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July 14, 2005

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV
AND FIRST-CLASS MAIL

Jonathan G. Katz, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: File No. SR-NASD-2003-158 Comment on Reorganization and Revisions to NASD Rules Relating to Customer Disputes, SEC Release No. 34-51856

Dear Mr. Katz:

We appreciate the opportunity to comment on the rewrite of the NASD Code of Arbitration Procedure. We have maintained an active securities practice in our firm since the firm was organized in 1982 and have been representing both claimants and respondents in securities arbitration before the National Association of Securities Dealers since 1987. We submit the following comments with respect to the proposed NASD rules relating to customer disputes as referenced above.

1. Request for Extension of Comment Period

The Securities and Exchange Commission first published the Code rewrite on June 23, 2005, and stated that comments would be due within 21 days thereafter on July 14, 2005. I strongly urge that the comment period be extended for at least 90 days.

The Code rewrite represents the first substantial revision of the entire NASD Code of Arbitration Procedure since the current Code was written in 1968. It governs all customer disputes before the NASD, of which over 8,000 were filed in each of 2003 and 2004.

The Code rewrite involves substantial revisions to the Code of Arbitration Procedure, including the addition of a definition section which affects nearly every aspect of the Code; the addition of numerous sections of interpretative material which were not previously part of the Code; the addition of various jurisdictional provisions; the addition of detailed procedural provisions; the incorporation of comprehensive discovery guidelines and rules; substantial revision of the arbitrator selection system; codification of an entirely new set of rules concerning motion practice; providing for motions to dismiss which were not part of the previous Code; and making numerous other substantive changes.

The Code rewrite package as submitted by the NASD numbered 270 pages.

The Code rewrite is undoubtedly the most important action taken by the NASD concerning arbitration procedure since the United States Supreme Court's approval of mandatory arbitration.

For attorneys whose practice involves NASD arbitration, the Code rewrite is comparable to a rewrite of the entire Federal Rules of Civil Procedure for court litigation.

To limit the comment period for the rewrite of the arbitration code to 21 days is unreasonable in view of the dimension, complexity, and importance of the changes proposed. Practitioners should be given a reasonable opportunity to study and analyze the proposed changes and to provide substantive comment. Since most practitioners in this area are extremely busy attorneys, both for claimants and respondents, it is unrealistic to assume that they would be able to devote the necessary time and study to providing substantive comments within a 21-day period.

Furthermore, the importance of the Code of Arbitration Procedure and the significance of the changes are such that the Securities and Exchange Commission should have the opportunity to receive and review comments, and use the initial comments as a basis for identifying areas the Commission believes are significant issues requiring additional input from the public.

There is abundant precedence for the SEC's extending comment periods. One of the more notable examples is the Merrill Lynch rule concerning investment advisers which was first proposed by the SEC on November 4, 1999, and on which the comment periods were repeatedly extended, the final extension being announced on January 5, 2005.

The importance of the Code of Arbitration Procedure to practitioners before the NASD is such that an extended time period for review and comment is essential. Accordingly, it is requested that the Commission announce an initial 90-day extension to allow a meaningful comment period on this extremely important proposal.

2. Comment on Rule 12100(n)(2) Definition of Non-Public Arbitrator

Recommendation: Exclude attorneys who have industry clients from the definition of non-public arbitrator.

Analysis: The Code rewrite includes a definition of non-public arbitrator to include "an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work in the last two years, to clients who are engaged in any of the business activities listed in paragraph (n)(1) . . . ." This section allows attorneys who have spent at least 20 percent of their time representing a broker or dealer to serve as an industry arbitrator.

This section ignores the purpose of the industry arbitrator. The NASD has required that an industry arbitrator be one of the three arbitrators sitting on panels. The theory is that the industry arbitrator would be familiar with industry practices and standards and would be able to provide input on these matters for the panel. Presumably, a further assumption is that the industry arbitrator has an interest in maintaining industry standards and that if a respondent diverges from the industry standards, the industry arbitrator would recognize the failures and insist on compliance with the rules to which all firms are subject.

However, there is no assurance or even likelihood that attorneys who devote 20 percent of their professional work to industry members have any such background. The only assurance is that they will have a pro-industry bias. Attorneys are not required to be tested or licensed under the securities laws. Furthermore, they do not have the training or supervisory background required in the brokerage industry.

Allowing an attorney who represents the brokerage industry to serve as an industry panel member creates an appearance of bias. This is because the attorney's role in representing an industry member is as an advocate. For example, attorneys representing industry members may defend these members in arbitration claims and disciplinary proceedings. Their objective is to aggressively represent their clients and to prevail on behalf of their clients. They serve as adversaries. They are not neutrals. Since attorneys representing the industry

have an adversarial mindset, it should not be assumed that they will provide unbiased input. Industry panel members should be restricted to those persons who are members of the industry and who are licensed and have supervisory training and background.

3. Comment on Rule 12100(r)(4) Definition of Public Arbitrator

Recommendation: Exclude attorneys who have industry clients from the definition of public arbitrator.

Analysis: This section provides that attorneys whose law firms represent broker-dealers which provide 10 percent or more of their firms' annual revenue in the past two years are ineligible as public arbitrators. Thus, attorneys may still sit as public arbitrators so long as their firms' work for industry clients consists of less than 10 percent of the firms' annual revenue.

First, it should be emphasized that there is no basis for concluding that an attorney whose firm's industry work is less than 10 percent of the firm's business will not have a conflict of interest or an appearance of bias. This is an arbitrary percentage and cannot be supported in any objective analysis. If an attorney's firm generates $1 million of business a year, why should a brokerage firm which accounts for less than $100,000 of the firm's billings command a different or materially reduced loyalty than a brokerage firm that generates $100,000 or more in billings. A brokerage client which generates 5 percent or even 1 percent of the firm's billings should command an equal commitment from the attorney as a client generating 10 percent or more of the billings. An attorney owes the same fiduciary obligation and commitment to every client, whether small or large. There simply is no correlation between the percentage of an attorney's business which a brokerage firm represents and the level of an attorney's commitment to that firm. The NASD's position is a fiction. It penalizes investors pursuing their claims in arbitration by allowing arbitrators who have clear conflicts of interest and bias to sit as public arbitrators in judgment of investor claims.

The repetitive nature of claims brought in arbitration is an additional reason for requiring that public arbitrator attorneys have no association with the securities industry. The vast majority of arbitration claims relies on essentially identical legal theories and relate to basic patterns of alleged wrongdoing which are faced to a greater or lesser degree by virtually every brokerage firm. Typical legal theories include suitability, negligence, breach of fiduciary duty, breach of contract, violation of federal and state securities laws, and violation of regulatory rules. These claims are made repeatedly against every major broker-dealer in the country. Any

attorney whose firm represents a broker-dealer is aware that his client is or may be subject to virtually identical claims regularly raised in arbitrations.

Equally important, the factual allegations supporting the claims also fall into common patterns which are the subject of similar claims against all major brokerage firms. These include such claims as sale of speculative, high-risk securities to investors who have conservative objectives; sale of variable annuities to investors for whom they are unsuitable for the purpose of generating commissions; improper sale of B shares; improper use of margin; churning; unauthorized transactions – and the list goes on. Any attorney whose firm represents a broker-dealer has a client which very likely is subject to claims factually similar to those the attorney is judging in the arbitration as a public arbitrator. To suggest that this attorney can objectively and impartially evaluate these claims as a public arbitrator and render an award to a claimant where the award may offend the attorney's existing client is wrong. No attorney would want to face his client, regardless of the percentage of business which the client represents, having granted a substantial award in a case where the attorney's client may have similar claims pending. The so-called public arbitrator attorney must take into consideration that his very own client could be sitting in the shoes of the respondent, or that his client will see the arbitration award and will question how its own attorney could be rendering awards with which the client may vigorously disagree. An attorney who is representing a broker-dealer cannot sit unbiased in judgment of another broker-dealer, addressing claims based on the same legal theories and similar factual patterns which may be pending or threatened against the attorney's client.

A hypothetical example illustrates the unfairness of the rule to claimants. Assume two attorneys are sitting as public arbitrators in a claim alleging that Merrill Lynch recommended dot-com stocks which received favorable analyst reports in exchange for investment banking fees. Assume the industry member on the panel is a broker associated with Smith Barney. Then assume that of the two public arbitrator attorneys, one represents Morgan Stanley and the other represents Goldman Sachs, and that neither representation triggers the 10 percent rule. The poor claimant would be faced with a panel with all three arbitrators subject to conflicts of interest and inherent bias. The burden would be on the claimant to make successful for-cause challenges. Certainly, Merrill would fight aggressively to prevent the public arbitrator attorneys from being removed for cause. It is therefore entirely possible that in such a situation, the claimant would be required to arbitrate with a panel stacked against him.

This example is extreme, and the conflicts which may be presented with attorney public arbitrators may be more subtle. It may simply be a case of issues relating to overselling variable annuities, and the attorney-arbitrator's being aware that his client also actively sells variable annuities. Or it simply may be a case which involves the garden-variety suitability claims where the attorney is aware his broker-client is subject to similar claims. The fact is that any attorney public arbitrator representation of a brokerage firm is a material conflict of interest and should not be allowed. Attorneys must be required to disclose their brokerage firm representation and should be disqualified from sitting as public arbitrators on that basis alone.

Another consideration is that the brokerage industry is highly regulated and apparently has difficulty living within the confines of the regulatory system. The NASD, NYSE, and SEC regularly impose substantial sanctions on brokerage firms, large and small, for violating regulations. Rule violations are commonplace in the industry. Even the largest, most prestigious firms are sanctioned millions of dollars for violating the rules. It is these same rules which are often argued as the standard of behavior which may generate liability in an arbitration claim. An attorney who represents a brokerage firm, whether that firm represents 10 percent, 5 percent, or 2 percent of his firm's business, may be reluctant to render a decision which involves a strict interpretation of regulations which his own client is violating, has violated, or may violate. A respondent which is held liable in such a situation could be expected to communicate the decision to the attorney's client, causing immediate repercussions for the attorney.

In the final analysis, there is simply no justification for allowing an attorney who represents a brokerage firm to sit as a public arbitrator in judgment of an investor's claims. The arbitration system has imposed the industry arbitrator on investors. To suggest that the industry arbitrator should be combined with public arbitrators who also possess industry ties, is a flaw in the arbitration system. Public arbitrators should be just that – public. They should be entirely independent of the industry. They should be free from pro-industry bias and be free from the appearance of bias.

No rational investor would voluntarily accept an NASD arbitration panel where a majority of the arbitrators are associated with the brokerage industry. The proposed NASD rules allow this result. Allowing public arbitrators to be tainted with industry influence, however slight, is unfair and cannot be allowed.

4. Comment on Rule 12504 Motions to Decide Claims Before a Hearing on the Merits

Recommendation: The rule should also state: "Arbitrators should not dismiss a claim without a full hearing where a material question of fact exists."

Analysis: This section is new and provides for motions to dismiss in arbitration. The NASD has properly placed a significant limitation on arbitrators granting motions to dismiss by providing that they are discouraged and may only be granted in extraordinary circumstances. Arbitrators are not judges, they do not have research clerks, and their legal mistakes are not subject to appeal. The essence of arbitration is an expedited, economical hearing. Denying a claimant a hearing is denial of the arbitration process.

In addition, a fundamental problem with allowing motions to dismiss in arbitration under any circumstances is that, unlike court proceedings where there is a full discovery process, including depositions and requests for admissions, arbitration discovery is typically limited to production of documents and requests for information. This means that the parties do not have an opportunity to address factual issues unless there is a full arbitration hearing.

The inability of the parties to address factual issues prior to a full hearing means that in virtually every case there will be material questions of fact which are raised by the pleadings and supporting documents which are unresolved. It is essential that arbitrators be aware that even in the extraordinary circumstances where a dismissal may seem proper, if there is an unresolved material question of fact, they cannot under any circumstances grant a motion to dismiss. The factual issue can only be resolved at an arbitration hearing. The arbitrators must understand that their role is not to decide factual issues in addressing a motion to dismiss, and in such cases, the motion always must be denied.

Even federal and state courts, which allow depositions and requests for admissions, as a matter of law cannot grant dismissals or summary judgment if there is a material factual question. In the event a court grants a dismissal or summary judgment where a material factual question is present, the decision may be overturned on appeal due to error of law. However, as stated, there is no appeal in arbitration, and an arbitrator's decisions cannot be overturned based on error of law. Thus, arbitrators must be doubly cautious to avoid improper

dismissals. The Code rewrite should contain an explicit instruction that arbitrators should not dismiss a claim when material factual issues are present.

Very truly yours,

Laurence S. Schultz

LSS/ch

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