

## (1) Disqualification by Director

After the appointment of an arbitrator and prior to the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, if the Director or a party objects to the continued service of the arbitrator, the Director shall determine if the arbitrator should be disqualified. If the Director sends a notice to the parties that the arbitrator shall be disqualified, the arbitrator will be disqualified unless the parties unanimously agree otherwise in writing and notify the Director not later than 15 days after the Director sent the notice.

## (2) Removal by Director

After the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, the Director may remove an arbitrator based only on information that is required to be disclosed pursuant to Rule 10312 and that was not previously disclosed.

*(3) The Director will grant a party's request to disqualify an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has an interest in the outcome of the arbitration. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.*

## (e) Discretionary Authority

The Director may exercise discretionary authority and make any decision that is consistent with the purposes of this Rule and the Rule 10000 Series to facilitate the appointment of arbitration panels and the resolution of arbitration disputes.

## (f) Challenges by Customers

*In cases involving public customers, any close questions regarding arbitrator classification or challenges for cause brought by a customer will be resolved in favor of the customer.*

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

(a) Each arbitrator shall be required to disclose to the Director of Arbitration any circumstances which might preclude such arbitrator from rendering an objective and impartial determination. Each arbitrator shall disclose:

(1) Any direct or indirect financial or personal interest in the outcome of the arbitration;

(2) Any existing or past financial, business, professional, family, social, or other relationships or circumstances

that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. Persons requested to serve as arbitrators *must* [should] disclose any such relationships or circumstances that they have with any party or its counsel, or with any individual whom they have been told will be a witness. They *must* [should] also disclose any such relationship or circumstances involving members of their families or their current employers, partners, or business associates.

(b) Persons who are requested to accept appointment as arbitrators *must* [should] make a reasonable effort to inform themselves of any interests, relationships or circumstances described in paragraph (a) above.

(c) The obligation to disclose interests, relationships, or circumstances that might preclude an arbitrator from rendering an objective and impartial determination described in paragraph (a) is a continuing duty that requires a person who accepts appointment as an arbitrator to disclose, at any stage of the arbitration, any such interests, relationships, or circumstances that arise, or are recalled or discovered.

## (d) Removal by Director

(1) The Director may remove an arbitrator based on information that is required to be disclosed pursuant to this Rule.

(2) After the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, the Director may remove an arbitrator based only on information not known to the parties when the arbitrator was selected. The Director's authority under this subparagraph (2) may be exercised only by the Director or the President of NASD Dispute Resolution.

*(3) The Director will grant a party's request to disqualify an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has an interest in the outcome of the arbitration. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.*

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

In its filing with the Commission, the NASD 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. The NASD 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

The NASD represents that the proposed rule change would amend Rules 10308 and 10312 of the Code to: (1) Modify the definitions of public and non-public arbitrators to further ensure that individuals with significant ties to the securities industry are not able to serve as public arbitrators; (2) provide specific standards for deciding challenges to arbitrators for cause; and (3) clarify that compliance with arbitrator disclosure requirements is mandatory.

#### Background

In July 2002, the SEC retained Professor Michael Perino to assess the adequacy of NASD (and New York Stock Exchange) arbitrator disclosure requirements, and to evaluate the impact of the recently adopted California Ethics Standards<sup>3</sup> on the current conflict disclosure rules of the self-regulatory organizations (SROs). The SEC released professor Perino's report, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations (Perino Report)*, on November 4, 2002.

The Perino Report concluded that undisclosed conflicts of interest were not a significant problem in SRO-sponsored arbitrations. Specifically, the Perino Report concluded that adoption of the California Ethics Standards by SROs would yield very few benefits to parties, but would impose significant costs and could have significant unintended consequences that might reduce investors' perception of the fairness of SRO arbitrations. However, the Perino Report recommended several amendments to SRO arbitrator classification and disclosure rules that, according to the Perino Report, might "provide additional assurance to investors that arbitrations are in fact neutral and fair."

<sup>3</sup> California Rules of Court, Division VI of the Appendix, entitled, "Ethics Standards for Neutral Arbitrators in Contractual Arbitration."