July 27, 2007

The Arbitration Policy Task Force Report — A Report Card

Authored by NASD Dispute Resolution[1]
With a foreword by David S. Ruder

FOREWORD

By David S. Ruder*

The "Report Card" written by NASD Dispute Resolution regarding the 1996 Securities Arbitration Reform report by the NASD Arbitration Policy Task Force quite clearly shows that the present NASD securities arbitration system is greatly improved over the 1996 system for resolving disputes involving public investors, securities industry firms, and firm employees.

NASD's securities arbitration system is fair to participants, and offers investors procedures for dispute resolution with broker-dealers that are equal to and frequently superior to actions in courts.

Independence, Financing, and Automation

The most dramatic change in NASD's securities arbitration system was the reorganization of NASD's governance of the system to be administered by NASD Dispute Resolution, Inc., an independent subsidiary of NASD. Dispute Resolution has been governed by a Board of Directors containing a majority of directors who are not associated with the securities industry. Its president, Linda D. Fienberg, was the Reporter for the Task Force and has brought great talent and success to her presidency.

Dispute Resolution has substantial financial resources, and is 75% financed by the securities industry. Key portions of the arbitration system are now automated through a computerized list selection vehicle (NLSS), a developing web-based case administration system (MATRICS), and a Dispute Resolution Web site. NASD hearings now take place in 68 locations, including all 50 states, Puerto Rico and London.

These improvements are very positive, and respond to the Task Force recommendation that the securities arbitration system be independent, well financed, and automated.

Predispute Arbitration Agreements

Broker-dealers require almost all individual investors who transact business or open accounts with them to sign predispute arbitration agreements requiring that their claims against brokerage firms be resolved in SRO (self-regulatory organization) sponsored arbitration systems, such as NASD's system, rather than in court.

In recognition of the effect of these predispute arbitration agreements, the Task Force urged that NASD take steps to help investors understand that when they sign brokerage agreements they are waiving their rights to have disputes decided in courts. The NASD has taken important steps to improve such disclosures to investors by rules, by *Notices to Members*, and by disciplinary proceedings. It has also taken steps to prevent broker-dealers from creating contracts that arbitrarily force the law of a particular state on investors in order to take advantage of industry favorable law in that state.

Arbitrator Selection, Quality, and Training

Improvements in matters involving arbitrators are dramatic and positive. NASD no longer selects arbitrators. Instead, the parties now select arbitrators through the NLSS automated neutral selection system that provides lists of public and non-public arbitrators whose backgrounds are fully disclosed, and whose records of past awards are also fully disclosed. In investor cases, the NLSS system proposes ten public arbitrators and five non-public arbitrators. The parties are given power to strike names, to rank the arbitrators, and to challenge for cause. If the parties cannot agree, NASD's computer system then selects the arbitrators.

Other positive improvements in the system include major improvements in arbitrator training and testing. As part of these improvements, NASD now makes extensive use of computer programs for arbitrator recruitment, information, education and training, as well as selection.

Despite these improvements, NASD should be open to further enhancements in the system. For example, NASD might consider additional training to prepare arbitrators better to manage complex cases and extensive motion and briefing practices.

Procedural Matters

Discovery - The 1996 Report identified discovery matters as contentious, time consuming and expensive. NASD improvements in this area through its Discovery Guide, arbitrator training, censure of members and other steps have been an excellent and positive response to the discovery problems.

Mediation and Early Neutral Evaluation - In response to Task Force recommendations, NASD has greatly expanded its mediation program so that it is now a major and very positive factor in resolution of securities disputes. Given the expanded mediation system, NASD's decision not to create a system for early neutral evaluation is not a cause for concern.

Simplified and Standard Case Rules - NASD has raised the ceiling for simplified cases to be decided based solely upon paper records from $10,000 to $25,000. It has created a single class for the remainder of the cases based upon an improved discovery process and the inauguration of initial pre-hearing conferences. These improvements seem to satisfy the Task Force's concerns regarding small, larger, and complex cases, although questions still might be raised regarding the system's ability to deal with very large claims.

The Six Year Eligibility Rule - At the time the Report was written, excessive litigation and uncertainty existed regarding the application of the NASD Eligibility Rule, under which claims would not be eligible for arbitration if six years had elapsed from the occurrence or event giving rise to the claim.

As noted in the Report Card, the Supreme Court has resolved some of the excess litigation problems created by the rule by holding that arbitrators rather than courts should resolve questions regarding whether the rule's provisions have been met. NASD's new 2005 rule conforms to the Court's decision and contains other provisions designed to cause all investor claims to be resolved in the same forum.

Punitive Damages

The most contentious issue considered by the Task Force was whether punitive damages should be awarded in securities arbitration cases. The industry argued that punitive damages are intended to deter misconduct, not compensate victims, that an extensive SEC and NASD system exists to regulate and punish misconduct, and that arbitration lacks the necessary procedural safeguards, including a right to appeal. The investor community argued that since investors are forced to accept arbitration through predispute arbitration agreements, elimination of punitive damage claims in arbitration would deprive them of rights available in the court system.

The Task Force presented a compromise position by recommending that a cap be imposed on punitive damages of the lesser of $750,000 or two times compensatory damages. NASD submitted a rule based on the Task Force recommendations to the SEC, but ultimately withdrew the rule after investor objections and SEC inaction. NASD has amended its conduct rules to preclude broker-dealers from including provisions in customer contracts denying the right to pursue punitive damages in arbitration. As NASD has observed, Supreme Court limits on "excessive" punitive damage awards may serve to limit such awards in arbitration.

Other Matters

Representation By Non-lawyers - The Task Force examined the question whether representation of investors in arbitration by non-lawyers benefited investors by providing low cost representation or might cause possible injury to investors by unqualified non-lawyer representatives. The Task Force did not urge that non-lawyer representation be prohibited. NASD's proposed rule as described in the Report Card meets the Task Force's recommendation that non-lawyers who are currently excluded from the securities industry or the practice of law be prevented from representing customers in NASD arbitration cases.

Newly created law school securities arbitration clinics provide a promising source of representation for investors whose claims are small. NASD should make it a high priority to assist such clinics in finding funding.

Employment Disputes - The new rules as described in the Report Card have improved the fairness of employment disputes between broker-dealers and their employees.

Injunctive Relief - The Task Force expressed concerns regarding complications and uncertainty with regard to injunctive relief in firm against firm disputes over "raiding" of employees by one firm from another firm. NASD has now implemented a system providing for court adjudication of claims for a temporary injunction and NASD arbitration of claims for permanent relief, and by so doing has alleviated some of the uncertainty in a very contentious area.

The Future

As the securities industry continues to be more automated and more complicated, it seems certain that investor, employee and firm disputes will continue. Although the Task Force Report is now more than ten years old, its concern that NASD's securities arbitration system provide fairness, speed and low cost in resolution of disputes should continue to drive the operation of NASD Dispute Resolution. Hopefully in all of its operations NASD Dispute Resolution will continue to emphasize the primary goal of fairness to participants in the system.

*David S. Ruder is a Professor of Law, Northwestern University School of Law. Professor Ruder was Chairman of the U.S. Securities and Exchange Commission from 1987 to 1989, was a member of the NASD Board of Governors from 1990 to 1993, and was the Chairman of the NASD Arbitration Policy Task Force.

The Arbitration Policy Task Force Report — A Report Card

Introduction

In 1994, NASD statistics showed a 28 percent increase in case filings over the prior two years. Hearings were lasting more than 15 percent longer, and case processing time had increased by more than ten percent over the prior year. Punitive damages accounted for over 13 percent of all damages arbitrators awarded during the year.

That description could be taken from almost any time period in the history of NASD dispute resolution, but the landscape in 1994 and the growing concerns about the evolving arbitration process led NASD officials to assemble a group of outside experts, led by former Securities and Exchange Commission (SEC) Chairman David S. Ruder, to conduct a thorough examination of the nature of NASD securities arbitration and recommend a roadmap for the future.

NASD's Board of Governors asked this blue-ribbon committee, the Arbitration Policy Task Force[2] (NASD Task Force or Task Force), to review the entire NASD securities arbitration process. It was the most wide-ranging examination of securities arbitration since the 1987 Supreme Court decision[3] that holds predispute arbitration agreements enforceable to compel arbitration of claims arising under the Securities Exchange Act of 1934. This article examines the major recommendations contained in the 1996 report of the NASD Task Force titled *Securities Arbitration Reform* (Task Force Report or Report) and traces the actions taken by NASD in response to those recommendations.

Background

The Task Force worked for more than 15 months, interviewing and receiving written submissions from representatives of investor and consumer groups, securities regulators, securities exchanges, securities firms, firm employee groups, arbitrators and mediators and others involved with securities dispute resolution. This method of gathering input from practitioners and listening to the users of dispute resolution services created a wealth of information and insights for the Task Force.

In January 1996, NASD released the Arbitration Policy Task Force Report, containing more than 70 recommendations for change. This Report represented the most comprehensive proposal to revamp securities industry arbitration since it was established to resolve investor disputes more than a century earlier. In announcing the Report, Chairman David S. Ruder stated: "Fairness, speed, and low cost are the focus of our changes. Our integrated package of recommendations will preserve and enhance a system that has benefited both investors and the securities industry."

During the next ten-plus years, the recommendations in the Task Force Report formed the framework that currently guides NASD Dispute Resolution policy and rulemaking. NASD has implemented nearly every key recommendation, although in several areas the path to implementation and the final outcome may be different than the Task Force recommended or envisioned. NASD has worked extensively to preserve and respect the basic elements of a fair and efficient dispute resolution system, while responding to the changing needs of our customers by embracing the modifications needed to enhance the system. In addition, NASD continued the Task Force's model of using the National Arbitration and Mediation Committee (NAMC),[4] focus group meetings and other proactive methods to seek direction from our forum's customers. This methodology led to adjustments to several of the Task Force recommendations and to a number of additional improvements not proposed by the Task Force.

A Delicate Balance

David Ruder described the Report as an "integrated package" of recommendations. The Report emphasized that the recommendations represented an "interrelated series of reforms." As Linda Fienberg[5] noted in her article, *The NASD Securities Arbitration Report: A View From the Inside*, which was presented to the 1996 Public Investors Arbitration Bar Association (PIABA) Annual Meeting, the recommendations reflected not only a delicate and sensible compromise among competing investor and industry positions, but also an effort to provide fair and workable solutions to improve the process.

Although the Task Force wanted to preserve the balance struck, particularly on the three most contentious issues—predispute arbitration agreements, punitive damages and the eligibility rule—the package drew fire in the implementation stages. As NASD brought forward specific rule proposals, investor and industry factions regrouped to support the portions deemed most favorable to them and to attack the "compromise" provisions. These groups were not part of the internal Task Force negotiations; thus, during the rulemaking process, NASD had to stand on its own as it proposed each recommendation. As the rulemaking process evolved, NASD preserved the objective to find fair and workable solutions to improve the forum.

Task Force Recommendations

NASD reviewed and analyzed each of the more than 70 recommendations and incorporated many of the suggestions into rules or procedures. This article traces NASD's course of action to implement the Task Force's recommendations in the following 11 key areas:

1) arbitrator selection, quality and training
2) discovery
3) mediation and early neutral evaluation
4) predispute arbitration agreements
5) six-year eligibility rule
6) party representation
7) simplified, standard, and large and complex case rules
8) punitive damages
9) employment disputes
10) injunctive relief
11) financing and governance of the NASD arbitration forum

At the conclusion, we will outline other significant NASD actions that go beyond the Report recommendations and summarize the outlook going forward.

1. Arbitrator Selection, Quality and Training

The core component of any arbitration system is, of course, the arbitrators. Not surprisingly, the Task Force focused on improving the quality of NASD's arbitration roster. The Task Force suggested that NASD provide greater party participation in selecting arbitrators, clarify the definitions of arbitrator classifications, improve arbitrator training, encourage party feedback on arbitrator performance, expand arbitrator recruitment and increase compensation. The most important of these recommendations was to establish a party-driven method of arbitrator selection.

Key Recommendations: The Task Force recommended that NASD: 1) adopt a list selection method for choosing the arbitration panel; 2) place arbitrators on the selection lists on a rotating basis to promote more frequent selection of arbitrators who complete the training programs; and 3) permit greater flexibility in designating individuals as public or non-public ("industry") arbitrators.

Arbitrator List Selection

In November 1998, NASD implemented the arbitrator list selection system. The SEC approved the use of NASD's neutral list selection system (NLSS) after extensive comments from forum users. NLSS allows the parties to have direct input into the arbitrator selection process and ensures that NASD staff does not control arbitrator appointment. NLSS proposes panelists from an arbitrator pool that generally[6] consists of one list of 10 public arbitrators and one list of five non-public arbitrators. NASD's computer program generates these lists using a rotational method. Along with the lists, NASD sends comprehensive background profiles for each of the proposed arbitrators. NASD also provides a mechanism for parties to review copies of past awards for each listed arbitrator by making them available free of charge on the NASD Web site.

Parties then may strike any or all of the names on each list and rank the remaining ones. Based on the results of the parties' consolidated lists, NASD appoints the highest ranked arbitrators to serve (two from the public list and one from the non-public list). If the panel cannot be constituted through the list process, the NLSS computer-generated appointment process extends the list and fills these vacancies with other arbitrators who the parties may challenge for cause.

Focus groups and other party feedback indicated that NASD's constituents viewed the transition to NLSS very favorably. In response to two concerns, one relating to extended lists and the other to inexperienced chairpersons who were sometimes selected for panels, NASD proposed changes to NLSS to address these issues as part of a comprehensive revision of the Code of Arbitration Procedure (Revised Code). Under the Revised Code (NASD filed the Revised Code with the SEC in October 2003, and the SEC approved the Revised Code on January 31, 2007), that became effective on April 16, 2007, NASD expanded the number of names on each list of proposed arbitrators, but now limits the number of strikes in order to reduce the instances of computer-generated extended lists. In addition, the Revised Code provides for a separate list of chairperson-qualified arbitrators, as recommended by the Task Force. Finally, NASD has replaced the complicated rotational system with a simplified random selection system that will reduce maintenance costs and provide an increased perception of fairness in the process.

Flexible Classification

The Task Force felt that giving the parties more control of the selection process would make the classification labels of public or non-public less important. The Task Force also surmised that removing some of the definitional barriers would facilitate arbitrator recruitment by allowing NASD to concentrate on finding qualified neutrals regardless of their backgrounds. However, constituents of NASD's forum have made clear that the labels remain important to the perception of fairness. Consistent with the theme of listening to forum customers, NASD rules now provide more exact standards for classifying arbitrators, including a much narrower definition of public arbitrator.

Arbitrator Background Information and Evaluation

Key Recommendations: The Task Force recommended that NASD: 1) expand significantly and regularly update the database of arbitrator information; and 2) take innovative steps to encourage a greater number of evaluations by participants, while keeping evaluations voluntary.

Database of Arbitrator Information

In the arbitrator selection stage, NASD provides parties with extensive descriptions of each potential arbitrator's educational background, employment history, dispute resolution training and experience and disclosures of potential conflicts. That background profile also contains a narrative description of the arbitrator's experience. Parties can request additional background information about an arbitrator.

After the Task Force Report, NASD made several changes designed to significantly expand and regularly update NASD's database of arbitrator information. In an effort to improve the quality of the arbitrator roster, NASD expanded the Department of Neutral Management in 1999 and centralized the responsibility for updating and revising arbitrator records. The staff also employs extensive quality control measures to ensure accuracy of arbitrator updates.

In 2003, NASD raised the standards for acceptance to the roster by requiring a minimum of two years of college-level credits and more in-depth information about each arbitrator candidate's background. The forum also instituted a policy of verifying with an outside vendor key background information provided by new arbitrator applicants. Finally, NASD staff checks the Central Registration Depository (CRD) database to help properly classify arbitrators as public or non-public, and to identify any regulatory history that could disqualify a candidate.

Written Disclosures

Arbitrators are primarily responsible for maintaining and ensuring that their information is accurate and current. They are required to review and update their disclosures at several intervals: when accepted to the roster, during arbitrator training sessions and periodically in response to mass mailings. Each arbitrator appointed to hear a case must execute an oath, complete an extensive questionnaire designed to prompt relevant disclosures and sign an affirmation of the accuracy of the arbitrator's background information. NASD regularly reminds arbitrators of the importance of disclosures and allows arbitrators to make disclosure updates through NASD's Web site.

NASD also provides information on past awards rendered by arbitrators. In 2001, NASD replaced the manual retrieval of these documents with an award library accessible to parties at no charge, via NASD's Web site. Additionally, NASD staff provides paper copies of awards to parties who do not have Internet access.

Encouraging Evaluations by Participants

NASD took several steps to improve party evaluation return rates. These included asking the parties and their representatives, peer arbitrators and NASD staff to rate arbitrator performance. To make the process easier, the party evaluation form is now online and NASD is converting peer and staff evaluation forms to the online format. NASD uses evaluations from all sources to identify and remove non-performing arbitrators from the roster.

Arbitrator Recruitment and Compensation

Key Recommendations: The Task Force recommended that NASD: 1) raise arbitrator compensation to attract well-qualified arbitrators and create incentives for training; and 2) intensify its efforts to recruit experienced arbitrators.

Compensation

In March 1999, NASD amended its rules to increase the honorarium paid to arbitrators from $150 to $200 for each hearing session, with an additional $75 per day for the panel's chairperson. Subsequently, NASD implemented a payment to arbitrators for deciding discovery-related motions and recently added a similar payment for considering contested motions for the issuance of subpoenas. To further recognize the time commitments of arbitrators in addition to the hearing duties, NASD amended the Code to allow additional compensation to arbitrators for late adjournments or settlements by parties.

Arbitrator Recruitment

NASD carefully selects arbitrator candidates from a broad cross-section of people, diverse in culture, with varying professions and backgrounds. NASD expanded its recruitment team and intensified efforts to provide more arbitrators to handle the caseload in each of NASD's 68 hearing locations.

Arbitrator Quality and Training

Key Recommendations: The Task Force recommended that: 1) NASD expand the scope and frequency of mandatory arbitrator training; 2) panel chairpersons receive more extensive training; 3) NASD continually evaluate the quality and effectiveness of training programs; and 4) Self-Regulatory Organizations (SROs) consolidate training efforts.

Expand Training

NASD recognizes that relevant, effective arbitrator training is essential to maintain the high quality of our forum. We seek to make arbitrator training convenient and affordable for arbitrators, as well as practical. Thus, NASD creates training programs as new developments warrant, and requires mandatory training on certain issues. To make our training more accessible and flexible, we adapted several programs to online formats and developed new programs for online delivery.

In 1996, NASD dramatically altered the format for panel member and chairperson training. These new programs featured a pre-course study and reference manual, accompanied by an onsite workshop. The course materials, developed in conjunction with members of the NAMC, provided comprehensive information on the arbitration process and the application of NASD arbitration rules. In addition, NASD prepared experienced arbitrators to serve as co-trainers in a comprehensive Train-the-Trainer course. In March 1998, as part of panel member training, NASD instituted mandatory testing for all new arbitrators, which requires a passing score of at least 80 percent on an examination at the conclusion of the onsite workshop.

NASD regularly reviews and updates each program using input from co-trainers and practitioners in the forum. As of 2006, the mandatory panel member training program requires arbitrator applicants to thoroughly review the online self-study materials and then pass the examination before attending the onsite program. In addition, the trainers evaluate the candidates based on classroom participation during the workshop.

NASD also offers subject-specific online training modules and records the courses completed on the disclosure reports provided to parties. Since 2003, NASD has developed six online arbitrator courses that allow arbitrators to gain an in-depth understanding of key issues, such as:

- arbitrators' obligations to disclose information to NASD, parties and co-arbitrators;
- the discovery process;
- restrictions on expungement of information from CRD records (mandatory course);
- applying the direct communication rule in arbitration cases;
- managing the prehearing conference; and
- the revised Codes of Arbitration Procedure (mandatory course).

Online access makes training manageable and convenient for arbitrators. The online environment also enables NASD to efficiently review and update its training materials as often as necessary. NASD makes all arbitrator training materials available online and will continue to release additional online courses at regular intervals.

In addition to onsite and online training, NASD instituted periodic call-in workshops on various topics. The forum also notifies and encourages arbitrators to view NASD's free webcasts, which are brief online tutorials about industry issues. Finally, six times a year in both hard copy and Web format, NASD publishes The Neutral Corner newsletter, which provides new rules, procedural updates and practice tips to NASD's arbitrators and mediators.

Chairperson Training

In response to the Task Force Report, NASD developed a training course in 1996 designed to assist arbitrators serving as chairpersons. The course instructs arbitrators on the additional responsibilities of arbitrators assuming the crucial role of chairperson. In 2003, NASD updated the materials for the

chairperson course and converted the course to an online format. In the Revised Code, successful completion of this course will be a prerequisite for serving as a chairperson, unless the arbitrator can demonstrate substantially equivalent training or experience.

Consolidating Training Efforts

Although NASD coordinated training programs with other SROs in the past, the implementation of NASD's testing requirement in 1998 led to a divergence among the SROs. In addition, the number of different SRO forums has decreased since 1996. NASD has become the arbitration and mediation administrator for the American Stock Exchange, the Municipal Securities Rulemaking Board, the Philadelphia Stock Exchange and the International Securities Exchange. Through merger, the New York and Pacific Stock Exchanges combined and several smaller exchanges rarely handle arbitration cases. These developments reduced the need to coordinate training efforts.

Results: The success of securities arbitration depends on the quality of the arbitrators on the roster. NASD has spent significant resources in the last ten years to enhance quality through intensified recruitment and training. We have built an extensive menu of training opportunities, from the panel and chairperson programs to the series of subject-specific modules and educational updates. NASD's improvements to arbitrator disclosures and upgrades to the evaluation process also help us maintain the quality of the roster. The introduction of NLSS, which gives parties more control of arbitrator selection, and our continued efforts to refine arbitrator classification definitions help to build confidence and trust in the arbitration system.

2. Discovery

The Task Force recognized that an essential element of a fair, transparent arbitration system is access to information. The Task Force members found that parties and arbitrators did not clearly understand the NASD rules and procedures governing discovery. The Task Force encouraged NASD to establish expected levels of documentary exchanges in the arbitration process and to clarify the respective roles of the arbitrators and parties in this process.

Key Recommendations: The Task Force recommended that: 1) parties be required to produce essential documents early in the arbitration process without awaiting a request; 2) arbitrators, and especially chairpersons, assume a much greater role in the discovery process; and 3) NASD provide better guidance to arbitrators on the proper scope and management of discovery.

The Discovery Guide

The Task Force reported that parties and their attorneys routinely failed to comply with discovery requests or complied only in part. In addition, NASD rules did not provide guidance to an arbitrator as to the proper scope of discovery and, thus, discovery disputes were resolved largely according to the standards of individual arbitrators. According to the Task Force, some arbitrators had experience in civil litigation, but others had little knowledge or training that would enable them to resolve a dispute according to any uniform standards or rules.

In response, NASD developed discovery guidance for parties and arbitrators. In keeping with the theme of soliciting expert input, NASD organized several groups to develop a consensus on the content of the guidelines. The Discovery Guide represents a compromise reached over a two-year period among numerous groups involved in our arbitration forum with diverse perspectives.

The Discovery Guide first became available in 1999 after a period of public comment in response to an SEC notice. The Guide is for arbitrators to use in customer arbitrations as a supplement to the guidance regarding discovery in the Securities Industry Conference on Arbitration[7] (SICA) *Arbitrator's Manual*. The Discovery Guide consists of introductory and instructional text followed by 14 lists of presumptively discoverable documents. Two lists apply in all cases: a list of documents for investors to produce, and a list for brokerage firms and associated persons. The 12 additional lists identify documents to be produced in cases involving specific types of alleged conduct or claims, such as unauthorized trading or failure to supervise. In addition to specific document production requirements, the Guide also discusses confidential treatment of documents, additional document requests, information requests, depositions, admissibility of evidence and sanctions. Nothing in the Discovery Guide precludes the parties from voluntarily agreeing to an exchange of documents in a manner different from that set forth in the Guide or lists. Finally, the Guide provides that an arbitrator has wide discretion to address non-compliance with an arbitrator's discovery order.

Parties and counsel viewed the introduction of the Discovery Guide as an unqualified success. To ensure its continued relevance, NASD recently formed a committee to update the Document Production Lists. NASD plans to file proposals for updated lists with the SEC in 2007.

NASD also has taken a series of additional steps to enhance the discovery process since the introduction of the Discovery Guide as described below.

The Revised Code and Discovery

The Revised Code makes significant improvements to the discovery process. The rules now reference the applicability of the Document Production Lists and contain specific rules on other discovery requests, objections to discovery requests, motions to compel, requests for information, depositions and discovery sanctions.

Actions Regarding Discovery Abuse

Responding to numerous complaints about abuse of the discovery process, NASD published a *Notice to Members* to remind broker-dealers and their associated persons that NASD actively monitors compliance with discovery orders and refers any perceived abuses to NASD's regulatory arm for investigation and disciplinary review. NASD published a similar notice to all parties and an article in the *Securities Arbitration Commentator* to remind all parties of their discovery obligations.

In July 2004, NASD censured and fined three brokerage firms for failing to comply with their discovery obligations in 20 arbitration cases from 2002 through 2004. In connection with these sanctions, NASD ordered the firms to implement written procedures designed to ensure that senior officers would review any future sanctions for discovery violations for appropriate corrective action.

Arbitrator Training on Discovery

In March 2004, NASD hosted a call-in program for arbitrators covering the discovery process, abuse of that process and available sanctions. Three months later, NASD launched an online training course that focuses on the respective duties of arbitrators and parties in the discovery process. The course discusses orders of confidentiality, guides arbitrators to recognize and address discovery abuse and reviews the array of possible sanctions if they become necessary.

The Discovery Arbitrator Pilot Program

Recently, NASD instituted a voluntary Discovery Arbitrator Pilot Program for deciding discovery issues early in selected geographic regions. NASD trained a small number of very experienced public arbitrators who decide all discovery-related motions in pilot program cases but do not serve on the regular arbitration panel selected to hear the case. Initial participants in this program to facilitate discovery rulings have reported favorable results. The pilot program will run through 2009.

Results: NASD has implemented all of the Task Force's discovery-related recommendations, primarily through the issuance of the Discovery Guide, but also through changes to the Code and new arbitrator training initiatives. The Discovery Guide follows the Task Force's recommendation that NASD encourage early production of essential documents.

3. Mediation and Early Neutral Evaluation

At the time of the Report, the Task Force cited the emergence of mediation, early neutral evaluation (ENE), and other forms of non-binding dispute resolution as important adjuncts to the arbitration process. Noting that NASD already had a relatively new mediation program, the Task Force encouraged its expansion and further development. It also suggested that NASD consider ENE and other non-binding forms of dispute resolution.

Key Recommendations: The Task Force recommended expansion of NASD's voluntary mediation program and development of an ENE program.

Mediation

NASD used the impetus of the Task Force Report to accelerate development of its mediation program. Prior to the Report and in response to the arbitration process becoming more adversarial, costly and time consuming, NASD had developed a small voluntary, non-binding mediation program. In this format, the parties controlled the dispute resolution process, including case scheduling, mediator selection, and—most importantly—the outcome of their case.

In response to the Task Force Report, NASD increased the number of mediation staff and began to raise awareness among practitioners about mediation. Through an aggressive strategy of educating parties and counsel about the benefits of mediation, NASD incorporated mediation into the landscape of securities dispute resolution. The strategy involved an extensive number of presentations about the advantages of mediation at bar association meetings throughout the country and at conferences of securities dispute resolution professionals. Through these presentations, NASD helped practitioners build their skills in representing clients in mediation. Because of these efforts, investors, brokerage firms, registered representatives and attorneys began to explore ways to use and benefit from the mediation alternative.

The staff also implemented innovative approaches to introduce mediation and to educate users, such as offering special pricing for parties during mediation "Settlement Events" to allow smaller cases to take advantage of the benefits of mediation. Beginning as week-long events in selected cities, NASD eventually developed a tradition of holding Mediation Settlement Month each October. During October, NASD teams with its mediators to reduce the normal mediation fees, presenting substantial savings for parties. The savings during Mediation Settlement Month also make the process affordable for smaller claims on the docket.

New York State and national mediation providers have adopted NASD's model of promoting the mediation process. Since 2001, NASD has coordinated a growing coalition of organizations to support Mediation Settlement Day in New York. More than 100 court mediation programs, bar associations, community-based programs, universities and government agencies celebrate Mediation Settlement Day by holding events to help educate judges, attorneys and parties about the benefits of mediation. The Governor of New York and the Mayor of New York City have recognized the value of these efforts.

The Mediator Roster

To address the growing interest in mediation, NASD steadily increased the number of qualified mediators by recruiting extensively and holding mediator training programs. NASD built the roster of mediators to participate in the program to over 1,000 nationally. The mediator qualification process involves a review by an NAMC mediation subcommittee to ensure that each approved mediator has a thorough knowledge of the mediation process and has demonstrated the skills necessary to help parties resolve disputes. In addition, we established qualification standards for "Practitioner" mediators to increase the number of mediators with extensive subject-matter knowledge.

The Mediation Caseload

NASD's mediation caseload started at fewer than 100 cases in 1995. By 2006, however, NASD's mediation program was handling more securities matters each year than any SRO arbitration forum outside of NASD. Since the establishment of the mediation program 11 years ago, we have processed over 14,000 cases involving a wide variety of securities disputes, with over 80 percent resulting in a settlement between the parties. Participants consistently report satisfaction with the process. In recent surveys of parties mediating with NASD, 80 percent of those who responded agreed that mediation resulted in time and cost savings.

ENE

The Task Force recommended a mandatory ENE pilot program, to be financed by NASD. The ENE process involves brief presentations by the parties, followed by a non-binding evaluation by a subject-matter expert of the likely outcome of the case. Parties could then use the evaluation and insights of the evaluator to re-assess their case and consider settlement. NASD explored development of an ENE program, but decided not to implement one because of prohibitive costs and likely delays in the overall process if the cases did not settle. More importantly, parties and counsel were deriving the benefits of ENE from the evaluative mediation process without the added steps and costs.

Results: NASD expanded the voluntary mediation program by adding resources to support the program and by actively promoting the use of mediation. NASD decided not to add ENE it to its dispute resolution services after analyzing potential costs, delays and redundancies to its existing mediation program.

4. Predispute Arbitration Agreements

The Task Force observed that brokerage firms regularly used arbitration clauses in customer account agreements and suggested more understandable disclosures about the terms of such clauses. The Task Force also recognized that, because customer predispute arbitration agreements were generally not the result of arm's-length negotiations between equal parties, certain uniform "investor-friendly" provisions should be required when firms elected to include arbitration clauses in account agreements.

Key Recommendations: The Task Force recommended that predispute arbitration agreements should contain certain uniform provisions and should provide clear notice that the customer is entering into an arbitration agreement and the consequences.

Predispute Arbitration Agreements

The Task Force Report observed that investors often were concerned that they could not open brokerage accounts unless they signed predispute arbitration agreements. Under the terms of such agreements, the parties contract in advance to resolve future disputes in an arbitration forum rather than in court. In the securities industry, such agreements generally provide for arbitration at NASD and the New York Stock Exchange, although other forums may be listed as additional alternatives. Under SRO rules, all firms and associated persons must arbitrate upon the demand of a customer, whether or not the customer has signed a predispute agreement.

The Report noted that predispute arbitration agreements contained certain disclosures the SROs mandate. NASD rules required such agreements to contain disclosures that the parties were waiving their right to seek remedies in court, including the right to a jury trial. Predispute agreements had to point out that arbitration was final and binding on the parties and describe procedural differences between court litigation and arbitration. The agreements were required to disclose that: discovery was generally more limited in arbitration; the arbitration award was not required to include factual findings or legal reasoning and any party's right to appeal or seek modification of the award was strictly limited; and the panel of arbitrators typically would include a minority of arbitrators who were or are affiliated with the securities industry.

Despite these requirements, many investor representatives expressed the view that the average customer did not sufficiently understand the arbitration provisions and their consequences. There was a particular concern with choice-of-law provisions that designated which state's law would govern the substantive issues raised by the claim and answer. The Report noted that the choice of law might affect the rights or remedies that would otherwise be available to the customer in court, such as punitive damages.

Revised Disclosures

Since the adoption of the first required disclosure rule in 1989, NASD has issued six *Notices to Members* that concern the acceptable parameters of predispute arbitration agreements. In 1998, based on Task Force recommendations, NASD filed a proposal with the SEC to: require broker-dealers to provide copies of predispute arbitration agreements and relevant arbitration forum rules to customers upon request; clarify the use of certain limiting provisions; incorporate into the agreement the rules of the arbitration forum in which a claim is brought; and require firms seeking to compel arbitration of claims initiated in court to arbitrate all of the claims contained in the complaint if the customer so requests.

The revised disclosure rule makes the consequences of a predispute arbitration agreement easier to understand, includes a new disclosure that the rules of some arbitration forums may impose time limits for bringing claims and adds a disclosure that, in some cases, claims that are ineligible for arbitration may be brought in court. The amended rule also requires that the agreement clearly state that rules of the arbitration forum in which a claim is brought are incorporated into the parties' agreement. NASD required firms to use the new disclosure language in all new customer account agreements containing predispute arbitration agreements beginning June 1, 2005.

The revised rule makes clear that the delivery and customer acknowledgement of the agreement must take place at the time of signing. In addition, firms must provide the customer with a copy of any predispute arbitration agreement upon request.

NASD also reminded firms that, in accordance with NASD *Notices to Members*, it would continue to interpret the revised rule to require that, if a choice-of-law provision is used, there must be an adequate nexus between the law chosen and the transaction or parties at issue.

Results: NASD carried out the intent of the Task Force recommendation through regular reminders to firms of the obligation to provide clear, concise language about the consequences of arbitration agreements. In addition, NASD revised the rules to restrict the use of choice-of-law provisions that might diminish investor rights and took various disciplinary actions to enforce the disclosure provisions.

5. The Six-Year Eligibility Rule

While the six-year eligibility rule has been part of the NASD arbitration process from the program's inception, the rule had become a source of some controversy and confusion. The Task Force offered recommendations to clear up misconceptions about the rule, including the scope of the forum's and arbitrators' authority to resolve disputes over timeliness of claims.

Key Recommendations: The Task Force made several recommendations urging NASD to address issues of timeliness of claims, including eliminating the eligibility rule in favor of having such issues resolved on statute of limitations grounds.

Eligibility

A time limitation on matters eligible for arbitration has existed since NASD first adopted the Code in 1968. At the time of the Task Force's work, the rule on time limitations for submission, known as the "eligibility rule," stated that no claim would be eligible for arbitration at NASD where six years had elapsed from the occurrence or event giving rise to the claim. The rule did not extend applicable statutes of limitations, nor did it preclude cases directed to arbitration by a court of competent jurisdiction.

The Report observed that the eligibility rule had resulted in frequent court litigation and created uncertainty about who should decide questions of eligibility and about the proper triggering event. The Report noted that without a "bright line" transaction date test to establish the beginning of the six-year period, fact-intensive inquiry and discovery might be required to determine whether the claim was eligible for arbitration. Firms often sought court intervention to bar investor claims in arbitration, and parties were confused as to whether they could pursue in court claims barred from arbitration by the eligibility rule.

In light of this confusion and collateral litigation, the Report recommended that NASD suspend the eligibility rule for a three-year period, and then ultimately eliminate it. The Report suggested that, during the three-year suspension, NASD develop procedures for resolving statutes of limitations arguments by means of dispositive motions. Finally, the Task Force proposed that parties be prohibited from litigating procedural arbitrability issues in court until after an award is rendered.

The recommendations generated significant opposition from investor and industry representatives. NASD concluded that repealing the eligibility rule would create problems for both investors and firms, and that the rule's original purpose remained valid. Consequently, NASD took a different approach by proposing a rule in 1997 that would provide for a staff gate-keeping function but eliminate the aspects of the existing rule that could be unfair to public investors. However, in light of a change in the law in 2002, during the pendency of the rule filing, NASD withdrew that proposal.

Developing Law

In 2002, the United States Supreme Court ruled in Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79 (2002), that the issue of whether a claim is time-barred under the eligibility rule is presumptively a matter for arbitrators, rather than for courts, to decide. To conform the Code to the Court's ruling, and to provide additional notice and guidance to parties on this issue, NASD amended the eligibility rule to explicitly state that eligibility determinations are made by the arbitrators. The revised proposal, which was shorter and simpler than the one proposed several years earlier, became effective on May 1, 2005.

The current eligibility rule retains the six-year time limit and provides that the panel will resolve any questions regarding a claim's eligibility under the rule. In addition, it states that dismissal of a claim on eligibility grounds does not prohibit a claimant from pursuing the matter in court. Finally, the new rule provides that the six-year time limit does not apply to claims that are directed to arbitration by a court upon request of a broker-dealer or associated person. An amendment that became effective at about the same time as the new eligibility rule was an "anti-bifurcation" provision, which states that if a broker-dealer seeks a court order to compel arbitration of a claim based on a predispute arbitration agreement, the broker-dealer agrees to arbitrate all other claims contained in the same complaint.

Results: Although NASD initially pursued the Task Force recommendation, constituent response and the Howsam decision moved us in a different direction. Arbitrators now have more definitive authority to resolve any questions regarding the eligibility of claims, there is less collateral court litigation and the rules provide greater assurances that investors have some forum—be it arbitration or court—in which to have their claims resolved. These results are consistent with the Task Force's objectives.

6. Party Representation

As far back as the early 1990s, the alternative dispute resolution world noted the emerging presence of non-lawyer representatives in the arbitration process and the questions this created. The Task Force offered suggestions as to who should resolve questions about party representation and what NASD's role should be in this process. The Task Force was mindful of the sometimes difficult balance of protecting investors from potential harm from unregulated non-lawyer representatives without hindering their access to affordable representation.

Key Recommendations: The Task Force recommended that: 1) state authorities, not NASD, determine whether non-lawyer representation constitutes the unauthorized practice of law; 2) NASD undertake a study of non-lawyer representation in NASD arbitrations; and 3) NASD require non-lawyers to certify that they have not been disbarred as an attorney or barred from the securities industry.

Non-Lawyer Representation

The NASD Task Force interviewed numerous participants in the arbitration process, including non-lawyer representatives, concerning the standards for representation of parties in securities arbitration. The Task Force heard complaints, including allegations concerning the unauthorized practice of law, the filing of frivolous claims, unethical practices such as false advertising, and participation by securities law violators as non-lawyer representatives. The Task Force also examined the findings of SICA's public hearings and two-year study on the subject.

In 1995, SICA had recommended some restrictions on non-lawyer representation and education for public investors regarding the advantages and disadvantages of retaining non-lawyer representatives. Aware of SICA's recommendations and the Task Force's findings, NASD made continued attempts to build a consensus for a rule that would protect investors and also meet certain consumer groups' objectives about access to affordable representation.

NASD recognizes that non-lawyer representation poses several risks to investors. For example, non-lawyers are not subject to ethical codes or to discipline by any organization, they are not required to carry malpractice insurance and their advertising is unregulated. We understand that investors may have difficulty finding legal representation for claims under $100,000. NASD also has observed that, over the past several years, a number of states have acted to regulate the representation of parties in arbitration by non-lawyer representatives and by attorneys licensed in other states.

In 2005, after careful consideration of actions by various states and further discussions by SICA and others, NASD proposed a rule change to address the issue of party representation. The proposed rule change does not prohibit representation by non-lawyers in arbitration and mediation cases. Rather, the rule proposal provides that applicable law should govern issues regarding the qualifications of a person to represent a party in arbitration. In addition, the proposed rule would provide safeguards to investors by explicitly preventing representation by anyone who is precluded from such representation by state law; is currently suspended or barred from the securities industry in any capacity; or is an attorney who is currently suspended or disbarred from the practice of law. The proposed rule is currently pending SEC approval.

Results: With the rule filing described above, NASD has complied with the Task Force's recommendations in this area. While NASD remains concerned about some aspects of non-lawyer representation, NASD does not wish to prohibit investors from retaining a non-lawyer representative if that person is the only affordable representation available. In this regard, we are encouraged by the growth in the number of law school clinics that specialize in the representation, in arbitration or mediation, of investors with small claims. These clinics provide small claim investors of limited means with law student representation under close supervision of licensed attorneys. Continued growth in this area will provide additional opportunities for legal representation to investors. NASD's Investor Education Foundation has provided a grant to spur development of new clinics that concentrate on investor representation in securities arbitration matters.

7. Simplified, Standard, and Large and Complex Case Rules

The Task Force recognized that a "one size fits all" approach to the NASD arbitration process was not efficient because claim size and complexity were important differentiating factors in determining how to structure arbitration rules. In light of those factors and the increases in the size of claims generally, the Task Force recommended that NASD raise the claim amounts for the simplified (*i.e.*, documents-only) and standard case processing tracks, and that it experiment with special rules to govern larger, more complex disputes.

Key Recommendations: The Task Force recommended that NASD: 1) raise the ceiling for simplified arbitration and increase the threshold for cases to be heard by a single arbitrator; and 2) continue the "large and complex" case pilot program.

Three-Tiered System

At the time of the Report, NASD operated under a three-tiered system for administering arbitration claims. For cases in which the amount in controversy did not exceed $10,000, the claim was eligible to proceed under the simplified arbitration procedures where a single arbitrator decides the case, without a hearing, based on the written submissions of the parties. Claims for damages of $1 million or more proceeded under the large and complex case rules. NASD administered all other claims, those in excess of $10,000 but less than $1 million, under the standard procedures. The Report suggested changes to the thresholds and ceilings for the different tiers to help expedite arbitration.

Cases Decided Solely on the Papers

At the time of the Task Force Report, public investors could elect to proceed solely on the papers for any case involving $10,000 or less. The simplified arbitration procedures preclude discovery except under very limited circumstances in order for these smaller cases to conclude more quickly.

The Report recommended that NASD increase the ceiling for cases decided on the papers from $10,000 to $30,000. The Task Force observed the significant increases over time in the amount of damages parties sought and concluded that it was logical to change the definition of "small" claims. In November 1998, NASD increased the ceiling for simplified cases from $10,000 to $25,000. In addition, NASD adopted the Report's recommendation that the amount of claimed damages used to calculate the simplified case ceiling include compensatory, punitive and treble damages.

Standard Cases

The new simplified case dollar limit created a corresponding increase in the threshold for cases administered under the standard procedures. NASD also adopted the recommendation for increasing the size limit for cases in which the rules suggested a single arbitrator unless the parties elected a three-member panel. As a result, NASD rules presumed that a single arbitrator would hear and decide claims seeking damages of greater than $25,000 but not more than $50,000. The new rule did not require mutual consent, as the Task Force recommended, for electing to proceed with three arbitrators instead of one. Any party in its initial filing or the presiding sole arbitrator could request that the panel consist of three arbitrators.

Large and Complex Cases

NASD realized that certain large and complex cases may require special management, and established new procedures for cases claiming at least $1 million in damages. The special rules became effective in 1995 for a one-year pilot period. NASD intended for these rules to encourage the parties to come to an agreement on the procedures necessary to manage the disposition of complex matters. The large and complex case rules included procedures for an administrative conference, the appointment of arbitrators from lists and a preliminary hearing. To help defray NASD's costs to provide these special administrative procedures, NASD charged higher fees to parties that chose the large and complex case rules. Regardless of the dollar amount in controversy, NASD assessed the fees associated with a claim over $5 million.

At the time of the Task Force Report, the large and complex case rules had been in effect for less than one year and the participation rate in this special process was low. The Report recommended that NASD continue the large and complex case pilot and encourage broader participation. In response, NASD extended the pilot expiration date through the end of 2002, but participation remained low. Parties elected to proceed under the special rules in only 43 of the first 880 eligible cases. In qualifying cases, less than one percent of the parties opted to proceed to the administrative conference phase, and none chose to continue past it.

Of the parties who elected the special rules, most did so because of the list selection option for selecting arbitrators. However, in 1998, NASD launched NLSS, thereby providing parties in all cases, regardless of the dollar amount involved, with the ability to select arbitrators through list selection. Similarly, in 1997, NASD had implemented the practice of conducting an initial pre-hearing conference among the parties and arbitrators for all cases decided by hearing. This pre-hearing conference provided the parties with an opportunity to discuss the case with the arbitrators earlier in the process. Parties and arbitrators were therefore able to work out scheduling, discovery and other issues in advance of the hearing. Because NASD made this type of administrative conference available in all hearings cases, parties eligible for the large and complex case rules did not need to pay higher costs for the same service.

Results: NASD implemented all of the key recommendations by increasing the threshold for simplified cases and for single arbitrator cases. NASD implemented special procedures to facilitate case management in large cases, but because we also made those tools available in standard cases, we ended the pilot in December 2000, which was earlier than expected.

8. Punitive Damages

The treatment of punitive damages was perhaps the most controversial and polarizing issue the Task Force faced. At the time of the Report, the question of whether arbitrators, under SRO arbitration rules, could award punitive damages was by no means settled. The industry generally was opposed to allowing arbitrators to award punitive damages, while investor groups were in favor of granting arbitrators this authority. The Task Force took a middle-ground approach and suggested that NASD amend its rules to allow arbitrators to award punitive damages, subject to a limit on the amount of such damages.

Key Recommendation: The Task Force recommended that punitive damages remain available in NASD arbitration, subject to a cap of the lesser of two times compensatory damages or $750,000.

Supreme Court Ruling on Punitive Damages

The Task Force noted that in Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995), the Supreme Court concluded that the availability of punitive damages in arbitration depends on whether a predispute agreement between parties provides for such damages. The Court determined that NASD rule language was broad enough to allow arbitrators to award punitive damages. However, the Task Force felt that Mastrobuono did not resolve the policy issue of whether punitive damages should be available in securities arbitration.

Industry and Investor Views Regarding Punitive Damages

The securities industry had two primary arguments in support of its opposition to the availability of punitive damages in arbitration. First, it argued that arbitration proceedings do not have procedural safeguards, such as reasoned decisions and full appeal rights that are present in court litigation and that may help curtail excessive awards of punitive damages. Second, the industry argued that punitive damages were unnecessary since the extensive regulation of the securities industry by the SROs and the SEC adequately served to punish wrongdoers and deter misconduct.

The investor community, on the other hand, believed that punitive damages should be available in arbitration. As a result of the Supreme Court decisions in McMahon and Rodriguez[8], investors generally are compelled to arbitrate their disputes with broker-dealers in SRO-sponsored arbitration forums. Thus, investors argued that punitive damages must remain available in SRO-sponsored arbitration proceedings or else these forums could deprive investors of a remedy that would otherwise be available to them in court litigation. Investors also interpreted NASD's Code and other NASD rules as a guarantee of the same remedies that would be available to them in court.

The Task Force's Recommendations

The Task Force evaluated these conflicting viewpoints, and reached a compromise that aimed to address each side's concerns. The Task Force recommended that punitive damages remain available in NASD arbitrations subject to a cap of the lesser of two times a compensatory damage award or $750,000. It further recommended that arbitrators should specify the amount of compensatory and punitive damages and, upon request, should describe the conduct that resulted in the punitive damage award. Finally, the Task Force recommended that NASD make punitive damages available to investors in those states whose courts would allow the award of punitive damages for the same claims.

NASD's Proposal

Responding to the Task Force's recommendations, in November 1997, NASD filed a proposed rule that contained guidance on the availability of punitive damages in public customer claims. Under the proposal, a party could request punitive damages if such damages were available in court for the same type of claim. Arbitrators were to apply the standard of conduct the courts applied in the requesting party's state. The damages were limited to the lesser of $750,000 or twice the compensatory damages, and the award would set out the compensatory and punitive damages.

NASD received significant opposition to the rule filing. Some investor groups argued that the cap would broaden the perception that SRO arbitration was biased in favor of firms. Others insisted that the availability of punitive damages in arbitration helped combat securities fraud.

In addition, the Supreme Court decision in BMW of North America, Inc. v. Ira Gore, Jr., 517 U.S. 599 (1996), clarified that courts would not uphold excessive awards of punitive damages . After considering the challenges to the proposal and the developing law related to punitive damages, NASD withdrew its proposal.

Results: NASD filed a rule as the Report suggested, but ultimately withdrew it because of negative comments and changes in the law that permitted reasonable punitive damages in securities arbitration. However, NASD amended its conduct rules expressly to prohibit NASD broker-dealer firms from using a predispute arbitration agreement to limit the types of damages that may be available in securities arbitrations. The amended rule effectively prevents the possibility, which the Mastrobuono decision left open, that a predispute arbitration agreement could serve to disallow punitive damages. Thus, through NASD action and development of the law by the Supreme Court, the Task Force's objectives of making punitive damages available in securities arbitrations, while ensuring that such awards are not excessive, have been met.

9. Employment Disputes

At the time of the Report, the Supreme Court had not yet determined the enforceability of agreements to arbitrate employment disputes under the Federal Arbitration Act. The Court had ruled, however, in the landmark Gilmer v. Interstate/Johnson Lane, Corp., 500 U.S. 20 (1991), case, that the arbitration provision contained in the uniform securities industry registration form (Form U4) was enforceable under the Federal Arbitration Act. The Task Force focused its recommendations on ensuring that employees had clear notice that disputes with their employers were subject to arbitration, and that NASD provided a fair forum for resolving such disputes.

Key Recommendations: The Task Force recommended that: 1) employment-related disputes, including statutory discrimination claims, remain eligible for arbitration; 2) the Form U4 and the Code disclose clearly that employment related disputes, including statutory discrimination claims, are subject to arbitration; and 3) employment discrimination arbitrators receive appropriate training or demonstrate familiarity with the relevant law.

Employment Arbitration

The Task Force recognized that employment arbitration offers the same advantages of speed and reduced cost identified with investor arbitration. The Task Force also noted that statutory discrimination claims are often interwoven with other industry-specific issues. The Task Force Report recommended that employment-related disputes, including statutory discrimination claims, remain eligible for arbitration with certain suggested enhancements similar to those recommended for investor arbitration.

To meet the Task Force's objectives, NASD gathered a wide assortment of views on this issue and in 1997 formed an Advisory Committee, consisting of six experts in the area. The Advisory Committee gathered input from representatives of civil rights organizations, the U.S. Equal Employment Opportunity Commission, attorneys who represent brokerage firms, attorneys who represent employees and representatives of employee organizations. The Advisory Committee also collected opinions from neutral experts in the alternative dispute resolution field.

After consideration of all the views presented, and recognizing the public's perception that civil rights claims may present important legal issues better dealt with in a judicial setting, NASD determined that the appropriate action was to remove the NASD arbitration requirement for such claims in the Form U4, but to further improve the forum so that it was viewed both by registered employees and firms as the fairest and most efficient forum for resolving all employment disputes. NASD amended its rules, effective January 1, 1999, to provide that NASD does not require securities industry employees to arbitrate claims alleging statutory employment discrimination. However, parties could arbitrate such claims with NASD if they agreed to do so, either before or after a dispute arose.

Special Rules for Employment Discrimination Claims

In January 2000, based on the findings of the Advisory Committee, NASD adopted the key provisions of the Due Process Protocol endorsed by the American Bar Association and various dispute resolution organizations. The new rules supplemented and, in some instances, superseded the provisions of the Code that apply to the arbitration of general employment disputes. NASD's special set of rules for employment discrimination cases to be decided in arbitration pursuant to party agreements included the following provisions:

- NASD would select only public arbitrators.
- The chairperson or single arbitrator must have special qualifications such as a law degree, substantial familiarity with employment law, and relevant practical experience, but may not have primarily represented the views of employees or employers within the past five years.
- Claims of up to $100,000 in damages would be heard by a single arbitrator.
- Discovery would be expanded, including consideration of depositions.
- The panel would have authority to award attorneys' fees if applicable law permitted.
- Awards must contain reasons for the decision and a statement regarding the disposition of any statutory claims.

In addition, the new rules contained provisions to consolidate discrimination claims in court or in arbitration to avoid bifurcation of such claims.

Notice to Associated Persons

In January 2000, NASD adopted a conduct rule that required firms to provide their associated persons with a standard, specific written statement whenever that firm asks an associated person to sign a new or amended Form U4. The required statement, which is modeled after the mandated disclosures for customers signing predispute arbitration agreements with firms, explains the nature and consequences of the arbitration clause contained in the Form U4.

Limitation of Employee Costs

In January 2006, NASD implemented a new rule to provide that a current or former associated person who brings a statutory employment discrimination claim that is subject to a predispute arbitration agreement will pay no more than a $200 filing fee at the time that the associated person asserts such a claim. The member that is a party to a statutory employment discrimination arbitration proceeding will pay the remainder of the filing fee, if any, as well as all forum fees. This change means that the forum fees for an associated person to have a statutory employment discrimination case heard in arbitration are no more than the likely filing fees in court. In addition, arbitration of these matters reduces

expenses for associated persons because of the quicker resolution and streamlined process as compared to court proceedings.

Results: NASD followed the Task Force recommendations and continued to allow parties to bring employment disputes, including statutory discrimination claims, to arbitration. To ensure a fair forum for such claims, NASD implemented due process measures, including special qualifications for arbitrators who decide these disputes. NASD also required firms to disclose in clear terms to associated persons the consequences of an arbitration agreement. Finally, NASD incorporated new rules to limit the cost for employees bringing employment discrimination claims.

10. Injunctive Relief

While the Task Force's primary focus was on investor disputes, it did tackle the challenging intra-industry problem of "raiding" disputes. These matters typically involved disputes over employees who "jumped" from one firm to another, along with their books of business. By their nature, these disputes required prompt action, usually in the form of injunctive relief. The Task Force offered recommendations on how NASD might address these issues, including a suggestion that NASD review carefully a set of pilot rules that would permit the forum to appoint arbitrators rapidly who could deal with injunctive issues.

Key Recommendations: The Task Force recommended that NASD closely monitor the process for injunctive relief and make appropriate modifications on the basis of experience during the pilot program.

Injunctive Relief

The Task Force Report noted that the industry representatives raised a significant issue regarding intra-industry disputes: whether securities arbitration can provide a forum capable of granting temporary injunctive relief in disputes between industry parties and then provide a means of enforcing that relief. Because the Code did not, prior to the Report, contain specific provisions authorizing arbitrators to issue interim relief or require an expedited hearing, firms initiated proceedings in court. These actions often resulted in dual proceedings (court for the injunctive relief and arbitration for the underlying dispute) increasing costs to the industry litigants and NASD, and creating confusion as to the appropriate forum for the final resolution of the dispute.

The Task Force recognized that the SEC had approved NASD's proposed rules governing injunctive relief claims involving brokerage firms and associated persons for a one-year pilot to begin in January 1996. The pilot rules codified the authority of the arbitrators to grant interim injunctive relief; required parties seeking injunctions, in court or from the arbitrators, to submit a claim to arbitration for permanent relief; and provided that parties failing to comply with injunctive orders could be subject to disciplinary action. The pilot rules forced eligible intra-industry disputes that included injunctive actions into arbitration, even if a party obtained initial temporary relief in court.

Monitoring the Pilot

The Task Force Report recommended that NASD closely monitor the process for injunctive relief and make appropriate modifications on the basis of experience during the pilot. Under the pilot, parties found the multiple layers of review too complex and the rule terminology confusing. In addition, although temporary injunctive relief was available in arbitration on an expedited basis, it was still not possible to obtain such injunctive relief in arbitration as quickly as in court. NASD extended the pilot several times before permanently adopting a substantially modified process to address concerns raised during the pilot.

Under the new rules implemented in 2002, parties seeking temporary injunctive relief in court must simultaneously file in arbitration a Statement of Claim requesting permanent injunctive relief and any other permanent relief, including damages. Thus, NASD is balancing the interest of the parties in being able to seek immediate temporary injunctive relief with the need to ensure that underlying disputes are resolved in arbitration in a timely manner.

Results: In accordance with the Task Force recommendations, NASD conducted and monitored a pilot rule and then, based on experience with the pilot, implemented a permanent rule that vested authority in arbitrators to address permanent relief, following a court's consideration of temporary injunctive relief. The major objectives of the new provisions, to streamline the process for obtaining injunctive relief and expedite the disposition of the merits of such cases, mirror the Task Force's guiding principles in this area.

11. Financing and Governance of the NASD Arbitration Forum

The Task Force recognized the already growing NASD arbitration caseload, which would peak at almost 9,000 case filings in 2003, and urged NASD's leadership to ensure adequate funding for the forum's needs. The Task Force also recommended that the arbitration forum maintain structural independence since, at the time of the Report, NASD still owned and operated The NASDAQ Stock Market.

Key Recommendations: The Task Force made several recommendations to ensure that: 1) the NASD Dispute Resolution forum had sufficient funds; and 2) NASD's administration of its arbitration forum be as independent as practicable.

Financial Support

NASD responded to the need for appropriate financial support by committing increased staff and other resources as the caseload continued to climb. In an effort to fund the increased expenditures and place the dispute resolution program on a self-funding basis, in 1998, NASD raised filing fees and forum fees and added firm surcharges. Under the revised fee structure, broker-dealers now bear about 75 percent of the cost of administering the forum, consistent with the Task Force recommendation about the proper source of funding. NASD also added firm case processing fees to build incentives for early resolution of disputes. These new fees generated enough revenue to move NASD Dispute Resolution from significant financial deficits to a self-sustaining basis. In addition, these fees provided funding for the development of a computerized list selection capability (NLSS) followed by development of a Web-based case administration system (MATRICS), and helped finance other improvements to the forum such as expanded arbitrator training.

Independent Administration

When the Task Force issued its Report, NASD was completing structural changes to separate the operation of the NASDAQ stock market from the function of regulating broker-dealer activity. The Task Force suggested that, to promote the independence of the arbitration function, Dispute Resolution report either to the NASD parent or to NASD Regulation, the newly created regulatory arm of NASD.

In conformance with the Task Force recommendation, NASD quickly decided to position the dispute resolution program as part of NASD Regulation. In addition, NASD changed its rules to ensure that the NAMC, which already contained significant public membership, would have a majority of its members from outside the securities industry. In 2000, to further enhance the perception of neutrality and increase the confidence among customers of the forum, NASD launched a new subsidiary, NASD Dispute Resolution, Inc. and created a separate Board for that entity. A majority of NASD Dispute Resolution Board members are also from outside the securities industry.

Results: Consistent with the Task Force recommendations, NASD took action to provide sufficient resources to serve Dispute Resolution customers properly and created the means to fund those resources. In addition, NASD implemented measures to create structural independence through reorganized governance and the addition of stronger public representation on the NAMC and other NASD governing bodies.

Other Initiatives NASD Implemented that Were Not Contemplated by the Arbitration Policy Task Force

In addition to the key recommendations covered above, NASD reviewed and considered many other innovations independently. That analysis and the changing needs of forum users led us to many other modifications and enhancements over the past ten plus years. Among the most important changes were:

- launching the Dispute Resolution Web site in 2000 as a resource tool accessible by staff, forum customers and neutrals;
- developing a Web-based case administration system (MATRICS) to replace the case administration system NASD had introduced seven years before the Task Force Report, that enabled online filing of mediation and arbitration claims and facilitated communication among staff, parties, counsel and neutrals;
- launching an online arbitration awards system in 2001, and enhancing it with expanded search capabilities in 2007; and
- expanding the number of hearing locations served by NASD to 68 locations to provide dispute resolution services in all 50 states, Puerto Rico and London.

In addition, NASD implemented numerous other investor-friendly initiatives such as:

- publishing Dispute Resolution materials in Spanish;
- adopting a streamlined arbitration process for claimants filing against defaulting, suspended or terminated industry respondents;
- organizing regular focus groups to gather feedback from constituents on targeted portions of the dispute resolution process;
- creating a special program to expedite proceedings for elderly or seriously ill parties; and
- undertaking a series of changes to arbitrator classification rules to tighten the definition of public arbitrators by excluding individuals with even minor or indirect ties to the securities industry from serving as public arbitrators in NASD cases.

Conclusion

Since 1996, NASD has been involved in reviewing and implementing the Task Force recommendations. By bringing the central recommendations to the constituents who use the forum, and testing the viability of the recommendations, NASD worked to build consensus for change. As a result of this process, NASD has amended a number of the Task Force recommendations to meet our constituents' concerns. As the rules and procedures evolved, the newly constituted NAMC and the Dispute Resolution Board played critical roles in working with the staff in this effort.

NASD has handled over 70,000 claims since 1996, which is approximately 90 percent of all securities arbitrations and mediations. Looking forward, we expect the momentum to continue and our leadership role in securities dispute resolution to strengthen. We will more frequently use Web-based interactions among the forum, parties and neutrals. We will control costs for parties by adapting our business operation model to gain efficiencies. In addition, we will continue to expand online training opportunities for NASD neutrals. These initiatives and others will allow NASD to make dispute resolution services more widely available in the U.S. and in other parts of the world.

NASD's position at the forefront of securities dispute resolution has resulted in increasing scrutiny of our rules, policies and procedures. We have responded by changing along with our environment, guided in large part by the Arbitration Policy Task Force recommendations, to seek fairness, speed and low cost. Using the Task Force model of proactively asking for the input of the individuals involved in our forum, we have attempted to preserve and respect the basic elements of a fair and efficient dispute resolution system, while embracing the adjustments needed to enhance the system and effectively serve an evolving customer base.

Endnotes:

1 This article was authored by Linda D. Fienberg, President, NASD Dispute Resolution, and Executive Vice President and Chief Hearing Officer, Regulatory Policy & Oversight, NASD, and Kenneth L. Andrichik, Senior Vice President and Director of Mediation and Business Strategies, NASD Dispute Resolution with the assistance of NASD Dispute Resolution staff members:

George H. Friedman, Executive Vice President and Director of Dispute Resolution; Richard Berry, Vice President and Director of Case Administration; Barbara Brady, Vice President and Director of Neutral Management; Jean I. Feeney, Vice President and Chief Counsel; Rachel Glasgow, Senior Attorney; Judith Hale Norris, Vice President and Regional Director; Rose Schindler, Vice President and Regional Director; and Rina Spiewak, Staff Attorney, NASD Dispute Resolution.

NASD gratefully acknowledges the research assistance of Robert Beynon, a student at Fordham Law School.

2 Mr. Ruder, SEC Chairman from 1987 to 1989, was, at the time of the Report, a Professor of Law at Northwestern University School of Law in Chicago and a former Dean of the School. Mr. Ruder also had served as a Member of the NASD Board of Governors.

In addition to Mr. Ruder, members of the Task Force and their credentials at the time of the Report included: **Linda D. Fienberg**, a Partner with Covington & Burling, Member, NASD Legal Advisory Board, NASD National Arbitration and Mediation Committee, and formerly Executive Assistant to the Chairman and Associate General Counsel of the SEC, who also served as reporter to the Task Force; **John Bachmann**, Managing Principal, Edward D. Jones & Co., and formerly Chairman of the Securities Industry Association; **Stephen J. Friedman**, Partner, Debevoise & Plimpton, and formerly SEC Commissioner, Executive Vice President and General Counsel of The Equitable Life Assurance Society of the United States, and Executive Vice President and General Counsel of The E. F. Hutton Group, Inc.; **Stephen L. Hammerman**, Vice Chairman and General Counsel, Merrill Lynch & Co., Chairman, Merrill Lynch, Pierce, Fenner & Smith, and Member, New York Stock Exchange Board of Directors, and formerly Member and Chairman, NASD Board of Governors, and SEC New York Regional Administrator; **J. Boyd Page**, Partner, Page & Bacek, Director, Officer, and past President of the Public Investors Arbitration Bar Association (PIABA), and formerly Public Member of the NASD National Arbitration and Mediation Committee; **Francis O. Spalding**, Professional Arbitrator and Mediator, Public Member and past Chair of the NASD National Arbitration and Mediation Committee, and author and lecturer on alternative dispute resolution; and **Richard E. Speidel**, the Beatrice Kuhn Professor of Law of the Northwestern University School of Law and co-author of a five volume treatise on federal arbitration law.

3 Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), reh'g denied, 483 U.S. 1056 (1987).

4 The NASD Board appoints the National Arbitration and Mediation Committee (NAMC) to advise the Board on the development and maintenance of an equitable and efficient system of dispute resolution that will equally serve the needs of public investors, brokerage firms and associated persons. The NAMC includes representation from the public at large, from the securities industry, and from the arbitrators and mediators serving in the NASD dispute resolution forum. This diverse composition ensures a neutral approach in the administration of NASD's forum, promoting fairness to all parties.

5 Ms. Fienberg joined NASD in June 1996 to, among other things, oversee NASD's dispute resolution operations.

6 For investor claims of under $50,000, parties select a single public arbitrator from a list of eight public arbitrators. In certain intra-industry cases, NLSS provides lists of all non-public arbitrators.

7 SICA was formed to develop and maintain a Uniform Code of Arbitration and to provide a forum for the discussion of new developments in securities arbitration among SRO arbitration forums and participants in those forums. The membership includes representatives of each securities SRO, three "public" members, and a representative from the Securities Industry and Financial Markets Association. In addition to those voting members, SICA has several "invitee" member organizations such as the SEC, the North American Securities Administrators Association, the National Futures Association, the Commodity Futures Trading Commission, and the American Arbitration Association. Invitees attend meetings and actively participate in discussions, although they do not have voting rights.

8 Rodriguez de Quijas v. Shearson/American Express, 490 U.S. 477 (1989).

NASD
1735 K Street, NW
Washington, DC 20006-1506

www.nasd.com