NASAA

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By E-mail: rule-comments@sec.gov

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. SR-NASD-2005-032 (Proposed Rule Change to Require Written Explanations in Arbitration Awards Upon the Request of Customers or Associated Persons)

Dear Mr. Katz:

On behalf of the North American Securities Administrators Association, Inc. (NASAA),[1] I am submitting comments on the NASD's proposed rule amendment that would entitle customers and associated persons to receive written explanations in arbitration awards, provided they submit a request at least 20 days prior to the first scheduled hearing date.

Summary

NASAA generally supports the rule change. However, we believe it does not go far enough and should be strengthened in three important respects. First, explanations should include legal authorities and damage calculations, not merely the factual grounds for the decision. Second, explanations should not be contingent upon request, but instead should be required. Finally, the exceptions for simplified arbitrations conducted without a hearing and for default cases should be eliminated, and explained decisions should be required in those cases as well.

The Proposed Rule Change

The proposed rule amendment, first submitted to the SEC on March 15, 2005, and resubmitted with technical changes on April 14, 2005, provides as follows:

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the state, provincial, and territorial securities administrators in the United States, Canada, and Mexico. NASAA supports the work of its members in protecting investors at the grassroots level and promoting fair and open capital markets.

Customers, and associated persons in industry controversies, may request "explained decisions." NASD members may not make such requests.
An "explained decision" is a "fact-based award stating the reason(s) each alleged cause of action was granted or denied."
Legal authorities and damage calculations need not be included in explained decisions.
Explained decisions must be requested at least 20 calendar days before the first scheduled hearing date, or, no later than the pre-hearing exchange of documents and witness lists.
Each arbitrator will receive an additional honorarium of $200 for writing an arbitration decision, $100 of which is to be allocated to the parties as part of the final award.
The right to request explained decisions will not apply in simplified cases decided without a hearing or in default cases.

Benefits Of The Proposed Rule Change

NASAA favors the rule change insofar as it entitles customers and associated persons to receive an explanation of the factual basis for the panel's award. The rule change will serve a number of important goals. It will improve the quality of arbitration, in that decision makers who must explain their thinking tend to arrive at more fair and correct results. Courts and commentators alike have noted that explanations improve the adjudicative process. *See Williamson v. Tucker,* 645 F. 2d 404, 411 n.3 (5th Cir.), *cert. denied,* 454 U.S. 897 (1981) (the findings required under Fed. R. Civ. P. 52(a) "insure care on the part of the trial judge in ascertaining the facts"); Marilyn Blumberg Cane & Marc J. Greenspon, *Securities Arbitration: Bankrupt, Bothered & Bewildered,* 7 Stan. J. L. Bus. & Fin. 131, 160 (Spring 2002) (opinions demonstrate that the arbitrator thoughtfully contemplated each claim).

Requiring explanations will also promote investor confidence and investor satisfaction in the arbitration process. To the extent decisions are fairer, the rule change obviously will enhance investor confidence in arbitration. Explanations offer the additional benefit of enabling parties to feel satisfied with the outcome, whatever it may be. Thus, even parties who may not have fared well in the award can still believe that justice was served if they receive a decision that explains how and why the arbitrators reached a given result. *See* Cane & Greenspan, *supra,* at 160 (the parties are more likely to accept the award if they believe the arbitrator considered the matter carefully). In fact, the absence of an explanation in most arbitration awards has long been one of the chief complaints about the arbitration process among non-prevailing parties, as the NASD noted in its rule proposal. *See* Proposed Rule Change, Apr. 14, 2005, at 9.

Written explanations also will assist courts in correcting bad decisions. Although judicial review of arbitration decisions is limited, fact-based explanations will provide a somewhat better record on which to appeal a badly flawed outcome. *See, e.g.,* 9 U.S.C. § 10) (setting forth the grounds for vacating an award under the Federal Arbitration Act); 9 U.S.C. § 11 (setting forth the grounds for modifying or correcting an award under the Federal Arbitration Act).

Written explanations also will offer more general benefits extending beyond the parties to a given arbitration. For example, explained decisions will improve the NASD's ability to monitor the quality of the arbitration panelists and to design effective training programs for arbitrators. Finally, written explanations will help form a jurisprudence that will guide both investors and industry. For all of these reasons, NASAA views the proposed rule change as a step in the right direction.

NASAA's Suggested Modifications

<u>Require Legal Authorities And Damage Calculations In Written Explanations</u>

The content of explained decisions should be enhanced. In its current form, the rule amendment requires only "fact-based" explanations, and it expressly provides that legal authorities or damage calculations need not be included. *See* Proposed Rule Change, Section 10330(j)(2). This is a significant deficiency in the proposed rule. The NASD should amend the rule so that it *requires* legal authorities and damage calculations, in addition to the fact-based reasons for the award. This change is important in order to achieve more fully the benefits that written decisions can offer: fair outcomes, enhanced investor confidence, a meaningful basis for appeal, and the evolution of a securities jurisprudence in arbitration cases. Without this additional requirement, the rule amendment will fall short of its objectives.

Requiring legal authorities and damage calculations in written decisions is especially important for correcting bad arbitration decisions. As noted above, the Federal Arbitration Act limits judicial review of arbitration awards. However, standards do exist for preventing serious errors. Two of the most important grounds for correcting an arbitration award are a "manifest disregard of the law" and a "miscalculation of figures." *See GMS Group, LLC v. Benderson*, 191 F. Supp. 2d 318, 321 (W.D. N.Y. 2001) (tracing the judicially-created doctrine of "manifest disregard of the law"), *aff'd*, 326 F.3d 75 (2d Cir. 2003); 9 U.S.C. § 11(a) (miscalculation of figures).

When arbitrators do not explain the factual and legal grounds for their decisions, courts find it nearly impossible to apply these standards of review. *See Dawahare v. Spencer*, 210 F.3d 666, 669 (6th Cir. 2000) ("Arbitrators are not required to explain their decisions. If they choose not to do so, it is all but impossible to determine whether they acted with manifest disregard of the law.") (citation omitted); *Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 1410, 1413 (11th Cir. 1990) (questioning whether the "manifest disregard" standard can ever be met where the arbitrator provides no reason for the award). Amending the proposed rule to require legal grounds and damage calculations in explanations is essential so that courts can apply appropriate standards of review to prevent injustice.

Arbitrators can and should be expected to include legal authorities and damage calculations in their awards without significant additional burden or delay. To the extent this change in the proposed rule would impose these costs, the benefits outweigh the burdens.

<u>Dispense With The Requirement That Written Explanations Be Requested By One Of The Parties</u>

From a procedural standpoint, the NASD should require explained decisions in all cases and not condition them on a request from one of the parties. Investors, especially those appearing without counsel, may not understand their right to request an explanation of the award. Even if investors do understand this right, a culture of discouragement may evolve in which investors are reluctant to ask for explained decisions for fear of burdening panelists or incurring their disfavor.

If this procedural requirement is not removed, then the NASD should amend the rule in several other respects. First, the timing requirement should be liberalized. In its current form, the proposed rule change requires that requests be made at least 20 days in advance of the first scheduled hearing date. The rule should be changed to permit requests for written explanations at any time until the hearing record is closed and the panel begins deliberating. This change would afford investors greater flexibility in requesting explained decisions. At the same time, it would protect panelists from the burdens they might face if they were to receive requests for explanations *after* they had studied the record and analyzed the case.

Second, if the proposed 20-day request requirement is retained, then the formulation of the deadline should be clarified. The proposed rule now contains two different provisions setting forth the deadline

for requesting an "explained decision." The proposed amendment to Rule 10321(c)(2) provides that any request for an explained decision must be submitted "at least twenty (20) calendar days prior to the first hearing date." At the same time, however, the proposed amendment to Rule 10330(j)(4) provides that any such request must be made "no later than the time for the pre-hearing exchange of documents and witness lists under Rule 10321(c)." While these deadlines may usually coincide, in some cases they may actually conflict. For example, the panel could conceivably change the deadline for exchanging documents and witness lists without altering the hearing date. At a minimum, these provisions may confuse the parties, especially those who are acting without counsel. Accordingly, this aspect of the rule should be clarified.[2]

Finally, if the rule in its final form still includes some form of a request requirement, then the NASD should institute procedures to ensure that investors fully understand their right to request written explanations.

Eliminate The Exception For Simplified Cases And Cases Involving Default

The NASD should make the rule amendment applicable to all simplified cases conducted under Rules 10203 or 10302, including those cases decided without a hearing. The NASD should also make the amendment applicable to default cases decided under Rule 10314(e). All of the reasons discussed above for requiring explained decisions apply to simplified and default cases as well as ordinary arbitrations. Those reasons include improving the quality of the decisions rendered, increasing the sense of fairness among the parties, creating a meaningful record for appeal, and generating a useful body of arbitration jurisprudence.

With respect to simplified arbitrations, the parties should receive explained decisions whether or not a hearing is held. Simplified arbitrations are defined as disputes "involving a dollar amount not exceeding $25,000, exclusive of costs and interest." *See* Code of Arbitration, Rules 10203(a) and 10302(a). This is a significant sum of money by any standard, and it may represent a devastating loss for some investors. The rule amendment in its current form acknowledges this fact by requiring explained decisions in simplified cases, but it creates an exception for simplified arbitrations "decided without a hearing." This distinction, based upon whether or not a hearing is held, should be eliminated, because it has no bearing on the reasons for explained decisions. Investors – and associated persons as well – may be compelled to forego a hearing not because the amount at stake is unimportant or they care less about the outcome. Rather, they may be deterred because of the added burden and expense of traveling, taking time away from work, and paying counsel to participate in the hearing. Those parties nevertheless deserve the benefits of explained decisions.

Claimants in arbitrations conducted under the default provisions also should receive explained decisions. Even if a respondent fails to defend, the claimant remains subject to the judgment and discretion of the arbitrator deciding the case. Under the rules, arbitrators deciding cases in default situations are prohibited from automatically granting the relief requested by the claimant. Rule 10314(e) states that "An arbitrator may not make an award based solely on the non-appearance of a party." The Rule further states that "The party who appears must present a sufficient basis to support the making of an award in the party's favor." And while the arbitrator may not award damages in an amount greater than the damages requested, the rule does not prohibit the arbitrator from awarding *less* than that amount. These

[2] The NASD should clarify another provision in the proposed rule amendment. It now states that "each arbitrator will receive an additional honorarium of $200 for writing an explained decision." *See* Proposed Rule Change, Section 10330. This suggests that explained decisions may entail an additional cost of $600, or $200 for *each* of the three arbitrators on the panel. Presumably, however, only one arbitrator will write the decision and receive the honorarium of $200. Therefore, the rule should make clear that the additional cost associated with an explained decision is at most $200.

provisions demonstrate that even in default cases, arbitrators must evaluate the claims and the evidence presented and must exercise their judgment in applying the law to the facts. While the award may often coincide with the amount claimed, it may not. Parties who are thus subject to the arbitrator's decision-making discretion should have the benefit of an explanation of whatever award is made.

Conclusion

In summary, NASAA believes that all explained decisions should include legal authorities and damage calculations, that explained decisions should not be contingent upon the request of a party, and that explained decisions should be required in simplified arbitrations conducted with or without a hearing and in default cases.

Thank you for considering our views. If you have any questions about our comments, I encourage you to contact Tanya Solov, Chair of NASAA's Broker-Dealer Section, at 312-793-2525, or Rex Staples, NASAA's General Counsel, at 202-737-0900.

Sincerely,

Franklin L. Widmann
NASAA President and
Chief, New Jersey Bureau of Securities

Cc: Tanya Solov
Rex Staples