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Arbitration Procedures Revised

New NASD Code may simplify process, but impose additional burdens

Virtually all securities customer and intra-industry disputes are subject to compulsory arbitration. The National Association of Securities Dealers, Inc. (NASD) operates the largest securities dispute resolution forum with over 11,000 arbitrations filed since 2005. The rules governing NASD arbitrations are provided for in the NASD Code of Arbitration Procedure (the Code), which governs all aspects of the process from the selection of arbitrators to the hearing. On April 16, comprehensive changes to the Code for both customer and intra-industry disputes came into effect and apply to all arbitrations filed on or after that date. For those representing investors or industry parties before the NASD, the new Code presents many substantive changes and new procedures of which practitioners should be aware. The following is a brief examination of some of the more significant changes. A comparison chart is available at http://www.nasd.com/ArbitrationMediation/Arbitration/CodeofArbitrationProcedure/NASDW_009566.

In announcing the changes, the SEC cited criticisms that the old Code was not user-friendly and was confusing to navigate, especially for those unfa-

miliar with the forum or for self-represented parties. *See* SEC Release No. 34-55158 (Jan. 24, 2007). For instance, some rules applied exclusively to industry disputes, others applied solely to customer cases, certain rules governed mediations, yet all were intertwined in a single Code. To simplify, the new Code is divided into three separate Codes: Customer (12000 series), Industry (13000 series), and Mediation (14000 series, which previously became effective in January 2007). The Customer Code applies to claims initiated by investors against member firms and their employees. The Industry Code governs intra-industry disputes, including employment claims and other disputes between or among member-firms and their employees. The Mediation Code applies to all mediations before the NASD. For ease of cross-reference, provisions that cover similar subjects in each Code are similarly numbered. Moreover, the new Codes are organized much like the Federal Rules of Civil Procedure to reflect how a typical case proceeds chronologically.

The arbitrator selection process has also been overhauled in the new Codes (Rules 12400 to 12404 and Rules 13400 to 13404). For instance, under the old Code, in customer cases claiming \$50,000 or more, separately represented parties ranked names from a list of 15 potential arbitrators (10 public and five

nonpublic) drawn from an arbitrator pool on a rotational basis. The parties were allowed unlimited challenges from these lists and could potentially strike all 15 arbitrators. In such a case, or if the NASD could not fill the panel from the parties' respective ranking lists, the NASD could randomly appoint an individual from the arbitrator pool. Furthermore, the parties were required to agree on and select one of the two public arbitrators appointed to the panel to serve as chairperson. If the parties could not reach a consensus, the NASD would select the highest ranked public arbitrator to act as the chairperson. A chairperson designated in this manner may not have chairperson training or qualifications.

Under the new Customer Code, potential arbitrators are divided into three separate ranking categories containing eight arbitrators each: Public Chairpersons (those public arbitrators that meet the training and other requirements to qualify as chairpersons), Public (professionals and laypersons with no securities industry experience or qualifications), and Nonpublic (including individuals with specialized securities or industry experience or qualifications). Each party is now limited to only four strikes in each arbitrator category. Because the chairperson is ranked separately, the new procedure also ensures that the chairperson has the appropriate qualifications.

In comparison to traditional discovery procedures, discovery in an NASD arbitration is streamlined to reduce costs and expedite the resolution of the

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dispute. As under the old Code, in both customer and industry cases, "parties may request documents or information from any party by serving a written request directly on the party." (Rules 12506 and 13506). However, discovery methods like depositions and interrogatories are typically not permitted (Rules 12510, 13510 and 12507, 13507).

Compared to industry cases, discovery in a customer arbitration is designed to be even more streamlined. In customer cases, the parties rely on a separate NASD Discovery Guide (Notice to Members 99-90), which includes various production lists. These production lists identify documents that are historically or presumptively discoverable for both sides in a customer arbitration and also include discovery items that are claim specific. Under the old Code, the parties were required to produce documents from the relevant production lists or make objections within 30-days of when the answer was first due. Theoretically, this would ensure that the parties were provided the typical discovery needed to prove or defend specific claims. In practice, however, parties often ignored the procedure.

Although the parties will still rely on the Discovery Guide in making their initial disclosures, the Discovery Guide is now incorporated by reference in the new Customer Code, which mandates compliance with the relevant production lists (Rules 12505 to 12511). The new rules require the parties to produce documents, explain why they cannot produce documents, or object within 60-days of the day the answer is originally due. Moreover, the new Codes codify a "good faith" standard and makes non-compliance with discovery provisions or frivolous objections in both customer and industry cases expressly subject to sanctions (Rules 12507, 12511 and 13507).

On April 2, new rules regarding the issuance of third-party subpoenas in NASD arbitrations became effective and were integrated into the new arbitration

Codes (Rules 12512 and 13512). This new subpoena procedure applies retroactively to all pending arbitrations. Under the old Code, arbitrators and the parties had the power to issue subpoenas as provided under the law. The new rules eliminate the parties' or their attorneys' ability to serve their own subpoenas, regardless of applicable state or federal law. The arbitration panel now has the exclusive ability and discretion to issue subpoenas, but only upon motion by a party.

Although motions are commonplace in NASD arbitrations, the old Code did not provide procedures for any motion practice. The new Codes establish procedures for all motions (Rules 12503, 13503). The new motion rules include: the requirement that efforts to resolve the dispute prior to making a motion be documented; the allowance for written motions or oral motions at a hearing; and time frames for making and responding to motions.

Rules dealing with motions to dismiss are currently absent from the new Codes, and proposed rules 12504 and 13504, which are awaiting approval by the SEC, will address this type of motion. There has been substantial debate regarding the appropriateness of dispositive motions in NASD arbitrations. Some jurisdictions have previously ruled that arbitrators can dismiss claims prior to a final evidentiary hearing. For instance, in *Sheldon v. Vermonty*, 269 F.3d 1202, 1206 (10th Cir. 2001), which is commonly cited by respondents in support of dismissal motions, the court held that "a NASD arbitration panel has full authority to grant a pre-hearing motion to dismiss with prejudice based solely on the parties' pleadings so long as the dismissal does not deny a party fundamental fairness." See also *Tricome v. Success Trade Securities*, 2006 WL 1451502 at *3 (E.D. Pa. 2006). According to proposed Rules 12504 and 13504, arbitrators will be permitted to hear motions to dismiss claims prior to a hearing. However, the practice would be expressly "discour-

aged" and dispositive motions would only "be granted in extraordinary circumstances." As a further disincentive to the practice, arbitrators would be permitted to award sanctions for making "frivolous" motions to dismiss.

The old Code did not expressly list the possible sanctions against parties, with the exception of the dismissal of claims or defenses or "lesser sanctions" for willful and/or intentional failure to comply with an order of the arbitrators when "lesser sanctions have proven ineffective." (Old Rule 10305(b)). Additional sanction rules were provided in the Discovery Guide and the NASD Arbitrator's Manual, but those sanctions only directly applied to discovery abuses.

The sanction rules are now incorporated into the new Codes and encompass both customer and industry disputes (Rules 12212, 13212). The parties are expressly subject to sanctions for discovery abuses, noncompliance with Code provisions and violations of arbitrator orders. The new Codes also provide a nonexhaustive list of sanctions available to arbitrators, including the imposition of penalties, forum fees, costs and attorneys' fees, as well as the preclusion of evidence or the making of adverse inferences.

In its January 2007 announcement, the SEC stated that the goals of the changes to the Code are to simplify the process and improve the "transparency of the arbitration process" for investors. See SEC Release No. 34-55158 (Jan. 24, 2007). The new rules may reach the goal of simplifying certain portions of the arbitration process. However, practicing under the new Codes warrants some caution, particularly in light of the broader discovery and sanction rules. In practice, the new Codes may impose additional burdens and costs on both sides and produce other unforeseen problems. Simply, the impact of the new Codes will not be fully revealed until they put to the test. ■