

October 6, 2003

Florence Harmon  
Senior Special Counsel  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001

Re: **SR-NASD-2003-153** Amendment to Pilot Rule in IM-10100(f) of the NASD  
Code of Arbitration Procedure Regarding Waiver of California Arbitrator  
Disclosure Standards; Immediate Effectiveness Requested

Dear Ms. Harmon:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Laura Gansler, Counsel, NASD Dispute Resolution, at (202) 728-8275; e-mail [laura.gansler@nasd.com](mailto:laura.gansler@nasd.com). The fax number is (202) 728-8833.

Very truly yours,

Barbara Z. Sweeney  
Senior Vice President  
and Corporate Secretary

Enclosures

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 19b-4 under the  
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. (“NASD Dispute Resolution”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend the pilot rule in IM-10100(f) of the NASD Code of Arbitration Procedure (“Code”) that requires industry parties in arbitration to waive application of contested California arbitrator disclosure standards, to include claims by members against other members or associated person that relate exclusively to promissory notes. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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**10000. Code of Arbitration Procedure**

**IM-10100. Failure to Act Under Provisions of Code of Arbitration Procedure**

It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member or a person associated with a member to:

(a) – (e) No change.

(f) fail to waive the California Rules of Court, Division VI of the Appendix, entitled, "Ethics Standards for Neutral Arbitrators in Contractual Arbitration" (the "California Standards"), if [all the parties in the case who are customers, or associated persons with a claim against a member firm or another associated person, have waived application of the California Standards in that case.] application of the California Standards has been waived by all parties to the dispute who are:

(1) customers with a claim against a member or an associated person;

(2) associated persons with a claim against a member or an associated person;

(3) members with a claim against another member; or

(4) members with a claim against an associated person that relates exclusively to a promissory note.

[The w] Written waiver by [the customer or the associated person asserting the claim against a member or associated person under the Code] such parties shall constitute and operate as a waiver for all member firms or associated persons against whom the claim has been filed. This rule applies to claims brought in California against all member firms and associated persons, including terminated or otherwise inactive member firms or associated persons.

Remainder Unchanged.

(b) Not applicable.

(c) Not applicable.

## 2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Governors of NASD on a mail vote of its Executive Committee on September 16, 2003, which authorized the filing of the rule change with the SEC. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules without recourse to the membership for approval. Section 4(a) of Article IX of the NASD By-Laws permits the NASD Board to appoint an Executive Committee to exercise all the powers and authority of the Board in the management of the business and affairs of the NASD between meetings of the Board. NASD requests that the rule change become effective on filing and that it apply to all new and pending claims.

(b) Questions regarding this rule filing may be directed to Laura Gansler, Counsel, NASD Dispute Resolution, at (202) 728-8275.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

NASD is proposing to amend the pilot rule in IM-10100(f) that requires industry parties in arbitration to waive application of contested California arbitrator disclosure standards, to include claims by members against other members or associated person that relate exclusively to promissory notes.

Background

In July 2002, the California Judicial Commission adopted a set of rules, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (“California Standards”)<sup>1</sup>, governing ethical standards for arbitrators. 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. The California Standards imposed 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>2</sup>

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<sup>1</sup> California Rules of Court, Division VI of the Appendix, entitled, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (the “California Standards”).

<sup>2</sup> These measures included providing venue changes for arbitration cases, using non-California arbitrators when appropriate, and waiving administrative fees for NASD-sponsored mediations.

In November 2002, NASD and NYSE filed a lawsuit in federal district court seeking a declaratory judgment that the California Standards are inapplicable to arbitration forums sponsored by self-regulatory organizations (“SROs”).<sup>3</sup> That litigation is currently pending on appeal. Since then, other lawsuits relating to the application of the California Standards to SRO-sponsored arbitration have been filed, several of which are also still pending.

To allow arbitrations to proceed in California while the litigation 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, or associated persons with claims against industry parties, have done so.<sup>4</sup> In such cases, 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>5</sup>

The pilot rule, which was originally approved for six months on September 26, 2002, has been extended, and is now due to expire on March 31, 2004.<sup>6</sup>

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<sup>3</sup> See Motion for Declaratory Judgment, NASD Dispute Resolution, Inc. and New York Stock Exchange, Inc. v. Judicial Council of California, filed in the United States District Court for the Northern District of California, No. C 02 3486 SBA (July 22, 2002), available on the NASD Web site at: [http://www.nasdaq.com/pdf-text/072202\\_ca\\_complaint.pdf](http://www.nasdaq.com/pdf-text/072202_ca_complaint.pdf).

<sup>4</sup> Originally, the pilot rule only applied 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 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 Rel. No. 48187 (July 16, 2003), 68 FR 43553 (July 23, 2003) (File No. SR-NASD-2003-106).

<sup>5</sup> The NYSE has a similar rule; Rule 600(g).

<sup>6</sup> See Securities Exchange Act Rel. No. 48553 (September 26, 2003) (File No. SR-NASD-2003-144).

Description of Proposed Rule Change

The pilot rule currently applies to all claims filed by customers, and to claims filed by associated persons against members or other associated persons. The proposed rule change would extend the pilot rule to apply to claims filed by members against other members, and to claims filed by members against associated persons that relate exclusively to promissory notes.

Specifically, the proposed rule change would amend IM-10100(f) to provide that if a member bringing a claim against another member, or a claim against an associated person that relates exclusively to promissory notes, waives application of the California Standards to the dispute, then the industry respondents will also be deemed to have waived the application of the Standards.<sup>7</sup> This rule change will allow to proceed the majority of the remaining intra-industry cases that are currently stalled due to the confusion surrounding the California Standards. It will also prevent delay in such cases that are filed in the future, and will facilitate the administration of cases against such parties in California while the rule is in effect. NASD proposes to make the proposed rule change, which will apply to pending and future arbitrations, operative immediately upon filing.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that by expediting the appointment of arbitrators under the proposed waiver, the proposed rule

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<sup>7</sup> The proposed rule change would include disputes that relate exclusively to promissory notes. It would not apply in cases that involve both promissory notes and other types of claims that do not already fall within the scope of the rule.

change will allow affected parties to pursue their contractual rights to proceed in arbitration in California, notwithstanding the confusion caused by the disputed California Standards.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

The proposed rule change is effective upon filing pursuant to Section 19(b)(3)(A) of the Act and paragraph (f)(6) of Rule 19b-4 thereunder, in that the proposed rule change does not significantly affect the protection of investors or the public interest; does not impose any significant burden on competition; and does not become operative for 30 days from the date on which it was filed or such shorter time as the Commission may designate. NASD believes that the proposed rule change will further the public interest by permitting parties to pursue their contractual rights to proceed in arbitration, despite the confusion caused by the disputed California Standards.

NASD requests the Commission to waive the five-day advance notice requirement and the requirement that the rule change not become operative for 30 days after filing. NASD believes

that waiving the five-day pre-filing provision and accelerating the operative date will have no effect on the protection of investors, and will further the public interest by immediately providing members that have claims against other members, or claims against associated persons that relate exclusively to promissory notes, with a mechanism to resolve their disputes. NASD proposes to make the proposed rule change operative immediately upon filing.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD

BY: \_\_\_\_\_  
Barbara Z. Sweeney, Senior Vice President and  
Corporate Secretary

Date: October 6, 2004

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-

File No. SR-NASD-2003-153)

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Regarding Waiver of California Arbitrator Disclosure Standards

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> notice is hereby given that on \_\_\_\_\_, the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. (“NASD Dispute Resolution”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Dispute Resolution. NASD has designated the proposed rule change as constituting a “non-controversial” rule change under paragraph (f)(6) of Rule 19b-4 under the Act,<sup>3</sup> which renders the proposal effective upon receipt of this filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to amend the pilot rule in IM-10100(f) of the NASD Code of Arbitration Procedure, which requires industry parties in arbitration to waive application of contested California arbitrator disclosure standards, to include claims by members against other

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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> 17 CFR § 240.19b-4

members or associated person that relate exclusively to promissory notes. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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**10000. Code of Arbitration Procedure**

**IM-10100. Failure to Act Under Provisions of Code of Arbitration Procedure**

It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member or a person associated with a member to:

(a) – (e) No change.

(f) fail to waive the California Rules of Court, Division VI of the Appendix, entitled, "Ethics Standards for Neutral Arbitrators in Contractual Arbitration" (the "California Standards"), if [all the parties in the case who are customers, or associated persons with a claim against a member firm or another associated person, have waived application of the California Standards in that case.] application of the California Standards has been waived by all parties to the dispute who are:

(1) customers with a claim against a member or an associated person;

(2) associated persons with a claim against a member or an associated person;

(3) members with a claim against another member; or

(4) members with a claim against an associated person that relates exclusively to a promissory note.

[The w] Written waiver by [the customer or the associated person asserting the claim against a member or associated person under the Code] such parties shall constitute and operate as a waiver for all member firms or associated persons against whom the claim has been filed.

This rule applies to claims brought in California against all member firms and associated persons, including terminated or otherwise inactive member firms or associated persons.

Remainder Unchanged.

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## II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

### (A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### (a) Purpose

NASD is proposing to amend the pilot rule in IM-10100(f) that requires industry parties in arbitration to waive application of contested California arbitrator disclosure standards, to include claims by members against other members or associated person that relate exclusively to promissory notes

#### Background

In July 2002, the California Judicial Commission adopted a set of rules, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (“California Standards”)<sup>4</sup>, governing ethical standards for arbitrators. 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

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<sup>4</sup> California Rules of Court, Division VI of the Appendix, entitled, “Ethics Standards for Neutral Arbitrators in Contractual Arbitration” (the “California Standards”).

basis by the SEC. The California Standards imposed 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 November 2002, NASD and NYSE filed a lawsuit in federal district court seeking a declaratory judgment that the California Standards are inapplicable to arbitration forums sponsored by self-regulatory organizations (“SROs”).<sup>6</sup> That litigation is currently pending on appeal. Since then, other lawsuits relating to the application of the California Standards to SRO-sponsored arbitration have been filed, several of which are also still pending.

To allow arbitrations to proceed in California while the litigation 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, or associated persons with claims against industry parties, have done so.<sup>7</sup> In such cases, the arbitration proceeds under the NASD Code of Arbitration Procedure, which already

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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> See Motion for Declaratory Judgment, NASD Dispute Resolution, Inc. and New York Stock Exchange, Inc. v. Judicial Council of California, filed in the United States District Court for the Northern District of California, No. C 02 3486 SBA (July 22, 2002), available on the NASD Web site at: [http://www.nasdaq.com/pdf-text/072202\\_ca\\_complaint.pdf](http://www.nasdaq.com/pdf-text/072202_ca_complaint.pdf).

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

contains extensive disclosure requirements and provisions for challenging arbitrators with potential conflicts of interest.<sup>8</sup>

The pilot rule, which was originally approved for six months on September 26, 2002, has been extended, and is now due to expire on March 31, 2004.<sup>9</sup>

#### Description of Proposed Rule Change

The pilot rule currently applies to all claims filed by customers, and to claims filed by associated persons against members or other associated persons. The proposed rule change would extend the pilot rule to apply to claims filed by members against other members, and to claims filed by members against associated persons that relate exclusively to promissory notes.

Specifically, the proposed rule change would amend IM-10100(f) to provide that if a member bringing a claim against another member, or a claim against an associated person that relates exclusively to promissory notes, waives application of the California Standards to the dispute, then the industry respondents will also be deemed to have waived the application of the Standards.<sup>10</sup> This rule change will allow to proceed the majority of the remaining intra-industry cases that are currently stalled due to the confusion surrounding the California Standards. It will also prevent delay in such cases that are filed in the future, and will facilitate the administration of cases against such parties in California while the rule is in effect. NASD proposes to make the proposed rule change, which will apply to pending and future arbitrations, operative immediately upon filing.

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terminated members and associated persons. See Securities Exchange Act Rel. No. 48187 (July 16, 2003), 68 FR 43553 (July 23, 2003) (File No. SR-NASD-2003-106).

<sup>8</sup> The NYSE has a similar rule; Rule 600(g).

<sup>9</sup> See Securities Exchange Act Rel. No. 48553 (September 26, 2003) (File No. SR-NASD-2003-144).

<sup>10</sup> The proposed rule change would include disputes that relate exclusively to promissory notes. It would not apply in cases that involve both promissory notes and other types of claims that do not already fall within the scope of the rule.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that by expediting the appointment of arbitrators under the proposed waiver, the proposed rule change will allow affected parties to pursue their contractual rights to proceed in arbitration in California, notwithstanding the confusion caused by the disputed California Standards.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

NASD has designated the proposed rule change as one that: (i) Does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate. Therefore, the foregoing rule change has become effective pursuant to Section 19(b)(3)(A) of the Act 6 and Rule 19b-4(f)(6) thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission

may summarily abrogate the rule change if it appears to the Commission that the action is necessary or appropriate in the public interest, for the protection of investors, or would otherwise further the purposes of the Act.

Pursuant to Rule 19b-4(f)(6)(iii) under the Act, the proposal may not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, and the self-regulatory organization must file notice of its intent to file the proposed rule change at least five business days beforehand. NASD has requested that the Commission waive the five-day pre-filing requirement and the 30-day operative delay so that the proposed rule change will become immediately effective upon filing. The Commission believes that waiving the five-day pre-filing provision and the 30-day operative delay is consistent with the protection of investors and the public interest. Waiving the five-day pre-filing provision and accelerating the operative date will have no effect on the protection of investors, and will further the public interest by immediately providing members that have claims against other members, or claims against associated persons that relate exclusively to promissory notes, with a mechanism to resolve their disputes. For these reasons, the Commission designates the proposed rule change effective on filing and operative immediately.

#### IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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 in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz  
Secretary