

# Notice to Members

SEPTEMBER 2002

## SUGGESTED ROUTING

Legal & Compliance  
Registered Representatives  
Registration  
Senior Management

## KEY TOPICS

Arbitration  
Default Procedures  
Dispute Resolution  
Registration  
Suspension  
Termination

## New Default Procedures Rule

SEC Approves Default Procedures Regarding Suspended or Terminated Respondents Who Fail to Answer Arbitration Claims; **Effective October 14, 2002**

### Executive Summary

The Securities and Exchange Commission (SEC or Commission) has approved amendments to Rule 10314 of the NASD Code of Arbitration Procedure (Code) governing Initiation of Proceedings.<sup>1</sup> The amendments provide default procedures for situations in which a suspended, terminated or otherwise defunct member or associated person fails to answer in an arbitration proceeding, and the claimant nevertheless elects to pursue arbitration.

The text of the amendments as provided in Attachment A will apply to all claims filed on or after October 14, 2002.

### Questions/Further Information

Questions regarding this *Notice* may be directed to Jean I. Feeney, Chief Counsel and Associate Vice President, NASD Dispute Resolution, at (202) 728-6959, or [jean.feeney@nasd.com](mailto:jean.feeney@nasd.com).

### Discussion

NASD Dispute Resolution is providing default procedures for situations in which a suspended, terminated or otherwise defunct member or associated person fails to answer in an arbitration proceeding, and the claimant nevertheless elects to pursue arbitration. The procedures are designed to make it easier for claimants to obtain an award against a defunct, non-answering party, which award then can be enforced in court.

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## Background

The United States General Accounting Office (GAO) issued a report in June 2000 expressing concern over the number of unpaid arbitration awards issued in connection with arbitration proceedings in the securities industry arbitration forums, and making several recommendations for improvements.<sup>2</sup> The GAO Report observed that most of the unpaid awards resulted from broker/dealers that were no longer in business. In response to the GAO Report, NASD committed to undertake several initiatives to address the issue of unpaid awards. The proposed rule change will complete NASD Dispute Resolution's implementation of all initiatives.<sup>3</sup>

In 2001, NASD amended Rule 10301(a) to prohibit a member firm whose membership has been terminated, suspended, canceled, or revoked, or that has been expelled from NASD, or that is otherwise defunct, from enforcing a predispute arbitration agreement against a customer in the NASD forum, unless the customer agrees to arbitration in writing after the claim has arisen. That rule change also provided that, before serving a customer claim against a member firm, NASD will notify the customer if the member firm falls into one of the enumerated categories, so customers can make an informed decision regarding whether to proceed in arbitration, to file their claim in court, or to take no action. Therefore, claims against defunct members now proceed in arbitration only at the customer's option.

## New Default Procedures

In line with the GAO's recommendations, the new rule is designed to make it easier for claimants to obtain an award against a defunct, non-answering member or associated person. The rule applies to all categories of claimants, whether they are customers, associated persons, or member firm claimants that are bringing a claim against a defunct member or associated person. It does not apply to customer respondents, nor does it apply to respondent members or associated persons that are not defunct, as defined in Rule 10314(e).

Under the new default procedures, if a respondent is an associated person whose registration is (1) terminated, revoked, or suspended; (2) a member whose membership has been terminated, suspended, canceled, or revoked; (3) a member that has been expelled from NASD; or (4) a member that is otherwise defunct, (collectively referred to in this *Notice* as "defunct") and that respondent fails to answer the claim in a timely manner,<sup>4</sup> the claimant may elect to proceed under optional default procedures as to the defunct respondent. If there are several claimants, all must agree to use default procedures before they can be used. If the same attorney represents all claimants, a letter from the attorney agreeing on behalf of all claimants is sufficient.

Default procedures may be used against one or more defunct, non-answering respondents while the rest of the initial arbitration proceeds against any remaining respondents under regular procedures. (See the discussion below on additional considerations in divided or "bifurcated" proceedings.)

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Defunct respondents who file an answer are not subject to the default procedures rule. Suspended or terminated associated persons and members should be aware that they remain subject to the filing of an arbitration claim against them for conduct that occurred while they were associated persons or members. Therefore, it is essential that they maintain a current address in the Central Registration Depository (CRD®) to ensure prompt notice of claims.<sup>5</sup>

If the claimant opts to use default procedures, the case against the defunct, non-answering respondent will proceed with a single arbitrator without a hearing. NASD will continue to send notices to the respondent until the conclusion of the case.<sup>6</sup>

The arbitrator in the default case will make a decision based upon the Statement of Claim and any other material submitted by the claimant. The arbitrator may request additional information from the claimant before rendering an award. No hearing will be held. In keeping with the streamlined nature of the procedures, neither the claimant nor the single arbitrator will have the option to ask that two additional arbitrators be appointed to decide the case.

The default procedures have several provisions to safeguard the integrity of the process and discourage abuses:

- ▶ The claimant may not amend a claim to increase the relief requested after the staff has notified the parties that the claim will proceed under default procedures.
- ▶ An arbitrator may not make an award based solely on the non-appearance of a respondent.

The claimant's materials must present a sufficient basis to support the making of an award in its favor.

- ▶ The arbitrator may not award damages in an amount greater than the damages requested in the Statement of Claim, and may not award any other relief that was not requested in the Statement of Claim.

The above safeguards apply only to the claim that is subject to default procedures. If another part of the original claim is proceeding under regular procedures, then the normal Code provisions apply.

Finally, if a respondent thought to be defunct belatedly files an answer after the staff has notified the parties that the claim will proceed under default procedures but before an award has been rendered in the default case, the default procedures will be terminated, and the case will proceed under the regular procedures.<sup>7</sup> As noted below, however, the late-answering respondent may have missed the opportunity to select the panel, and may be barred from presenting certain matters at the hearing.

## Bifurcated Proceedings

Default procedures may be used against one or more defunct respondents while the rest of the initial arbitration proceeds against any remaining respondents. This splitting of the original case is known as "bifurcation." If a case is to be bifurcated and handled under two different procedures, regular and default, each proceeding will be assigned a separate arbitration case number to avoid confusion. Rule 10314(e) provides that the default award will have no effect on any non-defaulting party.

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If the regular case is to be decided by a single arbitrator, that same arbitrator will decide the default case. If the regular case is to be decided by a panel of three arbitrators, then the chair of the panel will serve as the single arbitrator for the default proceeding.

If a respondent in a default case belatedly files an answer, the respondent will join the regular case where the respondent finds it. That is, if a panel already has been selected, the respondent must accept that panel without input into its selection, subject only to a challenge for cause. If a prehearing conference or hearing session has been held, the late-answering respondent must deal with what has gone on before unless the respondent successfully moves the panel for relief. Finally, Rule 10314(b)(2)(C) provides that a respondent who fails to file an answer within 45 calendar days from receipt of service of a claim, unless the time to answer has been extended, "may, in the discretion of the arbitrators, be barred from presenting any matter, arguments, or defenses at the hearing."

## Fees

Claimant already will have paid a nonrefundable filing fee and hearing session deposit when the original case was filed, and a nonrefundable member surcharge and process fees will have been assessed against the appropriate member at the same time, so no new fees will be due at the commencement of the default case. Since the default case will not involve a hearing, NASD will charge only the Deposit for Cases to Be Decided on the Paper Record as shown in Rule 10332(k), which ranges from \$25 to a maximum of \$300 for cases involving more than \$10,000 (NASD will cap this

fee at \$300 for default cases, even if the dispute is for over \$25,000). At the conclusion of the default case, the arbitrator may allocate the forum fees between or among the parties as usual, and the claimant may be issued a hearing deposit refund. When a case is bifurcated, there will be no additional fees for the default case.

## Effective Date

The amendments described in this *Notice* will apply to all claims filed on or after October 14, 2002.

## Endnotes

- 1 Exchange Act Release No. 46221 (July 17, 2002) (File No. SR-NASD-2002-15), 67 Federal Register 48237 (July 23, 2002).
- 2 The report is entitled, "Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards" ("GAO Report"), Report No. GAO/GGD-00-115 (June 2000), available online at [www.gao.gov](http://www.gao.gov).
- 3 See *Notices to Members 00-55* and *01-29* for information on prior initiatives.
- 4 Default procedures may be used when a defunct respondent fails to answer within the standard 45-day period provided in Rule 10314(b). In Simplified Arbitration (for claims not exceeding \$25,000), respondents have only 20 days to answer. Simplified cases already proceed on the papers with a single arbitrator; however, in the event that a claimant in a simplified case wishes to use the default procedures instead of the simplified procedures, the claimant may do so after waiting for the 45-day period to pass.
- 5 As explained in *Notice to Members 99-77*, both current and former associated persons must keep their addresses in CRD current in order to receive mailings from NASD. Such mailings will be sent to the associated person's last address in NASD's records, and are considered to have been received at that address, whether or not the individual has actually received them.

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Therefore, associated persons who have failed to update their addresses after termination may have a default decision issued against them in disciplinary proceedings. The same presumption of the accuracy of CRD addresses will apply in the context of default arbitration procedures.

- 6 Since Rule 10314(e)(7) provides for the possibility that a defunct respondent may file a late answer, which terminates the default procedures as to that respondent, three arbitrators will be chosen for cases that would otherwise require a three-person panel under Rule 10308, to eliminate delay in the event that a full three-person panel is needed later. However, only the chair will participate in the default case.
- 7 For this purpose, NASD will define the date “rendered” as the date when the award is served on the parties pursuant to Rule 10314(c)(1).

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## ATTACHMENT A

New language is underlined.

### Code of Arbitration Procedure

#### 10314. Initiation of Proceedings

Except as otherwise provided herein, an arbitration proceeding under this Code shall be instituted as follows:

(a) No change.

**(b) Answer – Defenses, Counterclaims, and/or Cross-Claims**

(1) No change.

(2) (A) - (B) No change.

(C) A Respondent, Responding Claimant, Cross-Claimant, Cross-Respondent, or Third-Party Respondent who fails to file an Answer within 45 calendar days from receipt of service of a Claim, unless the time to answer has been extended pursuant to subparagraph (5), below, may, in the discretion of the arbitrators, be barred from presenting any matter, arguments, or defenses at the hearing. Such a party may also be subject to default procedures as provided in paragraph (e) below.

(3) - (4) No change.

(5) No change.

(c) - (d) No change.

(e) Default Procedures

(1) A Respondent, Cross-Respondent, or Third-Party Respondent that fails to file an Answer within 45 calendar days from receipt of service of a Claim, unless the time to answer has been extended pursuant to paragraph (b)(5), may be subject to default procedures, as provided in this paragraph, if it is:

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(A) a member whose membership has been terminated, suspended, canceled, or revoked;

(B) a member that has been expelled from the NASD;

(C) a member that is otherwise defunct; or

(D) an associated person whose registration is terminated, revoked, or suspended.

(2) If all Claimants elect to use these default procedures, the Claimant(s) shall notify the Director in writing and shall send a copy of such notification to all other parties at the same time and in the same manner as the notification was sent to the Director.

(3) If the case meets the requirements for proceeding under default procedures, the Director shall notify all parties.

(4) The Director shall appoint a single arbitrator pursuant to Rule 10308 to consider the Statement of Claim and other documents presented by the Claimant(s). The arbitrator may request additional information from the Claimant(s) before rendering an award. No hearing shall be held, and the default award shall have no effect on any non-defaulting party.

(5) The Claimant(s) may not amend the claim to increase the relief requested after the Director has notified the parties that the claim will proceed under default procedures.

(6) An arbitrator may not make an award based solely on the non-appearance of a party. The party who appears must present a sufficient basis to support the making of an award in that party's favor. The arbitrator may not award damages in an amount greater than the damages requested in the Statement of Claim, and may not award any other relief that was not requested in the Statement of Claim.

(7) If the Respondent files an Answer after the Director has notified the parties that the claim will proceed under default procedures but before an award has been rendered, the proceedings under this paragraph shall be terminated and the case will proceed under the regular procedures.