options contracts which are eligible for entry into the CBOE's Retail Automatic Execution System (''RAES'') to 50 contracts, in order to match the size limits of orders which will be eligible for entry into the automatic execution system of the Philadelphia Stock Exchange (''Phlx'').

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

CBOE Rule 6.8(e) limits the size of RAES orders to twenty or fewer contracts.[4] As of August 20, 1999, options on Dell Computers (DLQ) are listed only on the Phlx, options on International Business Machines Corp. (IBM), Johnson & Johnson (JNJ), and Coca Cola (KO) are listed only on the CBOE, and Ford Motor Corporation (F) is dually listed on both the CBOE and the Phlx. However, in conformity with procedures of The Options Clearing Corporation (''OCC'') established under the Joint Exchange Options Plan (''Plan''), the Phlx recently sent notification to the OCC, the Commission, and the other options exchanges that it is seeking to multiply list options on IBM, JNJ, and KO. The CBOE has done likewise with respect to DLQ. As a result, on Monday, August 23, 1999, pursuant to OCC procedures, the Phlx plans to commence trading options on IBM, JNJ, and KO, and the CBOE plans to commence trading options on DLQ.

On August 19, 1999, the Phlx announced, pursuant to Rule 1080(c), that its order size limit for automatic execution for DLQ, IBM, JNJ, and KO will be 50 contracts. The current size limit for automatic execution of orders in F is already 50 contracts.

Therefore, pursuant to CBOE Rule 6.8 and Interpretation and Policy .01, the CBOE proposes to increase the RAES order size limit in F, IBM, JNJ, and KO to 50 contracts, and to set the initial order size limit for DLQ at 50 contracts, in order to match the size limits for orders in these option classes which are eligible for automatic execution on the Phlx.

The Exchange represents that RAES has the capacity to accommodate a RAES order limit size of 50 contracts in DLQ, IBM, JNJ, and KO, both in terms of systems capacity as well as the market-making capacity of market-makers participating in RAES.[5]

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act, in general, and furthers the objectives of Sections 6(b)(5) and 6(b)(8) of the Act in particular, in that it is designed to remove unnecessary burdens on competition, as well as remove impediments to and perfect the mechanism of a free and open market and a national market system, for the benefit of investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The CBOE does not believe that the proposed rule change will impose any burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing rule change constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the Exchange, it has become effective pursuant to section 19(b)(3)(A)(i) of the Act and subparagraph (f)(1) of Rule 19b–4 thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR–CBOE–99–47 and should be submitted by October 1, 1999.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[6]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 99–23612 Filed 9–9–99; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–41833; File No. SR–NASD–99–07]

Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the National Association of Securities Dealers, Inc. Creating a Discovery Guide for Use in NASD Arbitrations

September 2, 1999.

I. Introduction

On January 29, 1999, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), through its wholly owned subsidiary NASD Regulation, Inc. (''NASD Regulation''), filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder.[2] Under its

[4] Subsequently, the Commission has approved a proposed rule filing by the CBOE to increase the size limit of all RAES orders to 50 contracts. *See* Securities Exchange Act Release No. 41821 (September 1, 1999) (SR–CBOE–99–17).

[5] *See* Amendment No. 1.

[6] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

proposal, NASD Regulation seeks to create a discovery guide for use in NASD arbitrations. Notice of the proposal, as amended by Amendment No. 1 and Amendment No. 2, was published in the **Federal Register** on April 23, 1999 (''Notice'').[3] The Commission received eight comment letters on the filing.[4]

II. Description of the Proposal

NASD Regulation proposes to create a Discovery Guide to streamline the discovery process in NASD arbitrations involving customers. The Discovery Guide, which contains Document Production Lists, provides parties to an arbitration proceeding guidance on which documents they should exchange without arbitrator or NASD Regulation staff intervention. Further, the Discovery Guide provides arbitrators with guidance in determining which documents should be produced by customers and member firms or associated persons in customer arbitrations.

The Discovery Guide, which includes the Document Production Lists, is intended to function as a guide for parties and arbitrators in the discovery process. It is not intended to bind arbitrators or parties in a particular case. Further, nothing in the Discovery Guide precludes parties from voluntarily agreeing to an exchange of documents in a manner or scope different from that set forth in the Discovery Guide or Document Production Lists. In addition, any party can make a motion objecting to the production of particular documents included on the applicable Document Production List(s) in any arbitration proceeding. Likewise, any party can request that additional documents, not included on any of the Document Production Lists, be produced. However, if an arbitrator directs compliance with the Discovery Guide in connection with ordering the production of documents, the order, like any other document production order, is binding on the parties.

Background

The Discovery Guide is a consensus document that was developed over a two-year period. In January 1996, the Arbitration Policy Task Force (''Task Force'') chaired by former Commission Chairman David Ruder recommended that ''[a]utomatic production of essential documents should be required for all parties, and arbitrators should play a much greater role in directing discovery and resolving discovery disputes.'' [5] Based on Task Force recommendations, the NASD's National Arbitration and Mediation Committee, together with advisors from various diverse backgrounds, helped to draft the Discovery Guide in an effort to implement these recommendations. Among those contributing to the Discovery Guide were persons who are members of the Securities Industries Conference on Arbitration (''SICA'') [6], members of SIA, directors of PIABA, industry representatives, representatives from major broker-dealers, counsel for claimants, and counsel for the industry. The Discovery Guide reflects a compromise between the various interests of the drafters.

Discovery Guide Features

NASD Regulation proposes that the Discovery Guide be used as a supplement or an addendum to the guidance regarding discovery set forth in *The Arbitrator's Manual,* published by SICA, and particularly the provisions in the section entitled, ''Prehearing Conference,'' at pages 11–16. SICA members compiled *The Arbitrator's Manual* as a guide for arbitrators, and it is designed to supplement and explain the Uniform Code of Arbitration as developed by SICA. The procedures and policies set out in both *The Arbitrator's Manual* and the Discovery Guide are discretionary and may be changed by the arbitrator(s) so long as they are consistent with the rules of the forum. Further, nothing in the Discovery Guide, including the Document Production Lists, precludes the parties from voluntarily agreeing to an exchange of documents in a manner different from that set forth in the Discovery Guide.

The Discovery Guide consists of introductory and instructional text, and fourteen Document Production Lists. The first two lists, one for firms or associated persons and one for customers, contain documents that are presumptively discoverable in all customer cases, unless the arbitrator(s), in the exercise of discretion, determines that some or all of the documents in the two lists should not be produced. The next twelve lists, which are dispute specific, contain additional documents that should be produced by both customers and firms or associated persons for respectively, claims of churning, failure to supervise, misrepresentation/omissions, negligence/breach of fiduciary duty, unauthorized trading, and unsuitability. For example, a party involved in a churning claim should produce documents from either List One or Two, which apply to all customer cases, and documents from List Three or Four, which apply to churning claims.

NASD Regulation's Office of Dispute Resolution (''ODR'') will provide the parties with the Discovery Guide at the time ODR serves the statement of claim. If a particular Document Production List is applicable, the parties should consider those documents to be presumptively discoverage. Unless the party files a timely objection, those documents should be produced not later than 30 calendar days from the date the answer is due or filed, whichever is earlier. Objections to production of any document on a Document Production List, and any responses thereto, are to be considered by the arbitrator(s). The arbitrator(s) then determine whether the objecting party has overcome the presumption of discoverability based upon sufficient reason(s).

In addition to specific document production requirements, the Discovery Guide provides general guidance on other issues such as confidential treatment of documents, additional discovery requests, depositions, admissibility of evidence, arbitrator participation, and sanctions. This guidance is discussed below.

Confidential Treatment. The Discovery Guide provides that parties may stipulate to the confidential treatment of documents. Alternatively, the arbitrator(s) may issue confidentiality orders. However, the Discovery Guide further advises that arbitrator(s) should not issue orders or use confidentiality agreements to require parties to produce documents

[3] *See* Securities Exchange Act Release No. 41302 (April 16, 1999), 64 FR 20036 (File No. SR–NASD–99–07).

[4] *See* letters from Cliff Palefsky, National Employment Lawyers Association (''NELA''), to Secretary, Commission, dated May 4, 1999 (''NELA Letter''); Barbara Black, Professor of Law, to Secretary, Commission, dated May 13, 1999 (''Black Letter''); Mark E. Maddox, Public Investors Arbitration Bar Association (''PIABA''), to Jonathan G. Katz, Secretary, Commission, dated May 18, 1999 (''PIABA Letter''); Linda P. Drucker, Charles Schwab & Co. Inc. (''Schwab''), to Jonathan G. Katz, Secretary, Commission, dated May 14, 1999 (''Schwab Letter''); Stephen G. Sneeringer, Securities Industry Association (''SIA''), to Jonathan G. Katz, Secretary, Commission, dated May 14, 1999 (''SIA Letter''); Paul L. Matecki, Raymond James & Associates, Inc. (''Raymond James''), to Jonathan G. Katz, Secretary, Commission, dated May 14, 1999 (''Raymond James Letter''); Norman S. Poser, Professor of Law, to Secretary, Commission, dated May 13, 1999 (''Poser Letter''); Dan Jamieson, to Jonathan G. Katz, Secretary, Commission, dated June 1, 1999 (''Jamieson Letter'').

[5] *See Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors of NASD (''Task Force Report'')* at 2.

[6] SICA was formed to develop and maintain a Uniform Code of Arbitration and to provide a forum for the discussion of new developments in securities arbitration among arbitration self-regulatory organization (''SRO'') forums and participants in those forums. The membership includes representatives from the SROs with securities arbitration forums, three or four ''public'' members, and a representative from the SIA.

otherwise protected by established privileges. As discussed more fully below, a party objecting to discovery on grounds of privilege has the burden to demonstrate that a particular document is privileged.

Additional Discovery Requests. The Discovery Guide states that parties may request documents in addition to those identified in the Document Production Lists, and it provides guidance regarding the timing of such requests. Unless a longer period is allowed by the requesting party, requests should be satisfied or objected to within 30 days from the date of service of the document request. Any response to objections to a request should be served on all parties within 10 days or service of the objection.

The Discovery Guide also provides a mechanism for a party to seek to compel production of documents when the adverse party refuses to produce such documents or offers only to produce alternative documents that are unacceptable to the requesting party. The Discovery Guide instructs that the arbitrator(s) carefully consider such motions, regardless of whether the item requested is on any of the Document Production Lists.

Depositions. The Discovery Guide discusses the arbitrator(s)' authority to permit depositions. It suggests depositions be limited to circumstances such as: (a) To preserve the testimony of ill or dying witnesses; (b) to accommodate essential witnesses who are unable or unwilling to travel long distances for a hearing and may not otherwise be required to participate in the hearing; (c) to expedite large or complex cases; and (d) to address unusual situations where the arbitrator(s) determines that circumstances warrant departure from the general guidance.

Admissibility. Production of documents listed in the Discovery Guide does not create a presumption that the documents are admissible at the arbitration hearing. Nothing in the Discovery Guide prevents a party from objecting to the introduction of any document as evidence at the hearing to the same extent that any other objection may be raised in arbitration.

Arbitrator Participation. Under the Discovery Guide, the NASD arbitrator(s) will participate in the initial and subsequent prehearing conferences to organize the management of the case, set a discovery cut-off date, identify dispositive or other potential motions, schedule hearing dates, determine whether mediation is desirable, and resolve any other preliminary issues. If, at the time of the initial prehearing conference, the exchange of properly requested discovery has not occurred, the Discovery Guide provides that the arbitrator(s) should order the production of all required documents subject to production

Sanctions. The Discovery Guide instructs arbitration panels to issue sanctions if any party fails to produce documents or information required by a written order, unless the panel [7] finds that there is ''substantial justification'' for the failure to produce the documents or information. The Discovery Guide recognizes that panels have wide discretion to address non-compliance with discovery orders. For example, the panel may make an adverse inference against a party or assess adjournment fees, forum fees, costs and expenses, and/or attorneys' fees caused by noncompliance. In extraordinary cases, the Discovery Guide suggests the panel may initiate a disciplinary referral against a registered entity or person who is a party or witness in the proceeding or may, pursuant to Rule 10305(b), dismiss a claim, defense, or proceeding with prejudice as a sanction for intentional failure to comply with an order of the arbitrator(s) if lesser sanctions have proven ineffective.

III. Summary of Comments

The Commission received eight comment letters on the proposal.[8] One commenter urged the adoption of the Discovery Guide as proposed.[9] Further, none of the commenters opposed the concept of creating a Discovery Guide for use in customer arbitration.[10] However, most of the commenters had particular criticisms about certain aspects of the Discovery Guide. Additionally, seven of the eight commenters made suggestions on how to improve the Discovery Guide.[11] With respect to several specific criticisms, the comments were evenly distributed on both sides of the issue.

Discovery Guide as a Proposed Rule Change

Three commenters assert that the Discovery Guide should not be filed with the Commission as a proposed rule change.[12] They content that arbitration relies on the flexibility of arbitrators, and adopting the Discovery Guide as a rule would limit arbitrator(s)' discretion. In addition, they argue that because the Discovery Guide will be part of *The Arbitrator's Manual,* which is not a rule, and will only be a ''guide,'' it should not be submitted as a rule under the rule filing process. Finally, the commenters maintain that adopting the Discovery Guide as a rule will give it more importance than what was intended by its drafters. In contrast, another commenter contends that, because the Discovery Guide contains guidelines and not mandates, whether it is issued as a rule is immaterial.[13] Further, that commenter commends the Commission for allowing the public to comment on the guidelines through the formal rulemaking process.

Customer Personal Financial Information

Three commenters contend that producing certain documents reflecting personal financial information infringes on customers' privacy rights.[14] In particular, these commenters argue that the production of tax returns and other financial information, such as business ownership records, should be limited to certain types of claims, not be required at all, or the firm should have the burden of establishing the relevance of these documents in specific cases. One of these commenters asserts that a customer's right to privacy can only be waived by the customer, and not by the committees who created the Discovery Guide or by the securities industry as a condition of the industry complying with its legal obligation to provide relevant information in an arbitration.[15] The commenter argues that decisions affecting important rights of individual customers (*i.e.*, forced disclosure of personal and private information) should be made on a case-by-case basis, and the information should not be subject to routine disclosure. In addition, another commenter states that the production of statements concerning a customer's net worth is unfair because most customers would have to create these statements.[16]

On the other hand, three industry commenters argue that customer tax returns and other financial information are crucial in all types of customer/

[7] An arbitration panel's ruling need only be by majority vote; it need not be unanimous.

[8] *See supra* note 4.

[9] *See* PIABA Letter.

[10] Out of the eight commenters, seven stated that they were in favor of the concept of a Discovery Guide. *See* PIABA Letter, Black Letter, Schwab Letter, SIA Letter, Raymond James Letter, Poser Letter, and Jamieson Letter. The eighth, from NELA, stated that while the desire to facilitate discovery is appropriate, NELA believed that the proposed Discovery Guide is problematic in certain material aspects. *See* NELA Letter.

[11] *See* NELA Letter, Black Letter, Schwab Letter, SIA Letter, Raymond James Letter, Poser Letter, and Jamieson Letter.

[12] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[13] *See* Jamieson Letter.

[14] *See* NELA Letter, Black Letter, and Poser Letter.

[15] *See* NELA Letter.

[16] *See* Jamieson Letter.

broker disputes.[17] According to one of these commenters, tax returns and information about net worth are often the only pertinent documentation that a customer has.[18] Further, they assert that a customer's entire tax return (not only the portions listed in the Discovery Guide) and the customer items in List 8, such as a resumé, should be produced in every case. These commenters believe that this information is relevant in every dispute.

Production Burden on Firms

The three industry commenters argue that the use of documents dealing with an associated person's disciplinary history violates a basic premise of the *Federal Rules of Evidence*.[19] They maintain that evidence of prior bad acts, such as records of disciplinary history or information reported on Forms U–4 and U–5, should not be used in arbitration to demonstrate an alleged bad act. In response to these comments, another commenter states that production of these records is not prejudicial since an associated person's disciplinary history is already publicly available through the NASD's Public Disclosure Program.[20]

Additionally, one industry commenter argues that the production of disciplinary history documents would be particularly burdensome for discount and on-line brokers.[21] The commenter contends that because a customer of a discount broker deals with many associated persons, a firm's production burden would be tremendous for many types of disputes. In response to this problem, the commenter suggests limiting the production of documents to those concerning an associated person who is regularly and permanently assigned to the account, if any. On the other hand, another commenter notes that the materials to be produced by firms under the Discovery Guide are kept in the normal course of a firm's business pursuant to industry recordkeeping requirements.[22]

The three industry commenters also argue that firms should not have to produce internal audit reports in failure to supervise claims.[23] They maintain that since failure to supervise can be alleged in almost all claims, internal audit reports will have to be produced in every case. Moreover, these commenters assert that production might affect the vitality and candor of internal audit reports, and thus harm the ''self-policing'' obligation of firms.[24] Another commenter, however, argues that any increased exposure of internal audit reports will help ensure that the reports' recommendations are followed internally, and that self-policing will thereby by improved.[25] Furthermore, one commenter agrees with the Discovery Guide that internal audit reports are likely to be relevant in a failure to supervise case, regardless of whether they focus on a particular associated person.[26]

Miscellaneous

Most of the commenters make suggestions on how to improve the Discovery Guide and, in particular, the Document Production Lists. For example, one commenter suggests that the first two lists, which apply to all customer cases, be ''pruned'' to avoid placing an unreasonable burden on the parties.[27] In addition, another commenter suggests that confidentiality orders or stipulations be used sparingly because investors already have little information about the arbitration process.[28] Another commenter expressed concern that the Discovery Guide's recognition of ''privacy'' and ''confidentiality'' as valid objections to document production may encourage parties to make objections to delay the discovery process.[29]

Several commenters addressed privilege issues. Four commenters contend that the Discovery Guide should not contain a list of privileges because privileges are traditionally governed by state law.[30] Similarly, three of these commenters state that because most privileges would only be available to customers, a list of applicable privileges should not be included in the Discovery Guide.[31] In addition, one commenter recommends that the Discovery Guide contain a requirement that parties produce a privilege log to identify documents not produced as a result of the assertion of a privilege.[32] The commenter believes this will help protect parties from the improper assertion of a privilege.

In addition, one commenter argues that arbitrators should be given more power to sanction parties for non-production of documents.[33] The commenter states that with the current proposal, an arbitrator first needs an order for production before the arbitrator can issue sanctions. The commenter believes that the Discovery Guide should be amended so that if a party fails to produce a listed document, the party should be sanctioned unless the party can provide a substantial justification for not producing the document. Similarly, another commenter contends that the documents on the lists should not be presumptively discoverable, but automatically produced.[34] The commenter believes this will help streamline the arbitration process.

IV. Discussion

One commenter states that the Commission should give deference to this proposal because it was reached through compromise by organizations who represent opposing interests.[35] The Discovery Guide reflects a compromise between the various interests of the drafters. The Discovery Guide was drafted over a two-year period with the input of organizations who represent different interests within the securities industry. Among those contributing to the Discovery Guide were persons who are members of SICA, members of SIA, directors of PIABA, industry representatives, representatives from major broker-dealers, counsel for claimants, and counsel for the industry. Similarly, the comment letters received by the Commission reflect the views of a cross section of the securities industry, plaintiff representatives, academicians, and others involved in the arbitration process. The Discovery Guide, when considered as a whole, provides useful guidance to arbitrators, claimants, and industry participants in customer arbitrations and fairly balances their respective interests.

As noted above, several commenters assert that the Discovery Guide should not be filed with the Commission as a proposed rule change because arbitration relies on the flexibility of arbitrators, and adopting the Discovery Guide as a rule would limit arbitrators'

[17] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[18] *See* Schwab Letter.

[19] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[20] *See* Jamieson Letter.

[21] *See* Schwab Letter.

[22] *See* Jamieson Letter.

[23] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[24] Notwithstanding these comments, the Commission reminds all regulated entities and persons that nothing in the Discovery Guide or Document Production Lists changes or reduces their obligations to monitor compliance with the federal securities laws or rules of self-regulatory organizations.

[25] *See* Jamieson Letter.

[26] *See* Poser Letter.

[27] *See* Poser Letter.

[28] *See* Jamieson Letter.

[29] *See* Black Letter.

[30] *See* Schwab Letter, SIA Letter, Raymond James Letter, and Jamieson Letter.

[31] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[32] *See* NELA Letter.

[33] *See* Poser Letter.

[34] *See* Black Letter.

[35] *See* PIABA Letter.

discretion.[36] In addition, one commenter notes the Discovery Guide states that an arbitration panel should issue sanctions if a party fails to produce documents or information required by a written order, not for non-compliance with the Discovery Guide itself.[37] That commenter, therefore, argues that arbitrators should be given more power to sanction parties for non-compliance with the Discovery Guide. Further, another commenter asserts that instead of being presumptively discoverable as they are under the Discovery Guide, the Documents on the document Production Lists should be automatically produced.[38]

By its terms, the Discovery Guide provides for arbitrator(s) to exercise discretion in tailoring the Discovery Guide to particular cases.[39] Arbitrator(s) can change any Provision of the Discovery Guide. Further, nothing in the Discovery Guide shifts the burden of proof a party bears in arbitration, and the mere fact that a document is contained in a Document Production List does not make the document automatically admissible in any arbitration proceeding.

As stated in the Discovery Guide and the Purpose section of NASD Regulation's filing with the Commission, the Discovery Guide (including the Document Production Lists) is intended to function as a guide for arbitrators and parties in the discovery process and is not intended to bind arbitrators or parties in a particular case. While parties should consider the documents on the lists to be presumptively discoverable, the Discovery Guide specifically notes that all of the documents on each list are not required to be produced in every case. Nothing in the Discovery Guide prevents parties from voluntarily agreeing to an exchange of documents in a manner or scope different from that set forth in the Discovery Guide.

Furthermore, parties may also object to the production of any particular document, or seek the production of additional documents not on any of the Document Production Lists. The arbitrator(s) then makes a determination whether production is required. To the extent that an arbitrator uses the Discovery Guide in connection with ordering the production of documents, the order is binding on the parties. The failure to comply with the Discovery Guide itself does not automatically result in sanctions; rather, sanctions are imposed only after a party has failed to comply with an arbitrator's order. Thus, arbitrators retain their discretion under the Discovery Guide to manage arbitrations as they deem appropriate.

Some commenters objected to the burden on customers to produce certain documents in all customer arbitrations. For example, three commenters contend that producing certain documents infringes on customers' privacy rights.[40] Conversely, other commenters object to firms' production burdens under the Discovery Guide.[41] The Discovery Guide reflects a fair compromise between the interests of the drafters and will benefit arbitrators in handling document production. Further, we note that the Document Production Lists were drafted to provide parties with information that is reasonably calculated to lead to the discovery of admissible evidence in arbitrations.[42] Arbitrator(s) should use their discretion to consider whether in a particular case, the documents on the Document Production Lists will lead to the discovery of admissible evidence. Nothing in the Discovery Guide affects a party's ability to object to the production of any particular document or class of documents, or to request additional documents.

Three commenters also assert that firms should not have to produce documents about an associated person's disciplinary history because production would be burdensome and the documents would be inadmissible.[43] As one commenter noted, some disciplinary information about firms and associated persons is already available to the public through the NASD's Public Disclosure Program. Furthermore, as stated in the Discovery Guide, the production of documents in discovery under the Discovery Guide does not create a presumption that the documents are admissible in the arbitration proceeding.

In addition, three commenters argue that firms should not have to produce internal audit reports in failure to supervise claims because production might affect the vitality and candor of these reports. Another commenter, however, takes the opposite view—the commenter believes the production of these reports will result in better self-policing. The Discovery Guide is narrowly focused in that it only calls for the production of internal audit reports, if they exist, in failure to supervise claims. In addition, internal audit reports may help a firm defend a failure to supervise claim. Nothing in the Discovery Guide or the Document Production Lists changes firms' obligations to monitor compliance with the federal securities laws or rules of self-regulatory organizations. To the extent a firm objects to the production of such internal audit reports in any particular claim, nothing in the Discovery Guide precludes a firm from filing an objection with the arbitrator(s). In addition, whether such a report is admissible is a decision for the arbitrator(s).

Many of the commenters made specific suggestions on how to improve the Discovery Guide and, in particular, the Document Production Lists. For example, one commenter suggests that confidentiality orders or stipulations be used sparingly because investors already have little information on the arbitration process.[44] The Discovery Guide does not change current features of the arbitration process. Stipulations are, by definition, made by agreement of the parties and confidentiality orders can only be issued by arbitrator(s) after they fully consider the issue. While a confidentiality order may prevent the public dissemination of particular documents or information, it should not affect the arbitration process. The same commenter also asserts that the production of statements concerning a customer's net worth is unfair because most customers would have to create these statements. Nothing in the Discovery Guide requires customers to create documents that do not otherwise exist. Indeed, the Discovery Guide provides that, if a party has no responsive documents to any document request, the party should provide an affirmation to that effect.

In addition, many of the commenters made specific suggestions to modify one or more aspects of the Document Production Lists. Many of these suggestions may have considerable merit in particular cases. For example, one commenter suggests that the first

[36] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[37] *See* Poser Letter.

[38] *See* Black Letter.

[39] Under Rule 19b–4, a stated policy, practice, or interpretation of the self-regulatory organization shall be deemed to be a proposed rule change unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to meaning, administration, or enforcement of an existing rule of the self-regulatory organization. 17 CFR 240.19b–4(c). Proposed rule changes submitted under Section 19 of the Act and Rule 19b–4 are subject to a notice and comment period. The Discovery Guide falls within Rule 19b–4.

[40] *See* NELA Letter, Black Letter, and Poser Letter.

[41] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[42] *See e.g.*, Fed. R. Civ. P. 26(b)(1).

[43] *See* Schwab Letter, SIA Letter, and Raymond James Letter.

[44] *See* Jamieson Letter.

two Document Production Lists be ''pruned'' to avoid placing an unreasonable burden on the parties. In this regard, if production of a particular document or class of documents called for under an applicable Document Production List is unduly burdensome to a party, that party may object to production on that or any other grounds. The arbitrator(s) retains the ability to modify any request in order to protect against discovery abuses. Furthermore, there is nothing in the Discovery Guide that prevents a party from asking for additional documents such as those suggested by some commenters. We recognize the commenters' intentions to improve the Discovery Guide and the discovery process in general. However, the Discovery Guide reflects a compromise, which was obtained after a long period of negotiation, between various interests of the drafters. For each item that one commenter thought would be burdensome for a customer, another commenter believed a different item would be burdensome to a firm. As adopted, the Discovery Guide will benefit arbitrators and parties in handling document production.

One commenter suggests that parties produce a privilege log to identify documents not produced as a result of the assertion of a privilege. NASD Rule IM–10100 states that ''[i]t may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member of a person associated with a member to * * * fail to appear or to produce any document in his possession or control as directed pursuant to provisions of the NASD Code of Arbitration Procedure * * *'' All parties should act in good faith and carefully consider the relevant case law when asserting a privilege, and arbitrators should consider whether a privilege log is necessary to help facilitate the discovery process.[45] It is expected that the NASD Regulation will take appropriate action against members and registered persons who do not act in good faith or otherwise violate IM–10100.

The Discovery Guide will streamline the discovery process. By creating lists of documents that should be produced in all customer arbitrations as well as particular types of cases, the Discovery Guide will help expedite the discovery process and reduce the number of discovery disputes between parties, which in turn should help lower the cost of the arbitration discovery process. Further, nothing in the Discovery Guide changes the burden of establishing or defending any aspect of a claim. When considered as a whole, the Discovery Guide provides useful guidance to parties and arbitrators in NASD-sponsored customer arbitrations.

In addition, the Commission finds that the proposal is consistent with the requirements of Section 15A of the Act[46] and the rules and regulations thereunder that govern the NASD.[47] In particular, the Commission finds that the proposal is consistent with Section 15A(b)(6) of the Act[48] which requires, among other things, that the rules of an association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[49] that the proposed rule change (SR–NASD–99–07), as amended, is hereby approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[50]

Margaret H. McFarland,

Deputy Secretary.

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[45] The Commission agrees with several commenters that applicable privileges, which are usually a matter of state law, should not be specified in the Discovery Guide.

[46] 15 U.S.C. 78*o*–3.

[47] In addition, pursuant to Section 3(f) of the Act, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[48] 15 U.S.C. 78*o*–3(b)(6).

[49] 15 U.S.C. 78s(b)(2).

[50] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–41820; File No. SR–NASD–99–35]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Definition of ''Person Associated with a Member''

September 1, 1999.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on August 3, 1999, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which items have been prepared by the Association. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD is proposing to amend the definition of ''person associated with a member'' in the By-Laws of the NASD, NASD Regulation, Inc. (''NASD Regulation''), and The Nasdaq Stock Market, Inc. (''Nasdaq''). The text of the proposed rule change is set forth below. Additions are italicized and deletions are bracketed.

* * * * *

BY-LAWS OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

ARTICLE I DEFINITIONS

* * * * *

(ee) ''person associated with a member'' or ''associated person of a member'' means: (1) a natural person *who is* registered *or has applied for registration* under the Rules of the Association; [or] (2) a sole proprietor, partner, officer, director, or branch manager of a member, or [a] *other* natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the NASD under these By-Laws or the Rules of the Association; *or*[3] *(3) for purposes of Rule 8210, any other person listed in Schedule A of Form BD of a member;*

* * * * *

The NASD proposes conforming changes to Article I(y) of the NASD Regulation By-Laws and Article I(r) of the Nasdaq By-Laws, respectively.

* * * * *

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The NASD has approved the substitution of the word ''or'' in place of the word ''and'' in the proposed text here as it appeared in the NASD's original filing, to make clear that item (3) represents an alternative meaning of ''associated person.'' Telephone conversation between Mary Dunbar, Associate General Counsel, NASD Regulation, and Gordon Fuller, Special Counsel, and Ira L. Brandriss, Attorney, Division of Market Regulation, Commission (August 11, 1999).