

## 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 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 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

#### 1. Purpose

The purpose of the proposed rule change is threefold: to require additional disclosure in predispute arbitration agreements regarding the arbitration process, including possible limits on eligibility of claims; to require member firms to provide certain information regarding arbitration and predispute arbitration agreements to customers upon request; and to clarify the rule regarding use of choice-of-law provisions in predispute arbitration agreements.

#### Procedural History of Rule Filing

In 1997, NASD filed three separate rule filings with the Commission relating to predispute arbitration agreements. The first rule filing related to the eligibility of claims for arbitration, the second rule filing proposed a cap on punitive damages in arbitration disputes,<sup>6</sup> and the third, SR-NASD-98-74 (this rule filing) related to increased disclosure with respect to predispute arbitration agreements.<sup>7</sup> In

<sup>6</sup> On June 24, 1997, NASD submitted a proposed rule change concerning the eligibility of claims for arbitration ("Eligibility Rule Filing"). See Securities Exchange Act Release No. 39487 (December 23, 1997), 63 FR 588 (January 6, 1998) (SR-NASD-97-44). On July 7, 1997, NASD submitted a proposal to cap punitive damages in arbitration disputes ("Punitive Damages Rule Filing"). See Securities Exchange Act Release No. 39371 (November 26, 1997), 62 FR 64428 (December 5, 1997) (SR-NASD-97-47). The Eligibility Rule Filing was withdrawn on December 17, 2002, and the Punitive Damages Rule Filing was withdrawn on May 9, 2003.

<sup>7</sup> This proposal, SR-NASD-98-74, was initially filed with the Commission on October 6, 1998. On May 26, 1999, NASD submitted Amendment No. 1 to delete provisions from the proposed rule change relating to punitive damages so that all such provisions could be separately considered in connection with the Punitive Damages Rule Filing. On July 27, 1999, NASD submitted Amendment No. 2 to clarify the proposed rule language regarding permissible limitations in predispute arbitration agreements, and changed the effective date of the proposed rule change to coincide with the

July 1999, the effective date provisions of the three rule filings were linked to avoid the cost to firms, and the potential confusion to customers, of requiring multiple amendments to customer agreements in a relatively short period of time.

On November 19, 1999 the Commission published the proposed rule change for comment in the **Federal Register**.<sup>8</sup> This Notice incorporated Amendment Nos. 1 and 2 to the proposed rule change. The Commission received two comment letters on the proposed rule change.<sup>9</sup> On April 30, 2002, NASD submitted a Response to Comments and Amendment No. 3 to the proposed rule change.

NASD subsequently withdrew the Eligibility Rule Filing on December 17, 2002, and the Punitive Damages Rule Filing on May 9, 2003. As a result, NASD is proposing to revise the effective date of SR-NASD-98-74 so that the proposed rule change may proceed.

#### Background

The proposed rule change is intended to increase the disclosure required in predispute arbitration agreements. Many broker-dealers require that customers seeking to open accounts, particularly margin and option accounts or accounts with a checking or money market feature, agree in writing to arbitrate disputes concerning the account, typically in a self-regulatory organization ("SRO") sponsored forum. These agreements, called "predispute arbitration agreements," are generally part of the non-negotiated customer agreement drafted by the firm.

To ensure that customers are advised about what they are agreeing to when they sign predispute arbitration agreements, NASD Rule 3110(f) requires that such agreements contain highlighted disclosure about the differences between arbitration and litigation, including notice that by agreeing to arbitrate their disputes, customers may be waiving certain rights that would be available in court. Rule 3110(f) also requires that the agreement itself be highlighted, and that a copy of the agreement be given to the customer and acknowledged by the customer in writing.

Despite these precautions, investor representatives have expressed concern that many customers who sign predispute arbitration agreements still

do not adequately understand what they are agreeing to. For example, some predispute arbitration agreements contain "choice-of-law" provisions that specify that the law of a certain state will govern disputes arising out of the agreement. In some cases, the member knows that the law of the chosen state may limit the ability of a customer to bring a claim or obtain an award, but the customer would not be aware of these restrictions from the face of the agreement. By signing an agreement that contained a choice-of-law provision, a customer might inadvertently waive certain rights and remedies. Customers' perceptions of unfairness are heightened by the fact that, when customers must sign predispute arbitration agreements in order to open accounts, their participation in SRO-sponsored arbitration may be involuntary.

Consequently, in its 1996 report, Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors, National Association of Securities Dealers, Inc. ("Task Force Report"), the Arbitration Task Force, chaired by David Ruder (formerly Chairman of the SEC and a former NASD Board member), recommended that members be required to provide more disclosure about arbitration to customers who sign predispute arbitration agreements, and that the use of certain provisions that limit rights and remedies be restricted.

#### Proposed Amendments

##### *Required Disclosure and Notice of Possible Restrictions on Eligibility*

Currently, paragraph (f)(1) of Rule 3110 mandates certain disclosure language about the differences between litigation and arbitration that must be included in predispute arbitration agreements. The proposed amendments would simplify the language in some existing provisions and would add new provisions.

One of the most significant new provisions concerns notice of possible limits in some arbitration forums on the time for bringing claims. Paragraph (f)(1)(F) would require disclosure that the rules of some arbitration forums may impose time limits for bringing claims in arbitration, and that, in some cases, claims that are ineligible for arbitration may be brought in court. This provision is intended to give notice to customers of NASD Rule 10304 relating to eligibility of claims submitted to arbitration, as well as the rules in other forums.

Eligibility Rule Filing and Punitive Damages Rule Filing then pending before the Commission (SR-NASD-97-44 and SR-NASD-97-47).

<sup>8</sup> See *supra* note.

<sup>9</sup> See *supra* note.