

This rule change would implement those recommendations, as well as several other related changes to the definition of public and non-public arbitrators that are consistent with the Perino Report recommendations.

#### Definition of Public and Non-Public Arbitrators

The Code classifies arbitrators as public or non-public (*i.e.*, “industry”). When investors have a dispute with member firms or associated persons in NASD arbitration, they are entitled to have their cases heard by a panel consisting of either a single public arbitrator, or a majority public panel consisting of two public arbitrators and one non-public arbitrator, depending on the amount of the claim.

Rule 10308(a)(5) of the Code defines “public” arbitrators as persons who are qualified to serve as arbitrators and who are not either personally engaged in certain activities that would make them non-public, or the immediate family member of a person engaged in such activities. Specifically, under Rule 10308(a)(4) of the Code, a person is currently classified as a non-public arbitrator if he or she:

- (A) Is, or within the past three years, was:
  - Associated with a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer);
  - Registered under the Commodity Exchange Act;
  - A member of a commodities exchange or a registered futures association; or
  - Associated with a person or firm registered under the Commodity Exchange Act;

(B) Is retired from engaging in any of the business activities listed in subparagraph (4)(A).

(C) Is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in subparagraph (4)(A);

(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; or

(E) Is the immediate family member of anyone who meets the criteria above.

Rule 10308(a)(5) of the Code currently defines “immediate family member” to include spouses of non-public

arbitrators, as well as family members who share a home with, receive substantial financial support from, or are declared as dependents for federal income tax purposes by, non-public arbitrators.

The proposed rule change would amend these definitions in several ways to further ensure that individuals with significant ties to the securities industry are not able to serve as public arbitrators. Specifically, the proposed rule change would amend the definition of non-public arbitrator in Rule 10308(a)(4) of the Code to:

- Increase from three years to five years the period for transitioning from an industry to public arbitrator; and
- Clarify that the term “retired” from the industry includes anyone who spent a substantial part of his or her career in the industry.

In addition, the proposed rule change would amend the definition of public arbitrator in Rule 10308(a)(5)(A) of the Code to:

- Prohibit anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator, regardless of how many years ago the association ended;
- Exclude from the definition of public arbitrator attorneys, accountants, and other professionals whose firms have derived 10 percent or more of their annual revenue, in the last two years, from clients involved in the activities defined in the definition of non-public arbitrator; and
- Provide that investment advisers may not serve as public arbitrators, and many only serve as non-public arbitrators if they otherwise qualify under Rule 10308(a)(4) of the Code.

The proposed rule change would also significantly amend the definition of “immediate family member” in Rule 10308(a)(5)(B) of the Code to further ensure that individuals with significant, albeit indirect, ties to the securities industry may not serve as public arbitrators. The Perino Report recommended that NASD expand the definition of “immediate family member” to include parents and children, even if the parent or child does not share a home with or receive substantial support from, a non-public arbitrator. Although the Perino Report referred only to parents and children, NASD believes that the same rationale applies to stepparents and stepchildren, and therefore recommends including such relationships in the definition as well. And, although the Perino Report did not address the issue, NASD believes that it is consistent with the Perino Report recommendations to amend the definition of the term

“immediate family member” to also include anyone, related or not, who is a member of the household of a non-public arbitrator.

#### Standard for Deciding Challenges for Cause

Rules 10308(d) and 10312(d) of the Code provide that under certain circumstances, the Director of NASD Dispute Resolution may remove an arbitrator upon request of a party or under the Director’s own initiative. Rule 10308(d)(1) of the Code provides that, before the first hearing session, if a party objects to the continued service of an arbitrator, the Director may disqualify an arbitrator if the Director determines that the arbitrator should be disqualified. Rule 10312(d)(1) of the Code provides that the Director may remove an arbitrator from a panel based on information that must be disclosed pursuant to the rule. Under both rules, once the first hearing session has begun, the Director may only remove an arbitrator based on information that was required to be disclosed under Rule 10312 of the Code but was not previously disclosed.

The Code does not provide a specific standard for deciding whether an arbitrator should be removed under these provisions. However, the NASD Arbitrator’s Manual states that such challenges:

will be granted where it is reasonable to infer an absence of impartiality, the presence of bias, or the existence of some interest on the part of the arbitrator in the outcome of the arbitration as it affects one of the parties. The interest or bias must be direct, definite, and capable of reasonable demonstration, rather than remote or speculative.<sup>4</sup>

The Perino Report noted that including this standard in the Code would provide greater transparency with respect to challenges for cause, and would enhance the parties’ confidence that all challenges for cause will be granted or denied on the same basis. Therefore, NASD is amending Rule 10308(d) of the Code and Rule 10312(d) of the Code to provide that in deciding challenges for cause, the Director will apply the standard described above.

In addition, based on the recommendation of the Perino Report, NASD is amending Rule 10308 of the Code to add a new paragraph (f) providing that, consistent with both NASD current practice and the New York Stock Exchange’s Guidelines for Classifying Arbitrators, close questions regarding arbitrator classification or

<sup>4</sup> As the Perino Report noted, this is essentially the same standard followed by the New York Stock Exchange.