

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49688; File No. SR-NASD-2003-163)  
May 12, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Voluntary Direct Communication Between Parties and Arbitrators

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 31, 2003, the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. (“NASD Dispute Resolution”) 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 Dispute Resolution. On February 23, 2004, NASD filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Dispute Resolution is proposing a new rule of the NASD to permit parties in an arbitration to communicate directly with the arbitrators if all parties and arbitrators agree, and to establish guidelines for such direct communication. Below is the text of the proposed rule change. Proposed new language is in italics.

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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> See letter from Jean Feeney, Vice President and Chief Counsel, Dispute Resolution, NASD to Katherine England, Assistant Director, Division of Market Regulation, Commission, dated February 20, 2004.

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**10334. Direct Communication Between Parties and Arbitrators**

(a) This rule provides procedures under which parties and arbitrators may communicate directly.

(b) Only parties that are represented by counsel may use direct communication under this Rule. If, during the proceeding, a party chooses to appear pro se (without counsel), this Rule shall no longer apply.

(c) All arbitrators and all parties must agree to the use of direct communication during the Initial Prehearing Conference or a later conference or hearing before it can be used.

(d) Parties may send the arbitrators only items that are listed in an order.

(e) Parties may send items by regular mail, overnight courier, facsimile, or email. All the arbitrators and parties must have facsimile or email capability before such a delivery method may be used.

(f) Copies of all materials sent to arbitrators must also be sent at the same time and in the same manner to all parties and the Director. Materials that exceed 15 pages, however, shall be sent to the Director only by regular mail or overnight courier.

(g) The Director must receive copies of any orders and decisions made as a result of direct communications among the parties and the arbitrators.

(h) Parties may not communicate orally with the arbitrators outside the presence of all parties.

(i) Any party or arbitrator may terminate the direct communication order at any time, after giving written notice to the other arbitrators and the parties.

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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 Dispute Resolution 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 IV below. NASD Dispute Resolution 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

NASD proposes a rule that would permit direct communication with the arbitrators where all parties and arbitrators agree. The rule also would establish guidelines for direct communication.

**Background**

Under normal procedures, parties may exchange certain documents among themselves (such as those relating to discovery), but must address all communications intended for the arbitrators to NASD staff, who then forward the communications to the arbitrators. If the communication includes a motion or similar request, staff members customarily solicit a response from the other parties before forwarding the motion or request. Similarly, the arbitrators transmit their orders and any other communications through the staff.

In response to a recommendation of the NASD National Arbitration and Mediation Committee, the Chicago Office of NASD Dispute Resolution began a pilot project in June 2001 to determine whether direct communication between parties and arbitrators would enhance the

arbitration process. The Chicago Office developed the parameters governing whether a case would be eligible for inclusion in the pilot and changed the script used by the panel chairperson at the Initial Prehearing Conference (“IPHC”) on those cases. A modified IPHC Order also was given to the panel chairperson to memorialize all direct communication matters agreed to by the parties and the arbitrators.

In total, 839 cases were eligible for inclusion in the project. Of these cases, parties and arbitrators in 255 cases (30%) participated in the program. At the end of the one-year pilot period, staff formulated a survey for those arbitrators and party representatives who participated in the pilot project. NASD Dispute Resolution sent out 850 surveys and obtained 268 responses (32%). Although attempts were made to limit duplication, certain arbitrators and party representatives who participated in more than one eligible case in the pilot might have sent in multiple survey responses.

Of the responses NASD received, 193 came from arbitrators and 75 from party representatives. Overall, 73% of party representatives and 69% of the arbitrators who responded to the survey favored continuing direct communication with the arbitrators. Favorable comments reflected the opinion that direct communication expedited the arbitration process and was more convenient than the normal method of communicating through staff.

In light of the success of the Chicago pilot, NASD has developed a nationwide rule that would permit direct communication with the arbitrators where all parties and arbitrators agree. The rule also would establish guidelines for direct communication.

On October 2, 2002, the Securities Industry Conference on Arbitration (“SICA”)<sup>4</sup> adopted an amendment to Rule 23 of the Uniform Code of Arbitration that provides for joint administration of arbitrations by the arbitrators and the parties.<sup>5</sup> Like the NASD proposal, the SICA rule would apply only to matters in which all parties are represented by counsel, and in which the arbitrators and all parties agree to proceed under the rule; terminates if a party chooses to appear without counsel; prohibits oral communication between parties and arbitrators unless all parties are present; and requires parties to send written materials to the arbitrators and the director at the same time and in the same manner. Unlike the NASD proposal, the SICA rule would allow the arbitrators, without the assistance of the sponsoring self-regulatory organization, to “schedule all pre-hearing and hearing dates, the timing of the service and filing of appropriate papers, all discovery matters and all other matters relevant to the expeditious handling of the case.” The SICA rule allows the parties or the arbitrators to initiate conference calls under certain conditions; requires that parties send the director proof of service of written materials; and provides that the arbitrators may terminate or modify any joint administration order. The NASD rule, unlike the SICA rule, provides that parties may send the arbitrators only items that are listed in an arbitrator order; that materials that exceed 15 pages may only be sent to the director by regular mail or overnight courier; and that any party or any arbitrator may terminate the direct communication order. NASD understands that the SICA rule change has not been adopted by any self-regulatory organization. The NASD National Arbitration and Mediation Committee and the Board were apprised of the SICA amendment, but determined to model the NASD proposal on the successful Chicago pilot described above.

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<sup>4</sup> SICA’s voting members include representatives of the self-regulatory organizations that administer arbitration forums, the Securities Industry Association, and three members of the public. In addition, staff of the SEC, the Commodity Futures Trading Commission, the American Arbitration Association, the North American Securities Administrators Association, and the former public members of SICA are invited to attend meetings.

<sup>5</sup> The joint administration amendment is found in Section 23(e) of the Uniform Code, which is included in the Twelfth Report of the Securities Industry Conference on Arbitration (October 2003), available on the NASD Dispute Resolution Web site, under both Resources for Parties and Resources for Neutrals.

### **Proposed Rule Change**

The proposed rule is based largely on procedures used in the Chicago pilot, with a few changes to reflect staff's experience with the pilot and to provide for possible issues that might occur in a larger-scale application of the rule. Only parties that are represented by counsel may use direct communication under the proposed rule. If, during the proceeding, a party chooses to appear pro se (without counsel), the rule will no longer apply. All arbitrators and all parties must agree to the use of direct communication before it can be used. The scope of direct communication will be set forth in an arbitrator order, and parties may send the arbitrators only the types of items that are listed in the order.

The proposed rule provides that either an arbitrator or a party may rescind his or her agreement at any time if direct communication is no longer working well. Materials must be sent at the same time and in the same manner to all parties and the Director (through the assigned staff member), and staff must receive copies of any orders and decisions made as a result of direct communications among the parties and the arbitrators. As requested by staff of NASD Dispute Resolution, however, the rule contains a provision stating that materials more than 15 pages long shall be sent to the Director only by mail or courier, to avoid tying up busy fax machines and printers. Arbitrators (or parties) with similar concerns could include a similar provision as to themselves in the direct communication order. NASD will prepare a template for direct communication orders to guide the arbitrators and parties in considering these issues.

## 2. Statutory Basis

NASD Dispute Resolution believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>6</sup> which requires, among other things, that the Association's rules 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. NASD believes that permitting direct communication with the arbitrators where all parties and arbitrators agree, and where specific guidelines are followed, will protect investors and the public interest by expediting the arbitration process and giving parties more control over their arbitration cases.

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

NASD Dispute Resolution 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 Act, as amended.

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

Written comments were neither solicited nor received.

## III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A.) by order approve such proposed rule change, or
- (B.) institute proceedings to determine whether the proposed rule change should be

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

disapproved.

#### IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change 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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2003-163

##### 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-2003-163. 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 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 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 File Number SR-NASD-2003-163 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

J. Lynn Taylor  
Assistant Secretary

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<sup>7</sup> 17 CFR 200.30-3(a)(12)