

February 21, 2022

The Honorable Elizabeth Warren  
United States Senate  
309 Hart Senate Office Building  
Washington, DC 20510

The Honorable Katie Porter  
United States House of Representatives  
1117 Longworth House Office Building  
Washington, DC 20515

Dear Senator Warren and Representative Porter:

Thank you for your letter of February 9, 2022, requesting information regarding the arbitrator selection process FINRA Dispute Resolution Services (DRS) uses, and how DRS handles conflicts of interest as part of that process. FINRA takes this issue very seriously and is fully committed to ensuring the integrity of the arbitrator selection process.

### **Background**

As you know, FINRA is a not-for-profit, self-regulatory organization (SRO) responsible for regulating its member broker-dealers and their associated persons pursuant to the Securities Exchange Act of 1934 (Exchange Act). FINRA supports the Securities and Exchange Commission (SEC) in overseeing one subset of the securities industry—more than 3,400 registered broker-dealers and more than 600,000 registered individuals.

DRS administers an arbitration forum to assist in the resolution of disputes involving investors, securities firms and their registered employees. The arbitration forum operates in accordance with rules that have been approved by the SEC, after an opportunity for public comment and a finding that the rules are in the public interest. The SEC regularly examines DRS's operations.

As you know, broker-dealers and investment advisers often require their customers to enter into agreements to arbitrate disputes arising from the services provided to such customers. With respect to FINRA's member firms, FINRA rules do not require such agreements, nor do they preclude customers from pursuing relief in state or federal courts. FINRA's rules do require arbitration in the DRS arbitration forum when a customer requests to arbitrate the dispute there.<sup>1</sup>

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<sup>1</sup> See FINRA Rule 12200.

The Supreme Court has held that predispute arbitration agreements are enforceable as to claims brought under the Exchange Act.<sup>2</sup> Subsequently, in the Dodd-Frank Act, Congress provided to the SEC—not FINRA—the explicit authority to prohibit or place limitations on the use of such agreements.<sup>3</sup> Should the SEC determine to exercise this authority, such as by reviewing the use of these agreements and considering whether to reinstitute its earlier prohibition of them, FINRA stands ready to assist in that review.<sup>4</sup>

### **Overview of FINRA’s Arbitrator Selection Process**

Depending on the amount of damages being sought, disputes in the DRS arbitration forum are heard by either a panel of three arbitrators, or by a single arbitrator.<sup>5</sup> In all cases involving customers, each party has the option to have the case decided exclusively by public arbitrators who, among other requirements, have never been employed in the securities industry. DRS maintains a roster of more than 8,200 arbitrators,<sup>6</sup> conducts a comprehensive pre-approval background check on all arbitrator applicants, and provides training and continuing education for arbitrators.<sup>7</sup>

#### **Neutral List Selection System**

To ensure fairness to all parties, DRS’s arbitrator selection process uses the Neutral List Selection System (NLSS), a computer algorithm, that generates lists of arbitrators on a

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<sup>2</sup> See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

<sup>3</sup> Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), authorizes the SEC to limit or prohibit the use by broker-dealers, municipal securities dealers and investment advisers of customer agreements to arbitrate future disputes if it finds that such limitation or prohibition is in the public interest and for the protection of investors.

<sup>4</sup> Until its rescission in 1987 (following the Supreme Court’s *McMahon* decision), SEC Rule 15c2-2(a) provided that: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer."

<sup>5</sup> As a neutral administrator of the arbitration forum, DRS does not participate in the decision-making process by arbitrators. The decisions are made by the independent arbitrators selected by the parties.

<sup>6</sup> So that the roster is representative of its forum users, DRS actively recruits minority, female and LGBTQ arbitrators. DRS publishes data on the diversity of the arbitrator roster on FINRA’s website. See <https://www.finra.org/arbitration-mediation/our-commitment-achieving-arbitrator-and-mediator-diversity-finra>.

<sup>7</sup> See <https://www.finra.org/arbitration-mediation/become-finra-arbitrator>.

random basis from DRS's rosters of arbitrators for the selected hearing location.<sup>8</sup> NLSS automatically excludes arbitrators from the lists based upon current conflicts of interest identified within NLSS, such as when the arbitrator is currently employed by or currently has a securities account with a party.<sup>9</sup>

Once the list is generated through NLSS, DRS conducts a review for other conflicts not identified within NLSS, and if any arbitrators are removed due to such conflicts, NLSS is used to generate replacement arbitrators.<sup>10</sup> The arbitrator lists are then provided to the parties, and the parties select their panel through a process of striking and ranking the arbitrators on the lists.<sup>11</sup>

### Striking and Ranking Arbitrators

In customer cases with claims in excess of \$100,000, each party receives three lists:

- one with 10 chair-qualified public arbitrators;<sup>12</sup>
- one with 15 public arbitrators; and
- one with 10 non-public arbitrators.<sup>13</sup>

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<sup>8</sup> DRS has used NLSS to generate lists of arbitrators in a neutral fashion since 1998 when the SEC approved new procedures relating to the arbitrator selection process that incorporated NLSS. See Exchange Act Release No. 40555 (Oct. 14, 1998) (File No. SR-NASD-98-48) and Exchange Act Release No. 40556 (Oct. 14, 1998) (File No. SR-NASD-98-64). See *also* FINRA Rules 12400, 12401, 12402 and 12403.

<sup>9</sup> See FINRA Rules 12402(b)(2) and 12403(a)(3).

<sup>10</sup> Potential conflicts include that: the arbitrator is employed by a party to the case; the arbitrator is an immediate family member or relative of a party to the case or a party's counsel; the arbitrator is employed at the same firm as a party to the case; the arbitrator is employed at the same law firm as counsel to a party to the case; the arbitrator is representing a party to the case as counsel; the arbitrator is an account holder with a party to the case; the arbitrator is employed by a member firm that clears through a clearing agent that is a party to the case; or the arbitrator is in litigation with or against a party to the case. DRS may also remove an arbitrator for other reasons affecting the arbitrator's ability to serve, such as if DRS learns the arbitrator is deceased or has moved out of the hearing location.

<sup>11</sup> See FINRA Rules 12402 and 12403.

<sup>12</sup> In customer cases, chairpersons must be public arbitrators. Arbitrators are eligible for the chairperson roster if they have completed chairperson training provided by FINRA and: (1) have a law degree and are a member of a bar of at least one jurisdiction and have served as an arbitrator through award on at least one arbitration administered by an SRO in which hearings were held; or (2) have served as an arbitrator through award on at least three arbitrations administered by an SRO in which hearings were held. See FINRA Rule 12400(c).

<sup>13</sup> See FINRA Rules 12401 and 12403. If the amount of the claim is \$50,000 or less, exclusive of interest and expenses, the panel will consist of one arbitrator. If the amount of the claim is more than \$50,000 but not more than \$100,000, exclusive of interest and expenses, the panel will consist

The parties will also receive employment history for the past 10 years and other background information for each arbitrator.<sup>14</sup> Each party may strike from each of the three lists each party receives:

- up to four of the 10 arbitrators on the chair-qualified public list for any reason (at least six names must remain on this list);
- up to six of the 15 arbitrators on the public list for any reason (at least nine names must remain on this list); and
- up to all 10 arbitrators on the non-public list.<sup>15</sup>

Parties may also agree to remove an arbitrator from the ranking list. If an arbitrator is removed as a result of this process, DRS uses NLSS to generate a replacement arbitrator for the ranking list. Parties then rank the remaining arbitrators on each list. NLSS consolidates the parties' rankings to appoint the panelists based on those rankings.<sup>16</sup>

#### Arbitrator Disclosure Requirements

Before appointing arbitrators to a panel, DRS will notify the arbitrators of the nature of the dispute and the identity of the parties. FINRA rules require that each potential arbitrator make a reasonable effort to learn of, and disclose to DRS, any circumstances that might preclude the arbitrator from rendering an objective and impartial determination in the proceeding, including:

- any direct or indirect financial or personal interest in the outcome of the arbitration;
- any existing or past financial, business, professional, family, social, or other relationships or circumstances with any party, any party's representative, or anyone who the arbitrator is told may be a witness in the proceeding, that are likely to affect impartiality or might reasonably create an appearance of partiality or bias;
- any such relationship or circumstances involving members of the arbitrator's family or the arbitrator's current employers, partners, or business associates; and
- any existing or past service as a mediator for any of the parties in the case for which the arbitrator has been selected.<sup>17</sup>

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of one arbitrator, unless the parties agree in writing to three arbitrators. See *also* FINRA Rule 12402 (describing the arbitrator selection process for cases with one arbitrator).

<sup>14</sup> See FINRA Rule 12403(b)(1). Additional information regarding arbitrator disclosure requirements, including a sample Arbitrator Disclosure Report, is available on FINRA's website at <https://www.finra.org/arbitration-mediation/arbitrator-disclosure>.

<sup>15</sup> See FINRA Rule 12403.

<sup>16</sup> See FINRA Rule 12403. In addition, detailed information regarding the striking and ranking process is available on FINRA's website at <https://www.finra.org/arbitration-mediation/arbitrator-selection>.

<sup>17</sup> See FINRA Rule 12405(a).

If, during the arbitrator selection process, a party requests additional information about an arbitrator, DRS will request the additional information from the arbitrator, and will send any response to all the parties at the same time.<sup>18</sup>

The obligation to disclose interests, relationships, or circumstances that might preclude an arbitrator from rendering an objective and impartial determination is continuous, requiring an arbitrator who accepts appointment to an arbitration proceeding to disclose to DRS and the parties, at any stage of the proceeding, any such interests, relationships or circumstances that arise, or that the arbitrator recalls or discovers.<sup>19</sup>

### Challenges to Arbitrators

Generally, FINRA rules and procedures provide all parties with the ability to challenge arbitrators randomly selected by NLSS for the ranking lists, as well as arbitrators ultimately appointed to a panel. All parties can challenge arbitrators on the basis that they believe an arbitrator is biased, lacks impartiality, or has a direct or indirect interest in the outcome of the arbitration, among other reasons.<sup>20</sup>

If the challenge occurs before the commencement of the hearing, FINRA rules provide that DRS will grant a party's request to remove 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 a direct or indirect interest in the outcome of the arbitration. The interest or bias must be definite and capable of reasonable demonstration, rather than remote or speculative. Close questions regarding challenges to an arbitrator by a customer under this rule will be resolved in favor of the customer.<sup>21</sup>

If the challenge occurs after the commencement of the hearing, FINRA rules provide that DRS may remove an arbitrator based only on information required to be disclosed by an

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<sup>18</sup> See FINRA Rules 12402(c)(2) and 12403(b)(2).

<sup>19</sup> See FINRA Rule 12405(b).

<sup>20</sup> Examples of circumstances in which a party may challenge an arbitrator include that: the arbitrator has a personal bias toward a party; the arbitrator is or was a party's guardian; the arbitrator is or was a business partner, vendor, customer or client of a party; the arbitrator is currently an expert witness for a party; or a party, its attorneys or witnesses previously accused an arbitrator of wrongdoing in a prior action. See also <https://www.finra.org/arbitration-mediation/arbitrator-selection>.

<sup>21</sup> See FINRA Rule 12407(a)(1). DRS may also remove an arbitrator on its own initiative, after first notifying the parties. DRS may not remove the arbitrator if the parties agree in writing to retain the arbitrator within five days of receiving notice of DRS's intent to remove the arbitrator. See FINRA Rule 12407(a)(2).

arbitrator that was not previously known by the parties. DRS may exercise this authority upon request of a party or on DRS's own initiative.<sup>22</sup>

To challenge an arbitrator, a party must file a written motion with DRS and serve the motion on each party so that the motions are available to all parties. FINRA rules include detailed motion practice procedures.<sup>23</sup> If a party challenges an arbitrator, all other parties are provided an opportunity to make their arguments prior to any decision by DRS.

While FINRA does not make public the names of arbitrators who are removed from the ranking lists or a panel based on the parties' striking of arbitrators or challenges, the parties can publicly share information about their cases, including arbitrator removals.

### **Review of the Leggett Case**

FINRA is in the process of reviewing the arbitrator selection process in connection with *Leggett, et al vs. Wells Fargo Clearing, et al. (Case 17-01077)* (Leggett Case). While this process continues, based on its internal review to date, DRS has provided the following summary:

DRS is not aware of any information indicating that any arbitrator was excluded from this matter except in accordance with established rules, policies and procedures.

NLSS randomly generated the lists of arbitrators from DRS's roster of arbitrators for the selected hearing location for the Leggett Case and DRS conducted a review for conflicts not identified within NLSS. Based on that review, two arbitrators were removed from the list, in accordance with DRS policies and procedures, because they had financial accounts with the respondent or its affiliate. NLSS generated two replacement arbitrators for the ranking list, and the list was then provided to the parties.

During the striking and ranking process, counsel to both claimants and respondents struck arbitrators from the ranking lists.

During the arbitrator selection process, respondents' counsel filed a motion to remove and replace an arbitrator on a ranking list based on allegations of bias.<sup>24</sup> In addition, following the appointment of the panel, respondents' counsel filed a motion to remove a different arbitrator from the panel

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<sup>22</sup> See FINRA Rule 12407(b). After commencement of a hearing, only the DRS Director may remove an arbitrator from a panel. FINRA Rule 12407(b) does not permit this authority to be delegated.

<sup>23</sup> See FINRA Rule 12503.

<sup>24</sup> This is the "Postell arbitrator" referred to in the Atlanta Superior Court judge's order vacating the award in the Leggett Case.

alleging that a conflict of interest had arisen following the arbitrator appointment process. Counsel to both claimants and respondents fully briefed the issues through motions, responses, replies and, in the case of the motion to remove the first arbitrator, sur-replies.

After reviewing the motion papers in connection with the challenge to the arbitrator on the ranking list, DRS granted the motion to remove the arbitrator from the list and provided a replacement arbitrator for the parties to rank and strike. In addition, after reviewing the motion papers in connection with the challenge to the arbitrator on the panel, DRS granted the motion to remove the arbitrator from the panel. Following removal of the arbitrator from the panel and in accordance with DRS procedures, the parties selected a replacement arbitrator to serve on the panel. DRS notified, in writing, the counsel of record for each party at the same time in connection with each of its determinations, as well as the names of the replacement arbitrators.

We recognize the importance to the fairness and credibility of the DRS arbitration forum of having an arbitrator selection process that is—and that is perceived to be—operated in a fair and neutral manner, free from doubts or concerns regarding the basis for any arbitrator removals of the type alleged in the Leggett Case. In order to be certain that the arbitrator selection process in the Leggett Case was handled in a manner fully consistent with applicable rules, policies and procedures, and to provide additional assurances to all stakeholders regarding the integrity of the arbitrator selection process, FINRA is taking several immediate actions.

First, the Audit Committee of FINRA's Board of Governors has retained an outside law firm that will report to the Committee and perform an independent review of DRS's compliance with applicable rules, policies and procedures for arbitrator selection in connection with the Leggett Case.<sup>25</sup> FINRA will make the results of this independent review public.

In addition, while this independent review is ongoing, DRS is implementing enhanced oversight of its decisions in response to challenges by parties seeking removal of arbitrators. In particular, all such decisions will be escalated to the DRS Director for final review and determination. The DRS Director will also provide a monthly report to the FINRA Chief Legal Officer of all such decisions.

FINRA also has updated its website to provide additional clarity and transparency related to the arbitrator selection process.<sup>26</sup>

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<sup>25</sup> See <https://www.finra.org/media-center/newsreleases/2022/finra-hires-firm-conduct-independent-review-arbitrator-selection>.

<sup>26</sup> See <https://www.finra.org/arbitration-mediation/arbitrator-selection>. Changes include making the information more user friendly and including more detailed information regarding the processes in FINRA rules relating to parties challenging arbitrators on ranking lists and appointed to panels.

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FINRA is committed to ensuring the DRS arbitration forum is operated in a neutral and fair manner. FINRA continually strives to improve the DRS arbitration forum and to ensure that the policies and procedures related to the administration of the forum are clear and transparent, and we look forward to working with the SEC and Congress on these and other investor protection issues. If you have any questions, please do not hesitate to contact me at (202) 728-8425, or your staff may contact Greg Dean, Senior Vice President, Office of Government Affairs, at (202) 728-8217. In addition, we would be happy to meet with you or your staff to discuss this matter further.

Sincerely,

A handwritten signature in black ink that reads "Robert W. Cook". The signature is written in a cursive style with a large, stylized initial 'R'.

Robert W. Cook  
President and Chief Executive Officer