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Should McMahon Be Revisited?

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INTRODUCTION

Professor Norman S. Poser, in his article *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, explores the opportunities and pitfalls of securities arbitration.[1] Specifically, he points out that the arbitration of disputes between customers and their stockbrokers are distinctly different in several respects from normal commercial arbitrations, in that: (i) these disputes are not among members of an industry, but between a member of the securities industry and an individual investor, who may be unsophisticated and unknowledgeable about investment matters; (ii) the customer usually plays no role in drafting or negotiating the clause of the agreement containing the pre-dispute submission to arbitration and, indeed, may even be unaware that the agreement he or she has signed contains such a clause; (iii) the brokerage firm normally acts as agent for and adviser to the customer, who often relies upon its knowledge and expertise, thus creat-

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* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).

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One of the three Public Members originally appointed to SICA in 1977 was Mortimer Goodman, Esq. He retired from SICA in 1989 after thirteen years of dedicated, inspired and selfless service. Even after retirement he remained keenly interested in the continuing issues facing the public investor. Mortimer Goodman passed away in December 1993, and I would like to dedicate this article in tribute of the memory of this pioneer in the area of securities arbitration.

[1] 59 BROOK. L. REV. 1095 (1993).

ing a fiduciary relationship between the two; and, (iv) brokerage firms and their employees are compensated by a system of commissions whereby they are paid only if the customer buys or sells the investment.[2]

Because most securities disputes are now steered into arbitration as a result of *Shearson/American Express, Inc. v. McMahon*,[3] Professor Poser examines the issue of the fairness of such arbitrations, particularly those held at Securities Regulatory Organizations ("SROs"). After a thorough analysis, he concludes on an optimistic note about the continued future use of arbitration as a means of resolving customer disputes with their brokers.[4]

This Article seeks to justify Professor Poser's optimism by: tracing the history of securities arbitration before *McMahon*; pointing out the impact of the *McMahon* decision; outlining the additional efforts made thereafter to improve the arbitration process; examining current problems and issues; and, concluding that the process works well so long as the public is convinced that should a controversy arise, it will be resolved on a level playing field.

I. THE SIGNIFICANCE OF *MCMAHON*

The arbitration of securities disputes can be traced back to the New York Stock Exchange ("NYSE") in 1872.[5] Since that time, numerous other SROs have established arbitration programs for the settlement of such disputes.[6]

Under the United States Arbitration Act ("Federal Arbitration Act" or "Arbitration Act"),[7] agreements to arbitrate future disputes are, in general, specifically enforceable.[8] Before 1987,

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[2] *Id.* at 1096.

[3] 482 U.S. 220 (1987); *see infra* notes 6-19 and accompanying text.

[4] Poser, *supra* note 1, at 1112.

[5] PHILIP J. HOBLIN, SECURITIES ARBITRATION: PROCEDURES, STRATEGIES, CASES 1-2 (1988).

[6] *Id.*

[7] 9 U.S.C. §§ 1-14 (1988 & Supp. IV 1992).

[8] Section 2 of the Arbitration Act provides: "[a] written provision in . . . a contract evidencing a *transaction involving commerce* to settle by arbitration, a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." *Id.* § 2 (emphasis added). Because the Federal Arbitration

however, there was an exception recognized for customers' claims arising under the Securities Act of 1933[9] ("1933 Act" or "Securities Act"). This exception resulted from the Supreme Court's 1953 decision in *Wilko v. Swan*,[10] in which the Court considered the conflict between the mandate of the Federal Arbitration Act to arbitrate and the provisions in the Securities Act intended to protect the customer's rights. In essence, the *Wilko* Court resolved this conflict in favor of the Securities Act by concluding that Congress' desire to protect investors would be served more effectively by holding unenforceable any pre-dispute arbitration agreements relating to issues arising under the 1933 Act.[11]

Moreover, prior to 1987, most federal courts presumed that the *Wilko* prohibition also extended to the Securities Exchange Act of 1934[12] ("1934 Act" or "Exchange Act"). Thus, despite pre-dispute arbitration agreements, federal courts refused to order arbitration for customers' claims arising under the 1934 Act as well.[13] This extension of the *Wilko* prohibition was especially significant since the public brings most federal securities claims against brokers under the 1934 Act. This occurs because, unlike the 1933 Act, which is concerned with the initial distribution of securities,[14] the 1934 Act deals principally with post-distribution trading.[15]

Act applies to claims arising from transactions involving interstate commerce, *id.*, and because securities dealings usually involve such transactions, state securities claims, as well as those arising under the federal securities laws, are usually arbitrable. *See also NYSE Rules Compel Arbitration of Depository Receipts Disputes*, 4 WORLD ARB. AND MEDIATION REP. 203, 204 (1993).

[9] 15 U.S.C. § 77 (1988 & Supp. IV 1992).

[10] 346 U.S. 427 (1953).

[11] *Id.* at 434.

[12] 15 U.S.C. §§ 78a-78kk (1988).

[13] *See* Constantine N. Katsoris, *Securities Arbitration After* McMahon, 16 FORDHAM URB. L.J. 361, 368-69 (1988).

[14] The Securities Act of 1933 provides for civil liability. 15 U.S.C. §§ 77k, 77l, 77o (1982). The 1933 Act is concerned primarily with the initial distribution of securities and requires full and fair disclosure of the character of the securities sold to the public. *See* Constantine N. Katsoris, *Accountants' Third Party Liability—How Far Do We Go?*, 36 FORDHAM L. REV. 191, 208-09 (1967).

[15] Liability under the Exchange Act is generally founded upon either section 18, 15 U.S.C. § 78r (1988) or the implied rights of action under section 10(b), 15 U.S.C. § 78j(b) (1982) and the Securities and Exchange Commission ("SEC" or "Commission") Rule 10b-5, 17 C.F.R. § 240.10b-5 (1993). Most 1934 Act investor claims against brokers involve section 10(b) of the Act. Eugene W. Bell & Kenn K. Fitzgerald, *Mixed Arbitrable/Nonarbitrable Disputes*, 16 REV. SEC. REG. 849, 851-

In 1987, however, the Supreme Court held in *Shearson/American Express, Inc. v. McMahon*[16] that the *Wilko* exemption did not apply to 1934 Act claims. In addition, in 1989 the Supreme Court undid the *Wilko* exception entirely in *Rodriquez de Quijas v. Shearson/American Express, Inc.*,[17] holding that pre-dispute arbitration agreements would be upheld, even as to issues arising under the 1933 Act.[18] Because of the *McMahon* and *Rodriquez* decisions, most securities disputes are now arbitrated pursuant to pre-dispute arbitration agreements. Indeed, in the calendar year after *McMahon*, the number of SRO arbitrations more than doubled over the calendar year before *McMahon*.[19] And, although *McMahon* was clearly a landmark decision in the development of the process by which securities disputes are resolved, an examination of not only the events following *McMahon*, but also those preceding it is necessary in order to better understand its full impact.

II. SECURITIES ARBITRATION BEFORE *MCMAHON*

Prior to 1976, most SROs had differing rules for the administration of securities arbitration disputes.[20] In June 1976, the Securities and Exchange Commission ("SEC" or "Commission") solicited comments from interested persons on the feasibility of developing a "uniform system of dispute grievance procedures for the adjudication of small claims."[21] After conducting a public forum at which written and oral comments were received, the SEC's Office of Consumer Affairs issued a report recommending the adoption of procedures for handling investor disputes and the creation of a new entity to administer the system.[22]

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52 (1983); *see* Katsoris, *supra* note 14, at 214.

[16] 482 U.S. 220 (1987).

[17] 490 U.S. 477 (1989).

[18] *Id.* at 483-85.

[19] SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, SIXTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION 4 (Aug. 1989) [hereinafter SIXTH REPORT].

[20] *See* Constantine N. Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279 (1984).

[21] Settling Disputes Between Customers and Registered Brokers and Dealers, Exchange Act Release No. 12,528, 9 SEC Docket 833, 834 (1976).

[22] An Integrated Nationwide System in the Resolution of Investor Disputes,

Before implementing the proposal for a new arbitration forum, the Commission invited further public comment.[23] In response to this invitation, several SROs proposed the establishment of a securities industry task force to consider the development of "a uniform arbitration code and the means for establishing a more efficient, economic and appropriate mechanism for resolving investor disputes involving small sums of money."[24] As a result of this suggestion, a Securities Industry Conference on Arbitration ("SICA") was established in April 1977, consisting of representatives of various SROs,[25] the Securities Industry Association ("SIA")[26] and the public.[27] Since that time, SICA has published seven Reports to the SEC outlining SICA's progress.

Once SICA had been established, the Commission invited proposals from it to improve the methods for resolution of investors' small claims.[28] After holding numerous meetings throughout the country, SICA developed a simplified arbitration procedure for resolving such small claims.[29] Realizing, however, that the development of a small claims procedure was

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Exchange Act Release No. 12,974, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,807 (Nov. 15, 1976).

[23] *See id.*

[24] *See id.*; *see also* SIXTH REPORT, *supra* note 19, at 1.

[25] The following SROs were represented: the American ("ASE"), Boston ("BSE"), Cincinnati ("CSE"), Midwest ("MSE"), New York ("NYSE"), Pacific ("PSE") and Philadelphia ("PHSE") Stock Exchanges, the Chicago Board Options Exchange ("CBOE"), the Municipal Securities Rulemaking Board ("MSRB") and the National Association of Securities Dealers, Inc. ("NASD"). SIXTH REPORT, *supra* note 19, at 1.

[26] *Id.* The SIA is a trade association for the securities industry.

[27] Peter R. Cella, Jr., Esq., Mortimer Goodman, Esq. and the author have served as Public Members of SICA since its creation in 1977. *Id.* In 1983, Justin Klein, Esq., was added as the fourth Public Member of SICA. *Id.* Mortimer Goodman did not seek re-appointment as a Public Member as of the end of 1989, and a new public member, James Beckley, was appointed in his place. The current Public Members' terms shall expire, one each year, beginning on December 31, 1993. *See* Constantine N. Katsoris, *The Level Playing Field*, 17 FORDHAM URB. L.J. 419, 428 n.59 (1990). All new members will serve for four years and are eligible for one additional four-year term. The Public Members whose terms are not expiring will determine the appointment of new members, or reappointment. *Id.* The appointment, or reappointment, may be vetoed by a two-thirds vote of the non-public members of SICA. *Id.*

[28] Implementation of an Investor Dispute System, Exchange Act Release No. 13,470, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,136, at 87,905 (Apr. 26, 1977).

[29] SIXTH REPORT, *supra* note 19, at 1.

only a first step, SICA then developed a more comprehensive Uniform Code of Arbitration ("Uniform Code" or "Code") to cover all securities claims.[30] In addition, SICA prepared a booklet for prospective claimants ("Procedures Booklet"),[31] explaining procedures under the Code. To a large extent, the initial Code incorporated and harmonized the rules of the various SROs, and codified various procedures which the SROs had followed, but had not specifically included in their existing rules.[32]

The original Code[33] was adopted by the participating SROs during 1979 and 1980.[34] Between the time of its initial adoption and the *McMahon* case, various revisions were made to both the Code and the Procedures Booklet, which were reported in the Third, Fourth and Fifth SICA Reports to the SEC.[35] Shortly after *McMahon*, the SEC and SICA discussed a number of recommendations and suggestions for improving SRO arbitration, leading to many of the changes to the Code which are reflected in SICA's Sixth and Seventh Reports and which are discussed hereafter.[36] In addition, SICA also prepared an Arbitrator's Manual which was designed to guide arbitrators concerning their duties and responsibilities.[37]

To this date, SICA continues to meet in order to monitor the performance of the Code in action, with a view towards further fine-tuning and adjusting its provisions.[38] In addition, various guests are invited to SICA meetings, including representatives from the SEC, who attend on a regular basis. To date, nearly 50,000 cases have been filed with the participating

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[30] *Id.*

[31] SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, ARBITRATION PROCEDURES (1980) [hereinafter PROCEDURES BOOKLET].

[32] *See* Katsoris, *supra* note 20, at 284.

[33] *See* SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, SECOND REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION TO THE SECURITIES AND EXCHANGE COMMISSION: PROPOSAL FOR A UNIFORM CODE OF ARBITRATION (1978) [hereinafter SECOND REPORT].

[34] SIXTH REPORT, *supra* note 19, at 1. Once SICA adopts a new rule, each SRO must then generally go back to its respective organization in order to get a rule change, which is then usually submitted to the SEC for approval. Accordingly, there is often a time lag between SICA approval and SRO action.

[35] *See* Katsoris, *supra* note 27, at 428 n.59.

[36] *See* Katsoris, *supra* note 27, at 429-30.

[37] *See* Katsoris, *supra* note 27, at 464.

[38] *See* Katsoris, *supra* note 27, at 430.

SROs since the initial approval of the Uniform Code.[39]

III. POST-*McMAHON* EFFORTS TO IMPROVE SRO ARBITRATION

What is attractive about arbitration is that it is both expeditious and economical. Although speed and economy are important, they must not be achieved at the expense of fairness. Fairness, speed and economy, however, are not mutually exclusive, because speed and, particularly, economy increase the fairness to public investors who may not have the resources to sustain the cost of a lengthy proceeding, or who may have only very small claims. It is thus critical that the Code's rules facilitate and maintain these essential characteristics, for justice unduly delayed, or made prohibitively costly, is justice denied. This is hardly an insurmountable problem, for all three goals can and should co-exist, with fairness being the paramount consideration.

To maintain arbitration as an effective and attractive alternative dispute resolution process, however, it became necessary for SICA to provide safeguards to ensure a fair and complete hearing without destroying the fabric of arbitration in the process. Because such safeguards often slow the proceedings down, the benefits of each new procedure must be weighed against the resultant escalation of time and cost. It is against this background that SICA adopted the original Arbitration Code and continues to amend it to this day.[40]

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[39] *See* SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, SEVENTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION TO THE SECURITIES AND EXCHANGE COMMISSION 28 (1990) [hereinafter SEVENTH REPORT]; *see also* Dave Pettit, *NASD, Awash in Arbitration Cases, Urges Investors to Turn to Mediation*, WALL ST. J., Aug. 30, 1993, at B4.

[40] *See* Katsoris, *supra* note 27, at 431. Similarly, the AAA created a task force in 1991 consisting of members from the securities industry and the customers' bar to update its rules for use in securities arbitration. These efforts led to the adoption of amended AAA Securities Arbitration Rules which were effective as of May 1, 1993. *See also* George H. Friedman, *The New Securities Arbitration Rules of the American Arbitration Association, in* SECURITIES ARBITRATION 1993, at 23 (PLI Corporate Law & Practice Course Handbook Series No. B-819, 1990). The issue of whether non-attorneys should represent parties at SRO arbitrations currently is being discussed by SICA. *See* Michael Siconolfi, *Plan To Bar Nonlawyer Advisers in Investor Disputes is Debated*, WALL ST. J., Dec. 3, 1993, at C1; *SICA Seeks Comments on Code Changes Clarifying Who May Assist Claimants*, 25 Sec. Reg. & L. Rep. (BNA) 1350 (Oct. 8, 1993):

According to SICA the amendment being considered would allow a non-

A. *Single Independent Forum*

SICA has always been concerned with improving the image of SRO arbitration as a speedy, economic and fair forum for the resolution of securities disputes.[41] To the extent possible, it has also been SICA's goal to achieve uniformity in the SRO rules and consistency in their application.[42] Moreover, with the influx of more complicated cases, such as RICO and 1933 and 1934 Act claims, and with the implementation of many of the post-*McMahon* changes to the Code, securities arbitrations have generally increased both in duration and cost.[43] Such escalation of time and cost is of some concern to

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attorney to represent a party in arbitration if the would-be representative is: a friend, relative, or fellow employee; an officer or employee of a corporate or partnership party; or a business adviser "not regularly in the business of representing parties in arbitration." The proposed rule would bar non-lawyers "who seek to represent claimants on a regular basis from 'assisting' claimants," SICA noted. It said it proposed the rule out of concern "that non-attorney 'advisors' may not be competent to deal with the complex issues" that "occur more and more frequently in arbitration proceedings." Such issues include choice of forum, measures of damages, and post-decision rights and remedies, SICA stated. It added that it also is concerned that there is no supervisory body authorized to police such representatives, "nor are there ethical guidelines binding on 'advisors.'" By contrast, SICA noted, many states have a mechanism for disciplining lawyers who commit ethical violations, and most attorneys are required to have malpractice insurance. Finally, it said, parties to arbitration that do not have legal counsel are not protected by the attorney/client privilege. Thus, such parties "may be treated to the experience of their advisor's being cross-examined on conversations they believed privileged,'" according to SICA.

See also Kenneth N. Gilpin, *Fighting it out Over Arbitration*, N.Y. TIMES, Oct. 31, 1993, § 3, at 17 (Business). Indeed, some consumer groups and other arbitration associations such as the AAA do not agree with such limitations on representation. *Id.* If SICA ultimately does decide to implement the proposed rule regarding non-lawyer representation in the overall interest of consumer protection, perhaps it should also then permit an interested party the option of arbitrating the claim elsewhere, such as the AAA. Such a suggestion would hardly appear radical, since both the SEC and the SIA have previously urged that customers' agreements containing arbitration clauses be expanded to include the AAA option. *See* Katsoris, *supra* note 27, at 470.

[41] *See* Katsoris, *supra* note 27, at 452.

[42] Katsoris, *supra* note 27, at 452-53.

[43] *See* Self Regulatory Organization; Order Approving Proposed Rule Changes, Exchange Act Release No. 26,805, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,414 (May 10, 1989); *see also* Philip J. Hoblin, *The Case For a Single Securities and Commodities Arbitration Forum*, COMMODITIES L. LETTER, Aug. 1989, at 3; Katsoris, *supra* note 27, at 472-77.

SICA.

One possible means of achieving SICA's goals is the single independent forum (hereinafter "separate" and "single independent forum"). Long before *McMahon,* the Public Members of SICA raised the subject of a single independent forum with SEC oversight.[44] Indeed, SICA was seriously considering such a forum before *McMahon.*[45] However, because of the disenchantment of the SEC, the disagreement among the SROs and the presence of the American Arbitration Association ("AAA") as an alternative, the concept of a separate independent forum remained dormant until after *McMahon,* when it received the support of the SIA.[46]

The separate independent forum initially was considered in order to still any suggestion that investors are compelled to arbitrate securities claims "in a forum controlled by the securities industry."[47] Since *McMahon,* however, an additional compelling reason surfaced in favor of a separate independent securities arbitration forum, namely the escalating aggregate costs of arbitration to each of the separate SRO forums.[48] This is partly so because the more complicated and time-consuming RICO and federal securities violations cases have now been thrust into arbitration by the *McMahon* and *Rodriquez* decisions.[49] Moreover, administering the numerous post-*McMahon* amendments to the Code has contributed to an explosion of costs.[50] In addition, the costs to the SROs are likely to increase even more as a result of implementing the essential

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[44] *See* Katsoris, *supra* note 27, at 472-73.

[45] Katsoris, *supra* note 27, at 473-73.

[46] *See Unified Arbitration Forum Under Discussion,* 1 SEC. ARB. COMMENTATOR 1 (May 1988); *see also* Diana B. Henriques, *Market Place, Single Arbitration Agency is Sought,* N.Y. TIMES, Dec. 21, 1989, at D8; *SIA Seeks Formation of Arbitration Group,* WALL ST. J., Dec. 22, 1989, at A3A.

[47] Shearson/American Express, Inc. v McMahon, 482 U.S. 220, 261 (1987) (Blackmun, J., dissenting) ("The uniform opposition of investors to compel arbitration and the overwhelming support of the securities industry for the process suggests that there must be some truth to the investors' belief that the securities industry has an advantage in a forum under its own control."); *see* William Glaberson, *When the Investor Has a Gripe,* N.Y. TIMES, Mar. 29, 1987, § 3, at 8 (Business) ("[t]he [brokerage] houses basically like the present system because they own the stacked deck").

[48] *See* Katsoris, *supra* note 27, at 473.

[49] Katsoris, *supra* note 27, at 473.

[50] Katsoris, *supra* note 27, at 473-74.

programs, which will lead to an intensification of arbitrator training and education.[51]

For these reasons, SICA commissioned a study in 1990 to examine the feasibility of using such a single forum to administer all arbitrations involving the securities industry.[52] While SICA concluded from that report that no material economies of scale would result from a single forum, SICA nevertheless decided that it would continue to explore alternative methods of improving the governance and image of SRO arbitration.[53]

B. *Class Actions*

The use of class actions in SRO arbitrations is particularly troublesome—especially in the area of class determination.[54] After much debate and discussion, SICA added section 1(d) to the Uniform Code, which specifically prohibits the submission of a claim as a class action.[55] This prohibition of class actions, however, had no effect upon the consolidation or joinder of claims, which are still specifically permitted by section 13(d) of the Code.[56] Moreover, the Code continues to permit claimants to be eligible to join in a class action pending in Court despite an agreement to arbitrate; but the claimants may file such claims in arbitration only if they have elected not to participate in or have withdrawn from the class action.[57]

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[51] *See infra* notes 92-98 and accompanying text.

[52] *See* Henriques, *supra* note 46, at D8 ("The Securities Industry Association has called on Wall Street to set up a single industrywide agency to handle the arbitration of customer disputes, rather than continuing to maintain separate programs at various exchanges and at the National Association of Securities Dealers."); *see also* SEVENTH REPORT, *supra* note 39, at 7.

[53] *See* Constantine N. Katsoris, *Punitive Damages in Securities Arbitration: The Tower of Babel Revisited*, 18 FORDHAM URB. L.J. 573, 581 (1991).

[54] *See* SEVENTH REPORT, *supra* note 39, at 7.

[55] *See* UNIF. CODE OF ARB. § 1(d).

[56] *See* SEVENTH REPORT, *supra* note 39, at 15-16.

[57] *See* UNIF. CODE OF ARB. § 1(d). It will be interesting to note, however, what effect, if any, the recent case United Kingdom v. Boeing Co., 998 F.2d 68 (2d Cir. 1993), will have upon the involuntary consolidation of securities disputes before SROs arising from differing arbitration agreements. *See* Deborah Pines, *Consolidation of Arbitrations Invalidated*, N.Y. L.J., July 8, 1993, at 1.

C. *Six-Year Limitation*

From the very beginning the Code provided that no dispute, claim or controversy would be eligible for submission to SRO arbitration if six years had elapsed since the occurrence or event giving rise to the act or dispute, claim or controversy.[58] This rule was inserted as a matter of SRO convenience to weed out stale claims. It was never intended, however, to limit or eradicate claimants' rights. Unfortunately, some courts have interpreted this rule as substantive instead of merely procedural, thus denying claimant's relief after the six years elapsed.[59]

In order to eliminate such misunderstanding, SICA, at its Spring 1993 meeting, amended section 4 by adding subdivisions (b) and (c) which, in effect, provide that eligibility under the six-year rule shall be made by the Director of Arbitration, and that a determination of ineligibility thereunder shall not constitute a bar to asserting the underlying claim in a judicial forum, notwithstanding any existing pre-dispute arbitration agreement.[60]

D. *Adjournments*

Since the hallmark of arbitration is speed and economy, repeated and often unnecessary adjournments have plagued SRO arbitration from early on. Indeed, prior to 1989, as many as one-third of the cases heard had their first hearing date adjourned after the panel had already been appointed.[61] Furthermore, even this first adjourned date is often subsequently adjourned again one or more times before the first hearing is ever held.[62]

Quite often all of the parties agree to these adjournments. Nevertheless, such adjournments still have a crippling effect

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[58] *See* SECOND REPORT, *supra* note 33, at A-4.

[59] *See Time Concerns: SRO Eligibility*, 5 SEC. ARB. COMMENTATOR 1 (1993).

[60] This amendment was passed at the SICA meeting held in Washington, D.C., on April 21, 1993. *See In Brief: Timely Progress*, 5 SEC. ARB. COMMENTATOR 11, 12. (May 1993).

[61] *See* Constantine N. Katsoris, *Adjournments, "The Arbitration Virus,"* 2 SEC. ARB. COMMENTATOR 1 (Jan. 1989).

[62] *Id.* at 2.

on the arbitration process. For example, arbitrators who have already cleared the challenge and conflict processes must be replaced because their schedules cannot accommodate the new adjourned date.[63] This generally causes additional delay because the SRO staff must find a replacement arbitrator or arbitrators, who must then also clear the challenge and conflict hurdles *de novo*.[64]

Thus, seemingly harmless adjournments undercut the two advantages of arbitration—speed and economy. This is not to suggest, however, that legitimate requests for adjournments should not be granted. In fact, parties should be given the benefit of the doubt in this regard. Yet, the practice of seemingly granting automatic adjournments, even when both parties consented, strained and undermined the legitimate goal of keeping arbitration speedy, economical and fair.[65]

Originally, section 18 of the Code merely authorized arbitrators to grant adjournments.[66] But through a series of amendments to section 18 both before and after *McMahon*, a fee was often required if the adjournment was granted. Still plagued by the effects of adjournments, however, SICA seemingly overacted by once again amending section (b), which presently provides that:

> (b) Unless waived by the Director of Arbitration, a party requesting an adjournment after arbitrators have been appointed *shall deposit* a fee, equal to the initial deposit of forum fees for the first adjournment and twice the initial deposit of forum fees, not to exceed $1,000 for a second or subsequent adjournment requested by that party. If the adjournment is not granted the deposit shall be refunded. If the adjournment is granted, the arbitrators may direct the return of the adjournment fee.[67]

As presently phrased, the rule now makes payment of the fee (unless waived by the Director of Arbitration) a condition precedent to the seeking of the adjournment from the arbitrators. Such a precondition could impose a severe hardship on

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[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *See* SECOND REPORT, *supra* note 33, at A-8.

[67] *See* UNIF. CODE OF ARB. § 18(b) (emphasis added). The majority of the Public Members of SICA did not support this amendment. Moreover, this change has not been adopted by the NYSE. *See* N.Y. STOCK EXCH. R. 617(b), *in* N.Y.S.E. Guide (CCH) § 2617 (1981).

many public claimants, and should be rescinded.[68]

E. *Collection Feature*

Undue delay in the collection of an award can be injurious to claimants, particularly to the small investor, who may have a pressing need for the money. Indeed, SICA was concerned that some dealers unnecessarily delayed payment of awards issued against them. Accordingly, section 28 was amended after *McMahon*, and presently provides: "(g) All monetary awards shall be paid within thirty (30) days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction."[69] This payment requirement is a distinct advantage over court-litigated awards, since the SRO generally has disciplinary authority over the dealer.[70]

F. *Record of Proceedings*

The Uniform Code initially did not require a verbatim recording of the arbitration proceedings, although most SROs did so record.[71] After *McMahon*, however, the Code was amended specifically to require that a stenographic record or tape recording of all proceedings be kept.[72] This flexibility as to the method of recording takes into account the significant cost differential between a stenographic record and a tape recording. In a multi-sessioned proceeding spanning over a long period of time, however, the printed record is preferable, because it

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[68] In an arbitration system spanning the entire country, obtaining such a waiver from the Director of Arbitration in emergency circumstances may be problematic. Besides, for a claimant of few or depleted assets, requiring a deposit of such up-front money could cause a severe hardship.

[69] *See* SEVENTH REPORT, *supra* note 39, at 20. Section 28(h) of the Uniform Code also provides for interest on such awards. *Id.*

[70] *See SEC Approves NASD Rule Changes Promoting Compliance With Arbitration Awards*, 25 Sec. Reg. & L. Rep. (BNA) 190 (Feb. 5, 1993); *see also* N.Y. STOCK EXCH. R. 637, *in* N.Y.S.E. Guide (CCH) § 2637 (1981). The AAA is now seeking to extend similar disciplinary effect for AAA awards.

[71] *See* SECOND REPORT, *supra* note 33, at A-9. Section 25 of the original Code provided "[u]nless requested by the arbitrators or a party or parties to a dispute, no record of an arbitration proceeding shall be kept." *Id.*

[72] *See* UNIF. CODE OF ARB. § 24 (1993). After *McMahon*, the original section 25 was renumbered 24 and amended to require that a stenographic record or tape recording of all proceedings be kept. *See* SIXTH REPORT, *supra* note 19, at 11.

more easily enables arbitrators to refresh their recollection of past testimony.[73]

G. *Pre-Hearing Disclosures and Procedures*

Before *McMahon*, there was no established mechanism to ensure that parties cooperate in document production. Thus, some parties did not produce documents until the day of the hearing. This forced the demanding party into the unenviable choice of proceeding with the hearing without having an adequate opportunity to examine the newly produced documents, or of seeking a delay from arbitrators who had planned to start the hearing on that designated day. Such delayed production often resulted in trial by ambush. It became apparent after *McMahon* that the time had arrived to codify the informal practice of some SROs to get the arbitrators more involved in discovery disputes *before* the first hearing. Accordingly, SICA added specific provisions to section 20 of the Code relating to pre-hearing conferences, and to document and information production.[74]

Under these new provisions a request for documents or information can be served as early as twenty business days after service of the Statement of Claim.[75] If a party objects or fails to honor a request, a pre-hearing conference may be called to resolve the impasse.[76] The best hope for preventing these procedures from dragging out and unduly increasing the cost of the arbitration—as often happens in court proceedings—is to have experienced and knowledgeable arbitrators who will not let such matters get out of hand.

Prior to the initial hearing date, section 20 also now requires the parties to exchange witness lists and the documents that they intend to use in their direct case.[77] In addition, all

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[73] The new amended AAA Arbitration Code, *supra* note 40, *still* does not require a verbatim record of the proceedings. *See also* Constantine N. Katsoris, *I Won't Sit Without A Record*, 3 SEC. ARB. COMMENTATOR 1 (Sept. 1990). In 1993 the author presided at a non-SRO arbitration at which no record was required to be kept. Nevertheless, it is still his emphatic opinion that a verbatim record should generally be required.

[74] *See* SIXTH REPORT, *supra* note 19, at 2.

[75] UNIF. CODE OF ARB. § 20(b)(1); *see* SIXTH REPORT, *supra* note 19, at 9-10.

[76] UNIF. CODE OF ARB. § 20(b)(4).

[77] *Id.* § 20(c).

parties to a dispute must now receive copies of any subpoenas issued.[78] Finally, although the Uniform Code omits any reference to pre-hearing depositions, the circumstances under which such depositions are usually ordered by the arbitrators are discussed in the SICA Arbitrator's Manual.[79]

H. *The Arbitrators*

1. Selection

The task of achieving a fair arbitration format would be incomplete without focusing on the quality and integrity of the arbitrators who administer it. Indeed, even the slightest *appearance* that the deciding panels leaned toward the securities industry would undermine the public's confidence in the present system of securities arbitration. It is for this reason that the selection of securities arbitrators has come under so much scrutiny over the past few years.

Under the post-*McMahon* Code, arbitrators are more closely scrutinized both as to ability and background.[80] They are carefully selected, classified and evaluated, and then are subject to challenge.[81] Their awards are also subject to public scru-

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[78] *Id.* § 20(f).

[79] SECURITIES INDUSTRY CONFERENCE ON ARBITRATORS, THE ARBITRATOR'S MANUAL (1992) [hereinafter ARBITRATOR'S MANUAL].

> Access to depositions should be granted to preserve the testimony of ill or dying witnesses, or of persons who are unable or unwilling to travel long distances for a hearing and may not otherwise be required to attend the hearing, as well as to expedite large or complex cases, and in other situations deemed appropriate by the arbitrator. Balanced against this ability, however, is a traditional reservation about the overuse of depositions in arbitration.
>
> The effective use of discovery tools such as depositions rests in the careful exercise of judgment by the arbitrators. Care should be taken to avoid unnecessary expense or burdens to the parties and to avoid unnecessary delay. It is appropriate for arbitrators to consider whether the witness will be able to appear at the arbitration hearing, the necessity of preserving the witness's testimony, and other factors that bear on the efficiency and fairness of the proceeding.

Id. at 10.

[80] UNIF. CODE OF ARB. § 11; *see* SIXTH REPORT, *supra* note 19, at 7-8.

[81] UNIF. CODE OF ARB. § 10; *see* SIXTH REPORT, *supra* note 19, at 7. The SROs have developed a system for evaluating the performance of arbitrators which includes input from their fellow arbitrators, the parties and the SRO staff. *See* Edward W. Morris, Jr., et al., *Securities Arbitration at Self Regulatory Organizations:*

tiny, so that the parties can get a sense of each arbitrator's voting record and leanings.[82]

The selection of arbitrators at SRO forums does not employ the so-called *tri-partite* selection system, by which each party picks an arbitrator and the two appointees pick a third.[83] Instead, the SRO forums pick the arbitration panels,[84] but section 10 of the Code permits one peremptory challenge to the panel, and unlimited challenges for cause.[85]

Each SRO maintains a roster of individuals who are not employees of the sponsoring organization but whose professional qualifications and experience qualify them for service as arbitrators.[86] The Uniform Code specifically provides that unless the public customer requests otherwise, the matter will be arbitrated by a panel "at least a majority of whom shall not be from the securities industry." In other words, the majority of the panel must consist of public arbitrators.[87] The original Code, however, gave no significant guidance as to who qualified to be a public arbitrator, and the original version of the Procedures Booklet described public arbitrators only as "individuals who are neither associated with nor employed by a

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New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.—Administration and Procedures, *in* 7 SECURITIES ARBITRATION 1992, at 135, 177 (PLI Corp. Law Practice Course Handbook Series No. 781, 1992).

[82] Uniform Code of Arbitration § 28 requires that an award include summary data, such as the description of the issues in controversy and the amounts claimed and awarded. *See* SIXTH REPORT, *supra* note 19, at 11; *see also infra* notes 112-14 and accompanying text; *SEC Approves NASD Rule Change Making Arbitration Awards Publicly Available*, 25 Sec. Reg. & L. Rep. (BNA) 1166 (Aug. 1993).

[83] *See* JACQUELINE M. NOLAN-HALEY, ALTERNATIVE DISPUTE RESOLUTION, NUTSHELL SERIES 152 (1st ed. 1992); *see also* Michael F. Hoellering, *The Independence of Party-Appointees*, N.Y. L.J., June 3, 1993, at 1.

[84] Edward W. Morris, Jr., *Arbitrator Assignment—The Case for Agency Selection*, 2 SEC. ARB. COMMENTATOR 1, 3 (Feb. 1989).

[85] *See* SIXTH REPORT, *supra* note 19, at 7.

[86] *See* PROCEDURES BOOKLET, *supra* note 31, at 3.

[87] UNIF. CODE OF ARB. § 8; *see* SIXTH REPORT, *supra* note 19, at 6-7. It has been suggested that arbitration panels should consist only of public members. *See SIA NASAA Split Over Fairness of Securities Arbitration Procedures*, 20 Sec. Reg. & L. Rep. (BNA) 870 (June 10, 1988); *Seeking "Fairness" in Brokers' Disputes*, N.Y. DAILY NEWS, June 26, 1988, at 10 (Business). The principal problem with this suggestion is that eliminating all arbitrators affiliated with the securities industry from the arbitration panels would also eliminate sources of invaluable insight into the workings of the securities industry. In addition, the adoption of such an exclusionary rule would undoubtedly be perceived by the industry as stacking the deck in favor of the investors.

broker-dealer or securities industry organization."[88] Indeed, SICA initially left this test flexible so that the vast experience of many needed and qualified persons would not be lost.

As time went on, however, it became apparent that the category of public arbitrators had to be more clearly defined. Accordingly, Guidelines for the Classification of Public Arbitrators were added to the Procedures Booklet.[89] After *McMahon*, SICA further tightened this classification by amending section 8 of the Code specifically to *exclude* as public arbitrators, *inter alia*: (1) brokers and registered investment advisers and persons who are retired from the securities industry; (2) persons who had been employed in the industry in the past three years; (3) professionals, i.e., attorneys or accountants who devote 20% or more of their work efforts to securities industry clients; and, (4) spouses of industry personnel.[90]

In addition, section 11 of the Code requires each arbitrator to disclose to the Director of Arbitration any circumstances that might preclude such arbitrator from rendering an objective and impartial determination. To facilitate this process, arbitrators now receive a copy of the Code of Ethics each time they are assigned to a case in order to highlight the types of disclosures required. For example, the Code of Ethics requires that an arbitrator reveal any direct or indirect financial or personal interest in the outcome of the arbitration, and any existing or past financial, business, professional, family or social relationships, which are likely to affect impartiality or that might reasonably create an appearance of bias.[91]

2. Training

SICA's Procedures Booklet provides that arbitrators must be impartial and knowledgeable about the areas in controversy.[92] Positive steps were taken after *McMahon* to ensure that

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[88] *See* PROCEDURES BOOKLET, *supra* note 31, at 3.

[89] *See* SECURITIES INDUSTRY CONFERENCE ARBITRATION, FIFTH REPORT OF THE SECURITIES CONFERENCE ON ARBITRATION 5 (1986) [hereinafter FIFTH REPORT].

[90] *See* SIXTH REPORT, *supra* note 19, at 6-7; *see also* Robert S. Clemente, *Securities Arbitrator Training: Managing the Arbitration Process*, 1 SEC. ARB. 91, 104 (1993).

[91] See SIXTH REPORT, *supra* note 19, at 7-8.

[92] *See* PROCEDURES BOOKLET, *supra* note 31, at 3.

arbitrators are able to live up to investors' high expectations. In this regard the two largest SROs, the NASD and the NYSE, regularly conduct arbitration training sessions and seminars.[93] In addition, arbitrator training also takes place in the form of printed media. An informative newsletter specifically dedicated to the subject of securities arbitration is already in print and is being offered to NASD arbitrators at a discounted price.[94] Other publications dealing with arbitration are also available.[95] Another significant publication used for arbitrator training has been SICA's Arbitrator's Manual, which was developed specifically to instruct arbitrators concerning their duties and responsibilities.[96]

Distinctions, of course, must be made between inexperienced arbitrators and those who are eminently qualified. Yet, even the most sophisticated arbitrator can always use some sort of training to adjust to changing needs and circumstances. For example, in 1991 the United States Supreme Court in *Gilmer v. Interstate/Johnson Lane Corp.*[97] concluded that claims brought under the Age Discrimination in Employment Act could be subject to compulsory arbitration. Since *Gilmer*, discrimination disputes are ending up in SRO arbitration with greater frequency because of the presence of an arbitration

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[93] *See* Deborah Masucci, *Maintaining The Fairness of Arbitration*, *in* SECURITIES ARBITRATION PRACTICE AND PROCEDURES SEMINAR 144-45 (1989); Edward W. Morris, Jr., *Arbitration at the New York Stock Exchange*, *in* SECURITIES ARBITRATION PRACTICE AND PROCEDURES SEMINAR 114 (1989); Deborah Masucci & Robert S. Clemente, *Securities Arbitration at Self-Regulatory Organizations: New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.—Administration and Procedures*, 7 SEC. ARB. 115, 130 (1993); *see also* SIXTH REPORT, *supra* note 19, at 2-3; Deborah Masucci & Edward W. Morris, Jr., *Arbitration at the NASD and the NYSE*, *in* 1989 SECURITIES ARBITRATION 448 (PLI Seminar No. 437, 1989). Moreover, after 1992, the AAA is requiring training for its arbitrators. 5 SEC. ARB. COMMENTATOR 18 (March 1993).

[94] *See SAC Welcomes Our New Arbitrator Subscribers!*, 5 SEC. ARB. COMMENTATOR 1 (March 1993). Indeed, the *Securities Arbitration Commentator* is adapting part of its newsletter specifically to serve the needs of arbitrators. *See* 5 SEC. ARB. COMMENTATOR 17 (May 1993).

[95] *See, e.g.*, BNA *Alternate Dispute Resolution Report*; BNA *Securities Regulation and Law Report.*

[96] SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, THE ARBITRATOR'S MANUAL (1989); *see also* Masucci & Morris, *supra* note 93, at 47; ARBITRATOR'S MANUAL, 2 SEC. ARB. COMMENTATOR 1 (Aug. 1989).

[97] 500 U.S. 20 (1991); *see also* John P. Fuffaro & Maury B. Josephson, *Enforcing Arbitration Agreements*, N.Y. L.J., Nov. 6, 1992, at 3.

clause in securities industry employment contracts. Yet, most of the experienced securities arbitrators know precious little about such discrimination disputes. To meet this need, the NASD and the NYSE, in conjunction with the Association of the Bar of the City of New York, conducted a seminar in New York City specifically on employment discrimination.[98]

I. *The Agreement to Arbitrate*

SROs require by rule that their membership consent to arbitrate disputes with their customers.[99] Simply by belonging to the SRO, its members agree to be bound by the SRO's rules.[100] Consequently, customers of an SRO may compel a member of an SRO to arbitrate; absent a written contract, however, the member cannot compel the customer to arbitrate.[101] The standard arbitration clause "authorizes the customer to elect the arbitration forum from a list of several organizations. If the customer does not elect the forum within five days after receipt from the broker-dealer of a notification requesting such election, the broker-dealer becomes authorized to make the election."[102]

As a practical matter, the extent to which customers are "required" to sign what can basically be described as a typical industry-wide agreement containing a pre-dispute arbitration clause is a critical question. This is particularly so if "the customer may be precluded from doing business with the broker-dealer if he or she refuses to sign the agreement or the broker-dealer is unwilling to accept any modification of its terms."[103]

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[98] The seminar was held at the offices of the NASD at 33 Whitehall St. in New York City on April 27, 1993. *See* John Racine, *Discrimination Claims Rise, But Are Arbitrators Ready? Critics Say There's No Guarantee Panel Will Understand Issues*, BOND BUYER, Apr. 29, 1993, at 6A. The NASD was recently disqualified from arbitrating a sex discrimination and age discrimination lawsuit brought against Charles Schwab & Co. because the company's chairman serves on the NASD's governing board. Edward Felsenthal, *Schwab Arbitration*, WALL ST. J., June 3, 1993, at B2; *see also* Margaret A. Jacobs, *Little Diversity Found on Panels for Securities-Firm Arbitration*, WALL ST. J., Apr. 1, 1994, at B3.

[99] *See* HOBLIN, *supra* note 5, at 2-3 to 2-4.

[100] *Id.* at 2-4.

[101] *Id.*

[102] Exchange Act Release No. 15,984, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122, at 81,978 (July 2, 1979).

[103] *Id.*

It would appear that such agreements are largely in effect with respect to margin, option and commodity accounts, and, to lesser degree, cash accounts.[104]

In order to ensure that customers understand that they are signing an agreement which includes an arbitration clause, SICA added section 31 to the Code.[105] It provides that any pre-dispute arbitration clause be highlighted and immediately preceded by certain disclosure language that describes arbitration and its effect.[106] This SICA rule also provides that immediately preceding the signature line there shall be a statement, that the agreement contains a pre-dispute arbitration clause which shall be highlighted and *separately initialled* by the customer. Despite SICA approval several years ago, no SRO has approved this requirement as to *separate initialling*.[107] Consequently, such an initialling requirement does not appear in any SRO arbitration rule or code. This is unfortunate because separate initialling more clearly calls the arbitration clause to the customer's attention, thus reducing the amount of litigation based upon a customer's lack of awareness of the clause.[108]

Regretfully, many of these arbitration clauses often include choice-of-law provisions which unsuspectingly steer a customer into restrictions they may never have intended, such as foreclosing their right to seek punitive damages.[109] Such restrictions, which are not apparent on the face of the agreement, should be discouraged.[110]

J. *Written Opinions and Appeals*

The issue of whether written opinions should accompany awards, and the extent to which awards should be reviewable,

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[104] *See* Ann C. Stansbury & Justin P. Klein, *The Arbitration of Investor-Broker Disputes: A Summary of Development*, 35 ARB. J. 30, 32 (Sept. 1980); *see also* C. FLETCHER, DYNAMISM IN SECURITIES ARBITRATION, SECURITIES ARBITRATION PRACTICE AND PROCEDURES SEMINAR 14 (1989); GENERAL ACCOUNTING OFFICE REPORT, SECURITIES ARBITRATION, HOW INVESTORS FARE (1992) [hereinafter GAO REPORT].

[105] *See* SEVENTH REPORT, *supra* note 39, at 23.

[106] SEVENTH REPORT, *supra* note 39, at 23.

[107] *See* Katsoris, *supra* note 27, at 452.

[108] Katsoris, *supra* note 27, at 432.

[109] *See* Katsoris, *supra* note 53, at 593-96.

[110] *See infra* notes 138-47 and accompanying text.

continues to be controversial.

1. Written Opinions

Prior to *McMahon*, section 29 basically required that all awards must be in writing and signed by a majority of the arbitrators, and provided that awards were deemed final and not subject to review or appeal.[111] After *McMahon*, however, SICA renumbered section 29 as section 28, and amended it to require that any award also include summary data, such as a description of the issues in controversy and the amounts claimed and awarded.[112] This data must be made available to the public in accordance with the policies of the sponsoring SRO.[113] Indeed, an outside vendor is presently publishing such awards.[114]

Even with these additional requirements, however, the Code still falls short of requiring *written opinions*, although arbitrators remain free to so author. At first blush, this may appear to some as a deficiency in the Code, in that written opinions would give insight as to the rationale for past awards, thus helping the parties in formulating opinions about arbitrators with a view to exercising their peremptory challenges.[115] Upon closer analysis, however, such benefits may be outweighed by the negative implications of *requiring* such opinions. First of all, the opinions would not necessarily be binding on or of any precedential value to other arbitration panels.[116] Moreover, they would often be written by laymen, inexperienced in expressing themselves in legal terms, particularly since many claims are often vague, loosely put together and not always clearly set forth. Requiring opinions might discourage many fine arbitrators—often busy, successful people who serve at nominal cost—from serving.[117] Moreover, mandatory

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[111] *See* FIFTH REPORT, *supra* note 89, at 36-37.

[112] *See* SIXTH REPORT, *supra* note 19, at 11.

[113] SIXTH REPORT, *supra* note 19, at 11.

[114] *See* 2 SEC. ARB. COMMENTATOR 6-7 (June 1989) (Award Reporter); *see also* 2 SEC. ARB. COMMENTATOR 2-7 (Oct. 1989) (Award Reporter). Indeed, some awards are being analyzed and commented upon. *Id.* at 8-10.

[115] Katsoris, *supra* note 53, at 446.

[116] Katsoris, *supra* note 13, at 382.

[117] Katsoris, *supra* note 13, at 382.

written opinions would certainly slow down the rendering of awards, for awards are often the basis of consensus.[118] Nor would requiring written opinions necessarily enhance the cause of fairness.[119] Indeed, in some instances mandatory opinions might even result in fewer awards in favor of claimants on general equity grounds.[120] By the same token, instead of being used as a window into the rationale of arbitrators, a written opinion could be used as a platform and blueprint for many more appeals, because it would identify targets, meaningful or otherwise, for the losing party to attack. Appeals are both costly and time consuming. Furthermore, arbitrators would have to be compensated for the considerable additional time often required to render such written opinions. Similarly, such a requirement would also put additional pressure on the already strained staffs of the administering forum, as drafts of written opinions would be circulated and recirculated among the various arbitrators for corrections, redrafts and finalization.[121]

Thus, looking at the issue in totality, *requiring* written opinions of fact and law in all cases would delay and add to the cost of arbitration, without greatly enhancing or improving its operations. There should be an exception, however, if an award includes relief for punitive damages. Not only should such awards be separately stated, but they should also be accompanied by an explanation of the award in order to assist a reviewing court in assessing the propriety of such unique and unusual punitive relief.[122]

2. Review of the Award

The scope of judicial review of an arbitration award is very limited. "If the award is within the submission, and contains

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[118] For example, suppose that there are three arbitrators, *A*, *B* & *C*, that they found damages of $10,000, $20,000 and $30,000, respectively; and that they ultimately agree on a $20,000 award. When they write the opinion, however, *A* bases his award on unsuitability, *B* on churning, and *C* on unauthorized trading. Can *A*, *B* and *C* issue an award for $20,000, even though they cannot, in a written opinion, agree on the reasons? Moreover, would they?

[119] Katsoris, *supra* note 13, at 383.

[120] Katsoris, *supra* note 13, at 383.

[121] Katsoris, *supra* note 13, at 383.

[122] *See infra* notes 128-77 and accompanying text.

the honest decision of the arbitrators, after a full and fair hearing of the parties, a court of equity will not set it aside for error, either in law or fact."[123] In fact, the typical grounds for vacating an arbitration award are surprisingly uniform throughout the United States, namely:

> (1) There was an undisclosed relationship between an arbitrator and a party or his counsel affecting the arbitrator's impartiality or appearance of impartiality.
>
> (2) An arbitrator was corrupt.
>
> (3) The arbitrators did not schedule or conduct the hearing in a fair and judicious manner.
>
> (4) The arbitrators granted relief that they were not authorized to grant under the contract pursuant to which the arbitration was held.[124]

In addition, although courts generally will not set aside an award for a mistake of law, they will vacate where the arbitrators acted in "manifest disregard" of the law.[125]

Although SICA did consider broadening the scope of review of securities arbitration awards, the proposal was rejected as inimical to the simplicity and brevity of arbitration procedures.[126] In the area of punitive damages, however, some sort

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[123] Burchell v. Marsh, 58 U.S. 344, 349 (1854).

[124] Arthur J. Goldberg, *A Supreme Court Justice Looks at Arbitration*, 20 ARB. J. 63, § 6.03, at 61 (1965).

[125] *See* Brian N. Smiley, *Stockbroker-Customer Disputes: Making A Case For Arbitration*, 23 GA. B.J. 195 (1987). For an award to be vacated on this ground, "[t]he error must have been . . . readily and instantly perceived by the average person qualified to serve as an arbitrator." Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930 (2d Cir. 1986).

> Although the bounds of this ground have never been defined, it clearly means more than error or misunderstanding with respect to the law . . . . Moreover, the term "disregard" implies that the arbitrator appreciates the existence of a clearly governing legal principle but decides to ignore or pay no attention to it . . . . The governing law alleged to have been ignored by the arbitrators must be well defined, explicit, and clearly applicable. We are not at liberty to set aside an arbitration panel's award because of an arguable difference regarding the meaning or applicability of laws urged upon it.

Id. at 933; Blue Bell, Inc. v. Western Glove Works Ltd., 1993 U.S. Dist. LEXIS 3528 (S.D.N.Y. Mar. 22, 1993), *mot. for injunction denied*, 1993 U.S. Dist. LEXIS 13983 (S.D.N.Y. Oct. 1, 1993).

[126] SICA did consider broadening the scope of review of securities arbitration awards. *See* MORTIMER GOODMAN, PUBLIC MEMBER SECURITY INDUSTRY CONFERENCE ON ARBITRATION, IN RESPECT OF A RIGHT OF REVIEW OF AN ARBITRATION AWARD (filed with the SEC on Dec. 15, 1977); *see* Katsoris, *supra* note 20, at 291.

of reviewability is justified, as will be more fully developed hereafter.[127]

K. *Punitive Damages*

"Punitive" or "exemplary" damages—those in excess of compensatory damages[128]—are widely recognized in civil litigation. Such additional damages are generally accepted or rejected on policy grounds, and are usually imposed to punish the defendant and serve as a warning or example to others who may commit similar outrageous acts in the future.[129] In justifying this rationale of deterrence, most courts require a finding of malice or some other comparable act.[130]

Although exemplary damages are punitive in nature, they lack the Constitutional and other safeguards generally accompanying criminal penalties.[131] Furthermore, because of the frequency and magnitude of punitive damages,[132] the validity and propriety of such awards has come under increasing scrutiny by the courts, legislatures and legal scholars.[133] To whatev-

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The proposal was rejected as inimical to the simplicity and brevity of arbitration procedures. *See* UNIF. CODE OF ARB. § 28b. It is also interesting to note that the AAA does not encourage written opinions. *See* Robert Coulson, *Securities Arbitration at the American Arbitration Association, in* SECURITIES ARBITRATION 1989, at 696 (PLI Corp. Law & Practice Court Handbook Series No. 650, 1989). *But see* Stephen A. Hochman, *Reasoned Awards: Arbitrations Should State Findings and Conclusions or Explain or Give Reasons for Their Awards*, 5 SEC. ARB. COMMENTATOR 1, 9 (March 1993).

[127] *See infra* notes 128-77 and accompanying text.

[128] Compensatory damages are those allowed as a recompense for the injury *actually received. See* 1 BOUVIERE'S LAW DICTIONARY AND CONCISE ENCYCLOPEDIA 750 (3d rev. 1914) (emphasis added).

[129] *See* LINDA L. SCHLUETER & KENNETH R. REDDEN, PUNITIVE DAMAGES, § 2.1(c), at 23 (2d ed. 1989).

[130] *Id.* § 2.2(a)(1), at 26. The rationale of deterrence is particularly justified where the wrongdoer has received or expects to receive financial or other benefits from his misconduct. *Id.* Moreover, punitive damages act as an incentive to wronged parties to seek redress, because their compensatory damages may be nominal in relation to the relative cost of litigation. Thus, without such incentive, the wrongdoers' behavior would go unchecked to the detriment of society as a whole. *Id.* § 2.2(c)(1), at 30-31.

[131] *See id.* § 1.3(f), at 11.

[132] *See* John C. Jeffries, *A Comment on the Constitutionality of Punitive Damages*, 72 VA. L. REV. 139 (1986); Note, *Punitive Damages: An Appeal for Deterrence*, 61 NEB. L. REV. 651 (1982); Note, *The Imposition of Punishment by Civil Courts: A Reappraisal of Punitive Damages*, 41 N.Y.U. L. REV. 1158 (1966).

[133] *See* SCHLUETER & REDDEN, *supra* note 129, § 3.0, at 37.

er extent punitive damages are awardable in courtroom litigation, however, they should be similarly permitted in arbitration. Since *McMahon*, many of the larger and more complicated customer disputes are now being litigated in arbitration instead of before judges and juries. Although the SROs did not start making their awards public until after *McMahon*, it has been reported that since 1987 over $20,000,000 in punitive damages have been awarded in SRO and AAA securities arbitrations, with several of these awards having exceeded one million dollars.[134] Such awards have served to escalate the simmering debate surrounding the authority to award punitive damages through arbitration.

1. The Choice of Law Response

At the state level, courts have been unable to agree unanimously upon the availability of punitive damages in arbitration. Most notable in opposing such awards in arbitration is the decision of the New York Court of Appeals in *Garrity v. Lyle Stuart, Inc.*,[135] which involved a dispute over the payment of royalties. In a four-to-three decision, the court ruled that an arbitrator lacked authority "to award punitive damages, *even if agreed upon by the parties*."[136] The majority reasoned:

> If arbitrators were allowed to impose punitive damages, the usefulness of arbitration would be destroyed. It would become a trap for the unwary given the eminently desirable freedom from judicial overview of law and facts. It would mean that the scope of determination by arbitrators, by the license to award punitive damages, would be both unpredictable and uncontrollable.[137]

The *Garrity* holding takes on added significance because of the preeminence of New York as a situs for arbitration[138] and the frequent inclusion of a New York choice-of-law provision in

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[134] *See Punitive Award Survey*, 5 SEC. ARB. COMMENTATOR 5, 8 (May 1993); *see also* Barbara Franklin, *Securities Arbitrations*, N.Y. L.J., June 3, 1993, at 5.

[135] 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976).

[136] *Id.* at 356, 353 N.E.2d at 794, 386 N.Y.S.2d at 832.

[137] *Id.* at 359, 353 N.E.2d at 796, 386 N.Y.S.2d at 834.

[138] Nearly 30% of all SRO arbitrations are held in New York City. *See* Edward W. Morris, Jr., & Deborah Masucci, *Securities Arbitration at Self-Regulating Organizations: New York Stock Exchange and National Association of Securities Dealers—Administration and Procedures*, *in* SECURITIES ARBITRATION 1991, at 219, 235 (PLI Corp. L. & Prac. Course Handbook Series No. 742, 1991).

pre-dispute arbitration agreements.

The presence of choice-of-law clauses is particularly problematic in arbitrations subject to the Federal Arbitration Act ("FAA"). In *Volt Information Sciences, Inc. v. Board of Trustees of the Leland Stanford Junior University,*[139] the United States Supreme Court upheld a California choice-of-law clause that provided that the construction contract at issue would be governed by the law of "the place where the [p]roject is located."[140] The *Volt* Court reasoned:

> There is no federal policy favoring 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. Interpreting a choice-of-law clause to make applicable state rules governing the conduct of arbitration—rules which are manifestly designed to encourage resort to the arbitral process—simply does not offend the rule of liberal construction . . . , nor does it offend any other policy embodied in the FAA.[141]

Because many securities arbitration agreements contain a New York choice-of-law clause, the effect of *Volt* regarding the *Garrity* prohibition remains unclear and unsettling.

An *expansive* view of *Volt* takes the position that the opinion "endorsed the right of the parties to contract to agree on its terms and be bound thereby"[142] and, that "such contracts could be enforced so long as there is not preemption."[143] But, a more *restrictive* interpretation reasons that *Volt* merely established

> a *substance and procedure distinction*, with parties agreeing only to the application of the state's substantive law—*unless it is stated to the contrary*. Thus, with respect to punitive damages, a standard choice-of-law clause governed by the Federal Arbitration Act would be designating *only* that part of the state's law necessary to determine whether the conduct merits the awarding of such damages, not whether the arbitrators have the power to award them.[144]

After *McMahon*, in order to prevent the insertion of re-

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[139] 489 U.S. 468 (1989).

[140] *Id.* at 470.

[141] *Id.* at 476 (emphasis added).

[142] C. Evan Stewart, *Punitive Damages In Arbitration: Fish or Cut Bait*, N.Y. L.J., Feb. 21, 1991, at 5.

[143] *Id.* at 6.

[144] *Id.* (emphasis added); *see also* Lawrence W. Newman & Michael Burrows, *Punitive Damages Awards in Arbitration*, N.Y. L.J., Nov. 12, 1992, at 3.

strictive clauses in customers' agreements, SICA added subdivision (d) to section 31 of the Code which, *inter alia*, prohibits any condition that "limits or contradicts the rules of any self-regulatory organization, or limits the ability of a party to file any claim in arbitration or *limits the ability of the arbitrators to make any award.*"[145] Although this prohibition does not specifically mention punitive damages, it clearly expresses a strong distaste for restrictions in customers' agreements that limit the claim or award rendered by the arbitrators.[146] In this regard, choice-of-law provisions, which often appear in pre-dispute arbitration agreements and mandate the law to be applied in deciding the dispute, can be restrictive. This is particularly true where a choice-of-law provision subjects an investor to the law of a situs that has no true relationship to the place where the business was conducted.[147]

When a dispute persists between a customer and a broker, the path to relief is generally arbitration or court litigation. The choice, however, should only involve the differences in procedure, not the quantum of relief sought. To saddle arbitration with the perception that it provides less relief than that available in court would rekindle the suspicion that SRO arbitration creates a deck stacked in favor of the securities industry.[148]

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[145] *See* SIXTH REPORT, *supra* note 19, at 12 (emphasis added).

[146] *See* Katsoris, *supra* note 27, at 446. In view of the *Volt* decision, however, it is uncertain what effect this amendment to section 31 of the Code—which prohibits any limitation upon the arbitrators' ability to make any award—will have upon clauses prohibiting punitive damages.

[147] *See supra* notes 138-46 and accompanying text. Indeed, not only are New York choice-of-law provisions common in brokerage house agreements, they even appear in those of one or two houses not even headquartered in New York. *See Punitive Award Survey*, 5 SEC. ARB. COMMENTATOR 1, 2 (May 1993); *see also Arbitrators Must Decide Whether Firm Misrepresented Choice of Law Provision*, 25 Sec. Reg. & L. Rep. (BNA) 820 (June 11, 1993).

[148] *See* Katsoris, *supra* note 27, at 458; *see also* Franklin, *supra* note 134, at 5. Recently, a committee of the New York County Lawyers' Association issued a report calling on the State Legislature to overturn *Garrity*. *See Law on Punitive Damages in Arbitrations Urged*, N.Y. L.J., July 27, 1993, at 1. *But see SIA Opposes N.Y. Lawyers Groups Push for Punitive Damages in N.Y. Arbitrations*, 25 Sec. Reg. & L. Rep. (BNA) 1184 (Aug. 27, 1993).

2. The Judicial Review Response

On the other hand, one way to prevent runaway punitive damages awards by juries is reviewability. If, however, punitive damages are allowed in arbitration but are not generally reviewable, while those obtained in courtroom litigation are, then the playing field in arbitration would tilt in favor of claimants. Accordingly, along with providing similarity of relief—i.e., allowing punitive awards in arbitration as they are in courtroom litigation—the law should also provide for a similar reviewability of such awards. Thus, in exchange for a uniform nationwide rule permitting arbitrators to impose punitive damages in securities disputes, the punitive portion of any such award generally should be reviewable. Such a broad rule of appealability would not be too disruptive of arbitration's quest for speed and economy, if limited solely to the punitive damage portion.[149]

If review of punitive awards is desirable, what form or procedure would be preferable? Some have suggested bifurcated proceedings—that is, to try the punitive claim separately before a judge or jury.[150] The delay, extra cost and possibility for inconsistent or incompatible outcomes that could result from such separate procedures are hardly the panacea for a court system already clogged with too many other cases.[151] On the other hand, letting the arbitrators decide the entire case, and permitting only the punitive damage portion of the award to be generally subject to judicial review, would be more efficient and could serve to alleviate some of the apprehension

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[149] Indeed, punitive damages are an unusual sanction that, to date, are relatively rarely granted by arbitrators in securities disputes. *See Punitive Award Survey*, 5 SEC. ARB. COMMENTATOR 1, 8 (May 1993).

[150] *See* 4 SEC. ARB. COMMENTATOR 1, 4 (Jan. 1991); *see also* COMMERCIAL AND FEDERAL LITIGATION SECTION OF THE NEW YORK STATE BAR ASSOCIATION, REPORT ON PUNITIVE DAMAGES IN COMMERCIAL ARBITRATION (1990). Some commentators have suggested "[p]rohibiting arbitrators from awarding punitive damages under any circumstances, but providing a procedure for a prevailing party in arbitration to seek punitive damages in a subsequent court proceeding (which procedure might be made available (a) generally, or (b) only if the parties expressly reference it in their agreement)." *Id.* at 24. As to the undesirability of bifurcated proceedings generally, see Constantine N. Katsoris, *The Securities Arbitrators' Nightmare*, 14 FORDHAM URB. L.J. 3 (1986).

[151] *See* George H. Friedman, *Punitive Damages in Securities Cases*, N.Y. L.J., May 2, 1991, at 3, 30; *see also* Katsoris, *supra* note 53, at 599.

expressed by the Court in *Garrity*.[152]

To make such review meaningful, however, a record of the proceedings must be kept; otherwise, later attempts to reconstruct what occurred during the arbitration proceedings would invariably result in an affidavit shoot-out.[153] Similarly, punitive awards should not only be in writing, but should also explain the grounds for their issuance.[154] Only with these safeguards can a reviewing body understand the rationale of a punitive award in order to judge its adequacy meaningfully .

3. The Securities Industry's Response

The securities industry, in contrast, argues against awarding any punitive damages on the grounds that the law has already made sufficient provisions for deterrence and punishment, which eliminates the need for exemplary damages.[155] Indeed, the industry contends that its heavy regulation at both the federal and state levels, supplemented by the industry's own self-regulating system,[156] already constitutes a significant and adequate deterrent by allowing for punishment of those activities that contravene industry rules and regulations.[157] Accordingly, the securities industry takes the position that the enforcement procedures resulting from such regulation

> serve the needs of society to hold out as examples those who violate the mores of the industry. This is done in a very public forum with all of the due process safeguards and is a far better manner than any private arbitration or, for that matter, private civil suit, could

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[152] *See supra* notes 135-37 and accompanying text.

[153] *See* Katsoris, *supra* note 53, at 600; *see also supra* notes 71-73 and accompanying text.

[154] *See* Katsoris, *supra* note 53, at 600. It is interesting to note that some states are considering claiming a percentage of punitive awards issued in arbitration. *See* Douglas Wilson, *Florida Wants Share of Arbitration Award*, NAT'L L.J., Apr. 12, 1993, at 15.

[155] For example, injunctive relief is available in equity to deter continued wrongdoing. *See* SCHLUETER & REDDEN, *supra* note 129, § 2.2(a)(2), at 28.

[156] Organizations such as the NASD, the NYSE and various other SROs act as internal regulators of the securities industry. *See supra* note 70 and accompanying text.

[157] *See* William J. Fitzpatrick, Address of the General Counsel of the Securities Industry Association Before the New York County Lawyers Association (May 29, 1991) (on file with the *Brooklyn Law Review*).

ever accomplish.[158]

Needless to say, investors and their representatives do not share this conclusion as to punitive damages.[159]

4. The Supreme Court's Response

The debate over whether to award punitive damages, however, is not limited to securities arbitration. Indeed, other industries, businesses and professions have also wrestled with the propriety and effects of punitive damage awards.[160] As a result, judges and scholars alike have been raising and debating fundamental questions in an attempt to determine when and how punitive damages should be awarded. For example, what are the guidelines for imposing such damages? When are they justified? Even when justified, are they excessive, and do they therefore defeat the punitive or deterrent effect that they originally sought to accomplish? To date, no clear resolution is in sight. Rather, it often appears as though the courts and legislatures were creating a *"Tower of Babel"*[161] by discussing the issues in differing languages and dialects.

Especially troublesome in this whole area is the uncertainty surrounding the excessiveness of punitive damage awards. Indeed, a few years ago that very issue was vividly raised before the United States Supreme Court in *Pacific Mutual Life Insurance Company v. Haslip*.[162] In upholding a punitive dam-

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[158] *Id.*

[159] *See* Stuart C. GOLDBERG, PIABA'S 1991 REPORT ON PUNITIVE DAMAGES IN SECURITIES ARBITRATION 2 (1991) ("In the final analysis, securities arbitration without the possibility of punitive damages being awarded in egregious cases, would be no more effective in discouraging grossly fraudulent conduct than would be a grand larceny auto theft statute that limited punishment upon conviction to divestiture of the stolen car."); *see also* Raytheon Co. v. Automated Business Sys., Inc., 882 F.2d 6, 12 (1st Cir. 1989) ("[P]unitive damages serve as an effective deterrent to malicious or fraudulent conduct. Where such conduct could give rise to punitive damages if proved in court, there is no compelling reason to prohibit a party which proves the same conduct to a panel of arbitrators from recovering the same damages."); Thomas Watterson, *Vulnerability Fate of Widows and Widowers*, BOSTON GLOBE, Sept. 9, 1991, at 20.

[160] *See* Katsoris, *supra* note 53, at 573.

[161] *Id.* According to *Genesis*, Babel is a biblical city where the building of a tower was interrupted by the confusion of languages. *See Genesis* 11:1-9; *see also* WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 122 (1989).

[162] 499 U.S. 1 (1991).

age award, which was about *four times* the compensatory damages, the Court left undecided the extent to which "due process" acts as a check on a jury's discretion to award punitive damages in the absence of any express statutory limit.[163] In a dissenting opinion, however, Justice O'Connor pointed out that:

> [U]nlimited jury discretion—or unlimited judicial discretion for that matter—in the fixing of punitive damages may invite extreme results that *jar one's constitutional sensibilities* . . . . We need not, and indeed we cannot draw a mathematical straight line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case. We can say, however, that general concerns of reasonableness and adequate guidance from the court when the case is tried to a jury properly enter the constitutional calculus.[164]

The issue of excessiveness recently was again raised before the United States Supreme Court in *TXO Production Corp. v. Alliance Resources Inc.*[165] In that case, the compensatory damages were $19,000 and the punitive damages were $10,000,000, *a ratio exceeding 526 times the compensatory damages*[166]—seemingly clearly capable of jarring one's "constitutional sensibilities." Yet, in a 6-3 decision, the Supreme Court upheld the award[167] and, unfortunately, shed little light on this troubled area.[168] Indeed, Justice O'Connor, who dissented

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[163] Although the jury award was not broken down, it appears that over 80% of the more than one million dollar verdict was punitive in nature. *Id.* at 6 n.2; *see also* Pacific Mutual Life v. Haslip: *Supreme Court Refuses to Specify Due Process Standards for Awarding Punitive Damages*, 4 SEC. ARB. COMMENTATOR 1, 5 (Jan. 1991); Sanjit S. Shah, Note, *Can Punitive Damages Withstand a Due Process Challenge After* Bankers Life & Casualty Co. v. Crenshaw *and* Browning-Ferris Industries of Vermont v. Kelco Disposal?, 18 FORDHAM URB. L.J. 121 (1990).

[164] 499 U.S. at 18 (emphasis added).

[165] 113 S. Ct. 2711 (1993).

[166] *See* Debra Cassens Moss, *The Punitive Thunderbolt*, ABA J., May 1993, at 88.

[167] *TXO*, 113 S. Ct. at 2722-23. Apparently the plurality of the Court partly justified the punitive award by comparing it to *expected* gain or *potential* harm. In other words, the focus should not merely be on the $19,000 that claimant spent fighting a frivolous lawsuit (actual damages), but on the approximately several millions of dollars that claimant stood to lose had it not managed to defend itself and preserve its right to royalties. *See* Linda Greenhouse, *Court Again Rejects a Limit on Punitive Damages*, N.Y. TIMES, June 26, 1993, at 8.

[168] *See* Rick Ryder, TXO Production v. Alliance Resources: *The Promise Fades—Last Word on Punitive Damages?* 5 SEC. ARB. COMMENTATOR 1 (June 1993); *see also* Joseph C. Sweeney, *Supreme Court Again Rejects Constitutional Limits on Punitive Damages*, 10 LLOYDS MARITIME L. NEWSLETTER, 1-2 (July 1,

in *Haslip*, again dissented in *TXO*, stating:

> The plurality opinion erects not a single guidepost to help other courts find their way through this area. Rather, quoting *Haslip*'s observation that there is no 'mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable,' . . . the plurality abandons all pretense of providing instruction and moves directly into the specifics of this case.
>
> I believe that the plurality errs not only in its result but also in its approach. Our inability to discern a mathematical formula does not liberate us altogether from our duty to provide guidance to courts that, unlike this one, must address jury verdicts such as this on a regular basis. On the contrary, the difficulty of the matter imposes upon us a correspondingly greater obligation to provide the most coherent explanation we can. I agree with the plurality that we ought not adopt TXO's or respondents' suggested approach as a rigid formula for determining the constitutionality of punitive damages verdicts. But it does not follow that, in the course of deciding this case, we should avoid offering even a clue as to our own.[169]

Although the *TXO* decision is not a securities case and does not involve arbitration, it is directly concerned with the due process limitations, both procedural and substantive, on punitive damages awards.[170] Thus, between *TXO*'s silence as to guidelines, and *Garrity*'s[171] prohibition regarding awardability, the *"Tower of Babel"* lives on with respect to punitive awards in securities arbitration.[172]

In order to strengthen the hand of arbitrators in awarding punitive damages, at its January 1992 meeting, SICA added subdivision (h) to section 28 of the Uniform Code specifically to provide that the *"arbitrator(s) may grant any remedy or relief that the arbitrator(s) deem just and equitable and that would have been available in a court with jurisdiction over the matter."*[173] Unfortunately, no SRO board has yet approved this change, no doubt due to the reported strong industry lobbying by the SIA.[174]

In the meantime, the NASD—grappling with SICA's man-

1993).

[169] *TXO*, 113 S. Ct. at 2731-32.

[170] *See generally* Ryder, *supra* note 168.

[171] *See supra* notes 135-44 and accompanying text.

[172] *See supra* note 161 and accompanying text.

[173] *See* UNIF. CODE OF ARB. § 28(H); *see also Punitive Damages-In Brief*, 4 SEC. ARB. COMMENTATOR 10, 14, 15 (Apr. 1992).

[174] *Id.*

date that arbitrators may grant any remedy or relief they deem just and equitable[175]—has undertaken to study a wide variety of options as to how to handle punitive damages in securities arbitrations, such as permitting the appealability of punitive awards either internally within the arbitration process or in court, or placing some sort of cap on punitive damages, such as two or three times compensatory damages, etc.[176] Certainly, the *TXO* decision does not make a resolution of this problem any easier.[177]

L. *SICA is not Perfect*

Once in a while, a rule slips through SICA which hopefully will not survive a 19(b) filing.[178] Such a rule was recently approved by SICA at its January 1994 meeting where section 13 of the Uniform Code was amended by adding a new subdivi-

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[175] UNIF. COD OF ARB. § 28(h); *see also supra* notes 173-74 and accompanying text.

[176] *See Punitives at NASD*, 5 SEC. ARB. COMMENTATOR 11 (May 1993); *NASD Committee Readying Proposal to Address Punitive Damage Dispute*, SEC. WK., Aug. 31, 1992, at 3; *see also* Frank D. Ormsten, *Punitive Damages in Securities Arbitrations*, N.Y. L.J., Jan. 21, 1993, at 1. As between reviewability of punitive arbitration awards by the courts or internally within the SRO system, the former appears preferable, because an internal procedure would be met with skepticism and suspicion by the public. It is also interesting to note that in 1988, U.S. Representatives Boucher, Dingall and Markey supported legislation that would have expressly assured customers of the right to punitive damages in securities arbitration, but that provision was dropped from the bill. *See Punitive Award Survey*, 5 SEC. ARB. COMMENTATOR 1 (May 1993); *see also* Franklin, *supra* note 134, at 5.

[177] *See* Ryder, *supra* note 168, at 1; *see also* Linda S. Mullenix, *Questions Linger on Punitives and Evidence*, NAT'L L.J., Aug. 23, 1993, at S4; *NASD Takes Punitive Damage Issue to SEC; Adopts SICA'S Six-Year Eligibility Plan*, SEC. WK., July 26, 1993, at 1. Unfortunately, a judicial resolution does not seem imminent. *See* Tony Mauro, *The Shape of Business to Come*, LEGAL TIMES, Oct. 4, 1993, at S29.

> Even when the Court tries to be helpful to business, as with its long-standing effort to find something constitutionally wrong with high punitive damages, it fizzles in failure. Asked at a recent 8th Circuit conference whether the Court would take another punitive-damages case this term, Justice Sandra Day O'Connor asked dejectedly, "Why take another one and flap around again?"

Id.

[178] Under § 19(b) of the 1934 Act, each self-regulatory organization shall file with the SEC any proposed rule or change in the rules of such self-regulatory organization. 15 U.S.C. § 78s(b)(1) (1988 & Supp. IV 1992). Moreover, no such "proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection." *Id.*

sion (a) thereto.

The purpose behind the amendment (Attachment Rule) was to curb a growing practice of attaching irrelevant and/or extraneous materials to pleadings. Under the new rule, if one of the parties objects to such attachments and the issue cannot be resolved by the parties, the objectionable pleading shall be delivered to the SRO's Director of Arbitration for a ruling on the propriety of the attachments, and shall not be delivered to the arbitrators until the Director's ruling has been complied with. The rule specifically provides, however, that attachments that are redacted may still be offered into evidence at the hearing for the arbitrators' ruling. In this regard, the decision of the Director regarding the attachments may not be used by any party to support or oppose the admission of any disputed document to the arbitrators at the hearing.

The theory behind the amendment was to prevent the arbitrators from being infected by the poisoned fruit only during the interim period *before* the hearing, since they would probably see it at the hearing, if offered. Although the proposal has *some merit*, we must remember the basic attributes of arbitration are speed, economy, and fairness, both in fact and appearance.[179] Thus, the proposed rule must be measured against other alternatives or consequences that may arise or be considered. First of all, it would appear that one could easily circumvent the attachment procedure by simply putting highlighted excerpts and quotes of prospective attachments in the *body* of the pleading. Is the Director or Arbitration next going to be asked to search and destroy portions of the pleading proper? Such a course would hardly be advisable.

To the extent possible, SROs should not be making substantive judgmental decisions because SROs are still perceived by many as being a forum supported by the securities industry. Thrusting SRO personnel into motion pleading practice would only add to their suspicion. These types of decisions should be left to the panel, the majority of whom are public members.[180] Admittedly, *arbitrators* could make such decisions *before* the first hearing, but even such a procedure would add some delay and expense to the process.

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[179] *See* Katsoris, *supra* note 27, at 430-31.

[180] Katsoris, *supra* note 27, at 434-35.

Furthermore, pleadings are not in evidence until so introduced into the record at the first hearing. Even then, arbitrators generally do not consider them for the truth or falsity of their contents, but merely as the pleader's allegations. Accordingly, any such objections to attachments could be expeditiously handled at the first hearing session before the arbitrators. In fact, when the pleadings go to the arbitrators, they could be clearly marked to highlight that the attachments are objected to. If arbitrators are incapable of handing so simple a task as to expunge from their minds excludable evidence, then they should not remain arbitrators. Moreover, although irrelevant attachments to pleadings are troublesome, it has been this author's experience that such attachments often have an additional, unintended effect—namely, they suggest a weakness in the pleader's case.

When the Attachments Rule was presented to SICA at its January 1994 meeting, it was enacted by the narrowest of margins. *Four* SROs and the SIA[181] voted for the Rule, *two* SROs abstained, and *all* four of the Public Members voted against it. When one further considers that there are 15 voting members of SICA,[182] and the Attachments Rule received only five affirmative votes (1/3 of the membership), *with total public opposition*, it can safely be said that this controversial rule does not carry a persuasive mandate. Accordingly, for the reasons expressed herein, this author respectfully suggests and urges the SEC to reject this rule under the theory that one does not seek to eliminate an annoying insect with an elephant gun.

IV. THE CONTINUING ROLE OF SICA AND THE NEED FOR UNIFORMITY

One of the principal reasons for the creation of SICA was to establish a uniform system of SRO arbitration which would gain the respect and confidence of the investing public.[183] Since the Code's adoption, SRO arbitrations steadily increased,

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[181] *See supra* note 26 and accompanying text.
[182] *See supra* notes 25-27 and accompanying text.
[183] *See supra* notes 20-39 and accompanying text.

rising from 830 cases in 1980 to 2837 in 1986.[184] In 1987, the United States Supreme Court with its landmark decision in *Shearson/American Express, Inc. v. McMahon*[185] effectively mandated thousands of securities disputes into SRO arbitration by holding that 1934 Act claims were arbitrable pursuant to pre-dispute arbitration agreements.[186] Indeed, in the year after *McMahon*, SRO arbitrations more than doubled to 6097 cases in comparison to the 2837 filed in the year before *McMahon*.[187]

It is noteworthy that in the majority opinion in *McMahon*, Justice O'Connor reflected upon the previous "*mistrust* of arbitration that formed the basis for the *Wilko* opinion in 1953."[188] Similarly, in a dissenting opinion, Justice Blackmun pointed out that:

> It is true that arbitration procedures in the securities industry have improved since Wilko's day. *Of particular importance has been the development of a code of arbitration by the Commission with the assistance of representatives of the securities industry and the public. See* Uniform Code of Arbitration, Exch. C, Fifth Report of the Securities Industry Conference on Arbitration 29 (Apr. 1986) (Fifth SICA Report).[189]

Furthermore, in discussing the importance of SICA's Uniform Code, Justice Blackmun noted:

> This Code has been used to *harmonize* the arbitration procedure among the SROs. Constantine N. Katsoris, *The Arbitration of a Public Securities Dispute*, 53 Fordham L. Rev. 279, 283-284 (1984) (Katsoris). As the Commission explained: [T]his [Code] marks a substantial improvement over the various arbitration procedures currently being utilized by the securities industry and represents an important step towards establishing a *uniform system* for resolving investor complaints through arbitration. SEC Exchange Act Rel. No. 16390 (Nov. 30, 1979). 44 Fed. Reg. 70616, 70617.[190]

The significant impact of the Uniform Code upon SRO arbitrations is unquestionable. The attributes of uniformity and fairness are vital to this impact. Inconsistences among

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[184] *See* SEVENTH REPORT, *supra* note 39, at 28.
[185] 482 U.S. 220 (1987); *see also supra* notes 5-19 and accompanying text.
[186] *See supra* notes 12-15 and accompanying text.
[187] *See* SEVENTH REPORT, *supra* note 39, at 28.
[188] 482 U.S. at 233 (emphasis added).
[189] *Id.* at 258 (emphasis added).
[190] *Id.* (emphasis added).

SRO codes leads to confusion and forum shopping, and often constitute a trap for the unwary.[191] Unfortunately, not *all* sections of the Code have been adopted by the SROs. For example, *no* SRO code has adopted the SICA requirement that the pre-dispute arbitration clause be separately initialed.[192] Similarly, no SRO has yet adopted SICA's rule, *enacted over two years ago*, that arbitrators may grant "any relief they deem just and equitable."[193]

These examples of *inaction* are unfortunate, because they undermine SICA's efforts to achieve a level playing field. Even worse, however, is when SROs *affirmatively* by-pass SICA and seek rule changes on their own. This is particularly unfortunate since through its Public Members, together with the SEC's oversight of the SROs, SICA is a mechanism with which most of the public seems comfortable. In this connection, the Public Members of SICA have in the past welcomed,[194] and continue to welcome,[195] comments and suggestions to improve the SRO process.

Recently, the NASD, *sua sponte*, proposed to the SEC a rule change (Offer Rule) that permits parties in arbitration proceedings involving at least $250,000 in total damages to make pre-hearing settlement offers.[196] The proposed rule change would expire after two years.[197] It would *require* parties who reject such settlement offers to pay the offering party's reasonable costs (including expert witness fees) and attorneys fees incurred after the offer was made, if the award granted in the arbitration was not more favorable to the rejecting party than the settlement offer.[198] Although this proposal on its face would seem to encourage settlements of large and costly disputes, it was the unanimous conclusion of all of the Public Members of SICA that, on balance, such a rule change could have an unwelcome and decidedly coercive effect upon

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[191] *See* Katsoris, *supra* note 27, at 452-54.

[192] UNIF. CODE OF ARB. § 31; *see* SEVENTH REPORT, *supra* note 39, at 23.

[193] UNIF. CODE OF ARB. § 28(h); *see Punitive Damages-In Brief*, *supra* note 173; *see also supra* notes 173-74 and accompanying text.

[194] *See* 3 SEC. ARB. COMMENTATOR 9, 19 (Sept. 1990).

[195] *See Make The Connection!*, 5 SEC. ARB. COMMENTATOR 7, at 18 (May 1993).

[196] *See* Exchange Act Release No. 33,081 (Oct. 20, 1993).

[197] *Id.*

[198] *Id.*

public claimants to settle because of the risk of being assessed with excessive costs and attorneys fees of the opposing party.[199] Moreover, since the threshold sum of $250,000 includes

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[199] *See* Public Members' Comment Letter (Comment Letter) to the SEC dated November 16, 1993 (on file with the *Brooklyn Law Review*). This letter was submitted by Public Members Peter R. Cella, Justin P. Klein and the author. The fourth public member, James E. Beckley, who also opposed the Offer Rule, responded to the SEC under separate cover:

> The NASD's proposed amendment is modeled after rule 68 of the Federal Rules of Civil Procedure, a wholly different procedural system than that in arbitration. The thorough and extensive disclosure required under the federal rules (and as well the array of sanctions available and often used against parties reluctant to make disclosure) are not available in arbitration. Indeed the very limited sanctions provided for are rarely, if ever utilized by arbitrators, in the not uncommon occurrence of industry members refusing or otherwise evading disclosure.
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> Thus, the opportunity of a claimant to fully evaluate his or her claims in arbitration is severely hampered. Without that opportunity a claimant cannot possibly assess the basis, indeed the essential fairness of an offer of award. To the contrary it is the industry respondent who starts out in the arbitration process with all relevant documentation and immediate access to the registered representative, branch managers, compliance personnel and files, investigative and otherwise. The proposed amendment would give respondents an unfair advantage in utilizing an offer of award to negotiate unfairly from a position of strength. Further, in our view, it would continue to encourage the tactic of refusing or otherwise evading discovery requests.
>
> The proposed amendment would also be coercive of claimants. The federal rule provides only for *costs* in the event an offeree fails to prevail after a rejection of an offer. The NASD proposal would include attorney's fees, along with the myriad of other costs amongst which would be that of experts. Industry attorneys and experts are compensated on a substantial hourly fee basis that grows quickly. Such expenses are and have been a cost of doing business for broker-dealers. The proposal would provide not only a recapture of these costs but a weapon against claimants who having already lost substantial monies and would be threatened, indeed fearful of the "penalty" they could incur for pursuing their claims. One can envision circumstances where exorbitant industry litigation costs would exceed a claim.
>
> In addition to the foregoing deficiencies it must be pointed out that if the proposal were adopted and aggressively utilized as we believe it would, arbitration panels would be obliged to hold an additional bitterly contested hearing to consider what constitutes reasonable attorney and expert witness fees (including costs) for the purpose of assessment against a claimant.
>
> The threshold of $250,000.00 in the proposed amendment includes of course all sums claimed as punitive damages. Thus the proposal has the immediate probable effect of compelling claimants to reduce or eliminate a punitive damage claim so as to avoid crossing the threshold and being subjected to an offer of award. It would, if implemented, virtually eliminate punitive damage claims.

punitive damages, the proposed rule would have the additional effect of "compelling claimants to reduce or eliminate a punitive damage claim so as to avoid crossing the threshold and being subjected to an offer of award."[200]

When a proposal similar to the Offer Rule was first raised at a SICA meeting, it found virtually no support among the other SICA members, which include the arbitration directors of the SROs. Indeed, a recent article in Business Week denounced the Offer Rule as adding "a new element of unfairness to a system that already tilts toward brokers."[201]

In addition, there recently appeared an announcement that the NASD also will propose its *own* rule change dealing with large and complex cases.[202] Although at the present time this author will not comment on the possible merits of this latest proposal, he merely wishes to note this additional example of go-it-alone rule changing.

Of even greater importance than the issue of whether the SEC approves the two NASD proposed rule changes, however, is the troublesome manner in which they are being submitted for SEC approval. If the recent NASD lone-ranger approach is heralding a new era of go-it-alone changes which by-pass SICA, then the very integrity of and effectiveness of SICA is at stake. Coincidentally, it has recently been suggested that, because the Uniform Code was extensively updated after *McMahon*, SICA's role has diminished, implying that like old soldiers it should fade away.[203] The scenario then suggests that in the interest of uniformity and economy that all the SROs—other than the NASD—abandon their public arbitration

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Id.

[200] *Id.*

[201] *See* Michael Schroeder, *Wall Street Should Stop Playing The Bully*, BUS. WK., Dec. 20, 1993, at 92; *see also NASAA opposes NASD Proposal on Arbitration Settlement Offers*, 26 Sec. Reg. & L. Rep. (BNA) 75 (Jan. 27, 1994); Richard Karp, *Wall Street's New Nightmare*, BARRON'S, Feb. 21, 1994, at 15.

[202] *See NASD Will Propose Special Arbitration To Cover Some Cases*, WALL ST. J., Dec. 6, 1993, at A9A ("The special procedures have been approved by the NASD board and, will be forwarded to the Securities and Exchange Commission for its approval, said Mr. Curzon, who will draft the proposal for the SEC."); *see also NASD Proposal for Large Arbitrations Would Let Parties Decide Panel's Pay*, 25 Sec. Reg. & L. Rep. (BNA) 1662 (Dec. 10, 1993).

[203] *See* Letter from William J. Fitzpatrick, General Counsel of the SIA (Dec. 22, 1993) (on file with the *Brooklyn Law Review*); *see also Feedback*, 4 SEC. ARB. COMMENTATOR 2, 6 (Feb. 1993).

programs, leaving the public securities arbitration function thereafter solely to the NASD.[204] The suggestion is ludicrous because SROs, by their very makeup, lack the structural independence necessary to insure public confidence.[205]

Indeed, as the arbitrable issues expand (i.e., employment issues), and as the stakes grow (i.e., larger awards and punitive damage issues), the public will demand more and more that the *rules* of the battle be set by an independent group. At the recent Attachments Rule meeting, twenty-four specific items were listed on SICA's agenda for discussion—hardly the sign of a fading soldier. But even if its agenda items were to diminish, SICA's *very presence*, like the cop on the beat, is at least reassuring.

SICA's stabilizing influence, together with the SEC's oversight role, has reinjected investor confidence in the SRO arbitration system. Just as the investing public is well served by an independent Financial Accounting Standard Board ("FASB") in the formulation of financial reporting rules (with similar SEC oversight),[206] so too is it well served by an independent SICA in establishing and maintaining a level playing field (with SEC oversight) should a controversy arise.

To eliminate SICA now either through a *de jure* dismantling,[207] or by rendering it useless by *de facto* circumventing its role in rulemaking,[208] would be regrettable. Such a course eventually would undermine the public's confidence in the SRO process itself, and rekindle—justifiably or not—the image of a deck stacked in favor of the securities industry.[209] Should that

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[204] Letter from Willaim J. Fitzpatrick, *supra* note 203.

[205] *See* Katsoris, *supra* note 27, at 472-77.

> An independent forum entails exactly what it indicates—a forum independent from actual, inferential, subtle, practical or any other kind of imaginable pressure. The forum should be independent of the industry, independent of the plaintiff's bar, and other than the SEC's general oversight role, independent of that regulatory body. Similarly, individual arbitrators and the forum staff must be free from such influences or pressures.

Id. at 475.

[206] *See* Katsoris, *supra* note 20, at 312 n.259.

[207] *See supra* notes 203-04 and accompanying text.

[208] *See supra* notes 196-202 and accompanying text.

[209] See the dissenting opinion of Justice Blackmun in *McMahon*: "The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be some truth to the investors belief that the securities industry has an advantage in a forum un-

event unfortunately occur, perhaps the *McMahon* decision would have to be revisited, either judicially or legislatively.[210]

CONCLUSION

Because courts are furnished by the government itself, many claimants consider them to be more neutral forums than arbitrations conducted before SROs, which are perceived to be supported by the securities industry itself.[211] Yet, after studying nearly two thousand arbitration cases brought by consumers against brokers in 1989-90, the General Accounting Office ("GAO"), which conducts investigations for Congress, found "no indication of a pro industry bias" in decisions at industry sponsored forums.[212] Indeed, the GAO also found that investors won about sixty percent of their arbitration cases, with awards also averaging about sixty percent of the amounts claimed.[213] Thus, it would appear that the *McMahon* court's confidence in arbitration so far has been justified.[214]

Professor Poser's conclusion as to the viability of securities arbitration is indeed welcome news. The alternative of throwing thousands of cases back to congested court calendars is certainly not the answer. In such a scenario, the securities industry would be plagued by excessive litigation costs, which either directly or indirectly would be borne by the public as the industry's cost of doing business. In addition, the public would often be denied justice because of the excessive costs and delays associated with courtroom litigation.[215] Yet, although Pro-

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der its own control." 482 U.S. at 261 (citing N.Y. TIMES, Mar. 9, 1987, § 3, at 8 (quoting statement of Sheldon H. Elsen, Chairman, American Bar Association Task Force on Securities Arbitration: "The houses basically like the present system because they own the stacked deck")).

[210] *See supra* notes 188-90 and accompanying text; *see also* Constantine N. Katsoris, *SICA Does the Bell Toll for Thee?*, 6 SEC. ARB. COMMENTATOR 1, 1 (Jan. 1994).

[211] *See* Katsoris, *supra* note 27, at 452-53.

[212] *See* GAO REPORT, *supra* note 104, at 7; *see also* Michael McGowan, *See You in Arbitration*, ABA J., May 1993, at 110.

[213] *See* GAO REPORT, *supra* note 104, at 7.

[214] *See supra* notes 6-19 and accompanying text.

[215] *See* Stephen Labaton, *New Tactics in the War on Drugs Tilt Scales of Justice Off Balance*, N.Y. TIMES, Dec. 29, 1989, at A1 ("'We're becoming drug courts,' says Edward R. Becker, a Federal appeals judge in Philadelphia . . . . , 'The short of it is that we're getting an enormous volume of drug cases, and its making it very

fessor Poser's optimism is well founded, the process will work only so long as the playing field remains level for all. Vigilance, therefore, must constantly be exercised in order to maintain such equilibrium and confidence.[216] In this regard:

> To insure . . . public investment we must retain the public's confidence—confidence in the markets themselves and confidence that should a dispute arise, it will be fairly resolved. This confidence, however, can only be earned by maintaining a *de facto* as well as a *de jure* image of fairness. In other words, the procedural rules must be fair and the administration of the forum must be objective and independent.[217]

Notably looking out for the public investors' interests are SICA and the SEC, which maintains oversight of the SRO operations and is a frequent guest at SICA meetings. In addition, SICA has issued Seven Reports to the SEC regarding its activities, and the Eighth is now being prepared. Moreover, in the past the Public Members of SICA have welcomed,[218] and continue to welcome,[219] comments and suggestions to improve the SRO process.

In the final analysis, however, one can never become complacent and feel as though we have achieved the perfect system, for in a less than perfect world, "[l]aws and institutions are constantly tending to gravitate. Like clocks, they must be occasionally cleansed, and wound up, and set to true time."[220]

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difficult in many jurisdictions to hear civil cases."); *see also* Tim Smart, *The Federal Courts Have a Drug Problem*, BUS. WK., Mar. 26, 1990, at 76; Usa Wein, *Drastic Moves Urged to Ease U.S. Court's Load*, N.Y. TIMES, Mar. 23, 1990, at B5. Indeed, in California, the Los Angeles County Bar Association filed suit in federal court to appoint more state court judges because it takes about five years for a civil case to come to trial. *See* Paul Marcotte, *L.A. County Bar Sues California*, A.B.A. J., 28 (1988); *see also Lawsuits in Federal Courts*, N.Y. TIMES, July 16, 1987, at B6; Marianne Lavell, *Congress Now Considering Dispute Resolution Measures*, NAT'L L.J., Feb. 5, 1990, at 1; Arthur L. Penzel, *Alternative Dispute Resolution Offers Solution to Overwhelming Caseloads*, N.Y. L.J., May 3, 1993, at 58; Randall Samborn, *In Courts: Caseloads Still Rise*, NAT'L L.J., July 5, 1993, at 10.

[216] *See* Statement of Constantine N. Katsoris before The Securities and Exchange Commission (Dec. 8, 1977) (on file with the *Brooklyn Law Review*).

[217] *Id.*

[218] *See Make the Connection!*, 3 SEC. ARB. COMMENTATOR 19 (Sept. 1990).

[219] *See Make the Connection!*, 5 SEC. ARB. COMMENTATOR 18 (May 1993).

[220] HENRY WARD BEECHER, LIFE THOUGHTS 129 (1858).