

Notice to Members

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INFORMATIONAL

SUGGESTED ROUTING

Legal & Compliance

Arbitrator Classification

SEC Approves Amendments to Rules 10308 and 10312 Regarding Arbitrator Classification, Disclosures, and Challenges; **Effective Date: July 19, 2004**

KEY TOPICS

Arbitration
Arbitrators
Dispute Resolution

Executive Summary

The Securities and Exchange Commission (SEC or Commission) has approved amendments to Rules 10308 and 10312 of the NASD Code of Arbitration Procedure (Code) relating to arbitrator classification, disclosures, and challenges.¹

The text of the amendments is set forth in Attachment A. The amendments will be effective on July 19, 2004. Amendments relating to arbitrator classification will apply to arbitrator lists sent out according to Rule 10308(b)(5) on or after July 19, 2004, and to arbitrators appointed on or after July 19, 2004 by the Director of Arbitration under Rules 10308(c)(4)(B), 10308(d)(3), and 10313 when an insufficient number of names remain on the consolidated list. The amendments to the standard for deciding challenges for cause under Rule 10308(d) and Rule 10312(d) will apply to challenges for cause made on or after July 19, 2004.

Questions/Further Information

Questions regarding this *Notice* may be directed to Jean I. Feeney, Vice President and Chief Counsel, NASD Dispute Resolution, at (202) 728-6959, or e-mail jean.feeney@nasd.com.

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Discussion

NASD has amended Rules 10308 and 10312 of the Code to:

- (1) modify the definitions of public and non-public arbitrators to further ensure that individuals with significant ties to the securities industry are not able to serve as public arbitrators;
- (2) provide specific standards for deciding challenges to arbitrators for cause; and
- (3) clarify that compliance with arbitrator disclosure requirements is mandatory.

Background

In July 2002, the SEC retained Professor Michael Perino to assess the adequacy of NASD and New York Stock Exchange arbitrator disclosure requirements, and to evaluate the impact of the California Ethics Standards² on the current conflict disclosure rules of the self-regulatory organizations (SROs). The SEC released Professor Perino's report, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations* (Perino Report), on November 4, 2002.³

The Perino Report observed that, "Current SRO conflict standards are consistent with model disclosure standards and judicial opinions analyzing arbitrator disclosure requirements," and concluded that undisclosed conflicts of interest were not a significant problem in SRO-sponsored arbitrations. Specifically, the Report concluded that adoption of the California Ethics Standards by SROs would yield very few benefits to parties, but would impose significant costs and could have significant unintended consequences that might reduce investors' perception of the fairness of SRO arbitrations. However, the Perino Report recommended several amendments to SRO arbitrator classification and disclosure rules that, according to the Report, might "provide additional assurance to investors that arbitrations are in fact neutral and fair."

These amendments implement the Perino Report recommendations, as well as several other related changes to the definition of public and non-public arbitrators that are consistent with the Perino Report recommendations.

Definition of Public and Non-Public Arbitrators

The Code classifies arbitrators as public or non-public ("industry"). When investors have a dispute with member firms or associated persons in NASD arbitration, they are entitled to have their cases heard by a 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.⁴

Rule 10308(a)(5) defines public arbitrators as persons who are qualified to serve as arbitrators and who are not either personally engaged in certain activities that would make them non-public, or the immediate family member of a person engaged in such activities.

The amendments change these definitions in several ways to further ensure that individuals with significant ties to the securities industry are not able to serve as public arbitrators. Specifically, the definition of non-public arbitrator in Rule 10308(a)(4) has been amended to:

- ▶ Increase from three years to five years the period for transitioning from a non-public to a public arbitrator; and
- ▶ Clarify that the term “retired” from the industry includes anyone who spent a substantial part of his or her career in the industry.

In addition, the definition of “public arbitrator” in Rule 10308(a)(5)(A) has been amended to:

- ▶ Prohibit anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator, regardless of how many years ago the association ended;
- ▶ Exclude from the definition of public arbitrator those attorneys, accountants, and other professionals whose firms have derived 10 percent or more of their annual revenue, in the last two years, from clients involved in the activities defined in the definition of non-public arbitrator; and
- ▶ Provide that investment advisers may not serve as public arbitrators, and may only serve as non-public arbitrators if they otherwise qualify under Rule 10308(a)(4).

The amendments also change significantly the definition of “immediate family member” in Rule 10308(a)(5)(B) to further ensure that individuals with significant, albeit indirect, ties to the securities industry may not serve as public arbitrators. The Perino Report recommended that NASD expand the definition of “immediate family member” to include parents and children, even if the parent or child does not share a home with, or receive substantial support from, a non-public arbitrator. Although the Perino Report referred only to parents and children, NASD believes that the same rationale applies to stepparents and stepchildren, and therefore has included such relationships in the definition as well. In addition, although the Perino Report did not address the issue, NASD believes that it is consistent with the Perino Report recommendations to include in the definition of the term “immediate family member” anyone, related or not, who is a member of the household of a non-public arbitrator.

Standard for Deciding Challenges for Cause

Rules 10308(d) and 10312(d) of the Code provide that, under certain circumstances, the Director of Dispute Resolution may remove an arbitrator upon request of a party or under the Director's own initiative. Rule 10308(d)(1) provides that, before the first hearing session, if a party objects to the continued service of an arbitrator, the Director may disqualify an arbitrator if the Director determines that the arbitrator should be disqualified. Rule 10312(d)(1) provides that the Director may remove an arbitrator from a panel based on information that must be disclosed pursuant to the rule. Under both rules, once the first hearing session has begun, the Director may only remove an arbitrator based on information that was required to be disclosed under Rule 10312 but was not previously disclosed.

The Code does not provide a specific standard for deciding whether an arbitrator should be removed under these provisions. However, the NASD Arbitrator's Manual states:

A challenge for cause to a particular arbitrator will be granted where it is reasonable to infer an absence of impartiality, the presence of bias, or the existence of some interest on the part of the arbitrator in the outcome of the arbitration as it affects one of the parties. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.⁵

The Perino Report noted that including this standard in the Code would provide greater transparency with respect to challenges for cause, and would enhance the parties' confidence that all challenges for cause will be granted or denied on the same basis. Therefore, NASD has amended Rule 10308(d) and Rule 10312(d) to provide that, in deciding challenges for cause, the Director will apply the standard described above.

In addition, based on the recommendation of the Perino Report, NASD has amended Rule 10308 to add a new paragraph (f) providing that, consistent with both NASD current practice and the New York Stock Exchange's Guidelines for Classifying Arbitrators, close questions regarding arbitrator classification or challenges for cause brought by a public customer will be resolved in favor of the customer.

Arbitrator Duty to Disclose and Update Conflict Information

Rule 10312(a) of the Code provides that arbitrators “shall be required to disclose” any circumstances which might preclude an arbitrator from rendering an objective and impartial determination, and enumerates specific personal, professional and financial information that “should” be disclosed under the rule. Rule 10312(b) provides that arbitrators “should” make a reasonable effort to inform themselves of any such conflicts. Rule 10312(c) provides that the duties imposed by paragraphs (a) and (b) are ongoing, and that arbitrators must disclose at any stage of the proceeding any such information that arises, is recalled or discovered.

While NASD has always interpreted Rule 10312 to impose a mandatory duty on arbitrators to disclose the required information, and to update their disclosure, the Perino Report noted that the use of the term “should” in paragraphs (a) and (b) of the rule may create the misimpression that disclosing and updating the information are merely recommended, but not required. Therefore, to eliminate any possible misunderstanding or confusion, NASD has amended Rule 10312(a) and (b) to clarify that arbitrators “must” disclose the required information and “must” make reasonable efforts to inform themselves of potential conflicts and update their disclosures as necessary.

Updating of Arbitrator Disclosures

NASD has distributed 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 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 in open arbitration cases the arbitrator classification amendments will not apply to arbitrators on lists already sent to the parties prior to the effective date, or to arbitrators who are already serving on panels prior to the effective date. 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.

Effective Date

The amendments described in this Notice are effective on July 19, 2004. Amendments relating to arbitrator classification will apply to arbitrator lists sent out pursuant to Rule 10308(b)(5) on or after July 19, 2004, and to arbitrators appointed on or after July 19, 2004 by the Director of Arbitration under Rules 10308(c)(4)(B), 10308(d)(3), and 10313 when an insufficient number of names remain on the consolidated list. The amendments to the standard for deciding challenges for cause under Rule 10308(d) and Rule 10312(d) will apply to challenges for cause made on or after July 19, 2004.

Endnotes

- 1 Exchange Act Release No. 49573 (April 16, 2004) (File No. SR-NASD-2003-095), 69 Federal Register 21871 (April 22, 2004). An additional, technical amendment to Rule 10308 was filed for immediate effectiveness on June 7, 2004 (File No. SR-NASD-2004-087).
- 2 California Rules of Court, Division VI of the Appendix, entitled, "*Ethics Standards for Neutral Arbitrators in Contractual Arbitration.*" See more information on the NASD Web Site at: www.nasdadr.com/ca_arb_notice.asp
- 3 The Perino Report may be found on the SEC Division of Market Regulation Web Site at: <http://www.sec.gov/divisions/marketreg.shtml>.
- 4 The panel composition for intra-industry disputes (not involving any parties who are investors) 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 such panels.
- 5 As the Perino Report noted, this is essentially the same standard followed by the New York Stock Exchange.

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ATTACHMENT A

New language is underlined; deletions in brackets.

Code of Arbitration Procedure

* * * *

Rule 10308. Selection of Arbitrators

This Rule specifies how parties may select or reject arbitrators, and who can be a public arbitrator.

(a) Definitions

(1)-(3) Unchanged

* * *

(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 [three] 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 2 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.

(5) "public arbitrator"

(A) The term "public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and [is not]:

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

(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).

(B) For the purpose of this Rule, the term "immediate family member" means:

(i) the parent, stepparent, child, or stepchild, of a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);

[(i)] (ii) a [family member who shares a home with] member of the household of a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);

[(ii)] (iii) a person who receives financial support of more than 50 percent of his or her annual income from a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);
or

[(iii)] (iv) a person who is claimed as a dependent for federal income tax purposes by a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D).

* * *

(6)-(7) Unchanged

(b)-(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) Removal by Director

After the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, the Director may remove an arbitrator based only on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

(3) Standards for Deciding Challenges for Cause

The Director will grant a party's request to disqualify an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has an interest in the outcome of the arbitration. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.

[(3)] (4) Vacancies Created by Disqualification or Resignation

Prior to the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, if an arbitrator appointed to an arbitration panel is disqualified or is otherwise unable or unwilling to serve, the Director shall appoint from the consolidated list of arbitrators the arbitrator who is the most highly ranked available arbitrator of the proper classification remaining on the list. If there are no available arbitrators of the proper classification on the consolidated list, the Director shall appoint an arbitrator of the proper classification subject to the limitation set forth in paragraph (c)(4)(B). The Director shall provide the parties information about the arbitrator as provided in paragraph (b)(6), and the parties shall have the right to object to the arbitrator as provided in paragraph (d)(1).

(e) Discretionary Authority

The Director may exercise discretionary authority and make any decision that is consistent with the purposes of this Rule and the Rule 10000 Series to facilitate the appointment of arbitration panels and the resolution of arbitration disputes.

(f) Challenges by Customers

In cases involving public customers, any close questions regarding arbitrator classification or challenges for cause brought by a customer will be resolved in favor of the customer.

* * *

Rule 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, 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] must disclose any such relationships or circumstances that they have with any party or its counsel, or with any individual whom they have been told will be a witness. They [should] must 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] must make a reasonable effort to inform themselves of any interests, 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) Removal by Director

(1) The Director may remove an arbitrator based on information that is required to be disclosed pursuant to this Rule.

(2) After the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, 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 subparagraph (2) may be exercised only by the Director or the President of NASD Dispute Resolution.

(3) The Director will grant a party's request to disqualify an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has an interest in the outcome of the arbitration. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.

(e) Unchanged.

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