

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68632; File No. SR-FINRA-2013-003)

January 11, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to the Customer and Industry Codes of Arbitration Procedure to Revise the Public Arbitrator Definition

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on January 4, 2013, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“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 Customer and Industry Codes of Arbitration Procedure (“Codes”) to revise the definition of “public arbitrator” to exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators and to require individuals to wait for two years after ending certain affiliations before they may be permitted to serve as public arbitrators. FINRA believes that the proposed amendments to the public arbitrator definition would improve investors’ perception about the fairness and neutrality of FINRA’s public arbitrator roster.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

The text of the proposed rule change is available on FINRA's website 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

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

FINRA classifies arbitrators under the Codes as either "non-public" or "public" (non-public arbitrators are often referred to as "industry" arbitrators). Non-public arbitrators are affiliated with the securities industry either through their current or former employment in a securities business, or because they provide professional services to securities businesses. Public arbitrators do not have any significant affiliation with the securities industry; nor are they related to anyone with a significant affiliation with the securities industry.

To improve investor confidence in the neutrality of FINRA's public arbitrator roster, FINRA has amended its arbitrator definitions a number of times over the years.

In 2004, FINRA amended the definitions of public arbitrator and non-public arbitrator to:

- Increase from three years to five years the period for transitioning from a non-public to public arbitrator after leaving the securities industry;
- Clarify that the term “retired” from the industry includes anyone who spent a substantial part of his or her career in the industry;
- Prohibit anyone who has been associated with the industry for at least twenty years from ever becoming a public arbitrator, regardless of how long ago the association ended;
- Exclude from the public arbitrator roster attorneys, accountants, or other professionals whose firms have derived ten percent or more of their annual revenue in the previous two years from clients involved in securities-related activities; and
- Provide that investment advisers may not serve as public arbitrators, and may only serve as non-public arbitrators if they otherwise qualify as non-public.³

In 2007, FINRA revised the public arbitrator definition to exclude individuals who were employed by, or who served as an officer or director of, a company in a control relationship with a broker-dealer. Individuals were also excluded if a spouse or immediate family member served in such a capacity. In this rule change, FINRA also made it clear that people registered through a broker-dealer could not be public arbitrators even if they are employed by a non-broker-dealer (such as a bank).⁴

³ See Exchange Act Rel. No. 49573 (April 16, 2004), 69 FR 21871 (Apr. 22, 2004) (File No. SR-NASD-2003-95) (Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations). The changes were announced in Notice to Members 04-49 (June 2004).

⁴ See Act Rel. No. 54607 (Oct. 16, 2006), 71 FR 62026 (Oct. 20, 2006) (File No. SR-NASD-2005-094)(Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to Amendments to the Classification of Arbitrators Pursuant to Rule

Finally, in 2008, FINRA revised the public arbitrator definition to add a dollar limit to the 2004 ten-percent rule. This precluded an attorney, accountant, or other professional from serving as a public arbitrator if the individual's firm derived \$50,000 or more in annual revenue in the past two years from professional services rendered to certain industry entities relating to customer disputes concerning an investment account or transaction.⁵

Proposal to Amend the Arbitrator Definition

Recently, FINRA investor representatives raised concerns that they do not perceive certain arbitrators on the public roster as public because of their background or experience. To respond to this perception, FINRA is proposing to amend the public arbitrator definition to exclude persons associated with a mutual fund or hedge fund from serving as public arbitrators and to require individuals to wait for two years after ending certain affiliations before FINRA permits them to serve as public arbitrators.

The public arbitrator definition does not expressly prohibit individuals associated with mutual funds and hedge funds from serving as public arbitrators. However, because of their association with the financial services industry, FINRA believes that these individuals should not serve as public arbitrators. Therefore, FINRA's current practice is to exclude these individuals from the public arbitrator roster until they terminate their affiliation with the hedge fund or mutual fund. For example, FINRA removed a public arbitrator from the roster because he was serving as a director of a mutual fund. FINRA is proposing to amend Rules 12100(u)(3) and

10308 of the NASD Code of Arbitration Procedure). The changes were announced in Notice to Members 06-64 (Nov. 2006).

⁵ See Exchange Act Rel. No. 57492 (Mar. 13, 2008), 73 FR 15025 (Mar. 20, 2008) (File No. SR-NASD-2007-021) (Order Approving Proposed Rule Change To Amend the Definition of Public Arbitrator). The changes were announced in Regulatory Notice 08-22 (May 2008).

13100(u)(3), which exclude investment advisers from serving as public arbitrators, to exclude also persons associated with, including registered through, a mutual fund or hedge fund. The proposed rule change would respond to questions and concerns raised about arbitrator service by persons associated with mutual funds and hedge funds.

FINRA is also proposing to amend the public arbitrator definition to add a two-year “cooling off” period before FINRA permits certain individuals to serve as public arbitrators.

Currently under the Codes, an individual may not serve as a public arbitrator if he or she is:

- an investment adviser;
- an attorney, accountant, or other professional whose firm derived ten percent or more of its annual revenue in the past two years from certain financial industry entities;
- an attorney, accountant, or other professional whose firm derived \$50,000 or more in annual revenue in the past two years from professional services rendered to certain financial industry entities relating to any customer disputes concerning an investment account or transaction;
- employed by, or is the spouse or an immediate family member of a person who is employed by, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business; or
- a director or officer of, or is the spouse or an immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business.

However, as soon as the individual ends the affiliation that was the basis for the exclusion from the public roster, the individual may begin serving as a public arbitrator. In one instance, an individual applying to be a public arbitrator had retired one month earlier from a lengthy career at a law firm that represented securities industry clients. Currently, Rule 12100(u)(5) provides that a public arbitrator may not be an attorney, accountant, or other professional whose firm derived \$50,000 or more in annual revenue in the past two years from professional services rendered to specified securities industry clients relating to any customer disputes concerning an investment account or transaction. The applicant confirmed that the firm derived revenue of at least \$50,000 during the past two years from clients in the securities industry relating to customer disputes. If the individual applied while employed at the firm, FINRA would not have approved the application. However, since the applicant left the firm one month earlier, and the rule does not include a cooling off period, the applicant was permitted to join the public arbitrator roster.

FINRA is proposing to amend Rules 12100(u) and 13100(u) to provide that a person whom FINRA would not designate as a public arbitrator because of an affiliation under subparagraphs (3)-(7) (the exclusions detailed in the bullets above) shall not be designated as a public arbitrator for two calendar years after ending the affiliation. As stated above, FINRA is also proposing to add persons associated with mutual funds and hedge funds to Rules 12100(u)(3) and 13100(u)(3). Therefore, the two-year cooling off period would apply to these individuals as well. FINRA believes that the cooling off period would improve its constituents' perception about the neutrality of the arbitrators on the public roster.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Exchange Act,⁶ 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 the proposed amendments to the public arbitrator definition would benefit investors by addressing concerns raised about the fairness and neutrality of FINRA's public arbitrator roster. FINRA believes that by prohibiting persons associated with mutual funds or hedge funds from serving on the public roster, the proposed amendments further restrict the professional affiliations that a public arbitrator may have with the securities industry. The proposed two-year cooling off period seeks to ensure that potential arbitrators have sufficient separation from their affiliations with the securities industry. FINRA believes these restrictions would improve investors' perception of fairness and neutrality of the public roster.

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 Exchange 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

⁶ 15 U.S.C. 78o-3(b)(6).

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.

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 Exchange 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-2013-003 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-2013-003. 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 website (<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 website 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-2013-003 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.⁷

Kevin M. O'Neill
Deputy Secretary

⁷ 17 CFR 200.30-3(a)(12).