

## NASD Substantially Revises Customer Arbitration Rules

By Peter E. Cooper

Since shortly after it began offering a forum for securities arbitration to the securities industry and its customers in 1968, the National Association of Securities Dealers, Inc. (formerly "NASD" and now the Financial Industry Regulatory Authority ("FINRA"))<sup>1</sup> from time-to-time broadened, amended, and supplemented its rules and procedures to address new issues or to resolve perceived problems. Over time, the NASD Code of Arbitration Procedure, found at Rule 10000 *et seq.*, had become increasingly complex, occasionally contradictory, and frequently frustrating. To address these concerns, in October 2003, the NASD proposed to sever the arbitration provisions into three distinct codes, and published a new Customer Code for public comment. Over the following three years, as interested parties submitted comments and suggestions, the NASD revised its proposed new Customer Code. After a series of revisions, the Customer Code was approved by the SEC on January 24, 2007. *See* SEC Release No. 34-55158 (January 24, 2007). Under terms of the SEC Release, the Customer Code became effective for all matters filed on or after April 16, 2007.<sup>2</sup>

In its SEC Release, the NASD identified the goals of the proposed Customer Code revision:

- (a) to apply the SEC's "plain English" mandate to the NASD Code;
- (b) to reorganize the Customer Code in more coherent fashion;
- (c) to codify existing NASD practices;
- (d) to enact substantive changes to NASD procedure; and
- (e) to streamline and standardize the administration of NASD arbitrations.

Indeed, the Customer Code revisions accomplish these goals in large part.

The new Customer Code rationalizes some of the conflicting processes and rulings among panels and between courts that had arisen under the Old Arbitration Code. It codifies certain well-known practices, and limits other, more controversial customs. Yet, the new Customer Code imposes new restrictions and duties – in particular, upon industry participants – which may affect the way in which brokerage firms approach and handle securities arbitrations in the future.

### A. Organization and Simplification

While some may challenge the wisdom of substantive changes to the new Customer Code, no one can question the value of the new Customer Code's organization and simplification.

First, FINRA has reorganized the old NASD Arbitration Code into three separate codes for industry disputes, customer disputes and mediation. NASD-DR reorganized the old mediation provisions into a new Mediation Code, at Rule 14000, *et seq.* The Mediation Code went into effect in January. The NASD-DR broke out the industry provisions in the new Industry Code, found at Rule 13000, *et seq.*, which went into effect at the same time as the new Customer Code.

Second, to make it easier to navigate the new Customer Code, FINRA divided the Customer Code into nine parts, with each part intended to approximate the chronological order of a typical arbitration:

- Part I (Rule 12100 *et seq.*) contains definitions, as well as other rules relating to the organization and authority of the forum;
- Part II (Rule 12200 *et seq.*) contains general arbitration rules, including what claims are subject to arbitration in the NASD forum;
- Part III (Rule 12300 *et seq.*) contains rules explaining how to initiate a claim, how to respond to a claim, how to amend claims, and when claims may be

combined and separated;

- Part IV (Rule 12400 *et seq.*) contains rules relating to the appointment, authority and removal of arbitrators;
- Part V (Rules 12500 *et seq.*) contains rules governing the prehearing process, including proposed new rules relating to motions and discovery;
- Part VI (Rules 12600 *et seq.*) contains rules relating to hearings;
- Part VII (Rule 12700 *et seq.*) contains rules relating to the dismissal, withdrawal, or settlement of claims;
- Part VIII (Rule 12800 *et seq.*) contains rules relating to simplified (small cases) arbitrations and default proceedings; and
- Part IX (Rule 12900 *et seq.*) contains rules relating to fees and awards.<sup>3</sup>

Third, the Customer Code benefits from greater clarity and simplicity. While FINRA has expanded the Customer Code from the 58 rules in the Old Arbitration Code to 86, better organization and the application of the SEC's Plain English mandate have eased the use of the Customer Code. FINRA has vastly expanded definitions, and placed most at Rule 12100. For example, Rule 12100(d) defines "Claim" as "an allegation or request for relief," and thereafter uses the term "Claim" throughout the Customer Code. By contrast, the Old Arbitration Code referred to both "claims" and "dispute, claim or controversy," without defining either.

### B. General Arbitration Rules

#### 1. Six-Year Eligibility Provisions

New Rule 12206 does not substantially change the six-year eligibility requirement previously found in old Rule 10304. Rule 12206 does, however, contain two potentially significant modifications. First, new Rule 12206(c) provides that, where permitted by applicable law, when a claimant files a statement of claim in arbitration, any time limits for the filing of the claim in court will be tolled while the NASD retains jurisdiction of

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the claim. Thus, the new Code seeks to toll statutes of limitation during the pendency of NASD arbitrations.

Similarly, new Rule 12206(d) provides that the six-year time limitation for eligibility will not run while a court of competent jurisdiction retains jurisdiction over a claimed matter.

## 2. Extension of Deadlines

The new Code empowers the parties to extend deadlines at their convenience. Specifically, new Rule 12207(a) permits the parties to agree, in writing, to extend or modify any deadline for serving an answer; returning the arbitrators selection or chairperson selection list; responding to motions; or exchanging documents or witness lists. The Old Arbitration Code Rule 10314(b)(5) authorized the Director of Arbitration to extend the time for the filing of any pleading. Yet, the Old Arbitration Code cautioned that “extensions of the time period to file an Answer are disfavored and will not be granted by the Director except in extraordinary circumstances.” In addition to affording the parties an opportunity to change the deadlines, the new Customer Code grants greater authority to the Director of Arbitration: “The Director may extend or modify any deadline or time period set by the Code for good cause. The Director may also extend or modify any deadline or time period set by the panel in extraordinary circumstances.”

## C. Arbitration Pleadings

Part III, concerning the initiating and responding to claims appears, at first blush, mainly to re-codify and simplify the procedure for filing statements of claim and answers. Rules concerning statements of claim are found at new Customer Code Rule 12302; rules concerning answering the statement of claim are found at new Customer Code Rule 12303. The major changes concerning pleadings, however, appear in the other provisions of Part III.

### 1. Deficient Claims

Under Rule 12307, the Director shall not serve any claim that is deficient. Deficiency includes failure to complete a Uniform Submission Agreement, failure to file the correct number of copies of the statement of claim or supporting documents for

service on respondents, or failure to include certain essential information in the statement of claim. If a claimant fails to correct a deficient pleading within 30 days, the Director will close the case without serving the claim.

### 2. Disfavor of General Denials

New Rule 12308 modifies and expands Old Arbitration Rule 10314. The former rule provided: “A Respondent... who pleads only a general denial to a pleading that states specific facts and contentions may, upon objection by a party, in the discretion of the arbitrators, be barred from presenting any facts or defenses at the time of hearing.” New Rule 12308(b) is broader:

(b) If a party answers a claim that alleges specific facts and contentions with a general denial, or fails to include defenses or relevant facts in its answer that were known to it at the time the answer was filed, the panel may bar that party from presenting the omitted defenses or facts at the hearing.

Arguably, under the new Customer Code Rule, a claimant may seek to bar either defenses or “relevant facts” that the claimant alleges were “known” to a respondent when an answer was filed and not included in the answer. Whereas the Old Arbitration Code sought to discourage the filing of brief “general” denials, the new Customer Code imposes more draconian consequences for failing to assert defenses or allege facts that were known at the time of answering.

While new Customer Code Rule 12308 appears to grant greater discretion to a panel to bar a defense or factual assertion, it provides little guidance as to its application. For example, while the Rule alludes defenses and relevant facts “known” to a party, it does not explain when or how a respondent obtains such “knowledge.” For example, is the knowledge of a non-registered assistant imparted to the firm, such that failure to plead a fact known to the assistant, but to no one else, might ultimately bar a respondent? May statistical compliance analysis be imparted for supervisory reasons? Just as significantly, the new Rule does not indicate how a respondent will “know” a defense. Frequently, a

respondent, who broadly knows the general range of legal defenses, can only appreciate the applicability of a specific defense in light of the facts of a case.

Because the severity of the sanction for not pleading a “known” fact or defense is so great, respondents should anticipate increased efforts by claimants to seek to bar respondents from presenting evidence or defenses based on alleged pleading defects. In light of the significance of such preclusion, respondents may wish to intensify their pre-answer investigations to assure that they have alleged all known material facts and defenses at the time of their initial answer.

### 3. Amendment of Pleadings

New Customer Code Rule 12309 concerning amendments to pleadings attempts to remedy a weakness in the Old Arbitration Code. Under Old Arbitration Code Rule 10328, a party could amend pleadings at any time prior to panel appointment; after selection of a panel, a party would have to obtain the arbitrators’ approval to amend a pleading. Under that Rule, between the time that the Director of Arbitration consolidated the arbitrator selection list and the actual appointment of a panel, a party could amend a pleading to add a new party to the proceeding and the newly added party would neither be able to participate in arbitrator selection nor to object to being added to the arbitration. Under new Customer Code Rule 12309, no party may amend a pleading to add a new party until a panel has been appointed once the ranked arbitrator lists are due. After appointment of a panel, a proposed new party may respond to the motion to amend without waiving its rights or objections under the Code. Likewise, under new Rule 12407, any party added before arbitrator selection lists are due may participate in list selection. If added after a panel has been selected, the new party may still challenge an arbitrator for cause.

### D. Arbitrators and Arbitrator Selection

Among the most significant changes to the new Customer Code are

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the provisions concerning arbitrator selection.

The NASD has not hesitated to modify the arbitrator selection process in the past, including the introduction of the Neutral List Selection System in 1998.<sup>4</sup> Old Arbitration Code Rule 10308 provided that the parties would each receive two lists – a list of “public” arbitrators, composed of ten potential panelists, and a list of “non-public” arbitrators, composed of five people. From these lists, each party was to rank order each of the proposed arbitrators, with the ability to strike one or more of the arbitrators from either list for any reason. From the parties’ consolidated lists of ranked arbitrators, the Director of Arbitration would appoint a panel composed of the two highest ranked public arbitrators and the one highest ranked non-public arbitrator.

Under new Rule 12403, the parties will receive three lists rather than two: a list of eight arbitrators from the NASD’s non-public arbitrator roster; a list of eight arbitrators from the NASD’s public arbitrator roster; and a list of eight public arbitrators from the NASD’s chairperson roster.<sup>5</sup> Under Rule 12404, the parties may then separately rank the arbitrators and may strike up to four of the arbitrators from each list for any reason by crossing through the names of the candidate. However, at least four names must remain on each list. The striking and ranking of individuals on a separate chairperson roster (all of whom will be public arbitrators) will replace the current procedure for selection of chair by agreement by the parties or by the NASD.

The intent of the revisions to arbitrator selection is to remove some of the inefficiency and uncertainty involved in the prior proceedings. For example, it was not uncommon for the parties to strike collectively all of the candidates on a proposed arbitrator list. As a result, in a substantial number of NASD cases, the Director of Arbitration ended up appointing arbitrators pursuant to old Rule 10308(c)(4)(B), which allowed the Director to appoint one or more

arbitrators to complete an arbitration panel, and then to permit the parties to object for cause. Under the new procedures, however, it is more likely that not all arbitrators will be stricken by both parties and that the Director of Arbitration will be able to appoint a panel from the lists given to the parties.

The creation of a chairperson qualified list also is an advance. In the past, parties were sometimes presented with panels in which none of the arbitrators had sufficient background or experience to act effectively as a chairperson. Under the new Customer Code 12400(c), the eligibility requirements for the chairperson roster includes both formal NASD training and experience. Non-attorneys must have participated in at least three arbitrations which went to hearings; attorneys must have participated in at least two arbitrations in which hearings were held.

As with the previous Arbitration Code, under the new Customer Code, claims of less than \$25,000 will be heard by a single arbitrator. The list for the single arbitrators will be generated from the NASD’s chairperson roster. For cases valued between \$25,000 and \$50,000, the NASD will generate a single arbitrator, unless any party requests three arbitrators in its initial pleading. Unlike former Rule 10308(b)(1), which permitted an arbitrator to request the appointment of an additional two arbitrators, new Rule 12401(b) reserves that right to the parties.

## **E. Pre-Hearing Procedures and Discovery**

### **1. Initial Pre-Hearing Conferences**

New Rule 12500 codifies a portion of the current NASD Discovery Guide relating to initial pre-hearing conferences (“IPHCs”). Since the adoption of the Discovery Guide in 1999, IPHCs have been a standard practice with NASD arbitrations.

### **2. Motions**

One of the most significant changes to the new Customer Code is the explicit codification of the practice of permitting motions. Other than discussion of motions with respect to the issuance of subpoenas or directions to appear, the former Arbitration Code did not refer

to motions or provide any guidance with respect to motion practice. As a result, motion practice lacked uniformity and parties and arbitrators alike were frequently unsure whether and how motions should be made, responded to or decided. The allowance and consideration varied from panel to panel and from jurisdiction to jurisdiction. New Rule 12503 establishes a uniform practice for the making and considerations of motions.

First, new Rule 12503(a)(1) explicitly allows the presentation of written motions in accordance with the procedure laid out in Rule 12503, or oral motions at any hearing session. Written motions must be served at least twenty days before a scheduled hearing, unless a panel decides otherwise. Non-moving parties have ten days in which to respond to a motion, unless additional time is agreed to by the parties or granted by the panel. *See* new Customer Code Rules 12503(a)(3) and 12503(b). Written motions may take any form, including formal legal motion, a letter, or any other form that the panel believes is acceptable. Written motions must be served directly on each party and filed with the Director concurrently.

A significant aspect of any motion is a description by the moving party of its efforts to resolve the matter before making the motion. New Customer Code Rule 12503(a)(1). In general, the full panel decides motions, unless the parties agree otherwise. Motions relating to the use of the arbitral forum, removal of an arbitrator, the combination or separation of claims or arbitrations, or changing the hearing location before a panel is appointed, are directed to the Director. In addition, in accordance with the current rules concerning discovery, discovery related motions are decided by one arbitrator, generally the chairperson, although the arbitrator may refer such motions to a full panel, either on the arbitrator’s own initiative or at the request of a party.

Noticeably absent from the new Customer Code is Rule 12504 entitled “Motions to Decide Claims Before Hearing on the Merits.” The NASD originally proposed a rule that stated that dispositive motions were “discouraged,”

and to be entered only in "extraordinary circumstances." The proposed rules received criticism from both sides. Investors complained that the proposed new rule permitted summary disposition of cases without hearing, which investors lobby have always maintained is outside the scope of the arbitration rules. By the same token, industry representatives have asserted that the proposed Rule 12504 eliminated a process for efficient claims resolution that had been adopted by numerous arbitration panels and endorsed by courts throughout the United States. The NASD has proposed Rule 12504 as a separate rule change and published it for comment.<sup>6</sup>

### 3. Discovery

The new Customer Code codifies and reinforces the provisions of the Discovery Guide/Document Production List published by the NASD pursuant to Notice to Members 99-90. Rule 12506 provides that the Director of Arbitration will provide the NASD Discovery Guide and Document Production List when the Director serves the claim. The Rule provides that all documents on Lists 1 and 2 are presumably discoverable in all cases and must be served within 60 days of the date that an answer is due, unless the parties otherwise agree. Rule 12506(b)(2) provides that the parties must act in good faith in providing documents on the document list, and defines "good faith," as meaning that a party must use its "best efforts to produce all documents required or agreed to be produced." Further, the Rule requires that if a document cannot be produced in the required time, the non-producing party must establish a reasonable time-frame to produce the document.

In addition to the automatic disclosure provided under Customer Code Rule 12506, Rule 12507 permits parties to make supplemental discovery requests. As with the document production lists, additional discovery is due within 60 days from the date of request, and requires a "good faith" attempt to produce all responsive information.

Customer Code Rule 12508 delineates how objections may be made

to discovery requests. It requires a party to specifically identify which document or requested information it is objecting to and why. Moreover, Rule 12508(b) provides that any objection not made within the required time is waived unless the panel determines that the party had "substantial justification" for failing to make the objection within the required time.

New Customer Code Rule 12511 provides explicit sanctions for failure to cooperate in discovery. Specifically, a panel may sanction the parties for (a) failing to comply with the discovery provisions of the Code or (b) "frivolously objecting to the production of requested documents or information."

The new discovery provisions should go a long way to expediting discovery and eliminating some of the motion practice that had developed in connection with discovery. For example, the rules require production of documents that are in the possession or control of either party. Claimants historically have refused to produce documents in the custody of their accountants and attorneys, arguing that those documents were not in their "possession." The new language of Rule 12506(b) should eliminate that assertion. At the same time, Rule 12508 requires that objections "must specifically identify which document or requested information it is objecting to and why." Thus, broadly asserted objections which do not sufficiently identify the documents or information to which they apply may act as a waiver of an appropriate objection that could have been more narrowly stated.

### 4. Subpoenas

New Customer Code Rule 12512 substantially changes the authority to issue subpoenas in arbitration proceedings. Under the Old Arbitration Code Rule 10322, both arbitrators and counsel of record in a proceeding had the power to issue subpoenas, to the extent provided by law. Thus, in arbitrations pending in states that permitted attorneys to issue subpoenas, party counsel could issue a subpoena requesting information from third parties, without authorization of the arbitration panel.

New Rule 12512 limits the authority to issue subpoenas to the arbitration panel itself, and the issuance of a subpoena is neither automatic nor instantaneous. A party seeking the issuance of a subpoena must do so via a written motion with a copy of the draft subpoena attached. The non-moving party has ten days to object and the moving party then has ten days to respond to the objections. Importantly, the requesting party may not serve the motion or draft subpoena on a non-party until an arbitrator has issued the subpoena. If the arbitrator does issue the subpoena, the party that requested it must serve the subpoena at the same time and in the same manner on all parties and on the non-party receiving the subpoena. Further, if any party receives documents in response to a subpoena, that party must provide notice within five days of receipt of the documents to all parties and provide copies of the subpoenaed documents within ten days, if requested.

The upshot of this new subpoena rule should be to substantially reduce the number of subpoenas actually issued in connection with NASD arbitrations. This may be a boon to industry members, who must now respond to subpoenas for former customers or employees. At the same time, it penalizes industrious counsel, who track down and obtain important impeaching information from non-party witnesses. In any event, issuance of the subpoena will require substantial additional lead-time; anyone expecting to seek information or testimony from non-party witnesses should plan accordingly.

### 5. 20-Day Exchange

New Customer Code Rule 12514 materially changes the provisions with respect to the exchange of documents twenty days before commencement of the hearings. The concept of a 20-day exchange of information has long existed in the NASD arbitration procedures. However, old Arbitration Code Rule 10321 did not require "service of copies of documents or identification of witnesses which parties may use for cross-examination or rebuttal."

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New Customer Code Rule 12514(c) suggests an entirely different standard. It provides that parties may not present at hearing any documents or other materials not produced or witnesses not identified in the twenty day disclosure, “unless the panel determines that good cause exists for the failure to produce the document or identify the witness.” “Good cause” limits use of documents for rebuttal or impeachment purposes based on “developments during the hearing.” “Documents and lists of witnesses in defense of a claim are not considered rebuttal or impeachment information and, therefore, must be exchanged by the parties.”

**F. Hearings**

The NASD’s rules concerning hearings remain substantially unchanged, with a few minor exceptions. First, Customer Code Rule 12601 permits the parties to postpone a hearing by agreement. While former Arbitration Code Rule 10319 granted the arbitrators discretion to adjourn hearings, postponement is now mandatory if the parties agree.

Rule 12600 requires that the Director notify the parties of the time and place of the hearing at least twenty days before the hearing begins. Rule 12602 expressly permits experts to attend hearing sessions “absent persuasive reasons to the contrary.” Previously, certain jurisdictions would exclude all non-party witnesses from proceedings, while other jurisdictions allowed the attendance by experts. New Rule 12602 clarifies and regularizes those proceedings.

**G. Sanctions**

The new Customer Code addresses sanctions in two different rules: Rules 12212 and 12511.

Customer Code Rule 12212 incorporates and codifies the sanction provisions in the old NASD Discovery Guide. It is intended to provide more guidance to parties and arbitrators regarding the scope of arbitrator authority to address non-compliance with the new Code or panel orders. Among the sanctions available to the

arbitrators are:

- the assessing of monetary penalties payment to one or more party;
- preclusion of a party from presenting evidence;
- making adverse inference against a party;
- assessing postponement and/or forum fees; and
- assessing attorneys’ fees, costs and expenses.

In addition, a panel may dismiss a claim, defense or arbitration *with prejudice* as a sanction for material and intentional failure to comply with an order of the panel, if prior warnings or sanctions have proven ineffective.

Likewise, Rule 12511 provides that the failure to cooperate in the exchange of documents and information may also result in sanctions. The panel may also issue discovery sanctions for failing to comply with the discovery provisions of the Customer Code or for frivolously objecting to the production of requested information or documents. In particular, new Rule 12511 reasserts that a panel may dismiss a claim, defense or proceeding with prejudice “for intentional and material failure to comply with the discovery order of the panel if prior warnings or sanctions have proven ineffective.”

This last provision may prove to be particularly troublesome. Over the past several years, claimants have asserted with increasing frequency that arbitration respondents are withholding documents or failing to comply with legitimate discovery requests. The NASD has brought enforcement proceedings against certain broker-dealers, asserting that they had failed to adequately or properly respond to legitimate discovery requests in arbitrations. Because of the potential severity of the sanctions, parties should expect claimants to file more motions for discovery sanctions.

**Conclusion**

The new Customer Code of Arbitration Procedures substantially revises the arbitration proceedings under which the securities industry has been practicing for these past few decades. Without doubt, the reorganization of the Code in a more coherent and

chronological fashion will make it easier for all participants to find and understand relevant Code provisions. Likewise, the codification of arbitration practices and the restatement of certain procedures in “Plain English” make the Customer Code more comprehensive and easier to comprehend. Nevertheless, the Customer Code appears to impose additional pleading and discovery burdens on respondents and backs those burdens with the threat of profound sanctions. □

1. Effective July 30, 2007, NASD Dispute Resolution, Inc. (“NASD-DR”) and the New York Stock Exchange combined their regulatory, enforcement and dispute resolution operations into a single entity – Financial Industry Regulatory Authority (“FINRA”).
2. The new Customer Code is effective for all NASD-DR cases filed after the April 16, 2007, and all FINRA arbitrations filed on or after July 30, 2007. In conjunction with the adoption of Customer Code Rule 12512 concerning the issuance of subpoenas, the NASD-DR adopted a revision to Old Arbitration Code 10322 to allow only arbitrators to issue subpoenas, whether for discovery in arbitration or for appearance at a hearing before the arbitrators, effective April 2, 2007. See NTM 07-13.
3. The Industry Code, uses the Rule 13000 series and is organized in a similar manner.
4. See NTM 98-90 *New Arbitrator List Selection Rules And Monetary Thresholds For Simplified And Single Arbitration Cases Take Effect*.
5. Under Customer Code Rule 12403(a)(1) for claims involving a single arbitrator, the NASD will generate a list of eight public arbitrators from the NASD’s chairperson roster.
6. SR-NASD-2006-088.

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