NASD

National Association of
Securities Dealers, Inc.
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October 14, 1988

Mr. David S. Ruder
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Ruder:

On behalf of the National Association of Securities Dealers, Inc. ("NASD") I am pleased to respond to your letters of July 8 and 13, 1988, which solicited our comment concerning issues relating to the use of predispute arbitration clauses in broker/dealer customer agreements, and other matters.

As you know, the NASD has provided an arbitration forum for the resolution of disputes between and among our members, their associated persons, and their customers since 1968. The NASD's arbitration forum is currently the most active in the securities industry, and it is anticipated that in excess of 4,000 cases will be filed with us in 1988. This represents an approximately 40% increase in the 2886 filings made in 1987. Since the arbitration program's inception, the NASD has worked closely with the Securities and Exchange Commission to assure not only that arbitration proceedings conducted under our auspices are fair, but to assure that the arbitration process which provides an expeditious, efficient, and economical means for the resolution of disputes, is perceived as fair by all participants.

Under the NASD's committee structure, initiatives for the improvement of the Association's arbitration program are considered in the first instance by the NASD's National Arbitration Committee ("NAC"), which is composed of representatives of our membership as well as representatives of the public. Presently the Committee has five public members. As a result of its study of the issues raised by your correspondence, the NAC recommended that the NASD's Board of Governors take no action to prevent member firms from utilizing predispute arbitration agreements in their contractual relationship with customers, but recommended that the Board require more extensive and effective disclosure of the meaning and effect of such agreements to prospective customers. Simultaneously with the work of the Committee, the staff worked with other self-regulatory organizations through the Securities Industry Conference on Arbitration (SICA) to develop a uniform approach.

In making its recommendations, the NAC acknowledged that arbitration has proven to be an economical alternative to litigation, and that both the investing public and the securities industry have enjoyed the benefits of the dramatically lower costs of alternative dispute resolution. The NAC was particularly concerned that apart from legal considerations, a flat prohibition on the use of predispute arbitration agreements might result in general increases in commission rates or in a reduction in the availability of retail brokerage services, since broker/dealers affected by such a prohibition might feel obliged to react to foreseeable increases in litigation costs and to reduce their exposure to litigation risk. The NAC also considered the fact that the availability and cost of errors and omissions insurance coverage for broker/dealers might be adversely impacted by a prohibition on the use of predispute arbitration agreements. Evidence that underwriters consider the extent to which broker/dealers and their associated persons utilize such agreements in their assessment of risk and in the pricing of their coverage was provided to the Committee. The Committee also believed that if certain firms refused to do business with customers who didn't execute such an agreement, competitive forces would result in other firms soliciting their business.

On September 19, 1988, the NASD Board of Governors, in approving the recommendations of the NAC, directed that comment be solicited concerning a proposed amendment to Article III, Section 21 of the NASD's Rules of Fair Practice which would require each member utilizing a predispute arbitration clause in a customer agreement to highlight that clause, and to include similarly highlighted disclosures concerning the meaning and effect of such a clause. The proposed amendment would also prohibit the use in any agreement of language which would limit or contradict the arbitration rules of any self-regulatory organization, limit the ability of a party to file a claim in arbitration, or limit the ability of arbitrators to make an award under the arbitration rules of a self-regulatory organization and applicable law. In addition, the proposed amendment would require that immediately proceeding the signature line in a customer agreement a statement appear that the agreement contains a predispute arbitration clause. This statement would be required to be intialed by the customer and a copy of the entire agreement would be given to the customer who would acknowledge receipt. The NASD's position in this respect is consistent with that of SICA. At the direction of the Board of Governors, the NASD staff has prepared a draft Notice to Members (Attachment A) which sets forth the full text of the proposed amendment to Article III, Section 21 of the NASD Rules of Fair Practice. This notice will be published for the purpose of soliciting member comment on November 1, 1988.

The NAC, in conjunction with SICA, has also considered the request contained in your July 13th letter and enclosure to review procedures to permit investor access to the courts in appropriate cases such as those involving difficult and complex litigation and class actions. The Committee did not recommend additional rulemaking in

this area at this time. The NASD Code of Arbitration Procedure currently vests broad discretion in the Director of Arbitration[1] and arbitrators[2] to defer arbitration proceedings to the remedies provided by applicable law. It determined that the better approach would be to revise both the Arbitration Manual currently being prepared by SICA and NASD materials currently sent to each prospective user of NASD arbitration facilities to emphasize the fact that parties may seek relief under the foregoing rules. Action to make these revisions has been agreed to by SICA and is underway.

We are pleased that the Commission continues to believe that the provision of arbitration facilities for the resolution of broker-customer disputes is an important service which we offer to investors, and we are gratified by your commitment to promote the continued use of arbitration by investors. We believe that our initiatives mandating the disclosure of the meaning and effect of customer agreements, the proposed prohibition against the placing of limitations on the availability of arbitration to investors, and the educational efforts we have undertaken concerning procedures governing access by parties otherwise obligated by contract to the courts will significantly improve the reputation of the NASD arbitration process as a fair, expeditious, and economical means for resolving disputes.

Sincerely,

Joseph R. Hardiman
President

Attachment

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[1] Section 12(b) of the NASD Code of Arbitration Procedure

[2] Section 16 of the NASD Code of Arbitration Procedure