

# Notice to Members

NOVEMBER 2006

## SUGGESTED ROUTING

Legal & Compliance

## KEY TOPICS

Arbitration

Arbitrators

Dispute Resolution

## GUIDANCE

### Dispute Resolution

SEC Approves Amendments to Rule 10308 Regarding the Classification of Arbitrators; **Effective Date: January 15, 2007**

#### Executive Summary

The Securities and Exchange Commission has approved amendments to the arbitrator classification criteria set forth in Rule 10308 of the NASD Code of Arbitration Procedure (Code) to ensure that individuals with significant ties to the securities industry may not serve as public arbitrators in NASD arbitrations.<sup>1</sup>

The text of the amendments is set forth in Attachment A. The amendments will be effective on January 15, 2007.

#### Questions/Further Information

Questions regarding this *Notice* may be directed to Barbara L. Brady, Vice President and Director of Neutral Management, at (212) 858-4352 or via email at [barbara.brady@nasd.com](mailto:barbara.brady@nasd.com); or John D. Nachmann, Counsel, at (202) 728-8273 or via email at [john.nachmann@nasd.com](mailto:john.nachmann@nasd.com).

#### Discussion

The Code classifies arbitrators as public or non-public. When investors have a dispute with broker-dealer firms or their associated persons in NASD's arbitration forum, the investors are entitled to have their cases heard by an arbitration panel consisting of either a single public arbitrator or a majority public panel consisting of two public arbitrators and one non-public arbitrator, depending on the amount of the claim.<sup>2</sup>

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Under Rule 10308(a)(4) of the Code, a person is classified as a non-public arbitrator if he or she:

(A) is, or within the past 5 years, was:

- (i) associated with a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer);
- (ii) registered under the Commodity Exchange Act;
- (iii) a member of a commodities exchange or a registered futures association; or
- (iv) associated with a person or firm registered under the Commodity Exchange Act;

(B) is retired from, or spent a substantial part of a career, engaging in any of the business activities listed in subparagraph (4)(A);

(C) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in subparagraph (4)(A); or

(D) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities futures or options or supervises or monitors the compliance with the securities and commodities laws of employees who engage in such activities.

The criteria for public arbitrators are set forth in Rule 10308(a)(5) of the Code. Under this rule, an individual will be classified as a public arbitrator if he or she is qualified to serve as an arbitrator and:

- (i) is not engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);
- (ii) was not engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D) for a total of 20 years or more;
- (iii) is not an investment adviser;
- (iv) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past 2 years from any persons or entities listed in paragraph (a)(4)(A); and
- (v) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D).

In order to ensure that individuals with significant ties to the securities industry may not serve as public arbitrators in NASD arbitrations, NASD has amended the definition of public arbitrator in Rule 10308(a)(5) to exclude individuals who work for, or are officers or directors of, an entity that controls, is controlled by, or is under common control with, a partnership, corporation, or other organization that is engaged in the securities business.<sup>3</sup> The revision to the rule also applies to individuals who have a spouse or immediate family member who works for, or is an officer or director of, an entity that is in such a control relationship with a partnership, corporation, or other organization that is engaged in the securities business.

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Lastly, NASD has revised the definition of non-public arbitrator to clarify that persons who are registered through a broker-dealer may not be classified as public arbitrators. As noted above, arbitrators who are associated with a broker or dealer are considered non-public. In the financial services industry, it is not uncommon for a person to be employed by one company (such as a bank or insurance company) and to be registered to sell securities through another company (such as an affiliated broker-dealer). NASD believes that there may be some uncertainty among arbitrators who work for entities in a control relationship with a broker-dealer as to whether they are associated with a broker-dealer for purposes of Rule 10308, even though they hold licenses through the broker-dealer. Since the definition of "person associated with a member" in the NASD By-Laws includes persons who are registered with a broker-dealer, regardless of their status as employees, such persons should be considered non-public arbitrators. Therefore, NASD has amended the definition of non-public arbitrator in Rule 10308(a)(4)(A)(i) to clarify this issue.

#### **Updating of Arbitrator Disclosures**

NASD will distribute a survey to all arbitrators on the active roster, asking them to update their disclosures in light of the above amendments to the arbitrator classification rules. Arbitrators who do not respond by the deadline will be made inactive for future appointments until they have responded, and those who do not respond within a reasonable period thereafter may be removed permanently. After the surveys are returned and reviewed, arbitrators' disclosure records will be updated to reflect their proper classification under the amendments. Parties should be aware that the arbitrator classification amendments apply only to arbitrators appointed on or after the effective date; therefore, arbitrators who are already serving on panels may continue to serve even if their classification would otherwise change due to the amendments. These arbitrators will retain their former classification for purposes of these ongoing cases. This will avoid disruption and allow parties to continue with the arbitrators they have selected to hear their cases. Therefore, challenges for cause based solely on an arbitrator's reclassification will not be granted. Challenges for cause still may be made based upon the disqualification and removal criteria in Rules 10308(d) and 10312(d).

#### **Effective Date**

The amendments described in this *Notice* will be effective on January 15, 2007, and will apply to arbitrator lists sent out pursuant to Rule 10308(b)(5) on or after January 15, 2007, and to arbitrators appointed on or after January 15, 2007.

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## Endnotes

1. Securities Exchange Act Release No. 54607 (October 16, 2006), 71 *Federal Register* 62026 (October 20, 2006) (File No. SR-NASD-2005-094).
2. See Rules 10302 and 10308. For intra-industry disputes (not involving any parties who are investors) the panel composition is governed by Rule 10202. Depending on the nature of the dispute, intra-industry panels may consist of all public arbitrators, all non-public arbitrators or a majority of public arbitrators. The arbitrator classification provisions of Rule 10308 apply to all types of panels.
3. For purposes of this rule, the term “control” has the same meaning that it has for purposes of Form BD, which broker-dealers use to register with NASD and to make periodic updates. Specifically, control is defined as “[t]he power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. Any person that (i) is a director, general partner or officer exercising executive responsibility (or having similar status or functions); (ii) directly or indirectly has the right to vote 25% or more of a class of a voting security or has the power to sell or direct the sale of 25% or more of a class of voting securities; or (iii) in the case of a partnership, has the right to receive upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that company.” See Uniform Application for Broker-Dealer Registration (Form BD).

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## ATTACHMENT A

New language is underlined; deletions are in brackets.

### Code of Arbitration Procedure

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#### Rule 10308. Selection of Arbitrators

##### (a) Definitions

(1) - (3) No change

##### (4) "non-public arbitrator"

The term "non-public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and:

(A) is, or within the past 5 years, was:

(i) associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer);

(ii) registered under the Commodity Exchange Act;

(iii) a member of a commodities exchange or a registered futures association;

or

(iv) associated with a person or firm registered under the Commodity Exchange Act;

(B) is retired from, or spent a substantial part of a career, engaging in any of the business activities listed in subparagraph (4)(A);

(C) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in subparagraph (4)(A); or

(D) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities futures or options or supervises or monitors the compliance with the securities and commodities laws of employees who engage in such activities.

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(5) "public arbitrator"

(A) The term "public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and:

(i) is not engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);

(ii) was not engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D) for a total of 20 years or more;

(iii) is not an investment adviser;

(iv) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past 2 years from any persons or entities listed in paragraph (a)(4)(A); [and]

(v) is not employed by, and is not the spouse or an immediate family member of a person who is employed by, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business;

(vi) is not a director or officer of, and is not the spouse or an immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business; and

(vii) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D).

(B) No change

(6) - (7) No change

(b) - (f) No change

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