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The Betrayal of McMahon

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THE BETRAYAL OF *McMAHON**

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The controversy over the awarding of punitive damages by arbitrators is not limited to securities disputes. Other industries, businesses and professions have also wrestled with the propriety and effects of punitive damage awards. What makes securities arbitration somewhat unique, however, is that the vast majority of such disputes are filed at Self Regulatory Organizations ("SROs"), such as the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE"), which are subject to the oversight of the Securities and Exchange Commission ("SEC"). Some securities disputes are also filed at the American Arbitration Association ("AAA"), which is not subject to SEC oversight.

As a result, differing rules evolved for SRO arbitrations than those applicable at the AAA. Indeed, before 1977, many differences also existed among the arbitration rules of the various SROs. Accordingly, with SEC blessing, the Securities Industry Conference on Arbitration ("SICA") was created in 1977 to, *inter alia*, bring uniformity to the SRO arbitration process.[1] Shortly after its creation, SICA developed a Uniform Code of Arbitration ("Uniform Code" or "U.C. Arb."), which was adopted by all of the participating SROs. Since then, SICA has met regularly and continues to monitor the performance of SRO arbitration, amending the Uniform Code as the need arises. The SEC and the AAA, among others, have been regularly invited guests at SICA meetings.

To a large extent, uniformity of SRO arbitration procedures has been achieved. This uniformity, together with SICA's diversified composition and open discussion of issues over the past twenty

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1. SICA presently consists of ten SROs, three public members, and the Securities Industry Association (SIA). The SIA is a trade association for the securities industry. *See* James E. Buck, Statement of the New York Stock Exchange Before the Securities Exchange Commission Hearing on Release No. 34-12974, at 5 (Feb. 9, 1977) (on file with the Fordham Urban Law Journal) (testimony of the Secretary of the NYSE urging the creation of SICA). "[T]he Exchange does believe that the development of a uniform system of arbitration to be used by the self-regulatory agencies would be in the interest of investors and the securities industry." *Id.* at 3.

years, has gone a long way towards dispelling mistrust and anxiety on the part of public investors, the courts and regulators about the fairness of the arbitration process.[2] Unfortunately, recent events threaten to undermine SICA's efforts toward maintaining uniformity. One such divisive issue is the awardability of punitive damages in arbitration.

The Garrity Prohibition

In 1976, the year before SICA was created, the New York Court of Appeals rendered its decision (4-3) in *Garrity v. Lyle Stuart, Inc.*,[3] which prohibited arbitrators from awarding punitive damages, "even if agreed upon by the parties."[4] This decision took on added significance because many pre-dispute arbitration agreements contained a New York choice of law clause, regardless of where the customer resided or the transaction took place. Initially, however, the issue of punitive damages was not that pressing, because before 1987, arbitration was largely voluntary on the public's part. That changed with the Supreme Court's decision in *Shearson American Express, Inc. v. McMahon*,[5] which upheld the enforceability of pre-dispute arbitration agreements as to claims under the Securities Exchange Act of 1934 and forced most public customers into arbitration. Thus, after *McMahon*, greater focus was placed upon the *Garrity* decision, and its extra-territorial effect through the use of a New York choice of law clause.

Indeed, because various restrictive conditions were beginning to creep into pre-dispute securities arbitration agreements, in 1989 SICA amended §31(d) of its Uniform Code to prohibit any condition in pre-dispute arbitration agreements that "limits the ability of arbitrators to make any award."[6] Despite that amendment, however, no SRO rule *directly* authorized punitive damages, whereas a AAA rule *specifically* provided that arbitrators may award "any

2. *See* Constantine N. Katsoris, *The Level Playing Field*, 17 FORDHAM URB. L.J. 419 (1989)[hereinafter *Level Playing Field*].

3. 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (N.Y. 1976).

4. 40 N.Y.2d at 357, 353 N.E.2d at 795, 386 N.Y.S.2d at 833.

5. 482 U.S. 220 (1987). Before *McMahon*, the prevailing view was that claims under the 1934 Act could not be forced into arbitration partly because of the reservations expressed by the Supreme Court in *Wilko v. Swan* about the reliability of arbitration. 346 U.S. 427 (1953). *See* Constantine N. Katsoris, *Securities Arbitration After McMahon*, 16 FORDHAM URB. L.J. 361, 367-68 (1988).

6. EIGHTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION 24 (June 1994) [hereinafter EIGHTH REPORT].

remedy or relief which the arbitrators deem just and equitable and within the scope of the agreement of the parties . . . ."[7]

In 1991 the U.S. Court of Appeals for the Second Circuit, in *Fahnestock v. Waltman*,[8] affirmed the dismissal of a punitive damage award issued by a NYSE panel, noting that the result might have been different if the NYSE's rules on arbitral authority were as broad as the AAA's.[9] In response to the *Fahnestock* reference regarding arbitral authority, SICA added a new subdivision (h) to section 28 of the Uniform Code which provided that arbitrators could grant any remedy or relief that the arbitrators "deem just and equitable and that would have been available in a court with jurisdiction over the matter."[10] Unfortunately, no SRO board approved this change, largely due to the strong lobbying of the Securities Industry Association ("SIA").

Predictably, the turmoil over punitive damages continued in the courts. In 1994, both the NYSE and the NASD announced plans to address this and other troublesome issues facing SRO arbitrations. The NYSE held a two-day symposium where these issues were openly debated by a wide spectrum of leading experts in the field and, based upon such discussions, issued recommendations in the form of a Report.[11]

The NASD also sought to calm the troubled waters, but in a different way. In the Fall of 1994, the NASD announced the formation of its own Arbitration Task Force ("Ruder Committee" or "Task Force") to explore and propose broad reforms to the arbitration process, including the contentious issue of punitive damages.[12]

7. American Arbitration Association Securities Rule 45 (1997).

8. 935 F.2d 512 (2d Cir. 1991).

9. *Id.* at 519.

10. EIGHTH REPORT, *supra* note 6, at 21.

11. *See* Symposium, *New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry*, 63 FORDHAM L. REV. 1495, 1507-08 (1995) [hereinafter NYSE SYMPOSIUM]. The NYSE Symposium was held in the Fall of 1994. On May 30, 1995, the NYSE issued a Report thereon which listed recommendations and conclusions [hereinafter NYSE REPORT]. As to comments in response to the issues raised by the NYSE Report, *see* Robert S. Clemente, Director of Arbitration at the NYSE, Remarks at Seminar, entitled *Securities Arbitration and Litigation: The Changing Landscape* (New York, N.Y., Apr. 29, 1996)(on file with the Fordham Urban Law Journal).

12. The Ruder Committee was headed by Professor David S. Ruder, former Chairman of the SEC, and included distinguished practitioners and academics, most of whom had a background in the securities industry. Of the eight Task Force members, one represented investors, two were senior executives at brokerage firms, and three were lawyers in firms representing brokerage firms. *See* Scot J. Paltrow, *NASD Panel Calls For Big Changes in Arbitration of Investor Disputes*, L.A. TIMES, Jan. 23, 1996, at 1.

The practical effect of this action by the NASD was to preclude SICA from seeking a solution to the punitive damage maze, because of the NASD's position to defer further discussion of this issue at SICA pending the issuance of its Task Force's findings.

Intervention of *Mastrobuono*

In 1995 the Supreme Court decided *Mastrobuono v. Shearson Lehman Hutton, Inc.*[13] *Mastrobuono* involved a punitive damage award by a NASD panel under an arbitration agreement which contained two seemingly inconsistent clauses: a New York choice-of-law provision and a clause broadly relegating *any controversy* between the parties to arbitration.[14] Neither of these clauses referred to punitive damages. In reversing the lower courts, the Supreme Court allowed the punitive award to stand, noting that the two controversial clauses created an ambiguity as to the parties' intent about punitive damages; and, relying on a rule of contract interpretation, reasoned that where an ambiguity exists, it will be construed against the party that drafted it, in this case Shearson.[15]

The SEC, in its *amicus brief* in *Mastrobuono* urged the Supreme Court to clarify the effect of §31(d) of the Uniform Code (Rule 21(f)(4) of the NASD Rules of Fair Practice) prohibiting any condition in arbitration agreements that "limits the ability of the arbitrators to make any award."[16] The Court, however, avoided the issue by noting that the agreement in *Mastrobuono* was signed in 1985, long before the 1989 amendment to §31, but also acknowledged that, absent any ambiguities, the parties can agree to restrict punitive damages.[17]

What, therefore, would prevent counsel for the securities industry from tightening their brokerage agreements by adding language prohibiting punitive damages? Such a unilateral insertion into what is already a contract of adhesion[18] would hardly constitute the free and willing *consent* on the part of the investing public intended

13. 115 S. Ct. 1212 (1995).
14. *Id.* at 1214.
15. *Id.* at 1219.
16. *Id.* at 1218 n.6.
17. *Id.* at 1216.
18. *See* Constantine N. Katsoris, *Punitive Damages in Securities Arbitration: The Tower of Babel Revisited*, 18 FORDHAM URB. L.J. 573, at 593-96 (1991) [hereinafter *Tower of Babel*]. *See also* Barry Meier, *In Fine Print, Customers Lose Ability to Sue*, N.Y. TIMES, Mar. 10, 1997, at 1 (discussing how the increased use of arbitration agreements in various types of businesses deprives the public of its right to sue).

by *Mastrobuono*. Furthermore, any such amendments seeking to restrict an arbitrator's power to grant punitive damages are sure to run afoul of the clear language of §31(d) of the Uniform Code which prohibits limiting "the ability of arbitrators to make any award".[19]

In the fall of 1996 the New York Appellate Division, First Department, in *Mulder v. Donaldson Lufkin & Jenrette*,[20] citing *Mastrobuono*, set the stage for a new era by lifting the *Garrity* prohibition against arbitrators awarding punitive damages. Thus, unless the parties have *clearly* and *freely* agreed otherwise, punitive damages are broadly awardable in arbitration, subject to appropriate state restrictions, if any.

The Ruder Committee Recommendations

In early 1996, the Ruder Committee, whose meetings and deliberations were shrouded in secrecy, issued its report ("Ruder Report") which was over 150 pages in length and contained scores of recommendations—most of which are quite constructive.[21] Unfortunately, the two most significant recommendations—(i) the imposition of a cap on punitive damages of two times compensatory damages, or $750,000, *whichever* is *less* (rigid cap rule); and, (ii) the elimination of the so-called six year rule[22]—met with significant

19. *See supra* note 6 and accompanying text. *See also* joint NASD/NYSE Information Memo/Notice to Members 95-16, which advised their members that they may not include provisions in customer agreements which can be construed as restricting or limiting the ability of customers to arbitrate or arbitrators' powers to issue awards (on file with the Fordham Urban Law Journal).

20. 224 A.D.2d 125, 648 N.Y.S.2d 535 (N.Y. App. Div. 1996). *See also* R.C. Layne Construction, Inc. v. Stratton Oakmont, Inc., 651 N.Y.S.2d 973 (N.Y. App. Div. 1996) (upholding a punitive damages award in a securities arbitration); Constantine N. Katsoris, *Mastrobuono Not the Last Word on Punitives*, 13 ALTERNATIVES 144 (Nov. 1995).

21. SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (Jan. 1996) [hereinafter RUDER REPORT].

22. The so-called six year rule stems from Section 4 of the Uniform Code of Arbitration and it sets a six year time limitation for the submission of a claim to arbitration from the time of the occurrence or event giving rise to the claim. EIGHTH REPORT, *supra* note 6, at 9. It was never intended as a bar to the claim in court and was inserted merely as a matter of administrative convenience at a time when: (i) arbitration was basically voluntary on the public's part; (ii) there were no formal discovery rules; and, (iii) limited partnerships, which have been the subject of much litigation since the late 1980's were not contemplated. *See* NYSE SYMPOSIUM, *supra* note 11, at 1534. Unfortunately, some courts have interpreted the six year rule as barring such claims. *Id.* To solve this misunderstanding, SICA, on July 12, 1996, *unanimously* agreed to a bright line test as to when the six year period began; and, if the claim was not eligible for submission to arbitration, it would survive to be heard in court. *See*

opposition at SICA and elsewhere, including all of the Public Members of SICA.[23]

At a meeting on January 28, 1997, the Board of Governors of the NASD approved, in concept, an amendment regarding the six year rule that more resembled the solution agreed to at SICA than the Ruder Committee's recommendation;[24] and, for this, the NASD Board of Governors is to be commended. Unfortunately, however, despite significant opposition, the NASD Board of Governors continued to press for the rigid cap rule.[25] By way of comparison, no other SRO, nor the AAA has placed or (to this author's knowledge) is considering a similar cap on punitive damages.[26] Even the NASD's timing is awkward, seeking to impose this restriction on the public after the *Mastrobuono* and *Mulder* cases clearly sanctioned the public's right to receive punitive damages in arbitration.

From the investor's point of view, a rigid limit of $750,000 must be rejected out of hand, since it is totally inadequate in situations

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Proposal to SICA by Paul Dubow, Esq. (SIA representative at SICA) and Tom Grady, Esq. (Public Member at SICA) (on file with the Fordham Urban Law Journal). *On the other hand*, the Ruder Committee recommended eliminating the six year rule altogether (which by itself is favorable to the public), *but only* in exchange for other restrictions that are detrimental to the public. Unfortunately, the Ruder Committee's recommended elimination of this troublesome rule was tied to a potpourri of conditions that, in the aggregate, are far more burdensome than the six year rule itself, namely: (i) that arbitrators be *required* to apply the law of statutes of limitation; (ii) that arbitrators write reasoned decisions on statute of limitation issues; (iii) the imposition of an elaborate early disposition motion practice on statute of limitation issues which could be used to harass investors; and, (iv) encouraging that these motions be decided on the papers. RUDER REPORT, *supra* note 21, at 22-33. *See also* Constantine N. Katsoris, *Ruder Report is a Delicate Compromise*, 14 ALTERNATIVES 29 (Mar. 1996) [hereinafter *Delicate Compromise*].

23. The opposition by the Public Members has been expressed to the NASD on numerous occasions, including: (i) the SICA meeting held at Fordham Law School on February 8, 1996; (ii) at the special SICA meeting held at the NASD on November 8, 1996; and, (iii) in a joint letter on December 9, 1996 to Chairman Daniel P. Tully, of the Board of Governors of the NASD (on file with the Fordham Urban Law Journal). See also *Reactions to Ruder Report*, SEC. ARB. COMMENTATOR, March, 1996, at 1; *PIABA Conference: Ruder Commission Issues*, SEC. ARB. COMMENTATOR, Nov. 1996, at 1; Thomas J. Stipanowich, *NASD Should Reconsider Its Punitive Cap*, 15 ALTERNATIVES 13 (Feb. 1997).

24. *See supra* note 22 and accompanying text. *See also Stock Regulators Reconsider Plan*, N.Y. TIMES, Jan. 30, 1997, at 8; *NASD Acts On Key Arbitration Proposals Concerning Punitive Damages, Eligibility*, 29 SEC. REG. & L. REP. 124 (Jan. 31, 1997); *NASD Parent Board Turns to SICA-Modified Version of the Six-Year Eligibility Rule*, SEC. ARB. COMMENTATOR, Feb. 1997, at 4 [hereinafter *SICA-Modified Version*].

25. *See supra* notes 22-23 and accompanying text. *See also NASD Parent Board Ratifies Punitive Caps Proposal*, SEC. ARB. COMMENTATOR, Feb. 1997, at 4 [hereinafter *Punitive Caps Proposal*].

26. *See* Katsoris, *Delicate Compromise*, *supra* note 22, at 29.

involving large compensatory awards. In this regard, the rigid cap rule is unlike the tort reform bill enacted last year in Congress—and rejected by the President—in that said tort reform bill did not have an arbitrary rigid ceiling, but rather sought to impose a flexible punitive damage limit of $250,000 or two times compensatory damages, *whichever is greater.*[27] The Task Force seeks to justify its two tiered cap, whichever is *lower*, saying that it "will protect broker-dealers from 'runaway' awards that have *no relationship* to compensatory damages."[28] Yet, the Task Force fails to apply that *same* standard to its own proposed remedy. For example, what *relationship* does a $750,000 punitive damage award have to a *$20 million* compensatory award? To impose an arbitrary cap on punitive damages in arbitration which bears no relationship to the injury inflicted and which is not similarly imposed in court condones unconscionable conduct and relegates arbitration to a second class forum—a result never intended by *McMahon.*

It has also been suggested that the Ruder Report is a mosaic of compromised remedies, delicately balanced by the Task Force to forge consensus in resolving the many differing problems prevalent in SRO arbitration, and that a challenge to any of the parts would destroy the cohesiveness of this mosaic.[29] Indeed, it has more recently been suggested that the two most significant and controversial issues covered by the Ruder Report—the six year rule and the punitive damage cap—were paired against each other. "We believe the compromise we have finally gotten goes part way to satisfying both of our constituencies—investors and member firms . . . . [I]t does not give either side everything they want."[30] In point of fact, neither of the Ruder Committee's recommendations involving the six year rule or the cap on punitive damages favor the public. Not only should the six year rule never have been enacted, but the

27. *See* Neil A. Lewis, *Democrat is Disputing President on Lawsuits*, N.Y. TIMES, Mar. 20, 1996, at D23. Interestingly, a *recently* sponsored products liability bill *proposes* to cap punitive damages at *either* $250,000 or two times compensatory damages, *depending on the size of the business defendant*; however, because the American Bar Association "does not support broad federal products liability legislation, it will oppose the new bill." *See* Kenneth Jost, *Tort Issues Resurrected*, ABA JOURNAL, March 1997, at 18.

28. *See* RUDER REPORT, *supra* note 21, at 43 (emphasis added).

29. *See* Katsoris, *Delicate Compromise*, *supra* note 22, at 29. *See also* Leslie Eaton, *Arbitration Rules Would Give Some, Take Some*, N.Y. TIMES, Nov. 17, 1996, at 3 [hereinafter Eaton].

30. Brett D. Fromson, *NASD Alters Arbitration System; Proposal Caps Punitive Damages, Lowers Barriers to Investor Suits*, WASH. POST, Jan. 30, 1997, at D3 (quoting statement of Linda Feinberg, Esq., executive Vice-President of NASD Regulations).

solution to its dilemma was resolved by consensus within SICA itself, whereas the NASD's rigid cap rule clearly favors the industry,[31] so where is the *quid pro quo*? Moreover, assuming *arguendo* that there is *quid pro quo*, it is hardly justifiable to suggest to someone who has filed a *timely* claim in arbitration—regarding a devastating loss suffered by the outrageous, unethical and fraudulent conduct of an unscrupulous broker or firm—that their claim for punitive damages was *bargained* away by a task force eager to solve a totally *unrelated* issue regarding *tardily* filed claims.

In any event, even if the SEC approved the rigid cap rule in a 19b filing by the NASD,[32] there is a serious question whether such a rule has validity and would be enforceable. Simply put, where is the legislative authorization to deprive an investor of relief otherwise available in court?[33]

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31. *See supra* notes 22-23 and accompanying text. *See also SICA-Modified Version*, *supra* note 24, at 4; *Punitive Caps Proposal*, *supra* note 25, at 4.

32. Under § 19(b) of the 1934 Act, each SRO 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.*

33. The inquiry will revolve around the Congressional delegation of authority to the SEC regarding securities arbitration and related federal and state issues. *See* 15 U.S.C. §78s(b)(i) (1988 and Supp. IV 1992). Authorizing the SEC to approve all SRO rule changes in arbitration is hardly a legislative mandate to involuntarily strip a claimant of relief otherwise available in court. Indeed, in the Prudential global settlement with the SEC, two important rights were waived: the respondent could not assert a defense of statute of limitations and the claimant could not claim punitive damages; *but, participating in the procedure was optional.* Securities and Exchange Commission v. Prudential Sec. Inc., C.A. No. 93-2164, 1993 WL 473189 (D.D.C. Oct. 21, 1993) Fourth Quarterly Report of Claims Administrator. *See* NYSE SYMPOSIUM, *supra* note 11, at 1575. Proponents of the rigid cap rule point to the $300,000 limit imposed by 42 U.S.C. § 1981a(b)(3) as support for the rigid cap rule. RUDER REPORT, *supra* note 21, at 43. Congressional enactment of such a *statutory* limit, however, has a narrow and specific application within the framework of the Civil Rights Act of 1964 and the Americans with Disabilities Act of 1990. It hardly constitutes Congressional authorization to the NASD to enact caps on its own initiative. Moreover, the rigid cap rule itself violates that very same Congressional statutory limit of $300,000 by limiting punitive awards to two times compensatory damages. *See Markey Seeks Review on Mandatory Arbitration*, WALL STREET LETTER, Feb. 10, 1997, at 10 [hereinafter *Markey*]. Still others have argued that the ability to collect punitive damages is not a "right" of the claimant, for it is rather intended to punish the wrongdoer; accordingly, the NASD can restrict this so-called right. To carry such an argument to its logical conclusion the NASD, absent enabling legislation, would have the power to restrict RICO (treble damages) or any other federally mandated multi-damage statute merely by amending *its* rules—a result hardly contemplated by the Supreme Court in *McMahon*. *See* Cole v. Burns Int'l Security Servs., No. 96-7042, 1997 WL 51684 (D.C. Cir. Feb. 11, 1997). In upholding the enforceability of conditions of employment requiring individuals to arbitrate claims resting on statutory

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The conventional wisdom underlying the broad embracement of arbitration by the Supreme Court in *McMahon* was an investor's ability to *obtain in arbitration whatever relief was available in court.*[34] The Ruder Report's rigid cap rule clearly violates that mandate. Furthermore, such a unilateral imposition by an SRO of a rigid cap will undermine the public's perception of the fairness of SRO arbitration, and return us to pre-SICA days, when many suggested that the process was *stacked against the public investor.*[35]

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rights, the Court of Appeals in *Cole* emphasized that "'[b]y agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.'" *Id.* at *15 (citing *Rodgiguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 481 (1989)). In any event, adoption of the rigid cap rule by the NASD will surely be challenged in the courts. *See also* Deborah Lohse, *NASD Rule for Damages Is Criticized*, WALL ST. J., Feb. 3, 1997, at C1.

34. *See* Eaton, *supra* note 29, at 3 (statement of Linda Feinberg, Esq., reporter to Ruder Committee). "The new rules are supposed to make sure investors can get in arbitration what they can get in court." *Id.* *See also* NYSE SYMPOSIUM, *supra* note 11, at 1532. "Limitations on what arbitrators can do that are not parallel to what judges can do would be hostile to arbitration as a full alterative dispute resolution system." *Id.* (statement of Catherine McGuire, Esq., Chief Counsel, Market Regulation of the SEC). In addition, "[the FAA] prohibits enforcement of a contractual provision that limits remedies available to customers if the remedies are available in court." *Id.* at 1584. "The way arbitration was sold to both *the* Supreme Court and the SEC was that essentially you have the same rights in arbitration as you would have in court." *Id.* at 1523 (statement of Boyd Page, Esq. one of the members of the Ruder Committee). *See also* Securities Exchange Act Release No. 34-26805, 43 SEC Docket 1417, 1427 (1989) "Agreements cannot be used to curtail any rights that a party may otherwise have in a judicial forum. If punitive damages, or attorneys' fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them." *Id.* *See also* U.C. Arb. § 31(d), EIGHTH REPORT, *supra* note 6, at 24 (prohibiting any condition in pre-dispute arbitration agreements that "limits the ability of the arbitrators to make any award"). *See also* U.C. Arb. § 28(h), EIGHTH REPORT, *supra* note 6, at 21 (providing that arbitrators could grant "any remedy or relief that the arbitrators deem just and equitable and that would have been available in a court with jurisdiction over the matter").

35. *See* Shearson American Express, Inc. v. McMahon, 482 U.S. 220, 243 (1987)(Blackmun, J., dissenting). "As even the most ardent supporter of arbitration would recognize, the arbitral process at best places the investor on an equal footing with the securities-industry personnel against whom the claims are brought. Furthermore, there remains the danger that, *at worst*, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the market professionals. The Uniform Code provides some safeguards but despite them, and indeed because of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public." *Id.* at 260-61. "The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest

In the final analysis, such a rigid cap will be questioned by a justifiably suspicious public who will ask the obvious question: why is this restriction being imposed at an SRO forum and not at forums such as the AAA, where there is no punitive damage cap whatsoever? This inquiry takes on added significance when one considers that despite concerted efforts by the SEC, the SIA and SICA to insert the AAA as an alternate forum in securities arbitration agreements, the industry has ignored that plea, thus largely excluding the less restrictive AAA as an alternate forum.[36]

Alternative Solutions

If the industry fears large punitive damage awards in arbitration (even when punitives reasonably relate to compensatory damages), then perhaps claims involving punitive damages of more than $750,000 should be removed from arbitration, either automatically or at the option of the respondent, and the entire matter returned to the courts where the parties have the procedural safeguard of an appeal more readily available.[37]

Another possible solution would be to set a *threshold amount* for punitive damages in arbitration. If a panel exceeded the *threshold* amount the respondent would have the option to appeal the punitive award under an SRO appellate procedure before it became a final award, *unless* the claimant agreed to accept the threshold amount. Thus, the threshold amount would *not be a cap*, as recommended by the Ruder Report; instead, it would *become a trigger* for an appeal, with the cost of the appeal being borne by the respondent.

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that there must be some truth to the investors' belief that the securities industry has an advantage in a forum under its own control." *Id.* at 261 (citing William Glaberson, *When the Investor Has a Gripe*, N.Y. TIMES, Mar. 29, 1987, at 8, quoting 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.") *Id.*

36. At one point, the SEC, SICA and the SIA all endorsed the suggestion that the AAA be included as an alternative forum in brokerage account pre-dispute agreements. *See* Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 525 (1996) [hereinafter *SICA*]. Such a suggestion, however, has little chance of adoption because of the securities industry's certain opposition to the AAA's lack of either a punitive damage cap or a six year rule.

37. It would be preferable to remove the entire case to court when punitive damages in excess of $750,000 are pleaded so as to avoid bifurcated proceedings—i.e., the compensatory damages phase tried in arbitration and the punitive phase tried in court. *See* Constantine N. Katsoris, *The Securities Arbitrators' Nightmare*, 14 FORDHAM URB. L.J. 3 (1986).

The suggestion that punitive damage awards in securities arbitration be appealable is not a new concept,[38] and such an alternative solution was presented to SICA at its January 17, 1997 meeting in Los Angeles.[39] Unfortunately, because of enormous industry pressure outside of SICA, this suggestion has been stalled.[40] Indeed, so long as the NASD continues to dangle a rigid cap rule, there is no incentive for the SIA to seek reasonable alternatives.

Conclusion

Either of these alternative solutions—removal to court where punitive damages are pleaded in excess of $750,000, or an internal SRO appeal (where punitive damages are awarded in excess of the trigger amount)—would avoid the objections posed by a mandatory rigid cap suggested by the Ruder Report,[41] while still affording a reasonable measure of protection for the securities industry. *Most important*, however, is that neither of these alternative solutions would violate the covenant that a public investor *receive the same relief in arbitration as is available in court,*[42] albeit under different procedures. It is rather puzzling why the NASD has adopted an inflexible Maginot Line[43] mentality as to the rigid cap rule. It is even more puzzling why the SEC would even consider approving the rigid cap rule in a 19b filing.

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38. *See* Katsoris, *Tower of Babel*, *supra* note 18, at 599-600. Presumably, the appellate process could instead go through the courts, but that approach would no doubt require an amendment to the Federal Arbitration Act. *See* NYSE SYMPOSIUM, *supra* note 11, at 1669.

39. *See* Joint Memorandum presented to SICA by Professors Thomas J. Stipanowich and Constantine N. Katsoris, Public Members at SICA (Jan. 7, 1997)(on file with the Fordham Urban Law Journal). At the SICA meeting on November 8, 1996, a subcommittee (including the two aforementioned Public Members) was appointed to draft alternative solutions to the punitive damage dilemma. Numerous other suggestions were also considered by the subcommittee, such as a *de novo* retrial on the punitive issue in court if the punitive damage award in arbitration exceeded a certain amount; however, such suggestions were rejected as being more burdensome than the SRO appeal process. *See also* Saika v. Gold, 56 Cal. Rptr.2d. 922, 927 (Cal. Ct. App. 1996) (holding that a clause in a doctor-patient agreement providing for a trial *de novo* in court in the event an arbitration award exceeded $25,000 was unenforceable against a patient for public policy reasons). The attractiveness of the internal appeal process is that it provides the industry with an additional measure of protection from a runaway punitive award, yet preserves the rights of claimants to obtain relief similar to what is available in court.

40. *See* Mana Lumumba-Kasongo, *Punitive Damages Compromise Lands on Scrapheap*, WALL STREET LETTER, Jan. 20, 1997, at 1.

41. *See supra* notes 21-28 and accompanying text.

42. *See supra* note 29-31 and accompanying text.

43. The Maginot Line was a mighty system of *fixed* fortifications along the eastern frontier of France. *See* THE COLUMBIA ENCYCLOPEDIA 1658 (5th ed. 1993).

Many of the Ruder Report recommendations—i.e., a list selection process where the parties choose the arbitrators from a designated list instead of having the arbitrators selected by the SRO—*do not require uniformity* among the SRO's. As to a cap on punitive damages, however, uniformity among the SRO's *is* required; otherwise, it would lead to extensive and often confusing forum shopping. With this in mind, if the NASD rigid cap rule is approved by the SEC, will the SEC then press for uniformity among the SROs on this point?[44] Should that happen, it would establish a dangerous precedent whereby the NASD *unilaterally changes the rules*, and the other SROs are expected to follow.[45]

Such a scenario of following the *first SRO to file* is hardly reassuring to the investing public no matter how well meaning; for, what other "directives" can the public expect in the future from the Ruder Committee, or any other SRO appointed task force or committee? Moreover, it would surely lead to the demise of SICA, which would be most unfortunate,[46] because it was SICA that

44. Indeed, the Ruder Report itself suggests that its recommendations "will be most effective if applied uniformly and consistently by all self-regulatory organizations (SROs) that offer arbitration forums." RUDER REPORT, *supra* note 21, at 1.

45. *See* NYSE SYMPOSIUM, *supra* note 11 (statement of Catherine McGuire, Esq., Chief Counsel, Market Regulation of the SEC). "SROs are dominated by industry. I don't mean their staffs. I think the New York Stock Exchange has a board half public, half not public. The NASD's board, however, is more largely dominated, so any rules they adopt may reflect or appear to reflect, their affiliation with industry, which is usually in the defense position. I think this is not where I would start a laboratory for tort reform. I don't think it would be perceived as balanced." *Id.* at 1592. *See also* Katsoris, *SICA*, *supra* note 36, at 534. "From time to time, it has been suggested that, because the Uniform Code has been extensively updated since McMahon, SICA's role has diminished, implying that like old soldiers, it should fade away. The scenario then suggests, in the interest of uniformity and economy, that all the SROs collapse their public arbitration programs into one, leaving the public securities arbitration function solely to the NASD. This suggestion is ludicrous because SROs by their very makeup, presently lack the structural independence necessary to insure public confidence. Indeed, as the arbitrable issues expand (i.e., employment issues), and as the stakes grow (i.e., larger compensatory awards and punitive damages issues), the public will increasingly demand that the *rules* of battle be set by a truly independent group." *Id.* at 534.

46. *See* Constantine N. Katsoris, *SICA: Does the Bell Toll for Thee?*, SEC. ARB. COMMENTATOR, Jan. 1994, at 1. Under the present system, SICA, an independent body, proposes rule changes. The SRO boards approve and file them with the SEC. The SEC then decides what the rule will be. By that time, all participants have had at least two bites at the apple: the public at the SICA level, and at the 19(b) filing; the various SROs at the SICA level, and at their board's level; the industry at the SICA level, at the SRO level (where it lobbies intensely), and again at the 19(b) filing; and, the SEC at the SICA level (where SEC representatives and others are invited guests), and as the final word at the 19(b) filing. *See generally* Katsoris, *SICA*, *supra* note 36. This pattern for rule changes in securities arbitration should be preserved. As an

helped eliminate the widespread distrust of arbitration on the part of the public, the legislatures and the courts.[47] In many ways, SICA can be compared to the Financial Accounting Standards Board[48] in that: both were born out of crisis; both have been independent; both involve SEC oversight or participation; and, both are a buffer between the investing public on the one hand and the securities or business community on the other.[49] SICA cannot be replaced by the SIA, or PIABA (the claimants' bar),[50] or any of the SROs or their committees, or any combination thereof, for each basically has its own special interests or constituencies to serve.

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independent body, SICA establishes and maintains a level playing field. Its presence, like a cop on the beat these past 20 years, has been reassuring to regulators, the courts, and the investing public.

47. In *1953*, the United States Supreme Court in *Wilko v. Swan*—expressing some mistrust of arbitration—concluded that pre-dispute arbitration agreements would not be enforceable as to issues arising under the Securities Act of 1933. 346 U.S. 427, 438 (1953). In *1976* the New York Court of Appeals in *Garrity v. Lyle Stuart, Inc.*, expressing similar distrust of arbitration, held that arbitrators lacked authority to award punitive damages. 353 N.E.2d 793, 794 (1976). SICA was created in *1977*. It is noteworthy that in *1987* the majority opinion in *McMahon* reflected upon the previous *mistrust* of arbitration as follows: "[T]he mistrust of arbitration that formed the basis for the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time. This is expressly so in light of the *intervening changes* in the regulatory structure of the securities laws." 482 U.S. 220, 223 (emphasis added). Similarly, in a dissenting opinion in *McMahon*, Justice Blackmun observed that "[i]t 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." *Id.* at 258. Moreover, Justice Blackmun reasoned that:

> 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, 283-384 (1984). 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.

Id. at 258 n.16 (emphasis added). It is respectfully suggested that the single most important *intervening event* bridging the mistrust of arbitration expressed by both *Wilko* and *Garrity*, and the subsequent confidence evidenced in *McMahon* was the creation of SICA in 1977.

48. The Financial Accounting Standards Board is responsible for formulating the rules by which companies account and report their financial condition. *See* HORNGREN, INTRODUCTION TO FINANCIAL ACCOUNTING 57-58 (1984).

49. *See* Katsoris, *Level Playing Field*, *supra* note 2, at 476.

50. The Public Investors Arbitration Bar Association ("PIABA") is an association of attorneys representing investors and others in the resolution of their claims against the securities industry.

SICA on the other hand has been a *melting pot* of special interests, and that is why it has commanded widespread credibility.[51]

Arbitration was not intended to be used as a Trojan Horse from which to deny relief otherwise available in court.[52] That was not the foundation upon which *McMahon* was decided. If brokerage agreements force the public investor into SRO arbitration with an arbitrary cap on punitive damages *imposed by the very same SRO at which the hearing is held*, then we have arrived at the point where, in reality, the fox is guarding the henhouse; and, the time has come to revisit the issue of whether securities arbitration should once again become voluntary, as it was before *McMahon*.[53]

Accordingly, in view of the fact that it bears *no reasonable relationship* to compensatory damages,[54] its *unilateral imposition* by an SRO subjects it to questionable validity,[55] it is *strongly opposed* by the public,[56] it is *not imposed* at the AAA or at the other SRO arbitration forums,[57] it *violates §31* of the Uniform Code,[58] it *buttresses the argument* that the pre-dispute arbitration agreement has become an unenforceable contract of adhesion,[59] it *rekindles public distrust* of the SRO arbitration process,[60] it *violates the spirit* under which *McMahon* was decided,[61] and there are *less objectionable ways* to solve the securities industry's fears of a runaway punitive award,[62] *the rigid cap rule must be rejected.*

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51. An example of SICA's independence was evident regarding the thorny issue of non-attorney representation—a subject largely avoided by many bar associations. Despite some unfavorable publicity and pressure, SICA did not hesitate to seek a solution. It held meetings at both ends of the country, openly solicited comments, and finally wrote a well respected report which was published and widely distributed. *See Report of the Securities Industry Conference on Arbitration on Representation of Parties in Arbitration by Non-Attorneys*, 22 FORDHAM URB. L.J. 503 (1995).

52. *See* Katsoris, *Tower of Babel*, *supra* note 18, at 593-96.

53. *See* Constantine N. Katsoris, *Should McMahon Be Revisited?*, 59 BROOK. L. REV. 1113, 1147 (1993). Moreover, such a restriction on arbitral authority would itself violate U.C. ARB. § 31(d) which prohibits arbitration agreements that limit "the ability of the arbitrators to make any award." *See* EIGHTH REPORT, *supra* note 6, at 24. *See also Markey*, *supra* note 33, at 10.

54. *See supra* note 27 and accompanying text.

55. *See supra* note 33 and accompanying text.

56. *See supra* note 23 and accompanying text.

57. *See supra* note 26 and accompanying text.

58. *See supra* note 19 and accompanying text.

59. *See supra* note 18 and accompanying text.

60. *See supra* note 35 and accompanying text.

61. *See supra* notes 34-35 and accompanying text.

62. *See supra* notes 37-40 and accompanying text.