

April 14, 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-97-77; Arbitration of Statutory Employment
Discrimination Claims - Amendment No. 2, Response to Comments, and
Extension of Time for Commission Action**

Dear Ms. England:

Pursuant to Rule 19b-4, the NASD is submitting Amendment No. 2 to the above rule filing. The purpose of this amendment is to respond to the public comments received by the Commission in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-97-77.¹ The NASD hereby consents to an extension of time until May 1, 1998, for the Commission to consider the proposed rule change.

Comments

The Commission received nine comment letters on the proposed rule change.² In brief, organizations representing the interests of employees applaud the overall goal of the rule, but some recommend it be expanded to exempt common law employment claims from arbitration as

¹Release No. 34-39421 (Dec. 10, 1997); 62 F.R. 66164 (Dec. 17, 1997).

²Letters were received from: New York Attorney General Dennis C. Vacco (Dec. 17, 1997) ("Vacco"); U.S. Equal Employment Opportunity Commission (Dec. 19, 1997) ("EEOC"); Jeffrey L. Liddle, Liddle & Robinson, L.L.P. (Jan. 2, 1998) ("Liddle"); W. Hardy Callcott, Charles Schwab (Jan. 6, 1998) ("Schwab"); William J. Fitzpatrick (Jan. 8, 1998) ("Fitzpatrick"); Stuart J. Kaswell, Securities Industry Association (Jan. 13, 1998) ("SIA"); Helen Norton, Women's Legal Defense Fund (Jan. 7, 1998) ("WLDF"); Cliff Palefsky, National Employment Lawyers Association (Jan. 6, 1998) ("NELA"); George A. Schieren, Merrill Lynch, Pierce, Fenner & Smith Incorporated (Jan. 16, 1998) ("Merrill Lynch").

well. They also recommend that the NASD prohibit all predispute arbitration agreements in the employment context. Member firms feel the present system is fair, and object to the “bifurcation” of claims that would occur if only employment discrimination claims were allowed to proceed in court, while all other claims remained in arbitration. Several comment letters criticize the proposed effective date of one year after SEC approval. Some commenters would prefer an immediate, or at least earlier, effective date; one firm believes the effective date should relate to the date when the underlying facts occurred, not the filing date of the claim. This letter addresses the major issues raised by the commenters and provides NASD’s response.

Advisability of the Rule in General

As noted, most commenters favor the rule in general, although some feel it could be improved by certain amendments described below. One commenter who was previously associated with the securities industry objects to the proposed rule change in general, on the grounds that it is contrary to case law and federal legislation encouraging arbitration, ignores the concerns of the courts, creates needless bifurcation of employment claims, and undermines the long-time system of self-regulatory organization (SRO) arbitration without evidence that there is a problem.³ This commenter complains that the NASD did not meet with representatives from the court system as it was developing the proposed rule change.

In developing the proposed rule change, the NASD contacted several judges and persons associated with the judicial system, all of whom felt it would be inappropriate to comment on issues that might later come before them. NASD management and members of the Advisory Committee did, however, have a telephone conference call with a former Director of Alternative Dispute Resolution (ADR) Programs for a United States District Court, who also has designed and presented ADR training programs for federal district court judges organized by the Federal Judicial Center.

The NASD is aware that courts have consistently upheld the SROs’ present arbitration requirement, and that crowded court dockets may cause a discrimination claim to take longer to resolve in court than in arbitration. Nothing in the proposed rule change forces a party to file an arbitration claim in court, and the NASD has not taken a position on private arbitration agreements between members and their employees. Rather, the NASD simply determined that the appropriate action was to remove the NASD’s arbitration requirement for employment discrimination claims, and to improve the forum so that it is viewed by both registered employees and firms as the fairest and most efficient forum for resolving all employment disputes.

Effective Date

The commenters are divided as to the effective date of the proposed rule change. Some

³See Fitzpatrick letter, supra.

commenters believe that the proposed rule change should become effective sooner than one year after Commission approval. Suggestions for effective dates ranged from immediately upon SEC approval⁴ to three months after SEC approval.⁵ These commenters believe that the proposed rule change has received so much public attention that a longer period before effectiveness is not needed. One commenter raises questions as to what the effective date means; e.g., whether the rule will apply to claims filed after that date, to arbitration agreements signed after that date, or to causes of action that arise after that date.⁶ Another commenter who is opposed to the rule change expresses the view that, if the proposed rule change is approved, it should not be effective for at least a year so that potential problems can be addressed.⁷ One commenter believes the one year effective date is prudent, as it will give firms time to give measured consideration to the changes that the proposal would effect, such as administrative, staffing, and legal training initiatives.⁸ One commenter agrees that the one year period will give SROs and the industry time to resolve the issues created by the new rule.⁹

The NASD understands that there has been publicity concerning the proposed rule since the Board of Governors voted on it in August 1997. That publicity, however, has always included the fact that the rule would take effect one year after SEC approval, so firms and employees have not been on notice that they should act more quickly. Moreover, it is possible that, after the SEC approves the proposed rule change, other SROs that offer dispute resolution forums may wish to follow suit and amend their rules to be consistent. This process could take several months. Therefore, the NASD believes that making the rule effective shortly after SEC approval would be problematic. Nevertheless, the NASD understands the desirability of a definite effective date, and has determined to move the effective date to January 1, 1999, rather than one year after SEC approval. This date is nearly 16 months after the NASD announced that its Board had adopted the proposed rule, and gives other SROs, members and employees sufficient time to take action to respond to the rule.

With regard to the significance of the effective date, the rule change will apply to claims filed on or after the effective date of the rule change. For this purpose, therefore, it will not matter when the arbitration agreement was signed or when the cause of action arose (the effective date provision will not affect existing statutes of limitations or the eligibility rule). This method of applying effective dates is the one most commonly used with regard to changes

⁴See EEOC, NELA, and WLDF letters, supra.

⁵See Vacco letter, supra.

⁶See Schwab letter, supra.

⁷See Fitzpatrick letter, supra.

⁸See SIA letter, supra.

⁹See Merrill Lynch letter, supra.

to the Code of Arbitration Procedure, and is the most efficient to administer, as it does not involve subsidiary determinations as to the dates of other actions.

Types of Claims Covered

One commenter contends that the exception to the arbitration requirement should apply to all statutory employment claims, such as those under the Family and Medical Leave Act or ERISA, and not just to statutory claims of employment discrimination.¹⁰ Some commenters express the view that the exception should be extended to all common law claims.¹¹ They believe that common law claims such as wrongful termination, intentional infliction of emotional distress, defamation, negligent supervision, invasion of privacy, and tortious interference with economic opportunity often join statutory claims of employment discrimination. These commenters contend that splitting such claims into separate forums is costly and time-consuming, and could result in compelling employees either to drop their common law claims or to arbitrate their statutory employment discrimination claims.

Alternatively, the commenters fear that the court proceedings could be stayed pending resolution of the other claims in arbitration, and that the award could have res judicata or collateral estoppel effect on the court proceeding, thus denying the employee a complete hearing in court. An industry commenter also expresses concern that parties may file pretextual claims in court to gain the advantage of more liberal discovery that can then be used in arbitration.¹² This commenter also urges that investigative files of the Equal Employment Opportunity Commission and similar state agencies not be subject to discovery or use in arbitration.

The NASD drafted the proposed rule carefully to specify that the exception for claims of statutory employment discrimination claims was in fact just that: an exception to the long-standing rule that requires arbitration of disputes between members and associated persons. The interest groups that gave their views to the NASD during the consideration of this rule change focused their concerns on employment discrimination claims made under Title VII of the Civil Rights Act of 1964 and other federal anti-discrimination legislation, not on other federal laws or common law claims such as those listed above. It was generally understood that such other claims would remain subject to the arbitration requirement. Parties are, of course, free to make other agreements; some firms may agree to have all claims consolidated in court, while some employees may decide to proceed with all claims in arbitration. The NASD will observe developments in this area, and may consider amendments to the rule in the future if bifurcation proves to be a serious problem.

Definitions of Terms

¹⁰See WLDF letter, supra.

¹¹See Vacco, Liddle, and Schwab letters, supra.

¹²See Schwab letter, supra.

One commenter feels that the proposed rule change should not distinguish sexual harassment from other types of sex discrimination.¹³ The NASD believes this suggestion is helpful, and has incorporated it into the amendment below. The same commenter also expresses the view that the rule should include a definition of “statute” as encompassing laws at the federal, state, or local levels. As explained in the rule filing, Black’s Law Dictionary does so define “statute,” and the NASD does not believe that further changes are needed.

Expansion of Rule to Prohibit All Predispute Arbitration Agreements

Several commenters feel that the proposed rule change does not go far enough. They believe the NASD should prohibit all predispute arbitration agreements in the employment context.¹⁴ These commenters would limit private arbitration agreements to situations in which the agreement is voluntary and entered into after the dispute has arisen. The commenters express concern over the unequal bargaining power between employees and employers, and believe that predispute arbitration agreements required as a condition of employment are contrary to the principles of the federal civil rights laws.¹⁵ One commenter expresses the view that the proposed rule change implies that the NASD believes its arbitration system and pool of arbitrators are ill-equipped to adjudicate employment disputes.¹⁶ In contrast, some commenters state that arbitration is fundamentally fair, and is superior in many ways to court litigation.¹⁷ One commenter suggests that any concerns about the arbitration process should be addressed by working to improve the process, and not by removing one class of cases from arbitration.¹⁸

The NASD considered the above issues when it approved the proposed rule change, and it determined not to prohibit arbitration clauses in private agreements between employees and member firms. As explained in the rule filing, the NASD does not take a position on the desirability of private arbitration agreements between members and their employees. Rather, the NASD has simply determined to remove from its rules the mandatory arbitration requirement as to claims of statutory employment discrimination. This change does not in any way indicate a lack of confidence in the current arbitration system. The NASD believes that its arbitration forum is fair and that it provides many benefits to employees as well as to members. In addition, the NASD has set up a Working Group on Employment Discrimination Claims to consider what procedural changes could be made to handle employment discrimination claims more effectively

¹³See EEOC letter, supra.

¹⁴See Vacco and EEOC letters, supra.

¹⁵See EEOC letter, supra.

¹⁶See Liddle letter, supra.

¹⁷See SIA, Schwab, and Merrill Lynch letters, supra.

¹⁸See Schwab letter, supra.

in arbitration, and whether to impose certain due process and disclosure requirements on members who use arbitration agreements. This group has met several times and is continuing to study these issues for later submission to the NASD Board. The Working Group is one of many ongoing efforts the NASD is making to improve its arbitration forum.

Expansion of Rule to Include Due Process Requirements

One commenter expresses the view that any arbitration agreements used by employers should preserve the substantive protections and remedies afforded by statutes.¹⁹ The content of private arbitration agreements is not germane to the proposed rule change, which simply removes from the NASD's rules the arbitration requirement imposed through signing of the Form U-4. As discussed above, however, the NASD has formed a Working Group that is looking into possible due process requirements as a separate matter.

Expansion of Rule to Require Member Firms to Pay All Forum Fees

One commenter believes that if the present rule is to be adopted, it should include a requirement for broker/dealer members to pay all forum fees.²⁰ This commenter cites a recent District of Columbia Circuit Court case as support for the proposition that the employer must pay all fees.²¹ That case refers only to arbitrators' fees, not all forum fees, and suggests some confusion about the rules of the NASD and other securities industry SROs regarding the payment of arbitrators' fees.²²

Currently, the fee schedules in Rule 10205 are the same for all parties without regard to whether the party is a member or an employee, except that members pay a member surcharge of \$500 per arbitration proceeding (see Rule 10333). Rule 10205 does provide, however, that the arbitration panel may, in its award, determine the amount chargeable to the parties as forum fees and shall determine who shall pay such forum fees. The allocation of fees is therefore at the discretion of the arbitrator, taking into account both the relative means of the parties and the outcome of the arbitration.

Expansion of Rule to All SROs

¹⁹See Vacco letter, supra.

²⁰See Liddle letter, supra.

²¹Cole v. Burns Int'l Sec. Serv., 105 F.3d 1465 (D.C. Cir. 1997).

²²The court reasoned that the Supreme Court would never have upheld the mandatory arbitration agreement at issue in Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991), in the absence of an employer agreement to pay all of the arbitrators' fees. Id. at 1468. In fact, the Supreme Court simply did not focus on fees in the Gilmer decision as it considered other provisions of the New York Stock Exchange rules on arbitration. 500 U.S. at 30-32.

One commenter expresses the view that the Commission should extend the proposed rule change to all securities industry SROs.²³ This proposal is, of course, beyond the scope of the NASD's proposed rule change. Nevertheless, it is possible that other SROs will amend their arbitration rules to provide uniformity.

Amendment

After considering the above comments and discussing them with Commission staff, the NASD has determined to amend the effective date of the proposed rule change to January 1, 1999. The NASD believes that setting a specific date for effectiveness of the proposed rule change, rather than a date one year after Commission approval, will give employees and firms sufficient opportunity to make appropriate plans and provide the advantage of certainty. Therefore, the NASD proposes to amend Item 2 of the rule filing as follows:

The NASD will make the proposed rule change effective [in one year after Commission approval] on January 1, 1999.

In addition, the NASD believes that a change in phraseology suggested by the EEOC is a good one, and wishes to amend paragraph (b) of the proposed rule change as follows:

(b) A claim alleging employment discrimination, including a sexual harassment claim, [or sexual harassment] in violation of a statute is not required to be arbitrated. Such a claim may be arbitrated only if the parties have agreed to arbitrate it, either before or after the dispute arose.

If you have any questions, please call me at (202) 728-6959.

Very truly yours,

Jean I. Feeney
RF-97--1.WPD

cc: Heather Seidel

²³See NELA letter, supra.

Attachment: Exhibit A - Proposed rule change with the original language changes shown as if adopted and the new language marked to show additions and deletions made in this amendment.

CODE OF ARBITRATION PROCEDURE

10200. INDUSTRY AND CLEARING CONTROVERSIES

10201. Required Submission

(a) Except as provided in paragraph (b), a dispute, claim, or controversy eligible for submission under the Rule 10100 Series between or among members and/or associated persons, and/or certain others, arising in connection with the business of such member(s) or in connection with the activities of such associated person(s), or arising out of the employment or termination of employment of such associated person(s) with such member, shall be arbitrated under this Code, at the instance of:

(1) a member against another member;

(2) a member against a person associated with a member or a person associated with a member against a member; and

(3) a person associated with a member against a person associated with a member.

(b) A claim alleging employment discrimination, including a sexual harassment claim, [or sexual harassment] in violation of a statute is not required to be arbitrated. Such a claim may be arbitrated only if the parties have agreed to arbitrate it, either before or after the dispute arose.

(c) Any dispute, claim or controversy involving an act or failure to act by a clearing member; a registered clearing agency; or participants, pledgees, or other persons using the facilities of a registered clearing agency, under the rules of any registered clearing agency with which the Association has entered into an agreement to utilize the Association's arbitration facilities and procedures shall be arbitrated in accordance with such agreement and the rules of such registered clearing agency.