

Sarah J. Williams
Assistant General Counsel

April 30, 2002

Via Hand Delivery

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: File No. SR-NASD-98-74, Response to Comments and Amendment No. 3
Amendments to Rule 3110(f) Governing Predispute Arbitration Agreements with
Customers

Dear Ms. England:

Pursuant to Rule 19b-4, NASD Regulation, Inc. ("NASD Regulation") hereby responds to the comment letters received in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-98-74¹ regarding proposed changes to Rule 3110(f) governing predispute arbitration agreements with customers. In addition, NASD Regulation hereby submits Amendment No. 3 to the above-referenced rule filing.

The purpose of the proposed rule change is to require additional disclosure in predispute arbitration agreements regarding the arbitration process, to require member firms to provide certain information regarding arbitration and predispute arbitration agreements to customers upon request, and to clarify the rule regarding use of choice-of-law provisions in predispute arbitration agreements.

¹ Exchange Act Release No. 42160, 64 Fed. Reg. 66681 (Nov. 28, 1999). This Notice incorporated Amendments No. 1 and 2 to the proposed rule change. Amendment No. 1 deleted provisions from the proposed rule change relating to punitive damages so that all such provisions could be separately considered in connection with SR-NASD-97-47 relating to punitive damages. Amendment No. 2 clarified the proposed rule language regarding permissible limitations in predispute arbitration agreements, and changed the effective date of the proposed rule change to coincide with two related rule filings pending before the Commission.

Response to Comments

The Commission received two comment letters in response to the *Federal Register* publication of SR-NASD-98-74.² Both commenters expressed views on the use of choice-of-law provisions in predispute arbitration agreements. A choice-of-law provision specifies that the law of a certain state will govern disputes arising out of an agreement. In some cases, the law of a state might limit the availability of certain remedies, such as punitive damages, or the ability of a customer to bring a claim. Customers have argued that it is unfair for members to include provisions in predispute agreements that limit the availability of remedies, particularly when the effects of the provisions are not explained in the agreement.

To address these concerns, NASD Regulation proposes in SR-NASD-98-74 to clarify that predispute arbitration agreements may not: (1) limit or contradict the rules of any self-regulatory organization; (2) limit the ability of a party to file any claim in court that could otherwise be filed under the rules of the forums in which a claim may be filed under the agreement; and (3) limit the ability of arbitrators to make any award. The amended rules would also state that no choice-of-law provisions will be enforced unless there is significant contact or relationship between the law selected and either the transaction at issue or one or more of the parties.

The two commenters expressed the view that the laws of the state in which the customer resides should apply in arbitration disputes. NASD Regulation believes that the NASD should not dictate to the parties of a predispute arbitration agreement the law that would govern their disputes. NASD Regulation believes the approach taken in SR-NASD-98-74 effectively balances the rights of parties to contractually agree on the law that will govern their disputes with the concerns expressed by customers regarding choice-of-law provisions in predispute arbitration agreements.

Amendment No. 3

In 1997, NASD Regulation filed two related rule proposals, which are:

- The eligibility rule filing, which, among other things, relates to the time limits for submitting claims in the NASD arbitration forum (SR-NASD-97-44); and
- The punitive damages rule filing, which would limit the amount of punitive damages that can be awarded in NASD arbitrations to the lesser of \$750,000 or twice compensatory damages if notice of the limit was included in the parties' predispute arbitration agreement (SR-NASD-97-47).

² Comment letters were submitted by Mr. John Miller and Barry D. Estell, Attorney at Law.

The rule filings are still pending because, in 1999, NASD Regulation amended each of them to link their effective dates, meaning that all three rule filings have to be approved before any of them can become effective. The amendments to the effective date provisions of the three rule filings were made because, if approved, SR-NASD-97-47 and SR-NASD-98-74 would require amendments to the customer account agreements used by member firms. Some of the additional disclosure required by SR-NASD-98-74 relates to SR-NASD-97-44. The effective date provisions of the three rule filings were linked to avoid the cost to firms and the potential confusion to customers of requiring multiple amendments to customer agreements in a relatively short period of time. However, in light of the uncertain status of SR-NASD-97-47, NASD Regulation is proposing to revise the effective date of SR-NASD-98-74 so that the proposed rule change may proceed.

Accordingly, NASD Regulation is amending the effective date provision of the proposed rule change so that it will become effective 120 days after final Commission action on the later of SR-NASD-97-44 or SR-NASD-98-74.³ The 120-day period is intended to provide firms adequate time to amend their customer agreement forms. NASD Regulation also amends the proposed rule language to provide that the requirements of the rule regarding providing predispute arbitration agreements and information about arbitration forums apply upon the effective date of the rule regardless of when the agreement in question was executed. The proposed rule language for Rule 3110(f), as published in the *Federal Register*, is amended as follows (proposed new language is underlined; proposed deletions are in brackets):

- (7) The provisions of this Rule shall become effective on (effective date). The provisions of subparagraph (3) shall apply to all members as of the effective date of this Rule regardless of when the customer agreement in question was executed. Otherwise, agreements signed by a customer before (effective date) are subject to the provisions of this Rule in effect at the time the agreement was signed.

If you have any questions, please contact Sarah Williams, Office of General Counsel, NASD Regulation, Inc. at (202) 728-8083.

Very truly yours,

Sarah J. Williams

³ NASD Dispute Resolution, Inc. recently filed an amendment to SR-NASD 97-44 to unlink the effective date of that proposed rule change from the effective dates of the rule changes proposed in SR-NASD-98-74 and SR-NASD-97-47.