

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51825; File No. SR-NASD-2005-070)

June 13, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment No. 1 Thereto Relating to Rescinding the Pilot Rule in IM-10100(f) of the NASD Code of Arbitration Procedure Relating to the Waiver of the California Ethics Standards for Neutral Arbitrators in Contractual Arbitration

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 31, 2005 and on June 8, 2005 (Amendment No. 1), the National Association of Securities Dealers, Inc. (“NASD” or “Association”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and is approving the proposal on an accelerated basis.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to rescind the pilot rule in IM-10100(f) of the NASD Code of Arbitration Procedure relating to the waiver of the California Ethics Standards for Neutral Arbitrators in Contractual Arbitration.

Below is the text of the proposed rule change.<sup>3</sup> Proposed new language is

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Corresponding changes reflecting the proposed rule change will be made to the NASD Code of Arbitration Procedure for Customer Disputes filed on October 15, 2003, and amended on January 3, 2005, January 19, 2005, and April 8, 2005 (SR-NASD-2003-158); and the NASD Code of Arbitration Procedure for Industry Disputes filed on January 16, 2004, and amended on February 26, 2004, January 3, 2005, and April 8, 2005 (SR-NASD-2004-011).

italicized; proposed deletions are in brackets.

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**IM-10100. Failure to Act Under Provisions of Code of Arbitration Procedure**

It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member or a person associated with a member to:

(a) through (c) No change

(d) fail to honor an award, or comply with a written and executed settlement agreement, obtained in connection with an arbitration submitted for disposition pursuant to the procedures specified by the National Association of Securities Dealers, Inc., the New York, American, Boston, Cincinnati, Chicago, or Philadelphia Stock Exchanges, the Pacific Exchange, Inc., the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, or pursuant to the rules applicable to the arbitration of disputes before the American Arbitration Association or other dispute resolution forum selected by the parties where timely motion has not been made to vacate or modify such award pursuant to applicable law; or

(e) fail to comply with a written and executed settlement agreement, obtained in connection with a mediation submitted for disposition pursuant to the procedures specified by the National Association of Securities Dealers, Inc. [; or]

[(f) fail to waive the California Rules of Court, Division VI of the Appendix, entitled, "Ethics Standards for Neutral Arbitrators in Contractual Arbitration" (the "California Standards"), if application of the California Standards has been waived by all parties to the dispute who are:

(1) customers with a claim against a member or an associated person;

(2) associated persons with a claim against a member or an associated person;

(3) members with a claim against another member; or

(4) members with a claim against an associated person that relates exclusively to a promissory note.

Written waiver by such parties shall constitute and operate as a waiver for all member firms or associated persons against whom the claim has been filed. This rule applies to claims brought in California against all member firms and associated persons, including terminated or otherwise inactive member firms or associated persons.]

Remainder unchanged

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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, 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 III below. 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 purpose of the proposed rule change is to rescind the pilot rule in IM-10100(f) of the NASD Code of Arbitration Procedure ("Code") relating to the waiver of

the California Ethics Standards for Neutral Arbitrators in Contractual Arbitration (“Pilot Rule”).

Effective July 1, 2002, the California Judicial Council (“Judicial Council”) adopted a set of rules, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (“California Standards”),<sup>4</sup> which contain extensive disclosure and disqualification requirements for arbitrators. The California Standards imposed disclosure and disqualification requirements on arbitrators that conflict with the disclosure and disqualification rules of NASD and the New York Stock Exchange (“NYSE”). Because NASD could not both administer its arbitration program in accordance with its own rules and comply with the new California Standards at the same time, NASD initially suspended the appointment of arbitrators in cases in California, but offered parties several options for pursuing their cases.<sup>5</sup>

In September 2002, NASD implemented a pilot rule providing that if parties to an arbitration who are customers (or, in certain circumstances, associated persons) waived application of the California Standards to their arbitration proceeding, then the firm would be required to waive the application of the California Standards.<sup>6</sup> Under such a

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<sup>4</sup> California Rules of Court, Division VI of the Appendix.

<sup>5</sup> These measures included providing venue changes for arbitration cases, using non-California arbitrators when appropriate, and waiving administrative fees for NASD-sponsored mediations.

<sup>6</sup> This rule has been expanded on several occasions. Originally, the pilot rule only applied to claims by customers, or by associated persons asserting a statutory employment discrimination claim against a member, and required a written waiver by the industry respondents. In July 2003, NASD expanded the scope of the pilot rule to include all claims by associated persons against another associated person or a member. At the same time, the rule was amended to provide that when a customer, or an associated person with a claim against a member or another associated person, agrees to waive the application of the California Standards, all respondents that are members or associated persons will be deemed to have waived the application of the standards as well. The July 2003 amendment also clarified that the pilot rule applies to terminated members and associated persons. Exchange Act Release No. 48187 (July 16, 2003), 68 FR 43553 (July 23, 2003). In October 2003, the rule was further amended to include claims by members against other members, and claims by members against associated persons that relate exclusively to promissory notes. Exchange Act Release No. 48711 (October 29, 2003), 68 FR 62490 (November 4, 2003).

waiver, the arbitration proceeds under the existing NASD Code, which already contains extensive disclosure requirements and provisions for challenging arbitrators with potential conflicts of interest. In those cases where a waiver of the California Standards is not received, the appointment of arbitrators is temporarily postponed unless the parties agree to proceed in a non-California venue.

NASD also commenced litigation or became involved in a number of suits challenging the California Standards. On March 1, 2005, the United States Court of Appeals for the Ninth Circuit issued its decision in Credit Suisse First Boston Corp. v. Grunwald.<sup>7</sup> The Ninth Circuit held that the Exchange Act preempts application of the California Standards to NASD arbitrations. On May 23, 2005, the Supreme Court of California also held that the Exchange Act preempts application of the California Standards to NASD-administered arbitrations.<sup>8</sup>

The Pilot Rule was originally approved for six months in September 2002.<sup>9</sup> It was subsequently extended on several occasions and is now due to expire on September 30, 2005.<sup>10</sup> NASD has determined that the Pilot Rule should be rescinded prior to September 30, 2005, as it is no longer necessary. Specifically, with the recent decisions in Grunwald and Jevne, both the Ninth Circuit Court of Appeals and the California Supreme Court have found that the Exchange Act preempts the application of the California Standards to arbitrators in the NASD forum. Consequently, NASD believes that it can once again appoint arbitrators in California cases without requiring a waiver of the California Standards.

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<sup>7</sup> 400 F.3d 1119 (9th Cir. 2005).

<sup>8</sup> Jevne v. The Superior Court of Los Angeles County, S121532 (CA Sup. Ct. May 23, 2005).

<sup>9</sup> See Exchange Act Release No. 46562 (September 26, 2002), 67 FR 62085 (October 3, 2002).

<sup>10</sup> See Exchange Act Release No. 51213 (February 16, 2005), 70 FR 8862 (February 23, 2005).

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Exchange Act,<sup>11</sup> which requires, among other things, that NASD's 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. Specifically, rescinding the Pilot Rule will benefit all users of the forum as it will allow NASD to process those arbitration cases that have not been paneled because the necessary waivers of the California Standards have not been received.

### (B) Self-Regulatory Organization's Statement on Burden on Competition

NASD 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, as amended.

### (C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments on the proposed rule change were neither solicited nor received.

## III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

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<sup>11</sup> 15 U.S.C. 78o-3(b)(6).

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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2005-070 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2005-070. 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 Web site (<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 inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. Copies of such filings also will be available for inspection and copying at the principal offices of the NASD. 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

the File Number SR-NASD-2005-070 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder, applicable to a self-regulatory organization.<sup>12</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act,<sup>13</sup> which requires, among other things, that NASD's 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. The Commission notes that rescinding the Pilot Rule will benefit all users of the forum as it will allow NASD to process those arbitration cases that have not proceeded because the necessary waivers of the California Standards have not been received.

After careful consideration, the Commission finds good cause, pursuant to Section 19(b)(2) of the Exchange Act,<sup>14</sup> for approving the proposed rule change prior to the thirtieth day after the date of publication of notice in the Federal Register. In recent decisions in Grunwald and Jevne, both the Ninth Circuit Court of Appeals and the California Supreme Court have found that the Exchange Act preempts the application of the California Standards to arbitrations in the NASD forum. Consequently, the Commission believes that the NASD can once again appoint arbitrators in California cases without requiring a waiver of the California Standards. Accordingly, the

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<sup>12</sup> In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 15 U.S.C. 78o-3(b)(6).

<sup>14</sup> 15 U.S.C. 78s(b)(2).



Commission believes that there is good cause, consistent with Section 15A(b)(6) of the Exchange Act,<sup>15</sup> to approve the proposal on an accelerated basis.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,<sup>16</sup> that the proposed rule change (SR-NASD-2005-070) is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>17</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>15</sup> 15 U.S.C. 78o-3(b)(6).

<sup>16</sup> 15 U.S.C. 78s(b)(2).

<sup>17</sup> 17 CFR 200.30-3(a)(12).