

Regulatory Notice

08-22

Definition of Public Arbitrator

SEC Approves Rule Change to Amend the Definition of Public Arbitrator in the Arbitration Codes for Customer and Industry Disputes

Effective June 9, 2008

Executive Summary

Effective June 9, 2008, FINRA will add an annual revenue limitation to the definition of public arbitrator, set forth in the Code of Arbitration Procedure for Customer Disputes and the Code of Arbitration Procedure for Industry Disputes. The amendment, which was approved by the Securities and Exchange Commission, will ensure that individuals with ties to the securities industry may not serve as public arbitrators in FINRA arbitrations.¹

The text of the amendment is set forth in Attachment A. The amendment will apply to arbitrator lists sent out according to Rules 12403 or 13403 on or after June 9, 2008, and to arbitrators appointed by the Director of Arbitration according to Rules 12406(c), 12411(c), 13406(c) or 13411(c) on or after June 9, 2008, when an insufficient number of names remain on the consolidated list.

Questions concerning this *Notice* should be directed to Barbara L. Brady, Vice President and Director of Neutral Management, at (212) 858-4352 or barbara.brady@finra.org; or Mignon McLemore, Assistant Chief Counsel, FINRA Dispute Resolution, at (202) 728-8151 mignon.mclemore@finra.org.

May 2008

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal

Key Topic(s)

- Arbitration
- Code of Arbitration Procedure
- Dispute Resolution
- Public Arbitrator

Referenced Rules & Notices

- NASD Rule 12100(u)
- NASD Rule 13100(u)

Background

For most disputes, FINRA maintains three types of arbitrator rosters: public, non-public and chairperson.² When investors file a dispute against member firms or their associated persons in FINRA'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, one of whom is the chairperson, and one non-public arbitrator, depending on the amount of the claim.³

Under Rule 12100(p) of the Code of Arbitration Procedure for Customer Disputes (Customer Code) and Rule 13100(p) of the Code of Arbitration Procedure for Industry Disputes (Industry Code) (hereinafter, Rules 12100(p) and 13100(p)), a person is classified as a non-public arbitrator if he or she:

- (1) is or, within the past five years, was:
 - (A) associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer);
 - (B) registered under the Commodity Exchange Act;
 - (C) a member of a commodities exchange or a registered futures association; or
 - (D) associated with a person or firm registered under the Commodity Exchange Act;
- (2) is retired from, or spent a substantial part of a career engaging in, any of the business activities listed in paragraph (p)(1);
- (3) 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 paragraph (p)(1); or
- (4) 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 Rules 12100(u) and 13100(u). Under these rules, an individual will be classified as a public arbitrator if he or she is qualified to serve as an arbitrator and:

- (1) is not engaged in the conduct or activities described in paragraphs (p)(1)-(4);
- (2) was not engaged in the conduct or activities described in paragraphs (p)(1)-(4) for a total of 20 years or more;
- (3) is not an investment adviser;
- (4) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past two years from any persons or entities listed in paragraphs (p)(1)-(4);

- (5) 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;
- (6) 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
- (7) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (p)(1)-(4). For purposes of this rule, the term immediate family member means:
 - (A) a person's parent, stepparent, child, or stepchild;
 - (B) a member of a person's household;
 - (C) an individual to whom a person provides financial support of more than 50 percent of his or her annual income; or
 - (D) a person who is claimed as a dependent for federal income tax purposes.

Discussion

FINRA has amended Rules 12100(u) and 13100(u) to add a revenue limitation to the definition of public arbitrator to ensure that individuals with significant ties to the securities industry may not serve as public arbitrators in FINRA arbitrations. Specifically, the rule excludes individuals from the public arbitrator roster who are attorneys, accountants or other professionals whose firm derived \$50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1) relating to any customer disputes concerning an investment account or transaction, including but not limited to, law firm fees, accounting firm fees and consulting fees. The rule will enhance FINRA's public arbitrator roster by removing from the pool of public arbitrators those individuals whose firms receive a significant amount of compensation for providing services on matters closely related to those that arbitrators consider during arbitration proceedings.

The following example shows how FINRA will apply the rule.⁴ In the example, a public arbitrator is an accountant whose firm has been retained by a broker-dealer to review account statements and other documents in preparation for an arbitration relating to unauthorized trading in a customer's account.

In Year 1, the accountant's firm receives \$35,000 in annual revenue from the broker-dealer for rendering these services. Revenue earned under the rule is calculated after the year ends. Thus, the accountant could continue to serve as a public arbitrator in Year 2, because in the past year, the revenue that the accountant's firm received from the broker-dealer for professional services related to a customer dispute did not exceed \$50,000.

In Year 2, the accountant's firm receives \$45,000 in annual revenue from the broker-dealer for rendering the same types of services. Because the revenue that the accountant's firm received from the broker-dealer for professional services related to a customer dispute did not exceed \$50,000 in either Year 1 or Year 2, the accountant may continue to serve as a public arbitrator in Year 3.

In Year 3, the accountant's firm receives \$61,000 in annual revenue from the broker-dealer for rendering the same types of services. Under the rule, the accountant could no longer be classified as a public arbitrator, because the revenue that the accountant's firm received from the broker-dealer for professional services related to a customer dispute exceeded \$50,000 in Year 3.⁵

In Year 4, the accountant's firm receives \$20,000 in annual revenue from the broker-dealer for rendering the same types of services. Under the rule, the accountant continues to be ineligible to be classified as a public arbitrator, because the revenue that the accountant's firm received from the broker-dealer for professional services related to a customer dispute exceeded \$50,000 in Year 3 (one of the past two years). After the end of Year 5, if the accountant firm's revenue has not exceeded \$50,000 in Year 5, the arbitrator should update his or her arbitrator disclosures, so that staff may consider the past two years' revenue and all other applicable criteria to determine whether the arbitrator is again eligible to be classified as a public arbitrator.

Updating Arbitrator Disclosures

FINRA has distributed a survey to all arbitrators on the active roster asking them to update their disclosures in light of the above amendment to the definition of public arbitrator. 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 amendment.

As the two-year period is a rolling window of time, arbitrators are reminded to update their disclosures whenever there is a change in their circumstances that affects their classification.

Parties should be aware that the amendment to the public arbitration definition applies to lists generated on or after effective date, and to arbitrators appointed on or after the effective date. Arbitrators who have been included on a list sent to parties or who are already serving on panels may continue to serve even if their classification would otherwise change due to the amendment. These arbitrators will retain their former classification for purposes of these ongoing cases. This will avoid disruption to cases 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 12408 and 12410 and Rules 13408 and 13410.

Effective Date Provisions

The amendment will become effective on June 9, 2008; and will apply to arbitrator lists sent out according to Rules 12403 or 13403 on or after June 9, 2008, and to arbitrators appointed by the Director of Arbitration according to Rules 12406(c), 12411(c), 13406(c) or 13411(c) on or after June 9, 2008, when an insufficient number of names remain on the consolidated list.

Endnotes

- 1 Exchange Act Release No. 57492 (March 13, 2008), 73 Federal Register 15025 (March 20, 2008) (File No. SR-NASD-2007-021).
- 2 See Rules 12400(b) and 13400(b). There also is a specialized roster of experienced employment arbitrator for use in intra-industry disputes involving statutory employment discrimination. See Rule 13802.
- 3 See Rules 12401, 12402 and 12403. *See also* Rules 13401, 13402 and 13403 for panel composition rules governing intra-industry disputes (not involving any parties who are investors). For intra-industry disputes, depending on the nature of the dispute, panels may consist of all public arbitrators, all non-public arbitrators or a majority of public arbitrators.
- 4 The examples are meant to be illustrative only, and should not be viewed as an exhaustive list of circumstances to which the rule would apply.
- 5 The accountant may be eligible to serve as a non-public arbitrator, provided he or she meets the criteria of Rules 12100(p) and 13100(p).

ATTACHMENT A

New language is underlined; deletions are in brackets.

Code of Arbitration Procedure for Customer Disputes and Code of Arbitration Procedure for Industry Disputes

Customer Code

12100(u). Public Arbitrator

The term “public arbitrator” means a person who is otherwise qualified to serve as an arbitrator and:

(1) – (4) No change;

(5) is not an attorney, accountant, or other professional whose firm derived \$50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1) relating to any customer disputes concerning an investment account or transaction, including but not limited to, law firm fees, accounting firm fees, and consulting fees;

(6) 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;

[(6)] (7) 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

[(7)] (8) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (p)(1)-(4). For purposes of this rule, the term immediate family member means:

(A) a person’s parent, stepparent, child, or stepchild;

(B) a member of a person’s household;

(C) an individual to whom a person provides financial support of more than 50 percent of his or her annual income; or

(D) a person who is claimed as a dependent for federal income tax purposes.

{Remainder of rule – no change.}

Industry Code**13100(u). Public Arbitrator**

The term “public arbitrator” means a person who is otherwise qualified to serve as an arbitrator and:

(1) – (4) No change;

(5) is not an attorney, accountant, or other professional whose firm derived \$50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1) relating to any customer disputes concerning an investment account or transaction, including but not limited to, law firm fees, accounting firm fees, and consulting fees;

(6) 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;

[(6)] (7) 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

[(7)] (8) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (p)(1)-(4). For purposes of this rule, the term immediate family member means:

(A) a person’s parent, stepparent, child, or stepchild;

(B) a member of a person’s household;

(C) an individual to whom a person provides financial support of more than 50 percent of his or her annual income; or

(D) a person who is claimed as a dependent for federal income tax purposes.

{Remainder of rule – no change.}
