

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-51213; File No. SR-NASD-2004-180)**

**February 16, 2005**

**Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Regarding Waiver of California Arbitrator Disclosure Standards**

**I. Introduction**

On December 9, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), 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> a proposed rule change relating to the waiver of California Arbitrator Disclosure Standards. The proposed rule change was published for comment in the Federal Register on January 14, 2005.<sup>3</sup> For the reasons discussed below, the Commission is approving the proposed rule change.

**II. Description of the Proposed Rule Change**

A. Description of the Proposal

Effective July 1, 2002, the California Judicial Council adopted a set of rules, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (“California Standards”),<sup>4</sup> which contain extensive disclosure requirements for arbitrators. According to NASD, the rules were designed to address conflicts of interest in private arbitration forums that are not part of a federal regulatory system overseen on a uniform, national basis by the SEC. NASD states that the

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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> Securities Exchange Act Release No. 50971 (January 6, 2005), 70 FR 2685 (January 14, 2005) (the “Notice”).

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

California Standards impose disclosure requirements on arbitrators that conflict with the disclosure 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 response to the adoption of the California Standards and the conflict between the California Standards and the NASD Rules, NASD, the NYSE, and other claimants filed various actions in both the federal court system and the California state court system. These cases are presently proceeding through both the California and the federal court systems.<sup>6</sup>

To allow arbitrations to proceed in California while the litigation regarding the applicability of the California Standards to SRO arbitrations is pending, NASD implemented a pilot rule to require all industry parties (member firms and associated persons) to waive application of the California Standards to the case, if all the parties in the case who are customers, associated persons with claims against industry parties, member firms with claims against other member firms, or member firms with claims against associated persons that relate exclusively to promissory notes, have done so.<sup>7</sup>

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<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> For a more complete discussion of the various pending cases, please see the Notice, supra note 3.

<sup>7</sup> Originally, the pilot rule applied only 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

The pilot rule, which was originally approved for six months on September 26, 2002,<sup>8</sup> has been extended and is now due to expire on March 31, 2005.<sup>9</sup> NASD believes all the pending litigation regarding the California Standards is unlikely to be resolved by March 31, 2005. The Commission is approving NASD's request to extend the effectiveness of the pilot rule through September 30, 2005, in order to permit NASD to avoid disrupting the administration of cases covered by the pilot rule under the NASD Code of Arbitration Procedure.

B. Comment Summary

The proposal was published for comment in the Federal Register on January 14, 2005.<sup>10</sup> We received no comments on the proposal.

**III. Discussion and Findings**

The Commission finds the proposed rule change is consistent with the Act, and in particular with Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and

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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. See Securities Exchange Act Release No. 48187 (July 16, 2003), 68 FR 43553 (July 23, 2003) (SR-NASD-2003-106). In October 2003, NASD again expanded the scope of the pilot rule to include claims filed by members against other members and to claims filed by members against associated persons that relate exclusively to promissory notes. See Securities Exchange Act Release No. 48711 (October 29, 2003), 68 FR 62490 (November 4, 2003) (SR-NASD-2003-153).

<sup>8</sup> See Securities Exchange Act Release No. 46562 (September 26, 2002), 67 FR 62085 (October 3, 2002) (SR-NASD-2002-126).

<sup>9</sup> See Securities Exchange Act Release No. 50447 (September 24, 2004), 69 FR 58567 (September 30, 2004) (SR-NASD-2004-126).

<sup>10</sup> See note 3, supra.

equitable principles of trade, and, in general, to protect investors and the public interest.<sup>11</sup> The Commission believes that the proposed rule change is consistent with the provisions of the Act noted above because, in the event that the pending litigation regarding the California Standards is not resolved by March 31, 2005, the current pilot expiration date, the extension of the effectiveness of the pilot rule through September 30, 2005 will permit NASD to avoid disrupting the administration of cases covered by the pilot rule under the NASD Code of Arbitration Procedure. The Commission believes that NASD's current system provides an appropriate forum for the resolutions of cases covered by the pilot rule. Under the pilot rule, the arbitration proceeds under the NASD Code of Arbitration Procedure, which already contains extensive disclosure requirements and provisions for challenging arbitrators with potential conflicts of interest.<sup>12</sup> The Commission believes that the extension of the pilot rule will provide claimants with a continuing, consistent, and appropriate forum in which to arbitrate their claims, allowing claimants to proceed rather than requiring them to suspend their claims until the litigation is completed. The Commission believes that providing claimants with such a forum is consistent with the protection of investors and the public interest.

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

<sup>12</sup> NASD notes that the NYSE has a similar rule, NYSE Rule 600(g).

#### IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act<sup>13</sup> that the proposed rule change (SR-NASD-2004-180) be, and hereby is, approved through September 30, 2005.<sup>14</sup>

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>13</sup> 15 U.S.C. 78s(b)(2).

<sup>14</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>15</sup> 17 CFR 200.30-3(a)(12).