Regulatory Information Circular

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<th>2005-02</th>
<th>Contact:</th>
<th>Michael J. Simon</th>
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<tr>
<td>Date:</td>
<td>January 10, 2005</td>
<td>Telephone:</td>
<td>212-897-0230</td>
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Subject: Rule Change Notice – Changes to NASD Arbitration Rules

Pursuant to ISE Rule 1800, which in part states that the requirements of NASD Rule IM-3110(f) shall apply to predispute arbitration agreements between Members and their customers, this Regulatory Information Circular informs Members of an approved rule change to NASD Rule 3110(f) by the Securities and Exchange Commission, attached.


A copy of the notice is attached for reference.

Please contact me with any questions.
SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50713; File No. SR-NASD-98-74]

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change as Amended and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 by the National Association of Securities Dealers, Inc., Regarding NASD Rule 3110(f) Governing Prediscpute Arbitration Agreements With Customers


I. Introduction

On October 6, 1998, the National Association of Securities Dealers (“NASD”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) a proposed rule change pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) and Rule 19b-4 thereunder to amend NASD Rule 3110(f) governing prediscpute arbitration agreements.\(^1\)

Notice of the proposal, as amended by Amendment Nos. 1 and 2, was published in the Federal Register on November 29, 1999.\(^2\) The Commission received two comment letters on the proposed rule change.\(^3\) On April 30, 2002, NASD submitted a Response to Comments and Amendment No. 3 to the proposed rule change. On August 22, 2003, NASD filed Amendment No. 4 to the proposal, which replaced in its entirety the prior filings and amendments, except for the Response to Comments contained in Amendment No. 3. Notice of the proposal, as amended by Amendment Nos. 3 and 4,\(^4\) was published in the Federal Register on September 12, 2003.\(^5\) The Commission received 24 comment letters on Amendment Nos. 3 and 4.\(^6\)

January 9, 2004, NASD submitted a Response to Comments and Amendment No. 5 to the proposed rule change.\(^7\) This order approves the proposed rule change, grants accelerated approval to Amendment No. 5, and solicits comments from interested persons on Amendment No. 5.

II. Description of the Proposal

A. Background

1. Purpose and General Description of Proposal

The proposed rule change is intended to increase the disclosure required in prediscpute arbitration agreements. Manybroker-dealers require that customers seeking to open accounts, particularly margin and option accounts or accounts with a checking or money market feature, agree in writing to arbitrate disputes concerning the account, typically in an SRO-sponsored forum. These agreements, called “prediscpute arbitration agreements,” are generally part of the non-negotiated customer agreement drafted by the firm.

To ensure that customers are advised about what they are agreeing to when they sign prediscpute arbitration agreements, NASD Rule 3110(f) requires that such agreements contain highlighted disclosure about differences between arbitration and litigation, including notice that by agreeing to arbitrate their disputes, customers may be waiving certain rights that would be available in court. NASD Rule 3110(f)


7 See letter from Kosha Dalal, Assistant General Counsel, NASD, to Katherine A. Englund, Assistant Director, Division of Market Regulation, SEC, dated January 9, 2004 (“Amendment No. 5”).

8 See Estell Letter and Miller Letter, supra note 4.

9 See supra note 6.
the use of choice-of-law provisions. In response to these comments, NASD is amending the proposed rule change to withdraw Proposed Rule 3110(f)(4)(B), for the reasons explained below in Section II.

F. Restrictions on Provisions That Limit Rights and Remedies

Finally, one commenter criticized the proposed rule change for not permitting customers to opt out of prediscpute arbitration agreements in cases involving securities fraud, and for failing to eliminate the requirement that one non-public arbitrator serve on three-arbitrator panels, as required by NASD Rule 10308.10 NASD responded that these concerns, while noted, are outside the scope of the proposed rule filing.

B. Required Disclosure and Notice of Possible Restrictions on Eligibility

Currently, disclosure language about the differences between litigation and arbitration must be included in prediscpute arbitration agreements.11 NASD proposes to clarify existing disclosures and to require new disclosure that (i) the rules of some arbitration forums may impose time limits for bringing claims in arbitration; and (ii) in some cases, claims that are ineligible for arbitration may be brought in court.12

Under the proposal, members would be required to add the new disclosure requirements to all new customer account agreements containing prediscpute arbitration agreements as of the effective date of the rule. Accordingly, the proposed rule would not require members to replace existing agreements with current customers.13

C. Incorporation of Arbitration Forum Rules

The proposal provides that the rules of the arbitration forum in which a claim is brought, and any amendments thereto, are incorporated into the parties' agreement and are enforceable, as are other provisions of the arbitration contract.14 This provision should ensure that the rules of a forum apply to cases brought in that forum and eliminate the need to execute new agreements each time a forum changes its rules.

Accordingly, if a customer files a complaint in an NASD arbitration forum, NASD's arbitration rules would apply in all respects to the agreement.

D. Acknowledgement of Prediscpute Arbitration Clause

NASD Rule 3110(f) currently requires that (i) prediscpute arbitration agreements contain a highlighted statement indicating that the agreement contains an arbitration clause and specifying at what page and paragraph the arbitration clause is located; and (ii) a copy of the prediscpute arbitration agreement be provided to the customer, who must acknowledge receipt of the agreement in writing, either on the agreement itself or on a separate document. Proposed Rule 3110(f)(2)(B) would amend the current rule to require that delivery and customer acknowledgement of the agreement take place at the time of signing.

E. Requirement That Members Provide Copies of Customer Agreements and Information Regarding Arbitration Forums to Customers Upon Request: Proposal and Comments Received

Proposed Rule 3110(f)(3)(A) would require members, within ten days of receiving a customer request, either to provide the customer with a copy of any prediscpute arbitration agreement clause or agreement that the customer had signed, or inform the customer that the member does not have a copy of the agreement.15 In addition, the proposal would require that, upon request of a customer, a member must provide the customer with the names of, and information on how to contact or obtain the rules of, all arbitration forums in which a claim may be filed under the agreement.16

One commenter interpreted the phrase "or inform the customer that the member does not have a copy thereof" in Proposed Rule (f)(3)(A) to refer to a situation in which there is no prediscpute arbitration agreement between the customer and firm.17 NASD stated that, in fact, Proposed Rule 3110(f)(3)(A) is intended to address a situation in which a customer agreement or prediscpute arbitration agreement has been executed, but the firm is for some reason unwilling or unable to produce a copy to the customer. Current Rule 3110(f)(3) requires that copies of any prediscpute arbitration agreement be given to the customer, who must acknowledge receipt thereof. NASD has become aware, however, that members generally provide copies of such agreements at the time the agreement is signed, but sometimes refuse or are unable to do so after a dispute has arisen. Thus, Proposed Rule 3110(f)(A)(3) requires members to produce customer account or prediscpute arbitration agreements upon the request of the customer. NASD expects that members will retain such agreements, as required by NASD rules. However, if for some reason, whether through an act of nature, human error, or otherwise, a member is unable to comply with the customer's request, NASD proposes to require members to inform the customer of that fact, rather than simply failing to respond to the customer's request.

F. Restrictions on Provisions That Limit Rights and Remedies

Proposed Rule 3110(f)(4)(A) clarifies the prohibition against provisions in prediscpute arbitration agreements that limit rights or remedies, including provisions that would circumvent NASD's eligibility rule proposal, as amended.18 In particular, the proposal would provide that prediscpute arbitration agreements may not include any condition that would: (i) limit or contradict the rules of any self-regulatory organization ("SRO"); (ii) limit the ability of a party to file any claim in arbitration; (iii) limit the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement; or (iv) limit the ability of arbitrators to make any award.19

NASD initially proposed to amend Rule 3110(f)(4) to include paragraph (f)(4)(B), which would state that no choice-of-law provision would be enforceable unless there is a significant contact or relationship between the law selected and either the transaction at issue or one or more of the parties. NASD had proposed paragraph (f)(4)(B) in response to the recommendation of the Ruder Task Force Report and with the purpose of protecting investors from the use of arbitrary choice of law provisions. This would make explicit NASD's interpretation of current Rule 3110(f)(4) to require that, when prediscpute arbitration agreements between members and customers...
include a choice-of-law provision, there must be "an appropriate contact or relationship between the transaction at issue or the parties and the law selected." As explained more fully below, however, NASD has withdrawn proposed paragraph (f)(4)(B) in response to comments, but continues to caution its members against overreaching in choice of law provisions.

Although one commenter generally supported proposed paragraph 3110(f)(4)(B), the overwhelming majority of commenters opposed it as potentially harmful to investors. A majority of the commenters argued that, because relevant case law regarding choice-of-law provisions in predispute arbitration agreements has evolved considerably in the five years since the proposed rule change was filed, proposed paragraph (f)(4)(B) could be interpreted to endorse choice-of-law clauses that may not be enforceable under applicable state law. Two commenters suggested that members might use paragraph (f)(4)(B) to legitimize choice-of-law clauses that would override the protection of customers' home state blue sky laws. Given the strong opposition of most commenters and the fact that such adverse consequences were not intended by NASD, NASD is withdrawing proposed paragraph (f)(4)(B). However, by doing so, NASD is not implying that members may include arbitrary choice-of-law provisions in predispute arbitration agreements with customers. As it has in the past, NASD will continue to interpret NASD Rule 3110(f) to require that, if a choice-of-law provision is used, there must be an adequate nexus between the law chosen and the transaction or parties at issue in accordance with NASD Notices to Members 95–85 and 95–16.

G. Non-Bifurcation Provision

NASD proposes to require members seeking to compel arbitration of claims filed in court to agree to arbitrate all of the claims contained in the complaint if the customer requests, even if some of the claims would be ineligible for arbitration under the eligibility rule.

In a companion filing, NASD proposes to provide that by requesting dismissal of a claim on eligibility grounds in the NASD forum, the requesting party is agreeing that the party that filed the dismissed claim may withdraw all related claims without prejudice and may pursue all of the claims in court. NASD represents that this provision would protect parties against involuntary bifurcation of claims.

H. Effective Date Provisions

The proposed amendments to NASD Rule 3110(f) would require various changes to the customer agreements used by NASD member firms. In order to provide enough time for firms to modify customer agreements, the proposed rule change would take effect 90 days after NASD publishes a Notice to Members to announce Commission approval of the proposal. Moreover, NASD would issue such Notice to Members within 60 days of publication of the Commission's approval of the proposed rule change in the Federal Register.

The proposed amendments to NASD Rule 3110(f) would also provide that agreements signed before the effective date of the rule, as amended, would be subject to the provisions of NASD Rule 3110(f) in effect at the time the agreement was signed, except with regard to the provisions of subparagraph (f)(3) of the proposed rule change.

III. Discussion and Commission Findings

Currently, NASD Rule 3110(f) requires that predispute arbitration agreements contain highlighted disclosure about differences between arbitration and litigation, including notice that by agreeing to arbitrate their disputes, customers may be waiving certain rights that would be available in court. Further, NASD Rule 3110(f) provides that its members must highlight the agreement and provide a copy of the agreement to the customer, which the customer acknowledges in writing.

The Commission notes that despite the disclosure requirements under the current rule, NASD has determined that there are continuing concerns about whether customers who become parties to predispute arbitration agreements adequately understand the terms of the agreement. NASD has concluded that it is necessary to require its members to provide more disclosure about arbitration to customers who sign predispute arbitration agreements, and that the use of certain provisions that limit rights and remedies should be restricted. Accordingly, NASD submitted the proposed amendments to NASD Rule 3110(f) to address these concerns.

The Commission believes that the proposal should provide customers with clearer and enhanced disclosure regarding the terms of predispute arbitration agreements. The Commission believes that the proposed rule change incorporates important protections into the text of the arbitration agreement itself, including the rules of the SRO in which the arbitration takes place. This will permit better guidance to the parties, arbitrators, and the courts. Moreover, the proposed requirement that a member either provide a customer with the predispute arbitration agreement or inform the customer that the member does not have a copy within ten days, as well as provide the customer with information on how to obtain the rules of the arbitration forums in which a claim may be filed under the agreement, should help to protect investors and facilitate the dispute resolution process.

The Commission also notes that the proposal provides that if the member seeks to compel arbitration of claims, the member must agree to arbitrate all of the claims contained in the complaint if the customer requests. The Commission believes that the proposed rule change should benefit investors by preventing customers from being forced to bifurcate their claims. The proposed rule change, together with Rule 10304, as amended, addresses the concern that parties would be forced to arbitrate in two forums; limits the potential litigation strategies that could escalate the costs of and thereby impede dispute resolution; and eliminates the particular litigation strategy, never contemplated under NASD rules, of so-called "election of remedies," which foreclosed some investors' access to justice altogether.

Finally, the Commission notes the concerns raised by commenters regarding the proposed choice-of-law provision. The Commission believes that NASD's response in withdrawing paragraph 3110(f)(4)(B) is consistent with the Act, and that Proposed Rule 3110(4)(A) achieves an appropriate balance between the interests of investors and the ability of parties to agree contractually to fair terms that would govern their...
Based on the above, the Commission finds good cause, consistent with section 15A(b)(6) and section 19(b)(2) of the Act, for approving Amendment No. 5 prior to the 30th day after the date of publication of notice of filing thereof in the Federal Register.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning whether proposed Amendment No. 5 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. Please include File Number SR-NASD-98-74 on the subject line.

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–98–74. 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 at the principal office of 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 have made available publicly. All submissions should refer to File Number SR–NASD–98–74 and should be submitted on or before December 27, 2004.

VI. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act, that the proposed rule change (SR–NASD–98–74), as amended, is hereby approved, and Amendment No. 5 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.37

Margaret H. McNarland,
Deputy Secretary.

[FR Doc. E4–3450 Filed 12–2–04; 8:45 am]

SECURITIES AND EXCHANGE COMMISSION


Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto To Establish Fees for Companies With a Dual Listing on the New York Stock Exchange and Nasdaq


Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),3 and Rule 19b–4 thereunder,2 notice is hereby given that on September 28, 2004, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in items I, II, and III below, which items have been prepared by Nasdaq. On November 12, 2004, Nasdaq amended the proposed rule change.3 The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of the Substance of the Proposed Rule Change

Nasdaq proposes to adopt a fee schedule for issuers that are dually listed on the New York Stock Exchange (the "NYSE") and Nasdaq. Should the Commission approve the proposed rule change, Nasdaq will implement the proposed rule change immediately.

42 See Amendment No. 1 replaced and superseded the original filing in its entirety.