

January 9, 2004

BY ELECTRONIC MAIL AND HAND DELIVERY

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: Amendment No. 5 and Response to Comments to File No. SR-NASD-98-74 – Proposed Amendments to Rule 3110(f) Governing Predispute Arbitration Agreements with Customers

Dear Ms. England:

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC”) this Amendment No. 5 and response to comments to SR-NASD-98-74 (the “Rule Filing”), which proposes amendments to Rule 3110(f) governing predispute arbitration agreements with customers.¹

This letter responds to the comment letters received by the Securities and Exchange Commission in response to the publication in the *Federal Register* of Notice of Filing of Amendment Nos. 3 and 4 to the above-referenced rule filing.

I. Response to Comments

The SEC received 24 comment letters in response to SR-NASD-98-74.² Several commenters applauded the proposed rule change as an effort to help investors understand

¹ Exchange Act Release No 48444 (September 4, 2003), 68 FR 53762 (September 12, 2003), File No. SR-NASD-98-74.

² Comment letters were submitted to the SEC from the following: Al Van Kempen, Rohde & Van Kampen, dated October 11, 2003; Barbara Black and Jill I. Gross, Pace Investor Rights Project, Pace University School of Law, dated October 2, 2003; Carl J. Carlson, Carlson & Fabish, P.S., dated October 5, 2003; Daniel A. Ball, Selzer, Gurvitch, Rabin, Obecnny, dated October 3, 2003; Don K. Leufven, dated October 9, 2003; Donald G. McGrath, McGrath & Polvino, PLLC, dated October 3, 2003; H. Douglas Powell, Fishkind & Associates, Inc., dated October 6, 2003; Herb Pounds, Herbert E. Pounds, Jr., P.C.,

the consequences of signing predispute arbitration agreements. The majority of commenters, however, opposed proposed Rule 3110(f)(4)(B), relating to the use of choice-of-law provisions. For the reasons explained below, NASD is amending the proposed rule change to delete proposed paragraph (f)(4)(B).

Choice-of-Law Provision

NASD Rule 3110(f) governs the use of predispute arbitration agreements between members and customers. The proposed rule change would amend Rule 3110(f) to: require additional disclosure in predispute arbitration agreements about the arbitration process; require members to provide certain information regarding arbitration and predispute arbitration agreements to customers upon request; and clarify the rules regarding use of choice-of-law provisions in predispute arbitration agreements.

Currently, Rule 3110(f)(4) provides that:

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.

As it stated in NASD *Notice to Members* 95-85, NASD interprets current Rule 3110(f)(4) to require that, when predispute arbitration agreements between members and customers include a choice-of-law provision, there must be “an appropriate contact or relationship between the transaction at issue or the parties and the law selected.”³ In 1996, the Arbitration Policy Task Force chaired by former SEC chairman David Ruder (“Ruder Task Force”), recommended that NASD amend Rule 3110(f) to explicitly

dated October 6, 2003; J. Pat Sadler, Public Investors’ Arbitration Bar Association, dated October 2, 2003; Jeffrey A. Feldman, Esquire, dated October 6, 2003; John Miller, Law Office of John L. Miller, P.C., dated October 5, 2003; Jorge A. Lopez, Esquire, Jorge A. Lopez, P.A., dated October 5, 2003; Kari S. Turigliatto, Mutual Service Corporation, dated October 8, 2003; Kenneth A. Martyn, Attorney at Law, dated October 8, 2003; Laurence S. Schultz, Driggers, Schultz & Herbst, P.C., dated October 3, 2003; Lenny Steiner, dated October 4, 2003; Madelaine Eppenstein and Theodore G. Eppenstein, Eppenstein and Eppenstein, dated October 3, 2003; Ralph A. Lambiase, North American Securities Administrators Association, Inc., dated October 3, 2003; Richard M. Layne, Layne & Lewis LLP, dated October 2, 2003; Robert S. Banks, Jr., Banks Law Office, P.C., dated October 3, 2003; Rosemary J. Shockman, Shockman Law Office, P.C., dated October 2, 2003; Scott C. Iigenfritz, Johnson, Pope, Bokor, Ruppel & Burns, P.A., dated October 16, 2003; Steve Buchwalter, Law Offices of Steve A. Buchwalter, P.C., dated October 3, 2003; and Tracy Pride Stoneman, Tracy Pride Stoneman, P.C., dated October 3, 2003.

³ NASD *Notice to Members* 95-85 (October 16, 1995).

preclude the use of arbitrary choice-of-law provisions by establishing a threshold nexus between the law selected and the parties or transaction in question.⁴

Based on the Ruder Task Force's recommendation, NASD included the following proposed paragraph (f)(4)(B) to Rule 3110 when it filed the proposed rule change in 1998.

No member may seek to enforce any choice-of-law provision unless there is a significant contact or relationship between (i) the law selected and (ii) either the transaction at issue or one or more of the parties.

The purpose of the proposed provision was to protect investors from the use of arbitrary choice of law provisions by establishing a minimum nexus between the law chosen and the transaction or parties involved. Although one commenter supported the proposed paragraph,⁵ the overwhelmingly majority of commenters opposed it as potentially harmful to investors.

A majority of the commenters argued that, because relevant case law regarding choice-of-law provisions in predispute arbitration agreements has evolved considerably in the five years since the proposed rule change was filed, paragraph (f)(4)(B) could be interpreted to endorse choice-of-law clauses that may not be enforceable under applicable state law. Given the strong opposition of the commenters and the fact that such consequences were not intended by NASD, NASD is amending the Rule Filing to delete proposed paragraph (f)(4)(B).

However, by doing so, NASD is not implying that members may include arbitrary choice-of-law provisions in predispute arbitration agreements with customers. As it has in the past, NASD will continue to interpret Rule 3110(f) 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.

⁴ Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors, National Association of Securities Dealers, Inc. (January 1996), p. 21.

⁵ See comment letter from Barbara Black and Jill I. Gross, Pace Investor Rights Project, Pace University School of Law, dated October 2, 2003.

Proposed Paragraph (f)(3)(A)

Proposed paragraph (f)(3)(A) would require that members 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. One commenter questions the meaning of the phrase "or inform the customer that the member does not have a copy thereof" because the commenter "cannot contemplate" a situation in which "there is a PDAA between the firm and the customer, but the firm does not have a copy of it."⁶ The commenter suggests that perhaps NASD meant to refer to a situation in which there is no predispute arbitration agreement, rather than one in which a customer agreement or predispute arbitration agreement is executed, but the firm is for some reason unable to produce it.

In fact, the proposed provision is intended to address the latter situation. Current Rule 3110(f)(3) requires that copies of any predispute arbitration agreement be given to the customer, who must acknowledge receipt thereof. At the time the proposed rule change was being developed, several users of the forum reported that occasionally, members provided copies of such agreements at the time the agreement was signed, but refused or were unable to do so after a dispute had arisen. The proposed provision was intended to address such situations, by requiring members to produce customer account or predispute arbitration agreements upon the request of the customer. NASD expects that, in most cases, members will retain 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, NASD believes that the member must inform the customer of that fact, rather than simply failing to respond to the customer's request.

Scope of Rule Filing

Finally, another comment letter criticizes the proposed rule change for not permitting customers to opt out of predispute arbitration agreements in cases involving securities fraud, and for failing to eliminate the one non-public arbitrator on three-arbitrator panels.⁷ These concerns, while noted, are outside the scope of the proposed rule filing.

⁶ Id.

⁷ See comment letter from Madelaine Eppenstein and Theodore G. Eppenstein, Eppenstein and Eppenstein, dated October 3, 2003.

II. Amendment to Rule Filing

Accordingly, NASD amends the language of proposed Rule 3110(f) to delete proposed new language to paragraph (f)(4)(B). Additions proposed in the Rule Filing are underlined and deletions are in brackets. Proposed additions in this Amendment No. 5 are double underlined and deletions are struck through.

Rule 3110(f).

(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.]

~~(A)~~ 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; or
- (iv) limits the ability of arbitrators to make an award.

~~(B) No member may seek to enforce any choice of law provision unless there is a significant contact or relationship between (i) the law selected and (ii) either the transaction at issue or one or more of the parties.~~

III. Accelerated Approval of Amendment No. 5

NASD requests that the Commission find good cause pursuant to Section 19(b)(2) of the Securities Exchange Act of 1934 to approve proposed Amendment No. 5 prior to the 30th day after publication in the Federal Register. Although not previously published, the proposed rule change responds to comments and proposes to delete proposed Rule 3110(f)(4)(B).

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If you have any questions, please call Laura Gansler, NASD Dispute Resolution, at (202) 728-8275, e-mail laura.gansler@nasd.com; or the undersigned at (202) 728-6903; e-mail kosha.dalal@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Kosha K. Dalal
Assistant General Counsel

cc: Robert Love, Division of Market Regulation