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September 4, 1998

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

Re: **File No. SR-NASD-98-48, Amendment No. 4, Proposed Rule Change to Amend the Method of Selecting Arbitrators in Customer Disputes Response to Comments**

Dear Ms. England:

Pursuant to Rule 19b-4, the National Association of Securities Dealers, Inc. ("NASD") and NASD Regulation, Inc. ("NASD Regulation") (collectively, the "Association") file this letter as Amendment No. 4 to SR-NASD-98-48. The Association is also responding to the two comment letters filed regarding the proposed rule change. (*See* letters from Scot D. Bernstein, Esq., Sacramento, California, dated August 19, 1998 ("Commenter 1"), and Stephen G. Sneeringer, Chairman, Securities Industry Association ("SIA") Arbitration Committee, SIA, dated August 19, 1998 ("Commenter 2"), attached as Exhibit A.)

A. Proposed Rule Changes

The following are proposed amendments to the rule filing. The first two amendments are proposed as a result of changes suggested in the comment letters. The changes are Amendment No. 4 to SR-NASD-98-48.

1. Chairperson.

Commenter 1 suggests that the Association amend proposed Rule 10308(c)(5) regarding the appointment of a chairperson by the Director when the parties do not select a chairperson. The commenter suggests that the proposed rule provide that the Director will appoint the highest ranked public arbitrator as the chairperson in such circumstances. The Association agrees. In addition, Commenter 1 advocates the elimination of the standard now set forth in proposed Rule 10308(c)(5) that would exclude persons from serving as chairperson who represent certain investor interests. The Association does not believe it is appropriate to eliminate the exclusions from proposed paragraph (c)(5) entirely, but in order to implement Commenter 1's first suggestion, the Association proposes to amend proposed Rule 10308(c)(5) to read as follows:

(5) Selecting a Chairperson for the Panel

The parties shall have 15 days from the date the Director sends notice of the names of the arbitrators to select a chairperson. If the parties cannot agree, the Director shall appoint [one of the public arbitrators as the chairperson. Unless all parties agree otherwise, the Director shall not appoint as the chairperson a public arbitrator who: (A) is an attorney, accountant, or other professional, and (B) has devoted 50% or more of his or her professional or business activities, within the last two years, to representing or advising public customers in matters relating to disputed securities or commodities transactions or similar matters.] a chairperson from the panel as follows:

(A) The Director shall appoint as the chairperson the public arbitrator who is the most highly ranked by the parties as long as the person is not an attorney, accountant, or other professional who has devoted 50% or more of his or her professional or business activities, within the last two years, to representing or advising public customers in matters relating to disputed securities or commodities transactions or similar matters.

(B) If the most highly ranked public arbitrator is subject to the exclusion set forth in subparagraph (A), the Director shall appoint as the chairperson the other public arbitrator, as long as the person also is not subject to the exclusion set forth in subparagraph (A).

(C) If both public arbitrators are subject to the exclusion set forth in subparagraph (A), the Director shall appoint as the chairperson the public arbitrator who is the most highly ranked by the parties.

2. Consolidation of Ranking of Claimant with Other Claimants, Respondent with Other Respondents.

Commenter 1 indicates that the Association's proposed Rule 10308(c)(3)(B) provides certain parties, particularly respondents, the potential to unfairly weight the arbitration panel if the Director determines that a party respondent has a "sufficiently different" interest from other party respondents. The Association agrees generally that all claimants' rankings should be consolidated, and all respondents' rankings should be consolidated. Accordingly, the Association proposes to delete subparagraph (B) from proposed Rule 10308(c)(3); the paragraph will read as follows:

(3) Process of Consolidating Parties' Rankings

[(A) General Rule]The Director shall prepare one or two consolidated lists of arbitrators, as appropriate under paragraph (b)(2) or (b)(3), based upon the parties' numerical rankings. The arbitrators shall be ranked by adding the rankings of all claimants together and all respondents together, including third-party respondents, to produce separate consolidated rankings of the claimants and the respondents. The Director shall then rank the arbitrators by adding the consolidated rankings of the claimants, the respondents, including third-party respondents, and any other party together, to produce a single consolidated ranking number, excluding arbitrators who were stricken by any party.

[(B) Exception If the Director determines that the interests of a party are sufficiently different from the interests of other claimants or respondents, the Director may determine not to consolidate the rankings of that party with the rankings of the other claimants or respondents.]

3. Proposed Change to Rule 10313.

The Association proposes to amend the first sentence of Rule 10313 to clarify that the time period during which the Director may disqualify an arbitrator and the period following, during which the arbitrator(s) makes decisions relating to the

arbitration proceeding, including an arbitrator's decision to resign because of conflicts of interest or bias, are the same periods set forth in the previously proposed revisions to Rule 10312 and Rule 10315. Accordingly, the first sentence of Rule 10313 is proposed to read as follows:

> **Rule 10313. Disqualification or Other Disability of Arbitrators**
>
> In the event that any arbitrator, after the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing [session]but prior to the rendition of the award, should become disqualified, resign, die, refuse or otherwise be unable to perform as an arbitrator, the remaining arbitrator(s) shall continue with the hearing and determination of the controversy, unless such continuation is objected to by any party within 5 days of notification of the vacancy on the panel.

4. Effectiveness of the Proposed Rule Change.

As stated in the Association's original rule filing, the Association intends to make the rule change effective on a date to be stated in a Notice to Members ("NTM"). Depending on the date of the Commission's approval, however, the effective date may be less than 30 days following publication of the NTM announcing the Commission's approval. When effective, the rule changes will apply to any arbitration case filed with the Association if the Association has not mailed or otherwise transmitted to the parties a notice stating the names of the arbitrators appointed to hear the arbitration.

a. A case will be subject to current Rule 10308 for the purpose of selecting an arbitration panel, if, before the effective date of the rule change, the Association identifies the arbitrator (in a case having one arbitrator) or the three-arbitrator panel (in a case having three arbitrators) and mails or otherwise transmits a letter or other written communication to the parties notifying the parties of the names of the arbitrators. As of the effective date, the newly adopted changes to all other rules will apply to the case (*e.g.*, amendments to Rule 10104, Rules 10309 through 10313, and Rule 10315), as will those parts of newly adopted Rule 10308 relating to the actions or functions to be performed after a panel is appointed (initially) if such actions or functions can be performed without reference to party ranking of arbitrators. (*See, e.g.*, proposed Rule 10308 (c)(5) regarding selecting a chairperson. The parties will be allowed by agreement to select a chairperson; however if the parties did not select a chairperson by agreement, the Director will exercise authority under newly adopted Rule 10308(e) in order to select a chairperson because the Director will not have party rankings of arbitrators to rely upon and, thus, will not be able to act in accordance with certain paragraph (c)(5) provisions.)

b. A case will be subject to newly adopted Rule 10308 if, as of the rule change effective date, the Association has not mailed or otherwise transmitted a letter or other written communication to the parties notifying the parties of the names of the arbitrators appointed to hear the arbitration. In this instance, the other newly adopted rule changes will also apply to the case as of the effective date.

The Association believes that this is the most appropriate approach to provide the benefits of list selection to the greatest number of parties as quickly as possible. List selection provides the parties additional input into the arbitration proceeding; the Association believes that applying the new process for the appointment of arbitrators to certain cases filed shortly before the date of effectiveness will provide the benefits to such parties. Moreover, the Association does not believe that any party will suffer an unfair surprise if the list selection rule and the other rule changes are applied to an arbitration filed prior to the effective date. Finally, in order to implement the proposed rule change, the Association must make a number of operational changes. The administrative burdens of fully implementing the list selection process nationwide are many, and the Association believes that the benefits of implementing the new procedures rapidly and system-wide outweigh the benefits, if any, obtainable from continued use of the old system.

B. Post-Implementation Review

The following are comments that the Association believes should not be implemented presently. Instead, the Association requests that proposed Rule 10308 be approved as proposed. The Association will consider the following suggested changes after the staff has had experience with proposed Rule 10308.

1. Unlimited Number of Strikes and Number of Arbitrators on Lists.

The Association specifically requested comment on whether a party should have an unlimited number of strikes. Commenter 1 suggests that the Association limit the number of strikes that each party may exercise because the right to exercise an unlimited number of strikes allows a party to disable an important part of the new rule by eliminating the parties' rights to have their preferences for certain arbitrators count as the most significant factor in the process of appointing arbitrators. (By eliminating all listed arbitrators by striking them, a party then triggers the Director's obligation to appoint an arbitration panel using arbitrators not previously reviewed and ranked by the parties.) The Association has considered the comment and, although the Association believes that the unlimited strike right may be used to accomplish this end, the Association declines to amend the rule proposal at this time. Instead, the Association

believes that the proposed rule should be implemented as proposed and the Association should monitor how often the Director appoints arbitrators not previously reviewed and ranked by the parties to a panel because one or both parties have struck every arbitrator listed. If the Director is obligated to appoint unranked arbitrators to arbitration panels frequently because of parties exercising their unlimited strike rights, the Association will revisit the issue of limiting the number of strikes that a party may exercise.

2. Two Rounds.

Commenter 1 requested that a second round of list selection should be incorporated in proposed Rule 10308 if the first round fails to provide the number of arbitrators needed to appoint the appropriate a panel. The Association previously declined to propose a list selection rule that included two rounds of lists and does not believe it would be appropriate to do so now
because of the scarcity of arbitrators in certain locations, the substantially greater costs, and the significant additional delays in empaneling an arbitrator or an arbitration panel when using a two round list selection process. After the Association has had experience administering Rule 10308 as proposed, the Association will reconsider whether the process should be amended to include additional rounds of list selection.

3. Expansion of Subject Matter Expertise and Securities Categories.

Commenter 1 asks that "due diligence" be included as a topic in subject matter expertise and that "limited partnerships" be included as a topic in securities categories. "Limited partnerships" is a category currently under "securities" expertise. Because the Association is implementing the proposed list selection rule at this time, the Association wishes to defer receiving proposals to expand the various types of expertise categorized and tracked in the Neutral List Selection System ("NLSS") until a later date. The Association notes, however, that "due diligence" is a topic that is both too broad and too vague to be entered into NLSS as a category of subject matter expertise. However, the category, "underwriting," is currently included under subject matter expertise.

C. Response to Other Comments

1. Number of Arbitrators on List.

Commenter 1 also suggests that proposed Rule 10308 contain a provision for the minimum number of arbitrators (*i.e.*, the list for public arbitrators should contain not less than 12 arbitrators and the list for non-public arbitrators should contain not less than six arbitrators). The Association believes that the current proposal to provide, whenever possible, a list of 10 public arbitrators, and a second list of five non-public

arbitrators to the parties provides a sufficiently large number of arbitrator choices and provides a standard that will generally be attainable, even in arbitration locations where there are fewer arbitrators available for listing.

2. Rule Text Should Include More.

Commenter 1 requests that certain explanatory text in the rule filing be incorporated in the rule. This comment includes a number of items (conflicts-of-interest checks, Director's standard to disqualify, NLSS software operation, including selection rules, number of arbitrators on the list, arithmetic method for consolidating rankings, and how divergent interests will be treated).

First, the Association has stated the basic operational aspects of the rule in the rule text. It is not appropriate to describe all of the operational details relating to the NLSS software in the rule text or in the rule filing; to do so would make the rule very unclear and confusing to all but a few readers. However, the Assocation has described in general and clear terms those aspects of the NLSS that are essential functions of the proposed list selection rule.

Second, the arithmetic method that will be used for consolidating rankings was explained in a detailed, multi-part example. The Association does not believe that the rule text would be clearer by incorporating examples of calculations in the text.

Third, the Association has explained in detail in the rule filing its aspirations regarding providing parties with a certain number of listed arbitrators. However, as discussed above, the Association declines to provide an exact minimum number of arbitrators to be provided in the proposed rule because the number of available arbitrators varies greatly from place to place.

Fourth, Commenter 1 suggests that under proposed Rule 10308 the Association addresses only conflicts-of-interest based upon current employment and does not consider those conflicts that may arise based upon the past employment of an arbitrator or a party. The Association wishes to clarify that the rule filing indicates that the *initial* conflict-of-interest review, which is the review performed by NLSS, is limited to readily apparent conflicts of interest, such as whether the arbitrator is currently employed by, or currently has a securities account with, the respondent, but that there are subsequent checks performed by the Director that include all possible relationships, including past employment, that allow the Director to determine whether an arbitrator suffers from a conflict of interest and must not be appointed or must be disqualified after appointment.

Fifth, as discussed in greater detail below, the Association declines to state in proposed Rule 10308 a standard by which the Director will judge claims of an arbitrator's conflict of interest. The Director applies the facts as presented to assess whether a bias or a conflict of interest is present or may be present. The present Code of Arbitration does not contain an express standard. (The Association's treatment of divergent interests (among respondents or claimants) was addressed above in this response to comments and as part of Amendment No. 4.)

3. Publication of Rotation of Names.

Commenter 1 asks for the publication on an ongoing basis of the rotation of arbitrator names. The Association declines to publish these names; this would create an enormous administrative burden. The NLSS and the new list selection process are subject to review internally (*e.g.,* the Audit Committee, a committee of independent Governors of the NASD Board of Governors, to which the NASD's Office of Internal Review reports) and SEC oversight. Questions regarding the operational integrity of the NLSS will be addressed through these processes.

4. Persons Defined as an "Immediate Family Member."

Commenter 1 suggests persons defined as an "immediate family member" under proposed Rule 10308 (a)(5)(B)(ii) should be a larger group. Specifically, Commenter 1 states that the 50% support standard used to classify a person as an "immediate family member" of a person generally engaged in the securities industry in proposed Rule 10308(a)(5) should be lowered to 10%. The Association believes that the 50% standard is the appropriate standard generally. It should be noted that a person who falls below the 50% standard may be excluded later in the arbitration selection process by a party who strikes him or her or by the Director during a conflicts-of-interest review.

Conversely, Commenter 2 suggests that persons who fall within the definition of "immediate family member" should not be excluded by definition from the group of persons eligible to be classified as "public arbitrators." (At the same time, such persons may be excluded, in most cases, from being a "non-public arbitrator" if they lack qualifying experience.) The Association believes that excluding "immediate family members" from being classified as "public arbitrators" is a practical, realistic view of how such persons should be classified and reflects how most claimants would view such persons. If such persons were classified by the Association as "public arbitrators," and thereafter their background information, including a description of their relationship to a spouse or another family member engaged in securities activities, were distributed to the parties, the Association believes that the claimants would routinely strike such persons or request that such persons be disqualified by the Director at an early stage in the

proceeding. This change would benefit a very small group of persons desiring to serve as arbitrators, create a perception of unfairness, raise costs, and increase delays.

5. Disqualification Standards; Panel Authority to Disqualify.

Commenter 1 requests that in proposed Rule 10308(c)(4), referring to the Director's ability to disqualify a person (and other provisions under which the Director may disqualify a person), the Association provide a cross reference to a rule containing an explicit standard which the Director will apply to disqualification questions. The Association declines to make such a change; the following sources set forth the factors that the Director will consider when asked to consider a disqualification issue. The Director, the staff, and all NASD arbitrators must look to and follow "The Arbitrator's Manual," and the "Code of Ethics for Arbitrators in Commercial Disputes" ("Code of Ethics"), regarding the arbitrator's duty to disclose conflicts of interest, the appearance of bias, the assessment of challenges relating to an arbitrator's opinion or bias, business or personal relationships, previous or current involvement with a party or witness, or financial interests, and an arbitrator's ethical responsibilities to determine issues of disqualification and withdrawal. ("The Arbitrator's Manual," (Oct. 1996 ed.), pp. 2-6, App. A.) (The Code of Ethics was developed jointly by the American Bar Association and American Arbitration Association.) Every arbitrator must review and understand "The Arbitrator's Manual" and the Code of Ethics as part of mandatory arbitrator training. At any time that the Director must resolve a disqualification issue, the Director will refer to these provisions.

Commenter 1 also requests that the right of the panel to disqualify an arbitrator be stated explicitly in proposed Rule 10308(d) and proposed amendments to Rule 10312. The Association declines to make the amendments because, as discussed above, the manner in which disqualification and withdrawal issues are treated is set forth clearly in "The Arbitrator's Manual" and the Code of Ethics. At all times, including the period when the Director's authority to disqualify an arbitrator has ended, an arbitrator must consult "The Arbitrator's Manual" and the Code of Ethics, Canon II, regarding the arbitrator's duty to disclose conflicts of interest, issues of bias, and his or her ethical responsibilities to determine if withdrawal as an arbitrator is required. Under Cannon II. E., of the Code of Ethics, an arbitrator "should withdraw" if requested to do so by all the parties because of alleged partiality or bias. If requested to withdraw for such reasons by less than all of the parties, the arbitrator "should withdraw" unless "the arbitrator, after carefully considering the matter, determines that the reason for the challenge is not substantial, and that he or she can nevertheless act and decide the case impartially and fairly, and that withdrawal would cause unfair delay or expense to another party or would be contrary to the ends of justice." The Association's experience is that arbitrators apply the Code of Ethics more rigorously than a strict reading requires.

Commenter 2 requests that the Director retain the authority to disqualify an arbitrator until after the first prehearing conference. (Currently, under paragraph (d)(2), the Director's authority to remove ceases after the commencement of the earlier of (i) the first prehearing conference or (ii) the first hearing.) The Association declines to make the proposed change for the following reasons. The Association has proposed changes in Rule 10308 (d) and a series of related changes, stating the same time frames now set forth in Rule 10308(d) regarding the same issues (*e.g.*, Rule 10312, and Rule 10313) and related issues (*e.g.*, Rule 10315). These changes all have been made to make the rules consistently reflect a basic principle of arbitration -- an arbitration is administered and controlled by the arbitrator or the arbitration panel after the arbitrators have begun to address the issues that are the subject of the arbitration. Thus, as of the beginning of the first meeting among the parties and the arbitrators, it is no longer appropriate or consistent with arbitration principles for the Association to intervene in the arbitration in order to disqualify an arbitrator.

6. Communications with Listed Arbitrators Regarding Appointment.

Commenter 1 requests that the Association specify how the Association would communicate with listed arbitrators when the arbitrator is being contacted to determine if the arbitrator has any conflicts of interest and, if not, is available to serve on a particular panel. The Association believes that it would inappropriately limit the ability of the Association staff to administer cases to specify how the Association must attempt to communicate with a listed arbitrator to determine if the arbitrator is available to serve on a panel. Generally, however, the Association intends to contact the arbitrators by telephone.

7. Changes to Rule 10313.

Commenter 1 notes that Rule 10313, as amended, will provide for only causal challenge of a replacement arbitrator who is added to a panel after the arbitration has begun. This change is consistent with the other provisions of proposed Rule 10308. Thus, although the parties are provided an unlimited right to strike an arbitrator in the early stages of a proceeding, generally, under the new procedures, when an arbitrator is appointed later in the proceeding, the parties may challenge the arbitrator for cause only. The Association agrees with the suggestion of Commenter 1 that the replacement arbitrator the Director appoints should be obtained from an NLSS-derived "list of one." To replace an arbitrator under Rule 10313, and in the other instances where the Director must appoint an arbitrator not previously ranked by the parties (*see, e.g.*, paragraphs (c)(4)(B) and (d)(3) of proposed Rule 10308), the Director will return to the NLSS and obtain a "list of one," using the primary factors previously input into NLSS

to generate the list of arbitrators first sent to the parties. The Association does not believe it is necessary to specify in proposed Rule 10308 and proposed Rule 10313 that the Director will use NLSS in this manner to perform these rule functions.

Typographical errors introduced in the text have been eliminated. If you have any questions, please contact Sharon Zackula, Assistant General Counsel, Offfice of the General Counsel, NASD Regulation, Inc., at (202) 728-8985; e-mail zackulas@nasd.com. The fax number of the Office of the General Counsel is (202) 728-8264.

Very truly yours,

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Exhibit A - Bernstein and SIA Comment Letters