



Securities Industry Association

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December 23, 1997

Jonathan G. Katz, Secretary
United States Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. SR-NASD-97-47
Proposed Punitive Damages Rule

Dear Mr. Katz:

The Securities Industry Association ("SIA")¹ appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") regarding the Commission's Notice of Proposed Rule Changes Relating to Punitive Damages in Arbitration.

The SIA submits these comments in support of the proposed rule of the National Association of Securities Dealers ("NASD") regarding the availability of punitive damages in NASD arbitration. Specifically, the proposed rule limits the amount of a punitive damages award in NASD arbitration to the lesser of twice compensatory damages or \$750,000. Proposed NASD Rule 10336(c)(1). The rule applies to claims between a public customer and a member or associated person; it does not apply to "industry" arbitrations. Proposed NASD Rule 10336(a)(1). In addition, the proposed rule permits a party to request punitive damages if, at the time of filing his or her claim, "the party is a citizen of a state that allows its courts to award punitive damages for the same type of claim." Proposed NASD Rule 10336(a)(2). The proposed rule directs the arbitrators, in determining whether an award of punitive damages is appropriate, to rely on the standard of conduct set forth in the laws of the state of which the party requesting punitive damages is a citizen, regardless of whether a choice-of-law provision in a contractual arbitration clause might point in a different direction. Proposed NASD Rule 10336(b). The proposed rule also provides that the arbitrators may not award punitive damages if they have awarded "multiple damages" for the same claim under any state or federal statute that allows multiple damages, including the Racketeer Influenced and Corrupt Organization Act "RICO". Proposed NASD Rule 10336(c)(3). Finally, if the arbitrators award both compensatory and punitive damages, their decision must state separately the amount awarded for each. Proposed NASD Rule 10336(d).

The SIA maintains its longstanding opposition to punitive damages awards in securities arbitration, and believes that any proposal permitting such damages should be scrutinized carefully. If, however, the proposed NASD rule is contrasted with the current situation, in which the whims of an arbitral panel can dictate the availability and amount of punitive damages awards, then the proposed rule is an improvement. The SIA, therefore, lends its support to the proposed rule, even though that proposal rejects the SIA's primary submission, which was that punitive damages ought not be available at all in securities arbitration. The proposed rule is an improvement because it will preserve the numerous benefits associated with securities arbitration and will allow arbitration proceedings to remain a fair, efficient, and economical means of dispute resolution. In addition, as demonstrated below, opponents of the proposed rule base their criticisms on inaccurate statements of public policy and misinterpretations of law. None of these arguments should prevent the Commission from approving the NASD proposal.

The NASD's proposed cap on punitive damages satisfies the criteria that the SEC must consider when evaluating a proposed rule of a self-regulatory organization ("SRO"). Under Section 19(b)(2) of the Securities Exchange Act of 1934, the SEC must approve a rule proposed by the NASD if "it finds that such proposed change is consistent with the requirements of [the] Act and the rules and regulations thereunder applicable to such organization." 15 U.S.C. §78s(b)(2). The Act recognizes the strong public interest in regulating securities transactions because of the effect of such transactions on, among other things, interstate commerce and the national credit. 15 U.S.C. § 78a. Accordingly, NASD rules should "protect investors and the public interest," and should "remove impediments to and perfect the mechanisms of a free and open market and a national market system." 15 U.S.C. §78o-3b(6); Timpinaro v. Securities and Exchange Commission, 2 F.3d 453, 456 (D.C. Cir. 1992). The NASD's proposal does just that by ensuring that NASD arbitrators conduct arbitrations in a fair, efficient manner, and by giving the parties greater certainty in the outcome of the arbitration. The proposal furthers the strong public policy favoring arbitration, and provides investors with a substantial remedy for egregious violations of the applicable law.

The NASD's proposal also follows the trend established by a large number of state legislatures that have adopted caps on punitive damages. Far from being a regulatory anomaly, the NASD proposal incorporates the basic features of the limitations imposed by many state and federal statutes. The SIA believes that the SEC should approve the proposal to cap punitive damages because it (i) takes into account the interests of industry members and investors; (ii) strikes a reasonable balance among the competing considerations bearing on punitive damages awards; (iii) preserves the benefits associated with arbitration; and (iv) furthers the purposes of the Securities Exchange Act.

Benefits of NASD Rule

The availability of uncapped punitive damages limits the effectiveness of arbitration as an alternative method of dispute resolution and undermines the reasons parties choose arbitration to resolve their disputes. It is widely accepted that arbitration provides both claimants and defendants with an efficient, expedient, lower-cost alternative to litigation -- goals that the NASD arbitration rules currently promote. For example, under NASD rules, arbitral panels employ less stringent rules of evidence and procedure. NASD Manual (CCH), Code of Arbitration Procedure 10323 (1996). Although the parties may serve informal requests for

documents or information, they must tailor that discovery specifically to the matters at issue in the arbitration. Id. at 10321. Neither party is required to be represented by counsel, and the parties often are not. Indeed, a government report evaluating securities arbitration found that 42% of the parties involved were not assisted by counsel. General Accounting Office, Securities Arbitration: How Investors Fare 40 (1992). These factors make arbitration more accessible to claimants and more rapid and economical for members of the securities industry.

The possibility of unlimited punitive damages substantially raises the stakes of arbitration for industry members. Demands for large punitive damages awards are frequently included in arbitration claims, and force respondents to devote greater resources to defending against a claimant's charges, thus arbitrations have become more complex, time-consuming, and expensive. This is one of the reasons why the efficiency and speed of these proceedings have declined. This has negatively impacted the public as well as the industry. In short, securities arbitration has become more like litigation and less attractive as an alternative method of dispute resolution.

The SIA believes that the proposed cap on punitive damages will help preserve the important benefits of arbitration by removing much of the uncertainty that otherwise is associated with punitive damages. The NASD's proposed rule accomplishes this goal in two ways. First, placing a cap on punitive damages permits industry members to know and understand their exposure and to adjust their defense preparations and expenditures accordingly. Second, the provision of the rule that directs the arbitral panel to look to the law of the state of the party requesting punitive damages for the standards governing when and under what circumstances punitive damages can be available enhances the predictability of arbitrations. At the same time, the provision ensures claimants that their own state's law will govern any requests for punitive damages and that choice-of-law provisions in an arbitration agreement that potentially could make punitive damages more difficult to obtain will not have an adverse effect on their claims.

The proposed cap also provides industry members with an assurance of fairness regarding the damages that may be assessed against them in arbitration. Judicial review of decisions rendered in arbitration is normally quite limited. "[I]t is often a judgment that streamlined proceedings and expeditious results will best serve their needs that causes parties to agree to arbitrate their disputes; it is typically a desire to keep the effort and expense required to resolve a dispute within manageable bounds that prompts them mutually to forgo access to judicial remedies." Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 633 (1985). Under the Federal Arbitration Act, 9 U.S.C. §§ 1-14, a court may overturn an arbitration decision only if it is the product of fraud, bias, or corruption, or if the arbitration panel has exceeded its powers. See Thomas J. Stipanowich, Punitive Damages in Arbitration, Garrity v. Lyle Stuart, Inc. Reconsidered, 66 B.U. L. Rev. 953, 984 n.188 (1986). Because of the limited availability of judicial review, it is all the more important that the rules governing securities arbitration contain appropriate safeguards against runaway punitive damages awards.

Recent Supreme Court decisions have established that the Due Process Clause imposes substantive limits on the size of punitive damages awards and requires limitations on the discretion of the decisionmaker. BMW v. Gore, 116 S.Ct. 1589 (1996); Honda Motor Co. v. Oberg, 512 U.S. 415 (1994); Pacific Mutual Life Ins. v. Haslip, 499 U.S. 1 (1991). In BMW v. Gore, the Court held for the first time that a specific punitive damages award was so excessive as to violate the defendant's due process rights. Likewise, an excessive punitive damages

award may result in an unfair deprivation of property. Honda, 512 U.S. at 432. "One must concede that unlimited 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." Haslip, 499 U.S. at 18. Such constitutional limits may well apply with equal force to awards of punitive damages in securities arbitration.²

Although the Supreme Court has refused to set forth a precise formula for determining whether a punitive damages award violates due process, the Court has provided three "guideposts" to aid in the determination: the relationship between the amount of punitive damages and the plaintiff's actual harm or potential harm, the egregiousness of the defendant's conduct, and the difference between the punitive damages awarded and the civil penalties imposed or authorized in similar cases. Gore, 116 S. Ct. at 1598-99. In arbitration, there is no clearly available mechanism to ensure that the arbitrators will follow these guideposts. But awards of punitive damages are more likely to bear some relation to the compensatory damage award under the proposed rule, thus addressing one of these key guideposts. Finally, the proposed rule assures industry members that even if courts determine that the Constitution's due process guarantee does not necessarily make available judicial review for arbitral punitive damage awards, arbitral panels themselves will be restrained from rendering inequitable awards of punitive damages.

Punitive Damages as a Public Remedy

Many members of the securities industry believe that a non-judicial, non-government tribunal should not be authorized to impose punishment, because the role of punishing belongs exclusively to the state. The New York Court of Appeals, a court with extensive experience in sophisticated securities and commercial matters, adopted this view in Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 353 N.E.2d 793 (1976).

In Garrity, the court held that arbitrators are without authority to award punitive damages. The court explained that, as a means of punishment and deterrence, punitive damages are "a social exemplary 'remedy', not a private compensatory remedy," and as such have no place in private arbitration. 40 N.Y.2d at 358, 353 N.E.2d at 795-96. In addition, the court believed that a rule permitting punitive damages to be awarded in arbitration would substantially undermine the usefulness of arbitration because the arbitrator's discretion to award punitive damages "would be both unpredictable and uncontrollable." Id. at 359, 353 N.E.2d at 796. Other jurisdictions have followed Garrity's approach and have denied arbitrators authority to award punitive damages. Shaw v. Kuhnel & Assoc., 698 P.2d 880 (N.M. 1985); United States Fidelity & Guaranty v. DeFluiler, 456 N.E.2d 429 (Ind. 1983); see also Thomas J. Stipanowich, Punitive Damages in Arbitration, Garrity v. Lyle Stuart, Inc. Reconsidered, 66 B.U. L. Rev. 953, 963 (1986), and additional cases cited therein.

By contrast, numerous courts elsewhere have taken a contrary position and have refused to prohibit punitive damages in arbitration. Stressing that public policy strongly favors arbitration, these courts have concluded that any doubts about an arbitrator's authority to award particular remedies should be resolved in favor of that authority. Raytheon Co. v. Automated Business Systems, Inc., 882 F.2d 6 (1st Cir. 1989); Willoughby Roofing & Supply Co. v. Kajima Int'l, 598 F. Supp. 353 (N.D. Ala. 1984), aff'd, 776 F.2d 269 (11th Cir. 1985); see also Stipanowich, supra, at 970. Such authority is needed, according to the proponents of this position, to enable

arbitration to serve as a complete and effective substitute for civil litigation. Id. at 981-82.

The SIA believes that the NASD's proposed rule is an acceptable compromise between the view that punitive damages ought not be permitted at all in consensual dispute resolution arenas like arbitration and the view that egregious conduct must be punished, whatever dispute resolution mechanism the parties may choose. At the same time, the proposal confirms the availability of punitive damages under the standards set by the applicable state law, and it thus leaves NASD arbitrators with substantial discretion over such awards. This is a fair compromise that should satisfy both sides of the debate.

Potential Criticism of the NASD Proposal

I. Criticism Based on Assertions Regarding Public Policy

Opponents of the NASD proposal likely will argue that any limit on punitive damages curtails the rights of investors who have agreed to arbitration. They also may contend that any such limit somehow offends public policy or fundamental notions of fairness because pre-dispute limits allegedly will undermine the deterrent effect of the punishment and will not allow the arbitral panel to make ad hoc judgments about the severity of the alleged misconduct. Neither argument can be sustained because each relies on at least two faulty assumptions -- first, that the law favors the award of punitive damages and, second, that to be effective, punishment must not be subject to any pre-determined limits.

Although punitive or exemplary damages were available in certain circumstances at common law, Haslip, 499 U.S. at 15-16, they never have been awarded as of right. Smith v. Wade, 461 U.S. 30, 52 (1983). In many jurisdictions, a plaintiff does not have an automatic right to punitive damages, and the decision to make such an award lies within the discretion of the factfinder. See 1 L. Schlueter & K. Redden, Punitive Damages §2.1(C) (3d ed. 1995) (listing cases from 14 states). Punitive damages serve no compensatory function, and are considered a "windfall" to the plaintiff involved. City of Newport v. Fact Concerts, Inc., 453 U.S. 247, 266-67 (1981). By their very nature, such "damages" are awarded not to compensate for injury, but to punish the defendant for egregious conduct and to deter others from engaging in such conduct. International Brotherhood of Elect. Workers v. Foust, 442 U.S. 42, 48 (1979); 1 James D. Ghiardi et al., Punitive Damages Law & Practice, § 2.01 (1991 & Supp. 1996).

Because they serve the same or similar functions as criminal penalties, "[p]unitive damages have been described as quasi-criminal." Haslip, 499 U.S. at 19. But because such damages in fact are civil penalties and can be imposed without the full panoply of procedural safeguards normally afforded to criminal defendants, most states do not favor the award of punitive damages. See Schlueter & Redden, supra, at §2.1(C). By judicial decision, several states, including Washington, Louisiana, Nebraska, and Massachusetts, strictly prohibit the award of punitive damages, except in situations where such damages have been specifically authorized by statute. Id. at § 2.2. In New Hampshire, punitive damages are prohibited by statute unless otherwise provided. N.H. Rev. Stat. Ann. § 507:16. Although it has become standard practice for plaintiffs to request punitive damages in securities arbitration, the award of punitive damages generally has been called "an extraordinary event." Deshmukh v. Cook, 630 F. Supp. 956, 961 (S.D.N.Y. 1986). Courts and legislatures have advised that punitive damages should be awarded cautiously and within narrow limits. Schlueter & Redden, supra, at § 2.1 (C).

Precisely because no right to punitive damages exists, a court or legislature may limit or deny such an award. Schlueter & Redden, supra, at §2.1(C). Indeed, both federal and state legislatures have imposed caps on the amount of punitive damages available. See Victor E. Schwartz & Mark A. Behrens, Punitive Damages Reform -- State Legislatures Can and Should Meet the Challenge Issued by the Supreme Court of the United States in Haslip, 42 Am. U. L. Rev. 1365, 1374 (1993); see also James B. Sales and Kenneth B. Cole, Punitive Damages: A Relic that has Outlived its Origins, 37 Vand. L. Rev. 1117, 1168-69 (1984) (advocating that legislatures should impose specific dollar limits on punitive damages and citing as an example the treble damage provision of the Clayton Act).

For example, the Civil Rights Act of 1991 fixes an upper limit of \$300,000 for the total of compensatory and punitive damages available to victims of intentional discrimination. 42 U.S.C. §1981a. In arriving at this compromise, Congress sought to balance the need to properly punish and deter discriminatory conduct against the competing need to ensure that the Act would not unduly burden businesses. Compromise Civil Rights Bill Passed, XLVII Congressional Quarterly Almanac, 251, 255-57 (1991). Similarly, Section 222(C) of the Futures Trading Practices Act of 1992 permits the award of punitive or exemplary damages in cases of willful or intentional violations, but such damages are limited to no more than two times the actual losses sustained as a result of the violation. 7 U.S.C. § 25. At least 16 states have imposed some kind of cap on punitive damages. See Ghiardi, et al., supra, at §21.15; Gore, 116 S.Ct. at 1618-19 (Ginsburg, J., dissenting) (including an appendix of enacted or pending state legislation regarding punitive damages awards). Similar legislation is pending in at least two other jurisdictions. See H.B. 3019, 112th Gen. Assembly (S.C. 1997); S.B. 98, 181st Gen. Assembly (Pa. 1997). Such measures reflect a recognition that the costs associated with unlimited punitive damages are too high. The NASD proposal properly reflects a similar conclusion with respect to securities arbitrations.

The second assumption of critics of the NASD proposal -- namely, that for punitive damages to be effective, they must not be subject to any pre-determined limit -- flies in the face of common practice regarding fines and other civil penalties. Like fines, punitive damages can be subject to pre-determined maximums without losing any of their effectiveness. The Supreme Court has explained that punitive damages are "private fines." Foust, 442 U.S. at 48, quoting Gertz v. Welch, 418 U.S. 323, 350 (1974); Rosenbloom v. Metromedia, Inc., 403 U.S. 29, 74 (1971) (Harlan, J., dissenting); Smith v. Wade, 461 U.S. at 59 (Rehnquist, J., dissenting) (characterizing punitive damages as a "fine"). Indeed, civil fines serve the same function as punitive damages: they are assessed against the wrongdoer to punish him or her for wrongful conduct and to deter future violations by that person or others. Tull v. United States, 481 U.S. 412, 422 n. 7 (1987); Island Creek Coal Co. v. District 28, United Mine Workers, 29 F.3d 126, 131 n.7 (4th Cir.), cert. denied, 513 U.S. 1019 (1994); cf. Gore, 116 S.Ct. at 1597 (1996) (punitive damages similar to civil fines). Just as a legislature can set maximum civil or criminal fines in advance of the unlawful conduct without violating public policy or undermining the enforcement of statutory norms, so the NASD can establish a rule prospectively capping punitive damages without sacrificing any legitimate objectives in enforcing the securities laws.

Any assertion that the NASD proposal will not adequately punish those who violate the securities laws or deter others from engaging in unlawful conduct ignores the severity of the penalties available under the proposed NASD rule, as well as the numerous other mechanisms

through which violators of the securities laws can be punished. The amount of punitive damages available under the NASD proposal is far from insignificant; it allows an aggrieved party to collect not only full compensation for any injury suffered but also as much as double the amount of actual damages up to a maximum of \$750,000. Indeed, \$750,000 punitive damages award would devastate many members of the industry, as **that amount is greater than the total net capital of half of the members of the SIA and of several thousand firms belonging to the NASD.** The threat of such a penalty provides a strong disincentive against engaging in the kind of conduct that might give rise to such a fine. The latitude provided to arbitrators under the NASD proposal is greater than, or comparable to, that contained in many other proposed or enacted limitations on punitive damage awards. See Schwartz & Behrens, *supra*, at 1378-79 (describing proposals of the American College of Trial Lawyers and the American Law Institute limiting punitive damages to the greater of twice compensatory damages or \$250,000); see also Ghiardi, et al., *supra*, at § 21.15 (cataloguing punitive damage caps enacted by state legislatures). By permitting punitive awards as high as double compensatory damages up to a maximum of \$750,000, the NASD proposal ensures that arbitrators will have sufficient ammunition to deter those who otherwise might engage in conduct in violation of federal securities law and NASD regulations, and to punish those who do engage in such conduct.

Moreover, in considering the NASD's proposed limit on punitive damages, the SEC's own important role in punishing and deterring violations of the securities laws should not be forgotten. The SEC is empowered to discipline broker-dealers for unlawful conduct. 15 U.S.C. §78o. The SEC's enforcement authority is a powerful tool, which can result in criminal as well as civil penalties. The SEC can bring an enforcement action against a member firm to recover civil fines, 15 U.S.C. § 78u-2, and it can refer matters to the Department of Justice for criminal investigation. 15 U.S.C. §§ 78u, 78u-1, 78ff. The severity and effectiveness of these enforcement measures strongly support the view that the NASD's punitive damages proposal will not adversely affect legitimate law enforcement goals.

The NASD's own comprehensive system of rules and procedures governing its members' conduct further bolsters this conclusion. In all of their conduct and business operations, NASD members must "observe high standards of commercial honor and just and equitable principles of trade." NASD Manual (CCH), Conduct Rules 2110 (1996). In 1996, the NASD established an independent subsidiary, the NASDR, to regulate NASD members and to enforce federal laws and NASD regulations. NASD Manual (CCH) at 151. The NASDR routinely examines the books and records of each member to ensure the member's compliance with applicable law. *Id.* at 152-55. District Business Conduct Committees, which operate in each of the NASD's eleven districts, and a centralized Market Surveillance Committee also review the conduct of members for possible violations of the securities laws. *Id.*; see also 1994 NASD Notice to Members 94-54. These Committees may hold hearings on complaints and recommend informal remedial action or formal disciplinary action by the NASDR. NASD Manual at 153. NASDR sanctions for violations of NASD rules include fines, censure, suspension or expulsion from the NASD, restitution, suspension or revocation of a person's license to sell securities, or other appropriate measures. *Id.* In determining what sanctions to impose, the NASDR may take into account not only the seriousness of the offense, but also past conduct in the industry.

The NASD rules also provide numerous procedures by which a complaint may be brought to

the attention of the NASDR. First, "[a]ny person feeling aggrieved" by conduct that he or she believes to be in violation of federal law or NASD rules and regulations may register a complaint with a District Business Conduct Committee. NASD Manual (CCH), Complaints, Investigations & Sanctions 8110. Second, NASD members must report allegations of misconduct to the Central Registration Depository, and the NASDR regularly monitors these reports. 1994 NASD Notice to Members 94-54. Lastly, arbitrators may report a matter for disciplinary action if they believe that a statutory or regulatory violation has occurred. NASD Manual (CCH), Code of Arbitration Procedure 10105. In short, the multi-layered mechanisms for enforcing the securities laws and deterring potential violations obviate any possible need for punitive damages in excess of those authorized by the proposed NASD rule.

Notwithstanding all of the foregoing points, opponents of the proposed NASD rule may contend that because very large punitive damages awards have been rare in securities arbitration, the NASD's proposed cap is not needed to protect against excessive or abusive awards. This is a non sequitur, for at least two reasons. First, the fact that outrageous punitive damages awards may be uncommon does not mean that they are non-existent, or that their impact is any less devastating when they occur, particularly when the respondent is a small industry member or individual. Second, past experience provides no assurance or protection against runaway punitive damages awards in the future, and it makes no sense to say that the NASD should wait until numerous excessive or abusive awards have been rendered before acting to impose some limit on the availability of punitive damages in NASD arbitration. It would be scant solace for the firm ordered to pay an excessive punitive damages award that its unfortunate experience might lead eventually to NASD rulemaking. Moreover, it can be argued with at least equal force that, if exorbitant punitive damages awards indeed have been rare in past securities arbitrations, that fact demonstrates that the proposed NASD rule will not have an adverse effect on securities law enforcement but instead will operate as intended, to protect against aberrant and unreasonable awards. The correct lesson to be drawn from history, in other words, is not that the proposed NASD rule is unnecessary but that it will not undermine legitimate efforts to punish and deter securities law violations.

II. Criticism Based on Supreme Court Decisions Sustaining Enforceability of Arbitration Agreements

Critics of the NASD proposal may argue that the rationale underlying the Supreme Court's decisions in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), and Rodriguez De Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989), does not permit the NASD to alter in any way a claimant's ability to seek punitive damages in arbitration. The theory would be that the Court approved the enforcement of arbitration clauses in customer agreements only on the assumption that the relief available in such arbitrations would be equivalent to that available in court and that therefore the NASD may not impose its own limitations on the availability of punitive damages. This argument misconceives the Supreme Court's reasoning in McMahon and Rodriguez. The Court concluded in those cases that, given the nature of arbitration and the SEC's oversight of arbitration procedures, arbitration is an effective means of addressing alleged violations of the securities laws and protecting the substantive rights of claimants and that, accordingly, there was no basis for courts to refuse to enforce customer agreements to arbitrate disputes arising under the securities laws. It was never a premise of the Supreme Court's decisions that arbitration would duplicate litigation in all

significant respects.

In McMahon, the petitioner brokerage firm sought to enforce a pre-dispute agreement to resolve through arbitration claims filed by its customers under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. McMahon, 482 U.S. at 223. The Supreme Court ruled that the Federal Arbitration Act, 9 U.S.C. §§ 1-14, and the strong federal policy favoring arbitration required courts to enforce agreements to arbitrate statutory claims unless Congress clearly intended to create an exception for such claims. Id. at 226-27. The Court then examined the text, history, and purposes of the Securities Exchange Act, and determined that Congress had created no such exception for violations of the securities laws.

Respondents in McMahon relied heavily on the Supreme Court's earlier decision in Wilko v. Swan, 346 U.S. 427 (1953), which held that pre-dispute agreements to arbitrate claims arising out of the Securities Act of 1933 were not enforceable. Respondents urged that the Court adopt the following syllogism: (i) Section 29 of the Securities Exchange Act, 15 U.S.C. § 78cc, voided agreements to waive compliance with any provision of the Act; (ii) the parties' agreement to arbitrate acted as a waiver of the Act's provision giving the federal district courts exclusive jurisdiction over disputes arising under the statute (see 15 U.S.C. § 78aa); and therefore (iii) the agreement to arbitrate should not be enforced. McMahon, 482 U.S. at 228. The Supreme Court rejected this argument, holding that the Act's jurisdictional provision did not create any duties with which a party must comply or that could not be waived. Id. The Court also ruled that its decision in Wilko did not require an opposite conclusion. The Court explained that Wilko barred waiver of the judicial forum "only because arbitration was judged inadequate to enforce statutory rights created by [the Securities Act of 1933]." Id. at 228-29.

In response to the argument that the Court should follow Wilko and conclude that arbitration weakens investors' rights under the securities laws, 482 U.S. at 231, the Court reviewed the factors on which Wilko had relied and determined that subsequent decisions had rejected each one. The Court stated that "the reasons given in Wilko reflect a general suspicion of the desirability of arbitration and the competence of arbitral tribunals." Id. Subsequent decisions, however, recognized that arbitrators competently can handle complex issues of law and fact, and "that the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights." Id. at 232. The Court also explained that, even though only limited judicial review of arbitration decisions is available, such review is adequate to ensure that arbitrators comply with the statutory provisions in question. Id. Finally, the Court acknowledged that the increased oversight by the SEC of the arbitration procedures employed by SROs played a role in its determination that arbitration agreements do not waive the substantive protections of the Securities Exchange Act. Id. at 233-34. As a result, the Court explained that "[e]ven if Wilko's assumptions regarding arbitration were valid at the time Wilko was decided, most certainly they do not hold true today for arbitration procedures subject to the SEC's oversight authority." Id. at 233. At no point in the Court's discussion did it suggest that its holding depended on the assumption that arbitrations would duplicate judicial proceedings or that precisely the same forms of relief would be available in each.

Rodriguez explicitly overruled Wilko v. Swan. 490 U.S. at 484. The Court held that the rationale that supported its decision in McMahon applied with equal force to claims arising under the Securities Act of 1933. 490 U.S. at 480-83. It recognized that Wilko was the product of judicial

mistrust of arbitration, a position inconsistent with the current federal policy promoting that method of dispute resolution. Id. at 480-81. Again, the Court did not suggest that its decision depended on some presumed equivalence of the remedies available in litigation and arbitration.

McMahon and Rodriguez approved arbitration in securities cases because sufficient mechanisms exist to ensure the protection of a claimant's substantive rights under the securities laws. The decisions cannot be read as a promise to claimants that, whenever punitive damages are available in court, they must be equally available in arbitration. See Mitsubishi Motors, 473 U.S. at 628 ("By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum."). Claimants do not have a substantive right to obtain punitive damages, and an agreement to arbitrate does not alter that fact. In any event, the NASD proposal authorizes claimants to seek punitive damages in arbitration under the same standards that would apply in the courts of their own state. Proposed NASD Rule 10336(b)(1). The limitation on the amount of such an award does not alter a claimant's substantive rights, and therefore does not run afoul of McMahon and Rodriguez.

Conclusion

The NASD's proposed rule does not embrace either pole in the ongoing debate over punitive damages. That is the nature of compromise; neither side gets everything it wants, and each side must yield in pursuit of a greater good. The SIA is willing to accept such a compromise. As Senator Jeffords stated during the debate concerning the cap on punitive damages in the Civil Rights Act of 1991:

From the beginning . . . our effort has been to craft a civil rights bill that all the contending factions could live with. Almost by necessity, this means that none of those factions would love the result. Each would have had to have given up too much to get a bill that could become law. There is no thrill of victory here. This is as true on the issue of damages as it is for every other issue. I am convinced that the worst enemy of this good, is the quest for perfect legislation. Perfection is not obtainable in this instance, this is the best we can do at this time.

137 Cong. Rec. S15384 (daily ed. Oct. 29, 1991). The NASD's proposed rule is no different. The SIA believes that it promotes the efficient resolution of disputes and at the same time protects the interests of claimants and respondents. Without the rule, the unfairness and uncertainty inherent in current securities arbitration will undercut the faith of both sides in the arbitration process as an alternative method of dispute resolution. The NASD's proposal protects the interests of investors, promotes the equitable administration of NASD arbitrations, and furthers the purposes of the Securities Exchange Act. It should be approved.

SIA wishes to thank the Commission for the opportunity to comment on the proposed rule. If SIA can provide further information, please contact the undersigned or any of the following SIA staff at (202) 296-9410: Stuart J. Kaswell, Senior Vice President and General Counsel or Fredda L. Plessner, Vice President and Associate General Counsel.

Very truly yours,

Paul J. Dubow

Chairman of the Arbitration Subcommittee of the Litigation Committee

CC:

The Honorable Arthur Levitt, Chairman

The Honorable Norman S. Johnson, Commissioner

The Honorable Isaac C. Hunt, Jr., Commissioner

The Honorable Laura S. Unger, Commissioner

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Linda D. Fienberg, Executive Vice President, NASDR

Footnotes:

¹ The Securities Industry Association brings together the shared interests of more than 770 securities firms throughout North America to accomplish common goals. SIA members -- including investment banks, broker-dealers, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the U.S., SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50-million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans.

² The SIA and its members believe that the SEC's extensive oversight of NASD operations requires all NASD rules and procedures conducted thereunder to comport with due process requirements. See NASD Notice to Members 94-54 (1994) at 327 ("The award of punitive damages in arbitration is state action . . . for at least two reasons: imposing punitive damages is a public function, and, the government compels membership in an SRO."); Brief for the Securities Industry Association as Amicus Curiae Supporting Respondents, Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S.Ct. 1212 (1995) (No. 94-18) at 27-28 (explaining that because the SEC requires broker-dealers to become members of the NASD, and because the government cannot require membership in an organization whose rules would violate the Constitution if they were rules of the government, NASD rules must comport with due process). The SEC considers the rules of the NASD to have the force and effect of federal law. Brief for the United States and the Securities and Exchange Commission as Amici Curiae in Support of Petitioners, Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S.Ct. 1212 (1995) (No. 94-18) at 10-12. Accordingly, any rule imposed by the NASD on its members must comport with due process.