September 30, 2003

Florence Harmon
Senior Special Counsel
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-2003-95 - Amendments to Rules 10308 and 10312 of the NASD Code of Arbitration Procedure Governing Arbitrator Classification – Response to Comments

Dear Ms. Harmon:

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 SR-NASD-2003-95, proposing amendments to Rules 10308 and 10312 of the NASD Code of Arbitration Procedure Governing Arbitrator Classification.

The Commission received comment letters from the following commenters in response to the proposed rule change: the Public Investors Arbitration Bar Association ("PIABA"); the Securities Industry Association ("SIA"); A.G. Edwards & Sons, Inc. ("A.G. Edwards"); the National Employment Lawyers Association ("NELA"); and Joseph O'Donnell.[1]

PIABA supports the proposed rule change as a "positive and significant step toward the elimination of the appearance of pro-industry bias in the roster of those eligible to sit as 'public' arbitrators in NASD arbitrations." PIABA also urges NASD to consider further steps, such as eliminating all banking and insurance personnel from the public arbitrator pool, and categorizing all professional partners of all non-public arbitrators as non-public. While NASD takes note of these suggestions, they are beyond the scope of the current rule proposal.

[1] Letter from Charles W. Austin, Jr. to Jonathan G. Katz, Securities and Exchange Commission (September 11, 2003); Letter from Edward Turan, Chair, SIA Arbitration Committee to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission (September 11, 2003); Letter from Stephen G. Sneeringer, Senior Vice President and Counsel, A.G. Edwards & Sons, Inc. to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission (September 9, 2003); Letter from Cliff Palefsky, Co-Chair, ADR Committee, NELA, to Jonathan Katz, Secretary, Securities and Exchange Commission (September 9, 2003); Letter from Joseph O'Donnell to Secretary, Securities & Exchange Commission (July 16, 2003).

The SIA and A.G. Edwards also support the proposed rule change, with the following exceptions. Both object to the proposed amendment to Rule 10308(a)(5)(A)(iv) to exclude from the definition of public arbitrator any "attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past 2 years" from any persons or entities involved in the securities industry. They express concern that the provision could limit the depth of the NASD arbitrator pool, and argue that excluding such persons from serving as public arbitrators is overly broad and not supported by clear evidence that such persons are actually biased in favor of the industry.

NASD respectfully disagrees with SIA and A.G. Edwards that this provision will significantly impact the depth of the NASD public arbitrator pool. NASD took this concern into account before filing the proposed rule change, and has concluded that the amendment, if approved, will not adversely impact its ability to panel cases.

NASD also disagrees that the proposed provision unnecessarily excludes categories of persons from serving as public arbitrators. While some persons who have no actual bias in favor of the securities industry or against investors may be disqualified from serving as public arbitrators under the proposed rule change, the new provision is not intended to eliminate only persons with actual bias, but also persons who could reasonably perceive to be biased. NASD believes that the "ten percent of annual revenues" threshold will help eliminate the potential perception of bias, despite the fact that any given individual who falls within that category may not in fact be biased. As Professor Michael Perino noted in his Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations (Perino Report), "no classification rule could ever precisely define public and non-public arbitrators; there will always be classification questions at the margins about which reasonable people will differ."[2] Given the inherently imprecise nature of such definitions, NASD believes that, to protect both the integrity of the NASD forum, and investors' confidence in the integrity of the forum, it is preferable that the definition of public arbitrator be overly restrictive rather than overly permissive.

Both SIA and A.G. Edwards also specifically object to the use of the terms "professional" and "firm" in proposed Rule 10308(a)(5)(A)(iv), which they argue are overly vague and overbroad. They contend that because the term "professional" can be

[2] The SEC commissioned the Perino Report in July 2002 to assess the adequacy of NASD (and New York Stock Exchange) arbitrator disclosure requirements, and to evaluate the impact of the recently adopted California Ethics Standards on the current conflict disclosure rules of the self-regulatory organizations (SROs). (See "Ethics Standards for Neutral Arbitrators in Contractual Arbitration," California Rules of Court, Division VI of the Appendix.) The Perino Report, issued in November 2002, concluded that undisclosed conflicts of interest were not a significant problem in SRO-sponsored arbitrations. However, the Perino Report recommended several amendments to SRO arbitrator classification and disclosure rules that, according to the Report, might "provide additional assurance to investors that arbitrations are in fact neutral and fair."

interpreted to mean any "skilled laborer," and firm to mean "any business company," the terms are overly inclusive in the context of Rule 10308. Both commenters give examples that they believe illustrate the unintended scope of these terms. For example, A.G. Edwards argues that the 10 percent rule could be interpreted to mean that a golf professional who earns 10 percent of his or her annual income as the result of winning a tournament sponsored by a securities firm could be disqualified as a public arbitrator. Likewise, SIA suggests that the human resources director of a large law firm that derives a significant percentage of its revenue from representing brokers in employment disputes would be similarly disqualified.

NASD does not believe that the term "professional" or the term "firm" will prove to be as problematic in practice as the commenters fear. NASD notes that the term "professional" is used elsewhere in current Rule 10308, and has not been the source of confusion or controversy in the past. For example, Rule 10308(a)(4)(A) includes in the definition of non-public arbitrator "an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients" who are engaged in the securities business. Likewise, Rule 10308(c)(5)(A) provides that: "[t]he 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."[3] The term "professional" is also used in a similar rule provision adopted by the Securities Industry Conference on Arbitration ("SICA") earlier this year. NASD sees no reason to believe that the use of the term "professional" or "firm" in the proposed provision will be any more problematic in practice than the use of the term "professional" or the term "business activities" elsewhere in the rule.

In contrast to SIA's and A.G. Edwards' contention that the 10 percent threshold is too high, NELA believes that it is too low. As an alternative, NELA proposes that any lawyer whose firm represents any industry member should be classified as an industry (non-public) arbitrator, "regardless of the dollar volume of the business."[4] Again, NASD notes that no threshold can ever precisely define public and non-public arbitrators. However, NASD believes that the 10 percent threshold represents an appropriate balance.

[3] The term "professional" is also used in a similar amendment to the SICA's Uniform Code of Arbitration adopted earlier this year.

[4] NELA also argues that NASD should amend its rules to eliminate non-public arbitrators from "mandatory arbitration panels." NASD respectfully notes that this suggestion is outside the scope of the proposed rule change.

SIA also objects to the proposed expansion of the term "immediate family member" in Rule 10308(a)(5)(A). The current definition of "immediate family member" includes spouses of, as well as family members who share a home with, someone engaged in the securities business, but not close relatives who do not share a home with such persons. Under the proposed rule change, the definition of "immediate family member" would also include parents, stepparents, children and stepchildren of persons in the securities industry.

The proposed expansion of the definition of "immediate family member" was one of the recommendations contained in the Perino Report. To enhance the perception of fairness of SRO-sponsored arbitration, Professor Perino recommended that NASD consider expanding the definition of "immediate family member" to include parents and children, even if the parent or child does not share a home with or receive substantial support from, a non-public arbitrator.[5] (Although the Perino Report referred only to parents and children, NASD believes that the same rationale applies to stepparents and stepchildren, and therefore recommends including such relationships in the definition as well.) NASD acknowledges that, in some cases, this provision might prove to be over-inclusive. However, for the same reasons expressed above, NASD believes that the expansion of the definition of "immediate family member" will enhance the overall fairness of NASD's arbitration forum, as well as the investing public's confidence in the fairness and integrity of the forum.

Finally, Mr. O'Donnell, a registered investment adviser, objects to the exclusion of investment advisers from the definition of public arbitrators in Rule 10308(a)(5)(iii). Mr. O'Donnell argues that excluding investment advisers from the public arbitrator roster is unwarranted, and will harm investors by removing from the public roster arbitrators who have a sophisticated understanding of the securities industry but are not financially dependent on the securities industry. At a minimum, Mr. O'Donnell argues that the rule should distinguish between commission-based and fee-based investment advisers, as well as between independent advisers and those affiliated with broker-dealers.

NASD does not believe that the average investor draws such fine distinctions among investment advisers, many of whom are affiliated to some extent with broker/dealers. NASD notes that SICA has adopted a similar amendment to its Uniform Code of Arbitration. While Mr. O'Donnell is correct that some otherwise well-qualified individuals may be disqualified as public arbitrators, NASD believes that the pool of qualified public arbitrators will remain deep, and that the benefits of bolstering investor confidence in the integrity of the NASD arbitration process outweigh the loss of some individual investment advisers from the roster.

[5] Perino Report, page 19.

If you have any questions, please contact me at (202) 728-8275 or laura.gansler@nasd.com.

Very truly yours,

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