

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50713; File No. SR-NASD-98-74)

November 22, 2004

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change as Amended and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 by the National Association of Securities Dealers, Inc., Regarding NASD Rule 3110(f) Governing Predispute Arbitration Agreements with Customers

I. Introduction

On October 6, 1998, the National Association of Securities Dealers (“NASD”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder to amend NASD Rule 3110(f) governing predispute arbitration agreements.² Notice of the proposal, as amended by Amendment Nos. 1 and 2, was published in the Federal Register on November 29, 1999.³ The Commission received two comment letters on the proposed rule change.⁴ On April 30, 2002, NASD submitted a Response to Comments and Amendment No. 3 to the proposed rule change. On August 22, 2003, NASD filed Amendment No. 4 to the proposal, which replaced in its entirety the prior filings and amendments, except for the Response to Comments contained in Amendment No. 3. Notice of the proposal, as amended by Amendment Nos. 3 and 4, was published in the Federal Register on September 12, 2003.⁵ The Commission received 24 comment letters on Amendment Nos. 3 and 4.⁶ On January 9, 2004,

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Release No. 34-42160 (November 19, 1999), 64 FR 66681(November 29, 1999).

⁴ See letters from Barry D. Estell, dated December 15, 1999 (“Estell Letter”), and John J. Miller, dated December 27, 1999 (“Miller Letter”).

⁵ See Release No. 34-48444 (September 4, 2003), 68 FR 53762 (September 12, 2003).

⁶ See letters from Al Van Kampen, Rohde & Van Kampen, dated October 11, 2003; Barbara Black and Jill I. Gross, Pace Investor Rights Project, Pace University School of Law, dated October 2, 2003 (“Pace Letter”); Carl J. Carlson, Carlson & Fabish, P.S., dated October 5, 2003; Daniel A. Ball, Selzer, Gurvitch, Rabin,

NASD submitted a Response to Comments and Amendment No. 5 to the proposed rule change.⁷

This order approves the proposed rule change, grants accelerated approval to Amendment No. 5, and solicits comments from interested persons on Amendment No. 5.

II. Description of the Proposal

A. Background

1. Purpose and General Description of Proposal

The proposed rule change is intended to increase the disclosure required in predispute arbitration agreements. Many broker-dealers require that customers seeking to open accounts, particularly margin and option accounts or accounts with a checking or money market feature, agree in writing to arbitrate disputes concerning the account, typically in an SRO-sponsored forum. These agreements, called "predispute arbitration agreements," are generally part of the non-negotiated customer agreement drafted by the firm.

To ensure that customers are advised about what they are agreeing to when they sign predispute arbitration agreements, NASD Rule 3110(f) requires that such agreements contain highlighted disclosure about differences between arbitration and litigation, including notice that

Obecny, dated October 3, 2003; Don K. Leufven, dated October 9, 2003; Donald G. McGrath, McGrath & Polvino, PLLC, dated October 3, 2003; H. Douglas Powell, Fishkind & Associates, Inc., dated October 6, 2003; Herb Pounds, Herbert E. Pounds, Jr., P.C., dated October 6, 2003; J. Pat Sadler, Public Investors' Arbitration Bar Association, dated October 2, 2003; Jeffrey A. Feldman, Esquire, dated October 6, 2003; John Miller, Law Office of John L. Miller, P.C., dated October 5, 2003; Jorge A. Lopez, Esquire, Jorge A. Lopez, P.A., dated October 5, 2003; Kari S. Turigliatto, Mutual Service Corporation, dated October 8, 2003; Kenneth A. Martyn, Attorney at Law, dated October 8, 2003; Laurence S. Schultz, Driggers, Schultz & Herbst, P.C., dated October 3, 2003; Lenny Steiner, dated October 4, 2003; Madelaine Eppenstein and Theodore G. Eppenstein, Eppenstein and Eppenstein, dated October 3, 2003; Ralph A. Lambiase, North American Securities Administrators Association, Inc., dated October 3, 2003; Richard M. Layne, Layne & Lewis LLP, dated October 2, 2003; Robert S. Banks, Jr., Banks Law Office, P.C., dated October 3, 2003; Rosemary J. Shockman, Shockman Law Office, P.C., dated October 2, 2003; Scott C. Igenfritz, Johnson, Pope, Bokor, Ruppel & Burns, P.A., dated October 16, 2003; Steve Buchwalter, Law Offices of Steve A. Buchwalter, P.C., dated October 3, 2003; and Tracy Pride Stoneman, Tracy Pride Stoneman, P.C., dated October 3, 2003.

⁷ See letter from Kosha Dalal, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated January 9, 2004 ("Amendment No. 5").

by agreeing to arbitrate their disputes, customers may be waiving certain rights that would be available in court. NASD Rule 3110(f) also requires that the agreement itself be highlighted, and that a copy of the agreement be given to the customer and acknowledged by the customer in writing.

Despite these precautions, investor representatives have expressed concern that many customers who sign predispute arbitration agreements still do not understand adequately what they are agreeing to. Customers' perceptions of unfairness are heightened by the fact that, in order to open an account, they are forced to agree to SRO-sponsored arbitration.

Consequently, the Arbitration Task Force, chaired by David Ruder (formerly Chairman of the SEC and a former NASD Board member), recommended in its 1996 report, *Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors, National Association of Securities Dealers, Inc.* (“Ruder Task Force Report”), that members be required to provide more disclosure about arbitration to customers who sign predispute arbitration agreements, and that the use of certain provisions that limit rights and remedies be restricted.

Thus, NASD proposes to amend NASD Rule 3110(f) regarding predispute arbitration agreements (i) to require additional disclosure in predispute arbitration agreements about the arbitration process, including possible limits on eligibility of claims; (ii) to require member firms to provide certain information regarding arbitration and predispute arbitration agreements to customers upon request; (iii) to provide explicitly that the rules of the arbitration forum in which the claim is filed are incorporated into the predispute arbitration agreement; and (iv) to require members seeking to compel arbitration of claims initiated in court to arbitrate all of the claims contained in the complaint if the customer so requests.

2. General Comments on the Proposed Rule Change

In 1999, the Commission received two comment letters on the proposal, as amended by Amendment Nos. 1 and 2.⁸ In 2003, the Commission received 24 comment letters on the proposal, as amended by Amendment Nos. 3 and 4.⁹ Several commenters applauded the proposed rule change as an effort to help investors understand the consequences of signing predispute arbitration agreements. The majority of commenters, however, opposed Proposed Rule 3110(f)(4)(B), relating to the use of choice-of-law provisions. In response to these comments, NASD is amending the proposed rule change to withdraw Proposed Rule 3110(f)(4)(B), for the reasons explained below in Section II.F, Restrictions on Provisions that Limit Rights and Remedies.

Finally, one commenter criticized the proposed rule change for not permitting customers to opt out of predispute arbitration agreements in cases involving securities fraud, and for failing to eliminate the requirement that one non-public arbitrator serve on three-arbitrator panels, as required by NASD Rule 10308.¹⁰ NASD responded that these concerns, while noted, are outside the scope of the proposed rule filing.

B. Required Disclosure and Notice of Possible Restrictions on Eligibility

Currently, disclosure language about the differences between litigation and arbitration must be included in predispute arbitration agreements.¹¹ NASD proposes to clarify existing disclosures and to require new disclosure that (i) the rules of some arbitration forums may

⁸ See Estell Letter and Miller Letter, supra note 4.

⁹ See supra note 6.

¹⁰ See letter from Madelaine Eppenstein and Theodore G. Eppenstein, Eppenstein and Eppenstein, dated October 3, 2003.

¹¹ See NASD Rule 3110(f)(1).

impose time limits for bringing claims in arbitration; and (ii) in some cases, claims that are ineligible for arbitration may be brought in court.¹²

Under the proposal, members would be required to add the new disclosure requirements to all new customer account agreements containing predispute arbitration agreements as of the effective date of the rule. Accordingly, the proposed rule would not require members to replace existing agreements with current customers.¹³

C. Incorporation of Arbitration Forum Rules

The proposal provides that the rules of the arbitration forum in which a claim is brought, and any amendments thereto, are incorporated into the parties' agreement and are enforceable, as are other provisions of the arbitration contract.¹⁴ This provision should ensure that the rules of a forum apply to cases brought in that forum and eliminate the need to execute new agreements each time a forum changes its rules. Accordingly, if a customer files a complaint in an NASD arbitration forum, NASD's arbitration rules would apply in all respects to the agreement.

D. Acknowledgement of Predispute Arbitration Clause

NASD Rule 3110(f) currently requires that (i) predispute arbitration agreements contain a highlighted statement indicating that the agreement contains an arbitration clause and specifying at what page and paragraph the arbitration clause is located; and (ii) a copy of the predispute arbitration agreement be provided to the customer, who must acknowledge receipt of the agreement in writing, either on the agreement itself or on a separate document. Proposed Rule

¹² See Proposed Rule 3110(f)(1)(F). In a companion rule filing approved by the Commission today, NASD is amending its rule pertaining to time limits for bringing claims in arbitration (NASD Rule 10304), to provide explicitly that arbitrators, rather than the courts, determine the eligibility of claims, and that a party requesting dismissal of a claim on eligibility grounds in an NASD forum agrees that the party that filed the dismissed claim may withdraw all related claims without prejudice and may pursue all of the claims in court. See Release No. 34-50714 (November 22, 2004) (order approving amendments to Rule 10304).

¹³ See Proposed Rule 3110(f)(7).

¹⁴ See Proposed Rule 3110(f)(1)(G).

3110(f)(2)(B) would amend the current rule to require that delivery and customer acknowledgement of the agreement take place at the time of signing.

E. Requirement That Members Provide Copies of Customer Agreements and Information Regarding Arbitration Forums to Customers Upon Request: Proposal and Comments Received

Proposed Rule 3110(f)(3)(A) would require members, within ten days of receiving a customer request, either to provide the customer with a copy of any predispute arbitration agreement clause or agreement that the customer had signed, or inform the customer that the member does not have a copy of the agreement.¹⁵ In addition, the proposal would require that, upon request of a customer, a member must provide the customer with the names of, and information on how to contact or obtain the rules of, all arbitration forums in which a claim may be filed under the agreement.¹⁶

One commenter interpreted the phrase “or inform the customer that the member does not have a copy thereof” in Proposed Rule (f)(3)(A) to refer to a situation in which there is no predispute arbitration agreement between the customer and firm.¹⁷ NASD stated that, in fact, Proposed Rule 3110(f)(3)(A) is intended to address a situation in which a customer agreement or predispute arbitration agreement has been executed, but the firm is for some reason unwilling or unable to produce a copy to the customer. Current Rule 3110(f)(3) requires that copies of any predispute arbitration agreement be given to the customer, who must acknowledge receipt thereof. NASD has become aware, however, that members generally provide copies of such agreements at the time the agreement is signed, but sometimes refuse or are unable to do so after a dispute has arisen. Thus, Proposed Rule 3110(f)(A)(3) requires members to produce customer

¹⁵ See Proposed Rule 3110(f)(3)(A).

¹⁶ See Proposed Rule 3110(f)(3)(B).

¹⁷ See Pace Letter supra note 6.

account or predispute arbitration agreements upon the request of the customer. NASD expects that members will retain such agreements, as required by NASD rules. However, if for some reason, whether through an act of nature, human error, or otherwise, a member is unable to comply with the customer's request, NASD proposes to require members to inform the customer of that fact, rather than simply failing to respond to the customer's request.

F. Restrictions on Provisions that Limit Rights and Remedies

Proposed Rule 3110(f)(4)(A) clarifies the prohibition against provisions in predispute arbitration agreements that limit rights or remedies, including provisions that would circumvent NASD's eligibility rule proposal, as amended.¹⁸ In particular, the proposal would provide that predispute arbitration agreements may not include any condition that would: (i) limit or contradict the rules of any self-regulatory organization ("SRO"); (ii) limit the ability of a party to file any claim in arbitration; (iii) limit the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement; or (iv) limit the ability of arbitrators to make any award.¹⁹

NASD initially proposed to amend Rule 3110(f)(4) to include paragraph (f)(4)(B), which would state that no choice-of-law provision would be enforceable unless there is a significant contact or relationship between the law selected and either the transaction at issue or one or more of the parties. NASD had proposed paragraph (f)(4)(B) in response to the recommendation of the Ruder Task Force Report and with the purpose of protecting investors from the use of arbitrary choice of law provisions. This would make explicit NASD's interpretation of current Rule 3110(f)(4) to require that, when predispute arbitration agreements between members and

¹⁸ See supra note 12.

¹⁹ See Proposed Rule 3110(f)(4)(A).

customers include a choice-of-law provision, there must be “an appropriate contact or relationship between the transaction at issue or the parties and the law selected.”²⁰ As explained more fully below, however, NASD has withdrawn proposed paragraph (f)(4)(B) in response to comments, but continues to caution its members against overreaching in choice of law provisions.

Although one commenter generally supported proposed paragraph 3110(f)(4)(B),²¹ the overwhelming majority of commenters opposed it as potentially harmful to investors. A majority of the commenters argued that, because relevant case law regarding choice-of-law provisions in predispute arbitration agreements has evolved considerably in the five years since the proposed rule change was filed, proposed paragraph (f)(4)(B) could be interpreted to endorse choice-of-law clauses that may not be enforceable under applicable state law. Two commenters suggested that members might use paragraph (f)(4)(B) to legitimize choice-of-law clauses that would override the protection of customers’ home state blue sky laws.²² Given the strong opposition of most commenters and the fact that such adverse consequences were not intended by NASD, NASD is withdrawing proposed paragraph (f)(4)(B). However, by doing so, NASD is not implying that members may include arbitrary choice-of-law provisions in predispute arbitration agreements with customers. As it has in the past, NASD will continue to interpret NASD Rule 3110(f) to require that, if a choice-of-law provision is used, there must be an adequate nexus between the law chosen and the transaction or parties at issue in accordance with NASD Notices to Members 95-85 and 95-16.²³

²⁰ NASD Notice to Members 95-85 (October 16, 1995); see also NASD Notice to Members 95-16.

²¹ See Pace Letter, supra note 6.

²² See Estell Letter and Miller Letter, supra note 4.

²³ See supra note 20.

G. Non-Bifurcation Provision

NASD proposes to require members seeking to compel arbitration of claims filed in court to agree to arbitrate all of the claims contained in the complaint if the customer requests, even if some of the claims would be ineligible for arbitration under the eligibility rule.²⁴

In a companion filing, NASD proposes to provide that by requesting dismissal of a claim on eligibility grounds in the NASD forum, the requesting party is agreeing that the party that filed the dismissed claim may withdraw all related claims without prejudice and may pursue all of the claims in court.²⁵ NASD represents that this provision would protect parties against involuntary bifurcation of claims.²⁶

H. Effective Date Provisions

The proposed amendments to NASD Rule 3110(f) would require various changes to the customer agreements used by NASD member firms. In order to provide enough time for firms to modify customer agreements, the proposed rule change would take effect 90 days after NASD publishes a Notice to Members to announce Commission approval of the proposal. Moreover, NASD would issue such Notice to Members within 60 days of publication of the Commission's approval of the proposed rule change in the Federal Register.

The proposed amendments to NASD Rule 3110(f) would also provide that agreements signed before the effective date of the rule, as amended, would be subject to the provisions of NASD Rule 3110(f) in effect at the time the agreement was signed, except with regard to the provisions of subparagraph (f)(3) of the proposed rule change.²⁷

²⁴ See Proposed Rule 3110(f)(5).

²⁵ See supra note 12.

²⁶ Id.

²⁷ See Proposed Rule 3110(f)(7).

III. Discussion and Commission Findings

Currently, NASD Rule 3110(f) requires that predispute arbitration agreements contain highlighted disclosure about differences between arbitration and litigation, including notice that by agreeing to arbitrate their disputes, customers may be waiving certain rights that would be available in court. Further, NASD Rule 3110(f) provides that its members must highlight the agreement and provide a copy of the agreement to the customer, which the customer acknowledges in writing.

The Commission notes that despite the disclosure requirements under the current rule, NASD has determined that there are continuing concerns about whether customers who become parties to predispute arbitration agreements adequately understand the terms of the agreement. NASD has concluded that it is necessary to require its members to provide more disclosure about arbitration to customers who sign predispute arbitration agreements, and that the use of certain provisions that limit rights and remedies should be restricted.²⁸ Accordingly, NASD submitted the proposed amendments to NASD Rule 3110(f) to address these concerns.

The Commission believes that the proposal should provide customers with clearer and enhanced disclosure regarding the terms of predispute arbitration agreements. The Commission believes that the proposed rule change incorporates important protections into the text of the arbitration agreement itself, including the rules of the SRO in which the arbitration takes place. This will permit better guidance to the parties, arbitrators, and the courts. Moreover, the proposed requirement that a member either provide a customer with the predispute arbitration agreement or inform the customer that the member does not have a copy within ten days, as well as provide the customer with information on how to obtain the rules of the arbitration forums in

²⁸ In formulating its proposal, NASD referred to the work of its Arbitration Policy Task Force, chaired by

which a claim may be filed under the agreement, should help to protect investors and facilitate the dispute resolution process.

The Commission also notes that the proposal provides that if the member seeks to compel arbitration of claims, the member must agree to arbitrate all of the claims contained in the complaint if the customer requests. The Commission believes that the proposed rule change should benefit investors by preventing customers from being forced to bifurcate their claims. The proposed rule change, together with Rule 10304, as amended, addresses the concern that parties would be forced to litigate in two forums; limits the potential litigation strategies that could escalate the costs of and thereby impede dispute resolution; and eliminates the particular litigation strategy, never contemplated under NASD rules, of so-called “election of remedies,” which foreclosed some investors’ access to justice altogether.

Finally, the Commission notes the concerns raised by commenters regarding the proposed choice-of-law provision.²⁹ The Commission, believes that NASD’s response in withdrawing paragraph 3110(f)(4)(B) is consistent with the Act, and that that Proposed Rule 3110(f)(4)(A) achieves an appropriate balance between the interests of investors and the ability of parties to agree contractually to fair terms that would govern their disputes,³⁰ especially as explained in NASD Notice to Members 95-85.³¹

David Ruder. See supra text II.A.1, Purpose and General Description of Proposal.

²⁹ See supra text II.F, Restrictions on Provisions that Limit Rights and Remedies Provisions that Limit Rights and Remedies.

³⁰ The Supreme Court ruled in 1995 that the choice of law provision in the customer agreement before the Court did not have the effect of barring arbitrators from barring punitive damages. Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995). Rule 3110(f)(4) explicitly forbids broker-dealers from using any term of an agreement to limit such relief.

³¹ See supra note 20.

The Commission notes that NASD will publish a Notice to Members within 60 days of receiving Commission approval of the proposed rule change. The effective date of the proposed rule change will be 90 days after the publication of the Notice to Members.

After careful review, the Commission finds that the proposal is consistent with the requirements of Section 15A of the Act³² and the rules and regulations thereunder that govern NASD.³³ In particular, the Commission finds that the proposal is consistent with Section 15A(b)(6) of the Act³⁴ which requires, among other things, that the rules of an association 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; and are not designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

IV. Accelerated Approval of Amendment No. 5

The Commission believes that there is good cause for approving Amendment No. 5 prior to the 30th day after publication in the Federal Register. Amendment No. 5 responds to comments by withdrawing Proposed Rule 3110(f)(4)(B). Accelerated approval of Amendment No. 5 will enable NASD to announce promptly the final rules, in conjunction with those being approved today in a companion filing, SR-NASD-2003-101, which changes would be incorporated by Proposed Rule 3110(f) into any predispute arbitration agreement governing proceedings held in a NASD forum. Concurrent approval of Amendment No. 5 and SR-NASD-2003-101 will lessen member confusion as to the final requirements of both rule filings, allow their effective dates to be the same, and thereby permit members to make the necessary changes

³² 15 U.S.C. 78o-3.

³³ In addition, pursuant to Section 3(f) of the Act, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³⁴ 15 U.S.C. 78o-3(b)(6).

to comply with them in a timely fashion.³⁵ Based on the above, the Commission finds good cause, consistent with Section 15A(b)(6) and Section 19(b)(2) of the Act, for approving Amendment No. 5 prior to the 30th day after the date of publication of notice of filing thereof in the Federal Register.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning whether proposed Amendment No. 5 is consistent with the Act. Comments may be submitted by any of the following methods:

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. Please include File Number SR-NASD-98-74 on the subject line.

Paper comments:

Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-98-74. 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

³⁵ The Commission further notes that both rule filings and amendments thereto have been available since their

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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of 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 File Number SR-NASD-98-74 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

respective filing dates on www.nasdadr.com.

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁶ that the proposed rule change (SR-NASD-98-74), as amended, is hereby approved, and Amendment No. 5 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁷

Margaret H. McFarland
Deputy Secretary

³⁶ 15 U.S.C. 78s(b)(2).

³⁷ 17 CFR 200.30-3(a)(12).