

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-63250; File No. SR-FINRA-2010-053)

November 5, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 25, 2010, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend the panel composition rule, and related rules, of the Code of Arbitration Procedure for Customer Disputes (“Customer Code”), to provide customers with the option to choose an all public arbitration panel in all cases.

The text of the proposed rule change is available on FINRA’s Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

Background

Under FINRA Dispute Resolution rules, parties in arbitration participate in selecting the arbitrators who serve on their cases. For customer claims of more than \$100,000, the Customer Code currently provides for a three arbitrator panel³ comprised of a chair-qualified public arbitrator,⁴ a public arbitrator,⁵ and a non-public arbitrator.⁶ FINRA uses the computerized Neutral List Selection System (“NLSS”) to generate random lists of 10 arbitrators from each of these categories. The parties select their panel through a process of striking and ranking the arbitrators on the lists generated by NLSS. The Customer Code permits the parties to strike the names of up to four arbitrators from

³ Rule 12401 provides for a single, chair-qualified public arbitrator if the amount of the claim is not more than \$100,000. It provides for a three arbitrator panel if the amount of a claim is more than \$100,000, or is unspecified, or if the claim requests non-monetary damages. The parties, in claims of more than \$25,000, but not more than \$100,000, may agree in writing to have a three arbitrator panel.

⁴ Rule 12400(c) specifies the criteria for arbitrator inclusion on the chairperson roster.

⁵ Rule 12100(u) specifies the criteria FINRA uses to classify arbitrators as public.

⁶ Rule 12100(p) specifies the criteria FINRA uses to classify arbitrators as non-public.

each list. The parties then rank the arbitrators remaining on the lists in order of preference. FINRA appoints the panel from among the names remaining on the lists that the parties return.

FINRA is proposing to amend the Customer Code to provide customers with the option to choose between two panel selection methods – the current panel selection method, which would be labeled “Composition Rules for Majority Public Panel” (“Majority Public Panel”), and a new panel selection method, which would be labeled “Composition Rules for Optional All Public Panel” (“Optional All Public Panel”). Under the proposed rule change, customers could choose the panel selection method; neither firms nor associated persons could choose the selection method.

The Majority Public Panel option would continue to provide for a panel of one chair-qualified public arbitrator, one public arbitrator, and one non-public arbitrator, and would retain the current limit of four strikes for each arbitrator list. The new Optional All Public Panel provision, if chosen by the customer, would allow parties to select an all public arbitration panel. Under this new provision, FINRA would send the parties the same three lists of randomly generated arbitrators that they would have received under the Majority Public Panel option, but FINRA would allow each party to strike any or all of the arbitrators on the non-public arbitrator list. If individually, or collectively, the parties struck all of the non-public arbitrators, FINRA would complete the panel by appointing a public arbitrator. Thus, by striking all the arbitrators on the non-public list, any party could ensure that the panel would have three public arbitrators.

The proposed rule change would apply only to customer disputes. It would not apply to arbitrator selection in disputes involving only industry parties. FINRA believes

giving customers the option of an all public panel will enhance confidence in and increase the perception of fairness in the FINRA arbitration process. All customers will have greater freedom in choosing arbitration panels, and any customer will have the power to have his or her case heard by a panel with no industry participants.

FINRA's Public Arbitrator Pilot Program

Customer advocates argue that the mandatory inclusion of a non-public arbitrator (often referred to as the "industry" arbitrator) in a three arbitrator case raises a perception that FINRA Dispute Resolution's current forum is not fair to customers. In order to address this perception, FINRA launched a pilot program ("the Pilot") that allows parties to choose a panel of three public arbitrators instead of two public arbitrators and one non-public arbitrator.

FINRA designed the Pilot to run for two sequential years, beginning October 6, 2008, and ending October 5, 2010. In Year One, 11 brokerage firms volunteered to participate in the Pilot, each contributing a set number of cases to the Pilot per year for two years. In Year Two, FINRA expanded the number of participating brokerage firms to 14 firms. In addition, several of the original participants increased their respective case commitments for Year Two. Participating firms agreed to extend the Pilot for a third year at the same case levels while the rule making process proceeds. Year Three of the Pilot began October 6, 2010, and ends October 5, 2011, or upon implementation of the proposed rule change, whichever comes first.

Under the Pilot, FINRA only permits a customer bringing the arbitration claim to decide whether his or her case should proceed under Pilot rules; the participating firms cannot select the Pilot cases. The parties receive the same three lists of proposed

arbitrators that parties in non-Pilot cases receive. The difference is that, in the Pilot cases, any party can strike any or all of the arbitrators on the non-public list (as opposed to the four-strike limit for each party). If the parties rank one or more of the non-public arbitrators, FINRA appoints the highest ranked non-public arbitrator to the panel. If the parties strike all of the non-public arbitrators or if they are unable to serve, FINRA returns to the public arbitrator lists (the public list first, followed by the chair-qualified public list) to complete the panel. If no public arbitrators remain on the lists, FINRA uses NLSS to appoint randomly an additional public arbitrator. Thus, by striking all proposed non-public arbitrators, any party can choose a panel of three public arbitrators.

Reactions from participants in the Pilot indicate that customer representatives strongly support the right of customers to decide whether to select any non-public arbitrator. That feedback has led FINRA to propose amending the panel composition rule for customer cases to allow the customer party to choose between the current panel selection method and the method used in the Pilot. Unlike the Pilot, however, the proposed rule would apply to all customer disputes against any firm and any individual broker.

Details of the Proposed Rule Change

Currently, Rule 12402 (Composition of Arbitration Panels) specifies the panel composition for all customer cases.⁷ Rules 12403 (Generating and Sending Lists to the Parties),⁸ 12404 (Striking and Ranking Arbitrators),⁹ 12405 (Combining Lists),¹⁰ 12406

⁷ Rule 12402 provides that a single arbitrator panel will consist of a chair-qualified public arbitrator, and that a three arbitrator panel will consist of a chair-qualified public arbitrator, a public arbitrator, and a non-public arbitrator.

⁸ Rule 12403 provides that if a panel consists of one arbitrator, NLSS will generate a list of 10 chair-qualified public arbitrators. If a panel consists of three

(Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List),¹¹ and 12411 (Replacement of Arbitrators) enumerate the procedures for selecting, appointing, and replacing arbitrators.¹² FINRA is proposing to consolidate these rules into two new rules: new Rule 12402 relating to customer cases with one arbitrator, and new Rule 12403 relating to customer cases with three arbitrators. New Rule 12402 would describe the procedures for selecting, appointing, and replacing the arbitrator in a single arbitrator case. New Rule 12403 would describe the two options that customers have for selecting arbitrators and would include the procedures for appointing and replacing arbitrators. The proposed rule change would apply to all customer cases.

arbitrators, NLSS will generate a list of 10 chair-qualified public arbitrators, 10 public arbitrators, and 10 non-public arbitrators. Under the rule, NLSS excludes arbitrators from the list based on current known conflicts of interest identified in NLSS. The rule also details how NLSS generates the lists, and how FINRA sends lists to the parties and handles requests for additional information about arbitrators.

- ⁹ Rule 12404 states that parties may strike up to four arbitrators from each list, leaving at least six arbitrator names remaining. It also explains the process for ranking arbitrator preferences and returning the lists to FINRA.
- ¹⁰ Rule 12405 explains how FINRA prepares combined ranked lists of arbitrators based on the parties' numerical rankings.
- ¹¹ Rule 12406 explains that FINRA appoints the highest ranked available arbitrator from each of the combined lists and describes FINRA's procedures for appointing an arbitrator when the number of arbitrators available to serve from a combined list is not sufficient to fill the panel. The rule also provides that appointment occurs when FINRA sends notice to the parties of the names of the arbitrators on the panel and that arbitrators must execute FINRA's arbitrator oath or affirmation before making any decision as an arbitrator or attending a hearing.
- ¹² Rule 12411 provides that if FINRA removes an arbitrator, or an arbitrator becomes otherwise unable or unwilling to serve, FINRA appoints as a replacement arbitrator the arbitrator who is the most highly ranked available arbitrator from the applicable combined list. It also states the procedure for replacing an arbitrator if there aren't any arbitrators left on a combined list.

FINRA would delete current Rules 12402, 12403, 12404, 12405, 12406, and 12411 in their entirety. FINRA would renumber the remaining rules in the 12400 series so that the numbering would remain consecutive after FINRA consolidated the rules.

New Rule 12402 – Cases with One Arbitrator

New Rule 12402 (Cases with One Arbitrator) would consolidate the content of current Rules 12402, 12403, 12404, 12405, 12406, and 12411, relating to single arbitrator cases. FINRA is not proposing any substantive changes to the current procedures for selecting, appointing, and replacing arbitrators in cases with one arbitrator.

New Rule 12403 – Cases with Three Arbitrators

New Rule 12403 (Cases with Three Arbitrators) would provide customers with two options for panel selection in three arbitrator cases. The first option, the Majority Public Panel, would consist of the panel composition method currently provided in the Customer Code. It would ensure that FINRA appoints one non-public arbitrator on a three arbitrator panel. The second option, the Optional All Public Panel (based on the Pilot), if selected by the customer, would guarantee that any party could select an all public panel. As stated above, the proposed rule change allows only customers to make the election between the two panel selection methods. If implemented as proposed, FINRA will allow any customer that has not been sent lists of arbitrators to choose between the two panel selection methods. Except as outlined below, FINRA would incorporate into new Rule 12403 the contents of current Rules 12403, 12404, 12405, 12406, and 12411, that are pertinent to three arbitrator cases.

Under the proposed rule change, the customers could elect either arbitrator selection method within 35 days from service of the Statement of Claim. If the customers

declined to make an affirmative election by the 35-day deadline, FINRA would apply the composition rule for a Majority Public Panel.

Under either panel selection option, the parties would receive three lists – i.e., one with 10 chair-qualified public arbitrators, one with 10 public arbitrators, and one with 10 non-public arbitrators. FINRA would permit each party to strike up to four arbitrators on the chair-qualified public and public lists, leaving at least six arbitrator names remaining on each party's list. However, the process for striking arbitrators on the non-public list would be different for each method, as detailed below.

Majority Public Panel – This is the current method for panel composition. Under this method:

- Each separately represented party could exercise up to four strikes on the non-public list.
- FINRA would appoint the highest-ranked available non-public arbitrator from the combined rankings.
- In cases in which the parties struck all of the arbitrators appearing on the non-public list or when all remaining arbitrators on the non-public list were unable or unwilling to serve for any reason, FINRA would appoint a non-public arbitrator selected randomly by NLSS.

Optional All Public Panel – Under this method of panel composition:

- All parties would have unlimited strikes with respect to the non-public list (meaning that any party may strike up to all names on the non-public list).

- FINRA would not appoint a non-public arbitrator if the parties (individually or collectively) struck all the arbitrators appearing on the non-public list or if all remaining arbitrators on the non-public list were unable or unwilling to serve for any reason.
- If all non-public arbitrators were stricken or unavailable to serve, FINRA would select the next highest-ranked public arbitrator to complete the panel.
- If all public arbitrators were stricken or unavailable to serve, FINRA would select the next highest-ranked arbitrator on the public chair-qualified list.
- If all public chair-qualified arbitrators were stricken or unavailable to serve, FINRA would appoint a public arbitrator selected randomly by NLSS.

Additional Clarifying Provisions

FINRA proposes to add clarity to Rules 12402 and 12403 by stating that parties are not required to send a copy of their ranking list to opposing parties.

In addition, under the Optional All Public Panel method, FINRA would appoint a non-public arbitrator to a panel if the Director did not receive a party's ranked lists within the timeframe for returning lists to FINRA because the Director would proceed as though the party did not want to strike any arbitrator or have any preferences among the listed arbitrators. FINRA proposes to add clarity to the Optional All Public Panel provision by alerting parties that a failure to comply with the required timeframe for returning lists to FINRA may result in the appointment of a panel consisting of two public arbitrators and one non-public arbitrator.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹³ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that providing customers with choice on the issue of including a non-public arbitrator on the panel deciding their case will enhance customers' perception of the fairness of FINRA's rules and of its securities arbitration process.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

¹³ 15 U.S.C. 78o-3(b)(6).

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2010-053 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2010-053. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Web site viewing and printing in the Commission's Public Reference Room, 100 F

Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2010-053 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁴

Florence E. Harmon
Deputy Secretary

¹⁴ 17 CFR 200.30-3(a)(12).