GIOVANNI P. PREZIOSO
JACOB H. STILLMAN
ERIC SUMMERGRAD
MARK R. PENNINGTON
JOHN W. AVERY

Attorneys for Amicus Curiae
SECURITIES AND EXCHANGE COMMISSION
450 Fifth Street, N.W.
Washington, DC 20549-0606
Telephone: (202) 942-0816
Facsimile: (202) 942-9625

UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

(OAKLAND)

NASD DISPUTE RESOLUTION, INC. and NEW YORK STOCK EXCHANGE, INC., Plaintiffs, v. JUDICIAL COUNCIL OF CALIFORNIA, et al., Defendants.	CASE NO. C 02 3486 SBA BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, <u>AMICUS CURIAE</u>, IN SUPPORT OF PLAINTIFFS' MOTION FOR DECLARATORY JUDGMENT Date: September 24, 2002 Time: 1:00 p.m. Judge: Honorable Saundra B. Armstrong

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases **Page**

TABLE OF AUTHORITIES (CONT.)

TABLE OF AUTHORITIES (CONT.)

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION AND SUMMARY OF ITS POSITION

The Securities and Exchange Commission submits this brief as amicus curiae to address the question of whether California's standards for arbitrator disclosure and disqualification are preempted by federal law to the extent they apply to the arbitration systems of the NASD, Inc. ("NASD") and the New York Stock Exchange, Inc. ("NYSE").

The Commission has a strong and direct interest in this case. The Commission is the agency principally responsible for the administration and enforcement of the federal securities laws and regulations. It has been entrusted under those laws with the comprehensive oversight of self-regulatory organizations (SROs) such as the NASD and the NYSE. As part of that function, the Commission carefully reviews and must approve all rules under which the SROs conduct their arbitration systems, as well as any changes to those rules. The Commission also inspects the NASD and NYSE arbitration systems on a periodic basis in order to "identify areas where procedures should be strengthened, and to encourage remedial steps either through changes in administration or through the development of rule changes." Sec. Exch. Act Rel. No. 40109 (June 22, 1998), 1998 SEC Lexis 1223 at *26 n.53.

A central issue in this case is whether the states may independently direct the SROs how to conduct their arbitration systems. The Commission is of the view that in light of the Commission's comprehensive oversight under federal law of the SROs, only the Commission can decide what disclosure and disqualification standards are appropriate for the protection of investors in SRO arbitration, and can insure that those standards are part of an effective national system. The California standards, to the extent they apply to the SROs, 1/ are preempted by virtue of this scheme of federal regulation. In addition, the Commission is of the view that the California standards, as they apply to SRO arbitration, are preempted by the Federal Arbitration Act.

Although the Commission recognizes that California has adopted these standards on its view that they will benefit consumers, it is unclear if the additional disclosure required by California will, coming on top of the extensive disclosure already required by the SROs, have that effect in the case of SRO arbitrations. The Commission must also consider whether in some respects the California standards, as applied to the SROs, could actually work to the detriment of investors. At the time the standards were being drafted, the Commission staff discussed with California officials their concern that by increasing the opportunities to disqualify arbitrators and to vacate arbitration awards, the California approach could have the effect of protracting arbitrations and increasing their complexity, and could promote uncertainty of outcomes, with a corresponding increase in cost for the participants and the SROs. Such effects could work to the benefit of well-financed brokerage firms and not to that of the average investor.

The Commission is not in this brief taking the position that this increase in cost, complexity, and uncertainty will be the result of the California standards. The point is that the Commission must, in light of its responsibility to oversee the SROs' arbitration systems, consider all of these concerns in assessing changes to those systems. It must also consider that the SROs have other important regulatory functions, and that undue costs imposed in this area may detract from their ability to function in other areas, or else

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1/ The SROs argue that the standards cannot, consistent with the definition of "neutral arbitrator" in the California statute, be applied to their arbitrations. The Commission takes no position on this issue of state law.

increase the costs to members and other arbitration participants. 2/

The SROs cannot effect any substantial change in their arbitration procedures or other rules unless and until the Commission approves a change in their rules. The states cannot act unilaterally to change the SRO procedures where Congress has vested that function in the Commission. Only the Commission, moreover, is in a position to assess the effect of a rule change on the SROs. In adopting its new arbitration standards, California was not purporting to adopt rules tailored to the specialized needs of nationwide securities regulatory organizations. Nor does it profess to have expertise in the functions of those organizations. But even if California did attempt to weigh these matters, it could only do so with respect to its own disclosure and disqualification standards. If California can impose its own standards on the SROs, so can the other states. A single state cannot know what other states may do, cannot control what they do, and thus cannot take into account the effect of other state rules on the SROs. The SROs are, by Congressional design, nationwide organizations with a national mandate. Allowing the states to dictate rules in this area will subject the SROs to a patchwork of regulation, a system that cannot be responsive to the SROs' national needs.

Only the Commission is in a position to assess the nationwide impact of SRO rules and assure that the appropriate rules apply in an effective fashion. Indeed, the Supreme Court relied on the Commission's regulatory oversight of SRO arbitrations in upholding

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2/ On September 17, 2002, the Commission announced that it had asked Professor Michael Perino to "to assess whether the current disclosure requirements in the NASD and NYSE arbitration procedures should be modified to reflect any of the new disclosure concepts in the new California rules." See http://www.sec.gov/news/speech/spch580.htm.

pre-dispute agreements to arbitrate securities claims. See Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 234 (1987). In light of the Commission's uncontested responsibility in this area, the California standards as they apply to the SROs should be found to be preempted.

The California standards are also preempted by the Federal Arbitration Act. The FAA, as it has been construed by the courts, prohibits the states from imposing on arbitration agreements involving interstate commerce requirements that are specific to arbitration contracts (the states can impose requirements that apply to all contracts), and to which the parties have not agreed. While the parties can choose to arbitrate under California arbitration law, if the parties choose to use SRO procedures, the FAA precludes California from imposing other requirements, apart from those that apply to all contracts.

BACKGROUND

The NASD and the NYSE each acts as a dispute resolution provider organization, offering arbitration services for their members and the customers of their members under rules adopted by the SRO and approved by the Commission. 3/ Any customer may demand arbitration under the SRO's rules. More typically, the firm's customer agreement provides in advance to arbitrate disputes under the SRO's rules.

The NASD and the NYSE arbitration rules set forth specific standards for the qualifications of their arbitrators, including required disclosures by arbitrators, as well as mechanisms for disqualifying the arbitrators. Thus, NASD Rule 10312 and NYSE Rule 610 require an arbitrator to disclose "to the Director of Arbitration any circumstances

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3/ The arbitration system of the NASD is conducted through its subsidiary, NASD Dispute Resolution, Inc., one of the plaintiffs in this case.

which might preclude such arbitrator from rendering an objective and impartial determination," as well as certain specified financial or personal interests in the outcome of the arbitration, and any circumstances or relations that are likely to affect impartiality or create an appearance of bias. Rule 10312(d)(1) states that the NASD's Director of Arbitration "may remove an arbitrator based on information that is required to be disclosed pursuant to this Rule," although under Rule 10312(d)(2), "[a]fter the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, the Director may remove an arbitrator based only on information not known to the parties when the arbitrator was selected." NYSE Rule 610 allows disqualification on the same basis before the hearing begins.

The essence of these provisions were approved by the Commission in 1989 as part of a detailed package of changes to the SROs' arbitration procedures. In approving the rules, the Commission noted that "[t]he SROs have worked together over the past twelve years to develop uniform arbitration rules through the auspices of the Securities Industry Conference on Arbitration ('SICA'). * * * SICA is comprised of a representative from each SRO that administers an arbitration program, a representative of the securities industry, and four [now three] representatives of the public." The rules proposed by the SROs (which included the NASD, the NYSE, and the American Stock Exchange) also reflected substantial input from and discussions with the Commission. The rules approved included NYSE Rule 610 and NASD Rule 10312, then known as Section 23 of the NASD Code of Arbitration Procedure. See Sec. Exch. Act Rel. No. 26805 (May 10, 1989), 1989 SEC Lexis 843 at *3-*4. Since their original approval, these rules have with Commission approval been modified in the ensuing years.

In 2001, California adopted changes to Title 9 of the California Code of Civil

Procedure (CCCP) concerning arbitration. Among other things, the changes require a proposed "neutral arbitrator" 4/ to disclose in writing within ten days of his proposed appointment, "all matters that could cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial, including * * * [a]ny matters required to be disclosed by the ethics standards for neutral arbitrators adopted by the Judicial Council pursuant to this chapter." CCCP § 1281.9(a). A proposed neutral arbitrator can be disqualified by a party if he fails to make the required disclosures or if the disclosures give a basis for disqualification. 5/ Moreover, a court "shall" vacate an arbitration award if an arbitrator fails to disclose within the time required for disclosure a ground for disqualification of which he was then aware, or if he was subject to disqualification but failed to disqualify himself after being asked to do so by a party. CCCP § 1286.2(a)(6).

The Judicial Council was directed to adopt ethical standards for neutral arbitrators effective July 1, 2002. CCCP § 1281.85. These standards impose a detailed set of new disclosure requirements for arbitrators. The ethical standards also purport to apply not only to neutral arbitrators selected jointly by the parties or their arbitrators, but to any impartial arbitrators selected by a dispute resolution provider organization.

4/ "Neutral Arbitrator" is defined in CCCP § 1280(d) as "an arbitrator who is (1) selected jointly by the parties or by the arbitrators selected by the parties or (2) appointed by the court when the parties or the arbitrators selected by the parties fail to select an arbitrator who was to be selected jointly by them."

5/ CCCP § 1281.91. The grounds for disqualification appear to be the grounds set forth in CCCP § 170.1 for disqualification of a judge, including if "a person aware of the facts might reasonably entertain a doubt that the judge would be able to be impartial." CCCP § 170.1(6)(C).

ARGUMENT

The California disclosure and disqualification standards, as applied to the SRO arbitration systems, are preempted by the scheme of federal regulation of those systems under the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq. The Commission further believes that the standards are, in this context, preempted by the Federal Arbitration Act, 9 U.S.C. 1 et seq.

I. Overview of Preemption Principles

Under the Supremacy Clause, state law can be preempted "[w]hen Congress intends federal law to 'occupy the field.'" Crosby v. National Foreign Trade Council, 530 U.S. 363, 372 (2000), citing United States v. Locke, 529 U.S. 89 (2000). But even absent an expression of Congressional intent, state laws are "naturally preempted to the extent of any conflict with a federal statute." Crosby, 530 U.S. at 372. A court will find such preemption "where it is impossible for a private party to comply with both state and federal law, and where under the circumstances of a particular case, the challenged state law stands as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress." Id. (internal citations, quotation marks, and brackets omitted). "What is a sufficient obstacle is a matter of judgment, to be informed by examining the federal statute as a whole and identifying its purpose and intended effects." Id. at 373. In Crosby (530 U.S. at 373), the Court quoted Savage v. Jones, 225 U.S. 501, 533 (1912):

> For when the question is whether a Federal act overrides a state law, the entire scheme of the statute must of course be considered and that which needs must be implied is of no less force than that which is expressed. If the purpose of the act cannot otherwise be accomplished – if its operation within its chosen field else must be frustrated and its provisions be refused their natural effect – the state law must yield to the regulation of Congress within the sphere of the delegated power.

Properly adopted federal regulations, as well as federal statutes, can preempt state laws on the same principle. City of New York v. FCC, 486 U.S. 57, 64 (1988).

Although the Supreme Court traditionally termed the preemption stemming from overt Congressional intent "field preemption" and that flowing from conflicts "conflict preemption," in Crosby it recognized that these terms are misnomers, since a field of regulation may be preempted either because Congress intended it, or because of overt conflict of laws, or because of frustration of purpose. Id., 530 U.S. at 372 n.6.

II. Overview of the Federal Scheme for the Commission's Oversight and Regulation of SROs Under the Exchange Act

The regulation of the nation's securities markets has long relied in large part on the efforts of the SROs, subject to Commission oversight. See generally S. Rep. 94-75, 94th Cong., 1st Sess. 22-23 (1975). In general, any registered broker-dealer effecting transactions in securities must be a member of an SRO – either a registered national securities association (of which the NASD is the only one), or a national securities exchange (or both). Section 15(b)(8), 15 U.S.C. 78o(b)(8). SROs are required to register with the Commission, to promulgate rules governing the conduct of their members, and to enforce compliance by their members with those rules and with the federal securities laws. See Section 6 of the Exchange Act, 15 U.S.C. 78f (regarding securities exchanges); Section 15A of the Exchange Act, 15 U.S.C. 78o-3 (regarding securities associations); Section 19(g) of the Exchange Act, 15 U.S.C. 78s(g) (enforce compliance with rules). Under these sections, the SRO's rules must be approved by the Commission and must be consistent with the requirement that SRO rules be designed to prevent fraudulent and manipulative practices; to promote equitable principles of trade; to safeguard against unreasonable profits and charges; and generally to protect investors and the public interest. See also Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b) (approval of SRO rule changes). As these sections make clear, a national securities association or a national securities exchange serves, under Commission supervision, a public regulatory function. See generally Sparta Surgical Corp. v. NASD, Inc., 159 F.3d 1209, 1210-14 (9th Cir. 1998).

Under Section 19(b)(1) of the Exchange Act, 15 U.S.C. 78s(b)(1), each SRO must file with the Commission any proposed change to its rules. Upon the filing of any proposed rule change, the Commission must publish notice of the change and provide interested parties an opportunity to comment (id.). Subject to certain exceptions not relevant here, no proposed rule change may take effect unless approved by the Commission (id.). The Commission must grant such approval if it finds that the proposed rule is consistent with the requirements of the Exchange Act and with the rules and regulations thereunder applicable to SROs. Section 19(b)(2), 15 U.S.C. 78s(b)(2). Moreover, the Commission may, on its own initiative, "abrogate, add to, and delete from" any SRO rule if it finds such changes necessary or appropriate to further the purposes of the Act. Section 19(c), 15 U.S.C. 78s(c). The Commission, in short, has full supervisory authority over the rules adopted by SROs, including the power to mandate the adoption of additional rules it deems necessary in the public interest.

III. The California Standards Conflict With and Thus are Preempted by the Commission's Regulation of SRO Arbitration Under the Exchange Act.

A. The California Standards Conflict with the Federal Scheme of SRO Regulation Under the Exchange Act.

The defendants correctly note that Congress has never entirely precluded the states from regulating matters pertaining to securities. In both Section 18 of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77r, and Section 28 of the Exchange Act, 15 U.S.C.

78bb, Congress has carved out areas (none germane here) in which the states may regulate. 6/ The question, however, is not whether the states may play any role in the regulation of matters pertaining to securities. The question is a far narrower one -- whether the states may dictate how the regulatory functions of the SROs are carried out, where Congress has committed to the Commission comprehensive oversight over those functions and the Commission has exercised that authority.

While there is no express statement by Congress that it intended to preclude state law from applying to SRO regulation, allowing the states to intrude into how the SROs carry out their regulatory functions would fundamentally conflict with the objectives of the federal scheme under which the SROs are overseen. It would allow the states unilaterally to impose on the SROs requirements on how they conduct their regulatory business, when Congress designed a system under which such activities can be carried out, and are in fact carried out, under Commission oversight and only with Commission approval.

An SRO's arbitration system is an integral part of the SRO's role as a regulatory organization. A significant purpose of an SRO's regulatory function is to assure that

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6/ Section 18 of the Securities Act deals with securities registration under the Act and preserves the antifraud authority of state securities commissions. These matters are not at issue here. Section 28(a) of the Exchange Act preserves (except as specifically provided) existing state law rights and remedies, and provides that "[e]xcept as otherwise specifically provided in this title, nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder." (Emphasis added). These provisions likewise are not at issue here, where existing rights or remedies are not involved, and the jurisdiction of the state securities commission is not at issue. Moreover, even if that section were at issue here, we believe the California standards are in conflict with the Exchange Act.

investors are protected, and the arbitration system is intended to serve that purpose by allowing for the fair resolution of disputes between investors and member firms. As the Supreme Court observed in Shearson/American Express, Inc. v. McMahon, 482 U.S. at 233-34:

> the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.

The Court relied on the fact that the Commission had in fact exercised its regulatory authority to specifically approve the arbitration procedures of the NASD and the NYSE, along with those of the American Stock Exchange, in upholding pre-dispute agreements to arbitrate certain securities claims, on the view that Commission oversight assured the arbitration systems would be fair to investors. See 482 U.S. at 234.

The Commission has acted pursuant to this regulatory scheme with respect to disclosure and disqualification requirements for arbitrators who serve under the arbitration systems administered by the SROs. The current versions of the SRO requirements were, as noted, the product of detailed consideration by the SROs, following input from the securities industry and the public and substantial direction from the Commission. They were approved by the Commission as appropriate in the public interest, and have in the following years been amended with Commission approval.

In light of this regulatory arrangement, in which the SROs' arbitration procedures can be (and have been) adopted and amended only following consideration and approval by the Commission, there cannot be a parallel system in which the states make their own judgment about these procedures. A state law that requires SROs to adhere to rules that are not approved by the Commission would override this statutory scheme, since it would dictate to the SROs procedures that the Commission has not approved.

This is not just a matter of the Commission preserving its prerogative to consider and approve changes in the SROs' arbitration systems. Commission review and approval in this area are essential to protection of investors' interests under the federal securities laws. 7/ In deciding whether to change the disclosure and disqualification rules, the Commission must consider whether the added disclosure and disqualification procedures serve the interest of investors. The Commission must consider if additional disclosure is truly going to be beneficial to investors. 8/ It must also consider whether other aspects of the system may work to investors' detriment. As noted, serious concerns have been raised by the Commission staff that the added opportunities under the California system

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7/ In Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117 (1973), the Court held that a New York Stock Exchange rule requiring an employee of a brokerage firm to submit post-termination disputes to arbitration did not preempt California law allowing actions to recover improperly withheld wages. In reaching this position, which was consistent with the position urged in the case by the Commission, the Court noted among other things that the NYSE rule "would not be subject to the Commission's modification or review under § 19 (b)." Id. at 135. Subsequently, the Commission's oversight authority was greatly expanded in the 1975 amendments to the Exchange Act to include, among other things, modification and review of the SROs' arbitration rules. See McMahon, 482 U.S.at 233-34. In addition, in Ware the Court focused on the tenuous relation between the resolution of employer-employee disputes to the investor protection goals of the Exchange Act. Here, the need for Commission oversight of the SROs' systems for arbitration of investor claims against broker-dealers is, as the McMahon Court observed, directly connected to investor protection under the Exchange Act.

8/ Not all disclosure is necessarily a benefit. As the Supreme Court observed in adopting a materiality standard for corporate disclosure under antifraud provisions of the federal securities laws, "[s]ome information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." If the standard for disclosure is set too low, the adverse consequences of non-disclosure may lead corporations "simply to bury the shareholders in an avalanche of trivial information -- a result that is hardly conducive to informed decisionmaking." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976).

for disqualification and vacature of arbitral decisions may increase the complexity, cost, and uncertainty of the arbitration process. If so, this would serve the interests of well-financed brokerage firms, while the average investor would suffer from protracted and costly proceedings. The Commission must have an opportunity to consider these factors and make its own determination where to strike the appropriate balance.

In Buckman Co. v. Plaintiff's Legal Committee, 531 U.S. 341 (2001), the Supreme Court held that a state law tort claim that alleged that but for a fraudulently submitted application to the FDA, plaintiffs' injuries would not have occurred, was preempted by the Food, Drug and Cosmetic Act. Among the grounds for finding a conflict giving rise to preemption were that the federal statutory scheme "amply empowers the FDA to punish and deter fraud against the Administration, and that this authority is used by the Administration to achieve a somewhat delicate balance of statutory objectives," a balance that would have been disrupted by the state law action. Id. at 348. 9/ Here, too, unilateral imposition of the state's regulations would impair the balance that the Commission has struck in approving existing disclosure and disqualification rules, as well as its obligation to consider and strike a balance in any revision of those rules.

The Ninth Circuit has reached much the same conclusion, albeit under the rubric of immunity rather than preemption. In Sparta Surgical Corp., 159 F.3d at 1215, the court

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9/ See also Geier v. American Honda Motor Co., 529 U.S. 861 (2000). The Court held that a state tort law action was preempted by the National Traffic and Motor Vehicle Safety Act and a Federal Motor Vehicle Standard adopted under that Act. The suit alleged that the car in which plaintiff was injured was defective because it lacked a driver's side airbag. The federal provisions did not require or prohibit airbags, but they did set up a regime that seek to create a gradually developing mix of alternative passive restraint devices. A rule of tort law that held that any car that did not have airbags was defective would have stood as an obstacle to the accomplishment of that objective.

held that an issuer could not pursue a variety of state law claims against the NASD for temporarily delisting and suspending trading in its stock. 10/ The court of appeals stated (id.): "A rule permitting recovery under such a theory would allow states to define by common law the regulatory duties of a self-regulatory organization, a result which cannot co-exist with the Congressional scheme of delegated regulatory authority under the Exchange Act."

The defendants argue, however, that there is nothing inconsistent between the California standards and existing SRO standards – both aim at providing a fair arbitration process for investors. But the mere fact that the California standards seek to promote the same general objective as the SRO standards does not render them valid. In Crosby, 530 U.S. 363, the Court held preempted a state law that imposed restrictions on the authority of state agencies to purchase goods and services from companies doing business with Burma because of human rights violations by the government of that country. The Court relied on the fact that Congress had passed a statute authorizing the President to impose certain sanctions on that country, and to waive those sanctions under certain circumstances. The state law was therefore in conflict with the federal provision even though both had the same objectives, in that the means chosen by the state to achieve those objectives were different:

> [T]he fact that some companies may be able to comply with both sets of sanctions does not mean that the state Act is not at odds with achievement of the federal decision about the right degree of pressure to employ.* * * "'Conflict is imminent'" when "'two separate remedies are brought to bear

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10/ The plaintiff alleged breach of express and implied contract, breach of the covenant of good faith and fair dealing, gross negligence, intentional misrepresentation, negligent misrepresentation, and interference with economic relations.

> on the same activity,'" Wisconsin Dept. of Industry v. Gould Inc., 475 U.S. 282, 286, 89 L. Ed. 2d 223, 106 S. Ct. 1057 (1986) (quoting Garner v. Teamsters, 346 U.S. 485, 498-499, 98 L. Ed. 228, 74 S. Ct. 161 (1953)). Sanctions are drawn not only to bar what they prohibit but to allow what they permit, and the inconsistency of sanctions here undermines the congressional calibration of force.

530 U.S. at 380. Here, likewise, the Commission has made a decision about the appropriate balance within the NASD and NYSE disclosure and disqualification rules. Any changes in that decision should, under the Congressional scheme, be made by the Commission, after careful consideration of all relevant factors, and not by the states.

The states are not in a position to strike the appropriate balance. California adopted its arbitration rules under its general civil procedure code. It did not purport to tailor the rules to the specialized environment of arbitration between broker-dealers and investors. In particular, it did not take into account that the SROs serve a variety of important regulatory functions in the securities markets. Under the federal scheme, regulation of the securities markets places great reliance on the ability of the SROs to monitor and discipline the markets and broker-dealers. While the arbitration programs are important components of investor protection, they are only one component, and the optimum structure and procedures used in those programs must be evaluated in the context of the other functions served by the SROs. Unnecessary costs imposed in the arbitration process may adversely affect the ability of the SROs to carry out other functions. These are serious concerns that the Commission must evaluate in carrying out its rule changing authority under the Exchange Act.

The SROs are, moreover, national organizations, and rules that provide for investor protection without imposing unnecessary costs can only be imposed on a nationwide basis. They cannot be the subject of patchwork regulation by the states. If California can independently impose its disclosure and disqualification standards on the SROs, so can the other states. Yet no state is in a position to know, much less control, what each other state might do in this area. The SROs would be subjected to a system of disclosure and disqualification that was imposed on a piecemeal state by state basis, by jurisdictions that are not in a position to assess, nor given the responsibility to assess, the nationwide effect of regulation on the SROs. Only a single regulator, the Commission, can carry out that task.

B. The California Standards Conflict with the SRO Rules.

In addition to conflicting with the federal scheme for Commission oversight and regulation of the SROs, the California standards for disqualification conflict with the SRO rules in that they require arbitrator disqualification in circumstances where the SRO rules do not permit it. While the SRO rules provide that an arbitrator may, prior to the hearing, be disqualified by the Director of Arbitration based upon the information disclosed under SRO rules, and the NASD allows removal based on previously unknown disqualifying information after the hearing begins, the California statute mandates that an arbitrator "shall be disqualified," upon notice from either party, for failure to comply with the California disclosure requirements. CCCP § 1281.91(a).

The SRO rules require disclosure of information that might raise a question of the arbitrator's partiality. Thus, NASD Rule 10312(a)(2) requires disclosure of "[a]ny existing or past financial, business, professional, family, social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias." NYSE Rule 610(a)(2) contains a similar requirement.

California's standards, however, require disclosure of such relationships regardless whether they might create any appearance of bias or partiality. Thus, if an arbitrator has within a specified number of years sat on an arbitration involving a brokerage firm that is a party to the proceeding, or involving a lawyer in the current proceeding, that fact must be disclosed. If the arbitrator served as a dispute resolution neutral (other than an arbitrator) in a case involving a lawyer associated with a lawyer in the present case, that must be disclosed. The arbitrator must also disclose if any officer or director of a party was, within the past two years, the client of any lawyer with whom the arbitrator is or was associated. These and other disclosures must be made regardless whether they would disclose any bias or partiality.

Whatever the merits of these disclosures, these are not matters that must be disclosed under the SRO rules unless they might reasonably create an appearance of bias or partiality. Nor would this information, if undisclosed and not required to be disclosed, be a basis for disqualification of the arbitrator. Under the California standards, in contrast, failure to disclose any of these matters is ground for automatic disqualification, upon the timely request of a party.

This conflict cannot be resolved by the SROs simply by interpreting their existing rules more broadly to accommodate the California standards. All interpretations of rules that are not reasonably and fairly implied in the rule are classified as proposed rule changes and subject to Commission review. See Exchange Act Rule 19b-4(c), 17 C.F.R. 240.19b-4(c).

The other suggestion raised by the defendants, that the SROs should be required to amend their rules whenever a state promulgates requirements like the California standards, and presumably the Commission should be forced to approve them, is fundamentally inconsistent with the mechanism of SRO regulation established by

Congress. It would allow a court to compel the Commission to undertake a regulatory action that Congress has placed within the Commission's discretion.

IV. The California Standards, as Applied to SRO Arbitrations, Conflict With and Thus are Preempted by the Federal Arbitration Act.

As applied to SRO arbitrations, the California standards are preempted by the Federal Arbitration Act (FAA), 9 U.S.C. 1-16. Under section 2 of the FAA, 9 U.S.C. 2, arbitration agreements involving interstate commerce "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." The FAA "requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms." Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989). Although the FAA allows a state to apply to arbitration agreements law "concerning the validity, revocability, and enforceability of contracts generally" – that is, matters which apply under state law to all contracts – a state law principle that "takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with [the FAA]." Perry v. Thomas, 482 U.S. 483, 492 n.9 (1987). "Thus, generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening [the FAA]. Courts may not, however, invalidate arbitration agreements under state laws applicable *only* to arbitration provisions." Doctor's Associates, Inc. v. Casarotto, 517 U.S. 681, 687 (1996)(citations omitted). The Court there held that "[t]he 'goals and policies' of the FAA, this Court's precedent indicates, are antithetical to threshold limitations placed specifically and solely on arbitration provisions." Id. at 688.

The parties to an SRO arbitration are required to sign a "Submission Agreement" agreeing to submit their dispute to arbitration in accordance with the SRO's rules. Accordingly, the parties to an SRO arbitration enter into a contract to conduct their arbitration in accordance with the SRO's rules, including the rules governing arbitrator disclosure and disqualification.

In the case of an SRO arbitration, then, the California standards are preempted by section 2 of the FAA because the California standards would supplant the parties' agreement to conduct the proceeding in accordance with SRO rules. Instead of the disclosure requirements contained in the SRO rules, the California standards would impose their own disclosure requirements. And it would make non-compliance with those requirements grounds for invalidating an arbitration award. Indeed, CCCP § 1286.2(a)(6) provides that a court "shall vacate the award if the court determines," inter alia, that the arbitrator failed to disclose a ground for disqualification of which the arbitrator was then aware. The standards would also displace the method for disqualifying arbitrators contained in the SRO rules (and incorporated into the parties' agreement), with a method dictated by California, a method which includes mandatory disqualification for failure to make the required disclosures. The California standards also conflict with section 5 of the FAA, 9 U.S.C. 5, which provides that if an arbitration agreement provides a method for appointing an arbitrator, "such method shall be followed." 11/

11/ All of this only holds true if the parties elect to arbitrate under SRO rules. The parties must, in a pre-dispute arbitration agreement, provide for SRO arbitration as one option. They can choose, however, to provide as an alternative (at the investors' option) to arbitrate outside an SRO forum and have the agreement governed by a different set of arbitration rules, including the arbitration law of a particular state. Volt, 489 U.S. at 476 ("There is no federal policy favoring
(continued...)

Courts have readily applied the FAA to preempt state laws that impose requirements that are specific to arbitration agreements. In Doctor's Associates, the Supreme Court struck down a Montana law that required contracts containing an arbitration clause to have a notice to that effect typed in underlined capital letters on the first page of the contract. The Montana Supreme Court, which had considered the challenge to the law, viewed Volt as requiring only that state law not undermine the goals and policies of the FAA. In its judgment the notice requirement did not undermine those goals and policies because it did not preclude arbitration agreements, but simply required that such agreements be entered into knowingly. The United States Supreme Court disagreed, holding: "Montana's [notice requirement] directly conflicts with § 2 of the FAA because the State's law conditions the enforceability of arbitration agreements on compliance with a special notice requirement not applicable to contracts generally. The FAA thus displaces the Montana statute with respect to arbitration agreements covered by the Act." 517 U.S. at 687. Of particular interest in this case, the Court cited with approval (id.) a statement in the leading authority on the FAA that under Supreme Court precedent "state legislation requiring greater information or choice in the making of agreements to arbitrate than in other contracts is preempted." See 2 I. Macneil, R. Speidel, T. Stipanowich & G. Shell, Federal Arbitration Law § 19.1.1, pp. 19:4-19:5 (1995).

These principles have been applied to invalidate state laws that purport to provide greater protections to securities customers in arbitration than do SRO rules. In Securities

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11/(...continued)
arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.")

Industry Assoc. v. Connolly, 883 F.2d 1114 (1st Cir. 1989), the court invalidated under the FAA a Massachusetts law prohibiting broker-dealers from requiring pre-dispute arbitration agreements as a condition to an account relationship, requiring arbitration conditions to be brought conspicuously to customer's attention, and requiring written disclosure of the legal effect of an arbitration clause. 12/

The California disclosure requirements and standards for arbitrator disqualification apply, by definition, only to agreements to arbitrate, not to contracts generally. Unless the parties specifically agree to be bound by these California requirements (which they will not have done in an SRO arbitration), the California law imposes conditions on the parties' ability to arbitrate which go beyond those to which they agreed. Thus, this Court should hold that the California standards are preempted by the FAA in the case of agreements, such as the SRO arbitration agreements, to which the FAA applies.

The defendants nonetheless argue that the California requirements do not conflict with the SRO rules, but are complementary to them. Further, they argue, the California requirements share the goal of the FAA of fair and impartial arbitration. They point out that arbitrators are required under federal law to make disclosures of any conflicts, Commonwealth Coatings Corp. v. Continental Casualty Co., 393 U.S. 145 (1968), and that under the FAA a court can vacate an award where there was "evident" partiality in the arbitrators. See 9 U.S.C. 10(a)(2). This argument ignores the fact that the California

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12/ See Webb v. R. Rowland & Co., 800 F.2d 803 (8th Cir. 1986)(invalidating Missouri law requiring that contracts highlight the existence of arbitration clauses in 10-point capital letters); Collins Radio Co. v. Ex-Cell-O Corp., 467 F.2d 995 (8th Cir. 1972)(invalidating Texas law requiring arbitration agreement to bear attorney's signature attesting that all parties had been informed of agreement's effects).

requirements do not attach to contracts generally, but only to agreements to arbitrate.

The argument also vastly understates the difference between the California standards and FAA requirements. While arbitrators may be under a general obligation to disclose matters that might reasonably create an appearance of bias or partiality (and indeed the SRO rules themselves impose such an obligation), the California standards spell out in detail precisely what must be disclosed, and require disclosure of substantial information even when it does not disclose and such bias or partiality. Moreover, they make failure to disclose per se grounds for disqualification, while the SRO rules leave the matter of disqualification to the discretion of the SRO's Directors of Arbitration (and ultimately for the courts, under review pursuant to the FAA). Likewise, while the FAA provides for a court to vacate an award in the event of "evident" partiality, that determination is for the court to make based on the facts of the case before it. Under California's standards the determination can be based on the failure of the arbitrator to provide state-mandated disclosures, regardless whether the undisclosed information shows evident partiality.

While the California rules may be directed at the same objectives as the SRO rules, they seek to accomplish those objectives through different means. The defendants' arguments are quite similar to those made in support of the Massachusetts law, and rejected by the court of appeals, in Securities Industry Assoc. v. Connolly, 883 F.2d 1114 (1st Cir. 1989). The court held (id. at 1120):

> Appellants conceded before the district court, and on appeal, that the Regulations apply only to arbitration agreements. They suggest, however, that this bespeaks no unfriendliness: the Commonwealth treats arbitration agreements like other contracts between businesses and consumers, that is, it regulates them as extensively as necessary for the public weal. In our view, that self-congratulatory casuistry will not wash.

> Indeed, we think it evident that it was precisely this sort of categorization error which Congress sought to cure when it enacted the FAA.

The court went on to hold (id. at 1124):

> The Commonwealth may well be correct that [pre-dispute arbitration agreements] ought to be arrived at with greater negotiation and disclosure between broker-dealers and customers than currently takes place. That judgment, however, is not the Commonwealth's to make, at least in its current embodiment, for it singles out arbitration in an impermissible way. The states are forbidden from critical scrutiny expressed in a fashion which might mask historic hostility toward arbitration. Congress sought to avoid having that possibility come to fruition, choosing instead to emphasize and endorse arbitral efficiencies. That value judgment was within congressional domain – and only Congress, not the states, may create exceptions to it.

The California standards, by selectively imposing on NASD and NYSE arbitrations disclosure and disqualification requirements that go beyond those to which the parties have agreed, are preempted under the FAA.

CONCLUSION

For the foregoing reasons, the Commission urges the Court to hold that the California standards, as applied to SRO arbitrations, are preempted by federal law.

Respectfully submitted,

____
GIOVANNI P. PREZIOSO
General Counsel

____
JACOB H. STILLMAN
Solicitor

____
ERIC SUMMERGRAD
Deputy Solicitor

____
MARK R. PENNINGTON
Assistant General Counsel

____
JOHN W. AVERY
Special Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0606
(202) 942-0816 (Avery)

Of Counsel
MEYER EISENBERG
Deputy General Counsel

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