

Notice to Members

JANUARY 2005

SUGGESTED ROUTING

Legal & Compliance
Senior Management

KEY TOPICS

Arbitration
Books and Records
Predispute Arbitration Agreements

GUIDANCE

Predispute Arbitration Agreements

NASD Amends Rule Governing Predispute Arbitration Agreements with Customers; **Effective Date: May 1, 2005**

Executive Summary

The Securities and Exchange Commission (SEC) has approved amendments to NASD Rule 3110(f) that require firms to modify their predispute arbitration agreements with customers to provide enhanced disclosure about the arbitration process.¹ The amendments also: require members to provide copies of predispute arbitration agreements and relevant arbitration forum rules to customers upon request; clarify the use of certain limiting provisions; and require firms seeking to compel arbitration of claims initiated in court to arbitrate all of the claims contained in the complaint if the customer so requests. Rule 3110(f), as amended, is attached as Attachment A (new language is underlined; deletions are in brackets).

The effective date of this rule change is **May 1, 2005**. Predispute arbitration agreements will be governed by the version of Rule 3110(f) in effect at the time the agreement was executed, except that Rule 3110(f)(3) as amended applies to all new and existing agreements.

Questions/Further Information

Questions regarding this *Notice* can be directed to Laura Gansler, Assistant General Counsel, Regulatory Policy and Oversight, at (202) 728-8275 or laura.gansler@nasd.com; or Jean I. Feeney, Vice President and Chief Counsel, Dispute Resolution, at (202) 728-6959 or jean.feeney@nasd.com.

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Background and Discussion

Many broker-dealers require that customers seeking to open accounts, particularly margin and option accounts or accounts with a checking or money market feature, agree in writing to arbitrate disputes concerning the account, typically in a forum sponsored by a self-regulatory organization (SRO). To ensure that customers are advised about what they are agreeing to when they sign predispute arbitration agreements, NASD Rule 3110(f)(1) requires that such agreements contain highlighted disclosure about the differences between arbitration and litigation, including notice that by agreeing to arbitrate their disputes, customers may be waiving certain rights that would be available in court.

Despite these precautions, investor groups have expressed concern that the current disclosure is inadequate, and is not written in plain English. To address these concerns, NASD has amended Rule 3110(f)(1) to make the required disclosure easier to understand, and to include new disclosure that the rules of some arbitration forums may impose time limits for bringing claims in arbitration, and that, in some cases, claims that are ineligible for arbitration may be brought in court. The amendment also requires that the agreement clearly state that the parties agree that the rules of the arbitration forum in which a claim is brought, and any amendments thereto, are incorporated into the parties' agreement. This provision is intended to ensure that the rules of a forum apply to cases brought in that forum and eliminate the need to execute new agreements each time a forum changes its rules. Accordingly, if a customer files a complaint in the NASD arbitration forum, NASD's arbitration rules would apply in all respects to the agreement.

Firms are required to use the new disclosure language in all new customer account agreements containing predispute arbitration agreements as of **May 1, 2005**. The rule change does not require firms to modify or replace existing agreements with current customers. The specific language that must be used, and the manner in which it must be presented, is found in Rule 3110(f)(1)(A)-(G), as amended.

Delivery and Acknowledgment of Predispute Arbitration Clause at Time of Signing

NASD Rule 3110(f)(2) requires that predispute arbitration agreements contain a highlighted statement indicating that the agreement contains an arbitration clause and specifying at what page and paragraph the arbitration clause is located. It also requires that firms provide a copy of the predispute arbitration agreement to the customer, who must in turn acknowledge receipt of the agreement in writing, either on the agreement itself or on a separate document. However, the rule was vague as to when the delivery and acknowledgement must occur. New paragraph (f)(2)(B) of Rule 3110 makes clear that the delivery and customer acknowledgement of the agreement must take place at the time of signing.

New Requirement That Members Provide Copies of Customer Agreements and Information Regarding Arbitration Forums to Customers upon Request

In addition to the delivery requirement at the time of signing, Rule 3110(f)(3) has been amended to require that, within ten days of receiving a customer request, firms must provide the customer with a copy of any predispute arbitration agreement clause or agreement that the customer had signed. NASD has learned that in some instances, firms were refusing to provide copies of agreements to customers who requested them after a dispute arose, making it difficult for customers who had misplaced their original copies to assess their rights and obligations under the agreement. The provision also requires that, if a firm does not have a copy of an agreement requested by a customer, it must inform the customer of that fact. NASD fully expects firms to retain copies of such agreements, as required by NASD rules. However, if for some reason, whether through an act of nature, human error, or otherwise, a member is unable to comply with the customer's request, Rule 3110(f)(3), as amended, requires firms to inform the customer of that fact, rather than simply failing to respond to the customer's request.

Restrictions on Provisions That Limit Rights and Remedies

Rule 3110(f)(4)(A) currently prohibits the use of provisions in predispute arbitration agreements that limit a customer's rights or remedies, or limit the ability of an arbitrator to make an award. To amplify on this provision, the amendments provide that predispute arbitration agreements may not include any condition that would: (i) limit or contradict the rules of any SRO; (ii) limit the ability of a party to file any claim in arbitration; (iii) limit the ability of a party to file any claim in court that could otherwise be filed in court under the rules of the forum(s) in which a claim may be filed under the agreement; or (iv) limit the ability of arbitrators to make any award. These amendments are intended to, among other things, address provisions that attempt to circumvent NASD Rule 10304, governing the eligibility of claims in arbitration.

NASD originally proposed to include a provision explicitly prohibiting the use of arbitrary choice-of-law provisions in predispute arbitration agreements in order to indirectly deprive customers of rights and remedies to which they would otherwise be entitled under applicable state law. However, after reviewing the numerous comments received by the SEC on the proposal, NASD concluded that the proposed provision could be interpreted to undermine protections currently afforded investors under state law. Therefore, NASD withdrew the provision, but reminds firms that, as it has in the past, NASD will continue to interpret Rule 3110(f)(4)(A) to require that, if a choice-of-law provision is used, there must be an adequate nexus between the law chosen and the transaction or parties at issue in accordance with *NASD Notices to Members 95-85* and *95-16*.

Non-Bifurcation Provision

NASD has also amended Rule 3110(f) to require members seeking to compel arbitration of claims filed in court to agree to arbitrate all of the claims contained in the complaint if the customer so requests, even if some of the claims would otherwise be ineligible for arbitration under NASD Rule 10304. The SEC also has approved NASD's proposal to amend Rule 10304 to provide that, by requesting dismissal of a claim on eligibility grounds in the NASD forum, the requesting party is agreeing that the party that filed the dismissed claim may withdraw all related claims without prejudice and may pursue all of the claims in court.² The purpose of these two provisions is to protect investors against involuntary bifurcation of claims.

Effective Date Provisions

The amendments to NASD Rule 3110(f) require various changes to the customer agreements used by NASD member firms. In order to provide enough time for firms to modify customer agreements, the rule change will take effect on **May 1, 2005**, which is 90 days from the date of this *Notice*. The rule change does not require changes to existing agreements. Predispute arbitration agreements will be governed by the version of Rule 3110(f) in effect at the time the agreement was executed, except that Rule 3110(f)(3) as amended applies to all new and existing agreements.

Endnotes

- 1 SEC Rel. No. 34-50713 (Nov. 22, 2004), 69 Fed. Reg. 70293 (Dec. 3, 2004) (SR-NASD-98-74).
- 2 Specifically, NASD has amended Rule 10304 to provide explicitly that arbitrators, rather than the courts, determine the eligibility of claims, and that a party requesting dismissal of a claim on eligibility grounds in NASD's forum agrees that the party that filed the dismissed claim may withdraw all related claims without prejudice and may pursue all of the claims in court. Claims filed in court pursuant to this rule would still be subject to applicable statutes of limitation. See SEC Rel. No. 34-50714 (Nov. 22, 2004), 69 Fed. Reg. 69971 (Dec. 1, 2004) (SR-NASD-2003-101). See also *Notice to Members 05-xx*.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

3000. RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS, EMPLOYEES, AND OTHERS' EMPLOYEES

3110. BOOKS AND RECORDS

(f) Requirements When Using Predispute Arbitration Agreements [With] for Customer Accounts

(1) Any predispute arbitration agreement clause shall be highlighted and shall be immediately preceded by the following [disclosure] language [(printed) in outline form [as set forth herein) which shall also be highlighted]. This agreement contains a predispute arbitration clause. By signing an arbitration agreement the parties agree as follows:

(A) [Arbitration is final and binding on the parties.]All parties to this agreement are giving up the right to sue each other in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed.

(B) [The parties are waiving their right to seek remedies in court, including the right to a jury trial.]Arbitration awards are generally final and binding; a party's ability to have a court reverse or modify an arbitration award is very limited.

(C) [Pre-arbitration discovery is generally more limited than and different from court proceedings.]The ability of the parties to obtain documents, witness statements and other discovery is generally more limited in arbitration than in court proceedings.

(D) [The arbitrators' award is not required to include factual findings or legal reasoning and any party's right to appeal or seek modification of rulings of the arbitrators is strictly limited.]The arbitrators do not have to explain the reason(s) for their award.

(E) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

(F) The rules of some arbitration forums may impose time limits for bringing a claim in arbitration. In some cases, a claim that is ineligible for arbitration may be brought in court.

(G) The rules of the arbitration forum in which the claim is filed, and any amendments thereto, shall be incorporated into this agreement.

(2) (A) [Immediately preceding the signature line,]In any agreement containing a predispute arbitration agreement, there shall be a highlighted statement immediately preceding any signature line or other place for indicating agreement [which shall be highlighted] that states that the agreement contains a predispute arbitration clause. The statement shall also indicate at what page and paragraph the arbitration clause is located.

(B) At the time of signing, a copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document.

(3) [A copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document.]

(A) A member shall provide a customer with a copy of any predispute arbitration clause or customer agreement executed between the customer and the member, or inform the customer that the member does not have a copy thereof, within ten business days of receipt of the customer's request.

(B) Upon request by a customer, a member shall provide the customer with the names of, and information on how to contact or obtain the rules of, all arbitration forums in which a claim may be filed under the agreement.

(4) [No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.] No predispute arbitration agreement shall include any condition that:

(i) limits or contradicts the rules of any self-regulatory organization;

(ii) limits the ability of a party to file any claim in arbitration;

(iii) limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement;

(iv) limits the ability of arbitrators to make any award.

(5) [The requirements of subparagraphs (1) through (4) shall apply only to new agreements signed by an existing or new customer of a member after September 7, 1989.] If a customer files a complaint in court against a member that contains claims that are subject to arbitration pursuant to a predispute arbitration agreement between the member and the customer, the member may seek to compel arbitration of the claims that are subject to arbitration. If the member seeks to compel arbitration of such claims, the member must agree to arbitrate all of the claims contained in the complaint if the customer so requests.

(6) All agreements shall include a statement that “No person shall bring a putative or certified class action to arbitration, nor seek to enforce any predispute arbitration agreement against any person who has initiated in court a putative class action; or who is a member of a putative class action who has not opted out of the class with respect to any claims encompassed by the putative class action until: (i) the class certification is denied; or (ii) the class is decertified; or (iii) the customer is excluded from the class by the court. Such forbearance to enforce an agreement to arbitrate shall not constitute a waiver of any rights under this agreement except to the extent stated herein.”

(7) [The requirements of subparagraph (6) shall apply only to new agreements signed by an existing or new customer of a member after October 28, 1993.]The provisions of this Rule shall become effective on (effective date). The provisions of subparagraph (3) shall apply to all members as of the effective date of this Rule regardless of when the customer agreement in question was executed. Otherwise, agreements signed by a customer before (effective date) are subject to the provisions of this Rule in effect at the time the agreement was signed.

(g) - (h) Unchanged.