SECURITIES ARBITRATION: ISSUES OF INTEREST

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Let me begin by expressing my great personal regard for Dean Seligman, as well as the esteemed panel. This is a tough group to come before and call into question proposed changes to the securities arbitration process conducted by the National Association of Securities Dealers, Inc. ("NASD") and the other self-regulatory organizations, especially since Joel asked that we keep our remarks brief. Yet, I will not despair in the face of such overwhelming adversity. After all, I know something about securities arbitration. In a past life, I served on between five and ten New York Stock Exchange ("NYSE") panels pitting customers against their brokers and firms.

Customers, brokers, and firms won some and lost some on my panels. We did not award any punitive damages. The customers generally had honorable complaints and asserted them well. The brokers and firms also generally acquitted themselves in an honorable and professional manner. I believe that justice was served by those panels. Even if you could prove to me today that we were not right on a particular claim, I would continue to believe that all parties had a fair chance to be heard by an impartial panel. I am proud of my service.

It is not surprising therefore that I support arbitration for customer complaints. No doubt the process could be improved, and many of the Task

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This is the revised text of a speech delivered as part of the Courts on Trial Conference at the University of Arizona Law School on April 18, 1998. The views expressed in that speech, as well as in this article, do not necessarily represent the view of the United States Securities and Exchange Commission, other Commissioners, or the Commission's staff.

Force's recommendations would do just that.[1] Nevertheless, I will focus on two issues where I may disagree with my fellow panelists: (1) the merits of a proposed punitive damages cap, and (2) the appropriateness of mandatory arbitration for employment discrimination claims.

I. PUNITIVE DAMAGES

While the exchanges now generally prohibit limitations on the ability of arbitrators to make any award under applicable law,[2] the NASD recently sent proposed rules to the Securities and Exchange Commission ("Commission") for notice and comment that would set a punitive damages cap in the amount of the *lesser* of twice compensatory damages or $750,000.[3] The proposal also would clarify that arbitrators may award punitive damages *if* they may be awarded in the state court where the claimant resides. With some exceptions, the proposal tracks suggestions made in the Task Force Report.[4]

Some have argued that the NASD's proposal is a "package" that should be acceptable both to firms and to investors even if one part of the package is objectionable.[5] I sincerely commend the Task Force for trying to come up with a good compromise. However, as the Commission discovered in our recent foray into the shareholder proposal process, it is not easy to predict in advance which "packages" actually will be acceptable compromises.[6]

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1. SECURITIES ARBITRATION REFORM, REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASS'N OF SECURITIES DEALERS, INC. (Jan. 1996) [hereinafter TASK FORCE REPORT].

2. *See, e.g.*, NASD Rule 3110(f)(4) (Parties are not allowed to include in arbitration agreements "any condition which 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.").

3. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers Relating to Punitive Damages in Arbitration, Release No. 34-39371, File No. SR-NASD-97-47 (Nov. 26, 1997) <http:// www.sec.gov/rules/sros/nasd9747.txt>.

4. *See* TASK FORCE REPORT, *supra* note 2, at 40–46.

5. *See, e.g.*, Comment Letter submitted by the Compliance and Legal Division of the Securities Industry Association to Release No. 34-39371 (March 27, 1998) (on file with author). This letter and others related to the NASD's proposal are available in the Commission's Public Reference room in file number SR-NASD-97-47.

6. *See* Proposed Rule: Amendments to Rules on Shareholder Proposals, Release No. 34–39093; IC–22828; File No. S7–25–97 (Sept. 18, 1997) <http://www.sec. gov/rules/proposed/34-39093.htm>. In this release, the Commission proposed far-reaching amendments to our rules regarding the shareholder proposal process. While all of us at the Commission probably knew that some of the proposals would be sharply criticized, we said in our release that we were "proposing a 'package' of reforms that we believe best accommodates the concerns of most participants." The Commission received over 2,000 comments on these amendments. While a few commenters were supportive of the overall package, many were so critical of certain specific proposals that they opposed the package *in toto*. Final and much "scaled-down" rules were adopted by the Commission on May 21, 1998. *See* Final Rule: Amendments to Rules on Shareholder

One wave of commenters to the NASD's proposal strongly opposes the cap. Some argue that the proposed cap, or any cap, would have the following consequences: (1) usurp the authority of states allowing punitive awards, and (2) run counter to judicial precedent.[7] Others simply oppose the size of the proposed cap.[8]

A second wave opposes punitive damages as a dangerous tool in the hands of arbitrators, as well as a punishment-oriented sanction with no place in this arbitration forum. Many of these commenters, however, also support the proposed cap as a compromise that would, among other things, protect small brokerages from the risk of the whims of "rogue" arbitration panels.[9] I understand that the NASD is now considering a response to the comments.

Here is my preliminary view. No matter how narrowly some read the Supreme Court's holding in *Mastrobuono v. Shearson Lehman Hutton, Inc.*,[10] there is a trend towards judicial recognition that arbitrators may award punitive damages. Punitives are provided for by various states and in arbitrations conducted in accordance with the rules of the American Arbitration Association.

My current view is that banning punitives outright would be bad for investors and the industry. A ban would create the perception, if not the reality, that investors were worse off in self-regulatory organization ("SRO") arbitration forums than they would be in some courts or if they were claimants in other arbitration forums. That perception or reality is magnified where arbitration is mandatory, as it is in the securities industry. So, I agree with the Task Force as to the availability of punitives. However, I have significant concerns with the size of the proposed cap, and I am not sure whether I can support it in its current form.

I support arbitration for customer complaints because it can be cost-effective and fair. If I am right, it is partly because arbitrators have wide latitude in crafting appropriate remedies. Punitive damages, and at times even large punitive damage awards, may be appropriate remedies for certain conduct.

Frankly, I do not see the problem of large punitive damage awards the way that some do. The evidence I have seen indicates that such awards are granted

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Proposals, Release No. 34-40018; IC-23200; File No. S7-25-97 <http://www.sec.gov/rules/final/34-40018.htm>.

7. *See, e.g.*, comment letter submitted by Cliff Palefsky, Chair, Securities Industry Arbitration Committee of the National Employment Lawyers Association (Jan. 6, 1998) (on file with author).

8. *See, e.g.*, comment letter submitted by Don K. Leufven, Alonso & Ceronsky, P.C. (Feb. 9, 1998) (on file with author).

9. *See, e.g.*, comment letter submitted by Marshall Wishnack, Chairman and CEO, Wheat First Union (Mar. 17, 1998) (on file with author).

10. 514 U.S. 52 (1995). Dean Seligman notes that shortly "after *Mastrobuono* was decided, the NASD and the NYSE issued notices to their respective members clarifying that each [SRO] had adopted earlier rules regarding governing law clauses that could *not* be used to limit remedies such as punitive damages." Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327, 361 (1996) (emphasis added).

in only one to two percent of arbitrated cases, with very few awards over $750,000. I see no evidence of rogue arbitration panels. I share Professor Coffee's observation that the idea of a "runaway panel" is largely a myth. As he once put it, "a runaway panel of three arbitrators who are trained in the securities law is about as likely as a runaway court of appeals."[11]

Next, I do not know that it is the Commission's role to approve and oversee dollar limitations on investor remedies, particularly where the relevant state itself allows punitive damages without any cap. Setting dollar limits on remedies, it seems to me, is ordinarily the role of the legislative branch of government. I also do not know what expertise the Commission can bring to bear to determine whether a proposed cap is a good one. At the very least, if the Commission decides to approve a cap solely based on the Task Force's and the NASD's data, *the Commission itself* should conduct a study a few years hence as to the cap's effects. The Commission is, and should be, "on the hook"—not just the SROs—as to whether the new cap is fair, appropriate, and working as intended.

I also have reservations regarding a cap limited to the lesser of $750,000 or twice compensatory damages. I have heard some supporters of the cap say that it would have little effect on current practices, in part because: (1) punitive damages awards are rarely given in amounts over $750,000, and (2) the two times compensatory damages component of the proposed cap would reduce a punitive award in just a handful of the studied cases. As a preliminary matter, these arguments beg the question of why any cap is needed, but let us take that question off the table for now. I understand that only a handful of awards are at issue, but here is what I uncovered in my very limited and quite unscientific research.

First, a 1997 *New York Law Journal* article described how an NASD panel told a firm and two employees to pay $170,000 in punitives to an elderly couple whose account was churned by a broker.[12] Over 600 transactions were made in the account in 18 months, generating $172,000 in commissions and markups. The panel did not award the couple *any* compensatory damages because the couple showed a profit during the relevant period, albeit a very small profit when compared to overall market returns during that time period. Instead, the panel awarded punitives in the amount representing the commissions earned by the firm on the unauthorized trades.

A judge recently upheld the award, ruling that even if the couple "[was] not out of pocket due to the excessive trading..., arbitrators might well conclude that a broker who churns a customer's account should not be allowed to profit, at the customer's expense, from that churning."[13] Well, if that is what the facts and equities indicated, then I am fine with what the panel and the judge did, and I think that the industry and the Commission should be fine with it as well.

11. John C. Coffee, Jr., *Commentary*, 33 HOUS. L. REV. 376, 384 (1996).

12. Matthew Goldstein, *Arbitration Decision Awarding Punitive Damages Is Sustained*, N.Y. L.J., Dec. 11, 1997, at 1.

13. *Id.*

Next, a 1996 *St. Petersburg Times* article described how the widow of a man who killed himself after losing $298,000 trading stocks was awarded $350,000 in punitive damages by an NASD panel.[14] The panel gave the widow only *one dollar* in compensatory damages from the broker and *one dollar* from the firm, since the panel apparently determined that much of the actual loss was caused by the dead man's actions. According to this article, the panel assessed punitives because the firm failed to supervise the inexperienced broker on the account, especially as to the account's suspicious frequency of trading.

Now, I do not know exactly what happened in these matters, and these articles may not be complete enough or accurate enough or numerous enough for me or any other observer to rely upon in making policy decisions. Maybe I should pretend that the stories are just hypotheticals. If I do that, however, I do not have to feel the pain these investors suffered or the outrage these arbitration panelists probably felt.

Some would say that additional SRO and SEC enforcement is the answer, but I believe that the Commission, at least, does not have the resources to take action against each broker and firm flagged by an outraged arbitration panel. And not taking action after a panel is compelled by SRO rules approved by the Commission to give a widow no more than four dollars in punitive damages—as in the case I just mentioned—is something that I would find troubling indeed.

I look forward to reviewing the comments as they come in.

II. DISCRIMINATION CLAIMS

I will be brief on the topic of mandatory arbitration of discrimination claims. Securities firm employees now sign industry-wide pre-employment agreements requiring them to use arbitration to settle discrimination and related claims. The NASD recently proposed amendments to its rules that would remove the requirement to arbitrate such claims.[15] The practical effect of such rule changes is uncertain, since brokerage firms simply could redraft their employment agreements so that job applicants would have to waive their rights to sue in court as a condition of employment. Put another way, the impact of the NASD's initiatives could be virtually nil.

I have said on several other occasions that one of my priorities for 1998 is to end the practice of mandatory arbitration of employment discrimination claims,

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14. Helen Huntley, *Panel Orders Olde To Pay Widow $350,001*, ST. PETERSBURG TIMES, Aug. 17, 1996, at 1E.

15. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers Relating to the Arbitration of Employment Discrimination Claims, Release No. 34-39421, File No. SR-NASD-97-77 (Dec. 10, 1997) <http://www.sec.gov/rules/sros/nasd9777.txt>.

Subsequent to this speech, the Commission approved the NASD's rule change. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change Relating to the Arbitration of Employment Discrimination Claims, Release No. 34-40109, File No. SR-NASD 97-77 (June 22, 1998).

and I repeat that sentiment here. I applaud any firm willing to move away from the practice, and I will be very disappointed if more firms do not follow suit.[16] If the vast majority of firms still insist upon mandatory arbitration for such disputes, legislation may be needed.[17]

Here is my reason for stating this: as a general matter, I believe that alleged victims of discriminatory conduct deserve their day in court, or at least something more closely approximating a day in court.

Moreover, I believe that few arbitrators are qualified to hear such claims. This lack of qualification is in part because the diversity of the panels usually does not reflect the diversity of the claimants. It also stems from a lack of expertise and training of securities industry arbitrators in discrimination matters.

Finally, I am simply of the view that judges are better able to hear discrimination cases even if there are related securities claims. This does not mean that discrimination claims need to be made only in court. Employees, if *they* wish, should be able to make such claims in arbitration. The SROs probably would have to make the forum much more attractive for employees than it is now. But if that occurred, I would hope that employees would consider arbitration as a cost-efficient and fair way to resolve their disputes.

16. *See* Kathy Bishop, *Merrill Lynch: The Real Deal; Smith Barney's Settlement of a Sex Discrimination Suit Pales Next to This One*, N.Y. POST, May 7, 1998, at 35.

17. Legislation amending the federal civil rights statutes to prevent the application of arbitration to claims that arise from employment discrimination was proposed in the 105th Congress by Senator Feingold (S. 63) and by Representatives Markey, Jackson, and Eshoo (H.R. 983).

In addition, the Senate Committee on Banking, Housing, and Urban Affairs—chaired by Senator D'Amato—on July 31, 1998, held a hearing on mandatory arbitration of employment discrimination disputes in the securities industry. I testified on behalf of the Commission. *See Concerning Arbitration of Employment Discrimination Disputes in the Securities Industry Before the Comm. on Banking, Hous. and Urban Affairs*, 105th Cong. (July 28, 1998) (testimony of Isaac C. Hunt, Jr.).