



NASAA

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**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

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June 27, 2014

*Submitted electronically to rule-comments@sec.gov*

Elizabeth M. Murphy, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**RE: Release No. 34-72196; File No. SR-FINRA-2014-005**

Dear Ms. Murphy:

On behalf of the North American Securities Administrators Association (“NASAA”),<sup>1</sup> I hereby submit the following comments in response to Release No. 34-72196; File No. SR-FINRA-2014-005 entitled Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Partial Amendment No. 1, Relating to Broadening Arbitrators’ Authority to Make Referrals During an Arbitration Proceeding (“May 20, 2014 Release”). NASAA appreciates the opportunity to offer its comments on the above-referenced proposal and the Financial Industry Regulatory Authority’s (“FINRA”) prior rule proposals regarding mid-case referrals by arbitrators.

FINRA initially proposed this rule on July 12, 2010, see Release No. 34-62930, dated Sept. 17, 2010 (“Original Proposal”), and on July 7, 2011 proposed Amendment No.1 to the Original Proposal, which replaced the Original Proposal in its entirety. See Release No. 64954, dated July 25, 2011 (“Amended Proposal”). On January 24, 2014, FINRA withdrew the Amended Proposal without responding to comments, but on February 12, 2014, FINRA re-proposed and responded to comments received in response to the Amended Proposal.

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<sup>1</sup> NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as the forum for these regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

Importantly, however, FINRA did not propose to change any of the provisions of the Amended Proposal. On May 19, 2014, FINRA responded to additional comments received in response to the Amended Proposal and proposed to partially amend the Amended Proposal. Subsequently, on May 20, 2014, the Commission instituted the current proceedings to determine whether to approve or disapprove the proposed rule change. NASAA's comments below will address the Amended Proposal, including Partial Amendment No. 1, in their entirety.

NASAA strongly supports FINRA's effort to identify and stop potential on-going harm to investors through a process that would allow arbitrators to refer conduct that could pose a serious threat to investors to FINRA during the pendency of an arbitration proceeding. While NASAA supports FINRA's attempt to grant arbitrators this authority, FINRA must consider any negative impact the rule might have on investors in the midst of arbitration. As currently proposed, the rule could impose delays and additional costs on an investor whose case is referred during its pendency as the result of recusal requests made following a referral. Investors could also face additional uncertainty related to post-case challenges to arbitration awards in cases that have been referred. These possible delays and uncertainty would be the result of motions for recusal based upon the perceived bias of arbitrators that have referred a case prior to its conclusion.

The problem of delays and added costs created by referral-based recusal requests can and should be mitigated. FINRA should include in its proposed rule, for example, a clear instruction that a mid-case referral is not grounds for recusal, similar to the rule's clear instruction that mid-case referrals may not be made based on the pleadings alone. While FINRA has expressed its view in the most recent proposal notice that a mid-case referral is not grounds for recusal, that view should be incorporated explicitly in the text of the rule itself. An arbitrator would still have the discretion to recuse himself or herself following a mid-case referral if the arbitrator feels he or she is no longer able to decide the dispute impartially. Without an explicit reference in the rule, however, arbitrators may and likely will err on the side of recusal based on nothing more than a mid-case referral alone.

FINRA could also avoid recusal-related investor delays and costs by dropping the party notification requirement from the rule proposal. As FINRA and others have aptly noted, no courts have found arbitrators to present evident partiality for forming and voicing an opinion of a matter after hearing evidence in a case. Rather, as FINRA, the courts, and other commenters have recognized, it only makes sense for an arbitrator to form some opinions regarding a case prior to its conclusion, as arbitrators are not asked—nor expected—to wait until a case's conclusion to begin forming an opinion on the facts of the dispute.

Because it is logical for an arbitrator to begin forming opinions on the facts of a case before all the evidence is in, making a referral based on evidence is not a sign of partiality, but is

instead only an expression of the arbitrator's belief that based on the evidence at that point in the proceeding that the facts of the pending case could pose a serious threat to investors. As such, it is not clear why an arbitrator should not be allowed—or perhaps even encouraged—to make a mid-case referral on a confidential basis without notification to the parties.

Including an explicit instruction that a mid-case referral is not grounds for recusal (or eliminating the notification requirement) will result in administrative efficiencies by reducing the number of post-decision challenges based on evident partiality towards the prevailing party—one of the grounds under which an arbitration award can be overturned pursuant to the Federal Arbitration Act. As articulated in the notice, FINRA has adequately addressed this concern by requiring that a mid-case referral be made only after evidence has been presented to the arbitrator. The rule is clear that the referral cannot be based solely on the pleadings.

In addition to a specific instruction that a mid-case referral is not grounds for recusal (or elimination of the notification requirement), the proposed rule should also be revised to allow arbitrators to make their referrals directly to FINRA's enforcement division or, better yet, governmental authorities like the Securities and Exchange Commission ("Commission"), state securities regulators, or local or federal law enforcement. Unlike FINRA, these governmental authorities have the legal authority and means to shut down a serious, immediate threat. Direct referrals to the proper authorities will reduce the amount of time in which action can be taken to prevent investor harm. Funneling the referral through various layers of FINRA management as proposed by the rule, however, will only serve to add delays that would appear to frustrate the proposed rule's very purpose.

NASAA would also recommend that the rule be revised to require periodic disclosure to the Commission of statistics surrounding arbitration mid-case referrals and any associated recusals. Specifically, FINRA should report the number of mid-case referrals, the number of enforcement actions resulting from mid-case referrals, and the number of recusals resulting after a mid-case referral. Ideally, these statistics should be reported as part of FINRA's annual report, if not more frequently. Reporting these statistics would allow for an ongoing examination of the rule's effectiveness and utility.

In sum, NASAA supports FINRA in its attempt to further facilitate the flow of information that could be used to protect investors by allowing arbitrators to make mid-case referrals, and for the reasons outlined above, supports FINRA's proposed rule. The changes NASAA recommends, however, would strengthen the proposed rule and make it a much more effective investor protection tool. NASAA appreciates the opportunity to offer its comments, and should you have any questions regarding the comments in this letter, please do not hesitate

Elizabeth M. Murphy  
June 27, 2014  
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to contact Joseph Brady ([jb@nasaa.org](mailto:jb@nasaa.org)), NASAA General Counsel, via email or at 202-737-0900.

Sincerely,

A handwritten signature in black ink that reads "Andrea Seidt". The signature is written in a cursive, flowing style.

Andrea Seidt  
NASAA President  
Ohio Securities Commissioner