

include claims by members against other members or associated person that relate exclusively to promissory notes.

Background

In July 2002, the California Judicial Commission adopted a set of rules, "Ethics Standards for Neutral Arbitrators in Contractual Arbitration" ("California Standards"),⁴ governing ethical standards for arbitrators. The rules were designed to address conflicts of interest in private arbitration forums that are not part of a federal regulatory system overseen on a uniform, national basis by the SEC. The California Standards imposed disclosure requirements on arbitrators that conflict with the disclosure rules of NASD and the New York Stock Exchange ("NYSE"). Because NASD could not both administer its arbitration program in accordance with its own rules and comply with the new California Standards at the same time, NASD initially suspended the appointment of arbitrators in cases in California, but offered parties several options for pursuing their cases.⁵

In November 2002, NASD and NYSE filed a lawsuit in federal district court seeking a declaratory judgment that the California Standards are inapplicable to arbitration forums sponsored by self-regulatory organizations ("SROs").⁶ That litigation is currently pending on appeal. Since then, other lawsuits relating to the application of the California Standards to SRO-sponsored arbitration have been filed, several of which are also still pending.

To allow arbitrations to proceed in California while the litigation is pending, NASD implemented a pilot rule to require all industry parties (member firms and associated persons) to waive application of the California Standards to the case, if all the parties in the case who are customers, or associated persons with claims against industry parties, have done so.⁷ In such

cases, the arbitration proceeds under the NASD Code of Arbitration Procedure, which already contains extensive disclosure requirements and provisions for challenging arbitrators with potential conflicts of interest.⁸

The pilot rule, which was originally approved for six months on September 26, 2002, has been extended, and is now due to expire on March 31, 2004.⁹

Description of Proposed Rule Change

The pilot rule currently applies to all claims filed by customers, and to claims filed by associated persons against members or other associated persons. The proposed rule change would extend the pilot rule to apply to claims filed by members against other members, and to claims filed by members against associated persons that relate exclusively to promissory notes.

Specifically, the proposed rule change would amend IM-10100(f) to provide that if a member bringing a claim against another member, or a claim against an associated person that relates exclusively to promissory notes, waives application of the California Standards to the dispute, then the industry respondents will also be deemed to have waived the application of the Standards.¹⁰ This rule change will allow to proceed the majority of the remaining intra-industry cases that are currently stalled due to the confusion surrounding the California Standards. It will also prevent delay in such cases that are filed in the future, and will facilitate the administration of cases against such parties in California while the rule is in effect. NASD proposes to make the proposed rule change, which will apply to pending and future arbitrations, operative immediately upon filing.

a member, and required a written waiver by the industry respondents. In July 2003, NASD expanded the scope of the pilot rule to include all claims by associated persons against another associated person or a member. At the same time, the rule was amended to provide that when a customer, or an associated person with a claim against a member or another associated person, agrees to waive the application of the California Standards, all respondents that are members or associated persons will be deemed to have waived the application of the standards as well. The July 2003 amendment also clarified that the pilot rule applies to terminated members and associated persons. See Securities Exchange Act Rel. No. 48187 (July 16, 2003), 68 FR 43553 (July 23, 2003) (File No. SR-NASD-2003-106).

⁸ The NYSE has a similar rule; Rule 600(g).

⁹ See Securities Exchange Act Rel. No. 48553 (September 26, 2003), 68 FR 57494 (October 3, 2003) (File No. SR-NASD-2003-144).

¹⁰ The proposed rule change would include disputes that relate exclusively to promissory notes. It would not apply in cases that involve both promissory notes and other types of claims that do not already fall within the scope of the rule.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act,¹¹ which requires, among other things, that NASD's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that by expediting the appointment of arbitrators under the waiver, the proposed rule change will allow affected parties to pursue their contractual rights to proceed in arbitration in California, notwithstanding the confusion caused by the disputed California Standards.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

NASD has designated the proposed rule change as one that: (i) Does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate. Therefore, the foregoing rule change has become effective pursuant to section 19(b)(3)(A) of the Act¹² and Rule 19b-4(f)(6) thereunder.¹³ At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that the action is necessary or appropriate in the public interest, for the protection of investors, or would otherwise further the purposes of the Act.

Pursuant to Rule 19b-4(f)(6)(iii) under the Act,¹⁴ the proposal may not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent

⁴ California Rules of Court, Division VI of the Appendix, entitled, "Ethics Standards for Neutral Arbitrators in Contractual Arbitration" (the "California Standards").

⁵ These measures included providing venue changes for arbitration cases, using non-California arbitrators when appropriate, and waiving administrative fees for NASD-sponsored mediations.

⁶ See Motion for Declaratory Judgment, *NASD Dispute Resolution, Inc. and New York Stock Exchange, Inc. v. Judicial Council of California*, filed in the United States District Court for the Northern District of California, No. C 02 3486 SBA (July 22, 2002), available on the NASD Web site at: http://www.nasdadr.com/pdf-text/072202_ca_complaint.pdf.

⁷ Originally, the pilot rule only applied to claims by customers, or by associated persons asserting a statutory employment discrimination claim against

¹¹ 15 U.S.C. 78o-3(b)(6).

¹² 15 U.S.C. 78s(b)(3)(A).

¹³ 17 CFR 240.19b-4(f)(6).

¹⁴ 17 CFR 240.19b-4(f)(6)(iii).