

August 5, 2005

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

Re: **File Number SR-NASD-2005-032**  
**Proposed Rule Changes to NASD Code of Arbitration**  
**Relating to Written Explanations in Arbitration Awards**

Dear Mr. Katz:

Charles Schwab & Co., Inc. ("Schwab") welcomes the opportunity to comment on SR-NASD-2005-032, the NASD's proposal to require written explanations of arbitration awards upon the request of customers and associated persons ("the Proposed Rule"). Schwab recognizes that any rule relating to the arbitration process potentially affects the interests of several different parties, including public investors, NASD member firms and their associated persons, and Schwab commends the NASD for its ongoing efforts to enhance the arbitration process.

Schwab, however, does not support the Proposed Rule, which the NASD says is intended to "increase investor confidence in the fairness of the NASD arbitration process," but instead shares the view of one commentator who has called the Proposed Rule a "profoundly bad idea."<sup>1</sup> In short, Schwab does not support the Proposed Rule because it will negatively impact the arbitration process, and is fundamentally unfair because it grants a new right to a select group of arbitration participants – rather than to *all* participants. For the reasons discussed below, Schwab urges the Securities and Exchange Commission (SEC) not to approve the Proposed Rule.

Schwab supports many of the other comment letters that have been submitted in opposition to the Proposed Rule, particularly that of the Securities Industry Association (SIA) which thoroughly addresses the numerous negative aspects of the so-called reasoned awards contemplated by the Proposed Rule. Schwab agrees with the SIA and many other commentators who have noted that the Proposed Rule will substantially decrease the finality, efficiency and cost-effectiveness of the arbitration process. And, in a twist on the old saying that 'politics makes strange bedfellows', Schwab also agrees with many of the statements in

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<sup>1</sup> [Can't Get No Satisfaction! How Explained Decisions Will Undermine the Arbitration Process](#), Aegis J. Frumento, *Securities Arbitration Commentator*, Vol. 2005, No. 3, p. 1.

the Public Investors Arbitration Bar Association (PIABA) comment letter - "Reasoned awards have the potential to detract from one of the benefits of alternative dispute resolution. Inadequate 'reasons' may provide a basis for motions to vacate"... and "A reasoned award is unlikely to answer [why an investor lost] to the satisfaction of the losing party" - although not with PIABA's conclusion that only investors and associated persons should have the option to obtain a reasoned award.

Rather than repeat arguments that have already been made by other commentators, Schwab will limit its comments to two aspects of the Proposed Rule that have not been significantly addressed by others. First, if the Proposed Rule is adopted - and Schwab believes it should not be adopted - the right to request a reasoned award must be given to all parties to the arbitration process, not just to investors and associated persons in industry disputes. Second, the deadline to request a reasoned award should be set at the time that arbitrators are appointed in order to give potential panelists the ability to decline an appointment to a case where a reasoned award will be required.

#### **A. All Parties to the Arbitration Should Have the Right to Request a Reasoned Award**

The Proposed Rule is unfairly one-sided in that it confers upon investors and associated persons – and only those parties – the option to request and obtain a reasoned award. The two slim rationales given for this disparate treatment of different parties to the same arbitration are (1) it will “protect customers and associated persons, because they alone will determine whether to request an explained decision while bearing in mind the potential costs and the prospect that a reviewing court might find grounds in the explanation to vacate the award”; and (2) it will prevent potential conflicts “between co-respondents who may disagree on whether to request a decision.” This second rationale can be debunked rather quickly because that conflict could equally apply to co-*claimants* and, in any event, would be applicable in only a small number of cases and would not warrant giving the supposed benefits of the Proposed Rule only to customers and associated persons.<sup>2</sup> Moreover, this ‘conflict’ is easily solved by having the rule specifically require either that (1) all claimants or respondents must unanimously request the reasoned award; or, alternatively (2) any one claimant or respondent can request it.

The first rationale for giving the right only to investors and associated persons – namely “...the prospect that a reviewing court might find grounds in the explanation to vacate the award” – is only slightly more credible. As one arbitration participant has noted, this is a “strange rationale given that the NASD identified only *unsuccessful* claimants as those

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<sup>2</sup> Frumento, p.3.

clamoring for reasons, and they would not face a vacatur motion anyway.”<sup>3</sup> Indeed, this rationale seems more aimed at protecting *successful* claimants from having their award challenged - by limiting who can request a reasoned award - than it is at providing *unsuccessful* ones with the reasons why they lost. If, as the NASD implies, the risk of post-award litigation due to a reasoned award threatens the *prevailing* party, why are member firms not entitled to obtain a reasoned award?<sup>4</sup> Logically, a member firm that requests a reasoned award, and wins, would run the same risks regarding vacatur that a winning customer would.

The Proposed Rule, therefore, provides no real justification for giving the right to obtain a reasoned award to one discrete group of arbitration participants. In truth, however, there seems to be only one logical reason for this inequality. The NASD clearly acknowledges that reasoned awards will result in more vacatur proceedings when it notes “...the prospect that a reviewing court might find grounds in the explanation to vacate the award.” As discussed above, this would be true for *any* prevailing party. But the true inequality of the Proposed Rule is exposed when one considers what a reasoned award might do for a *losing* customer. Having a reasoned award - which the NASD expressly recognizes may result in more vacatur proceedings - will give losing customers a strategic advantage that member firms will not have. A losing member firm, on the other hand, will not have that same advantage unless the customer happened to have requested a reasoned award. Thus, rather than maintaining a level playing field for all arbitration participants, the one-sided nature of the Proposed Rule tilts it in favor of investors and associated persons.<sup>5</sup> If the right to obtain a reasoned award becomes a reality, which it should not, that right must be given to all arbitration participants.

Another odd, and completely unexplained, aspect of the Proposed Rule is its unilateral application to investors and associated persons, “*regardless of whether he or she is the claimant or respondent in the arbitration.*” As stated, Schwab believes it is fundamentally unfair for the NASD to grant a new right to only one group of arbitration participants. It is patently prejudicial, however, to grant that right to a particular group of participants regardless of whether they are seeking to recover money or seeking to avoid paying money owed. For example, in a customer-versus-member case, the Proposed Rule would allow the customer (claimant) who is *seeking* monetary damages to request a reasoned award; but the member (respondent) from whom money is sought would have no such right. Conversely, in member-versus-customer dispute where the member firm is seeking monetary damages resulting from, say, a margin liquidation (or a promissory note in an industry dispute), the firm (claimant)

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<sup>3</sup> Frumento, p.3.

<sup>4</sup> Schwab recognizes that the Proposed Rule allows member firms to request a reasoned award; however, that right is meaningless because, unlike a request from a public customer, arbitrators are not required to heed that request.

<sup>5</sup> Beware of What You Ask For: You Might Just Get It, Constantine N. Katsoris, *Securities Arbitration Commentator*, Vol. 2005, No. 2., fn. 10.

would have no right to obtain a reasoned award, while the customer (respondent) would.<sup>6</sup> Under these circumstances, in particular, the Proposed Rule is blatantly one-sided, and simply cannot be justified under the guise of “increas[ing] investor confidence in the fairness of the NASD arbitration process.”

Lastly, and more broadly, the Proposed Rule represents a significant shift for the NASD and its Code of Arbitration in that it grants a new, substantive right to one side - and one side only - of an adversarial process built on the notion that both sides will be treated *equally*.<sup>7</sup> Schwab is unaware of any other provision of the Code of Arbitration Procedure that so clearly favors one party at the expense of the other. The Proposed Rule will change how parties plead and try their cases, how arbitrators write their awards, and how reviewing courts evaluate those awards. It would be profoundly unfair to grant such a far-reaching new right to only one group of arbitration participants.

#### **B. The Deadline to Request a Reasoned Award Should Be Earlier in the Proceedings**

A secondary concern, and one that is only relevant if the Proposed Rule is adopted as currently drafted, is the Proposed Rule’s provision which allows customers or associated persons to request a reasoned award at anytime up to the 20-day pre-hearing exchange. This deadline should be set much earlier in the proceedings to provide more notice to all participants of the arbitration, including the arbitrators.

As noted by others commentators, NASD arbitrators provide a valuable and important service and are paid relatively little for their efforts. The proposed additional \$200.00 honorarium (a portion of which, Schwab notes, will be allocated by the arbitrators and not necessarily paid by the party who requests the award) will not change that, given that there is simply no telling how long it will take three arbitrators to agree on the wording and rationale of a ‘reasoned’ award.<sup>8</sup> For this reason, arbitrators who are asked to serve on a panel should know at that time – before they accept an appointment – whether they will be required to issue a reasoned award. The NASD’s statement that providing at least 20 calendar days notice “allows arbitrators adequate notice that a case will require an explained decision” misses the

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<sup>6</sup> The Proposed Rule seems to contradict itself on this point because its primary beneficiaries are supposed to be “customers and associated persons who lose in arbitration (*or consider their recovery insufficient*)...” (Emphasis added) Thus, the Proposed Rule seems to be aimed at those situations where customers and/or associated persons seek to recover money as claimants, and its application to situations where customers and/or associated persons are respondents is difficult to comprehend.

<sup>7</sup> There is no doubt that the right to obtain a reasoned award is a *substantive* right, as it will “change how arbitrations work” and “will make arbitration outcomes more ‘legal’ and less ‘equitable.’” Frumento, p.3.

<sup>8</sup> Schwab disagrees with the NASD’s position that requiring only “fact-based” awards, without citation to legal authorities or damage calculations, will maintain “the speed and efficiency of arbitration.”

point that some arbitrators may simply not have the time or inclination to issue a reasoned award and may forgo serving on a panel in those situations.

There are other good reasons to set this deadline earlier in the proceedings. First, the Proposed Rule would allow an investor to request a reasoned award after certain pre-hearing proceedings have been decided against the investor – for example, adverse rulings in a discovery dispute. Allowing the choice to be made at this point will inject an element of strategy into the decision, and will also allow claimant’s counsel to send a not-too-subtle signal to the panel following an adverse ruling. Second, and in the interest of fairness, member firms have a right to know in advance if a reasoned award will be issued, and learning this fact at the time of the 20-day exchange is too late. Setting this deadline at the time that arbitrators are selected would satisfy this concern as well. Customers and associated persons would not be prejudiced by having to exercise their new right to request a reasoned award at an earlier point in the proceeding.

Thank you for considering Schwab’s comments on this important issue.

Very truly yours,



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Charles Schwab & Co., Inc.

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