

**File No. SR-NASD-97-77
Amendment No. 1**

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

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

Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), NASD Regulation, Inc. ("NASD Regulation") is herewith filing a proposed rule change to Rule 10201 of the Rules of the National Association of Securities Dealers, Inc. ("NASD" or "Association"). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * *

CODE OF ARBITRATION PROCEDURE

10200. INDUSTRY AND CLEARING CONTROVERSIES

10201. Required Submission

(a) Except as provided in paragraph (b), [Any] a dispute, claim, or controversy eligible for submission under the Rule 10100 Series between or among members and/or associated persons, and/or certain others, arising in connection with the business of such member(s) or in connection with the activities of such associated person(s), or arising out of the employment or termination of employment of such associated person(s) with such member, shall be arbitrated under this Code, at the instance of:

(1) a member against another member;

(2) a member against a person associated with a member or a person associated with a member against a member; and

(3) a person associated with a member against a person associated with a member.

(b) A claim alleging employment discrimination or sexual harassment in violation of a statute is not required to be arbitrated. Such a claim may be arbitrated only if the parties have agreed to arbitrate it, either before or after the dispute arose.

[(b)] (c) Any dispute, claim or controversy involving an act or failure to act by a clearing member; a registered clearing agency; or participants, pledgees, or other persons using the facilities of a registered clearing agency, under the rules of any registered clearing agency with which the Association has entered into an agreement to utilize the Association's arbitration facilities and procedures shall be arbitrated in accordance with such agreement and the rules of such registered clearing agency.

* * *

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on August 4, 1997, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries. The NASD Board of Governors reviewed the proposed rule change at its meeting on August 7, 1997, and had an opportunity to review the final rule language at its meeting on October 9, 1997. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(4) to Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to the Code of Arbitration Procedure without recourse to the membership for approval.

The NASD will make the proposed rule change effective in one year after Commission approval.

(b) Questions regarding this rule filing may be directed to Jean I. Feeney, NASD Regulation, Office of General Counsel, at (202) 728-6959.

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

(a) The proposed rule change will modify the current requirement that associated persons arbitrate all disputes arising out of their employment or termination of employment with a member broker/dealer. The proposed rule provides that associated persons are no longer required, solely by virtue of their association or their registration with the NASD, to arbitrate claims of statutory employment discrimination. Associated persons still will be required to arbitrate other employment-related claims, as well as any business-related claims involving investors or other persons.

Background

Although most arbitration claims submitted to the NASD involve disputes between members and customers, a growing number of matters involve employment-related disputes between members and their associated persons.¹

The growth in this area is the result of several recent court decisions concerning the requirement of persons associated with a broker/dealer to arbitrate their employment disputes.

¹ The number of employment discrimination claims filed with the NASD rose from 4 in 1991 to 109 in 1996. The latter figure represents, however, less than two percent of all arbitration claims filed with the NASD in 1996.

The requirement for associated persons to register with the NASD arises from Section 15A(g)(3)(B) of the Act, which provides that the NASD may "require a natural person associated with a member, or any class of such natural persons, to be registered with the association in accordance with procedures so established [by the rules of the association]." The registration requirement was made mandatory by Exchange Act Rule 15b7-1 in 1993.² The NASD, other self-regulatory organizations (SROs), and state regulatory authorities require all applicants for registration as persons associated with a broker/dealer (registered representatives, assistant representatives or principals) to complete and sign the Form U-4, the "Uniform Application for Securities Industry Registration or Transfer."³ Form U-4 requires registered persons to submit to arbitration any claim that is eligible under the rules of the organizations with which they register (as indicated in Item 10 of the Form U-4). The relevant language on the Form U-4 states:

I agree to arbitrate any dispute, claim or controversy that may arise between me and my firm, or a customer, or any other person, that is required to be arbitrated under the rules, constitutions, or by-laws of the organizations indicated in Item 10 as may be amended from time to time and that any arbitration award rendered against me may be entered as a judgement in any court of competent jurisdiction.⁴

Thus, the Form U-4 incorporates by reference the rules of the SRO with which the individual is to be registered. NASD Rule 10101 provides as follows:

This Code of Arbitration Procedure is prescribed . . . for the arbitration of any dispute, claim, or controversy arising out of or in connection with the business of any member of the Association, or arising out of the employment or termination of employment of associated person(s) with any member, with the exception of disputes involving the insurance business of any member which is also an insurance company . . . between or among members and associated

² 17 C.F.R. ' 240.15b7-1. The rule provides as follows: "No registered broker or dealer shall effect any transaction in, or induce the purchase or sale of, any security unless any natural person associated with such broker or dealer who effects or is involved in effecting such transaction is registered or approved in accordance with the standards of training, experience, competence, and other qualification standards (including but not limited to submitting and maintaining all required forms, paying all required fees, and passing any required examinations) established by the rules of any national securities exchange or national securities association of which such broker or dealer is a member or under the rules of the Municipal Securities Rulemaking Board (if it is subject to the rules of that organization)."

³ The Form U-4 was adopted effective October 1, 1975

⁴ From page 4 of the Form U-4 as revised in November 1991. A new version of the Form U-4 was approved by the Commission on July 5, 1996. Exchange Act Rel. No. 37407, 61 Fed. Reg. 36595 (July 11, 1996). Use of the revised form has been deferred pending related changes to the Central Registration Depository (CRD). Exchange Act Rel. No. 37994 (Nov. 27, 1996), 61 Fed. Reg. 64549 (Dec. 5, 1996). The substance of the quoted language was not changed in the revision.

persons

For industry and clearing controversies, Rule 10201 requires that all matters eligible under Rule 10101 be submitted to arbitration at the request of any member or associated person.⁵ Rules 10101 and 10201 were amended in 1993 to include the language relating to disputes “arising out of the employment or termination of employment” of an associated person. This language was added in order to clarify that employment disputes were required to be arbitrated, since a California court had held that the Code of Arbitration Procedure did not cover such disputes, but only covered disputes arising out of or in connection with business transactions.⁶ The Commission found the amendment to be consistent with Section 15A(b)(6) of the Act and approved the rule change.⁷

Over the past several years, employees have raised several challenges to the mandatory arbitration of employment discrimination disputes. Such challenges were addressed by the Supreme Court in Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991).⁸ In Gilmer, which involved a person registered with the New York Stock

⁵ As one court explained, "Section 1 [now Rule 10101] defines the general universe of issues that may be arbitrated, and Section 8 [now Rule 10201] describes a subset of that universe that must be arbitrated under the Code." Armijo v. Prudential Ins. Co. of Am., 72 F.3d 793, 798 (10th Cir. 1995).

⁶ Higgins v. Superior Court of Los Angeles County, No. B057028 (Cal. App. Oct. 8, 1991), review denied and decision ordered not officially published, 1 Cal. Rptr. 2d 57 (1992). The state court noted the difference between the NYSE rule (at issue in the Supreme Court's Gilmer decision, discussed below), which refers to disputes arising out of the employment or termination of employment of an associated person, and the NASD rule, which at the time did not contain the phrase relating to employment. A federal court reached the same conclusion while the rule change was pending approval. Farrand v. Lutheran Bhd., 993 F.2d 1253 (7th Cir. 1993). The Association stated in its rule filing that the amendment was a clarification of existing intent rather than a new policy; some courts accepted this view, while other courts interpreted the rule amendment as a change in policy. See Kuehner v. Dickinson & Company, 84 F.3d 316, 320 n.1 (9th Cir. 1996) (describing splits in the Seventh, Tenth and Eleventh Circuits on this issue).

⁷ Exchange Act Rel. No. 32802 (Aug. 25, 1993), 54 SEC Docket 1814. In its order approving this change and a related change in the composition of arbitration panels to hear employment disputes, the Commission recognized that claims based on allegations of age, sex, or race discrimination, or relating to sexual harassment, were subject to the arbitration requirement.

⁸ Those challenges included contentions that anti-discrimination laws are designed to further important social policies that should be addressed in a public forum, that arbitration panels may be biased, that discovery is more limited in arbitration than in court, that arbitrators often do not issue written opinions, that arbitration procedures do not provide for broad equitable relief and class actions, and that there is unequal bargaining

Exchange, the Court examined many challenges to the adequacy of arbitration procedures raised by the registered representative and found that none was sufficient to prevent the Court from enforcing the representative's agreement, pursuant to his signing of the Form U-4, to arbitrate his federal age discrimination claim. Therefore, the Court held that Mr. Gilmer had not met his burden of showing that Congress intended to preclude arbitration of claims under the Age Discrimination in Employment Act of 1967.⁹

Subsequent to the Gilmer decision, courts have declined to find a Constitutional or statutory bar to enforcement of the agreement to arbitrate contained in the Form U-4.¹⁰ They have extended the reasoning of Gilmer to cover disputes arising under Title VII of the Civil Rights Act of 1964,¹¹ the Americans with Disabilities Act,¹² and state statutes of similar nature.¹³ Courts also have extended the application of Gilmer to the NASD, since its rules are similar to the NYSE rule at issue in Gilmer.¹⁴ Nevertheless, registered persons and others have continued to challenge the requirement to arbitrate claims of statutory employment discrimination.¹⁵

power between employers and employees. The Court noted that most of these contentions were generalized attacks on arbitration that had been rejected in prior Supreme Court decisions. 500 U.S. at 30.

⁹ 500 U.S. at 35. The Court cited its earlier holding that, “So long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function.” 500 U.S. at 28, quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 637 (1985).

¹⁰ The U.S. Court of Appeals for the Ninth Circuit has held that a registered person’s waiver of the right to adjudication in court through signing of the Form U-4 must be “knowing” in order for the arbitration requirement to be enforced. Prudential Ins. Co. of Am. v. Lai, 42 F.3d 1299, 1305 (9th Cir. 1994), cert. denied, 116 S. Ct. 61 (1995). But see Prudential Ins. Co. of Am. Sales Prac. Litig., 924 F. Supp. 627, 642 (D.N.J. 1996) (“...Lai has been rather extensively criticized”), and cases cited therein.

¹¹ See, e.g., Alford v. Dean Witter Reynolds, Inc., 939 F.2d 229 (5th Cir. 1991).

¹² See, e.g., Austin v. Owens-Brockway Glass Container, Inc., 78 F.3d 875, 881 (4th Cir.), cert. denied, 117 S. Ct. 432 (1996).

¹³ See, e.g., Kaliden v. Shearson Lehman Hutton, Inc., 789 F. Supp. 179, 180 (W.D. Pa. 1991).

¹⁴ See, e.g., Metz v. Merrill Lynch Pierce, Fenner & Smith, Inc., 39 F.3d 1482, 1488 (10th Cir. 1994).

¹⁵ See, e.g., Commission on Future of Worker-Management Relations (“Dunlop

Task Force Views

In January 1996, the NASD' Arbitration Policy Task Force (Task Force)¹⁶ released its Report on Securities Arbitration Reform. The Task Force Report made numerous recommendations to improve the arbitration process. Since the Report was released, NASD Regulation has been engaged in a major effort to implement the Task Force recommendations.

Employment arbitration was not an area of major focus for the Task Force.¹⁷ The Task Force found, however, that such arbitration offers the advantages of speed and cost that are identified with customer arbitration, and observed that statutory discrimination claims are almost always interwoven with industry-specific issues. Moreover, the Task Force believed that arbitration's equitable approach to dispute resolution is fully capable of vindicating the important public rights expressed in the anti-discrimination statutes. The Task Force, therefore, found compelling reasons to keep employment-related disputes within NASD arbitration. The Task Force Report recommended that employment-related disputes, including statutory discrimination claims, remain eligible for arbitration with certain enumerated enhancements, many of which had been recommended elsewhere in the Report in the context of customer arbitration.¹⁸ The NASD intends to implement many of the recommended enhancements to its arbitration forum in the next year.¹⁹

Commission"), Report and Recommendations 33 n.15 (1994); Equal Employment Opportunity Commission, Policy Statement on Mandatory Binding Arbitration of Employment Discrimination Disputes as a Condition of Employment n.2 (1997).

¹⁶ The NASD formed the Arbitration Policy Task Force in September 1994 for the purposes of studying the securities arbitration process administered by the NASD and of making suggestions for reform. The Task Force, chaired by David S. Ruder, former Chairman of the Securities and Exchange Commission, delivered its Report to the NASD Board in January 1996.

¹⁷ The Task Force directed its attention primarily to customer-member arbitration. See Task Force Report at 123.

¹⁸ The Task Force noted that employment arbitration, and in particular the issue of whether cases that raise statutory civil rights claims should remain subject to predispute arbitration agreements, is an area in which the law and commentary are rapidly evolving. Therefore, the Task Force recommended that the NASD closely monitor developments in employment arbitration and look to other sources in formulating future recommendations for the direction the NASD should pursue in this area. Task Force Report at 123 and n.164.

¹⁹ The Task Force recommended certain changes that would enhance the NASD's ability

Controversy Surrounding the Issue

In the past year, there has been a great deal of activity and public discussion about the arbitration of employment discrimination disputes. In February of 1997, three members of Congress wrote to the SEC and questioned the authority of the NASD and other SROs to require arbitration of discrimination claims in employment disputes through an associated person's signing of the Form U-4.²⁰ Legislation was introduced this year in both the House and Senate²¹ that would prohibit employers and employees from entering into predispute arbitration agreements concerning claims of unlawful employment discrimination. Under the proposed legislation, the parties could agree, after a dispute arose, whether to resolve it by arbitration or to go to court.

The NASD has received letters on this subject from groups with differing points of view, such as the Securities Industry Association, the Equal Employment Opportunity Commission (EEOC), the National Women's Law Center, the Women's Legal Defense Fund, the American Civil Liberties Union, the National Employment Lawyers Association, the National Association of Investment Professionals, several members of Congress, and attorneys representing parties in employment disputes.

to handle employment-related arbitrations, including expanded arbitrator education, greater disclosure to registered persons, the inclusion of employment-related disputes in the early neutral evaluation pilot, and development of a list of documents that parties should produce during discovery for various kinds of employment-related claims. In addition, the Task Force felt that its other recommendations relating to early automatic document production, mediation, simplified arbitration, punitive damages, and list selection should apply to arbitration of employment-related disputes.

²⁰ Letter from Representatives Edward J. Markey, Anna G. Eshoo, and Jesse L. Jackson, Jr., to Arthur Levitt, Chairman, SEC (Feb. 3, 1997). With regard to whether the mandatory arbitration requirement was within the scope of the NASD's authority, the Commission's response stated that sound arguments could be made on both sides of the issue. Letter from Chairman Levitt to Representative Markey (Mar. 17, 1997). The Commission acknowledged that the NASD rule requiring registered persons to arbitrate employment disputes was approved by the Commission as being consistent with the Act, and that it would not be unreasonable to conclude that SROs do have the authority to mandate the arbitration of discrimination claims, provided that fair procedures are in place. The response also acknowledged the concerns of the Equal Employment Opportunity Commission, members of Congress, and others about the special role of civil rights legislation. The Commission concluded that, given the self-regulatory scheme of the Act, it would be premature for the Commission to take any action, and suggested that it would defer expressing any conclusions until the matter was sent to the Commission by the NASD in the form of a proposed rule change.

²¹ H.R. 983 and S. 63, 105th Cong. (1997).

Recent NASD Actions

To gather a wide assortment of views on this issue, NASD staff met with various groups and individuals, including national and regional member firms, members of NASD Regulation District Committees, attorneys representing employees and attorneys representing employers in employment litigation, members of the Bar of the City of New York Labor and Employment Committee, and staff of the New York Stock Exchange. In general, the groups from or representing the securities industry believed the current practice is fair, and that it is more cost-effective for all parties than going to court. The groups representing employees were unanimous in believing that the NASD and other SROs should remove the requirement for registered persons to arbitrate employment discrimination disputes as a condition of registration in the industry.

Many persons meeting with NASD staff recommended that the SROs adopt the Due Process Protocol endorsed by the American Bar Association and various dispute resolution organizations. Some attendees expressed a willingness to work with the SROs in revising the process if arbitration of discrimination claims were made voluntary.

In May 1997, the NASD Regulation formed an Advisory Committee to assist it in reaching a decision on the outstanding questions. The Advisory Committee consisted of six persons of varying and distinguished backgrounds. The Advisory Committee held a meeting in Washington, D.C. on June 16, 1997 and invited to speak representatives of civil rights organizations, the EEOC, general counsels of member firms, attorneys who represent employees, representatives of employee organizations, and attorneys who represent member firms. Afterwards, the Committee spoke with neutral experts in the alternative dispute resolution field, and discussed the issues with NASD management and staff.

After consideration of all the views presented, and in light of the public perception that civil rights claims may present important legal issues better dealt with in a judicial setting, the NASD determined that the appropriate action was to remove the arbitration requirement for such claims, but to further improve the forum so that it is viewed by both registered employees and firms as the fairest and most efficient forum for resolving all employment disputes. In August 1997, proposals were presented to the NASD Regulation and NASD Boards, which authorized the proposed rule change.²²

Details of the Proposed Rule Change

Paragraph (a) of the proposed rule adds a prefatory phrase indicating that the requirement to arbitrate employment disputes contains an exception, set forth in paragraph

²² The text of the proposed rule change was provided to the NASD Regulation Board at its meeting on September 22, 1997, and the NASD Board had an opportunity to review the final rule language at its meeting on October 9, 1997.

(b).

New paragraph (b) provides that claims alleging employment discrimination or sexual harassment in violation of a statute are not required to be arbitrated by NASD rules. This means that such claims may be filed in the appropriate court, if the employee chooses to do so and is not under a separate predispute obligation to arbitrate the dispute.²³ An employee also may agree to arbitrate after a dispute arises, and may choose to do so for a number of reasons.²⁴

Paragraph (b) applies only to claims alleging employment discrimination or sexual harassment²⁵ in violation of a statute.²⁶ Paragraph (b) does not apply to causes of action created solely by judicial precedents.²⁷ Similarly, it does not apply to other causes of action under state or federal law, which remain subject to mandatory arbitration under paragraph (a).

Paragraph (c) of the proposed rule is former paragraph (b), which is unchanged except for the renumbering.

Effective Date and Related Issues

The NASD has requested that the proposed rule become effective one year from the date of Commission approval for several reasons. The NASD believes that a one year period from the date of Commission approval would permit employees and firms to

²³ The NASD takes no position regarding private agreements between employees and firms to arbitrate employment disputes.

²⁴ The Task Force Report observed that arbitration of employment related disputes offers advantages in terms of speed and cost, and that arbitration's essentially equitable approach to dispute resolution is fully capable of vindicating the important public rights expressed in anti-discrimination statutes. Task Force Report at 119. Therefore, the NASD expects that many employees will continue to file their discrimination claims in arbitration if the proposed rule becomes effective, and the NASD intends to make further enhancements to its arbitration forum to make it even more attractive to parties.

²⁵ Sexual harassment has been held to be a form of sex discrimination, and thus a violation of Title VII. Meritor Savings Bank v. Vinson, 477 U.S. 57, 64 (1986).

²⁶ The term "statute" is intended to be interpreted in its broad sense, as defined in Black's Law Dictionary 1410 (6th ed. 1990): "A formal written enactment of a legislative body, whether federal, state, city, or county."

²⁷ Such judicially created causes of action might include, for example, claims alleging "wrongful discharge" without any accompanying claim of discrimination on account of age, sex, race, or other status protected by a specific law.

determine what agreements they might wish to reach with regard to dispute resolution. During this period, the NASD will make related enhancements to the forum so that employees will have confidence that there are adequate procedures and safeguards of their rights in NASD arbitration. The NASD has formed an advisory working group to explore various options for the employment arbitration area, including additional due process standards, standard discovery lists, arbitrator list selection, and other related issues. It is expected that the working group will be able to provide advice to NASD management and the Boards during 1998. Such enhancements to the NASD's arbitration forum are expected to be the subject of future rule proposals.

In this connection, the NASD also plans to provide improved disclosure to employees of the effect of signing the Form U-4, their rights under the proposed rule, and the features of arbitration, so that they can make informed decisions.

Finally, the NASD intends to work with other regulators to consider expanded disclosure on the Form U-4 itself. Amendment to the Form U-4, an industry-wide form, requires the agreement of the SROs, the state regulatory authorities, and NASAA, as well as approval by the Commission. This process could take several months or longer.

(b) NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act in that the amendment will protect the public interest by allowing associated persons to choose whether to pursue their statutory claims of employment discrimination in court or in arbitration, and by improving parties' confidence in the arbitration process.

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

NASD Regulation 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

Not applicable.

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

Not applicable.

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 Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____
Joan C. Conley, Corporate Secretary

November 20, 1997

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-97-77)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Arbitration of Employment Discrimination Claims

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on , the NASD Regulation, Inc. ("NASD Regulation") 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 Regulation. 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 Regulation is proposing to amend Rule 10201 of the Code of Arbitration Procedure of the National Association of Securities Dealers, Inc. ("NASD" or "Association"), to remove the requirement to arbitrate claims of statutory employment discrimination. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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CODE OF ARBITRATION PROCEDURE

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10201. Required Submission

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(b) A claim alleging employment discrimination or sexual harassment in violation of a statute is not required to be arbitrated. Such a claim may be arbitrated only if the parties have agreed to arbitrate it, either before or after the dispute arose.

[(b)] (c) Any dispute, claim or controversy involving an act or failure to act by a clearing member; a registered clearing agency; or participants, pledgees, or other persons using the facilities of a registered clearing agency, under the rules of any registered clearing agency with which the Association has entered into an agreement to utilize the Association's arbitration facilities and procedures shall be arbitrated in accordance with such agreement and the rules of such registered clearing agency.

* * *

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 Regulation 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 Regulation 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) The proposed rule change will modify the current requirement that associated persons arbitrate all disputes arising out of their employment or termination of employment with a member broker/dealer. The proposed rule provides that associated persons are no longer required, solely by virtue of their association or their registration with the NASD, to arbitrate claims of statutory employment discrimination. Associated persons still will be required to arbitrate other employment-related claims, as well as any business-related claims involving investors or other persons.

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¹ The number of employment discrimination claims filed with the NASD rose from 4 in 1991 to 109 in 1996. The latter figure represents, however, less than two percent of all arbitration claims filed with the NASD in 1996.

² 17 C.F.R. ' 240.15b7-1. The rule provides as follows: "No registered broker or dealer shall effect any transaction in, or induce the purchase or sale of, any security unless any natural person associated with such broker or dealer who effects or is involved in effecting such transaction is registered or approved in accordance with the standards of training, experience, competence, and other qualification standards (including but not limited to submitting and maintaining all required forms, paying all required fees, and passing any required examinations) established by the rules of any national securities exchange or national securities association of which such broker or dealer is a member or under the rules of the Municipal Securities Rulemaking Board (if it is subject to the rules of that organization). "

³ The Form U-4 was adopted effective October 1, 1975.

⁴ From page 4 of the Form U-4 as revised in November 1991. A new version of the Form U-4 was approved by the Commission on July 5, 1996. Exchange Act Rel. No. 37407, 61 Fed. Reg. 36595 (July 11, 1996). Use of the revised form has been deferred pending related changes to the Central Registration Depository (CRD). Exchange Act Rel. No. 37994 (Nov. 27, 1996), 61 Fed. Reg. 64549 (Dec. 5, 1996). The substance of the quoted language was not changed in the revision.

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For industry and clearing controversies, Rule 10201 requires that all matters eligible under Rule 10101 be submitted to arbitration at the request of any member or associated person.⁵ Rules 10101 and 10201 were amended in 1993 to include the language relating to disputes “arising out of the employment or termination of employment” of an associated person. This language was added in order to clarify that employment disputes were required to be arbitrated, since a California court had held that the Code of Arbitration Procedure did not cover such disputes, but only covered disputes arising out of or in connection with business transactions.⁶ The Commission found the amendment to be consistent with Section 15A(b)(6) of the Act and approved the rule change.⁷

⁵ As one court explained, "Section 1 [now Rule 10101] defines the general universe of issues that may be arbitrated, and Section 8 [now Rule 10201] describes a subset of that universe that must be arbitrated under the Code." Armijo v. Prudential Ins. Co. of Am., 72 F.3d 793, 798 (10th Cir. 1995).

⁶ Higgins v. Superior Court of Los Angeles County, No. B057028 (Cal. App. Oct. 8, 1991), review denied and decision ordered not officially published, 1 Cal. Rptr. 2d 57 (1992). The state court noted the difference between the NYSE rule (at issue in the Supreme Court's Gilmer decision, discussed below), which refers to disputes arising out of the employment or termination of employment of an associated person, and the NASD rule, which at the time did not contain the phrase relating to employment. A federal court reached the same conclusion while the rule change was pending approval. Farrand v. Lutheran Bhd., 993 F.2d 1253 (7th Cir. 1993). The Association stated in its rule filing that the amendment was a clarification of existing intent rather than a new policy; some courts accepted this view, while other courts interpreted the rule amendment as a change in policy. See Kuehner v. Dickinson & Company, 84 F.3d 316, 320 n.1 (9th Cir. 1996) (describing splits in the Seventh, Tenth and Eleventh Circuits on this issue).

⁷ Exchange Act Rel. No. 32802 (Aug. 25, 1993), 54 SEC Docket 1814. In its order approving this change and a related change in the composition of arbitration panels to hear employment disputes, the Commission recognized that claims based on allegations of age, sex, or race discrimination, or relating to sexual harassment, were subject to the arbitration requirement.

Over the past several years, employees have raised several challenges to the mandatory arbitration of employment discrimination disputes. Such challenges were addressed by the Supreme Court in Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991).⁸ In Gilmer, which involved a person registered with the New York Stock Exchange, the Court examined many challenges to the adequacy of arbitration procedures raised by the registered representative and found that none was sufficient to prevent the Court from enforcing the representative's agreement, pursuant to his signing of the Form U-4, to arbitrate his federal age discrimination claim. Therefore, the Court held that Mr. Gilmer had not met his burden of showing that Congress intended to preclude arbitration of claims under the Age Discrimination in Employment Act of 1967.⁹

Subsequent to the Gilmer decision, courts have declined to find a Constitutional or statutory bar to enforcement of the agreement to arbitrate contained in the Form U-4.¹⁰ They have extended the reasoning of Gilmer to cover disputes arising under Title VII of the Civil Rights Act of 1964,¹¹ the Americans with Disabilities Act,¹² and state statutes of similar nature.¹³ Courts also have extended the application of Gilmer to the NASD, since

⁸ Those challenges included contentions that anti-discrimination laws are designed to further important social policies that should be addressed in a public forum, that arbitration panels may be biased, that discovery is more limited in arbitration than in court, that arbitrators often do not issue written opinions, that arbitration procedures do not provide for broad equitable relief and class actions, and that there is unequal bargaining power between employers and employees. The Court noted that most of these contentions were generalized attacks on arbitration that had been rejected in prior Supreme Court decisions. 500 U.S. at 30.

⁹ 500 U.S. at 35. The Court cited its earlier holding that, "So long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function." 500 U.S. at 28, quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 637 (1985).

¹⁰ The U.S. Court of Appeals for the Ninth Circuit has held that a registered person's waiver of the right to adjudication in court through signing of the Form U-4 must be "knowing" in order for the arbitration requirement to be enforced. Prudential Ins. Co. of Am. v. Lai, 42 F.3d 1299, 1305 (9th Cir. 1994), cert. denied, 116 S. Ct. 61 (1995). But see Prudential Ins. Co. of Am. Sales Prac. Litig., 924 F. Supp. 627, 642 (D.N.J. 1996) ("...Lai has been rather extensively criticized"), and cases cited therein.

¹¹ See, e.g., Alford v. Dean Witter Reynolds, Inc., 939 F.2d 229 (5th Cir. 1991).

¹² See, e.g., Austin v. Owens-Brockway Glass Container, Inc., 78 F.3d 875, 881 (4th Cir.), cert. denied, 117 S. Ct. 432 (1996).

¹³ See, e.g., Kaliden v. Shearson Lehman Hutton, Inc., 789 F. Supp. 179, 180 (W.D. Pa.

its rules are similar to the NYSE rule at issue in Gilmer.¹⁴ Nevertheless, registered persons and others have continued to challenge the requirement to arbitrate claims of statutory employment discrimination.¹⁵

Task Force Views

In January 1996, the NASD's Arbitration Policy Task Force (Task Force)¹⁶ released its Report on Securities Arbitration Reform. The Task Force's Report made numerous recommendations to improve the arbitration process. Since the Report was released, NASD Regulation has been engaged in a major effort to implement the Task Force recommendations.

Employment arbitration was not an area of major focus for the Task Force.¹⁷ The Task Force found, however, that such arbitration offers the advantages of speed and cost that are identified with customer arbitration, and observed that statutory discrimination claims are almost always interwoven with industry-specific issues. Moreover, the Task Force believed that arbitration's equitable approach to dispute resolution is fully capable of vindicating the important public rights expressed in the anti-discrimination statutes. The Task Force, therefore, found compelling reasons to keep employment-related disputes within NASD arbitration. The Task Force Report recommended that employment-related disputes, including statutory discrimination claims, remain eligible for arbitration with certain enumerated enhancements, many of which had been recommended elsewhere in the Report in the context of customer arbitration.¹⁸ The NASD intends to implement many of the recommended enhancements to its arbitration forum in the next year.¹⁹

1991).

¹⁴ See, e.g. Metz v. Merrill Lynch Pierce, Fenner & Smith, Inc., 39 F.3d 1482, 1488 (10th Cir. 1994).

¹⁵ See, e.g. Commission on Future of Worker-Management Relations ("Dunlop Commission"), Report and Recommendations 33 n.15 (1994); Equal Employment Opportunity Commission, Policy Statement on Mandatory Binding Arbitration of Employment Discrimination Disputes as a Condition of Employment n.2 (1997).

¹⁶ The NASD formed the Arbitration Policy Task Force in September 1994 for the purposes of studying the securities arbitration process administered by the NASD and of making suggestions for reform. The Task Force, chaired by David S. Ruder, former Chairman of the Securities and Exchange Commission, delivered its Report to the NASD Board in January 1996.

¹⁷ The Task Force directed its attention primarily to customer-member arbitration. See Task Force Report at 123.

¹⁸ The Task Force noted that employment arbitration, and in particular the issue of whether cases that raise statutory civil rights claims should remain subject to predispute arbitration agreements, is an area in which the law and commentary are rapidly evolving.

Controversy Surrounding the Issue

In the past year, there has been a great deal of activity and public discussion about the arbitration of employment discrimination disputes. In February of 1997, three members of Congress wrote to the SEC and questioned the authority of the NASD and other SROs to require arbitration of discrimination claims in employment disputes through an associated person's signing of the Form U-4.²⁰ Legislation was introduced this year in both the House and Senate²¹ that would prohibit employers and employees from entering into predispute arbitration agreements concerning claims of unlawful employment discrimination. Under the proposed legislation, the parties could agree, after a dispute arose, whether to resolve it by arbitration or to go to court.

Therefore, the Task Force recommended that the NASD closely monitor developments in employment arbitration and look to other sources in formulating future recommendations for the direction the NASD should pursue in this area. Task Force Report at 123 and n.164.

¹⁹ The Task Force recommended certain changes that would enhance the NASD's ability to handle employment-related arbitrations, including expanded arbitrator education, greater disclosure to registered persons, the inclusion of employment-related disputes in the early neutral evaluation pilot, and development of a list of documents that parties should produce during discovery for various kinds of employment-related claims. In addition, the Task Force felt that its other recommendations relating to early automatic document production, mediation, simplified arbitration, punitive damages, and list selection should apply to arbitration of employment-related disputes.

²⁰ Letter from Representatives Edward J. Markey, Anna G. Eshoo, and Jesse L. Jackson, Jr., to Arthur Levitt, Chairman, SEC (Feb 3, 1997). With regard to whether the mandatory arbitration requirement was within the scope of the NASD's authority, the Commission's response stated that sound arguments could be made on both sides of the issue. Letter from Chairman Levitt to Representative Markey (Mar. 17, 1997). The Commission acknowledged that the NASD rule requiring registered persons to arbitrate employment disputes was approved by the Commission as being consistent with the Act, and that it would not be unreasonable to conclude that SROs do have the authority to mandate the arbitration of discrimination claims, provided that fair procedures are in place. The response also acknowledged the concerns of the Equal Employment Opportunity Commission, members of Congress, and others about the special role of civil rights legislation. The Commission concluded that, given the self-regulatory scheme of the Act, it would be premature for the Commission to take any action, and suggested that it would defer expressing any conclusions until the matter was sent to the Commission by the NASD in the form of a proposed rule change.

²¹ H.R. 983 and S. 63, 105th Cong. (1997).

The NASD has received letters on this subject from groups with differing points of view, such as the Securities Industry Association, the Equal Employment Opportunity Commission (EEOC), the National Women's Law Center, the Women's Legal Defense Fund, the American Civil Liberties Union, the National Employment Lawyers Association, the National Association of Investment Professionals, several members of Congress, and attorneys representing parties in employment disputes.

Recent NASD Actions

To gather a wide assortment of views on this issue, NASD staff met with various groups and individuals, including national and regional member firms, members of NASD Regulation District Committees, attorneys representing employees and attorneys representing employers in employment litigation, members of the Bar of the City of New York Labor and Employment Committee, and staff of the New York Stock Exchange. In general, the groups from or representing the securities industry believed the current practice is fair, and that it is more cost-effective for all parties than going to court. The groups representing employees were unanimous in believing that the NASD and other SROs should remove the requirement for registered persons to arbitrate employment discrimination disputes as a condition of registration in the industry.

Many persons meeting with NASD staff recommended that the SROs adopt the Due Process Protocol endorsed by the American Bar Association and various dispute resolution organizations. Some attendees expressed a willingness to work with the SROs in revising the process if arbitration of discrimination claims were made voluntary.

In May 1997, NASD Regulation formed an Advisory Committee to assist it in reaching a decision on the outstanding questions. The Advisory Committee consisted of six persons of varying and distinguished backgrounds. The Advisory Committee held a meeting in Washington, D.C. on June 16, 1997 and invited to speak representatives of civil rights organizations, the EEOC, general counsels of member firms, attorneys who represent employees, representatives of employee organizations, and attorneys who represent member firms. Afterwards, the Committee spoke with neutral experts in the alternative dispute resolution field, and discussed the issues with NASD management and staff.

After consideration of all the views presented, and in light of the public perception that civil rights claims may present important legal issues better dealt with in a judicial setting, the NASD determined that the appropriate action was to remove the arbitration requirement for such claims, but to further improve the forum so that it is viewed by both registered employees and firms as the fairest and most efficient forum for resolving all employment disputes. In August 1997, proposals were presented to the NASD Regulation and NASD Boards, which authorized the proposed rule change.²²

²² The text of the proposed rule change was provided to the NASD Regulation Board at its meeting on September 22, 1997, and the NASD Board had an opportunity to review the final rule language at its meeting on October 9, 1997.

Details of the Proposed Rule Change

Paragraph (a) of the proposed rule adds a prefatory phrase indicating that the requirement to arbitrate employment disputes contains an exception, set forth in paragraph (b).

New paragraph (b) provides that claims alleging employment discrimination or sexual harassment in violation of a statute are not required to be arbitrated by NASD rules. This means that such claims may be filed in the appropriate court, if the employee chooses to do so and is not under a separate predispute obligation to arbitrate the dispute.²³ An employee also may agree to arbitrate after a dispute arises, and may choose to do so for a number of reasons.²⁴

Paragraph (b) applies only to claims alleging employment discrimination or sexual harassment²⁵ in violation of a statute.²⁶ Paragraph (b) does not apply to causes of action created solely by judicial precedents.²⁷ Similarly, it does not apply to other causes of action under state or federal law, which remain subject to mandatory arbitration under paragraph (a).

Paragraph (c) of the proposed rule is former paragraph (b), which is unchanged except for the renumbering.

²³ The NASD takes no position regarding private agreements between employees and firms to arbitrate employment disputes.

²⁴ The Task Force Report observed that arbitration of employment related disputes offers advantages in terms of speed and cost, and that arbitration's essentially equitable approach to dispute resolution is fully capable of vindicating the important public rights expressed in anti-discrimination statutes. Task Force Report at 119. Therefore, the NASD expects that many employees will continue to file their discrimination claims in arbitration if the proposed rule becomes effective, and the NASD intends to make further enhancements to its arbitration forum to make it even more attractive to parties.

²⁵ Sexual harassment has been held to be a form of sex discrimination, and thus a violation of Title VII. Meritor Savings Bank v. Vinson, 477 U.S. 57, 64 (1986).

²⁶ The term "statute" is intended to be interpreted in its broad sense, as defined in Black's Law Dictionary 1410 (6th ed. 1990): "A formal written enactment of a legislative body, whether federal, state, city, or county."

²⁷ Such judicially created causes of action might include, for example, claims alleging "wrongful discharge" without any accompanying claim of discrimination on account of age, sex, race, or other status protected by a specific law.

Effective Date and Related Issues

The NASD has requested that the proposed rule become effective one year from the date of Commission approval for several reasons. The NASD believes that a one year period from the date of Commission approval would permit employees and firms to determine what agreements they might wish to reach with regard to dispute resolution. During this period, the NASD will make related enhancements to the forum so that employees will have confidence that there are adequate procedures and safeguards of their rights in NASD arbitration. The NASD has formed an advisory working group to explore various options for the employment arbitration area, including additional due process standards, standard discovery lists, arbitrator list selection, and other related issues. It is expected that the working group will be able to provide advice to NASD management and the Boards during 1998. Such enhancements to the NASD's arbitration forum are expected to be the subject of future rule proposals.

In this connection, the NASD also plans to provide improved disclosure to employees of the effect of signing the Form U-4, their rights under the proposed rule, and the features of arbitration, so that they can make informed decisions.

Finally, the NASD intends to work with other regulators to consider expanded disclosure on the Form U-4 itself. Amendment to the Form U-4, an industry-wide form, requires the agreement of the SROs, the state regulatory authorities, and NASAA, as well as approval by the Commission. This process could take several months or longer.

(b) NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act²⁸ in that the amendment will protect the public interest by allowing associated persons to choose whether to pursue their statutory claims of employment discrimination in court or in arbitration, and by improving parties' confidence in the arbitration process.

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

NASD Regulation 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

²⁸ 15 U.S.C. ' 78o-3.

TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

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