July 10, 1998

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

Re: **SR-NASD-98-48**
Proposed Rule Change to Amend the Method of Selecting Arbitrators in Customer Disputes

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed is the above-numbered rule filing. Also enclosed is a 3-l/2" disk containing the rule filing in WordPerfect 5.0 to facilitate production of the Federal Register.

If you have any questions, please contact Sharon Zackula, Assistant General Counsel, Office of the General Counsel, NASD Regulation, Inc., at (202) 728-8985; e-mail zackulas@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Joan C. Conley
Secretary

Attachment

File No. SR-NASD-98-48
Consists of 113 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 Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), NASD Regulation, Inc. ("NASD Regulation") is filing with the Securities and Exchange Commission ("SEC") a proposed rule change to amend Rule 10308 of the National Association of Securities Dealers, Inc. ("NASD" or "Association") to set forth new procedures to be used to select arbitrators for arbitrations involving public customers.[1] Under the new procedures, NASD Regulation will allow the parties to an arbitration to rank arbitrators from lists generated primarily using an automated process, providing parties with a substantial role in determining the composition of their arbitration panels. NASD Regulation is proposing conforming changes to Rules 10104, 10309, 10310, 10311, 10312, and 10313. In addition, NASD Regulation proposes to amend Rule 10315 concerning the scheduling of the first meeting of the parties and the arbitration panel to reflect that such meetings usually occur prior to the first hearing of an arbitration proceeding. Finally, NASD Regulation proposes to correctly state in the Rule 10000 Series and any other Rules the name of the NASD Regulation committee that addresses arbitration and related matters, the National Arbitration and Mediation Committee.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

[1] NASD Regulation also intends to file a proposed rule change to use a similar list selection process for intra-industry arbitrations.

* * *

10104. Composition and Appointment of Panels

Except as otherwise specifically provided in Rule 10308, t[T]he Director [of Arbitration] shall compose and appoint panels of arbitrators from the existing pool of arbitrators of the Association to conduct the arbitration of any matter which shall be eligible for submission under this Code. [The Director of Arbitration may request that the Executive Committee of the National Arbitration Committee undertake the composition and appointment of a panel or undertake consultation with the Executive Committee regarding the composition and appointment of a panel in any circumstance where he determines such action to be appropriate.]

*** * ***

10308. [Designation of Number of Arbitrators] Selection of Arbitrators in Customer Disputes

[(a) Except as otherwise provided in Rule 10302, in all arbitration matters involving public customers and where the amount in controversy does not exceed $30,000, the Director of Arbitration shall appoint a single public arbitrator knowledgeable in but who is not from the securities industry to decide the dispute, claim or controversy. Upon the request of a party in its initial filing or the arbitrator, the Director of Arbitration shall appoint a panel of three (3) arbitrators which shall decide the matter in controversy. At least a majority of the arbitrators appointed shall not be from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

(b) In arbitration matters involving public customers and where the amount in controversy exceeds $50,000, exclusive of attendant costs and interest, or where the matter in controversy does not involve or disclose a money claim, the Director of Arbitration shall appoint a panel of three (3) arbitrators, at least a majority of whom shall not be from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

(c) An arbitrator will be deemed as being from the securities industry if he or she:

(1) is a person associated with a member or other broker/dealer, municipal securities dealer, government securities broker, or government securities dealer, or

(2) has been associated with any of the above within the past three (3) years, or

(3) is retired from any of the above, or

(4) is an attorney, accountant, or other professional who has devoted twenty (20) percent or more of his or her professional work effort to securities industry clients within the last two years, or

(5) is an individual who is registered under the Commodity Exchange Act or is a member of a registered futures association or any commodities exchange or is associated with any such person(s).

(d) An arbitrator who is not from the securities industry shall be deemed a public arbitrator. A person will not be classified as a public arbitrator if he or she has a spouse or other member of the household who is a person who is associated with a member or other

broker/dealer, municipal securities dealer, government securities broker, or government securities dealer.]

This rule specifies how parties may select or reject arbitrators, and who can be a public arbitrator in arbitration proceedings involving a customer.

(a) Definitions

(1) "day"

For purposes of this rule, the term "day"means calendar day.

(2) "claimant"

For purposes of this rule, the term "claimant" means one or more persons who file a single claim.

(3) "Neutral List Selection System"

The term "Neutral List Selection System" means the software that maintains the roster of arbitrators and performs various functions relating to the selection of arbitrators.

(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 years, was:

(i) associated with a broker or a dealer (including a government or a municipal securities broker or 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 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 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) engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D); or

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

(ii) 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) 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) "respondent"

For purposes of this rule, the term "respondent" means one or more persons who individually or jointly file an answer to a complaint.

(7) "send"

For purposes of this rule, the term "send" means to send by first class mail, facsimile, or any other method available and convenient to the parties and the Director.

(b) Composition of Arbitration Panel; Preparation of Lists for Mailing to Parties

(1) Composition of Arbitration Panel

(A) General Rule Regarding Panel Composition

(i) If the amount of a claim is $50,000 or less, the Director shall appoint an arbitration panel composed of one public arbitrator, unless the parties agree otherwise.

(ii) If the amount of a claim is more than $50,000, the Director shall appoint an arbitration panel composed of one non-public arbitrator and two public arbitrators, unless the parties agree otherwise.

(B) Special Request

If the amount of a claim is greater than $25,000 and not more than $50,000 and the claimant requests that a panel of three arbitrators be appointed, the Director shall appoint an arbitration panel composed of one non-public arbitrator and two public arbitrators, unless the parties agree otherwise.

(2) One List for Panel of One Arbitrator

If one arbitrator will serve as the arbitration panel, the Director shall send to the parties one list of public arbitrators, unless the parties agree otherwise.

(3) Two Lists for Panel of Three Arbitrators

If three arbitrators will serve as the arbitration panel, the Director shall send two lists to the parties, one with the names of public arbitrators and one with the names of non-public arbitrators. The lists shall contain numbers of public and

non-public arbitrators, in a ratio of approximately two to one, respectively, to the extent possible, based on the roster of available arbitrators.

(4) Preparation of Lists

(A) Except as provided in subparagraph (B) below, the Neutral List Selection System shall generate the lists of public and non-public arbitrators on a rotating basis within a designated geographic hearing site and shall exclude arbitrators based upon conflicts of interest.

(B) If a party requests that the lists include arbitrators with expertise classified in the Neutral List Selection System, the lists may include some arbitrators having the designated expertise.

(5) Sending of Lists to Parties

The Director shall send the lists of arbitrators to all parties at the same time approximately 30 days after the last answer is due.

(6) Information About Arbitrators

The Director shall send to the parties employment history for each listed arbitrator for the past 10 years and any information disclosed by the arbitrator under Rule 10312 relating to personal or financial interests or the existence of a relationship that gives rise to an appearance of a conflict of interest or bias. If a party requests additional information about an arbitrator, the Director shall send such request to the arbitrator, and shall send the arbitrator's response to all parties at the same time. When a party requests additional information, the Director may,

but is not required to, toll the time for the parties to return the ranked lists under paragraph (c)(2).

(c) Striking, Ranking, and Appointing Arbitrators on Lists

(1) Striking and Ranking Arbitrators

(A) Striking An Arbitrator

A party may strike one or more of the arbitrators from each list for any reason.

(B) Ranking - Panel of One Arbitrator

Each party shall rank all of the arbitrators remaining on the list by assigning each arbitrator a different, sequential, numerical ranking.

(C) Ranking - Panel of Three Arbitrators

Each party shall rank all of the public arbitrators remaining on the list by assigning each arbitrator a different, sequential, numerical ranking, and separately shall rank all of the non-public arbitrators remaining on the list, using the same procedure.

(D) Joint Action Permitted

All claimants may act jointly and all respondents, including third-party respondents, may act jointly to file a single list that reflects their unanimous agreement as to the striking and ranking of arbitrators. If multiple claimants or respondents do not act jointly, the rankings of multiple claimants or respondents will be consolidated as described in paragraph (b)(3)(A).

(2) Period for Ranking Arbitrators; Failure to Timely Strike and Rank

A party must return to the Director the list or lists with the rankings not later than 20 days after the Director sent the lists to the parties, unless the Director has extended the period. If a party does not timely return the list or lists, the Director shall treat the party as having retained all the arbitrators on the list or lists and as having no preferences.

(3) Process of Consolidating Parties' Rankings

(A) General Rule

The Director shall prepare one or two consolidated lists of arbitrators, as appropriate under paragraph (b)(2) or (b)(3), based upon the parties' numerical rankings. The arbitrators shall be ranked by adding the rankings of all claimants together and all respondents together, including third-party respondents, to produce separate consolidated rankings of the claimants and the respondents. The Director shall then rank the arbitrators by adding the consolidated rankings of the claimants, the respondents, including third party respondents, and any other party together, to produce a single consolidated ranking number, excluding arbitrators who were stricken by any party.

(B) Exception

If the Director determines that the interests of a party are sufficiently different from the interests of other claimants or respondents,

the Director may determine not to consolidate the rankings of that party with the rankings of the other claimants or respondents.

(4) Appointment of Arbitrators

(A) Appointment of Listed Arbitrators

The Director shall appoint arbitrators to serve on the arbitration panel based on the order of rankings on the consolidated list or lists, subject to availability and disqualification.

(B) Discretion to Appoint Arbitrators Not on List

If the number of arbitrators available to serve from the consolidated list is not sufficient to fill a panel, the Director shall appoint one or more arbitrators to complete the arbitration panel; *provided*, however, unless the parties agree otherwise, the Director may not appoint a non-public arbitrator under paragraphs (a)(4)(B) or (a)(4)(C).

(5) Selecting a Chairperson for the Panel

The parties shall have 15 days from the date the Director sends notice of the names of the arbitrators to select a chairperson. If the parties cannot agree, the Director shall appoint one of the public arbitrators as the chairperson. Unless all parties agree otherwise, the Director shall not appoint as the chairperson a public arbitrator who:

(A) is an attorney, accountant, or other professional, and

(B) has devoted 50% or more of his or her professional or business activities, within the last two years, to representing or advising public

customers in matters relating to disputed securities or commodities transactions or similar matters.

(6) Additional Parties

If a party is added to an arbitration proceeding before the Director has consolidated the other parties' rankings, the Director shall send to that party the list or lists of arbitrators and permit the party to strike and rank the arbitrators. The party must return to the Director the list or lists with numerical rankings not later than 20 days after the Director sent the lists to the party. The Director shall then consolidate the rankings as specified in this paragraph (c).

(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 (i) the first prehearing conference or (ii) 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

After the commencement of the earlier of (i) the first prehearing

conference or (ii) the first hearing, the Director's authority to remove an arbitrator from an arbitration panel ceases.

(3) Vacancies Created by Disqualification or Resignation

If an arbitrator appointed to an arbitration panel is disqualified or resigns from an arbitration panel, 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).

(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.

Rule 10309. Composition of Panels

Except as otherwise specifically provided in Rule 10308, t[T]he individuals who shall serve on a particular arbitration panel shall be determined by the Director [of Arbitration]. Except as otherwise specifically provided in Rule 10308, t[T]he Director [of Arbitration] may name the chairman of the panel.

Rule 10310. Notice of Selection of Arbitrators

(a) The Director shall inform the parties of the arbitrators' names and employment histories for the past 10 years, as well as information disclosed pursuant to Rule 10312, at least 15 business days prior to the date fixed for the first hearing session. A party may make further inquiry of the Director [of Arbitration] concerning an arbitrator's background. In the event that, prior to the first hearing session, any arbitrator should become disqualified, resign, die, refuse or otherwise be unable to perform as an arbitrator, the Director shall appoint a replacement arbitrator to fill the vacancy on the panel. The Director shall inform the parties as soon as possible of the name and employment history of the replacement arbitrator for the past 10 years, as well as information disclosed pursuant to Rule 10312. A party may make further inquiry of the Director [of Arbitration] concerning the replacement arbitrator's background and within the time remaining prior to the first hearing session or the 10 day period provided under Rule 10311, whichever is shorter, may exercise its right to challenge the replacement arbitrator as provided in Rule 10311.

(b) This rule shall not apply to arbitration proceedings that are subject to Rule 10308.

Rule 10311. Peremptory Challenge

(a) In an[y] arbitration proceeding, each party shall have the right to one [(1)] peremptory challenge. In arbitrations where there are multiple Claimants, Respondents, and/or Third-Party Respondents, the Claimants shall have one [(1)] peremptory challenge, the Respondents shall have one [(1)] peremptory challenge, and the Third-Party

Respondents shall have one [(1)] peremptory challenge. The Director [of Arbitration] may in the interests of justice award additional peremptory challenges to any party to an arbitration proceeding. Unless extended by the Director [of Arbitration], a party wishing to exercise a peremptory challenge must do so by notifying the Director [of Arbitration] in writing within 10 business days of notification of the identity of the person(s) named under Rule 10310 or Rule 10321(d) or (e), whichever comes first. There shall be unlimited challenges for cause.

(b) This rule shall not apply to arbitration proceedings that are subject to Rule 10308.

Rule 10312. Disclosures Required of Arbitrators and Director's Authority To Disqualify

(a) through (c) No change

* * *

(d) The Director shall inform the parties to an arbitration proceeding of any information disclosed to the Director under this Rule unless the arbitrator who disclosed the information withdraws from being considered for appointment voluntarily and immediately after the arbitrator learns of any interest or relationship described in paragraph (a) that might preclude the arbitrator from rendering an objective and impartial determination in the proceeding.

([d]e) [Prior to the commencement of the first hearing session] Prior to the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, the Director [of Arbitration] may remove an arbitrator based on information disclosed

pursuant to this Rule. [The Director of Arbitration shall also inform the parties of any information disclosed pursuant to this Rule if the arbitrator who disclosed the information is not removed.]

(f) After the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, the Director's authority to remove an arbitrator from an arbitration panel ceases.

Rule 10313. Disqualification or Other Disability of Arbitrators

In the event that any arbitrator, after the commencement of the first hearing session but prior to the rendition of the award, should become disqualified, resign, die, refuse or otherwise be unable to perform as an arbitrator, the remaining arbitrator(s) shall continue with the hearing and determination of the controversy, unless such continuation is objected to by any party within 5 days of notification of the vacancy on the panel. Upon objection, the Director [of Arbitration] shall appoint a replacement arbitrator to fill the vacancy and the hearing shall continue. The Director [of Arbitration] shall inform the parties as soon as possible of the name and employment history of the replacement arbitrator for the past 10 years, as well as information disclosed pursuant to Rule 10312. A party may make further inquiry of the Director [of Arbitration] concerning the replacement arbitrator's background. If the arbitration proceeding is subject to Rule 10308, the party may exercise his or her right to challenge the replacement arbitrator within the time remaining prior to the next scheduled hearing session by notifying the Director in writing of the name of the arbitrator challenged and the basis for such challenge. If the arbitration proceeding is not subject to Rule 10308, [and] within the

time remaining prior to the next scheduled hearing session or the 5 day period provided under Rule 10311, whichever is shorter, a party may exercise the party's [its] right to challenge the replacement arbitrator as provided in Rule 10311.

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Rule 10315. Designation of Time and Place of First Meeting [Hearing]

The Director shall determine [T]the time and place of the first meeting of the arbitration panel and the parties, whether the first meeting is a pre-hearing conference or a hearing, [initial hearing shall be determined by the Director of Arbitration and each hearing thereafter by the arbitrators.] and shall give [N]notice of the time and place [for the initial hearing shall be given] at least [eight (8)]15 business days prior to the date fixed for the first meeting [hearing] by personal service, registered or certified mail to each of the parties unless the parties shall, by their mutual consent, waive the notice provisions under this Rule. The arbitrators shall determine the time and place for all subsequent meetings, whether the meetings are pre-hearing conferences, hearings, or any other type of meetings, and shall give [N]notice [for each hearing thereafter shall be given] as the arbitrators may determine. Attendance at a meeting [hearing] waives notice thereof.

* * *

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 ("NASD Regulation Board") at its meeting on September 20, 1996, which authorized the filing of the proposed rule change with the SEC. The proposed rule change was amended by the NASD Regulation Board on November 15, 1996. The Nasdaq Stock Market, Inc. ("Nasdaq") 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 NASD to Subsidiaries. The NASD Board of Governors ("NASD Board") had an opportunity to review the proposed rule change at its meetings on October 3, 1996, and January 28, 1997. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(2) to Article VI of the By-Laws permits the NASD Board to adopt amendments to the 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 Sharon Zackula, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8985.

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

a. Purpose

(1) Background

(A) Recommendations of the Task Force

The Arbitration Policy Task Force ("Task Force") in Securities Arbitration Reform: Report of the Arbitration Policy Task Force To the Board of Governors of NASD ("Task Force Report"), published in January 1996, made fourteen broad recommendations to the NASD Board to improve the securities arbitration process administered by the NASD. Recommendation No. 8 provided: "Arbitrator selection, quality, training, and performance should be improved by various means, including adoption of a list selection method, earlier appointment of arbitrators, enhancement of arbitrator training, and increased [arbitrator] compensation."[2]

The Task Force recommended that the NASD adopt "a variant of the AAA's method of selecting arbitrators" ("Recommendation One").[3] Under the system proposed by the Task Force:

> the parties would be provided with three lists of candidates: (i) a list of public arbitrators qualified to be panel chairs to contain no fewer than three names, (ii) a list of other public arbitrators, to contain no fewer than five names; and (iii) a

[2] Task Force Report at 2.

[3] Task Force Report at 94.

> list of industry arbitrators, to contain no fewer than five names. Each party could strike names from any of the lists and would then rank the remaining names on each list in order of preference. If mutually agreeable arbitrators are not selected, new lists would be provided for each category in which agreement was not reached. This process would continue for no more than three rounds. If, at the end of three rounds, an industry and two public arbitrators, one qualified as a panel chair, had not been chosen, the NASD Arbitration Department would appoint the remaining arbitrator or arbitrators. Arbitrators selected by the staff could be challenged only for cause. (Footnotes omitted)[4]

The Task Force also made two other recommendations to implement improvements in the selection of arbitrators. The Task Force recommended that the appropriate NASD staff (now NASD Regulation's Office of Dispute Resolution ("ODR")) should be able to exercise flexibility in designating arbitrators as either "public" or "industry" ("Recommendation Two").[5] In addition, the Task Force recommended that arbitrators be placed on the selection lists on a rotating basis to

[4] Task Force Report at 94-95.

[5] Task Force Report at 96.

promote more frequent selection of arbitrators who complete an arbitrator training program ("Recommendation Three").[6]

(B) Parties Consulted In Development of Rule

NASD Regulation considered the Task Force's recommendations at length. NASD Regulation also consulted with its National Arbitration and Mediation Committee ("NAMC"),[7] the Securities Industry Conference on Arbitration ("SICA"),[8] PIABA, the staff of the SEC, and others about the efficacy of the proposals. All persons consulted favored the selection of arbitrators by the parties using some form of list selection. In addition, most were in favor of developing a system featuring the capability, when appropriate and as technologically feasible, to generate the arbitrator lists from a computer programmed to incorporate relevant selecting factors, such as geographic proximity of an arbitrator to the proposed site of the hearing, subject matter expertise, and classification of an arbitrator as a public arbitrator[9] or a non-public arbitrator,[10] rather than developing a system in which the lists of arbitrators to be forwarded to parties for ranking would be generated solely on the basis of ODR's judgment.

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[6] Task Force Report at 97.

[7] The NAMC is a balanced committee of NASD Regulation. Committee members are individuals with broad and diverse experience in securities arbitration and mediation as representatives of investors, firms, firm employees, and neutrals (arbitrators and mediators).

[8] The membership of SICA is diverse and includes persons representing the interests of public customers (including members of the Public Investors Arbitration Bar Association ("PIABA")), representatives from the self-regulatory organizations, and the Securities Industry Association ("SIA").

[9] The term "public arbitrator" is defined in proposed Rule 10308(a)(5).

[10] The term "non-public arbitrator" is defined in proposed Rule 10308(a)(4).

(C) General Principles Underlying Proposed Rule Change

NASD Regulation recommends as a general principle that parties in arbitration be given more input into the selection of arbitrators. In furtherance of this principle, NASD Regulation has developed a rule providing that, in a one-arbitrator panel case, the parties to the arbitration will be provided a list of public arbitrators, and, in a three-arbitrator panel case, the parties will be provided a list of public and a list of non-public arbitrators.[11] The parties will use the lists to express numerical preferences for the arbitrators listed and those rankings will determine the outcome of the arbitrator selection process, unless all ranked arbitrators decline to serve because they are unavailable, recuse themselves, or are disqualified because of conflicts of interest.

The list or lists of arbitrators will be generated from an arbitrator database by a computer to further fairness and neutrality. This automated system is the Neutral List Selection System ("NLSS").[12] However, to preserve the exercise of discretion and judgment when appropriate and to act on behalf of a party's request, when a party or parties express a request for a process that may legitimately be considered in the selection of an arbitration panel but that NLSS is not capable of performing, or request an arbitration panel that may not be "selected" or "sorted" using the NLSS, the Director of Arbitration ("Director") may supplement the NLSS process.

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[11] In this rule filing, for ease of reference the discussion of the process of selecting an arbitration panel focuses more on the selection of a three-person arbitration panel than a one-person panel because the process of selecting one arbitrator is simpler and much less frequently employed.

[12] The term "Neutral List Selection System" is defined in proposed Rule 10308(a)(3).

In developing an arbitrator list selection rule to implement the Task Force's Recommendation One, NASD Regulation concluded that there were not enough arbitrators on the arbitrator roster of the ODR to provide sufficient names for three selection rounds. In addition, although NASD Regulation also initially considered a two-round, two-list selection method, NASD Regulation concluded that the operational burdens of administering such a process, especially given the limited number of arbitrators relative to the large caseload, would be too great. Also, NASD Regulation was concerned that a two-round, two-list selection method would make the process of appointing arbitrators too lengthy and would be too costly. Accordingly, NASD Regulation is proposing that the list selection rule contain a single-round, two-list selection process as set forth in greater detail below.

Notwithstanding, NASD Regulation's proposed rule change implements the fundamental aspect of Recommendation One in that it sets forth a list selection process that allows the parties to play the dominant role in selecting their arbitrators. In this proposed rule filing, NASD Regulation is also implementing Recommendation Three by placing arbitrators on a rotating list. By implementing Recommendations One and Three, the list selection process will function primarily through the operation of the NLSS, supplemented by the actions and judgments of the Director, but only when required to effect the appointment of a panel.

NASD Regulation is not implementing the Task Force's Recommendation Two that NASD staff should have discretionary authority regarding the classification of an arbitrator. Applying the explicit standards set forth in proposed paragraph (a), ODR will

designate an arbitrator as either "public" or "non-public" (*i.e.*, "industry") based upon the information provided about the person. At this time, NASD Regulation believes that it is impracticable to grant to the Director or the ODR the discretion or flexibility to modify the classification of an arbitrator based on information or criteria other than that which is set forth in the defined terms of "public arbitrator" or "non-public" arbitrator. Perceptions and expectations of participants about the backgrounds of potential arbitrators indicate that the participants do not believe that this flexibility would enhance the arbitrator selection process.[13]

NASD Regulation believes that the proposed methodology for selecting arbitrators will benefit investors, firms, associated persons, and other users of the arbitration forum. First, proposed Rule 10308 and NLSS, the technology developed to implement key parts of the proposed Rule, provide a system for selecting arbitrators that allows parties to have the greatest impact in the composition of their arbitration panel. Second, Proposed Rule 10308 is a more streamlined process than the process envisioned in the Task Force's Recommendation One. Third, proposed Rule 10308, a single-round process, will be less costly. Fourth, the proposed process borrows from the process used successfully for some time by the American Association of Arbitration ("AAA"), the largest domestic arbitration forum sponsor.

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[13] However, the ODR will have authority to change the classification of an arbitrator already classified in the NLSS based upon new information *(e.g.*, an arbitrator changes his or her employment and, after such change, the arbitrator fits the criteria for a non-public arbitrator, rather than the criteria for a public arbitrator).

(2) Description of Proposed Rule Change

The proposed rule change, which only governs the selection of arbitrators in cases involving public customers, is divided into five parts. Paragraph (a) contains definitions. In paragraph (b), NASD Regulation specifies how the lists of public and non-public arbitrators will be compiled and forwarded to the parties. Paragraph (c) specifies how the parties indicate their preferences by numerical rankings and how the Director reconciles the preferences of the parties, selects the arbitrators, selects the chairperson if the parties do not make the selection, and, if necessary, disqualifies an arbitrator before the arbitrator is appointed. Paragraph (d) describes generally how parties and the Director may remove a person from serving as an arbitrator if the person has a conflict of interest or a bias. Paragraph (e) specifies that the Director has discretionary authority to resolve issues arising in the administration of the list selection process.

There are several other rules in the Rule 10000 Series that NASD Regulation must amend in order to make the Rule Series 10000 consistent. The proposed amendments to those rules are discussed at the end of the discussion of the proposed changes to Rule 10308. *See* Miscellaneous Related Proposed Rule Changes, *infra*. Finally, NASD Regulation requests comments on the proposed rule change, including one important specific topic set forth separately below. *See* Request for Comments on Specific Issue, *infra*.

(A) Definitions -- Paragraph (a)

Paragraph (a) of the proposed rule change contains seven definitions: “day,” “claimant,” “Neutral List Selection System,” “non-public arbitrator,” “public arbitrator,”

"respondent" and "send." "Public arbitrator," "non-public arbitrator," and "Neutral List Selection System" are the three terms that are central to understanding how proposed Rule 10308, the proposed list selection rule, will operate.

In proposed paragraph (a)(4), a "non-public arbitrator" is defined as a person who is otherwise qualified to be an arbitrator and is employed in or retired from the securities or commodities industry or in a related position in the banking industry. The rule includes in the definition a person who is a professional, such as a lawyer or an accountant, who has a substantial client base that is engaged in the securities or commodities industry, or in a related banking activity described in the rule. Specifically, for arbitrator classification purposes, a non-public arbitrator is a person who:

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

(i) associated with a broker or a dealer (including a government or a municipal securities broker or 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 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 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 definition largely retains the existing definition in the Rule 10000 Series (the Code of Arbitration) of an arbitrator who is deemed to be "from the securities industry," but it adds to that defined term persons employed by banks and other financial institutions who are engaged in securities activities or in the supervision of such activities.

The second key defined term, "public arbitrator," is defined in paragraph (a)(5). "Public arbitrator" generally means a person who is otherwise qualified to serve as an arbitrator and is not engaged in the conduct of, or business activities that indicate an affiliation with, the securities industry or the related industries. Thus, in order to be classified as a public arbitrator one may not be engaged in any of the activities listed under the definition of "non-public arbitrator" in paragraphs (a)(4)(A) through (D), set forth above. The definition generally excludes: a person currently employed in the securities or commodities industry or a person retired from such business activities; a professional who devotes 20 percent or more of his or her time to securities industry clients; and an employee of a bank or other financial institution who is engaged in securities activities or in the supervision of such activities.

In addition, a spouse or an immediate family member of a current or retired member of the securities or commodities industry, or a person engaged in any of the other

types of business activities that require one to be classified as a "non-public arbitrator," is also excluded from being a "public arbitrator" because such persons' economic interests are too closely tied to those of the securities or commodities industry, even though such spouses and immediate family members may not be directly involved in the relevant business activities. "Immediate family member" is defined with reference to the person's familial or economic ties to the person associated with the securities or commodities industry.[14] Proposed Rule 10308(a)(5)(B). A person who has a close familial, personal, or economically dependent relationship with an associated person may be viewed as possessing a bias in favor of the securities or commodities industry even though he or she is not involved directly with the identified industry.[15]

The third key defined term, "Neutral List Selection System," defines the new software program that will implement the proposed list selection rule. NASD Regulation defines "Neutral List Selection System" as "the software that maintains the roster of

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[14] "Immediate family member" means:

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

[15] A small group of persons will be excluded from serving as either public or non-public arbitrators (*e.g.*, spouses and immediate family members of registered representatives). Excluded by subparagraph (a)(5) from serving as public arbitrators, such persons are also excluded from serving under subparagraph (a)(4) as non-public arbitrators because a non-public arbitrator must have the professional securities experience (or the related qualifications) listed in subparagraph (a)(4). For example, unless the spouse of a registered representative was also employed in the securities or commodities industry (or engaged in one of the business activities related to the securities industry), that person might not possess securities industry experience (or the related qualifications) and therefore could not serve as a non-public arbitrator. In addition, because of the marital relationship, the spouse would be excluded from serving as a public arbitrator.

arbitrators and performs various functions relating to the selection of arbitrators." Proposed Rule 10308(a)(3). Among other things, NLSS will maintain the roster of arbitrators, identify arbitrators as public or non-public, screen arbitrators for conflicts of interest with parties, list arbitrators according to geographic hearing sites and, on occasion, by expertise, and consolidate the numerical rankings that parties assign to listed arbitrators.

Two other terms, "claimant" and "respondent," are defined in paragraph (a) to simplify certain aspects of the rule. Under proposed Rule 10308(a)(2), if one or more persons files a single claim they will be treated as one claimant. A parallel definition is proposed for respondents; one or more persons who file the same answer will be treated as one respondent. Proposed Rule 10308(a)(6). The ODR views claimants who file one claim or respondents who file one answer as generally having sufficiently similar interests in the outcome of the proceeding to be considered as one party for purposes of the list selection process.[16] This approach will simplify consolidating the parties' preferences for arbitrators described below.[17]

(B) Composition of Arbitration Panel; Compilation of Lists of

Under proposed Rule 10308(b)(1), the rule sets forth the number of arbitrators that the Director should appoint to a panel, general panel composition requirements, and

[16] The consolidation process in described in greater detail below. However, it should be noted that a group of claimants that does not file a single claim, or, similarly, a group of respondents that does not file a single answer, does not obtain an advantage in the consolidation process or in the weighting of their preferences for arbitrators. For example, if in a case there are two claimants who are not viewed as one claimant under the rule, and one respondent, the two claimants' arbitrator rankings will be weighted as only 50% of the total; the one respondent's arbitrator rankings will be weighted as the other 50%.

[17] The terms "day" and "send" are also defined in paragraph (a).

exceptions to those requirements. If the claim is $50,000 or less, the claim will be heard by a single public arbitrator, unless the parties agree otherwise. Proposed Rule 10308 (b)(1)(A)(i). If the claim is more than $50,000, a panel of two public arbitrators and one non-public arbitrator will hear the dispute, unless the parties agree otherwise. Proposed Rule 10308(b)(1)(A)(ii). Under proposed paragraph (b)(1)(B), a claimant with a claim valued greater than $25,000 and not more than $50,000 may request a three-person arbitration panel.[18] Whether for a one-person panel or a three-person panel, the requirement that public arbitrators be empaneled is for the protection of investors, and parties may agree to waive this compositional requirement.

When the parties agree to change the composition of an arbitration panel from that set forth in proposed paragraph (b)(1)(A)(i) or (ii), references in the balance of the rule to a panel must be interpreted according to the panel composition that the parties have chosen. For example, if the parties agree to a panel composed of three public arbitrators, under proposed paragraph (c)(1)(C) the parties would rank a list of public arbitrators only, since the Director would not send the parties a list of non-public arbitrators. In addition, parties should be aware that if the panel composition varies from that provided in proposed paragraph (b)(1)(A)(i) or (ii), NLSS is not capable of processing all such combinations. NLSS can generate the lists and consolidate the rankings for a one-person panel of either public or non-public classification. For a three-person panel, NLSS can generate the lists and consolidate the rankings for a panel composed of one non-public

[18] Obtaining a three-person panel under this subparagraph then obligates the parties to pay hearing session deposit fees for a three-person panel under Rule 10332.

and two public arbitrators or three non-public arbitrators. NLSS cannot process requests for a panel composed of one public arbitrator and two non-public arbitrators or three public arbitrators.[19]

Under proposed paragraphs (b)(2) and (b)(3), the Director will send lists of names of arbitrators for ranking to the claimant and the respondent. As noted above, by operation of paragraph (a) of the proposed rule, a group of claimants who have filed one complaint will be viewed as one claimant; the same treatment is accorded to respondents who file a single answer. Thus, when reviewing the lists and otherwise taking action under the proposed rule, one or more persons viewed as one claimant must act jointly, and one or more persons viewed as one respondent must act jointly.

When only one arbitrator will hear the proceeding, the Director will send to the parties one list of public arbitrators. Proposed Rule 10308(b)(2). When three arbitrators will hear the proceeding, the Director will send the parties two lists, one containing the names of public arbitrators and the other containing the names of non-public arbitrators. Proposed Rule 10308(b)(3).

(i) Director's Minimum Numbers for Lists

Proposed Rule 10308 is flexible, and although subparagraphs (b)(2)and (b)(3) do not set a fixed ratio of arbitrators or a minimum number of arbitrators that ODR must list, ODR has established the following guidelines. For a panel of one arbitrator, the Director intends to provide five names of public arbitrators whenever possible, but not less than

[19] Although in theory the parties could agree to an arbitration panel composed of three public arbitrators, experience indicates that a panel of this type for disputes involving customers is almost never convened.

three names. For a panel of three arbitrators, the Director intends to provide lists that contain up to 10 public arbitrator names and five non-public arbitrator names; when that is not possible, the Director will provide a public arbitrator list of not less than six names, and a non-public arbitrator list of not less than three names. In addition, as illustrated by the example of the minimum numbers set forth above, to the extent possible, for a three-person panel, the list of public arbitrators will contain approximately twice as many names as the list of non-public arbitrators. The Director's ability to provide full lists of names will vary and is dependent on the number of available arbitrators and the local demands on the arbitrator roster. Circumstances may arise where a small arbitrator roster in a particular hearing location (*e.g.*, Richmond, Va., Norfolk, Va., Alaska, or Hawaii), combined with a high demand for arbitrators, will prevent the Director from meeting the objectives.

To address possible arbitrator shortages, the Director plans to combine arbitrators from proximate hearing locations when necessary. For example, under proposed paragraph (b)(2), the list to be sent to the parties should contain, at a minimum, three names of public arbitrators. If, with one hearing location coded into NLSS, NLSS does not generate the names of three public arbitrators, the Director will return to NLSS, add a second hearing location code, and generate a list of public arbitrators that will include the additional arbitrators. The second hearing location coded will be one that is geographically proximate to the first hearing location code used (*e.g.*, for a Richmond, Va. hearing, the Richmond hearing location code will be used first, and then the Atlanta or the Washington, D.C. hearing location code could be added). The additional process

in NLSS will be performed at no additional cost to the parties. The same process will be used to address any shortages in arbitrators under the lists prepared under proposed paragraph (b)(3).

(ii) NLSS Functions and Capabilities

Proposed paragraphs (b)(2), (3), and (4) together set forth the four factors which are used by NLSS to generate the list or lists of arbitrators by "selecting" or "sorting" the NLSS database. The four factors are arbitrator classification, hearing location code, rotation, and identified conflicts of interests.

To generate a list, NLSS performs the following steps. NLSS first identifies the subgroup of arbitrators by classification (public or non-public arbitrators). NLSS then identifies those arbitrators in the same hearing location as the arbitration. Thereafter, NLSS selects such public or non-public arbitrators who are located in the hearing location in rotation from the NLSS database.[20] Finally, NLSS excludes from the selection an

[20] The NLSS rotation feature also may be described as a "first-in-first-out" feature. For a case that will be heard by one public arbitrator, the following steps would apply. As an arbitrator's name rises to the top of the list of all arbitrators who are, for example, public arbitrators and found in one hearing location, the arbitrator's name will be generated by NLSS, absent an identified conflict of interest, on a list for ranking by parties to an arbitration. Once the arbitrator's name is sent to the parties, even if the arbitrator is later not appointed an arbitrator for the panel, NLSS places such arbitrator at the bottom of the computerized NLSS list. Thus, an arbitrator may be listed, and thereafter rotated to the bottom of the NLSS list even if: (1) the arbitrator recuses him or herself; (2) the arbitrator is not ranked highly enough by the parties to be appointed or the arbitrator was struck; or (3) the arbitrator is ranked highly enough to serve, is contacted, has no conflict of interest or bias that would disqualify him, but is unavailable to serve.

When a three person panel will be appointed, generally two public arbitrators and one non-public arbitrator are needed. For the generation of the list of non-public arbitrators and the list of public arbitrators, the same process would be used. For the selection of the non-public arbitrators, the first five non-public arbitrators in the system will be rotated forward for the first arbitration case. However, if, for example, the case is against Firm X and the first person that NLSS generates, Arbitrator A51000, is employed by Firm X, NLSS will not select Arbitrator A51000 but will skip over him or her and will list the next person classified as a non-public arbitrator. Arbitrator A51000 will remain at the top of the internal NLSS rotating list for non-public arbitrators, and the NLSS will generate his or her name when next requested to produce the names of non-public arbitrators for a case in the same hearing location. The process for obtaining the list of public arbitrators is the same.

arbitrator subject to a clear conflict of interest with one of the parties.[21] Proposed Rule 10308(b)(4).

Although some who participated in developing the proposed rule suggested selecting arbitrators on a random basis, NASD Regulation selected the rotation method instead. Among other things, random number selection algorithms in computer programs are extremely difficult to design, and such algorithms ultimately do not produce mathematically perfect randomness. If NASD Regulation used an imperfect random-selection software program, over time, some arbitrators would be chosen more often than others. Arbitrators chosen less often or not at all would be underutilized even though they might be highly qualified. By using a rotation method, all arbitrators on the roster will be placed on a selection list with the same regularity.

Under proposed paragraph (b)(4)(B), the automated NLSS selection process that generates the arbitrators may be altered in order to accommodate a fifth factor, expertise. Expertise has three subcategories: (1) subject matter expertise (also known as a controversy code); (2) security expertise (also known as a security code); and (3) case expertise (also known as a qualification code).

Two of these types of expertise, subject matter expertise and security expertise, are factors that may be included in the NLSS' selection or sorting process at the option of a party as provided in proposed paragraph (b)(4)(B). These are discussed in the following

[21] NLSS can identify only obvious, disclosed conflicts of interest. For example, NLSS recognizes a conflict of interest when the member firm that is the respondent is also the employer of an arbitrator rotating forward in NLSS. NLSS would not list such a person on a non-public arbitrator list being generated for that case.

paragraphs. The third type of expertise, case expertise, will be a factor in the NLSS selection process at the option of the Director or at the request of the parties; the category is very narrow and its use is primarily to aid in the administration of a case. Case expertise contains only three subcategories: injunctive relief cases; employment law cases; and large and complex cases. Only one of the subcategories, that identifying expertise in large and complex cases, is relevant for any customer arbitration and is very infrequently utilized.[22] When used, the NLSS will search for the names of arbitrators, if such arbitrators exist, in the appropriate hearing location with expertise in large and complex cases.

As noted above, the two types of expertise that may be factors to be included in the NLSS's selection or sorting process at the option of a party are subject matter expertise and security expertise. First, a party may request for listing arbitrators who possess certain types of subject matter expertise.[23] Thus, although NLSS will always "sort" or "search" for arbitrators according to the four primary factors (arbitrator classification, hearing location code, rotation, and identified conflicts of interest), when a party requests that the lists include arbitrators with subject matter expertise, the NLSS will add the additional factor and sort or select for placement on the lists some arbitrators having the subject matter expertise identified. However, the Director is not obligated to provide a list that contains one or more arbitrators having the requested subject matter expertise

[22] The two other types of case expertise, expertise involving injunctive relief and employment issues, are used only in intra-industry arbitrations.

[23] An arbitrator is deemed to have certain subject matter expertise if he or she represents on an NASD arbitration intake form that he or she possesses it. ODR does not verify such representations.

because (1) such arbitrators may not be available in the applicable hearing location; or, (2) even if such persons exist in the hearing location, the NLSS or the Director may be required to exclude them from the lists under another provision of the proposed rule (*e.g.*, a conflict of interest identified by the ODR upon a review of the proposed arbitrator's Central Registration Depository ("CRD") record, discussed below). In addition, NLSS currently is limited to those areas of subject matter expertise that have been coded for the NLSS and, if not coded into the NLSS, ODR does not have the administrative capacity to identify arbitrators who might possess in-depth knowledge in the desired subject (*e.g.*, bankruptcy is not a category of expertise identified in the NLSS; "churning" and "suitability" are subject matter categories that are identified.)[24]

The second subcategory of expertise, security expertise, is also added to the NLSS selection process at the option of a party. There are 22 security subcategories, listing various types of securities or other financial instruments (*e.g.*, common stock, municipal bonds, stock index futures, Ginnie Maes, etc.) , and a party may indicate whether expertise regarding a particular instrument is desired. The same procedure described above regarding NLSS selection to accommodate the additional factor of subject matter expertise will apply if a party opts to include security expertise in the NLSS selection process. If available in the hearing location, certain arbitrators may be added to the arbitrator lists generated by NLSS. However, the Director is not obligated to provide a list that contains one or more names having the requested security expertise.

[24] The areas of subject matter expertise that are coded in NLSS are those that previously have been identified in arbitrator disclosure forms. NASD Regulation plans in the future to update and to amend the designated subject matter areas. At that time, NASD Regulation will make corollary changes to NLSS.

(iii) Conflicts-of-Interest

During the preparation of the arbitrator lists, two types of conflict-of-interest checks will occur. The first is the check for conflicts of interests between parties and potential arbitrators that will be performed as part of the automated NLSS process that was noted above.[25] The second process will be a review for conflicts of interest performed manually by ODR.

The second review for conflicts of interest will occur after the NLSS creates a list of arbitrators, but before the list is finalized. ODR will perform a review based upon information that each arbitrator discloses to ODR[26] and, for non-public arbitrators, additional information found in the CRD. After a review of available information, ODR may remove an arbitrator based upon such disclosure.[27] *See also* proposed amendments to Rule 10312. ODR's screening for a conflict of interest will avoid limiting the parties' choices later. ODR will eliminate arbitrators from a list who would almost certainly be disqualified at a later stage in the proceeding due to a conflict of interest. If arbitrators are eliminated during this process, ODR will replace them by returning to NLSS so that the minimum number of public arbitrators, and, if applicable, non-public arbitrators, are on the list or lists that will be mailed to the parties.

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[25] See discussion regarding proposed Rule (b)(4)(A) and n. 21, *supra*.

[26] Under current Rule 10312, a person who wishes to be considered for appointment as an arbitrator must make disclosures to the Director of certain financial, business, employment, and personal information for the purpose of determining whether any interest, relationship or circumstances exists that might preclude a person, if appointed to an arbitration panel, from rendering an objective and impartial decision. The obligation to disclose is a continuing one. Rule 10312(c).

[27] At this stage of the arbitrator appointment process, ODR staff would not make telephone inquiries.

After the parties receive the lists, the parties also will have the ability to review information disclosed by the potential arbitrators to determine if a conflict of interest exists. Under proposed paragraph (b)(6), for each arbitrator listed, the Director will provide the parties with the arbitrator's employment history for the past 10 years and any other information disclosed by the arbitrator under Rule 10312. This information may disclose a conflict of interest between a party and the arbitrator listed and permits the parties to make more informed decisions during the process of ranking and striking the listed arbitrators. Under paragraph (b)(6), the parties may request additional information from the arbitrators; any response by an arbitrator is forwarded to all parties. If a party identifies a conflict of interest, the party's remedy is to strike the person from the list, in the process described in greater detail below. Proposed Rule 10308 (c)(1)(A).

(iv) Transmittal to Parties

The Director shall send the lists to all parties approximately 30 days after the respondent's answer is due, or, if there are multiple respondents, approximately 30 days after the last answer is due. If there is a third-party claim, the Director shall send the lists approximately 30 days after the third-party respondent's answer is due or, if there are multiple third-party respondents, approximately 30 days after the last answer is due. Proposed Rule 10308(b)(5). Under proposed paragraph (a)(7), "send" means to send by first class mail, facsimile, or any other method available and convenient to the parties and the Director, and the lists and all other transmissions between the parties and the Director shall be sent using one of these methods.

(C) Striking, Ranking, and Appointing Arbitrators -- Paragraph (c)

Generally, paragraph (c) of the proposed rule sets forth the method by which a party strikes and ranks arbitrators and the procedures ODR will use to consolidate the parties' preferences and appoint an arbitration panel. Under paragraph (c), the parties rank the arbitrators on the list according to the parties' preferences, and strike arbitrators to remove them from consideration. Proposed paragraph (c) will implement the most important feature of the list selection rule, that of allowing a party to exercise significant influence over the composition of the party's arbitration panel.

(i) Striking and Ranking Arbitrators

Proposed paragraph (c)(1) provides the basic structure for the parties to exercise their influence in selecting arbitrators for their arbitration proceeding. First, each claimant and each respondent strike any one or more arbitrators from the list (or lists, if there are two lists) for any reason, including the party's concern that the arbitrator may have a conflict of interest. Second, the party ranks each arbitrator remaining on the list by assigning the arbitrator a different numerical ranking. A "1" rank indicates the party's first choice, a "2" indicates the party's second choice, and so on, until all the arbitrators are ranked. When a party receives one list of public arbitrators and one list of non-public arbitrators, the party must rank arbitrators on each list separately. Proposed Rule 10308(c) (1). As noted above, all claimants who file a single claim are treated as one claimant; and similar treatment is accorded to all respondents who file one answer. Thus, frequently, persons must act jointly to determine which arbitrators to strike and how to rank the remaining arbitrators on the lists in order for persons who are parties to have

their preferences for arbitrators weighed appropriately. Moreover, even when all claimants do not file a single claim (or all respondents do not file a single answer), the party claimants' (or the party respondents') rankings will be consolidated prior to the consolidation that occurs of claimant and respondent rankings, where the party claimants (or party respondents) do not submit one set of rankings. *See* proposed Rule 10308 (c)(1)(D).

Under proposed paragraph (c)(2), each party's lists of arbitrators reflecting the party's strikes and rankings must be returned to the Director not later than twenty days after the Director's letter communicating the lists was sent. If a party does not timely return the lists, the Director shall treat the party as having retained all the arbitrators on the lists and as having no preferences. If the lists are returned but a party fails to rank an arbitrator on a list, the Director will assign the arbitrator the next lower ranking after the lowest-ranked arbitrator on that list. For example, if a party ranks arbitrators on a list containing ten public arbitrators by striking six arbitrators and ranking arbitrators A, B, and C, as "1," "2," and "3," respectively, and fails to rank public arbitrator D, ODR will assign arbitrator D a ranking of "4."

If a party fails to rank more than one arbitrator on the same list or gives two or more arbitrators on the same list the same numerical ranking, then the Director shall rank the multiple, unranked arbitrators in the same order of preference that the list originally generated by NLSS reflected and transmitted to the parties for their ranking. (When NLSS generates a list, the person listed first is ranked as high or higher by NLSS selection factors than the person listed second, third, and so on. Generally, this NLSS

ranking is not relevant because the ranking by the parties is the basis for appointing arbitrators. NLSS "ranking" only becomes relevant when the parties fail to rank, or improperly rank multiple arbitrators on a list.)[28]

(ii) Consolidating Parties' Rankings

After the claimant and respondent have returned their lists to the Director, the Director implements the parties' preferences for arbitrator selection using the process described in proposed paragraph (c)(3). Under proposed paragraph (c)(3), the Director, using the NLSS, creates a consolidated list of the public arbitrators, and, if non-public arbitrators are also ranked, a second consolidated list of non-public arbitrators, using a one or two-step consolidation process.

Since generally all parties who file a single claim are treated as one claimant and all respondents who file one answer are treated as one respondent, in most cases, the Director will consolidate the parties' preferences for arbitrators using a one-step process. The Director will add the consolidated rankings of the claimant and the respondent to produce a single consolidated list for the public arbitrators and, if necessary, a second

[28] In this process, when only the four factors are considered in the NLSS-list generation process (*e.g.*, arbitrator classification, hearing location code, rotation, and no identified conflicts of interest), the person who has taken part in the fewest list selection processes (*i.e.*, having a higher rotation number) would be placed higher on the NLSS-generated list than a person who has participated in more list selection processes. (E.*g.*, P, a public arbitrator in Richmond, Virginia who has participated in the list selection process six times would be listed more highly by NLSS than Z, a public arbitrator from Richmond, Virginia who has participated in the list selection process seven times, if both were generated for the same list. Therefore, if a party failed to rank both P and Z, the Director would refer to the original NLSS-generated list and rank P more highly than Z). If additional factors are introduced, such as subject matter expertise, those persons having the greatest cluster of desired factors or characteristics would be listed most highly on the NLSS-generated lists and that ordering would be used by the Director for the default "ranking" process that is used only when the parties fail to rank multiple arbitrators.

consolidated list for the non-public arbitrators. Proposed Rule 10308(c)(3). NLSS performs the consolidation functions.

When there are multiple claimants or respondents, the Director will use a two-step consolidation process. First, the Director will consolidate all rankings of the multiple claimants or respondents. For example, if there are two respondents, R #1 and R #2, the rankings of R #1 and R #2 are added together, resulting in one consolidated respondent ranking for each listed public arbitrator and a second consolidated respondent ranking for each listed non-public arbitrator. This first step in the two-step consolidation process may be avoided by cooperation. The parties may file a list to which the parties have jointly agreed. Proposed Rule 10308(c)(1)(D). The first step of the consolidation process, consolidating all the preferences of multiple claimants and, separately, those of multiple respondents, prevents numerous parties on one side of the case from unfairly affecting the selection of the arbitrators. By consolidating the rankings of parties on the same side, the process ensures that claimants' and respondents' choices will have the same weight in the arbitrator selection process. Second, as previously described, the NLSS will consolidate the rankings of the claimants and the respondents to produce a single consolidated list for public arbitrators and, if necessary, a second list for non-public arbitrators.[29] (Proposed Rule 10308(c)(3)).

In instances where the Director determines that the interests of a claimant or a respondent (including a third party respondent) are so substantially different from the

[29] The proposed rule also accommodates the interests of a party added to the case if the party is added before the Director has consolidated the other parties' rankings. Proposed Rule 10308(c)(6).

interests of other claimants or respondents, the Director may determine not to consolidate the numerical rankings of that party with the numerical rankings of the other claimants (or with the other respondents, as the case may be). Proposed Rule 10308(c)(3)(B). In those instances, NLSS will not have the capacity to create the consolidated list (or lists). Instead, the consolidated list (or lists) will be created based upon calculations performed manually by the ODR with each party's rankings having an equal weighting (*e.g.*, where a claimant, a respondent, and a third party respondent are recognized as having substantially different interests, each of the parties rankings will have a 33 _% weight in the consolidated list or lists).

The following examples illustrate the consolidation process:

- If the dispute will be heard by one public arbitrator, the NLSS will produce a consolidated list that will contain the names of five public arbitrators, ranked 1 through 5, based upon the consolidated rankings derived from the parties' rankings.
- If the list of public arbitrators sent to both parties contained five names and the claimant strikes one name, then the consolidated list will rank, numerically, the four names remaining on the list. If the claimant strikes one name and the respondent strikes a second name, then the consolidated list will contain only the names of the three public arbitrators that neither party chose to strike.

- A detailed example is set forth below:[30]

Original List

Arb#[31]	List Position	Arb Name
A00001	1	Red
A00100	2	Orange
A01000	3	Yellow
A10000	4	Green
A10001	5	Blue
A00500	6	Indigo
A99999	7	Violet
A20000	8	Cyan
A00200	9	Magenta
A02200	10	Fuchsia

[30] The example illustrates the process that will be used for each list of arbitrators distributed to the parties. Therefore, in cases where a panel of one non-public and two public arbitrators will be selected, this process will be used to produce two consolidated arbitrator lists.

[31] Each arbitrator in the NLSS is assigned an arbitrator identification number as he or she enters the system. For example, a person who has been an NASD arbitrator since 1995 has a lower arbitration identification number (*e.g.*, A13888) than a person who has been an NASD arbitrator since 1997 (*e.g.*, A17050).

With Parties' Rankings

Arb#	List Position	Arb Name	Consolidated Claimant	Consolidated Respondent	Total	Difference
A00001	1	Red	1	6	7	5
A00100	2	Orange	Strike	7	N/A	N/A
A01000	3	Yellow	2	1	3	1
A10000	4	Green	3	5	8	2
A10001	5	Blue	4	4	8	0
A00500	6	Indigo	5	3	8	2
A99999	7	Violet	6	2	8	4
A20000	8	Cyan	7	Strike	Strike	N/A
A00200	9	Magenta	8	8	16	0
A02200	10	Fuchsia	9	Strike	Strike	N/A

System Results

Arb#	List Position	Arb Name	Consolidated Rank	Notes
A00001	1	Red	2	Total is 7
A00100	2	Orange	Strike	N/A
A01000	3	Yellow	1	Total is 3
A10000	4	Green	4	Total is 8 Difference is 2 List Position is 4
A10001	5	Blue	3	Total is 8 Difference is 0 List Position is 5
A00500	6	Indigo	5	Total is 8 Difference is 2 List Position is 6
A99999	7	Violet	6	Total is 8 Difference is 4 List Position is 7
A20000	8	Cyan	Strike	N/A
A00200	9	Magenta	7	Total is 16
A02200	10	Fuchsia	Strike	N/A

Rearranged by Rank

Arb#	Arb Name	Consolidated Rank	Notes
A01000	Yellow	1	Total is 3
A00001	Red	2	Total is 7
A10001	Blue	3	Total is 8 Difference is 0 List Position is 7
A10000	Green	4	Total is 8 Difference is 2 List Position is 4
A00500	Indigo	5	Total is 8 Difference is 2 List Position is 6
A99999	Violet	6	Total is 8 Difference is 4 List Position is 7
A00200	Magenta	7	Total is 16

Numerical ties between two or more arbitrators during consolidation will be broken by NLSS by the following principles. First, NLSS will break a tie during consolidation by preferentially ranking one arbitrator above another based upon which of the tied arbitrators has a set of rankings, that, when compared, result in the smallest numerical difference between the claimant ranking and the respondent ranking. For example, in the tabular example above, the consolidated rankings of the consolidated claimant and the consolidated respondent have resulted in four arbitrators, Green, Blue, Indigo, and Violet, each receiving a consolidated ranking of 8, resulting in a four-way tie. (*See* table entitled "With Parties Rankings.") Of the four tied arbitrators, Blue will be assigned a ranking as the most preferred arbitrator because the difference between Blue's consolidated claimant's ranking and Blue's consolidated respondent's ranking is 0 (*i.e.*, 4 - 4 = 0); conversely, Violet would be given the fourth (or lowest or least preferred) ranking of the

four arbitrators in the four-way tie because of the largest difference in the rankings that the consolidated claimant and the consolidated respondent gave Violet, compared to the three others (*i.e.*, the consolidated claimant ranked Violet 6 and the consolidated respondent ranked Violet 2, resulting in a difference of 4 (*i.e.*, 6 - 2 = 4), whereas the differences in the rankings assigned Blue, Green, and Indigo are, respectively, 0 , 2 and 2.) (*See* table entitled, "Rearranged by Rank").

A second principle that governs tie-breaking within NLSS is that, given an equal difference in the consolidated ranking, an arbitrator who was listed higher (as more preferred) on the list as originally generated by the NLSS and transmitted to the parties will be given a more preferred or higher ranking in order to break this type of tie. Referring to the same example, Green and Indigo both show consolidated rankings of 8, resulting in the first type of tie discussed above. In addition, Green and Indigo each received rankings from consolidated claimants and respondents that are different by only 2. The first principle applied to break a tie does not provide any assistance; the second principle must be applied. Applying the second principle, during the consolidation process NLSS will rank Green as more preferred (or higher) than Indigo because, on the original list generated by NLSS, Green had a list position of 4, which was higher than Indigo's list position of 6. (*See* table entitled, "Rearranged by Rank," and the column entitled "Notes," for the final NLSS consolidated rankings taking into account these two tie-breaking principles, and the table entitled "Original List" for the position of the arbitrators on the list as originally generated by NLSS.)

(iii) Appointing Arbitrators

Proposed Rule 10308(c)(4) sets forth the steps the Director will take to appoint arbitrators after consolidation occurs. Assuming that the tabular example above is a list of public arbitrators, if the arbitration is to be heard by one public arbitrator, the Director contacts the public arbitrator ranked highest on the list. Thus, the Director would contact Yellow first to determine if Yellow was available to serve and, if not disqualified, Yellow would be appointed. Using the tabular example above, if the Director were required to appoint a three-person arbitration panel, the Director would contact Yellow and Red to determine if they were available to serve and, if not disqualified, would appoint them. If necessary, due to the unavailability or disqualification of one of the two arbitrators, the Director would then contact Blue, and invite Blue to serve. The Director would refer to a second list, generated according to the same principles, to determine which non-public arbitrator should be contacted first.

The contact is to determine if the arbitrator is available and, after being provided the issues of the case and the names of the parties, if the arbitrator is aware of any conflicts of interest or bias or other reason that may preclude the arbitrator from rendering an objective and impartial decision. Based upon the information that the arbitrator has previously provided under Rule 10312, and any information obtained from any other source, the Director shall determine if the arbitrator should be disqualified. If the Director determines that the arbitrator should not be disqualified and that the arbitrator is available, the Director appoints the arbitrator. Proposed Rule 10308(c)(4).

The Director will establish a time frame for ODR's guidance if a listed arbitrator is contacted but fails to respond to ODR's inquiries regarding availability and disqualification. For example, if an arbitrator is telephoned and fails to respond, ODR will eliminate such arbitrator and contact the next listed arbitrator after an appropriate, but relatively brief, period. ODR must exercise such discretion in fairness to all parties who are waiting for their arbitration cases to be resolved.

(iv) Selecting a Chairperson

The Director notifies the parties of the appointments and requests that the parties appoint a chairperson. The parties may jointly select one of the arbitrators (including the non-public arbitrator) to be the chairperson of the panel. Proposed Rule 10308(c)(5). If the parties fail to appoint a chairperson by mutual agreement within 15 days, the Director will appoint the chairperson. If the Director appoints the chairperson, the chairperson will be one of the public arbitrators, but one who is not an attorney or other professional who has devoted 50% or more of his or her professional or business activities, within the past two years, to representing or advising public customers in adversarial proceedings concerning disputed securities or commodities transactions or related matters.[32] This provision also excludes a person who is employed by a person engaged in the listed professional activities from being appointed as chairperson.

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[32] Specifically, proposed paragraph (c)(5) prohibits the Director from appointing as the chairperson a public arbitrator who:

> (A) is an attorney, accountant, or other professional, and
> (B) has devoted 50% or more of his or her professional or business activities, within the last two years, to representing or advising public customers in matters

(v) When the Consolidated List is Insufficient

Under proposed Rule 10308(c)(4), if the Director is not able to appoint the number of arbitrators needed for the panel using the consolidated list, the Director may appoint other arbitrators from the NLSS roster as necessary. If the Director is required to appoint a non-public arbitrator, the Director may not appoint a non-public arbitrator who meets the criteria set forth in paragraph (a)(4)(B) or (a)(4)(C), unless the parties otherwise agree. A non-public arbitrator in proposed paragraph (a)(4)(B) is one who is retired from the securities or commodities industry; proposed paragraph (a)(4)(C) describes a non-public arbitrator who is a professional who devotes 20 percent or more of his or her professional time to clients who are engaged in any of the securities or commodities business activities described in subparagraph (a)(4).[33] When the Director appoints a non-public arbitrator in this stage of the proceeding, the parties no longer have the ability to strike. Thus, the rule requires that the Director choose a non-public arbitrator who is active and fully involved in the securities or commodities industry or related industry.

(D) Arbitrator Disclosures and Removing Arbitrators -- Paragraph (d)

An arbitrator has a continuing obligation under Rule 10312 of the Code to disclose to the Director any circumstances that might preclude the arbitrator from rendering an

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relating to disputed securities or commodities transactions or similar matters.

[33] Although a party does not have the right to strike an arbitrator appointed under the process described in proposed paragraph (c)(4)(B), a party retains the right to request that the Director consider disqualifying an arbitrator appointed pursuant to proposed Rule 10308(c)(4)(B).

objective and impartial determination in an arbitration including, a direct or indirect financial or personal interest in the outcome of the arbitration, or any existing or past financial, business, professional, family or social relationships with a party, counsel, or representative (or, when later identified, a witness) that might affect impartiality or might reasonably create an appearance of partiality or bias. The ODR, in turn, must disclose to the parties any information the arbitrators provide. As noted previously, under proposed Rule 10308(c), ODR forwards to the parties the information disclosed to the Director under Rule 10312.

If the parties believe that the information forwarded to them from ODR or information from any other source suggests that the arbitrator may not be impartial regarding the issues or the case, and if such information is received before the party has returned the arbitrator lists to the Director, a party may simply strike the arbitrator under proposed Rule 10308(c). Thus, prior to sending in the party's preferences to the Director for consolidation, a party has an unlimited right to strike any potential arbitrator as to whom the party suspects bias.

Proposed paragraph (d)(1) provides for disqualification after an arbitrator has been appointed by the Director under paragraph (c)(4).[34] Under proposed Rule 10308(d)(1), a party or the Director may raise a disqualification issue. However, the decision to disqualify an arbitrator already selected under proposed Rule 10308(c)(4) lies solely with

[34] As noted above, disqualification issues that arise after the Director, using NLSS, has begun consolidating parties' preferred arbitrators, may be addressed by the Director directly as part of the appointment process described in paragraph (c)(4).

the Director. The Director may not make any decision to disqualify an arbitrator, however, after the commencement of the earlier of two events: (i) the first prehearing conference or (ii) the first hearing. Proposed Rule 10308(d)(2). At that point or thereafter, if a party believes that an arbitrator should be disqualified, the matter must be raised before the arbitration panel. Vacancies created as a result of a disqualification under proposed paragraph (d)(1) are filled by the Director by referring to the appropriate consolidated list from which the panelists were originally obtained (proposed Rule 10308(d)(3)) or, if there are no persons remaining on the consolidated list, by a person the Director selects under proposed Rule 10308(c)(5).

(E) Discretionary Authority -- Paragraph (e)

Under paragraph (e), the Director's authority to exercise discretionary authority is stated explicitly. In paragraph (e), the Director has authority to resolve a problem that arises relating to the appointment of arbitrators or any other procedure under the rule if (i) the rule does not have an applicable provision, or (ii) the application of a specific provision in the rule would not result in a resolution of the underlying problem because the facts and circumstances are unanticipated or unusual.

(3) Miscellaneous Related Proposed Rule Changes

(A) Proposed Conforming Amendments

NASD Regulation is proposing conforming amendments to Rules 10104, 10309, 10310, 10311, 10312, and 10313.

NASD proposes to make parallel amendments to Rule 10104 and Rule 10309. NASD Regulation proposes to amend Rule 10104 to reflect that the specific provisions of proposed Rule 10308, rather than the general provisions of Rule 10104, regarding the composition and appointment of arbitration panels, will apply to arbitrations involving public customers. Rule 10104 would not apply to a question regarding the composition and appointment of such arbitration panels unless none of the specific provisions in proposed Rule 10308 would be applicable.[35] NASD Regulation proposes the same type of amendment to Rule 10309, a similarly general provision relating to the composition of arbitration panels.

NASD Regulation proposes to amend Rule 10310 and 10311 to make both of them inapplicable to proceedings subject to Rule 10308. Under Rule 10310, NASD Regulation notifies parties of arbitrators appointed, and under Rule 10311, parties have the right to a peremptory challenge of an arbitrator. Because proposed Rule 10308 deals with both types of procedures, NASD Regulation proposes to amend Rules 10310 and Rule 10311 so that neither will apply to arbitration proceedings involving public customers.

NASD Regulation is proposing to amend Rule 10312 to make it consistent with proposed Rule 10308. Both Rules contain provisions regarding an arbitrator's obligation to disclose information to the Director and disqualification based upon such disclosure. The proposed changes to Rule 10312 state explicitly when the Director's authority to

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[35] Rule 10104 and certain other rules in the Rule 10000 Series may be amended further or rescinded when a list selection rule applicable to intra-industry arbitration proceedings is approved. NASD Regulation plans to file a rule shortly so that NLSS may be used for panel selection in intra-industry arbitrations, as well as in customer arbitrations.

disqualify an arbitrator terminates, and provide an arbitrator the option to withdraw from an arbitration panel prior to disclosure of arbitrator information to the parties. A final change in Rule 10312 makes the timing of a disclosure consistent with the parallel provision in proposed Rule 10308.

The proposed changes to Rule 10313 are necessary because Rule 10313 incorporates by reference certain procedures in Rule 10311, and that rule, if amended, will not apply to arbitrations involving public customers. Specifically, NASD Regulation proposes to amend the last sentence of current Rule 10313 so that, for arbitration proceedings involving public customers, a party may exercise the right to challenge a replacement arbitrator within the time remaining prior to the next scheduled hearing session by notifying the Director in writing of the challenged arbitrator's name and the basis for such challenge.

(B) Proposed Amendments to Rule 10315

In the past, the first formal meeting of the arbitration panel and the parties generally was the first hearing. As the arbitration process has evolved, NASD Regulation has encouraged most arbitration panels to hold prehearing conferences. For most arbitrations currently, the first formal meeting of the arbitration panel and the parties is a prehearing telephone conference. NASD Regulation proposes to amend Rule 10315 regarding the scheduling of the first meeting to reflect the current practice.

NASD Regulation also proposes to amend from eight business days to 15 business days the period that NASD has for giving notice of the first meeting to the parties and the

arbitrators. The period is being amended to conform to the 15 business day period set forth in Rule 10310, which formerly also was a period of only eight business days.

(C) Proposed Amendments to Various Rules to Correctly Identify Committee Name

The committee of NASD Regulation that addresses arbitration matters is the National Arbitration and Mediation Committee. NASD Regulation proposes to amend each rule in which the outdated term "National Arbitration Committee" is used by replacing the outdated term with the current committee name, the "National Arbitration and Mediation Committee." (*See, e.g.*, Rule 10102, Rule 10103, Rule 10104 referenced specifically above, Rule 10301, and Rule 10401).

(4) Request for Comments on Specific Topic

NASD Regulation proposes to allow parties to have the right to strike an unlimited number of arbitrators from lists under proposed Rule 10308(c)(1)(A). NASD Regulation specifically requests comment on whether parties should have an unlimited number of strikes, or whether the right to strike should be limited. If a claimant, for example, strikes every arbitrator listed, all the listed arbitrators are ineligible, the respondent's preferences are nullified, and the Director appoints arbitrators who are not listed. Thus, the unlimited right to strike may be too broad to accomplish the purposes intended by the rule proposal.

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.

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.

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 hereunto duly authorized.

NASD REGULATION, INC.

BY: _____

Joan C. Conley, Secretary

Date: July 10, 1998

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-98-48)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to The Selection of Arbitrators in Arbitrations Involving Public Customers

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on , NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC") 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 Rule 10308 of the Rules of the National Association of Securities Dealers, Inc. ("NASD" or "Association"), to set forth new procedures to be used to select arbitrators for arbitrations involving public customers.[1] Under the new procedures, NASD Regulation will allow the parties to an arbitration to rank arbitrators from lists generated primarily using an automated process, providing

[1] NASD Regulation also intends to file a proposed rule change to use a similar list selection process for intra-industry arbitrations.

parties with a substantial role in determining the composition of their arbitration panels. NASD Regulation is proposing conforming changes to Rules 10104, 10309, 10310, 10311, 10312, and 10313. In addition, NASD Regulation proposes to amend Rule 10315 concerning the scheduling of the first meeting of the parties and the arbitration panel to reflect that such meetings usually occur prior to the first hearing of an arbitration proceeding. Finally, NASD Regulation proposes to correctly state in the Rule 10000 Series and any other Rules the name of the NASD Regulation committee that addresses arbitration and related matters, the National Arbitration and Mediation Committee.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * *

10104. Composition and Appointment of Panels

Except as otherwise specifically provided in Rule 10308, t[T]he Director [of Arbitration] shall compose and appoint panels of arbitrators from the existing pool of arbitrators of the Association to conduct the arbitration of any matter which shall be eligible for submission under this Code. [The Director of Arbitration may request that the Executive Committee of the National Arbitration Committee undertake the composition and appointment of a panel or undertake consultation with the Executive Committee regarding the composition and appointment of a panel in any circumstance where he determines such action to be appropriate.]

* * *

10308. [Designation of Number of Arbitrators] Selection of Arbitrators in Customer Disputes

[(a) Except as otherwise provided in Rule 10302, in all arbitration matters involving public customers and where the amount in controversy does not exceed $30,000, the Director of Arbitration shall appoint a single public arbitrator knowledgeable in but who is not from the securities industry to decide the dispute, claim or controversy. Upon the request of a party in its initial filing or the arbitrator, the Director of Arbitration shall appoint a panel of three (3) arbitrators which shall decide the matter in controversy. At least a majority of the arbitrators appointed shall not be from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

(b) In arbitration matters involving public customers and where the amount in controversy exceeds $50,000, exclusive of attendant costs and interest, or where the matter in controversy does not involve or disclose a money claim, the Director of Arbitration shall appoint a panel of three (3) arbitrators, at least a majority of whom shall not be from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

(c) An arbitrator will be deemed as being from the securities industry if he or she:

(1) is a person associated with a member or other broker/dealer, municipal securities dealer, government securities broker, or government securities dealer, or

(2) has been associated with any of the above within the past three (3) years, or

(3) is retired from any of the above, or

(4) is an attorney, accountant, or other professional who has devoted twenty (20) percent or more of his or her professional work effort to securities industry clients within the last two years, or

(5) is an individual who is registered under the Commodity Exchange Act or is a member of a registered futures association or any commodities exchange or is associated with any such person(s).

(d) An arbitrator who is not from the securities industry shall be deemed a public arbitrator. A person will not be classified as a public arbitrator if he or she has a spouse or other member of the household who is a person who is associated with a member or other broker/dealer, municipal securities dealer, government securities broker, or government securities dealer.]

This rule specifies how parties may select or reject arbitrators, and who can be a public arbitrator in arbitration proceedings involving a customer.

(a) Definitions

(1) "day"

For purposes of this rule, the term "day"means calendar day.

(2) "claimant"

For purposes of this rule, the term "claimant" means one or more persons who file a single claim.

(3) "Neutral List Selection System"

The term "Neutral List Selection System" means the software that maintains the roster of arbitrators and performs various functions relating to the selection of arbitrators.

(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 years, was:

(i) associated with a broker or a dealer (including a government or a municipal securities broker or 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 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 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) engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D); or

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

(ii) 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) 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) "respondent"

For purposes of this rule, the term "respondent" means one or more persons who individually or jointly file an answer to a complaint.

(7) "send"

For purposes of this rule, the term "send" means to send by first class mail, facsimile, or any other method available and convenient to the parties and the Director.

(b) Composition of Arbitration Panel; Preparation of Lists for Mailing to Parties

(1) Composition of Arbitration Panel

(A) General Rule Regarding Panel Composition

(i) If the amount of a claim is $50,000 or less, the Director shall appoint an arbitration panel composed of one public arbitrator, unless the parties agree otherwise.

(ii) If the amount of a claim is more than $50,000, the Director shall appoint an arbitration panel composed of one non-public arbitrator and two public arbitrators, unless the parties agree otherwise.

(B) Special Request

If the amount of a claim is greater than $25,000 and not more than $50,000 and the claimant requests that a panel of three arbitrators be appointed, the Director shall appoint an arbitration panel composed of one non-public arbitrator and two public arbitrators, unless the parties agree otherwise.

(2) One List for Panel of One Arbitrator

If one arbitrator will serve as the arbitration panel, the Director shall send to the parties one list of public arbitrators, unless the parties agree otherwise.

(3) Two Lists for Panel of Three Arbitrators

If three arbitrators will serve as the arbitration panel, the Director shall send two lists to the parties, one with the names of public arbitrators and one with the names of non-public arbitrators. The lists shall contain numbers of public and non-public arbitrators, in a ratio of approximately two to one, respectively, to the extent possible, based on the roster of available arbitrators.

(4) Preparation of Lists

(A) Except as provided in subparagraph (B) below, the Neutral List Selection System shall generate the lists of public and non-public arbitrators on a rotating basis within a designated geographic hearing site and shall exclude arbitrators based upon conflicts of interest.

(B) If a party requests that the lists include arbitrators with expertise classified in the Neutral List Selection System, the lists may include some arbitrators having the designated expertise.

(5) Sending of Lists to Parties

The Director shall send the lists of arbitrators to all parties at the same time approximately 30 days after the last answer is due.

(6) Information About Arbitrators

The Director shall send to the parties employment history for each listed arbitrator for the past 10 years and any information disclosed by the arbitrator

under Rule 10312 relating to personal or financial interests or the existence of a relationship that gives rise to an appearance of a conflict of interest or bias. If a party requests additional information about an arbitrator, the Director shall send such request to the arbitrator, and shall send the arbitrator's response to all parties at the same time. When a party requests additional information, the Director may, but is not required to, toll the time for the parties to return the ranked lists under paragraph (c)(2).

(c) Striking, Ranking, and Appointing Arbitrators on Lists

(1) Striking and Ranking Arbitrators

(A) Striking An Arbitrator

A party may strike one or more of the arbitrators from each list for any reason.

(B) Ranking - Panel of One Arbitrator

Each party shall rank all of the arbitrators remaining on the list by assigning each arbitrator a different, sequential, numerical ranking.

(C) Ranking - Panel of Three Arbitrators

Each party shall rank all of the public arbitrators remaining on the list by assigning each arbitrator a different, sequential, numerical ranking, and separately shall rank all of the non-public arbitrators remaining on the list, using the same procedure.

(D) Joint Action Permitted

All claimants may act jointly and all respondents, including third-party respondents, may act jointly to file a single list that reflects their unanimous agreement as to the striking and ranking of arbitrators. If multiple claimants or respondents do not act jointly, the rankings of multiple claimants or respondents will be consolidated as described in subparagraph (b)(3)(A).

(2) Period for Ranking Arbitrators; Failure to Timely Strike and Rank

A party must return to the Director the list or lists with the rankings not later than 20 days after the Director sent the lists to the parties, unless the Director has extended the period. If a party does not timely return the list or lists, the Director shall treat the party as having retained all the arbitrators on the list or lists and as having no preferences.

(3) Process of Consolidating Parties' Rankings

(A) General Rule

The Director shall prepare one or two consolidated lists of arbitrators, as appropriate under subparagraph (b)(2) or (b)(3), based upon the parties' numerical rankings. The arbitrators shall be ranked by adding the rankings of all claimants together and all respondents together, including third-party respondents, to produce separate consolidated

rankings of the claimants and the respondents. The Director shall then rank the arbitrators by adding the consolidated rankings of the claimants, the respondents, including third party respondents, and any other party together, to produce a single consolidated ranking number, excluding arbitrators who were stricken by any party.

(B) Exception

If the Director determines that the interests of a party are sufficiently different from the interests of other claimants or respondents, the Director may determine not to consolidate the rankings of that party with the rankings of the other claimants or respondents.

(4) Appointment of Arbitrators

(A) Appointment of Listed Arbitrators

The Director shall appoint arbitrators to serve on the arbitration panel based on the order of rankings on the consolidated list or lists, subject to availability and disqualification.

(B) Discretion to Appoint Arbitrators Not on List

If the number of arbitrators available to serve from the consolidated list is not sufficient to fill a panel, the Director shall appoint one or more arbitrators to complete the arbitration panel; *provided,*

however, unless the parties agree otherwise, the Director may not appoint a non-public arbitrator under paragraphs (a)(4)(B) or (a)(4)(C).

(5) Selecting a Chairperson for the Panel

The parties shall have 15 days from the date the Director sends notice of the names of the arbitrators to select a chairperson. If the parties cannot agree, the Director shall appoint one of the public arbitrators as the chairperson. Unless all parties agree otherwise, the Director shall not appoint as the chairperson a public arbitrator who:

(A) is an attorney, accountant, or other professional, and

(B) has devoted 50% or more of his or her professional or business activities, within the last two years, to representing or advising public customers in matters relating to disputed securities or commodities transactions or similar matters.

(6) Additional Parties

If a party is added to an arbitration proceeding before the Director has consolidated the other parties' rankings, the Director shall send to that party the list or lists of arbitrators and permit the party to strike and rank the arbitrators. The party must return to the Director the list or lists with numerical rankings not later than 20 days after the Director sent the lists to the party. The Director shall then consolidate the rankings as specified in this paragraph (c).

(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 (i) the first prehearing conference or (ii) 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

After the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, the Director's authority to remove an arbitrator from an arbitration panel ceases.

(3) Vacancies Created by Disqualification or Resignation

If an arbitrator appointed to an arbitration panel is disqualified or resigns from an arbitration panel, 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).

(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.

Rule 10309. Composition of Panels

Except as otherwise specifically provided in Rule 10308, t[T]he individuals who shall serve on a particular arbitration panel shall be determined by the Director [of Arbitration]. Except as otherwise specifically provided in Rule 10308, t[T]he Director [of Arbitration] may name the chairman of the panel.

Rule 10310. Notice of Selection of Arbitrators

(a) The Director shall inform the parties of the arbitrators' names and employment histories for the past 10 years, as well as information disclosed pursuant to Rule 10312, at least 15 business days prior to the date fixed for the first hearing session. A party may make further inquiry of the Director [of Arbitration] concerning an arbitrator's background. In the event that, prior to the first hearing session, any arbitrator should become disqualified, resign, die, refuse or otherwise be unable to perform as an arbitrator, the Director shall appoint a replacement arbitrator to fill the vacancy on the panel. The Director shall inform the parties as soon as possible of the name and employment history of the replacement arbitrator for the past 10 years, as well as information disclosed

pursuant to Rule 10312. A party may make further inquiry of the Director [of Arbitration] concerning the replacement arbitrator's background and within the time remaining prior to the first hearing session or the 10 day period provided under Rule 10311, whichever is shorter, may exercise its right to challenge the replacement arbitrator as provided in Rule 10311.

(b) This rule shall not apply to arbitration proceedings that are subject to Rule 10308.

Rule 10311. Peremptory Challenge

(a) In an[y] arbitration proceeding, each party shall have the right to one [(1)] peremptory challenge. In arbitrations where there are multiple Claimants, Respondents, and/or Third-Party Respondents, the Claimants shall have one [(1)] peremptory challenge, the Respondents shall have one [(1)] peremptory challenge, and the Third-Party Respondents shall have one [(1)] peremptory challenge. The Director [of Arbitration] may in the interests of justice award additional peremptory challenges to any party to an arbitration proceeding. Unless extended by the Director [of Arbitration], a party wishing to exercise a peremptory challenge must do so by notifying the Director [of Arbitration] in writing within 10 business days of notification of the identity of the person(s) named under Rule 10310 or Rule 10321(d) or (e), whichever comes first. There shall be unlimited challenges for cause.

(b) This rule shall not apply to arbitration proceedings that are subject to Rule 10308.

Rule 10312. Disclosures Required of Arbitrators and Director's Authority To Disqualify

(a) through (c) No change

* * *

(d) The Director shall inform the parties to an arbitration proceeding of any information disclosed to the Director under this Rule unless the arbitrator who disclosed the information withdraws from being considered for appointment voluntarily and immediately after the arbitrator learns of any interest or relationship described in paragraph (a) that might preclude the arbitrator from rendering an objective and impartial determination in the proceeding.

([d]e) [Prior to the commencement of the first hearing session] Prior to the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, the Director [of Arbitration] may remove an arbitrator based on information disclosed pursuant to this Rule. [The Director of Arbitration shall also inform the parties of any information disclosed pursuant to this Rule if the arbitrator who disclosed the information is not removed.]

(f) After the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, the Director's authority to remove an arbitrator from an arbitration panel ceases.

Rule 10313. Disqualification or Other Disability of Arbitrators

In the event that any arbitrator, after the commencement of the first hearing session but prior to the rendition of the award, should become disqualified, resign, die, refuse or otherwise be unable to perform as an arbitrator, the remaining arbitrator(s) shall continue with the hearing and determination of the controversy, unless such continuation is objected to by any party within 5 days of notification of the vacancy on the panel. Upon objection, the Director [of Arbitration] shall appoint a replacement arbitrator to fill the vacancy and the hearing shall continue. The Director [of Arbitration] shall inform the parties as soon as possible of the name and employment history of the replacement arbitrator for the past 10 years, as well as information disclosed pursuant to Rule 10312. A party may make further inquiry of the Director [of Arbitration] concerning the replacement arbitrator's background. If the arbitration proceeding is subject to Rule 10308, the party may exercise his or her right to challenge the replacement arbitrator within the time remaining prior to the next scheduled hearing session by notifying the Director in writing of the name of the arbitrator challenged and the basis for such challenge. If the arbitration proceeding is not subject to Rule 10308, [and] within the time remaining prior to the next scheduled hearing session or the 5 day period provided under Rule 10311, whichever is shorter, a party may exercise the party's [its] right to challenge the replacement arbitrator as provided in Rule 10311.

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Rule 10315. Designation of Time and Place of First Meeting [Hearing]

The Director shall determine [T]the time and place of the first meeting of the arbitration panel and the parties, whether the first meeting is a pre-hearing conference or a hearing, [initial hearing shall be determined by the Director of Arbitration and each hearing thereafter by the arbitrators.] and shall give [N]notice of the time and place [for the initial hearing shall be given] at least [eight (8)]15 business days prior to the date fixed for the first meeting [hearing] by personal service, registered or certified mail to each of the parties unless the parties shall, by their mutual consent, waive the notice provisions under this Rule. The arbitrators shall determine the time and place for all subsequent meetings, whether the meetings are pre-hearing conferences, hearings, or any other type of meetings, and shall give [N]notice [for each hearing thereafter shall be given] as the arbitrators may determine. Attendance at a meeting [hearing] waives notice thereof.

* * *

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

(1) Background

(A) Recommendations of the Task Force

The Arbitration Policy Task Force ("Task Force") in Securities Arbitration Reform: Report of the Arbitration Policy Task Force To the Board of Governors of NASD ("Task Force Report"), published in January 1996, made fourteen broad recommendations to the NASD Board to improve the securities arbitration process administered by the NASD. Recommendation No. 8 provided: "Arbitrator selection, quality, training, and performance should be improved by various means, including adoption of a list selection method, earlier appointment of arbitrators, enhancement of arbitrator training, and increased [arbitrator] compensation."[2]

The Task Force recommended that the NASD adopt "a variant of the AAA's method of selecting arbitrators" ("Recommendation One").[3] Under the system proposed by the Task Force:

[2] Task Force Report at 2.

[3] Task Force Report at 94.

> the parties would be provided with three lists of candidates: (i) a list of public arbitrators qualified to be panel chairs to contain no fewer than three names, (ii) a list of other public arbitrators, to contain no fewer than five names; and (iii) a list of industry arbitrators, to contain no fewer than five names. Each party could strike names from any of the lists and would then rank the remaining names on each list in order of preference. If mutually agreeable arbitrators are not selected, new lists would be provided for each category in which agreement was not reached. This process would continue for no more than three rounds. If, at the end of three rounds, an industry and two public arbitrators, one qualified as a panel chair, had not been chosen, the NASD Arbitration Department would appoint the remaining arbitrator or arbitrators. Arbitrators selected by the staff could be challenged only for cause. (Footnotes omitted)[4]

The Task Force also made two other recommendations to implement improvements in the selection of arbitrators. The Task Force recommended that the appropriate NASD staff (now NASD Regulation's Office of Dispute Resolution ("ODR")) should be able to exercise flexibility in designating arbitrators as either

[4] Task Force Report at 94-95.

"public"or "industry" ("Recommendation Two").[5] In addition, the Task Force recommended that arbitrators be placed on the selection lists on a rotating basis to promote more frequent selection of arbitrators who complete an arbitrator training program ("Recommendation Three").[6]

(B) Parties Consulted In Development of Rule

NASD Regulation considered the Task Force's recommendations at length. NASD Regulation also consulted with its National Arbitration and Mediation Committee ("NAMC"),[7] the Securities Industry Conference on Arbitration ("SICA"),[8] PIABA, the staff of the SEC, and others about the efficacy of the proposals. All persons consulted favored the selection of arbitrators by the parties using some form of list selection. In addition, most were in favor of developing a system featuring the capability, when appropriate and as technologically feasible, to generate the arbitrator lists from a computer programmed to incorporate relevant selecting factors, such as geographic proximity of an arbitrator to the proposed site of the hearing, subject matter expertise, and classification of an arbitrator as a public arbitrator[9] or a non-public arbitrator,[10] rather

[5] Task Force Report at 96.

[6] Task Force Report at 97.

[7] The NAMC is a balanced committee of NASD Regulation. Committee members are individuals with broad and diverse experience in securities arbitration and mediation as representatives of investors, firms, firm employees, and neutrals (arbitrators and mediators).

[8] The membership of SICA is diverse and includes persons representing the interests of public customers (including members of the Public Investors Arbitration Bar Association ("PIABA")), representatives from the self-regulatory organizations, and the Securities Industry Association ("SIA").

[9] The term "public arbitrator" is defined in proposed Rule 10308(a)(5).

than developing a system in which the lists of arbitrators to be forwarded to parties for ranking would be generated solely on the basis of ODR's judgment.

(C) General Principles Underlying Proposed Rule Change

NASD Regulation recommends as a general principle that parties in arbitration be given more input into the selection of arbitrators. In furtherance of this principle, NASD Regulation has developed a rule providing that, in a one-arbitrator panel case, the parties to the arbitration will be provided a list of public arbitrators, and, in a three-arbitrator panel case, the parties will be provided a list of public and a list of non-public arbitrators.[11] The parties will use the lists to express numerical preferences for the arbitrators listed and those rankings will determine the outcome of the arbitrator selection process, unless all ranked arbitrators decline to serve because they are unavailable, recuse themselves, or are disqualified because of conflicts of interest.

The list or lists of arbitrators will be generated from an arbitrator database by a computer to further fairness and neutrality. This automated system is the Neutral List Selection System ("NLSS").[12] However, to preserve the exercise of discretion and judgment when appropriate and to act on behalf of a party's request, when a party or parties express a request for a process that may legitimately be considered in the selection

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[10] The term "non-public arbitrator" is defined in proposed Rule 10308(a)(4).

[11] In this rule filing, for ease of reference the discussion of the process of selecting an arbitration panel focuses more on the selection of a three-person arbitration panel than a one-person panel because the process of selecting one arbitrator is simpler and much less frequently employed.

[12] The term "Neutral List Selection System" is defined in proposed Rule 10308(a)(3).

of an arbitration panel but that NLSS is not capable of performing, or request an arbitration panel that may not be "selected" or "sorted" using the NLSS, the Director of Arbitration ("Director") may supplement the NLSS process.

In developing an arbitrator list selection rule to implement the Task Force's Recommendation One, NASD Regulation concluded that there were not enough arbitrators on the arbitrator roster of the ODR to provide sufficient names for three selection rounds. In addition, although NASD Regulation also initially considered a two-round, two-list selection method, NASD Regulation concluded that the operational burdens of administering such a process, especially given the limited number of arbitrators relative to the large caseload, would be too great. Also, NASD Regulation was concerned that a two-round, two-list selection method would make the process of appointing arbitrators too lengthy and would be too costly. Accordingly, NASD Regulation is proposing that the list selection rule contain a single-round, two-list selection process as set forth in greater detail below.

Notwithstanding, NASD Regulation's proposed rule change implements the fundamental aspect of Recommendation One in that it sets forth a list selection process that allows the parties to play the dominant role in selecting their arbitrators. In this proposed rule filing, NASD Regulation is also implementing Recommendation Three by placing arbitrators on a rotating list. By implementing Recommendations One and Three, the list selection process will function primarily through the operation of the NLSS, supplemented by the actions and judgments of the Director, but only when required to effect the appointment of a panel.

NASD Regulation is not implementing the Task Force's Recommendation Two that NASD staff should have discretionary authority regarding the classification of an arbitrator. Applying the explicit standards set forth in proposed paragraph (a), ODR will designate an arbitrator as either "public" or "non-public" (*i.e.*, "industry") based upon the information provided about the person. At this time, NASD Regulation believes that it is impracticable to grant to the Director or the ODR the discretion or flexibility to modify the classification of an arbitrator based on information or criteria other than that which is set forth in the defined terms of "public arbitrator" or "non-public" arbitrator. Perceptions and expectations of participants about the backgrounds of potential arbitrators indicate that the participants do not believe that this flexibility would enhance the arbitrator selection process.[13]

NASD Regulation believes that the proposed methodology for selecting arbitrators will benefit investors, firms, associated persons, and other users of the arbitration forum. First, proposed Rule 10308 and NLSS, the technology developed to implement key parts of the proposed Rule, provide a system for selecting arbitrators that allows parties to have the greatest impact in the composition of their arbitration panel. Second, Proposed Rule 10308 is a more streamlined process than the process envisioned in the Task Force's Recommendation One. Third, proposed Rule 10308, a single-round process, will be less costly. Fourth, the proposed process borrows from the process used

[13] However, the ODR will have authority to change the classification of an arbitrator already classified in the NLSS based upon new information *(e.g.*, an arbitrator changes his or her employment and, after such change, the arbitrator fits the criteria for a non-public arbitrator, rather than the criteria for a public arbitrator).

successfully for some time by the American Association of Arbitration ("AAA"), the largest domestic arbitration forum sponsor.

(2) Description of Proposed Rule Change

The proposed rule change, which only governs the selection of arbitrators in cases involving public customers, is divided into five parts. Paragraph (a) contains definitions. In paragraph (b), NASD Regulation specifies how the lists of public and non-public arbitrators will be compiled and forwarded to the parties. Paragraph (c) specifies how the parties indicate their preferences by numerical rankings and how the Director reconciles the preferences of the parties, selects the arbitrators, selects the chairperson if the parties do not make the selection, and, if necessary, disqualifies an arbitrator before the arbitrator is appointed. Paragraph (d) describes generally how parties and the Director may remove a person from serving as an arbitrator if the person has a conflict of interest or a bias. Paragraph (e) specifies that the Director has discretionary authority to resolve issues arising in the administration of the list selection process.

There are several other rules in the Rule 10000 Series that NASD Regulation must amend in order to make the Rule Series 10000 consistent. The proposed amendments to those rules are discussed at the end of the discussion of the proposed changes to Rule 10308. *See* Miscellaneous Related Proposed Rule Changes, *infra*. Finally, NASD Regulation requests comments on the proposed rule change, including one important specific topic set forth separately below. *See* Request for Comments on Specific Issue, *infra*.

(A) Definitions -- Paragraph (a)

Paragraph (a) of the proposed rule change contains seven definitions: "day," "claimant," "Neutral List Selection System," "non-public arbitrator," "public arbitrator," "respondent" and "send." "Public arbitrator," "non-public arbitrator," and "Neutral List Selection System" are the three terms that are central to understanding how proposed Rule 10308, the proposed list selection rule, will operate.

In proposed paragraph (a)(4), a "non-public arbitrator" is defined as a person who is otherwise qualified to be an arbitrator and is employed in or retired from the securities or commodities industry or in a related position in the banking industry. The rule includes in the definition a person who is a professional, such as a lawyer or an accountant, who has a substantial client base that is engaged in the securities or commodities industry, or in a related banking activity described in the rule. Specifically, for arbitrator classification purposes, a non-public arbitrator is a person who:

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

(i) associated with a broker or a dealer (including a government or a municipal securities broker or 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 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 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 definition largely retains the existing definition in the Rule 10000 Series (the Code of Arbitration) of an arbitrator who is deemed to be "from the securities industry," but it adds to that defined term persons employed by banks and other financial institutions who are engaged in securities activities or in the supervision of such activities.

The second key defined term, "public arbitrator," is defined in paragraph (a)(5). "Public arbitrator" generally means a person who is otherwise qualified to serve as an arbitrator and is not engaged in the conduct of, or business activities that indicate an affiliation with, the securities industry or the related industries. Thus, in order to be classified as a public arbitrator one may not be engaged in any of the activities listed under the definition of "non-public arbitrator" in paragraphs (a)(4)(A) through (D), set forth above. The definition generally excludes: a person currently employed in the securities or commodities industry or a person retired from such business activities; a

professional who devotes 20 percent or more of his or her time to securities industry clients; and an employee of a bank or other financial institution who is engaged in securities activities or in the supervision of such activities.

In addition, a spouse or an immediate family member of a current or retired member of the securities or commodities industry, or a person engaged in any of the other types of business activities that require one to be classified as a "non-public arbitrator," is also excluded from being a "public arbitrator" because such persons' economic interests are too closely tied to those of the securities or commodities industry, even though such spouses and immediate family members may not be directly involved in the relevant business activities. "Immediate family member" is defined with reference to the person's familial or economic ties to the person associated with the securities or commodities industry.[14] Proposed Rule 10308(a)(5)(B). A person who has a close familial, personal, or economically dependent relationship with an associated person may be viewed as possessing a bias in favor of the securities or commodities industry even though he or she is not involved directly with the identified industry.[15]

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[14] "Immediate family member" means:

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

[15] A small group of persons will be excluded from serving as either public or non-public arbitrators (*e.g.*, spouses and immediate family members of registered representatives). Excluded by subparagraph (a)(5) from serving as public arbitrators, such persons are also excluded from serving under subparagraph (a)(4) as non-public arbitrators because a non-public arbitrator must have the professional securities experience (or the related

The third key defined term, "Neutral List Selection System," defines the new software program that will implement the proposed list selection rule. NASD Regulation defines "Neutral List Selection System" as "the software that maintains the roster of arbitrators and performs various functions relating to the selection of arbitrators." Proposed Rule 10308(a)(3). Among other things, NLSS will maintain the roster of arbitrators, identify arbitrators as public or non-public, screen arbitrators for conflicts of interest with parties, list arbitrators according to geographic hearing sites and, on occasion, by expertise, and consolidate the numerical rankings that parties assign to listed arbitrators.

Two other terms, "claimant" and "respondent," are defined in paragraph (a) to simplify certain aspects of the rule. Under proposed Rule 10308(a)(2), if one or more persons files a single claim they will be treated as one claimant. A parallel definition is proposed for respondents; one or more persons who file the same answer will be treated as one respondent. Proposed Rule 10308(a)(6). The ODR views claimants who file one claim or respondents who file one answer as generally having sufficiently similar interests in the outcome of the proceeding to be considered as one party for purposes of the list

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qualifications) listed in subparagraph (a)(4). For example, unless the spouse of a registered representative was also employed in the securities or commodities industry (or engaged in one of the business activities related to the securities industry), that person might not possess securities industry experience (or the related qualifications) and therefore could not serve as a non-public arbitrator. In addition, because of the marital relationship, the spouse would be excluded from serving as a public arbitrator.

selection process.[16] This approach will simplify consolidating the parties' preferences for arbitrators described below.[17]

(B) Composition of Arbitration Panel; Compilation of Lists of Arbitrators for Parties' Selection -- Paragraph (b)

Under proposed Rule 10308(b)(1), the rule sets forth the number of arbitrators that the Director should appoint to a panel, general panel composition requirements, and exceptions to those requirements. If the claim is $50,000 or less, the claim will be heard by a single public arbitrator, unless the parties agree otherwise. Proposed Rule 10308 (b)(1)(A)(i). If the claim is more than $50,000, a panel of two public arbitrators and one non-public arbitrator will hear the dispute, unless the parties agree otherwise. Proposed Rule 10308(b)(1)(A)(ii). Under proposed paragraph (b)(1)(B), a claimant with a claim valued greater than $25,000 and not more than $50,000 may request a three-person arbitration panel.[18] Whether for a one-person panel or a three-person panel, the requirement that public arbitrators be empaneled is for the protection of investors, and parties may agree to waive this compositional requirement.

When the parties agree to change the composition of an arbitration panel from that set forth in proposed paragraph (b)(1)(A)(i) or (ii), references in the balance of the rule to

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[16] The consolidation process in described in greater detail below. However, it should be noted that a group of claimants that does not file a single claim, or, similarly, a group of respondents that does not file a single answer, does not obtain an advantage in the consolidation process or in the weighting of their preferences for arbitrators. For example, if in a case there are two claimants who are not viewed as one claimant under the rule, and one respondent, the two claimants' arbitrator rankings will be weighted as only 50% of the total; the one respondent's arbitrator rankings will be weighted as the other 50%.

[17] The terms "day" and "send" are also defined in paragraph (a).

[18] Obtaining a three-person panel under this subparagraph then obligates the parties to pay hearing session deposit fees for a three-person panel under Rule 10332.

a panel must be interpreted according to the panel composition that the parties have chosen. For example, if the parties agree to a panel composed of three public arbitrators, under proposed paragraph (c)(1)(C) the parties would rank a list of public arbitrators only, since the Director would not send the parties a list of non-public arbitrators. In addition, parties should be aware that if the panel composition varies from that provided in proposed paragraph (b)(1)(A)(i) or (ii), NLSS is not capable of processing all such combinations. NLSS can generate the lists and consolidate the rankings for a one-person panel of either public or non-public classification. For a three-person panel, NLSS can generate the lists and consolidate the rankings for a panel composed of one non-public and two public arbitrators or three non-public arbitrators. NLSS cannot process requests for a panel composed of one public arbitrator and two non-public arbitrators or three public arbitrators.[19]

Under proposed paragraphs (b)(2) and (b)(3), the Director will send lists of names of arbitrators for ranking to the claimant and the respondent. As noted above, by operation of paragraph (a) of the proposed rule, a group of claimants who have filed one complaint will be viewed as one claimant; the same treatment is accorded to respondents who file a single answer. Thus, when reviewing the lists and otherwise taking action under the proposed rule, one or more persons viewed as one claimant must act jointly, and one or more persons viewed as one respondent must act jointly.

[19] Although in theory the parties could agree to an arbitration panel composed of three public arbitrators, experience indicates that a panel of this type for disputes involving customers is almost never convened.

When only one arbitrator will hear the proceeding, the Director will send to the parties one list of public arbitrators. Proposed Rule 10308(b)(2). When three arbitrators will hear the proceeding, the Director will send the parties two lists, one containing the names of public arbitrators and the other containing the names of non-public arbitrators. Proposed Rule 10308(b)(3).

(i) Director's Minimum Numbers for Lists

Proposed Rule 10308 is flexible, and although subparagraphs (b)(2)and (b)(3) do not set a fixed ratio of arbitrators or a minimum number of arbitrators that ODR must list, ODR has established the following guidelines. For a panel of one arbitrator, the Director intends to provide five names of public arbitrators whenever possible, but not less than three names. For a panel of three arbitrators, the Director intends to provide lists that contain up to 10 public arbitrator names and five non-public arbitrator names; when that is not possible, the Director will provide a public arbitrator list of not less than six names, and a non-public arbitrator list of not less than three names. In addition, as illustrated by the example of the minimum numbers set forth above, to the extent possible, for a three-person panel, the list of public arbitrators will contain approximately twice as many names as the list of non-public arbitrators. The Director's ability to provide full lists of names will vary and is dependent on the number of available arbitrators and the local demands on the arbitrator roster. Circumstances may arise where a small arbitrator roster in a particular hearing location (*e.g.*, Richmond, Va., Norfolk, Va., Alaska, or Hawaii), combined with a high demand for arbitrators, will prevent the Director from meeting the objectives.

To address possible arbitrator shortages, the Director plans to combine arbitrators from proximate hearing locations when necessary. For example, under proposed paragraph (b)(2), the list to be sent to the parties should contain, at a minimum, three names of public arbitrators. If, with one hearing location coded into NLSS, NLSS does not generate the names of three public arbitrators, the Director will return to NLSS, add a second hearing location code, and generate a list of public arbitrators that will include the additional arbitrators. The second hearing location coded will be one that is geographically proximate to the first hearing location code used (*e.g.,* for a Richmond, Va. hearing, the Richmond hearing location code will be used first, and then the Atlanta or the Washington, D.C. hearing location code could be added). The additional process in NLSS will be performed at no additional cost to the parties. The same process will be used to address any shortages in arbitrators under the lists prepared under proposed paragraph (b)(3).

(ii) NLSS Functions and Capabilities

Proposed paragraphs (b)(2), (3), and (4) together set forth the four factors which are used by NLSS to generate the list or lists of arbitrators by "selecting" or "sorting" the NLSS database. The four factors are arbitrator classification, hearing location code, rotation, and identified conflicts of interests.

To generate a list, NLSS performs the following steps. NLSS first identifies the subgroup of arbitrators by classification (public or non-public arbitrators). NLSS then identifies those arbitrators in the same hearing location as the arbitration. Thereafter,

NLSS selects such public or non-public arbitrators who are located in the hearing location in rotation from the NLSS database.[20] Finally, NLSS excludes from the selection an arbitrator subject to a clear conflict of interest with one of the parties.[21] Proposed Rule 10308(b)(4).

Although some who participated in developing the proposed rule suggested selecting arbitrators on a random basis, NASD Regulation selected the rotation method instead. Among other things, random number selection algorithms in computer programs are extremely difficult to design, and such algorithms ultimately do not produce mathematically perfect randomness. If NASD Regulation used an imperfect random-selection software program, over time, some arbitrators would be chosen more often than others. Arbitrators chosen less often or not at all would be underutilized even though

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[20] The NLSS rotation feature also may be described as a "first-in-first-out" feature. For a case that will be heard by one public arbitrator, the following steps would apply. As an arbitrator's name rises to the top of the list of all arbitrators who are, for example, public arbitrators and found in one hearing location, the arbitrator's name will be generated by NLSS, absent an identified conflict of interest, on a list for ranking by parties to an arbitration. Once the arbitrator's name is sent to the parties, even if the arbitrator is later not appointed an arbitrator for the panel, NLSS places such arbitrator at the bottom of the computerized NLSS list. Thus, an arbitrator may be listed, and thereafter rotated to the bottom of the NLSS list even if: (1) the arbitrator recuses him or herself; (2) the arbitrator is not ranked highly enough by the parties to be appointed or the arbitrator was struck; or (3) the arbitrator is ranked highly enough to serve, is contacted, has no conflict of interest or bias that would disqualify him, but is unavailable to serve.

When a three person panel will be appointed, generally two public arbitrators and one non-public arbitrator are needed. For the generation of the list of non-public arbitrators and the list of public arbitrators, the same process would be used. For the selection of the non-public arbitrators, the first five non-public arbitrators in the system will be rotated forward for the first arbitration case. However, if, for example, the case is against Firm X and the first person that NLSS generates, Arbitrator A51000, is employed by Firm X, NLSS will not select Arbitrator A51000 but will skip over him or her and will list the next person classified as a non-public arbitrator. Arbitrator A51000 will remain at the top of the internal NLSS rotating list for non-public arbitrators, and the NLSS will generate his or her name when next requested to produce the names of non-public arbitrators for a case in the same hearing location. The process for obtaining the list of public arbitrators is the same.

[21] NLSS can identify only obvious, disclosed conflicts of interest. For example, NLSS recognizes a conflict of interest when the member firm that is the respondent is also the employer of an arbitrator rotating forward in NLSS. NLSS would not list such a person on a non-public arbitrator list being generated for that case.

they might be highly qualified. By using a rotation method, all arbitrators on the roster will be placed on a selection list with the same regularity.

Under proposed paragraph (b)(4)(B), the automated NLSS selection process that generates the arbitrators may be altered in order to accommodate a fifth factor, expertise. Expertise has three subcategories: (1) subject matter expertise (also known as a controversy code); (2) security expertise (also known as a security code); and (3) case expertise (also known as a qualification code).

Two of these types of expertise, subject matter expertise and security expertise, are factors that may be included in the NLSS' selection or sorting process at the option of a party as provided in proposed paragraph (b)(4)(B). These are discussed in the following paragraphs. The third type of expertise, case expertise, will be a factor in the NLSS selection process at the option of the Director or at the request of the parties; the category is very narrow and its use is primarily to aid in the administration of a case. Case expertise contains only three subcategories: injunctive relief cases; employment law cases; and large and complex cases. Only one of the subcategories, that identifying expertise in large and complex cases, is relevant for any customer arbitration and is very infrequently utilized.[22] When used, the NLSS will search for the names of arbitrators, if such arbitrators exist, in the appropriate hearing location with expertise in large and complex cases.

[22] The two other types of case expertise, expertise involving injunctive relief and employment issues, are used only in intra-industry arbitrations.

As noted above, the two types of expertise that may be factors to be included in the NLSS's selection or sorting process at the option of a party are subject matter expertise and security expertise. First, a party may request for listing arbitrators who possess certain types of subject matter expertise.[23] Thus, although NLSS will always "sort" or "search" for arbitrators according to the four primary factors (arbitrator classification, hearing location code, rotation, and identified conflicts of interest), when a party requests that the lists include arbitrators with subject matter expertise, the NLSS will add the additional factor and sort or select for placement on the lists some arbitrators having the subject matter expertise identified. However, the Director is not obligated to provide a list that contains one or more arbitrators having the requested subject matter expertise because (1) such arbitrators may not be available in the applicable hearing location; or, (2) even if such persons exist in the hearing location, the NLSS or the Director may be required to exclude them from the lists under another provision of the proposed rule (*e.g.*, a conflict of interest identified by the ODR upon a review of the proposed arbitrator's Central Registration Depository ("CRD") record, discussed below). In addition, NLSS currently is limited to those areas of subject matter expertise that have been coded for the NLSS and, if not coded into the NLSS, ODR does not have the administrative capacity to identify arbitrators who might possess in-depth knowledge in the desired subject (*e.g.*,

[23] An arbitrator is deemed to have certain subject matter expertise if he or she represents on an NASD arbitration intake form that he or she possesses it. ODR does not verify such representations.

bankruptcy is not a category of expertise identified in the NLSS; "churning" and "suitability" are subject matter categories that are identified.)[24]

The second subcategory of expertise, security expertise, is also added to the NLSS selection process at the option of a party. There are 22 security subcategories, listing various types of securities or other financial instruments (*e.g.*, common stock, municipal bonds, stock index futures, Ginnie Maes, etc.) , and a party may indicate whether expertise regarding a particular instrument is desired. The same procedure described above regarding NLSS selection to accommodate the additional factor of subject matter expertise will apply if a party opts to include security expertise in the NLSS selection process. If available in the hearing location, certain arbitrators may be added to the arbitrator lists generated by NLSS. However, the Director is not obligated to provide a list that contains one or more names having the requested security expertise.

(iii) Conflicts-of-Interest

During the preparation of the arbitrator lists, two types of conflict-of-interest checks will occur. The first is the check for conflicts of interests between parties and potential arbitrators that will be performed as part of the automated NLSS process that was noted above.[25] The second process will be a review for conflicts of interest performed manually by ODR.

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[24] The areas of subject matter expertise that are coded in NLSS are those that previously have been identified in arbitrator disclosure forms. NASD Regulation plans in the future to update and to amend the designated subject matter areas. At that time, NASD Regulation will make corollary changes to NLSS.

[25] See discussion regarding proposed Rule (b)(4)(A) and n. 21, *supra*.

The second review for conflicts of interest will occur after the NLSS creates a list of arbitrators, but before the list is finalized. ODR will perform a review based upon information that each arbitrator discloses to ODR[26] and, for non-public arbitrators, additional information found in the CRD. After a review of available information, ODR may remove an arbitrator based upon such disclosure.[27] *See also* proposed amendments to Rule 10312. ODR's screening for a conflict of interest will avoid limiting the parties' choices later. ODR will eliminate arbitrators from a list who would almost certainly be disqualified at a later stage in the proceeding due to a conflict of interest. If arbitrators are eliminated during this process, ODR will replace them by returning to NLSS so that the minimum number of public arbitrators, and, if applicable, non-public arbitrators, are on the list or lists that will be mailed to the parties.

After the parties receive the lists, the parties also will have the ability to review information disclosed by the potential arbitrators to determine if a conflict of interest exists. Under proposed paragraph (b)(6), for each arbitrator listed, the Director will provide the parties with the arbitrator's employment history for the past 10 years and any other information disclosed by the arbitrator under Rule 10312. This information may disclose a conflict of interest between a party and the arbitrator listed and permits the parties to make more informed decisions during the process of ranking and striking the

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[26] Under current Rule 10312, a person who wishes to be considered for appointment as an arbitrator must make disclosures to the Director of certain financial, business, employment, and personal information for the purpose of determining whether any interest, relationship or circumstances exists that might preclude a person, if appointed to an arbitration panel, from rendering an objective and impartial decision. The obligation to disclose is a continuing one. Rule 10312(c).

[27] At this stage of the arbitrator appointment process, ODR staff would not make telephone inquiries.

listed arbitrators. Under paragraph (b)(6), the parties may request additional information from the arbitrators; any response by an arbitrator is forwarded to all parties. If a party identifies a conflict of interest, the party's remedy is to strike the person from the list, in the process described in greater detail below. Proposed Rule 10308 (c)(1)(A).

(iv) Transmittal to Parties

The Director shall send the lists to all parties approximately 30 days after the respondent's answer is due, or, if there are multiple respondents, approximately 30 days after the last answer is due. If there is a third-party claim, the Director shall send the lists approximately 30 days after the third-party respondent's answer is due or, if there are multiple third-party respondents, approximately 30 days after the last answer is due. Proposed Rule 10308(b)(5). Under proposed paragraph (a)(7), "send" means to send by first class mail, facsimile, or any other method available and convenient to the parties and the Director, and the lists and all other transmissions between the parties and the Director shall be sent using one of these methods.

(C) Striking, Ranking, and Appointing Arbitrators -- Paragraph (c)

Generally, paragraph (c) of the proposed rule sets forth the method by which a party strikes and ranks arbitrators and the procedures ODR will use to consolidate the parties' preferences and appoint an arbitration panel. Under paragraph (c), the parties rank the arbitrators on the list according to the parties' preferences, and strike arbitrators to remove them from consideration. Proposed paragraph (c) will implement the most

important feature of the list selection rule, that of allowing a party to exercise significant influence over the composition of the party's arbitration panel.

(i) Striking and Ranking Arbitrators

Proposed paragraph (c)(1) provides the basic structure for the parties to exercise their influence in selecting arbitrators for their arbitration proceeding. First, each claimant and each respondent strike any one or more arbitrators from the list (or lists, if there are two lists) for any reason, including the party's concern that the arbitrator may have a conflict of interest. Second, the party ranks each arbitrator remaining on the list by assigning the arbitrator a different numerical ranking. A "1" rank indicates the party's first choice, a "2" indicates the party's second choice, and so on, until all the arbitrators are ranked. When a party receives one list of public arbitrators and one list of non-public arbitrators, the party must rank arbitrators on each list separately. Proposed Rule 10308(c) (1). As noted above, all claimants who file a single claim are treated as one claimant; and similar treatment is accorded to all respondents who file one answer. Thus, frequently, persons must act jointly to determine which arbitrators to strike and how to rank the remaining arbitrators on the lists in order for persons who are parties to have their preferences for arbitrators weighed appropriately. Moreover, even when all claimants do not file a single claim (or all respondents do not file a single answer), the party claimants' (or the party respondents') rankings will be consolidated prior to the consolidation that occurs of claimant and respondent rankings, where the party claimants (or party respondents) do not submit one set of rankings. *See* proposed Rule 10308 (c)(1)(D).

Under proposed paragraph (c)(2), each party's lists of arbitrators reflecting the party's strikes and rankings must be returned to the Director not later than twenty days after the Director's letter communicating the lists was sent. If a party does not timely return the lists, the Director shall treat the party as having retained all the arbitrators on the lists and as having no preferences. If the lists are returned but a party fails to rank an arbitrator on a list, the Director will assign the arbitrator the next lower ranking after the lowest-ranked arbitrator on that list. For example, if a party ranks arbitrators on a list containing ten public arbitrators by striking six arbitrators and ranking arbitrators A, B, and C, as "1," "2," and "3," respectively, and fails to rank public arbitrator D, ODR will assign arbitrator D a ranking of "4."

If a party fails to rank more than one arbitrator on the same list or gives two or more arbitrators on the same list the same numerical ranking, then the Director shall rank the multiple, unranked arbitrators in the same order of preference that the list originally generated by NLSS reflected and transmitted to the parties for their ranking. (When NLSS generates a list, the person listed first is ranked as high or higher by NLSS selection factors than the person listed second, third, and so on. Generally, this NLSS ranking is not relevant because the ranking by the parties is the basis for appointing arbitrators. NLSS "ranking" only becomes relevant when the parties fail to rank, or improperly rank multiple arbitrators on a list.)[28]

[28] In this process, when only the four factors are considered in the NLSS-list generation process (*e.g.*, arbitrator classification, hearing location code, rotation, and no identified conflicts of interest), the person who has taken part in the fewest list selection processes (*i.e.*, having a higher rotation number) would be placed higher on the NLSS-generated list than a person who has participated in more list selection processes. (E.*g.*, P, a public arbitrator

(ii) Consolidating Parties' Rankings

After the claimant and respondent have returned their lists to the Director, the Director implements the parties' preferences for arbitrator selection using the process described in proposed paragraph (c)(3). Under proposed paragraph (c)(3), the Director, using the NLSS, creates a consolidated list of the public arbitrators, and, if non-public arbitrators are also ranked, a second consolidated list of non-public arbitrators, using a one or two-step consolidation process.

Since generally all parties who file a single claim are treated as one claimant and all respondents who file one answer are treated as one respondent, in most cases, the Director will consolidate the parties' preferences for arbitrators using a one-step process. The Director will add the consolidated rankings of the claimant and the respondent to produce a single consolidated list for the public arbitrators and, if necessary, a second consolidated list for the non-public arbitrators. Proposed Rule 10308(c)(3). NLSS performs the consolidation functions.

When there are multiple claimants or respondents, the Director will use a two-step consolidation process. First, the Director will consolidate all rankings of the multiple claimants or respondents. For example, if there are two respondents, R #1 and R #2, the rankings of R #1 and R #2 are added together, resulting in one consolidated respondent

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in Richmond, Virginia who has participated in the list selection process six times would be listed more highly by NLSS than Z, a public arbitrator from Richmond, Virginia who has participated in the list selection process seven times, if both were generated for the same list. Therefore, if a party failed to rank both P and Z, the Director would refer to the original NLSS-generated list and rank P more highly than Z). If additional factors are introduced, such as subject matter expertise, those persons having the greatest cluster of desired factors or characteristics would be listed most highly on the NLSS-generated lists and that ordering would be used by the Director for the default

ranking for each listed public arbitrator and a second consolidated respondent ranking for each listed non-public arbitrator. This first step in the two-step consolidation process may be avoided by cooperation. The parties may file a list to which the parties have jointly agreed. Proposed Rule 10308(c)(1)(D). The first step of the consolidation process, consolidating all the preferences of multiple claimants and, separately, those of multiple respondents, prevents numerous parties on one side of the case from unfairly affecting the selection of the arbitrators. By consolidating the rankings of parties on the same side, the process ensures that claimants' and respondents' choices will have the same weight in the arbitrator selection process. Second, as previously described, the NLSS will consolidate the rankings of the claimants and the respondents to produce a single consolidated list for public arbitrators and, if necessary, a second list for non-public arbitrators.[29] (Proposed Rule 10308(c)(3)).

In instances where the Director determines that the interests of a claimant or a respondent (including a third party respondent) are so substantially different from the interests of other claimants or respondents, the Director may determine not to consolidate the numerical rankings of that party with the numerical rankings of the other claimants (or with the other respondents, as the case may be). Proposed Rule 10308(c)(3)(B). In those instances, NLSS will not have the capacity to create the consolidated list (or lists). Instead, the consolidated list (or lists) will be created based upon calculations performed

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"ranking" process that is used only when the parties fail to rank multiple arbitrators.

[29] The proposed rule also accommodates the interests of a party added to the case if the party is added before the Director has consolidated the other parties' rankings. Proposed Rule 10308(c)(6).

manually by the ODR with each party's rankings having an equal weighting (*e.g.*, where a claimant, a respondent, and a third party respondent are recognized as having substantially different interests, each of the parties rankings will have a 33 _% weight in the consolidated list or lists).

The following examples illustrate the consolidation process:

- If the dispute will be heard by one public arbitrator, the NLSS will produce a consolidated list that will contain the names of five public arbitrators, ranked 1 through 5, based upon the consolidated rankings derived from the parties' rankings.
- If the list of public arbitrators sent to both parties contained five names and the claimant strikes one name, then the consolidated list will rank, numerically, the four names remaining on the list. If the claimant strikes one name and the respondent strikes a second name, then the consolidated list will contain only the names of the three public arbitrators that neither party chose to strike.

- A detailed example is set forth below:[30]

[30] The example illustrates the process that will be used for each list of arbitrators distributed to the parties. Therefore, in cases where a panel of one non-public and two public arbitrators will be selected, this process will be used to produce two consolidated arbitrator lists.

Original List

Arb#[31]	List Position	Arb Name
A00001	1	Red
A00100	2	Orange
A01000	3	Yellow
A10000	4	Green
A10001	5	Blue
A00500	6	Indigo
A99999	7	Violet
A20000	8	Cyan
A00200	9	Magenta
A02200	10	Fuchsia

With Parties' Rankings

Arb#	**List Position**	**Arb Name**	**Consolidated Claimant**	**Consolidated Respondent**	**Total**	**Difference**
A00001	1	Red	1	6	7	5
A00100	2	Orange	Strike	7	N/A	N/A
A01000	3	Yellow	2	1	3	1
A10000	4	Green	3	5	8	2
A10001	5	Blue	4	4	8	0
A00500	6	Indigo	5	3	8	2
A99999	7	Violet	6	2	8	4
A20000	8	Cyan	7	Strike	Strike	N/A
A00200	9	Magenta	8	8	16	0
A02200	10	Fuchsia	9	Strike	Strike	N/A

[31] Each arbitrator in the NLSS is assigned an arbitrator identification number as he or she enters the system. For example, a person who has been an NASD arbitrator since 1995 has a lower arbitration identification number (*e.g.*, A13888) than a person who has been an NASD arbitrator since 1997 (*e.g.*, A17050).

System Results

Arb#	List Position	Arb Name	Consolidated Rank	Notes
A00001	1	Red	2	Total is 7
A00100	2	Orange	Strike	N/A
A01000	3	Yellow	1	Total is 3
A10000	4	Green	4	Total is 8 Difference is 2 List Position is 4
A10001	5	Blue	3	Total is 8 Difference is 0 List Position is 5
A00500	6	Indigo	5	Total is 8 Difference is 2 List Position is 6
A99999	7	Violet	6	Total is 8 Difference is 4 List Position is 7
A20000	8	Cyan	Strike	N/A
A00200	9	Magenta	7	Total is 16
A02200	10	Fuchsia	Strike	N/A

Rearranged by Rank

Arb#	Arb Name	Consolidated Rank	Notes
A01000	Yellow	1	Total is 3
A00001	Red	2	Total is 7
A10001	Blue	3	Total is 8 Difference is 0 List Position is 7
A10000	Green	4	Total is 8 Difference is 2 List Position is 4
A00500	Indigo	5	Total is 8 Difference is 2 List Position is 6
A99999	Violet	6	Total is 8 Difference is 4 List Position is 7
A00200	Magenta	7	Total is 16

Numerical ties between two or more arbitrators during consolidation will be broken by NLSS by the following principles. First, NLSS will break a tie during consolidation by preferentially ranking one arbitrator above another based upon which of the tied arbitrators has a set of rankings, that, when compared, result in the smallest numerical difference between the claimant ranking and the respondent ranking. For example, in the tabular example above, the consolidated rankings of the consolidated claimant and the consolidated respondent have resulted in four arbitrators, Green, Blue, Indigo, and Violet, each receiving a consolidated ranking of 8, resulting in a four-way tie. (*See* table entitled "With Parties Rankings.") Of the four tied arbitrators, Blue will be assigned a ranking as the most preferred arbitrator because the difference between Blue's consolidated claimant's ranking and Blue's consolidated respondent's ranking is 0 (*i.e.*, 4 - 4 = 0); conversely, Violet would be given the fourth (or lowest or least preferred) ranking of the four arbitrators in the four-way tie because of the largest difference in the rankings that the consolidated claimant and the consolidated respondent gave Violet, compared to the three others (*i.e.*, the consolidated claimant ranked Violet 6 and the consolidated respondent ranked Violet 2, resulting in a difference of 4 (*i.e.*, 6 - 2 = 4), whereas the differences in the rankings assigned Blue, Green, and Indigo are, respectively, 0 , 2 and 2.) (*See* table entitled, "Rearranged by Rank").

A second principle that governs tie-breaking within NLSS is that, given an equal difference in the consolidated ranking, an arbitrator who was listed higher (as more preferred) on the list as originally generated by the NLSS and transmitted to the parties will be given a more preferred or higher ranking in order to break this type of tie.

Referring to the same example, Green and Indigo both show consolidated rankings of 8, resulting in the first type of tie discussed above. In addition, Green and Indigo each received rankings from consolidated claimants and respondents that are different by only 2. The first principle applied to break a tie does not provide any assistance; the second principle must be applied. Applying the second principle, during the consolidation process NLSS will rank Green as more preferred (or higher) than Indigo because, on the original list generated by NLSS, Green had a list position of 4, which was higher than Indigo's list position of 6. (*See* table entitled, "Rearranged by Rank," and the column entitled "Notes," for the final NLSS consolidated rankings taking into account these two tie-breaking principles, and the table entitled "Original List" for the position of the arbitrators on the list as originally generated by NLSS.)

(iii) Appointing Arbitrators

Proposed Rule 10308(c)(4) sets forth the steps the Director will take to appoint arbitrators after consolidation occurs. Assuming that the tabular example above is a list of public arbitrators, if the arbitration is to be heard by one public arbitrator, the Director contacts the public arbitrator ranked highest on the list. Thus, the Director would contact Yellow first to determine if Yellow was available to serve and, if not disqualified, Yellow would be appointed. Using the tabular example above, if the Director were required to appoint a three-person arbitration panel, the Director would contact Yellow and Red to determine if they were available to serve and, if not disqualified, would appoint them. If necessary, due to the unavailability or disqualification of one of the two arbitrators, the Director would then contact Blue, and invite Blue to serve. The Director would refer to a

second list, generated according to the same principles, to determine which non-public arbitrator should be contacted first.

The contact is to determine if the arbitrator is available and, after being provided the issues of the case and the names of the parties, if the arbitrator is aware of any conflicts of interest or bias or other reason that may preclude the arbitrator from rendering an objective and impartial decision. Based upon the information that the arbitrator has previously provided under Rule 10312, and any information obtained from any other source, the Director shall determine if the arbitrator should be disqualified. If the Director determines that the arbitrator should not be disqualified and that the arbitrator is available, the Director appoints the arbitrator. Proposed Rule 10308(c)(4).

The Director will establish a time frame for ODR's guidance if a listed arbitrator is contacted but fails to respond to ODR's inquiries regarding availability and disqualification. For example, if an arbitrator is telephoned and fails to respond, ODR will eliminate such arbitrator and contact the next listed arbitrator after an appropriate, but relatively brief, period. ODR must exercise such discretion in fairness to all parties who are waiting for their arbitration cases to be resolved.

(iv) Selecting a Chairperson

The Director notifies the parties of the appointments and requests that the parties appoint a chairperson. The parties may jointly select one of the arbitrators (including the non-public arbitrator) to be the chairperson of the panel. Proposed Rule 10308(c)(5). If the parties fail to appoint a chairperson by mutual agreement within 15 days, the Director

will appoint the chairperson. If the Director appoints the chairperson, the chairperson will be one of the public arbitrators, but one who is not an attorney or other professional who has devoted 50% or more of his or her professional or business activities, within the past two years, to representing or advising public customers in adversarial proceedings concerning disputed securities or commodities transactions or related matters.[32] This provision also excludes a person who is employed by a person engaged in the listed professional activities from being appointed as chairperson.

(v) When the Consolidated List is Insufficient

Under proposed Rule 10308(c)(4), if the Director is not able to appoint the number of arbitrators needed for the panel using the consolidated list, the Director may appoint other arbitrators from the NLSS roster as necessary. If the Director is required to appoint a non-public arbitrator, the Director may not appoint a non-public arbitrator who meets the criteria set forth in paragraph (a)(4)(B) or (a)(4)(C), unless the parties otherwise agree. A non-public arbitrator in proposed paragraph (a)(4)(B) is one who is retired from the securities or commodities industry; proposed paragraph (a)(4)(C) describes a non-public arbitrator who is a professional who devotes 20 percent or more of his or her professional time to clients who are engaged in any of the securities or commodities business activities

[32] Specifically, proposed paragraph (c)(5) prohibits the Director from appointing as the chairperson a public arbitrator who:

> (A) is an attorney, accountant, or other professional, and
> (B) has devoted 50% or more of his or her professional or business activities, within the last two years, to representing or advising public customers in matters relating to disputed securities or commodities transactions or similar matters.

described in subparagraph (a)(4).[33] When the Director appoints a non-public arbitrator in this stage of the proceeding, the parties no longer have the ability to strike. Thus, the rule requires that the Director choose a non-public arbitrator who is active and fully involved in the securities or commodities industry or related industry.

(D) Arbitrator Disclosures and Removing Arbitrators --

Paragraph (d)

An arbitrator has a continuing obligation under Rule 10312 of the Code to disclose to the Director any circumstances that might preclude the arbitrator from rendering an objective and impartial determination in an arbitration including, a direct or indirect financial or personal interest in the outcome of the arbitration, or any existing or past financial, business, professional, family or social relationships with a party, counsel, or representative (or, when later identified, a witness) that might affect impartiality or might reasonably create an appearance of partiality or bias. The ODR, in turn, must disclose to the parties any information the arbitrators provide. As noted previously, under proposed Rule 10308(c), ODR forwards to the parties the information disclosed to the Director under Rule 10312.

If the parties believe that the information forwarded to them from ODR or information from any other source suggests that the arbitrator may not be impartial regarding the issues or the case, and if such information is received before the party has

[33] Although a party does not have the right to strike an arbitrator appointed under the process described in proposed paragraph (c)(4)(B), a party retains the right to request that the Director consider disqualifying an arbitrator appointed pursuant to proposed Rule 10308(c)(4)(B).

returned the arbitrator lists to the Director, a party may simply strike the arbitrator under proposed Rule 10308(c). Thus, prior to sending in the party's preferences to the Director for consolidation, a party has an unlimited right to strike any potential arbitrator as to whom the party suspects bias.

Proposed paragraph (d)(1) provides for disqualification after an arbitrator has been appointed by the Director under paragraph (c)(4).[34] Under proposed Rule 10308(d)(1), a party or the Director may raise a disqualification issue. However, the decision to disqualify an arbitrator already selected under proposed Rule 10308(c)(4) lies solely with the Director. The Director may not make any decision to disqualify an arbitrator, however, after the commencement of the earlier of two events: (i) the first prehearing conference or (ii) the first hearing. Proposed Rule 10308(d)(2). At that point or thereafter, if a party believes that an arbitrator should be disqualified, the matter must be raised before the arbitration panel. Vacancies created as a result of a disqualification under proposed paragraph (d)(1) are filled by the Director by referring to the appropriate consolidated list from which the panelists were originally obtained (proposed Rule 10308(d)(3)) or, if there are no persons remaining on the consolidated list, by a person the Director selects under proposed Rule 10308(c)(5).

[34] As noted above, disqualification issues that arise after the Director, using NLSS, has begun consolidating parties' preferred arbitrators, may be addressed by the Director directly as part of the appointment process described in paragraph (c)(4).

(E) Discretionary Authority -- Paragraph (e)

Under paragraph (e), the Director's authority to exercise discretionary authority is stated explicitly. In paragraph (e), the Director has authority to resolve a problem that arises relating to the appointment of arbitrators or any other procedure under the rule if (i) the rule does not have an applicable provision, or (ii) the application of a specific provision in the rule would not result in a resolution of the underlying problem because the facts and circumstances are unanticipated or unusual.

(3) Miscellaneous Related Proposed Rule Changes

(A) Proposed Conforming Amendments

NASD Regulation is proposing conforming amendments to Rules 10104, 10309, 10310, 10311, 10312, and 10313.

NASD proposes to make parallel amendments to Rule 10104 and Rule 10309. NASD Regulation proposes to amend Rule 10104 to reflect that the specific provisions of proposed Rule 10308, rather than the general provisions of Rule 10104, regarding the composition and appointment of arbitration panels, will apply to arbitrations involving public customers. Rule 10104 would not apply to a question regarding the composition and appointment of such arbitration panels unless none of the specific provisions in proposed Rule 10308 would be applicable.[35] NASD Regulation proposes the same type

[35] Rule 10104 and certain other rules in the Rule 10000 Series may be amended further or rescinded when a list selection rule applicable to intra-industry arbitration proceedings is approved. NASD Regulation plans to file a rule shortly so that NLSS may be used for panel selection in intra-industry arbitrations, as well as in customer arbitrations.

of amendment to Rule 10309, a similarly general provision relating to the composition of arbitration panels.

NASD Regulation proposes to amend Rule 10310 and 10311 to make both of them inapplicable to proceedings subject to Rule 10308. Under Rule 10310, NASD Regulation notifies parties of arbitrators appointed, and under Rule 10311, parties have the right to a peremptory challenge of an arbitrator. Because proposed Rule 10308 deals with both types of procedures, NASD Regulation proposes to amend Rules 10310 and Rule 10311 so that neither will apply to arbitration proceedings involving public customers.

NASD Regulation is proposing to amend Rule 10312 to make it consistent with proposed Rule 10308. Both Rules contain provisions regarding an arbitrator's obligation to disclose information to the Director and disqualification based upon such disclosure. The proposed changes to Rule 10312 state explicitly when the Director's authority to disqualify an arbitrator terminates, and provide an arbitrator the option to withdraw from an arbitration panel prior to disclosure of arbitrator information to the parties. A final change in Rule 10312 makes the timing of a disclosure consistent with the parallel provision in proposed Rule 10308.

The proposed changes to Rule 10313 are necessary because Rule 10313 incorporates by reference certain procedures in Rule 10311, and that rule, if amended, will not apply to arbitrations involving public customers. Specifically, NASD Regulation proposes to amend the last sentence of current Rule 10313 so that, for arbitration proceedings involving public customers, a party may exercise the right to challenge a

replacement arbitrator within the time remaining prior to the next scheduled hearing session by notifying the Director in writing of the challenged arbitrator's name and the basis for such challenge.

(B) Proposed Amendments to Rule 10315

In the past, the first formal meeting of the arbitration panel and the parties generally was the first hearing. As the arbitration process has evolved, NASD Regulation has encouraged most arbitration panels to hold prehearing conferences. For most arbitrations currently, the first formal meeting of the arbitration panel and the parties is a prehearing telephone conference. NASD Regulation proposes to amend Rule 10315 regarding the scheduling of the first meeting to reflect the current practice.

NASD Regulation also proposes to amend from eight business days to 15 business days the period that NASD has for giving notice of the first meeting to the parties and the arbitrators. The period is being amended to conform to the 15 business day period set forth in Rule 10310, which formerly also was a period of only eight business days.

(C) Proposed Amendments to Various Rules to Correctly Identify Committee Name

The committee of NASD Regulation that addresses arbitration matters is the National Arbitration and Mediation Committee. NASD Regulation proposes to amend each rule in which the outdated term "National Arbitration Committee" is used by replacing the outdated term with the current committee name, the "National Arbitration

and Mediation Committee." (*See, e.g.*, Rule 10102, Rule 10103, Rule 10104 referenced specifically above, Rule 10301, and Rule 10401).

(4) Request for Comments on Specific Topic

NASD Regulation proposes to allow parties to have the right to strike an unlimited number of arbitrators from lists under proposed Rule 10308(c)(1)(A). NASD Regulation specifically requests comment on whether parties should have an unlimited number of strikes, or whether the right to strike should be limited. If a claimant, for example, strikes every arbitrator listed, all the listed arbitrators are ineligible, the respondent's preferences are nullified, and the Director appoints arbitrators who are not listed. Thus, the unlimited right to strike may be too broad to accomplish the purposes intended by the rule proposal.

NASD Regulation is requesting that the proposed rule change be effective within 45 days of SEC approval.

(b) NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[36] 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.

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[36] 15 U.S.C § 78o-3.

(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