcome of the arbitration;

(2) Any existing or past financial, business, professional, family, [or] social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. Persons requested to serve as arbitrators should disclose any such relationships or circumstances that they [personally] have with any party or its counsel, or with any individual whom they have been told will

be a witness. They should also disclose any such relationship or circumstances involving members of their families or their current employers, partners, or business associates.

(b) Persons who are requested to accept appointment as arbitrators should make a reasonable effort to inform themselves of any interests, [or] relationships or circumstances described in paragraph (a) above.

(c) The obligation to disclose interests, relationships, or circumstances that might preclude an arbitrator from rendering an objective and impartial determination described in paragraph (a) is a continuing duty that requires a person who accepts appointment as an arbitrator to disclose, at any stage of the arbitration, any such interests, relationships, or circumstances that arise, or are recalled or discovered.

(d) [Prior to the commencement of the earlier of (1) the first pre-hearing conference or (2) the first hearing, t]The Director may remove an arbitrator based on information that is required to be disclosed pursuant to this Rule. The Director may remove an arbitrator based only on information not known to the parties when the arbitrator was selected. The Director's authority under this paragraph may be exercised only by the Director or the President of NASD Dispute Resolution.

(e) [Prior to the commencement of the earlier of (1) the first pre-hearing conference or (2) the first hearing, t]The Director shall inform the parties to an arbitration proceeding of any information disclosed to the Director under this Rule unless either the arbitrator who disclosed the information withdraws voluntarily as soon as the arbitrator learns of any interest, [or] relationship, or circumstances described in paragraph (a) that might preclude the arbitrator from

rendering an objective and impartial determination in the proceeding, or the Director removes the arbitrator.

[(f) After the commencement of the earlier of (1) the first pre-hearing conference or (2) the first hearing, the Director's authority to remove an arbitrator from an arbitration panel ceases. During this period, the Director shall inform the parties of any information disclosed by an arbitrator under this Rule.]

\* \* \*

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on May 17, 2000, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on May 18, 2000. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective

date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Jean I. Feeney, Special Advisor, Office of Dispute Resolution, NASD Regulation, Inc., at (202) 728-6959; e-mail [jean.feeney@nasd.com](mailto:jean.feeney@nasd.com).

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

(a) Purpose

The Code of Arbitration Procedure (“Code”) presently provides that the authority of the Director of Arbitration to remove an arbitrator for cause ceases after the earlier of the first pre-hearing conference or the first hearing. The proposed rule change would amend the Code to eliminate this restriction, and to allow the Director to remove an arbitrator for sufficient cause shown at any juncture, where there is a challenge based on information not known to the parties at the time of the arbitrator’s appointment.

Background and Discussion

In order to protect the integrity of the process and to ensure the impartiality of arbitrators, Rule 10312(a) requires that arbitrators make full disclosure of certain enumerated interests, relationships, and circumstances, as well as “any circumstances which might preclude such arbitrator from rendering an objective and impartial determination.” Prior to implementation of the Neutral List Selection System (“list selection”) in November 1998, the Code required the Director to inform the parties of information disclosed by the arbitrator at

least 15 days before the first hearing. Parties were allowed one peremptory challenge and unlimited challenges for cause.<sup>1</sup>

Under list selection, the above provisions no longer apply. Rather, Rule 10308(b)(6) requires the Director to send the parties the employment history and other background information about the arbitrators on their lists. The parties may request additional information. Then, as provided in Rule 10308(c), they may strike arbitrators from the list for any reason, and rank those who remain. The Director (or his staff)<sup>2</sup> consolidates the parties' lists in ranking order and, if the number of arbitrators available to serve from the consolidated list is not sufficient to fill a panel, the Director uses NLSS to extend the list and appoints one or more additional arbitrators to complete the panel. Parties receive information about any arbitrators appointed by extending the list, and have the right to object as provided in Rule 10308(d)(1).

Rule 10308(c)(4)(A) provides that the Director appoints arbitrators "subject to availability and disqualification." "Availability" refers to the arbitrator's ability to serve on the case in the desired hearing location during the relevant time period. "Disqualification" could occur either when a disqualifying fact is revealed to the Director after the parties have completed the striking and ranking process, or when the Director consults with a ranked candidate just prior to appointment and the candidate, upon hearing more case-specific information, reveals information that the Director determines is a basis for disqualification.

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<sup>1</sup> The standard for circumstances that would be considered "for cause" would be the same as the general disclosure standard contained in Rule 10312: "any circumstances which might preclude such arbitrator from rendering an objective and impartial determination."

<sup>2</sup> Rule 10103 provides that the duties and functions of the director may be delegated, as appropriate.

Under Rule 10312(c), an arbitrator's disclosure obligation continues throughout the arbitration. If a disqualifying fact comes to light after a panel has been appointed, Rules 10308(d) and 10312(d) permit the Director to remove an arbitrator based on such information before the earlier of the first pre-hearing conference or the first hearing.<sup>3</sup> Once one of these events occurs, Rules 10308(d)(2) and 10312(f) specifically state that the Director's authority to remove an arbitrator ceases.

Nevertheless, Rule 10312(f) requires the Director to inform the parties of any potentially disqualifying information disclosed after the first pre-hearing or hearing session. At that point, however, a party can no longer use a challenge for cause to remove the arbitrator. Rather, the parties can only attempt to resolve the matter themselves, which can be difficult in the adversarial setting of an ongoing arbitration. The parties may agree that the arbitrator be removed, in which case the arbitration may continue with the two remaining arbitrators or a replacement may be appointed under Rule 10313. If all the parties do not agree, a party objecting to the continued service of the arbitrator may make a formal request for the arbitrator to recuse himself or herself; however, the arbitrator may decline the request. The Director may suggest that the arbitrator withdraw voluntarily, but may not remove the arbitrator.

In summary, when a for-cause objection is raised after the first pre-hearing or hearing session, the arbitrator can only be removed where (1) he or she agrees to step down, or (2) all the parties agree that the arbitrator should be removed. Failing that, an aggrieved party's only

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<sup>3</sup> Rule 10308(d) states that either the Director or a party may object to the continued service of the arbitrator, whereas Rule 10312(d) does not indicate that a specific objection is required.

recourse is to seek judicial intervention, which increases the party's legal expenses, and which could reduce confidence in the fairness and efficiency of the arbitration process.<sup>4</sup>

NASD Regulation believes that an alternative dispute resolution forum should be able to resolve all issues relating to an arbitration without forcing the parties to go to court. As presently written, the Code does not permit the Director to remove an arbitrator for cause after the first pre-hearing or hearing session has commenced, no matter how egregious the circumstances. Accordingly, NASD Regulation proposes that the Code be amended to permit the Director to remove an arbitrator for cause at any time, if there is a challenge to the arbitrator based on information not known to the parties when the arbitrator was appointed. In addition, NASD Regulation proposes certain minor language changes to clarify that both relationships and circumstances must be disclosed if they fit within the criteria of Rule 10312, and that the Rule is not limited to personal relationships and circumstances of the arbitrator, as described in more detail below.

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<sup>4</sup> In Commonwealth Coatings Corp. v. Continental Casualty Co., 393 U.S. 145 (1968), which vacated an award because of an arbitrator's failure to disclose a business relationship with one of the parties, Justices White and Marshall noted in their concurring opinion:

The arbitration process functions best when an amicable and trusting atmosphere is preserved and there is voluntary compliance with the decree, without need for judicial enforcement. This end is best served by establishing an atmosphere of frankness at the outset, through disclosure by the arbitrator of any financial transactions which he has had or is negotiating with either of the parties. In many cases the arbitrator might believe the business relationship to be so insubstantial that to make a point of revealing it would suggest he is indeed easily swayed, and perhaps a partisan of that party. But if the law requires the disclosure, no such imputation can arise. And it is far better that the relationship be disclosed at the outset, when the parties are free to reject the arbitrator or accept him with knowledge of the relationship and continuing faith in his objectivity, than to have the relationship come to light after the arbitration, when a suspicious or disgruntled party can seize on it as a pretext for invalidating the award. The judiciary should minimize its role in arbitration as judge of the arbitrator's impartiality. That role is best consigned to the parties, who are the architects of their own arbitration process, and are far better informed of the prevailing ethical standards and reputations within their business.

393 U.S. at 151 (footnote omitted).

NASD Regulation believes there are four major reasons for the proposed rule change:

**The present rule is no longer necessary.** The present rule has only been in the Code since the adoption of the list selection rule in November 1998.<sup>5</sup> It does, however, reflect a long-standing policy that was developed at a time when there was no structural separation of the NASD market and regulation functions. The policy was designed, in part, to eliminate any perception that member firms could influence the composition of the panel after hearings have commenced. With the corporate separation of the market and regulation functions, and the planned spin-off of the NASD Regulation Office of Dispute Resolution as a separate company<sup>6</sup> – further ensuring the independence of the Director – the need for the present rule is diminished. In addition, the proposed amendment provides that the Director may exercise the removal authority only in limited circumstances, and may not delegate this authority to lower-level staff.

**The present rule is inconsistent with the concept of administered arbitration.** NASD Regulation offers an “administered” arbitration system, in that the parties submit their dispute to NASD Regulation for complete administration of the dispute, from filing a claim to issuance of an award. One of the key benefits of administered arbitration is the ability to have all ancillary issues relating to the arbitration – such as removal of arbitrators for cause – resolved without recourse to the courts. Moreover, the present rule is inconsistent with the approaches of the major dispute resolution forums, such as the American Arbitration Association (“AAA”)<sup>7</sup>

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<sup>5</sup> The rule change to implement list selection was approved by the Commission in Exchange Act Rel. No. 40555 (Oct. 14, 1998) (File No. SR-NASD-98-48), 63 Fed. Reg. 56670 (Oct. 22, 1998).

<sup>6</sup> See Exchange Act Rel. No. 41971 (Sept. 30, 1999) (File No. SR-NASD-99-21), 64 Fed. Reg. 55793 (Oct. 14, 1999), which approved creation of a new dispute resolution subsidiary, NASD Dispute Resolution, Inc. That subsidiary is scheduled to begin operations on July 10, 2000.

and JAMS,<sup>8</sup> whose rules permit the administering organization to remove an arbitrator for cause at any time in the arbitration process. In addition, the Securities Industry Conference on Arbitration (SICA) adopted an amendment to the Uniform Code of Arbitration at its meeting on March 14, 2000, which is analogous to this proposed rule change.<sup>9</sup>

**The present rule invites delay and administrative disruption.** The present rule invites delays in the process, while parties wrestle with the issue of for-cause challenges to sitting arbitrators, and perhaps seek judicial intervention. In the NASD Regulation forum, there have been situations in which viable for-cause challenges were raised after the Director's authority to remove arbitrators ceased. Under current rules, the Director would be unable to rule on the

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<sup>7</sup> The Commercial Dispute Resolution Procedures of the AAA (January 1, 1999), provide as follows:

**R-19. Disclosure and Challenge Procedure**

(a) Any person appointed as a neutral arbitrator shall disclose to the AAA any circumstance likely to affect impartiality or independence, including any bias or any financial or personal interest in the result of the arbitration or any past or present relationship with the parties or their representatives. Upon receipt of such information from the arbitrator or another source, the AAA shall communicate the information to the parties and, if it deems it appropriate to do so, to the arbitrator and others.

(b) Upon objection of a party to the continued service of a neutral arbitrator, the AAA shall determine whether the arbitrator should be disqualified and shall inform the parties of its decision, which shall be conclusive.

<sup>8</sup> The Procedures for Securities Arbitrations Administered by JAMS Under the Securities Industry Conference on Arbitration Non-SRO Pilot Program (Website visited June 1, 2000)

<<http://www.jamsadr.com/arbitrationrules/securitiesarb.htm#13>. Disclosure>, provide:

**Section 13. Disclosure and Challenge Procedure**

Any person appointed as an arbitrator must disclose to JAMS any circumstance likely to affect impartiality, including any bias or any financial or personal interest in the result of the arbitration or any past or present relationship with the parties or their representatives. Upon receipt of such information from the arbitrator or other source, JAMS will communicate the information to the parties and, if it deems it appropriate to do so, to the arbitrator and others. Upon objection of a party to the continued service of an arbitrator, JAMS will determine whether the arbitrator should be disqualified and will inform the parties of its decision, which will be conclusive.

<sup>9</sup> Section 11 of the Uniform Code of Arbitration, Disclosures Required by Arbitrators, was revised to read as follows:

(e) Once the hearings have commenced, the Director may remove an arbitrator based only on information required to be disclosed under subsection (a), not known to the parties when the arbitrator was selected. The Director's authority under this subsection (e) may not be delegated.

merits of such challenges, despite clear substantive grounds supporting removal, and the prevailing party would be subject to the risk of having the award vacated on grounds of evident partiality.<sup>10</sup>

**The arbitrator should not be the only source of information.** Rule 10312 of the Code can be interpreted to limit the Director’s authority to challenges based on information disclosed by the arbitrator under that rule. This could prevent the Director from entertaining a challenge based on information, obtained from some other source, that should have been disclosed by the arbitrator. Consistent with the rules of other dispute resolution forums, NASD Regulation proposes to amend the Code to permit the Director to entertain for-cause challenges based on sources in addition to the arbitrator. Therefore, the proposed changes would allow the Director to remove an arbitrator based on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

Some users of the arbitration forum may be concerned about giving more power to NASD Regulation staff to remove arbitrators who were selected by the parties. To address that concern, the proposed rule change provides that the only persons who can remove arbitrators under the proposed amendments will be the Director and the President to whom he reports. This authority cannot be delegated. In addition, as discussed above, removal can only

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<sup>10</sup> Under the Federal Arbitration Act, courts may vacate arbitration awards for, among other reasons, “evident partiality or corruption in the arbitrators.” 9 U.S.C. Sec. 10(a)(2). See, e.g., Wages v. Smith Barney Harris Upham & Co., 937 P.2d 715 (Ariz. Ct. App. 1997), in which the court vacated an award to investors of \$950,000 plus costs and fees, where the chair of an arbitration panel declined to recuse himself after it was learned that he had represented claimants in a similar matter against a predecessor of the respondent firm; the court found that the arbitrator’s later harsh rulings against respondent showed evident partiality. See also Schmitz v. Zilveti et al., 20 F.3d 1043, 1049 (9th Cir. 1994) (“A finding of evident partiality in one arbitrator generally requires vacatur of the arbitration award.”).

be based on information that was required to be disclosed pursuant to Rule 10312 and that was not known to the parties at the time the arbitrator was appointed.

Description of Proposed Amendments

NASD Regulation proposes to amend Rule 10308, the list selection rule, to provide that the authority of the Director to disqualify or remove arbitrators does not end when the first pre-hearing or hearing session begins. Rather, proposed 10308(b)(2) provides that, after that first session, the Director may remove an arbitrator from an arbitration panel based on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

NASD Regulation proposes to amend Rule 10312, the arbitrator disclosure rule, in several places. NASD Regulation proposes to amend Rule 10312(a)(2) to include any existing or past financial, business, professional, family, social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. NASD Regulation proposes to delete the word “personally” from Rule 10312(a)(2), as it might be read too narrowly, and to add the phrase “or circumstances” to paragraphs (b) and (e) of Rule 10312. This will clarify that the arbitrator is required to disclose any relationships or circumstances that might fit under Rule 10312.

NASD Regulation also proposes to amend Rule 10312 to provide, as in Rule 10308, that the Director’s authority to remove arbitrators does not cease with the first pre-hearing or hearing session, and that the Director may remove an arbitrator based only on information not known to the parties when the arbitrator was selected. This provision is intended to prevent parties from raising challenges late in the process which could have been raised at the outset.

Rule 10312(d) will provide that the Director's authority may only be exercised by the Director or by the President of NASD Dispute Resolution, Inc.<sup>11</sup>

Finally, NASD Regulation proposes to amend Rule 10312(e) consistently with the above changes, to delete language limiting the time within which the Director may remove arbitrators for cause; and Rule 10312(f) is deleted as no longer necessary in light of the preceding changes.

(b) Statutory Basis

NASD Regulation 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. The NASD believes that the proposed rule change will protect the public interest by providing a procedure to remove an arbitrator for sufficient cause shown at any time in an arbitration, where the challenge is based on information not known to the parties at the time of the arbitrator's appointment.

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

NASD Regulation 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.

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<sup>11</sup> See generally SR-NASD-99-21, *supra* note 6.

5. 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.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD

Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: \_\_\_\_\_  
Joan C. Conley, Senior Vice President and  
Corporate Secretary

Date: June 12, 2000

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-NASD-00-34)

Re: Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Authority of the Director of Arbitration to Remove Arbitrators for Cause

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> notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. 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 Regulation is proposing to amend NASD Rules 10308 and 10312 to provide authority for the Director of Arbitration (“Director”) to remove arbitrators for cause after hearings have begun. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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

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

## **10000. CODE OF ARBITRATION PROCEDURE**

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### **10308. Selection of Arbitrators**

(a) - (c) Unchanged.

(d) Disqualification and Removal of Arbitrator Due to Conflict of Interest or Bias

(1) Disqualification by Director

After the appointment of an arbitrator and prior to the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, if the Director or a party objects to the continued service of the arbitrator, the Director shall determine if the arbitrator should be disqualified. If the Director sends a notice to the parties that the arbitrator shall be disqualified, the arbitrator will be disqualified unless the parties unanimously agree otherwise in writing and notify the Director not later than 15 days after the Director sent the notice.

(2) [Authority of Director to Disqualify Ceases] Removal by Director

After the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, the Director[~~'s authority to~~] may remove an arbitrator from an arbitration panel [ceases] based on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

(3) Unchanged.

(e) Unchanged.

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**10312. Disclosures Required of Arbitrators and Director's Authority to Disqualify**

(a) Each arbitrator shall be required to disclose to the Director of Arbitration any circumstances which might preclude such arbitrator from rendering an objective and impartial determination. Each arbitrator shall disclose:

(1) Any direct or indirect financial or personal interest in the outcome of the arbitration;

(2) Any existing or past financial, business, professional, family, [or] social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. Persons requested to serve as arbitrators should disclose any such relationships or circumstances that they [personally] have with any party or its counsel, or with any individual whom they have been told will be a witness. They should also disclose any such relationship or circumstances involving members of their families or their current employers, partners, or business associates.

(b) Persons who are requested to accept appointment as arbitrators should make a reasonable effort to inform themselves of any interests, [or] relationships or circumstances described in paragraph (a) above.

(c) The obligation to disclose interests, relationships, or circumstances that might preclude an arbitrator from rendering an objective and impartial determination described in paragraph (a) is a continuing duty that requires a person who accepts appointment as an arbitrator to disclose, at any stage of the arbitration, any such interests, relationships, or circumstances that arise, or are recalled or discovered.

(d) [Prior to the commencement of the earlier of (1) the first pre-hearing conference or (2) the first hearing, t]The Director may remove an arbitrator based on information that is required to be disclosed pursuant to this Rule. The Director may remove an arbitrator based only on information not known to the parties when the arbitrator was selected. The Director's authority under this paragraph may be exercised only by the Director or the President of NASD Dispute Resolution.

(e) [Prior to the commencement of the earlier of (1) the first pre-hearing conference or (2) the first hearing, t]The Director shall inform the parties to an arbitration proceeding of any information disclosed to the Director under this Rule unless either the arbitrator who disclosed the information withdraws voluntarily as soon as the arbitrator learns of any interest, [or] relationship, or circumstances described in paragraph (a) that might preclude the arbitrator from rendering an objective and impartial determination in the proceeding, or the Director removes the arbitrator.

[(f) After the commencement of the earlier of (1) the first pre-hearing conference or (2) the first hearing, the Director's authority to remove an arbitrator from an arbitration panel ceases. During this period, the Director shall inform the parties of any information disclosed by an arbitrator under this Rule.]

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## 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 Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on

the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation 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

(a) Purpose

The Code of Arbitration Procedure (“Code”) presently provides that the authority of the Director of Arbitration to remove an arbitrator for cause ceases after the earlier of the first pre-hearing conference or the first hearing. The proposed rule change would amend the Code to eliminate this restriction, and to allow the Director to remove an arbitrator for sufficient cause shown at any juncture, where there is a challenge based on information not known to the parties at the time of the arbitrator’s appointment.

Background and Discussion

In order to protect the integrity of the process and to ensure the impartiality of arbitrators, Rule 10312(a) requires that arbitrators make full disclosure of certain enumerated interests, relationships, and circumstances, as well as “any circumstances which might preclude such arbitrator from rendering an objective and impartial determination.” Prior to implementation of the Neutral List Selection System (“list selection”) in November 1998, the Code required the Director to inform the parties of information disclosed by the arbitrator at

least 15 days before the first hearing. Parties were allowed one peremptory challenge and unlimited challenges for cause.<sup>3</sup>

Under list selection, the above provisions no longer apply. Rather, Rule 10308(b)(6) requires the Director to send the parties the employment history and other background information about the arbitrators on their lists. The parties may request additional information. Then, as provided in Rule 10308(c), they may strike arbitrators from the list for any reason, and rank those who remain. The Director (or his staff)<sup>4</sup> consolidates the parties' lists in ranking order and, if the number of arbitrators available to serve from the consolidated list is not sufficient to fill a panel, the Director uses NLSS to extend the list and appoints one or more additional arbitrators to complete the panel. Parties receive information about any arbitrators appointed by extending the list, and have the right to object as provided in Rule 10308(d)(1).

Rule 10308(c)(4)(A) provides that the Director appoints arbitrators "subject to availability and disqualification." "Availability" refers to the arbitrator's ability to serve on the case in the desired location during the relevant time period. "Disqualification" could occur either when a disqualifying fact is revealed to the Director after the parties have completed the striking and ranking process, or when the Director consults with a ranked candidate just prior to appointment and the candidate, upon hearing more case-specific information, reveals information that the Director's staff determines is a basis for disqualification.

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<sup>3</sup> The standard for circumstances that would be considered "for cause" would be the same as the general disclosure standard contained in Rule 10312: "any circumstances which might preclude such arbitrator from rendering an objective and impartial determination."

<sup>4</sup> Rule 10103 provides that the duties and functions of the director may be delegated, as appropriate.

Under Rule 10312(c), an arbitrator's disclosure obligation continues throughout the arbitration. If a disqualifying fact comes to light after a panel has been appointed, Rules 10308(d) and 10312(d) permit the Director to remove an arbitrator based on such information before the earlier of the first pre-hearing conference or the first hearing.<sup>5</sup> Once one of these events occurs, Rules 10308(d)(2) and 10312(f) specifically state that the Director's authority to remove an arbitrator ceases.

Nevertheless, Rule 10312(f) requires the Director to inform the parties of any potentially disqualifying information disclosed after the first pre-hearing or hearing session. At that point, however, a party can no longer use a challenge for cause to remove the arbitrator. Rather, the parties can only attempt to resolve the matter themselves, which can be difficult in the adversarial setting of an ongoing arbitration. The parties may agree that the arbitrator be removed, in which case the arbitration may continue with the two remaining arbitrators or a replacement may be appointed under Rule 10313. If all the parties do not agree, a party objecting to the continued service of the arbitrator may make a formal request for the arbitrator to recuse himself or herself; however, the arbitrator may decline the request. The Director may suggest that the arbitrator withdraw voluntarily, but may not remove the arbitrator.

In summary, when a for-cause objection is raised after the first pre-hearing or hearing session, the arbitrator can only be removed where (1) he or she agrees to step down, or (2) all the parties agree that the arbitrator should be removed. Failing that, an aggrieved party's only

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<sup>5</sup> Rule 10308(d) states that either the Director or a party may object to the continued service of the arbitrator, whereas Rule 10312(d) does not indicate that a specific objection is required.

recourse is to seek judicial intervention, which increases the party's legal expenses, and which could reduce confidence in the fairness and efficiency of the arbitration process.<sup>6</sup>

NASD Regulation believes that an alternative dispute resolution forum should be able to resolve all issues relating to an arbitration without forcing the parties to go to court. As presently written, the Code does not permit the Director to remove an arbitrator for cause after the first pre-hearing or hearing session has commenced, no matter how egregious the circumstances. Accordingly, NASD Regulation proposes that the Code be amended to permit the Director to remove an arbitrator for cause at any time, if there is a challenge to the arbitrator based on information not known to the parties when the arbitrator was appointed. In addition, NASD Regulation proposes certain minor language changes to clarify that both relationships and circumstances must be disclosed if they fit within the criteria of Rule 10312, and that the Rule is not limited to personal relationships and circumstances of the arbitrator, as described in more detail below.

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<sup>6</sup> In Commonwealth Coatings Corp. v. Continental Casualty Co., 393 U.S. 145 (1968), which vacated an award because of an arbitrator's failure to disclose a business relationship with one of the parties, Justices White and Marshall noted in their concurring opinion:

The arbitration process functions best when an amicable and trusting atmosphere is preserved and there is voluntary compliance with the decree, without need for judicial enforcement. This end is best served by establishing an atmosphere of frankness at the outset, through disclosure by the arbitrator of any financial transactions which he has had or is negotiating with either of the parties. In many cases the arbitrator might believe the business relationship to be so insubstantial that to make a point of revealing it would suggest he is indeed easily swayed, and perhaps a partisan of that party. But if the law requires the disclosure, no such imputation can arise. And it is far better that the relationship be disclosed at the outset, when the parties are free to reject the arbitrator or accept him with knowledge of the relationship and continuing faith in his objectivity, than to have the relationship come to light after the arbitration, when a suspicious or disgruntled party can seize on it as a pretext for invalidating the award. The judiciary should minimize its role in arbitration as judge of the arbitrator's impartiality. That role is best consigned to the parties, who are the architects of their own arbitration process, and are far better informed of the prevailing ethical standards and reputations within their business.

393 U.S. at 151 (footnote omitted).

NASD Regulation believes there are four major reasons for the proposed rule change:

**The present rule is no longer necessary.** The present rule has only been in the Code since the adoption of the list selection rule in November 1998.<sup>7</sup> It does, however, reflect a long-standing policy that was developed at a time when there was no structural separation of the NASD market and regulation functions. The policy was designed, in part, to eliminate any perception that member firms could influence the composition of the panel after hearings have commenced. With the corporate separation of the market and regulation functions, and the planned spin-off of the NASD Regulation Office of Dispute Resolution as a separate company<sup>8</sup> – further ensuring the independence of the Director – the need for the present rule is diminished. In addition, the proposed amendment provides that the Director may exercise the removal authority only in limited circumstances, and may not delegate this authority to lower-level staff.

**The present rule is inconsistent with the concept of administered arbitration.**

NASD Regulation offers an “administered” arbitration system, in that the parties submit their dispute to NASD Regulation for complete administration of the dispute, from filing a claim to issuance of an award. One of the key benefits of administered arbitration is the ability to have all ancillary issues relating to the arbitration – such as removal of arbitrators for cause – resolved without recourse to the courts. Moreover, the present rule is inconsistent with the approaches

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<sup>7</sup> The rule change to implement list selection was approved by the Commission in Exchange Act Rel. No. 40555 (Oct. 14, 1998) (File No. SR-NASD-98-48), 63 Fed. Reg. 56670 (Oct. 22, 1998).

<sup>8</sup> See Exchange Act Rel. No. 41971 (Sept. 30, 1999) (File No. SR-NASD-99-21), 64 Fed. Reg. 55793 (Oct. 14, 1999), which approved creation of a new dispute resolution subsidiary, NASD Dispute Resolution, Inc. That subsidiary is scheduled to begin operations on July 10, 2000.

of the major dispute resolution forums, such as the American Arbitration Association (“AAA”)<sup>9</sup> and JAMS,<sup>10</sup> whose rules permit the administering organization to remove an arbitrator for cause at any time in the arbitration process. In addition, the Securities Industry Conference on Arbitration (SICA) adopted an amendment to the Uniform Code of Arbitration at its meeting on March 14, 2000, which is analogous to this proposed rule change.<sup>11</sup>

**The present rule invites delay and administrative disruption.** The present rule invites delays in the process, while parties wrestle with the issue of for-cause challenges to sitting arbitrators, and perhaps seek judicial intervention. In the NASD Regulation forum, there have been situations in which viable for-cause challenges were raised after the Director’s authority to

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<sup>9</sup> The Commercial Dispute Resolution Procedures of the AAA (January 1, 1999), provide as follows:

**R-19. Disclosure and Challenge Procedure**

(a) Any person appointed as a neutral arbitrator shall disclose to the AAA any circumstance likely to affect impartiality or independence, including any bias or any financial or personal interest in the result of the arbitration or any past or present relationship with the parties or their representatives. Upon receipt of such information from the arbitrator or another source, the AAA shall communicate the information to the parties and, if it deems it appropriate to do so, to the arbitrator and others.

(b) Upon objection of a party to the continued service of a neutral arbitrator, the AAA shall determine whether the arbitrator should be disqualified and shall inform the parties of its decision, which shall be conclusive.

<sup>10</sup> The Procedures for Securities Arbitrations Administered by JAMS Under the Securities Industry Conference on Arbitration Non-SRO Pilot Program (Website visited June 1, 2000) <<http://www.jamsadr.com/arbitrationrules/securitiesarb.htm#13>. Disclosure>, provide:

**Section 13. Disclosure and Challenge Procedure**

Any person appointed as an arbitrator must disclose to JAMS any circumstance likely to affect impartiality, including any bias or any financial or personal interest in the result of the arbitration or any past or present relationship with the parties or their representatives. Upon receipt of such information from the arbitrator or other source, JAMS will communicate the information to the parties and, if it deems it appropriate to do so, to the arbitrator and others. Upon objection of a party to the continued service of an arbitrator, JAMS will determine whether the arbitrator should be disqualified and will inform the parties of its decision, which will be conclusive.

<sup>11</sup> Section 11 of the Uniform Code of Arbitration, Disclosures Required by Arbitrators, was revised to read as follows:

Continued

remove arbitrators ceased. Under current rules, the Director would be unable to rule on the merits of such challenges, despite clear substantive grounds supporting removal, and the prevailing party would be subject to the risk of having the award vacated on grounds of evident partiality.<sup>12</sup>

**The arbitrator should not be the only source of information.** Rule 10312 of the Code can be interpreted to limit the Director’s authority to challenges based on information disclosed by the arbitrator under that rule. This could prevent the Director from entertaining a challenge based on information, obtained from some other source, that should have been disclosed by the arbitrator. Consistent with the rules of other dispute resolution forums, NASD Regulation proposes to amend the Code to permit the Director to entertain for-cause challenges based on sources in addition to the arbitrator. Therefore, the proposed changes would allow the Director to remove an arbitrator based on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

Some users of the arbitration forum may be concerned about giving more power to NASD Regulation staff to remove arbitrators who were selected by the parties. To address that concern, the proposed rule change provides that the only persons who can remove

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(e) Once the hearings have commenced, the Director may remove an arbitrator based only on information required to be disclosed under subsection (a), not known to the parties when the arbitrator was selected. The Director’s authority under this subsection (e) may not be delegated.

<sup>12</sup> Under the Federal Arbitration Act, courts may vacate arbitration awards for, among other reasons, “evident partiality or corruption in the arbitrators.” 9 U.S.C. Sec. 10(a)(2). See, e.g., Wages v. Smith Barney Harris Upham & Co., 937 P.2d 715 (Ariz. Ct. App. 1997), in which the court vacated an award to investors of \$950,000 plus costs and fees, where the chair of an arbitration panel declined to recuse himself after it was learned that he had represented claimants in a similar matter against a predecessor of the respondent firm; the court found that the arbitrator’s later harsh rulings against respondent showed evident partiality. See also Schmitz v. Zilveti et al., 20 F.3d 1043, 1049 (9th Cir. 1994) (“A finding of evident partiality in one arbitrator generally requires vacatur of the arbitration award.”).

arbitrators under the proposed amendments will be the Director and the President (following the spin-off), to whom he reports. This authority cannot be delegated. In addition, as discussed above, removal can only be based on information that was required to be disclosed pursuant to Rule 10312 and that was not known to the parties at the time the arbitrator was appointed.

#### Description of Proposed Amendments

NASD Regulation proposes to amend Rule 10308, the list selection rule, to provide that the authority of the Director to disqualify or remove arbitrators does not end when the first pre-hearing or hearing session begins. Rather, proposed 10308(b)(2) provides that, after that first session, the Director may remove an arbitrator from an arbitration panel based on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

NASD Regulation proposes to amend Rule 10312, the arbitrator disclosure rule, in several places. NASD Regulation proposes to amend Rule 10312(a)(2) to include any existing or past financial, business, professional, family, social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. NASD Regulation proposes to delete the word “personally” from Rule 10312(a)(2), as it might be read too narrowly, and to add the phrase “or circumstances” to paragraphs (b) and (e) of Rule 10312. This will clarify that the arbitrator is required to disclose any relationships or circumstances that might fit under Rule 10312.

NASD Regulation also proposes to amend Rule 10312 to provide, as in Rule 10308, that the Director’s authority to remove arbitrators does not cease with the first pre-hearing or hearing session, and that the Director may remove an arbitrator based only on information not

known to the parties when the arbitrator was selected. This provision is intended to prevent parties from raising challenges late in the process which could have been raised at the outset. Rule 10312(d) will provide that the Director's authority may only be exercised by the Director or by the President of NASD Dispute Resolution, Inc.<sup>13</sup>

Finally, NASD Regulation proposes to amend Rule 10312(e) consistently with the above changes, to delete language limiting the time within which the Director may remove arbitrators for cause; and Rule 10312(f) is deleted as no longer necessary in light of the preceding changes.

(b) Statutory Basis

NASD Regulation 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. The NASD believes that the proposed rule change will protect the public interest by providing a procedure to remove an arbitrator for sufficient cause shown at any time in an arbitration, where the challenge is based on information not known to the parties at the time of the arbitrator's appointment.

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<sup>13</sup> See generally SR-NASD-99-21, *supra* note 8.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz  
Secretary