

**Securities Industry Association**

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November 12, 1996

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: SR - NASD - 96-37

Dear Mr. Secretary:

This is in response to your request for comments on the proposed rule change to amend its policy and practice concerning the application of eligibility provision in Rule 10304 of the Code of Arbitration Procedure ("Code") of the National Association of Securities Dealers, Inc. ("NASD") to the effect that arbitrators, not the NASD Regulation staff, shall determine whether a dispute is eligible for arbitration.

On behalf of the Securities Industry Association ("SIA") Litigation Committee, I request that the proposed rule change not be approved by the Securities and Exchange Commission ("Commission"). I ask this for the following reasons which will be explained more fully below:

- 1.The proposal is contrary to public policy since it will cause an increase in unnecessary litigation by parties to an arbitration to enforce their legal rights.
- 2.The proposal is contrary to the agreement of the parties to arbitrate in accordance with the rules of the NASD.
- 3.The proposal is contrary to the law as interpreted by five United States Circuit Courts of Appeal.
- 4.The retroactive nature of this proposal violates the plain language of the Securities Exchange Act of 1934 ("Exchange Act").

1. The Proposal is Contrary to Public Policy.

It is the public policy of the United States to encourage the use of arbitration as an alternative means to the courts to resolve disputes. ¹ In furtherance of this policy, the NASD established an arbitration forum in 1968 and adopted rules for it. This was a voluntary act on the part of the NASD since there is nothing in Section 15A of the Exchange Act which requires the establishment of an arbitration forum in order to be registered as a self-regulatory organization ("SRO"). In fact the NASD had existed for 30 years as a registered SRO without having such a forum. The eligibility rule was part of the original Code and its purpose is to keep out of

arbitration old, stale disputes. The rules stated simply that if matters under dispute were older than the designated period of time (the time limit has changed over the years) the matter would not be eligible for arbitration. From its inception, those who have administered the arbitration forum have understood that they were not to accept for arbitration matters which are clearly ineligible. In fact, the NASD concedes this in their filing where, on Form 19b-4, page 4, it states "Until recently, the NASD Regulation staff made preliminary eligibility determinations in cases where a brightline test could be applied."

The NASD is not the only SRO which has an eligibility rule in its arbitration code. In 1980, when the Securities Industry Conference on Arbitration ("SICA") promulgated its Uniform Code, it included the NASD's eligibility rule. The other SROs have interpreted the eligibility rule in the same manner as the NASD, that is, the administrators reject arbitration claims which are older than six years. If this proposal is accepted, there will be a variance in the application of the eligibility rule amongst the SROs. The whole purpose of the rule is to keep stale matters away from arbitrators and out of arbitration. The proposal does just the opposite and creates unnecessary confusion for those who use the process.

The result of this will be increased applications to court to resolve the confusion. Referring ineligible matters to arbitrators does not confer on the arbitrators the authority for them to function legally. Any action they may take is voidable. To avoid the cost and necessity of preparing for and actually attending an arbitration whose decision will eventually be vacated, parties will resort to the courts at the beginning of the arbitration to restrain the arbitration of the ineligible matter from going forward. This forcing parties to seek redress in court to avoid the necessity to arbitrate ineligible claims is contrary to public policy and for this reason alone, the Commission should not approve this proposal. SICA has recently adopted an amended version of the eligibility rule which should clarify any ambiguities in the existing rule and when adopted should eliminate the necessity of parties petitioning courts at the inception of an arbitration to protect their rights. If the current proposal is approved, it will create confusion in the interim period while the new version is being approved and will cause a number of matters which are ineligible for arbitration under the Code to go forward in arbitration and to face the distinct possibility of a court challenge. The wiser and more logical public policy would be to not approve this proposal so that all SROs will continue to interpret the eligibility rule as they have in the past and thereby eliminating the need for court challenges.

2. The Proposal is Contrary to the Agreement to Arbitrate.

The standard arbitration agreement used in the securities industry states that the parties agree to submit all disputes to arbitration in accordance with the rules of the NASD (or whatever SRO is involved). Section 15 of the NASD Code states that controversies which are older than six years are not eligible for arbitration. Therefore, the parties have not agreed to arbitrate these older disputes. It is basic arbitration law that arbitrators derive their authority solely from the underlying agreement to arbitrate. Therefore, under the standard brokerage arbitration agreement, arbitrators do not have authority to decide the question of the arbitrability of matters that are older than six years. The United States Supreme Court has consistently ruled that if parties have not agreed to submit a question to the arbitrators, then it is the courts which must decide this question of arbitrability.² Justice Breyer in the **Kaplan** opinion concludes "--- arbitration is simply a matter of contract between the parties; it is a way to resolve those disputes -- **but only those disputes** -- that the parties have agreed to submit to arbitration."

(Emphasis added) In arbitration based on agreements to arbitrate under NASD rules, the parties have not agreed to arbitrate matters which are older than six years.

The same logic applies when there is no agreement between the parties and the authority of the arbitrators is based on the by-laws and rules of the NASD. A member of the NASD agrees to abide by its rules and those rules require the member to arbitrate disputes in accordance with the Code if requested. Since the Code says that matters over six years are ineligible for arbitration, the member in joining the NASD has only agreed to arbitrate matters which are under six years.

The proposal is contrary to the Federal Arbitration Act³ which requires all arbitration agreements to be enforced as they are written. The current proposal is in violation of this requirement and, as a matter of public policy, should not be approved.

3. The Proposal is Contrary to the Law as Interpreted by Five United States Circuit Courts of Appeal.

In five U. S. Circuit Courts of Appeal, there are decisions which state that the question of eligibility under Section 15 of the NASD's Arbitration Code is a question for the courts and not for arbitrators.⁴ If, indeed, the proposal is approved and NASDR submits the question of eligibility to arbitrators for disputes involving anyone within the jurisdiction of the 19 states within the Circuits covered by these five Courts of Appeal, any party desiring not to proceed with an ineligible arbitration can appeal to the federal courts in those jurisdictions for immediate relief. This, again, raises the question of the wisdom and logic of approving this proposal which will engender litigation causing both parties needless expense and time. By not approving this proposal the current status will remain in effect until such time as the amendment to the eligibility rule can be approved. It is contrary to public policy to create the possibility of multiple litigations at a time when a solution is at hand which should end all of the circumstances necessitating early court intervention in arbitration.

4. The Retroactive Nature of the Proposal is in Violation of the Exchange Act.

The proposal states that "Effective August 1st, 1996, the NASD Regulation staff will no longer make preliminary determinations concerning the eligibility of a claim for arbitration." It further states "For those cases filed prior to August 1st, 1996, where the staff has made a preliminary eligibility ruling in response to a respondent's motion, the moving papers will be forwarded to the arbitrators with a reminder that the arbitrators must review the issue de novo and must not accord the staff's preliminary ruling any weight." This establishment of an artificial effective date of August 1st, 1996 is in violation of the plain language of the Exchange Act which says "No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection."⁵ The procedure under Section 19 requires the SEC to publish the rule change proposal to allow for comments and then within 35 days of the publication of notice which can be extended, either approve the rule or institute proceedings to disapprove it. Under normal proceedings, the earliest this rule change could be effective would be November 22, 1996 (the date specified in SEC Release 34-37875 as the deadline for comments published November 1, 1996). The attempt to make this effective as of August 1st, 1996 is clearly inconsistent with the plain language of the Exchange Act and the intent of it.

There is provision within the Act for a proposed rule change to take effect upon filing with the Commission if the proposal is designated as "constituting a stated policy, practice, or interpretation with respect to the meaning, administration or enforcement of an existing rule of the self-regulatory organization,...." The NASD has so designated this proposed rule change and has therefore claimed that it is effective upon filing. Even under this theory, the NASD filed this proposal on October 15th, 1996 and it cannot retroactively establish an effective date back in August. However, even its claim for early effectiveness upon filing is erroneous. The filing itself is contradictory on its face in that on page 4, it states "Until recently, the NASDR staff made preliminary eligibility determinations both before and after a claim had been served, in cases where a brightline test could be applied." On page 5, the NASD says "Thus, adoption of the policy set forth above is not a substantive change in Rule 10304 or its interpretation." The submission of an ineligible matter to arbitration contrary to its own rules and contrary to the agreement of the parties to the arbitration is most certainly a substantive change. This in no way can masquerade as a "stated policy, practice or interpretation." This is not an explanation to an existing policy or practice; it is a complete change of one affecting the substantive rights of parties to arbitration. The Commission should not accept this as one of the exceptions permitting instant effectiveness upon filing, but should adhere to the procedures in the Exchange Act which require the effectiveness of a proposed SRO rule change upon the approval of the Commission. The Commission, however, should not approve this proposal since it is contrary to public policy, harmful to those who participate in the arbitration program, adversely affecting their substantive rights, and defective on its face as proposed.

As part of the NASD submission on page 6, the answer to Question number 5 is defective. While it is true the NASD did not solicit written comments, it did receive at least one. Attached is a [comment letter](#) submitted by the SIA Arbitration Subcommittee on October 3rd, 1996.

On behalf of the SIA Litigation Committee, I appreciate the opportunity to comment on this rule change proposal and if the Commission desires any further information concerning this subject, the Litigation Committee of SIA stands ready to assist it in any way possible. For the reasons stated above, it is requested that the proposed rule change not be approved and that instead the NASD proceed to approve and file the SICA amended eligibility rule which should eliminate the necessity of petitioning courts at the commencement of an arbitration for relief.

Very truly yours,

William J. Fitzpatrick
Consultant, Litigation

CC:

Hon. Arthur Levitt, Chairman, SEC
Hon. Steven Wallman, Commissioner, SEC
Hon. Isaac C. Hunt, Jr., Commissioner, SEC
Hon. Norman S. Johnson, Commissioner, SEC
Katherine A. England, Asst. Director, Division of Market Regulation, SEC
Alden S. Adkins, Esq., V.P. & General Counsel, NASD Regulation, Inc.

Footnotes

¹ Moses H. Cone Memorial Hospital v. Mercury Construction Corp. 460 U.S. 1 (1983).

² Kaplan et al. v. First Options of Chicago Inc. 115 S.Ct. 1920 (1995); AT&T Technologies v. Communication Workers 475 U.S. 643 (1986).

³ 9 U.S.C.

⁴ Edward D. Jones & Co. v. Sorrells 957 F.2d 509 (7th Cir. 1992).PaineWebber Inc. v. Hartmann 921 F.2d 507 (3rd Cir. 1990).Roney & Co. v. Kassab 981 F.2d 894 (6th Cir. 1990).Cogswell v. Merrill Lynch 78 F.3d 474 (10th Cir. 1996).Merrill Lynch v. Cohen 62 F.3d 381 (11th Cir. 1995).

⁵ Securities Exchange Act of 1934, Section 19(b)(1).