PACE INVESTOR RIGHTS PROJECT

Pace University School of Law

DIRECTOR OF RESEARCH
BARBARA BLACK
BBLACK@LAW.PACE.EDU

78 NORTH BROADWAY
WHITE PLAINS, NY 10603
TEL: 914-422-4333
FAX: 914-422-4391
WWW.LAW.PACE.EDU/PIRP

DIRECTOR OF ADVOCACY
JILL I. GROSS
JGROSS@LAW.PACE.EDU

June 6, 2006

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 -- Proposed Rule Change to Amend NASD Arbitration Rules for Customer Disputes, Amendment No. 5

To Whom It May Concern:

The Pace Investor Rights Project (PIRP) at Pace University School of Law is writing to convey its concern regarding one revision contained in Amendment No. 5 to NASD's proposal to amend its Code of Arbitration Procedure ("Current Code") and establish the NASD Code of Arbitration Procedure for Customer Disputes ("Proposed Customer Code").

In Amendment No. 5, NASD proposes additional language to clarify the meaning of "extraordinary circumstances" in Proposed Rule 12504 (Motions to Decide Claims Before a Hearing on the Merits). Thus, NASD proposes to add the following language in the Dispositive Motions section of the ruling filing:

> For purposes of this rule, if a party demonstrates affirmatively the legal defenses of, for example, accord and satisfaction, arbitration and award, settlement and release, or the running of an applicable statute of repose, the panel may consider these defenses to be extraordinary circumstances. In such cases, the panel may dismiss the arbitration claim before a hearing on the merits if the panel finds that there are no material facts in dispute concerning the defense raised, and there are no determinations of credibility to be made concerning the evidence presented.[1]

According to NASD, this additional language – which arose as a compromise at "a policy meeting with various constituent groups of the arbitration forum, including investor and industry representatives" -- was proposed to provide arbitrators with more guidance as to when it might be appropriate to grant a party's motion to dismiss a claim before a hearing.[2]

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[1] *See* Amendment No. 5, at 32.
[2] *Id.* at 31-32.

Because PIRP was not included in the above-referenced policy meeting, we would like to reiterate two points that we made in our Comment Letter to the original Proposed Rule 12504. We wrote:

> [C]ourts have held that arbitrators have the authority to decide pre-hearing motions to dismiss, so long as the arbitrator's refusal to hold a full evidentiary hearing is not fundamentally unfair.[3] In our view, there are only very limited circumstances where dispositive motions may be appropriate, since generally there are disputed issues of material fact and issues of credibility that would make it fundamentally unfair to dismiss a claim without giving the claimant an opportunity to complete discovery and to present evidence, both written and oral. **We note also that many motions to dismiss on eligibility rule grounds involve disputed issues of fact and are not suitable for summary disposition.** We therefore support the language in paragraph (a) that dispositive motions are "discouraged" and "may be granted only in extraordinary circumstances" and **recommend that the exception for motions on eligibility rule grounds be stricken**.
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> In addition, we believe that arbitrators would benefit from more specific guidance and recommend that the proposed rule state that the panel should deny dispositive motions whenever (1) credibility is an issue; (2) there are disputed issues of material fact; or **(3) the panel believes a hearing is necessary in the interests of justice. We also believe that the proposed rule should make clear that arbitrators should not apply a "failure to state a claim" standard, since claimants are not required to plead legally cognizable claims.** Finally, we support giving the panel explicit authority to issue sanctions against a party that makes a dispositive motion in bad faith, because we are concerned that the use of these motions will become more prevalent with the adoption of this rule.[4]

Thus, NASD has adopted our suggestion that arbitrators be given more guidance on dispositive motions, and specifically incorporated two of our three suggestions as to the nature of that guidance. However, the proposed new language does not incorporate our catch-all "justice requires a hearing" standard. It also omits our suggestions to make clear that "failure to state a claim" is not a basis for dismissing claims and to strike the exception for eligibility rule-based motions.

We continue to believe that the proposed additional language would be improved significantly by the adoption of these three suggestions. First, we urge that the SEC require that the Proposed Customer Code make it clear that "failure to state a claim" is not a basis for dismissing claims. We have witnessed an alarming trend by courts to uphold arbitrators' decisions to deny a hearing on the grounds that a Statement of Claim

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[3] *See, e.g.* Sheldon v. Vermonty, 269 F.3d 1202, 1206 (10th Cir. 2001); Warren v. Tacher, 114 F. Supp.2d 600, 602-03 (W.D. Ky. 2000).

[4] *See* PIRP Comment Letter to SEC, July 14, 2005, at 4-5 (emphasis added).

did not meet pleading requirements required by rules of civil procedure, rules that are plainly applicable only in courts of law. For example, an Ohio appellate court recently confirmed an award where the panel dismissed the investor's claims because the claim was facially deficient. The court found that the claimant failed to plead fraud with the specificity required by Federal Rule of Civil Procedure 9(b).[5]

Second, as we stated in our initial Comment Letter, motions to dismiss on grounds that the claim does not comply with the eligibility rule very often involve issues of fact and credibility determinations. These motions frequently are not suitable for summary determination. However, the Proposed Customer Code strongly suggests to arbitrators that NASD considers such motions to be suitable for summary determination. PIRP believes this is a dangerous message and may prejudice the rights of claimants to a fundamentally fair hearing.

Finally, without a "catch-all," arbitrators might feel compelled to dismiss a claim if it technically fits a scenario covered by the proposed new language, although unique facts and circumstances might call for an exception. A palpable danger remains that arbitrators, many of whom are not lawyers, might interpret the carefully-crafted, compromise language as compulsory rather than permissive, and, as a result, may deny a hearing to an investor where fundamental fairness might require a hearing. Simply put, the proposed new language cannot cover all factual and/or legal variations on the itemized defenses. We urge the SEC to reconsider this proposed language by adding an "interests of justice" exception.

Please do not hesitate to contact us further if you have additional questions regarding these comments.

Sincerely,

Jill Gross & Barbara Black

Directors, Pace Investor Rights Project

[5] See Reinglass v. Morgan Stanley Dean Witter, Inc., 2006 WL 802751 (Ohio Ct. App.Mar. 30, 2006).