

## INFORMATIONAL

# Predispute Arbitration Agreements

SEC Approves Amendments To Prohibit Terminated Or Suspended Member Firms From Enforcing Predispute Arbitration Agreements Against Customers In The NASD Arbitration Forum;  
**Effective Date: June 11, 2001**

## SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representatives
- Legal & Compliance
- Senior Management

## KEY TOPICS

- Arbitration
- Code of Arbitration Procedure

## Executive Summary

On April 6, 2001, the Securities and Exchange Commission (SEC or Commission) approved an amendment to National Association of Securities Dealers, Inc. (NASD®) Rule 10301 to prohibit a member firm whose membership has been terminated, suspended, canceled, or revoked, or that has been expelled from the NASD, or that is otherwise defunct, from enforcing a predispute arbitration agreement against a customer in the NASD forum, unless the customer agrees to arbitration in writing after the claim has arisen.<sup>1</sup>

As a corollary to this rule change, before serving a customer claim against a member firm, NASD Dispute Resolution, Inc. will notify the customer if the member firm falls into one of the categories enumerated in the rule, so customers can make an informed decision regarding whether to proceed in arbitration, to file their claim in court, or to take no action. Although the rule change only applies to claims against member firms, before serving a customer claim against an associated person, NASD Dispute Resolution will also inform the customer if the associated person's registration is terminated, revoked, or suspended.

Included with this *Notice* is Attachment A, the text of the amendment that will become effective on June 11, 2001.

## Questions/Further Information

Questions regarding this *Notice* may be directed to Laura Leedy Gansler, Counsel, NASD Dispute Resolution, Inc., at (202) 728-8275.

## Discussion, Background

In October 1998, the General Accounting Office (GAO) undertook a study of the securities industry arbitration process, focusing on the number of unpaid arbitration awards. In its June, 2000 report, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards* (GAO Report), the GAO found that a significant percentage of the awards favorable to customers that were issued in 1998 were unpaid. The majority of unpaid awards involved arbitration cases against firms that the NASD had terminated from membership for serious violations of the federal securities laws and NASD rules, or that had filed for bankruptcy. In fact, investors collect their awards in well over 90 percent of the NASD cases involving active firms.

The GAO noted that the NASD takes aggressive action to address complaints about non-payment of awards. In response to the recommendations in the GAO Report, NASD Dispute Resolution has taken the following additional steps to track and address non-payment. In *NASD Notice to Members 00-55*, published August 10, 2000, NASD Dispute Resolution introduced a new system of monitoring and tracking compliance with arbitration awards by members and associated persons. On September 18, 2000, NASD Dispute Resolution began asking claimants to notify it if a member or associated person has not paid the arbitration award within 30 calendar days of receipt of the award. In addition, member firms are now required to notify NASD Dispute Resolution in writing within 30 days of receipt of an award that they or their associated persons have paid or otherwise complied with the award, or to identify a valid basis

for non-payment. NASD Dispute Resolution has agreed to provide the Commission with quarterly reports on the results of this process. These steps will enable the NASD to institute suspension proceedings promptly when appropriate, and will prevent unnecessary regulatory effort in cases in which the award is the subject of a pending motion to vacate or there is another valid basis for non-payment.

Even with NASD Dispute Resolution's vigorous efforts to ensure payment of awards, the GAO Report highlighted that customers in arbitration cases involving terminated or suspended members face a significantly higher risk of non-payment than do customers in cases involving active members. While non-payment of awards by terminated or suspended members is beyond the control of NASD Dispute Resolution, NASD Dispute Resolution believes that, even if customers have signed a predispute arbitration agreement, they should be able to seek relief in court, where they could more directly and immediately avail themselves of any judicial remedies available under state law, including those that might prevent the dissipation of assets.

Accordingly, NASD Dispute Resolution has amended the Code of Arbitration Procedure (Code) to prohibit member firms whose NASD membership has been terminated, suspended, canceled, or revoked, or that have been expelled from the NASD, or that are otherwise defunct, from enforcing predispute arbitration agreements against customers in the NASD arbitration forum, unless the customer agrees to arbitration in writing after the claim has arisen.

### Description Of Amendment

NASD Dispute Resolution has amended Rule 10301 of the Code, governing required submission of claims, to provide that a claim by a customer involving a member firm (1) whose membership is terminated, suspended, canceled, or revoked, (2) that has been expelled from the NASD, or (3) that is otherwise defunct, is ineligible for arbitration in the NASD arbitration forum unless the customer agrees to arbitration in writing after the claim has arisen.<sup>2</sup>

The rule applies only to claims against member firms that fall into one of the categories enumerated in the rule. As a corollary to this rule change, before serving a customer claim against a member firm, NASD Dispute Resolution will notify the customer if the member firm falls into one of the enumerated categories, so that the customer can make an informed decision regarding whether to proceed in arbitration, to file the claim in court, or to take no action.

Because the rule does not apply to claims against associated persons, such claims remain eligible for arbitration pursuant to Rule 10301(a). However, before serving a customer claim against an associated person, NASD Dispute Resolution will inform the customer if the associated person's registration is terminated, revoked, or suspended.

### Effective Date

The amended rule will apply to all claims served on or after June 11, 2001.

### Endnotes

- 1 Exchange Act Release No. 44158 (April 6, 2001) (File No. SR-NASD-01-08), 66 Federal Register 19267 (April 13, 2001).
- 2 NASD Dispute Resolution notes that the rule is similar in principle to Rule 10301(d) of the Code, which provides that class actions are ineligible for arbitration in the NASD forum.

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## ATTACHMENT A

Text of Amendment

New language is underlined; deleted language is in brackets.

### **10000. Code of Arbitration Procedure**

#### **10301. Required Submission**

(a) Any dispute, claim, or controversy eligible for submission under the Rule 10100 Series between a customer and an active member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated persons shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer. A claim involving a member in the following categories shall be ineligible for submission to arbitration under the Code unless the customer agrees in writing to arbitrate the claim after it has arisen:

(1) A member whose membership is terminated, suspended, canceled, or revoked;

(2) A member that has been expelled from the NASD; or

(3) A member that is otherwise defunct.

(b) – (d) Unchanged.