

issues of regulatory concern. For these reasons, the Commission believes that good cause exists, consistent with Section 6(b)(5)⁹ and Section 19(b)¹⁰ of the Act, to approve Amendment No. 1 to the proposed rule on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1, including whether Amendment No. 1 is consistent with the Act. 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 other 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 at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CHX. All submissions should refer to File No. SR-CHX-98-15 and should be submitted by November 12, 1998.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹¹ that the amended proposed rule change (SR-CHX-98-15) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40555; File No. SR-NASD-98-48]

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3 and 4 to Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers

I. Introduction

On July 10, 1998, the National Association of Securities Dealers, Inc., ("NASD" or "association") through its wholly-owned subsidiary, NASD Regulation, submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend Rule 10308 to set forth new procedures to be used to select arbitrators for arbitrations involving public customers.³ 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 larger role in determining the composition of their arbitration panels. NASD Regulation also 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 correct in its rules the name of the NASD Regulation committee that addresses arbitration and related matters, the National Arbitration and Mediation Committee.

The proposed rule change, together with the substance of the proposal, was published for comment in Securities Exchange Act Release No. 40261 (July 24, 1998) 63 FR 40761 (July 30, 1998). Three comment letters were received in response to the proposal.⁴ NASD

Regulation filed Amendment Nos. 3 and 4 to the proposed rule change⁵ on August 14, 1998 and September 4, 1998, respectively. The NASD also responded to the comment letters.⁶ Below is the text of the proposed rule change contained in the Amendment Nos. 3 and 4. Proposed new language is italicized; proposed deletions are in brackets.

10308. Selection of Arbitrators in Customer Disputes

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Arbitration Committee, to Jonathan G. Katz, Secretary, Commission, dated August 19, 1998 ("SIA Letter"); Scot D. Bernstein ("Bernstein"), Law Offices of Scot D. Bernstein, to Jonathan G. Katz, Secretary, Commission, dated August 19, 1998 ("Bernstein Letter"); and Richard P. Ryder ("Ryder"), Securities Arbitration Commentator, to Jonathan G. Katz, Secretary, Commission, dated September 2, 1998 ("Ryder Letter").

⁵ Amendment No. 3 amends the definition of "non-public arbitrator" to incorporate the standard terminology "municipal securities dealer" and to add an explicit reference to government and municipal securities to make clear that employees of banks or other financial institutions who engage in government or municipal securities transactions are included in the definition; by reordering proposed Rule 10308(b)(1) to make it more clear and to conform it to previously approved amendments to Rule 10308 and Rule 10302; by amending Rule 10308(b)(1) to clarify parties' right to change the panel composition if they all agree; to clarify in the rule language what information will be available with regard to the initial conflict of interest review by NLSS; to clarify in the rule language that the information on each arbitrator forwarded to the parties is employment information for a 10 year period and any other background information; to clarify in the rule language that a ranking of "1" means the most preferred arbitrator; to clarify in the rule language that when the Director must appoint an unranked arbitrator the Director will provide the parties Rule 10308(b)(6) information and the parties shall have the right to object to the arbitrator as provided in Rule 10308(d)(1); to delete the reference in the rule to parties acting cooperatively to rank arbitrators; and to reorder Rule 10312(d), (e), and (f) and to clarify the information contained in those paragraphs. See letter from John M. Ramsay, Vice President and Deputy General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Market Regulation, Commission, dated August 14, 1998 ("Amendment No. 3").

Amendment No. 4 amends Rule 10308(c)(5) to state that the Director must choose one of the public arbitrators as chairperson of the arbitration panel, subject to certain parameters; amends Rule 10308(c)(3) to eliminate the exception where a Director could determine not to consolidate a party's rankings with the other parties if he or she determines that their interests are "sufficiently divergent;" amends Rule 10313 to align the time period with previous revisions to rules 10312 and 10315; to clarify the effective date of the proposed rule change; and to respond to the comment letters. See letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Market Regulation, Commission, dated September 4, 1998 ("Amendment No. 4").

⁶ See Amendment No. 4 and letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Market Regulation, Commission, dated September 11, 1998 ("Response Two").

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ NASD Regulation filed a proposed rule change to use a similar list selection process for intra-industry arbitrations (SR-NASD-98-64), which the Commission is approving on an accelerated basis simultaneously with this filing.

⁴ See letters from Stephen G. Sneeringer, Chairman, Securities Industry Association ("SIA")

⁹ U.S.C. 78(b)(5).

¹⁰ U.S.C. 78s(b).

¹¹ 15 U.S.C. 78s(b)(2).

¹² 17 CFR 200.30-3(a)(12).

(a) Definitions

(1) through (3) No change

(4) "non-public arbitrator"

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

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

(i) associated with a broker or a dealer (including a government securities broker or dealer or a municipal securities [broker or] dealer);

(ii) through (iv) No change

(B) through (C) No change

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

(5) through (7) No change

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

(1) Composition of Arbitration Panel

(A) *Claims of \$50,000 or Less* [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] to the appointment of a non-public arbitrator.

(i) *If the amount of a claim is \$25,000 or less and an arbitrator appointed to the case 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 to a different panel composition.*

(ii) *If the amount of a claim is greater than \$25,000 and not more than \$50,000 and a party in its initial filing or an arbitrator appointed to the case 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 to a different panel composition.*

[(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] *Claims of More than \$50,000. 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 to a different panel composition.*

[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) through (3) No change

(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 identified within the Neutral List Selection System database.

(B) No change

(5) No change

(6) Information About Arbitrators

The Director shall send to the parties employment history for each listed arbitrator for the past 10 years and [any] other background 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) No change

(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, with a "1" rank indicating the party's first choice, a "2" indicating the party's second choice, and so on.

(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, with a "1" rank indicating the party's first choice, a "2" indicating the party's second choice, and so on. Each party [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) No change

(3) Process of Consolidating Parties' Rankings

[(A) General Rule] The Director shall prepare one or two consolidated lists of arbitrators, as appropriate under paragraphs (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) No change

(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). The Director shall provide the parties information about the arbitrator as provided in paragraph (b)(6), and the parties shall have the right to object to the arbitrator as provided in paragraph (d)(1).

(5) Selecting the 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.] a chairperson from the panel as follows:

(A) The Director shall appoint as the chairperson the public arbitrator who is the most highly ranked by the parties as long as the person is not an attorney, accountant, or other professional who 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.

(B) If the most highly ranked public arbitrator is subject to the exclusion set forth in subparagraph (A), the Director shall appoint as the chairperson the other public arbitrator, as long as the person also is not subject to the exclusion set forth in subparagraph (A).

(C) If both public arbitrators are subject to the exclusion set forth in subparagraph (A), the Director shall appoint as the chairperson the public arbitrator who is the most highly ranked by the parties.

(6) No change

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

(1) through (2) No change

(3) Vacancies Created by Disqualification or Resignation

Prior to the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, [I]f an arbitrator appointed to an arbitration panel is disqualified or is otherwise unable or unwilling to serve, [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). The Director shall provide the parties information about the arbitrator as provided in paragraph (b)(6), and the parties shall have the right to object to the arbitrator as provided in paragraph (d)(1).

(e) No change

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

(a) through (c) No change

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(d) Prior to the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, the Director may remove an arbitrator based on information disclosed pursuant to this Rule.

(e) Prior to the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing, [T]he Director shall inform the parties to an arbitration proceeding of any information disclosed to the Director under this Rule unless either the arbitrator who disclosed the information withdraws [from being considered for appointment] voluntarily as soon as [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, or the Director removes the arbitrator.

[(e) Prior to the commencement of the earlier of (i) the first prehearing conference of (ii) the first hearing, the Director may remove an arbitrator based on information disclosed pursuant to this Rule.]

(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. During this period, the Director shall inform the parties of any information disclosed by an arbitrator under this Rule.

Rule 10313. Disqualification or Other Disability of Arbitrators

In the event that any arbitrator, after the commencement of the earlier of (i) the first prehearing conference or (ii) 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.

II. Background and Description

NASD Regulation developed a rule that provides parties in arbitration with more input into the selection of arbitrators. Under the proposal, parties will select their arbitrators from lists provided by NASD Regulation. 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.⁷ 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 lists of arbitrators will be generated by computer from an arbitrator database called the Neutral List Selection System ("NLSS").⁸ However, the Director of Arbitration ("Director") also has the discretion to supplement the NLSS process in response to party requests.

The proposed rule change is divided into five parts.⁹ Paragraph (a) contains definitions. Paragraph (b) specifies how 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.

NASD Regulation amended several other rules in the Rule 10000 Series in order to make the Rule Series 10000 consistent. Proposed amendments to those rules are discussed at the end of the discussion of the proposed changes to Rule 10308.

Definitions—Paragraph (a)

Paragraph (a) of Rule 10308 of the proposed rule change contains seven definitions: "day," "claimant," "Neutral List Selection System," "non-public arbitrator," "public arbitrator," "respondent" and "send."

⁷ For ease of reference, the NASD focused the discussion in this rule filing on of the process of selecting a three-person arbitration panel.

⁸ The term "Neutral List Selection System" is defined in proposed Rule 10308(a)(3).

⁹ The NASD has filed a proposed rule change to apply a similar list selection process to intra-industry disputes, which the Commission is approving on an accelerated basis simultaneously with this filing. See SR-NASD-98-64.

The definition of "non-public arbitrator" at paragraph (a)(4) largely retains the existing definition in the Rule 10000 Series 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 definition of "public arbitrator" at paragraph (a)(5) of Rule 10308 also largely retains the existing definition in the Rule 10000 series. The proposed rule change clarifies the securities-related activities or affiliations that would exclude an arbitrator from the "public arbitrator" classification. For example, the proposed rule change adds that persons employed by banks and other financial institutions who are engaged in securities activities or in the supervision of such activities may not be public arbitrators.

"Immediate family member" is defined in proposed Rule 10308(a)(5)(B) with reference to the person's familial or economic ties to the person associated with the securities or commodities industry.¹⁰ A person who has a close familial, personal, or economically dependent relationship with an associated person can be viewed as biased in favor of the securities or commodities industry even though he or she is not involved directly with the identified industry.¹¹

The 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."¹² 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.¹³ The Office of Dispute Resolution ("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.¹⁴ This approach will simplify consolidating the parties' preferences for arbitrators described below.¹⁵

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

Proposed Rule 10308(b)(1) states 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 generally will be heard by a single public arbitrator, unless the parties agree to the appointment of a non-public arbitrator.¹⁶ 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 to a different panel composition.¹⁷ Under proposed paragraph (b)(1)(i), if the claim is \$25,000 or less and an arbitrator appointed to the case requests that a panel of three arbitrators be appointed, the Director will appoint an arbitration panel composed of one non-public and two public arbitrators, unless the parties agree to a different panel composition.¹⁸

Under proposed paragraphs (b)(2) and (b)(3) of Rule 10308, the Director will send lists of names of arbitrators for ranking to the claimant and the respondent. When only one arbitrator will hear the proceeding, the Director will send the parties one list of public arbitrators.¹⁹ 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.²⁰ When the parties agree to change the panel composition, references in the balance of the rule to a panel would be interpreted accordingly. 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; the Director would not send the parties a list of non-public arbitrators. In addition, if the panel composition varies from that provided in proposed paragraph (b)(1)(A) or (B), NLSS is not capable of processing all combinations. NLSS can generate the lists and consolidate the rankings for one-person panel of either public or non-public classification. For a three-person panel, NLSS can only generate the lists and consolidate the rankings for a panel composed of one non-public and two public arbitrators or three non-public arbitrators.²¹

(i) Director's Minimum Numbers for Lists

Subparagraphs (b)(2) and (b)(3) of proposed Rule 10308 do not set a fixed ratio of arbitrators or a minimum number of arbitrators that ODR must

hearing session deposit fees for a three-person panel under Rule 10332. An arbitrator appointed to the case may also request a three arbitrator panel. See Amendment No. 3.

¹⁷ See Proposed Rule 10308(b)(1)(A)(ii) and Amendment No. 3.

¹⁸ See Amendment No. 3.

¹⁹ Proposed Rule 10308(b)(2).

²⁰ Proposed Rule 10308(b)(3).

²¹ Although the parties could agree to changes in panel composition, NASD Regulation states that experience indicates that composition changes for disputes involving customers is almost never requested.

¹⁰ "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 paragraph (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 paragraph (a)(4)(A) through (D).

¹¹ As under existing rules, a small group of persons will continue to 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.

¹² Proposed Rule 10308(a)(3).

¹³ Proposed Rule 10308(a)(6).

¹⁴ The consolidated process is 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 be weighted as the other 50%.

¹⁵ The terms "day" and "send" are also defined in paragraph (a).

¹⁶ See Proposed Rule 10308(b)(1)(A)(i) and Amendment No. 3. Under proposed paragraph (b)(1)(A)(ii) of Rule 10308, a claimant with a claim valued greater than \$25,000 and not more than \$50,000 may request a three-person arbitration panel. Obtaining a three-person panel under this subparagraph then obligates the parties to pay

list. ODR, however, 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. To the extent possible, NASD Regulation expects that, 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 depends on the number of available arbitrators and the demands on the arbitrator roster. Circumstances may arise where a small arbitrator roster in a particular hearing location (for example, Richmond, Va., Norfolk, Va., Alaska, or Hawaii), combined with a high demand for arbitrators, would prevent the Director from meeting the objectives.

To address possible arbitrator shortages, NASD Regulation plans to combine arbitrator rosters from near-by hearing locations. 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 close to the first hearing location code.

(ii) NLSS Functions and Capabilities

Proposed paragraphs (b)(2), (3), and (4) of Rule 10308 together state 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,²² and conflicts of interests²³ identified within the NLSS database.²⁴

Under proposed Rule 10308(b)(4)(B), the automated NLSS selection process that generates the arbitrators may be altered in order to add 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's selection or sorting process at the option of a party as provided in proposed paragraph (b)(4)(B) of Rule 10308.

First, a party may request for listing arbitrators who possess certain types of subject matter expertise.²⁵ The NLSS will add the additional factor and sort or select for placement on the lists some

²² 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.

²³ Proposed Rule 10308(b)(4). 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.

²⁴ See Amendment No. 3.

²⁵ 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.

arbitrators having the subject matter expertise identified unless such arbitrators are not available.²⁶

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 included in 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.

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.²⁷ 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.

(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

²⁶ NLSS selects based upon the areas of subject matter expertise that have been coded for the NLSS. 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.). 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.

²⁷ The two other types of case expertise, expertise involving injunctive relief and employment issues, are used only in intra-industry arbitrations.

above.²⁸ The second process will be a review for conflicts of interest performed manually by ODR, which 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 and, for non-public arbitrators, additional information found in the Central Registration Depository ("CRD"). After a review of available information, ODR may remove an arbitrator based upon such disclosure.²⁹ 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) of Rule 10308, for each arbitrator listed, the Director will provide the parties with the arbitrator's employment history for the past 10 years and other background information. This information may help parties to discover a conflict of interest between a party or its witnesses 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.³⁰

(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.³¹ Under proposed paragraph (a)(7) of Rule 10308, "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.

Striking, Ranking, and Appointing Arbitrators—Paragraph (c)

Generally, paragraph (c) of proposed Rule 10308 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 may 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.³² 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.³³ 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. Multiple claimants and multiple respondents may 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.³⁴

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.)³⁵

(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) of Rule 10308. Under

³⁵ 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.

²⁸ See discussion regarding proposed Rule 10308(b)(4)(A) and Note 23, *supra*.

²⁹ At this stage of the arbitrator appointment process, ODR staff would not make telephone inquiries.

³⁰ Proposed Rule 10308(c)(1)(A).

³¹ Proposed Rule 10308(b)(5).

³² This language explaining the ranking was added to the rule language in proposed Rule 10308(c)(1)(B) and (C). See Amendment No. 3.

³³ Proposed Rule 10308(c)(1).

³⁴ Proposed paragraph (c)(1)(D) of Rule 10308, which addresses multiple-party concepts, has been deleted because NASD Regulation believes that it is implicit that parties may act cooperatively to rank arbitrators. See Amendment No. 3.

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.³⁶ 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. The first step of the consolidation process, consolidating all the preferences of multiple claimants and, separately, those of multiple respondents, prevents numerous parties on the claimant or respondent side of the case from having a greater influence in 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.³⁷

NASD Regulation has eliminated the exception to the general rule for consolidation of all claimants or all respondents, which had stated that 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).³⁸

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. 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.

(iii) Appointing Arbitrators

Proposed Rule 10308(c)(4) states the steps the Director will take to appoint arbitrators after consolidation occurs. If the arbitration is to be heard by one public arbitrator, the Director contacts the public arbitrator ranked highest on the public arbitrator list. If the Director were required to appoint a three-person arbitration panel, the Director would contact the next two highest ranked arbitrators 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 the third highest ranked arbitrator, and invite him or her to serve. The Director would refer to the 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 provided the issues of the cases 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, any information provided to the Director under Rule

10312,³⁹ 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.⁴⁰

NASD Regulation will establish a time frame to guide its staff when 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 period. NASD Regulation undertakes to exercise its discretion in fairness to the parties waiting for their arbitration cases to be resolved.

(iv) Selecting a Chairperson

Under the proposal, the Director will notify the parties of the appointments and request 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.⁴¹ If the parties fail to appoint a chairperson by mutual agreement within 15 days, the Director will appoint the chairperson. The Director will appoint the public arbitrator most highly ranked by the parties, as long as that person 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.⁴² If the most highly ranked public arbitrator is subject to this exclusion, the Director shall appoint the other public arbitrator as chairperson, unless that person is also subject to the same exclusion. If both public arbitrators are subject to this exclusion, the Director shall appoint the most highly ranked public arbitrator as chairperson.⁴³

(v) When the Consolidated List Is Insufficient

Under proposed Rule 10308(c)(4), if the Director is not able to appoint the

³⁶ Proposed Rule 10308(c)(3).

³⁷ Proposed Rule 10308(c)(3). 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).

³⁸ See Amendment No. 4, deleting proposed Rule 10308(c)(3)(B).

³⁹ Current Rule 10312, also discussed below, requires an arbitrator to disclose, with respect to a particular case and the issues, parties, and witnesses in the case, any information which might preclude the arbitrator from rendering an objective and impartial determination in the case.

⁴⁰ Proposed Rule 10308(c)(4).

⁴¹ Proposed Rule 10308(c)(5).

⁴² See Amendment No. 4.

⁴³ See Amendment No. 4.

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). 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. When the Director appoints a non-public arbitrator in this stage of the proceeding, the parties no longer have the ability to strike.⁴⁴

Arbitrator Disclosures and Removing Arbitrators—Paragraph (d)

Proposed Rule 10308(d)(1) provides a mechanism for the Director to disqualify an arbitrator after the arbitrator has been appointed by the Director under proposed paragraph (c)(4). As noted previously, during the period that a party is reviewing and ranking the lists of arbitrators (see paragraphs (c) (1) and (2)), a party has an unlimited right to eliminate a listed arbitrator by striking the arbitrator from the list, and may do so to eliminate an arbitrator who the party believes may not be impartial or fair, among other reasons. Proposed paragraph (d)(1) applies after the parties have exercised this unlimited right to strike, the arbitrator lists have been consolidated, the arbitrators have made disclosures to the Director under Rule 10312 regarding the specific parties, issues and witnesses in the case as discussed below, and the arbitrators have been appointed.⁴⁵

⁴⁴ Under the proposal, the Director provides the parties information about the arbitrator as provided in proposed paragraph (b)(6). Based upon that information, the parties have the right to object to the arbitrator as provided in proposed paragraph (d)(1) of Rule 10308. See Amendment No. 3. This means that although a party does not have the right to strike an arbitrator appointed under the process described in proposed (c)(4)(B) of Rule 10308, a party retains the right to request that the Director consider disqualifying an arbitrator appointed pursuant to proposed Rule 10308(c)(4)(B).

⁴⁵ 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).

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. Generally, the ODR, in turn, must disclose to the parties any information the arbitrators provide.

Under paragraph (d)(1), a party or the Director may raise a disqualification issue, and the Director may disqualify an arbitrator already appointed. 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.⁴⁶ 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 or because the arbitrator is otherwise unable to or unwilling to serve⁴⁷ under proposed paragraph (d)(1), prior to the commencement of the earlier of 1) the prehearing conference or 2) the first hearing,⁴⁸ 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)(4)(B). Under the proposal, the Director provides the parties information about the replacement arbitrator(s) as provided in proposed paragraph (b)(6), and the parties have the right to object to that arbitrator as provided in proposed paragraph (d)(1).⁴⁹

Discretionary Authority—Paragraph (e)

Under paragraph (e) of Rule 10308, 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.

Miscellaneous Related Proposed Rule Changes

Proposed Conforming Amendments

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

NASD Regulation 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, 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.⁵⁰ 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 pre-emptory 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

⁵⁰ The NASD has stated that 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 has filed a proposed rule change to apply the NLSS to panel selection in intra-industry arbitrations, as well as in customer arbitrations (SR-NASD-98-64) which is being noticed and granted accelerated approval simultaneously with this rule approval. See Securities Exchange Act Release No. 40556 (October 14, 1998).

⁴⁶ Proposed Rule 10308(d)(2).

⁴⁷ See Amendment No. 3.

⁴⁸ See Amendment No. 3.

⁴⁹ See Amendment No. 3.

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. Specifically, under proposed Rule 10312(d), prior to the commencement of the earlier of 1) the prehearing conference or 2) the first hearing, the Director may remove an arbitrator based upon Rule 10312 information.⁵¹ Under proposed Rule 10312(e), in the same time frame, the Director must disclose any Rule 10312 information to the parties unless the arbitrator voluntarily withdraws as soon as the arbitrator learns of any conflict, or the Director removes the arbitrator.⁵² Finally, under proposed Rule 10312(f), after commencement of the earlier of the prehearing conference or the first hearing, the Director shall disclose any Rule 10312 information disclosed by an arbitrator to the parties.⁵³

The proposed changes to Rule 10313 are necessary because Rule 10313 incorporates by reference certain procedures in Rule 10311. That rule, if amended, will not apply to arbitrations involving public customers. Accordingly, 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. NASD Regulations also proposes to amend the first sentence of Rule 10313 to clarify that if an arbitrator becomes disqualified or otherwise unable to serve after the start of the earlier of the pre-hearing conference or first hearing but prior to rendition of an award, the remaining arbitrator(s) shall continue on, unless a party objects.⁵⁴

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 eight business days.

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."⁵⁵

Date of Effectiveness

The Association intends to make the rule change effective on a date to be stated in a Notice to Members ("NTM"). Depending on the date of the Commission's approval, however, the effective date may be less than 30 days following publication of the NTM announcing the Commission's approval. When effective, the rule changes will apply to any arbitration case filed with the Association if the Association has not mailed or otherwise transmitted to the parties a notice stating the names of the arbitrators appointed to hear the arbitration.

A case will be subject to current Rule 10308 for the purpose of selecting an arbitration panel, if, before the effective date of the rule change, the Association identifies the arbitrator (in a case having one arbitrator) or the three-arbitrator panel (in a case having three arbitrators) and mails or otherwise transmits a letter or other written communication to the parties notifying the parties of the names of the arbitrators. As of the effective date, the newly adopted changes to all other rules will apply to the case (e.g., amendments to Rule 10104, Rules 10309 through 10313, and Rule 10315), as will those parts of newly adopted Rule 10308 relating to the actions or functions to be performed after a panel is appointed (initially) if such actions or functions can be performed without reference to party ranking of arbitrators. (See, e.g.,

proposed Rule 10308(c)(5) regarding selecting a chairperson. The parties will be allowed by agreement to select a chairperson; however if the parties did not select a chairperson by agreement, the Director will exercise authority under newly adopted Rule 10308(e) in order to select a chairperson because the Director will not have party rankings of arbitrators to rely upon and, thus, will not be able to act in accordance with certain provisions of paragraph (c)(5). A case will be subject to newly adopted Rule 10308 if, as of the rule change effective date, the Association has not mailed or otherwise transmitted a letter or other written communication to the parties notifying the parties of the names of the arbitrators appointed to hear the arbitration. In this instance, the other newly adopted rule changes will also apply to the case as of the effective date.

The Association believes that this is the most appropriate approach to provide the benefits of list selection to the greatest number of parties as quickly as possible. List selection provides the parties additional input into the arbitration proceeding; the Association believes that applying the new process for the appointment of arbitrators to certain cases filed shortly before the date of effectiveness will provide the benefits to such parties. Moreover, the Association does not believe that any party will suffer an unfair surprise if the list selection rule and the other rule changes are applied to an arbitration filed prior to the effective date. Finally, in order to implement the proposed rule change, the Association must make a number of operational changes. The administrative burdens of fully implementing the list selection process nationwide are many, and the Association believes that the benefits of implementing the new procedures rapidly and system-wide outweigh the benefits, if any, obtainable from continued use of the old system.

III. Summary of Comments

The three commenters⁵⁶ generally support the proposed rule change as an

⁵⁶ A fourth comment letter was received on October 6, 1998; the comment period ended on August 20, 1998. See letter from Theodore G. Eppenstein ("Eppenstein"), Eppenstein & Eppenstein, to Jonathan G. Katz, Secretary, Commission, dated October 1, 1998. The issues raised by this commenter were the same as those raised by other commenters except for one issue that is not germane to this proposed rule change and one new issue. Eppenstein argues that the arbitration panel for customer arbitrations should be composed exclusively of public arbitrators. The Commission does not believe that the proposed rule change raises this issue because the composition of the three member arbitration panel for customer arbitrations currently is two public members and

⁵¹ See Amendment No. 3.

⁵² See Amendment No. 3.

⁵³ See Amendment No. 3. The Director does not have authority after this time period to remove an arbitrator.

⁵⁴ See Amendment No. 4.

⁵⁵ See, e.g., Rule 10102, Rule 10103, Rule 10104 referenced specifically above, Rule 10301, and Rule 10401.

improvement over the current method for selecting arbitrators, but suggest improvements to the proposed rule.⁵⁷

The SIA believes that the Director should have the ability to remove an arbitrator until after the first pre-hearing conference, up until the start of the first hearing; the proposed rule states that the Director can remove an arbitrator up until the commencement of either the pre-hearing conference or the first hearing.⁵⁸ NASD Regulation states that it has made changes to Rule 10308(d) and a series of related rules to reflect this new time frame, in order to reflect a basic principle that an arbitration is administered and controlled by the arbitrator or the arbitration panel after the arbitrators have begun to address the issues that are the subject of the arbitration. Thus, NASD Regulation believes that as of the beginning of the first meeting among the parties and the arbitrators, it is no longer appropriate or consistent with arbitration principles for the Association to intervene in the arbitration in order to disqualify an arbitrator.⁵⁹

The SIA also believes that the NASD should reexamine the rationale behind the automatic exclusion of any immediate family member of registered representatives or others who work in the securities industry from serving as public or non-public arbitrators.⁶⁰ The SIA argues that there is no reason that a spouse or dependent child of a securities industry professional should be presumptively adjudged to be incapable of being a capable, effective and impartial arbitrator. In addition, the SIA argues that the mechanics of the list selection method make the parties' attorneys able to deal with any perceived problems or biases, by either ranking such candidates low on their

list or not ranking them at all. The SIA does not believe that the NASD, at a time when it is trying to expand and more fully train its arbitrator pool, should collectively eliminate an entire category of arbitrators based upon a perceived bias.⁶¹ NASD Regulation responds that the exclusion of "immediate family member" from classification as public arbitrators is a practical, realistic view of how such persons should be classified, and reflects how most claimants would view such persons. NASD Regulation believes that if such persons were classified as public arbitrators, and then their background information (including a description of their relationship to a spouse or family member engaged in securities activities) was distributed to the parties, most claimants would routinely strike those people or request that the Director disqualify them. NASD Regulation also states that this would only benefit a small group of people desiring to serve as arbitrators, while creating a perception of unfairness, raising costs, an increasing delays.⁶²

Bernstein argues that the size of the list of arbitrators given to the parties should be larger and that the number of strikes allowed each party should be smaller.⁶³ He argues that unlimited strikes, combined with a small list, will lead to either party being able to void a list simply by striking everyone on the list, which would give the selection authority back to the NAD.⁶⁴ Similarly, Richard P. Ryder ("Ryder"), does not believe that the proposed rule change will actually result in most arbitrators being selected by the parties themselves, but that administrative appointments will occur in a substantial number of cases because too few candidates will remain after the parties have struck the nominees on the list.⁶⁵

NASD Regulation, although recognizing this fear, believes that the rule should be implemented as proposed and monitored to see how often the Director must appoint arbitrators not previously reviewed and

ranked by the parties to a panel because one or both parties have struck every arbitrator listed.⁶⁶ NASD Regulation will revisit the issue of limiting the number of strikes if the Director appoints unranked arbitrators frequently because of the parties exercising their unlimited strike rights. NASD Regulation believes that the current proposed number of arbitrators on each list provides a sufficiently large number of arbitrator choices and provides a standard that will generally be attainable.⁶⁷

Bernstein argues that there should be a second round of list selection with a larger list if the first round fails, in order to fill any vacancies. He argues that this is more in line with the Task Force's recommendation and closer to the goals of allowing parties to choose their arbitrators and keeping the NASD out of the selection process.⁶⁸ He also argues that the NASD's concerns over the cost of a second round of list selection should be disregarded as well, in part because the costs are small compared to the savings that mandatory arbitration affords the member firms. Ryder suggests that instead of having only one round of selection, NASD Regulation should give the parties the choice between having one round and a default to staff appointment (but within the same time frame as proposed in the rule) or a second round approach but with a shorter time limit within which the parties must respond to the lists; this shorter time frame would result in more arbitrators being freed up more quickly for other simultaneous proceedings.⁶⁹ Ryder also suggests staggering first round lists in a locale where there are simultaneous cases, by allowing NASD Regulation more time to generate and send lists to parties in other cases. NASD Regulation could then take arbitrators rejected by the first arbitration and put them back into the pool for other cases. In any event, Ryder suggests that the Commission require the NASD to keep statistics on how often administrative appointments occur under the proposed system, and that the NASD should explore a practical, flexible solution to the limited

one non-public member, and is not substantively amended by this proposed rule filing. Eppenstein also argues that there should be a mandatory tolling provision for the time within which the parties have to respond and submit their arbitrator rankings in the event they wish to request additional information on the arbitrators. The Commission believes that the proposed rule change reasonably accommodates the needs of the parties both by lengthening the time for the parties to engage in due diligence from the time period in the current rule, and by specifically providing that the Director may use his or her discretion to toll the time period for the parties to return their ranked lists. See proposed Rule 10308(b)(6). The Commission expects NASD Regulation to monitor the operation of the list selection process carefully to see whether the proposed time frames operate appropriately.

⁵⁷ See *supra* note 4.

⁵⁸ SIA Letter. The SIA believes that the pre-hearing conference itself could expose some evident bias, or an inability or unwillingness on the part of the arbitrator to be impartial; therefore, the Director should retain the ability to remove an arbitrator until after the pre-hearing conference.

⁵⁹ See Amendment No. 4.

⁶⁰ SIA Letter.

⁶¹ Scot D. Bernstein ("Bernstein") argues that the 50% support standard used to classify a person as an immediate family member" of a person generally engaged in the securities industry should be lowered to 10%, effectively broadening this group of persons. See Bernstein Letter. NASD Regulation responds that it believes the 50% standard is generally appropriate, and also notes that a person who falls below the 50% standard may be excluded later in the arbitration selection process by a party who strikes him or her or by the Director during a conflict of interest review. See Amendment No. 4.

⁶² See Amendment No. 4.

⁶³ Bernstein suggests lists that provide no less than twelve public arbitrators and six non-public arbitrators.

⁶⁴ See Bernstein Letter.

⁶⁵ See Ryder Letter.

⁶⁶ See Amendment No. 4.

⁶⁷ *Id.*

⁶⁸ Bernstein argues that the NASD's concern about a limited number of arbitrators related to the large caseload is not a reason to not have a second round of selection. He states that the same number of arbitrators will be appointed to a case regardless of how they are chosen, and that the size of the available pool of arbitrators will not be affected if a second round were implemented because those arbitrators not chosen would simply rotate to the bottom of the list.

⁶⁹ See Ryder Letter.

supply objection to a second round list selection.

NASD Regulation responds that they will not impose a second round at this time because of the scarcity of arbitrators in certain locations, the substantially greater costs, and the significant delays in empaneling an arbitrator or an arbitration panel.⁷⁰ However, after the NASD has had some experience administering the rule, it will reconsider whether to add an additional round of list selection.⁷¹

Bernstein objected to the procedure in the proposal for selecting a chairperson, and suggests that the highest-ranked public arbitrator selected by the parties be the chairperson. In addition, Bernstein argues that advocates for public investors should not be excluded from serving as chair of the arbitration panel, and that a rule that disqualifies advocates for public investors from chairing arbitration panels is inconsistent with investor protection.⁷² In response, NASD Regulation amended proposed Rule 10308(c)(5) to provide that the Director will appoint the highest ranked public arbitrator, unless that person represents or advises customers in matters relating to the securities or commodities industry for fifty percent of his or her time, in which case the Director would appoint the other public arbitrator. If both public arbitrators are subject to the exclusion, the Director will appoint the highest ranked public arbitrator.⁷³

Bernstein also argues that some of the descriptive text in the proposed rule filing regarding the administration of ODR should be included in the rule language so that the NASD's interpretations cannot be changed without Commission approval.⁷⁴ NASD

Regulation argues that it has stated the basic operational aspects of the rule in the rule text and it is not appropriate to describe all of the operational details relating to the NLSS software in the rule text or in the rule filing because to do so would make the rule very unclear and confusing to all but a few readers.⁷⁵ However, the Association has described in general and clear terms those aspects of the NLSS that are essential functions of the proposed list selection rule.

NASD Regulation states that the arithmetic method will be used for consolidating rankings was explained in a detailed, multi-part example. The Association does not believe that the rule text would be clearer by incorporating examples of calculations in the text. In addition, the Association has explained in detail in the rule filing its aspirations regarding providing parties with a certain number of listed arbitrators, and declines to provide an exact minimum number of arbitrators in the proposed rule because the number of available arbitrators varies from place to place.

In response to Bernstein's suggestion that under proposed Rule 10308 the Association should address conflicts that may arise based upon the past employment of an arbitrator or a party, as well as conflicts-of-interest based upon current employment, NASD Regulation points out that the rule filing indicates that the initial conflict-of-interest review performed by NLSS is limited to readily apparent conflicts of interest,⁷⁶ but that there are subsequent checks performed by the Director that include all possible relationships, including past employment that allow the Director to determine whether an arbitrator has a conflict of interest and should not be appointed or must be disqualified after appointment.⁷⁷ The

Association also declines to state in proposed Rule 10308 a standard by which the Director will judge claims of an arbitrator's conflict of interest, arguing that the Director applies the facts as presented to assess whether a bias or a conflict of interest is present or may be present, and that the present Code does not contain an express standard.⁷⁸ Also, NASD Regulation states that it would inappropriately limit the ability of the Association staff to administer cases to specify how the Association must attempt to communicate with a listed arbitrator to determine if the arbitrator is available to serve on a panel. Generally, however, the Association intends to contact the arbitrators by telephone.⁷⁹

Bernstein asks how many strikes are allocated to each party when there is more than one party on a side and their bankings are consolidated. Bernstein also argues that the proposed rule should require the NASD to publish, on its website and possibly in hard-copy form for each case in which a list of arbitrators is proposed, the following information: date; geographic location; case number; and names of arbitrators included in the list of lists of proposed arbitrators. He argues that this is necessary in order for the public to be able to verify that the rotation required by the rule is occurring. NASD Regulation declines to publish the arbitrators names in the rotation because its would create an enormous administrative burden. In addition, NASD Regulation states that the NLSS and new list selection process are subject to review internally by the Audit Committee,⁸⁰ and to SEC oversight.⁸¹

Bernstein argues that the reference in proposed Rule 10308(c)(4)(A) to the Directors' ability to disqualify arbitrators should cross-reference all provisions under which disqualification may occur, and as previously argued, should contain the standards for disqualification. NASD Regulation responds that the Director, the staff, and all NASD arbitrators must look to and follow "The Arbitrators Manual" and "Code of Ethics for Arbitrators in Commercial Disputes" ("Code of Ethics"), regarding the arbitrator's duty to disclose conflicts of interest, the appearance of bias, the assessment of challenges relating to an arbitrator's

⁷⁰ See Amendment No. 4 and Response Two.

⁷¹ *Id.*

⁷² Bernstein argues that attorneys who represent public investors are not subject to the same financial pressure on their decisions as are representatives of industry participants, yet an attorney who derives 19% of his or her income from representing industry participants is allowed to chair a panel under the proposed rule.

⁷³ See *supra* notes 42 and 43 and accompanying text, and Amendment No. 4.

⁷⁴ See Bernstein Letter. For example, he argues that: 1) the standards for exclusion from serving as an arbitrator based upon conflicts of interest as a function of current employment should be included in the rule (and that both current and former employment should be a basis for exclusion); 2) the standards that apply to a Director's rulings on for cause challenges should be included in proposed Rule 10308(d)(1); 3) the method of operation of the list selection software and the selection rules that will be used when that software cannot be used, should be a matter of public record and should be stated in the rule; 4) the standards for all determinations made by the software (geographic proximity, conflicts of interests, subject matter expertise, ranking and rotation) should be included in the rule; 5) the number of arbitrators required to

be on a list should be a part of the rule; 6) the arithmetic method that the NASD will use to consolidate the rankings of parties on the same side should be explained in the text and in the rule; 7) the standards for what would constitute "sufficiently divergent" when a Director can decline to consolidate rankings of parties when their interests diverge sufficiently should be explained in detail; 8) the standards for when the NASD manually performs a conflict of interest check should be made public; 9) the time that prospective arbitrators will have to respond to the NASD's call should be specified in the rule; and the NASD should be obligated to attempt to reach a selected arbitrator at all available telephone and facsimile numbers for that arbitrator in the NASD's database; and 10) the rule should state that the NASD and its staff shall not communicate with the proposed arbitrators or otherwise operate in such a manner as to influence the outcome of the selection process.

⁷⁵ See Amendment No. 4.

⁷⁶ Such as whether the arbitrator is currently employed by, or currently has a securities account with, the respondent.

⁷⁷ See Amendment No. 4.

⁷⁸ The Association's treatment of divergent interests (among respondents or claimants) is previously addressed, *supra* note 38 and related text.

⁷⁹ See Amendment No. 4.

⁸⁰ NASD Regulation states that the Audit committee is comprised of independent Governors of the NASD Board of Governors.

⁸¹ See Amendment No. 4.

opinion or bias, business or personal relationships, previous or current involvement with a party or witness, or financial interests, and an arbitrator's ethical responsibilities to determine issues of disqualification and withdrawal.⁸² NASD Regulation states that every arbitrator must review and understand "The Arbitrator's Manual" and the Code of Ethics as part of mandatory arbitrator training, and any time that the Director must resolve a disqualification issue, the Director will refer to these provisions.⁸³

Bernstein also proposes that proposed Rules 10308(d)(2) and 10312(f) should state that after the Director's authority to disqualify an arbitrator has ceased, the panel still has that authority, as consistent with the descriptive text of the proposal.⁸⁴ NASD Regulation declines to make the amendments because the manner in which disqualification and withdrawal issues are treated is set forth in "The Arbitrator's Manual" and the Code of Ethics. At all times, including the period when the Director's authority to disqualify an arbitrator has ended, an arbitrator must consult "The Arbitrator's Manual" and the Code of Ethics, Canon II, regarding the arbitrator's duty to disclose conflicts of interest, issues of bias, and his or her ethical responsibilities to determine if withdrawal as an arbitrator is required. Under Canon II. E., of the Code of Ethics, an arbitrator "should withdraw" if requested to do so by all the parties because of alleged partiality or bias. If requested to withdraw for such reasons by less than all of the parties, the arbitrator "should withdraw" unless "the arbitrator, after carefully considering the matter, determines that the reason for the challenge is not substantial, and that he or she can nevertheless act and decide the case impartially and fairly, and that withdrawal would cause unfair delay or expense to another party or would be contrary to the ends of justice." The Association stated that its experience is that arbitrators apply the Code of Ethics more rigorously than a strict reading requires.⁸⁵

Bernstein believes that due diligence and expertise concerning Ponzi schemes and other illegal securities or transactions should be included as an identified area of subject matter expertise. He also believes that limited partnerships should be included in the list of "various types of securities or other financial instruments" in which an arbitrator may have expertise. NASD Regulation notes that the topic of due diligence is too broad and vague to be entered into NLSS as a subject matter category, and that "underwriting" is currently a subject matter expertise category. Also, NASD Regulation wishes to defer receiving proposals to expand the various types of expertise until a later date.

Finally, Bernstein argues that proposed Rule 10313, which currently provides for no challenge other than a for-cause challenge to replacement arbitrators, should allow for a peremptory challenge of the replacement arbitrator because the industry, which is requiring the public to "give up the right to a judge and jury and come instead to the industry's forum," should prevent the appearance of impropriety.⁸⁶ NASD Regulation responds that this change is consistent with the other provisions of proposed Rule 10308. Thus, although the parties are provided an unlimited right to strike an arbitrator in the early stages of a proceeding, generally, under the new procedures, when an arbitrator is appointed later in the proceeding, the parties may challenge the arbitrator for cause only. The Association agrees with Bernstein's suggestion that the replacement arbitrator the Director appoints should be obtained from an NLSS-derived "list of one." To replace an arbitrator under Rule 10313, and in the other instances where the Director must appoint an arbitrator not previously ranked by the parties (*see, e.g.,* paragraphs (c)(4)(B) and (d)(3) of proposed Rule 10308), the Director will return to the NLSS and obtain a "list of one," using the primary factors previously input into NLSS to generate the list of arbitrators first sent to the parties. The association does not believe it is necessary to specify in proposed Rule 10308 and proposed Rule 10313 that the Director will use NLSS in this manner to perform these rule functions.⁸⁷

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association, and, in particular, with the requirements of Section 15A(b)(6),⁸⁸ which require, 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 interests.⁸⁹ Specifically, the Commission believes that allowing parties greater input into the selection of the arbitrators to hear their cases will help ensure a more fair and neutral arbitration process.

The Commission believes that the NASD's list selection procedures and methodology, as proposed, provide for the protection of investors in the selection of arbitrators and will benefit all users of the arbitration program. The Commission believes that the computerized generation of the lists of arbitrators should help ensure greater confidence in the fairness and neutrality in the selection of the arbitrators, while at the same time allowing the Director the flexibility to supplement the NLSS process if necessary.⁹⁰ The Commission notes that the arbitrators will be selected by the computer using a rotation method, rather than on a random basis,⁹¹ so that all arbitrators are placed on a selection list with the same regularity.⁹² The Commission also notes that the NLSS is designed to sort arbitrators based on certain factors that should help ensure a neutral list of arbitrators who will be better suited to the particular arbitration. The NLSS sorts arbitrators based on whether an arbitrator is public or non-public, and based on hearing location, rotation, and whether any clear conflict of interest exists between a party and potential arbitrators. In addition, NLSS can also sort arbitrators by subject matter expertise, security expertise, and case expertise. The Commission believes that the subject matter, security, and case expertise categories are a reasonable

⁸⁸ 15 U.S.C. 78o-3.

⁸⁹ In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁹⁰ At the request of a party, the Director can add a procedure that is outside the NLSS capability, but that may legitimately be considered in the selection of an arbitration panel.

⁹¹ See Notice Release.

⁹² The NASD states that the random selection method does not always produce perfect randomness, which could lead to some arbitrators being chosen more often than others over time.

⁸² "The Arbitrator's Manual," (Oct. 1996 ed.), pp. 2-6, App. A. The Code of Ethics was developed jointly by the American Bar and American Arbitrator Association. See Amendment No. 4.

⁸³ See Amendment No. 4.

⁸⁴ In addition, Bernstein argues that the standards for removal in such cases should be the same as those that apply to for-cause challenges, and that the arbitrator against whom the challenge or recusal motion is made should not be permitted to participate in any vote or other decision regarding that issue.

⁸⁵ See Amendment No. 4.

⁸⁶ Bernstein also adds that the rule should specify that the replacement arbitrator will be a "list of one" selected by the computer (*ie.* the next arbitrator in the rotation).

⁸⁷ See Amendment No. 4.

attempt at this time to "personalize" an individual arbitration, and that it is not necessary for the NASD to expand upon them as it begins to implement its selection process.

The Commission believes that the list selection method provides adequate measures to identify potential or actual conflicts of interest between a party and an arbitrator, both prior to compilation of the list and selection of the arbitrators, and once an arbitrator or an arbitration panel is selected. The NLSS performs two conflict-of-interest checks. First, the NLSS checks for any obvious, disclosed conflict of interest between parties and potential arbitrators that can be identified in the NLSS database while generating the list, such as when the respondent member firm is also the employer of an arbitrator in NLSS.⁹³ Second, ODR will perform a manual conflict of interest review after the list is created but before it is finalized and sent to the parties.⁹⁴ The Commission believes that checking for conflicts of interest before the list is forwarded to the parties will likely eliminate arbitrators that would have been struck by a party later, and will result in those arbitrators being replaced (through the NLSS) before the lists are sent to the parties, which should help avoid limiting the parties' choices at the selection stage. While reviewing the lists, parties can review any information on the arbitrators that ODR has in its possession, including employment history for the past ten years, in order to make their own determination as to conflict of interest concerns, and may request additional information from the arbitrators under Rule 10312(b)(6). In addition, once the parties have ranked the arbitrators and the lists have been consolidated into one list, the Director performs another determination as to whether to disqualify an arbitrator.⁹⁵ If

the arbitrator is not disqualified, and is available, the Director appoints the arbitrator.

The Commission also finds that the conflict of interest safeguards in place after a panel is appointed are adequate to help protect investor interests by providing that any new information on the arbitrators that may lead to a conflict of interest is disclosed to the parties, unless the arbitrator is removed or resigns. Each arbitrator has a continuing obligation under Rule 10312 to disclose any circumstances that might preclude the arbitrator from rendering an impartial and objective determination to the Director, who has the ability to remove an arbitrator up until the start of the earlier of the pre-hearing conference or the first hearing.⁹⁶ After this point, a party must raise a disqualification matter with the arbitration panel.⁹⁷ Finally, the Director

any conflict of interest or bias or other reason that may preclude the arbitrator from rendering an objective and impartial decision. Based upon the information previously provided by the arbitrator, any information provided under Rule 10312, and any information from any other source, the Director determines if the arbitrator should be disqualified. The Commission does not believe it is necessary for the NASD to specify in the rule language a response time for each arbitrator contacted, or that the NASD should be obligated to attempt to reach a selected arbitrator at all available telephone and facsimile numbers for that arbitrator. The Commission also does not believe it is necessary for NASD Regulation to specify how it shall communicate with proposed arbitrators to determine if they are available to serve.

⁹⁶ The Director must disclose this information to the parties unless the Director disqualifies the arbitrator or the arbitrator voluntarily withdraws. After the commencement of the earlier of the pre-hearing conference or the first hearing, the Director must disclose any new information on the arbitrators to the parties.

The Commission does not believe it is necessary for the NASD to include in the rule text the standards that apply to a Director's ruling on a for-cause challenge to an arbitrator already appointed, because the Director applies the facts of each situation as presented, based upon the Code of Ethics developed by the American Bar Association and American Arbitration Association, to assess whether a conflict exists or may exist. The Commission also notes that the present Code does not contain a more express standard.

⁹⁷ The Commission believes it is reasonable to limit the Director's authority to remove an arbitrator after the commencement of the earlier of the pre-hearing conference or the first hearing, to reduce party concerns about NASD Regulation's influence over particular cases, and because it is reasonable for the arbitration to be administered and controlled by the arbitrators once the arbitrators have begun to address the issues in the arbitration. Accordingly, it is reasonable for NASD Regulation to decide that, based upon NASD Regulation's characterization of its past experience with arbitrator recusals, it is no longer appropriate for the Director to be able to remove an arbitrator after the earlier of the pre-hearing conference or the first hearing. The Commission does not believe it is necessary for the NASD to state more explicitly the procedures to disqualify an arbitrator in the rule text because the manner in which disqualification and withdrawal issues are treated is addressed in the Code of Ethics

must disclose information about a replacement arbitrator appointed by the Director to the parties, who can object to the arbitrator, at which time the Director can decide to disqualify the arbitrator. To replace an arbitrator (and in other instances where the Director must appoint an unranked arbitrator), the Director will return to the NLSS to obtain a "list of one," using the primary factors previously input into NLSS to generate the initial list of arbitrators sent to the parties.⁹⁸ The Commission notes that the Director and all arbitrators must review and abide by "The Arbitrators Manual" and the Code of Ethics regarding the arbitrator's duty to disclose conflicts of interest, the appearance of bias, the assessment of challenges relating to an arbitrator's opinion or bias, business or personal relationships, previous or current involvement with a party or a witness, or financial interests, and an arbitrator's ethical responsibilities to determine issues of disqualification or withdrawal.⁹⁹

In addition, the Commission believes that the proposed rule change provides for sufficient public representation on each arbitration panel by requiring a majority of public arbitrators on each arbitration panel, unless all of the parties agree to a different panel composition. The Commission notes that the NASD staff classifies arbitrators as public or non-public based on the information it receives for that arbitrator.¹⁰⁰ The Commission also believes that the method for selecting a chairperson when the parties do not agree is reasonable. In response to a comment, NASD Regulation amended the process to provide that the Director will first attempt to appoint the highest ranked public arbitrator on the panel as the chairperson.¹⁰¹

and "The Arbitrators Manual." See *supra* note 82 and accompanying text.

⁹⁸ See Amendment No. 4.

⁹⁹ See Amendment No. 4.

¹⁰⁰ The Commission believes that the NASD's definition of "immediate family member" as a person who receives more than 50% of his or her annual income from a person generally engaged in the securities industry and its exclusion of such persons from serving as public arbitrators is a reasonable view of how such persons should be classified, so as to guard against any perceived bias or conflict of interest.

¹⁰¹ See Amendment No. 4. The Director will chose the highest ranked public arbitrator unless that arbitrator meets the exclusion for representing certain investor interests, in which case the Director will appoint the other public arbitrator as chairperson. If both public arbitrators are subject to the exclusion, the Director will appoint the highest ranked public arbitrator as chairperson. See *supra* noted 42 and 43 and accompanying text.

⁹³ The Commission does not believe it is necessary for the NASD to include in the rule language the standards for exclusion from serving as an arbitrator based upon conflicts of interest as a function of current employment, or that the standards for the manual conflict of interest review need to be included in the rule language or made public. NASD Regulation has stated the basic operational aspects of the rule in the rule language and the rule filing. The addition of more detail to the text may be confusing.

⁹⁴ The Commission notes, in response to a comment, that even though the initial conflict of interest review performed by NLSS is limited to readily apparent conflicts of interest (such as current employment), the subsequent manual checks include a wider range of possible relationships, including past employment. See Amendment No. 4.

⁹⁵ The Director contacts each arbitrator to determine if he or she is available to serve. At this time, the Director will provide the arbitrator with the issues of the case and the names of the parties, and determine whether the arbitrator is aware of

The Commission believes that the ODR's guideline¹⁰² for the minimum number of arbitrators on each list forwarded to the parties is reasonable to provide a pool of arbitrators for the parties to choose from to select an arbitration panel. The Commission notes that, for a three arbitrator panel, NASD Regulation has undertaken to provide a public list that contains at least two times as many names as the non-public list, to the extent feasible. In addition, to address possible arbitrator shortages, the Director can combine arbitrators from nearby hearing locations when necessary.¹⁰³ The Commission recognizes that there are times when the parties will strike all the names on a list and notes that one commenter expressed a concern with the number of arbitrators on each list, but believes that it is not necessary at this time to require a larger list of arbitration. The Commission notes that requiring a larger number of arbitrators on the list might not be feasible, given the limited number of arbitrators. The Commission also notes that NASD Regulation has stated it will monitor how often the Director must appoint unranked arbitrators because one or both parties have struck all the names on the list.

The Commission also believes it is reasonable to allow each party unlimited strikes because this should allow parties greater control in choosing the composition of the arbitration panel, and reducing the number of strikes could limit a party's ability to strike an arbitrator he or she does not want on the panel. The Commission recognized the possibility that a respondent and/or respondents acting together could use the unlimited strikes to strike all the arbitrators from the list, resulting in the Director choosing the panel.¹⁰⁴ However, the Commission believes it is reasonable at this time to implement the proposed rule change as proposed, with the number of arbitrators suggested and unlimited strikes, and notes that NASD Regulation states it will reevaluate the issue of limiting the number of strikes

if it finds that the Director appoints unranked arbitrators too frequently due to the parties' exercise of their unlimited strike rights.

The Commission also finds that a one-round list selection method (as opposed to a two-round procedure as suggested by commenters) is reasonable and consistent with the Act in that it supports the goals of arbitration as a less expensive and less time-consuming method of resolving disputes, while at the same time providing a process by which parties have greater control over the selection of arbitrators. The Commission notes that although NASD Regulation initially considered a two-round, two-list selection method, it 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 significantly delay the empaneling of the arbitrators and would be too costly. The Commission also stresses that NASD Regulation will reconsider whether to add an additional round of list selection after it has gained some experience in administering the rule.

The Commission believes it is reasonable to consolidate all claimants' rankings, and all respondents' rankings, whether through all the claimants (or respondents) jointly ranking arbitrators and submitting one set of rankings, or the Director, using the NLSS, creating a consolidated list for each side. The Commission notes that the consolidation gives claimants and respondents equal weight in the rankings when the two sides are subsequently consolidated. The Commission also notes that in response to a comment that proposed Rule 10308(c)(3)(B) may have provided certain parties the potential to unfairly weight the arbitration panel, NASD Regulation amended proposed Rule 10308(c)(3) to eliminate the Director's ability to determine not to consolidate the rankings of a claimant (or respondent) with the rankings of the other claimants (or respondents) if he or she determined there interests were sufficiently divergent.¹⁰⁵ Also, the Commission finds that the methodology for consolidating claimants' and respondents' rankings to create one list for public and one for non-public (if necessary), and for appointing arbitrators from that list, is reasonable.¹⁰⁶

In summary, the Commission notes that list selection is a new process designed to allow parties greater control over the selection of their arbitrators, and that there were different approaches that the NASD could have taken to obtain this goal. The Commission believes that the NASD has created reasonable procedures for implementing the new process that should give investors and other parties more input into the selection of the arbitration panel and which are consistent with the Act.¹⁰⁷ The Commission also believes the NASD has stated the basic operational principles in the rule language.

The Commission finds good cause to approve Amendment Nos. 3 and 4 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Specifically, Amendment No. 3 amends the actual rule language to clarify and strengthen the proposed rule change by, in part, amending the definition of "non-public arbitrator" to incorporate standard terminology and to add an explicit reference to government and municipal securities; by re-ordering proposed Rule 10308(b)(1) to make it more clear and to conform it to previously approved amendments to Rule 10308 and Rule 10302; by amending Rule 10308(b)(1) to clarify a party's right to change the panel composition if they all agree; to clarify in the rule language what information will be available with regard to the initial conflict of interest review by NLSS; to clarify in the rule language that the information on each arbitrator forwarded to the parties is employment information for a 10 year period and any other background information; to clarify in the rule language that a ranking of "1" means the most preferred arbitrator; to clarify in the rule language that when the Director must appoint an unranked arbitrator the Director will provide the parties (b)(6) information and the parties shall have the right to object to the arbitrator as provided in (d)(1); and to delete the reference in the rule to parties acting cooperatively to rank arbitrators, since that ability is implicit.

Similarly, Amendment No. 4 also amends the proposed rule change in response to comments received to strengthen the proposal by providing generally for the highest ranked public

the method that will be used to consolidate rankings, both on each side and them both sides together, and that it is not necessary to include examples of calculations in the rule text.

¹⁰⁷ The Commission also finds the changes to related rules to conform those rules to the proposed changes to Rule 10308 reasonable.

¹⁰² See *supra* Background and Description Section. The guidelines state that for one arbitrator, NASD Regulation should supply a public list with 3 to 5 arbitrators. For a three arbitrator panel, the NASD should supply a public list with 6 to 10 arbitrator names, and a non-public list with 3 to 5 arbitrator names.

¹⁰³ The Commission believes it is reasonable not to specify a minimum number of arbitrators in the actual rule text because the number arbitrators varies from place to place, and notes that NASD Regulation has explained its guidelines in the proposed rule change.

¹⁰⁴ See Bernstein Letter. The Commission also believes that the process for ranking arbitrators when the parties fail to rank them, or improperly rank multiple arbitrators, is reasonable.

¹⁰⁵ See Amendment No. 4.

¹⁰⁶ The Commission finds that NASD Regulation adequately explained in detail and with examples

arbitrator to be the chairperson of the panel, to eliminate the exception to consolidation of parties' rankings for parties with "sufficiently divergent" interests, and to amend the time frame in proposed Rule 10313 to align it with the time frames set forth in proposed Rule 10312 and 10315. Accordingly, because the changes in Amendment Nos. 3 and 4 are technical in nature and serve to clarify and strengthen the proposal, the Commission believes that it is consistent with Section 15A(b)(6) of the Act to approve Amendment Nos. 3 and 4 to the proposal on an accelerated basis.

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 3 and 4 to the rule proposal, including whether the amendments are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 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 at the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-98-48 and should be submitted by November 12, 1998.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁰⁸ that the proposed rule change (SR-NASD-98-48), including Amendment Nos. 3 and 4 on an accelerated basis, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰⁹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40563; File No. SR-OCC-98-05]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Authorizing the Designation of Sunday as a Business Day and Clarifying the Rules for Margining Exercised and Assigned Positions in Currency Options

October 15, 1998.

On June 5, 1998, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change (File No. SR-OCC-98-05) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").¹ Notice of the proposal was published in the **Federal Register** on August 11, 1998.² For the reasons discussed below, the Commission is approving the proposed rule change.

I. Description

The rule change provides OCC with the flexibility to designate Sunday as a business day for the purposes of determining the exercise settlement date for foreign currency and cross-rate foreign currency options. The rule change also clarifies the rule governing the calculation of margin with respect to positions in cross-rate foreign currency options following their exercise and assignment.

Currently, the Sunday following an expiration is deemed to be a business day for the purposes of determining the exercise settlement date for expiring foreign currency options.³ This designation permits expiring foreign currency options to settle on the same day as the foreign currency futures contracts traded on the International Monetary Market ("IMM") and to a lesser degree on the Philadelphia Board of Trade ("PBOT"). IMM futures contracts expire on a quarterly basis, and the coordination of exercise settlement dates among OCC-cleared options, IMM-traded futures contracts, and PBOT-traded futures contracts create hedging opportunities and settlement efficiencies for OCC's membership.

While the use of Sunday as a business day aligned the exercise settlement dates for the above-described contracts,

it resulted in certain operational issues for OCC. For example, non-expiring foreign currency options that were exercised on the same date as expiring foreign currency options were settled on a different exercise settlement date than the expiring options. It is not always necessary to use Sunday as a business day for determining the settlement date for currency options. The opportunity to hedge with the IMM or PBOT futures realistically only occurs four times a year. For twenty other expirations, the benefits derived from using Sunday as a business day are not fully achieved.

The rule change allows OCC to coordinate the date on which exercise settlement occurs for expiring options exercised on Friday and non-expiring options also exercised on Friday. The rule change provides that if Sunday is used as a business day for determining the exercise settlement date of exercised expiring options, it will also be used as a business day for exercised non-expiring options. When Sunday is not designated as a business day, DVP processing will occur on Monday. OCC will notify the membership in advance of when Sunday would be used as a business day for determining an exercise settlement date.⁴

In addition, two amendments are made to Rule 602(f) concerning the calculation of margin on currency option contracts following their exercise and assignment. The first change clarifies Rule 602(f)(2)(i) to state that margin calculations are performed separately on positions in foreign currency options and cross-rate foreign currency options and that a clearing member's positions in cross-rate currency options which generate a net margin credit can be used to offset the clearing member's margin requirement arising from other positions. The second amendment conforms Rule 602 to the changes relating to the designation of Sunday as a business day.

II. Discussion

Section 17A(b)(3)(F) of the Act⁵ requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions. The Commission believes that allowing OCC to designate Sunday as a business day will increase settlement efficiency

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 40295 (July 31, 1998) 63 FR 42655.

³ Securities Exchange Act Release No. 23781 (November 17, 1986) 51 FR 41556.

⁴ Changes are made to Rules 602, 1602, 1604, 1605, 1606, 2102, 2104, 2105 and 2106 (either in the text or in the Interpretations and Policies thereto) to conform them to the proposed changes for the reasons stated above. The complete text of the proposed changes to the Rules is included in OCC's filing, which is available for inspection and copying at the Commission's public reference room and through OCC.

⁵ 15 U.S.C. 78q-1(b)(3)(F).

¹⁰⁸ 15 U.S.C. 78s(b)(2).

¹⁰⁹ 17 CFR 200.30-3(a)(12).