

January 26, 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 2-2/Room 2097

**Re: SR-NASD-98-04, Change to Policy on Accepting Claims for Arbitration Involving Exempted Securities**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in WordPerfect 5.0 to facilitate production of the Federal Register.

If you have any questions, please contact Elliott R. Curzon, Office of the General Counsel, NASD Regulation, Inc., at (202) 728-8451. The fax number of the Office of General Counsel is (202) 728-8894.

Very truly yours,

Joan C. Conley  
Secretary

Attachment

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C.

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Form 19b-4

Proposed Rule Change

by

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

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

1. Text of Proposed Rule Change

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 the Code of Arbitration Procedure (Code) of the National Association of Securities Dealers, Inc. ("NASD" or "Association") to change the interpretation of the Code such that claims relating to transactions in exempted securities, including government and municipal securities, may be submitted to the Office of Dispute Resolution (Office) for arbitration under the NASD's Code of Arbitration Procedure (Code) without limitation. Accordingly, when such claims arise involving public customers, Rule 10301 of the Code will require member firms and associated persons to arbitrate them at the request of the customer. In addition, when such claims arise between members and other members or associated persons, Rule 10201 (which governs intra-industry disputes) will require them to be arbitrated at the request of one of the parties. Finally, when such claims arise between a member firm and a customer, customers may be required under the terms of a predispute arbitration agreement to arbitrate the claims.

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 September 22, 1997, and the Board of Governors of the NASD determined not to review the proposed rule change at its meeting on October 9, 1997, which authorized the filing of the rule change with the SEC. No other action by the NASD is necessary for the filing of the rule change. Article VI, Section 1(a)(4), of the 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 within 45 days of Commission approval.

(b) Questions regarding this rule filing may be directed to Elliott R. Curzon, NASD Regulation, Office of General Counsel, at (202) 728-8451.

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

**Background**

Since at least 1989, the Office of Dispute Resolution (Office) has declined to accept claims for mandatory<sup>1</sup> arbitration involving transactions in exempted securities<sup>2</sup> naming member firms that were registered solely under Section 15C of the Exchange Act.<sup>3</sup> The Office will, however, accept claims where both parties agree to submit the claim to arbitration. If the claim involves a municipal securities transaction by a member firm,<sup>4</sup> the

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<sup>1</sup> “Mandatory” arbitration is when one party to a dispute is compelled to submit the claim to arbitration by rule or contract. For example, Rule 10201 of the Code of Arbitration Procedure (Code) requires members and associated persons to arbitrate claims at the request of another member or associated person, and Rule 10301 requires members and associated persons to arbitrate claims at the request of a customer.

<sup>2</sup> The term “exempted securities” is defined in Section 3(a)(12) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78c(a)(12), to mean government securities, municipal securities, and several other types of securities classified as exempted for specific purposes under the Exchange Act.

<sup>3</sup> Section 15C of the Exchange Act, 15 U.S.C. § 78o-5, governs the registration of government securities dealers. Since 1986, when Section 15C was adopted, government securities dealers have been required to become members of an exchange or the NASD.

<sup>4</sup> Section 15B of the Exchange Act, 15 U.S.C. § 78o-4, governs the registration of municipal securities dealers. Municipal securities dealers are not required to become members of an exchange or the NASD. Nevertheless, some NASD members which are engaged in a general securities business are registered as municipal securities dealers, and some firms which are exclusively municipal securities dealers have become members of the NASD.

Office will accept the claim for arbitration, but will ask the claimants if they want the claim referred to the Municipal Securities Rulemaking Board (MSRB) for arbitration.<sup>5</sup> Finally, if a claim involves a government securities transaction by a general securities broker/dealer member firm, the Office will accept the claim for mandatory arbitration.

Until recently, NASD Regulation had limited regulatory jurisdiction over member firm activities in connection with government securities and no jurisdiction over firms that engaged only in exempted securities activities. The policy with respect to accepting or rejecting claims for mandatory arbitration was based on the view that the subject matter jurisdiction of NASD Regulation's arbitration forum should not be significantly different from the regulatory jurisdiction of the NASD.

With the broadening of NASD Regulation's regulatory jurisdiction over government securities as a result of the Government Securities Act of 1993, and the recent adoption of amendments to the NASD's rules in recognition of the broader jurisdiction,<sup>6</sup> NASD Regulation has revisited the policy. NASD Regulation believes it would be appropriate to include claims involving exempted securities by members engaged exclusively in exempted securities activities within the scope of those claims that are subject to mandatory arbitration under the Code.

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<sup>5</sup> Rule 10301(c) of the Code permits claims "which arise out of a readily identifiable market" to be referred to the arbitration forum for that market if the claimant consents. Since this provision was adopted, the Office will ask the claimants in a case involving municipal securities if they want their case referred to the MSRB. No cases have been referred, and the MSRB has recently submitted a proposed rule change to the SEC for approval seeking to terminate its arbitration program. The MSRB's proposed rule change would require the financial institutions that are subject to its rules to submit to arbitration in the NASD's forum as if they were NASD members. See, SR-MSRB-97-04.

<sup>6</sup> In Notice to Members 96-66, published in October 1996, the NASD announced the consolidation of its Government Securities Rules into the Conduct Rules, ending the regulatory distinction between the

## Discussion

Rule 10101 of the Code provides that disputes “arising out of or in connection with the business of any member” are eligible for submission to arbitration under the Code. The definition of “investment banking or securities business” in Article I, paragraph (l) of the By-Laws means “the business carried on by a broker, dealer, or municipal securities dealer . . . , or government securities broker or dealer . . . .” Rule 10301(a) provides that eligible disputes “arising in connection with the business of [a] member or in connection with the activities of [an] associated person” *must* be arbitrated pursuant to any enforceable arbitration agreement or upon the demand of a customer. While these rules (and the definition) sweep in a very broad range of disputes, Rule 10301(b) permits the Office to decline to arbitrate certain matters.

In reliance on Rule 10301(b), and the NASD’s limited regulatory jurisdiction over government securities-only member firms, the Office has for many years declined to accept for arbitration claims that involved transactions in government securities by member firms engaged only in activities involving government securities unless both parties voluntarily agreed to submit the claim. The Office’s position means that these claims cannot be compelled into arbitration under either a demand for arbitration or a predispute arbitration agreement. Members engaged in municipal securities transactions have been required to arbitrate their claims because they are either general securities broker/dealers that are otherwise required to arbitrate all of their other claims, or because they voluntarily became NASD members. The Office's decision to decline to mandate arbitration of government

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activities general securities broker/dealers and government securities broker/dealer.

securities claims was based on the following rationale: (1) the NASD only regulated the exempted securities activities of member firms to the limited extent permitted in Section 15A(f)(2) of the Exchange Act; and, (2) the subject matter jurisdiction of the arbitration forum should not be significantly different from the NASD's regulatory jurisdiction over its members and associated persons.

In response to the passage of the Government Securities Act of 1993, which amended Section 15A(f)(2) of the Exchange Act and granted the NASD the authority to regulate broadly the business practices of members with respect to government securities,<sup>7</sup> NASD Regulation amended its rules to consolidate the Government Securities Rules it had adopted pursuant to Section 15A(f)(2) of the Exchange Act with its more generally applicable Conduct Rules. NASD Regulation now regulates the activities of members engaged in government securities activities that are both general securities broker/dealers and limited purpose government securities broker/dealers.

NASD Regulation believes that with its broad new authority to regulate the government securities business of its members, it is appropriate to open its arbitration forum to disputes involving transactions in all kinds of securities, including exempted securities, consistent with the plain language of the Code and the By-Laws. While the subject matter jurisdiction of the arbitration forum now extends to municipal securities activities that are not strictly within the regulatory scope of NASD Regulation, such activities are “business” within the definitions of the By-Laws and the meaning of the Code. Moreover, NASD

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<sup>7</sup> The NASD is still barred from establishing regulations covering the municipal securities activities of broker/dealers; that authority is reserved to the MSRB.

Regulation does not believe that there should be unreasonable barriers to customers seeking relief in arbitration for claims relating to the business of members. Therefore, compelling NASD members to arbitrate municipal securities claims would be consistent with the intent of the MSRB's rule filing.<sup>8</sup>

Under this policy, a member who is registered solely as a government securities broker/dealer and that has a dispute with a customer over a transaction in exempted securities shall be required to submit the dispute to arbitration upon the demand of the customer.<sup>9</sup> Such disputes also may be compelled to arbitration pursuant to a valid predispute arbitration agreement. Intra-industry disputes involving exempted securities also will be subject to mandatory arbitration upon the request of one of the parties.

NASD Regulation also believes the policy should permit any claim involving exempted securities to be submitted for arbitration without regard to when the transaction occurred; however, if more than six years have elapsed from the transaction, occurrence, or event giving rise to the claim, under Rule 10304 of the Code, the claim will not be eligible for submission to arbitration.<sup>10</sup> All claims involving general securities broker/dealers will continue to be accepted for arbitration consistent with past practice. Claims previously

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<sup>8</sup> See footnote 5, supra.

<sup>9</sup> NASD Regulation notes that few government securities claims involving public customers have been filed or attempted to be filed with the Office. Most of the claims involving government securities have involved member-to-member claims.

<sup>10</sup> NASD Regulation notes that it has a proposed amendment to Rule 10304, rule filing SR-NASD-97-44, pending approval with the SEC. Under the proposed rule change all claims are presumed to be eligible; however, the presumption can be overcome if the respondent challenges the claim on the basis that more than six years have elapsed since the act or occurrence giving rise to the claim.



submitted that the Office has already declined to arbitrate under the old policy cannot be resubmitted under the policy being announced herein.

(b) NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act in that eliminating a barrier to the arbitration of disputes involving exempted securities, public customers and members will have access to a fair, efficient, and cost-effective forum for the resolution of such disputes.

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

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

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

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:

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Joan C. Conley, Secretary

Date: January 26, 1998

**EXHIBIT 1**

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-98-04)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Mandatory Arbitration of Claims Involving Exempted Securities

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 change the interpretation of the National Association of Securities Dealers, Inc.'s ("NASD" or "Association") Code of Arbitration Procedure (Code) such that claims relating to transactions in exempted securities, including government and municipal securities, may be submitted to the Office of Dispute Resolution (Office) for arbitration under the NASD's Code of Arbitration Procedure (Code) without limitation. Accordingly, when such claims arise involving public customers, Rule 10301 of the Code will require member firms and associated persons to arbitrate them at the request of the customer. In addition, when such claims arise between members and other members or

associated persons, Rule 10201 (which governs intra-industry disputes) will require them to be arbitrated at the request of one of the parties. Finally, when such claims arise between a member firm and a customer, customers may be required under the terms of a predispute arbitration agreement to arbitrate the claims.

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

**Background**

Since at least 1989, the Office of Dispute Resolution (Office) has declined to accept claims for mandatory<sup>1</sup> arbitration involving transactions in exempted securities<sup>2</sup> naming member firms that were registered solely under Section 15C of the Exchange Act.<sup>3</sup> The

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<sup>1</sup> “Mandatory” arbitration is when one party to a dispute is compelled to submit the claim to arbitration by rule or contract. For example, Rule 10201 of the Code of Arbitration Procedure (Code) requires members and associated persons to arbitrate claims at the request of another member or associated person, and Rule 10301 requires members and associated persons to arbitrate claims at the request of a customer.

<sup>2</sup> The term “exempted securities” is defined in Section 3(a)(12) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78c(a)(12), to mean government securities, municipal securities, and several other types of securities classified as exempted for specific purposes under the Exchange Act.

<sup>3</sup> Section 15C of the Exchange Act, 15 U.S.C. § 78o-5, governs the registration of government securities dealers. Since 1986, when Section 15C was adopted, government securities dealers have been required to become members of an exchange or the NASD.

Office will, however, accept claims where both parties agree to submit the claim to arbitration. If the claim involves a municipal securities transaction by a member firm,<sup>4</sup> the Office will accept the claim for arbitration, but will ask the claimants if they want the claim referred to the Municipal Securities Rulemaking Board (MSRB) for arbitration.<sup>5</sup> Finally, if a claim involves a government securities transaction by a general securities broker/dealer member firm, the Office will accept the claim for mandatory arbitration.

Until recently, NASD Regulation had limited regulatory jurisdiction over member firm activities in connection with government securities and no jurisdiction over firms that engaged only in exempted securities activities. The policy with respect to accepting or rejecting claims for mandatory arbitration was based on the view that the subject matter jurisdiction of NASD Regulation's arbitration forum should not be significantly different from the regulatory jurisdiction of the NASD.

With the broadening of NASD Regulation's regulatory jurisdiction over government securities as a result of the Government Securities Act of 1993, and the recent adoption of amendments to the NASD's rules in recognition of the broader jurisdiction,<sup>6</sup> NASD

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<sup>4</sup> Section 15B of the Exchange Act, 15 U.S.C. § 78o-4, governs the registration of municipal securities dealers. Municipal securities dealers are not required to become members of an exchange or the NASD. Nevertheless, some NASD members which are engaged in a general securities business are registered as municipal securities dealers, and some firms which are exclusively municipal securities dealers have become members of the NASD.

<sup>5</sup> Rule 10301(c) of the Code permits claims "which arise out of a readily identifiable market" to be referred to the arbitration forum for that market if the claimant consents. Since this provision was adopted, the Office will ask the claimants in a case involving municipal securities if they want their case referred to the MSRB. No cases have been referred, and the MSRB has recently submitted a proposed rule change to the SEC for approval seeking to terminate its arbitration program. The MSRB's proposed rule change would require the financial institutions that are subject to its rules to submit to arbitration in the NASD's forum as if they were NASD members. See, SR-MSRB-97-04.

<sup>6</sup> In Notice to Members 96-66, published in October 1996, the NASD announced the consolidation of its

Regulation has revisited the policy. NASD Regulation believes it would be appropriate to include claims involving exempted securities by members engaged exclusively in exempted securities activities within the scope of those claims that are subject to mandatory arbitration under the Code.

### **Discussion**

Rule 10101 of the Code provides that disputes “arising out of or in connection with the business of any member” are eligible for submission to arbitration under the Code. The definition of “investment banking or securities business” in Article I, paragraph (l) of the By-Laws means “the business carried on by a broker, dealer, or municipal securities dealer . . . , or government securities broker or dealer . . . .” Rule 10301(a) provides that eligible disputes “arising in connection with the business of [a] member or in connection with the activities of [an] associated person” *must* be arbitrated pursuant to any enforceable arbitration agreement or upon the demand of a customer. While these rules (and the definition) sweep in a very broad range of disputes, Rule 10301(b) permits the Office to decline to arbitrate certain matters.

In reliance on Rule 10301(b), and the NASD’s limited regulatory jurisdiction over government securities-only member firms, the Office has for many years declined to accept for arbitration claims that involved transactions in government securities by member firms engaged only in activities involving government securities unless both parties voluntarily agreed to submit the claim. The Office’s position means that these claims cannot be

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Government Securities Rules into the Conduct Rules, ending the regulatory distinction between the activities general securities broker/dealers and government securities broker/dealer.

compelled into arbitration under either a demand for arbitration or a predispute arbitration agreement. Members engaged in municipal securities transactions have been required to arbitrate their claims because they are either general securities broker/dealers that are otherwise required to arbitrate all of their other claims, or because they voluntarily became NASD members. The Office's decision to decline to mandate arbitration of government securities claims was based on the following rationale: (1) the NASD only regulated the exempted securities activities of member firms to the limited extent permitted in Section 15A(f)(2) of the Exchange Act; and, (2) the subject matter jurisdiction of the arbitration forum should not be significantly different from the NASD's regulatory jurisdiction over its members and associated persons.

In response to the passage of the Government Securities Act of 1993, which amended Section 15A(f)(2) of the Exchange Act and granted the NASD the authority to regulate broadly the business practices of members with respect to government securities,<sup>7</sup> NASD Regulation amended its rules to consolidate the Government Securities Rules it had adopted pursuant to Section 15A(f)(2) of the Exchange Act with its more generally applicable Conduct Rules. NASD Regulation now regulates the activities of members engaged in government securities activities that are both general securities broker/dealers and limited purpose government securities broker/dealers.

NASD Regulation believes that with its broad new authority to regulate the government securities business of its members, it is appropriate to open its arbitration forum

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<sup>7</sup> The NASD is still barred from establishing regulations covering the municipal securities activities of broker/dealers; that authority is reserved to the MSRB.

to disputes involving transactions in all kinds of securities, including exempted securities, consistent with the plain language of the Code and the By-Laws. While the subject matter jurisdiction of the arbitration forum now extends to municipal securities activities that are not strictly within the regulatory scope of NASD Regulation, such activities are “business” within the definitions of the By-Laws and the meaning of the Code. Moreover, NASD Regulation does not believe that there should be unreasonable barriers to customers seeking relief in arbitration for claims relating to the business of members. Therefore, compelling NASD members to arbitrate municipal securities claims would be consistent with the intent of the MSRB’s rule filing.<sup>8</sup>

Under this policy, a member who is registered solely as a government securities broker/dealer and that has a dispute with a customer over a transaction in exempted securities shall be required to submit the dispute to arbitration upon the demand of the customer.<sup>9</sup> Such disputes also may be compelled to arbitration pursuant to a valid predispute arbitration agreement. Intra-industry disputes involving exempted securities also will be subject to mandatory arbitration upon the request of one of the parties.

NASD Regulation also believes the policy should permit any claim involving exempted securities to be submitted for arbitration without regard to when the transaction occurred; however, if more than six years have elapsed from the transaction, occurrence, or event giving rise to the claim, under Rule 10304 of the Code, the claim will not be eligible

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<sup>8</sup> See footnote 5, supra.

<sup>9</sup> NASD Regulation notes that few government securities claims involving public customers have been filed or attempted to be filed with the Office. Most of the claims involving government securities have involved member-to-member claims.



for submission to arbitration.<sup>10</sup> All claims involving general securities broker/dealers will continue to be accepted for arbitration consistent with past practice. Claims previously submitted that the Office has already declined to arbitrate under the old policy cannot be resubmitted under the policy being announced herein.

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act<sup>11</sup> in that eliminating a barrier to the arbitration of disputes involving exempted securities, public customers and members will have access to a fair, efficient, and cost-effective forum for the resolution of such disputes.

(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 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

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<sup>10</sup> NASD Regulation notes that it has a proposed amendment to Rule 10304, rule filing SR-NASD-97-44, pending approval with the SEC. Under the proposed rule change all claims are presumed to be eligible; however, the presumption can be overcome if the respondent challenges the claim on the basis that more than six years have elapsed since the act or occurrence giving rise to the claim.

<sup>11</sup> 15 U.S.C. § 78o-3.

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