NASD Notice to Members 94-52

Mail Vote—NASD Solicits Member Vote On Proposed Amendments To The NASD By-Laws To Facilitate The *NASD Manual* Revision; **Last Voting Date: August 29, 1994**

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ☐ Internal Audit
- ■ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☐ Training

Executive Summary

The NASD invites members to vote on proposed amendments to the NASD By-Laws to prepare for a planned new numbering scheme for the *NASD Manual*; to correct certain minor errors found in the By-Laws; and to provide for Board approval of future spelling and numbering changes. The last voting date is August 29, 1994. The text of the amendment follows this Notice.

Background

The NASD is developing a proposal to reorganize the *NASD Manual* to make it easier for members and others to use. This will be a non-substantive reordering of the existing rules, interpretations, and other provisions of the *Manual* to present the rules more logically in the *Manual*. This project will require certain changes in numbering and terminology in the NASD By-Laws and rules. Changes that the NASD is currently aware of are described below. To facilitate the *Manual* revision, the NASD is seeking approval of an amendment to the By-Laws that would allow the Board to make future editorial changes to numbering or spelling in the By-Laws without a member vote.

As described previously in *Notice to Members 93-15*, the amendments are the second phase of a multi-part program, the purpose of which is to make all rule approval and amendment procedures under the NASD By-Laws uniform and to make the *Manual* easier to use. The program envisions that all rules in the *Manual*, including not only the current Rules of Fair Practice but also such specialized rules as the Government Securities Rules, The Nasdaq Stock Market Rules (Schedule D to the By-Laws), Code of Arbitration Procedure, etc., will be numbered consecutively throughout the *Manual* and considered together as "Rules." The entire body of requirements affecting members, including the Certificate of Incorporation, By-Laws, and Rules, will be referred to as the "rules of the Corporation." The proposed changes to the By-Laws reflect these changes in terminology. In addition, a common numbering and naming scheme for subdivisions within a Rule will be used.

Description of Proposals

The sections of Article I of the By-Laws have been rearranged so that the definitions are now in alphabetical order for easier use. As discussed above, the term "Rules" will be used in the *Manual* revision to refer to all rules that may now be referred to by various names, but for purposes of new Article I, Section s, the existing names for these types of rules have been retained to provide examples of the types of rules that are included. To make the provision more broadly applicable, however, the language "any other rules" has been added. This would include, for example, the text of Schedules that are proposed to be converted to rules in the *Manual* revision project.

Article III, Section 7 is amended to reflect that, as part of the *Manual* revision project, the term "Rules of Fair Practice" will be eliminated and replaced with the general term "Rules." In Section 10 of the same Article, the reference to Article I has been changed to reflect the new order of the definitions that are to be placed in alphabetical order and relettered, as described above.

In Article IV, Section 4, references to specific Rules of Fair Practice will be changed to the proposed new Rule numbers that will be used in the *Manual* revision project. These new numbers will not be printed in the

Manual until the entire revision is completed. Also in Section 4, an existing, erroneous cross-reference to Section 2(b) has been corrected.

In Article V, Sections 3 and 4, references to Rules of Fair Practice and the Code of Procedure have been changed to the more general term "other rules" as part of the *Manual* revision project.

In Article VII, Section 1, references to the "Rules of Fair Practice" have been changed to "Rules" to conform to the new terminology used in the *Manual* revision. In light of this change, former subsection (a)(3), which gave the Board general authority to adopt rules and interpretations to implement the Securities Exchange Act of 1934, will duplicate subsections (a)(2) and (4), which do essentially the same thing. The reference to implementing the provisions of the Act is duplicative of Article XII, Section 1 (text below), which provides that the Board is authorized to adopt Rules "to carry out the purposes of the Corporation and of the Act." Therefore, it is proposed to delete subsection (a)(3) as part of the *Manual* revision project.

To make the numbering scheme of the By-Laws internally consistent, using the method employed throughout the rules in the proposed *Manual* revision wherein subdivisions follow the format of (a)(1)(A)(i), the subsection numbers in lower-case Roman numerals in Article VII, Sections 3 and 4 have been replaced with Arabic numbers. In Section 7(c), the reference to Article III, Section 8 should have been changed to Section 9 when those sections were renumbered. In Article VII, Section 8 the proposed changes are related to the renumbering of subsections in Section 4 to conform to the standard numbering scheme.

The proposed changes to Articles VIII and IX are to correct the same erroneous cross-reference described previously under Article VII, Section 7(c).

The proposed change to Article XII reflects the new terminology of "Rules" rather than "Rules of Fair Practice" that will be used in the *Manual* revision.

Finally, the amendment to Article XVII would provide latitude for the Board to approve minor changes to spellings or numbering in the By-Laws to correct errors or to conform to the renumbering of Rules referred to in the By-Laws, without the necessity of a membership vote. Such changes would continue to be called to the attention of members through the regular CCH Report Letters updating the looseleaf *Manuals*. This will not only reduce delays in making rule changes effective, but will also result in administrative cost savings. A member vote will continue to be required for substantive changes to the NASD By-Laws.

Request For Vote

The NASD Board of Governors believes that the proposed amendment to the By-Laws will facilitate the updating and simplifying of the *Manual* and will aid the Board in making minor corrections to the By-Laws in a timely manner, subject to approval by the Securities and Exchange Commission, without the costs and delays inherent in sending proposed numbering and spelling changes to nearly 6,000 members for a mail vote. Please mark the attached ballot according to your convictions and mail it in the enclosed, stamped envelope to The Corporation Trust Company. Ballots must be postmarked no later than August 29, 1994.

Questions concerning this Notice should be directed to T. Grant Callery, Vice President and General Counsel, at (202) 728-8285.

Proposed Amendments to Articles I, III, IV, V, VII, VIII, IX, XII, and XVII of the NASD By-Laws

(**Note**: New text is underlined; deleted text is in brackets.)

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ARTICLE I

Definitions

When used in these By-Laws, and any rules of the Corporation, unless the context otherwise requires, the term:

(a) "Act" means the Securities Exchange Act of 1934 as amended;

(b) "bank" means (1) a banking institution organized under the laws of the United States, (2) a member bank of the Federal Reserve System, (3) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks, and which is supervised and examined by a State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of the Act, and (4) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (1), (2) or (3) of this subsection;

[(r)] (c) "Board" means the Board of Governors of the Corporation[.];

[(c)] (d) "branch office" means an office defined as a branch office in

[Article III, Section 27 of the Rules of Fair Practice] Rule __;[1]

[(d)] (e) "broker" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank;

[(e)] (f) "Commission" means the Securities and Exchange Commission;

[(f)] (g) "Corporation" means the National Association of Securities Dealers, Inc.;

[(g)] (h) "dealer" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business;

[(p)] (i) "government securities broker" shall have the same meaning as in Section 3(a)(43) of the Act except that it shall not include financial institutions as defined in Section 3(a)(46) of the Act[.];

[(q)] (j) "government securities dealer" shall have the same meaning as in Section 3(a)(44) of the Act except that it shall not include financial institutions as defined in Section 3(a)(46) of the Act[.];[

[1]Rule numbers will be inserted upon completion of the *Manual* revision project.

[(s)] (k) "Governor" means a member of the Board[.];

[(h)] (l) "investment banking or securities business" means the business, carried on by a broker, dealer, or municipal securities dealer (other than a bank or department or division of a bank), or government securities broker or dealer of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others;

[(i)] (m) "member" means any broker or dealer admitted to membership in the Corporation;

[(j)] (n) "municipal securities" means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond as defined by Section 3(a)(29) of the Act;

[(k)] (o) "municipal securities broker" means a broker, except a bank or department or division of a bank, engaged in the business of effecting transactions in municipal securities for the account of others;

[(l)] (p) "municipal securities dealer" means any person, except a bank or department or division of a bank, engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account either individually or in some fiduciary capacity but not as a part of a regular business;

[(m)] (q) "person associated with a member" or "associated person of a member" means every sole proprietor, partner, officer, director, or branch manager of any member, or any natural person occupying a similar status or performing similar functions, or any natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by such member, whether or not any such person is registered or exempt from registration with the Corporation pursuant to these By-Laws;

[(n)] (r) "registered broker, dealer, municipal securities broker or dealer, or government securities broker or dealer" means any broker, dealer, municipal securities broker or dealer, or government securities broker or dealer which is registered with the Commission under the Act;

[(o)] (s) "rules of the Corporation" means all rules of the Corporation including the Certificate of Incorporation, By-Laws, Rules of Fair Practice, Government Securities Rules, Code of Procedure, Uniform Practice Code, any other rules, and any interpretations thereunder.

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ARTICLE III

Membership

Transfer and Termination of Membership

Sec. 7. (a) Except as provided hereinafter, no member of the Corporation may transfer its membership or any right arising therefrom and the membership of a corporation, partnership or any other business organization which is a member of the Corporation shall terminate upon its liquidation, dissolution or winding up, and the membership of a sole proprietor which is a member shall terminate at death, provided that all obligations of membership under the By-Laws and Rules [of Fair Practice] of the Corporation have been fulfilled.

(b) Unchanged.

* * *

District Committees' Right to Classify Branches

Sec. 10. A District Committee may classify any branch of a member not meeting the definition of Article [I(c)] I(d) of the By-Laws as a "branch office" if such Committee is satisfied that the definition of Article [I(c)] I(d) of the By-Laws is substantially met and that the business of said branch in the district is of sufficient importance to justify such a classification.

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ARTICLE IV

Registered Representatives and Associated Persons

Retention of Jurisdiction

Sec. 4. A person whose association with a member has been terminated and is no longer associated with any member of the Corporation or a person whose registration has been revoked shall continue to be subject to the filing of a complaint under the Code of Procedure based upon conduct which commenced prior to the termination or revocation or upon such person's failure, while subject to the Corporation's jurisdiction as provided herein, to provide information requested by the Corporation pursuant to [Article IV, Section 5 of the NASD Rules of Fair Practice] Rule ___, but any such complaint shall be filed within:

(a) two (2) years after the effective date of termination of registration pursuant to Section 3 above, provided, however that any amendment to a notice of termination filed pursuant to Section [2(b)] 3(b) that is filed within two years of the original notice which discloses that such person may have engaged in conduct actionable under any applicable statute, rule or regulation shall operate to recommence the running of the two-year period under this paragraph;

(b) two (2) years after the effective date of revocation of registration pursuant to [Article V, Section 2 of the Association's rules of Fair Practice] Rule __, or;

(c) in the case of an unregistered person, within two (2) years after the date upon which such person ceased to be associated with the member.

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ARTICLE V

Affiliates

Agreement of Affiliate

Sec. 3. No applicant may become an affiliate of the Corporation unless it agrees:

(a) Unchanged.

(b) Unchanged.

(c) That, after affiliation, it will at all times keep its charter, by-laws, [rules of fair practice and code of procedure] and other rules so integrated with the corresponding Charter, By-Laws, [Rules of Fair Practice and Code of Procedure] and other rules of the Corporation as not to conflict in any way therewith; and

(d) Unchanged.

Conditions of Affiliation

Sec. 4. No applicant may become an affiliate of the Corporation unless it appears to the Board of Governors:

(a) Unchanged.

(b) That the charter, by-laws, [rules of fair practice and code of procedure] and other rules of the applicant are so integrated with the corresponding Charter, By-Laws, [Rules of Fair Practice and Code of Procedure] and other rules of the Corporation as not to conflict in any way therewith.

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ARTICLE VII

Board of Governors

Powers and Authority of Board of Governors

Sec. 1. (a) Unchanged.

(1) Unchanged.

(2) adopt such Rules [of Fair Practice] and changes or additions thereto as it deems necessary or appropriate, provided, however, that the Board may at its option submit to the membership any such adoption, change or addition to the Rules [of Fair Practice];

[(3) (a) adopt such rules as the Board of Governors deems appropriate to implement the provisions of the Act as amended and the rules and regulations promulgated thereunder, and (b) make such regulations, issue such orders, resolutions, interpretations, including interpretations of the rules adopted pursuant to this Section, and directions, and make such decisions as it deems necessary or appropriate.]

[(4)] (3) Unchanged.

[(5)] (4) Unchanged.

[(6)] (5) Unchanged.

[(7)] (6) Unchanged.

[(8)] (7) Unchanged.

[(9)] (8) Unchanged.

[(10)] (9) Unchanged.

(b) Unchanged.

Authority to Take Action Under Emergency or Extraordinary Market Conditions

Sec. 3. (a) The Board of Governors, or between meetings of the Board, a Committee consisting of the Chairman of the Board (or in his absence, a Vice Chairman of the Board), the President of the Corporation, and a member of the Executive Committee, in the event of an emergency or extraordinary market conditions, shall have the authority to take any action regarding [(i)] (1) the trading in or operation of the over-the-counter securities market, the operation of any automated system owned or operated by the Corporation or any subsidiary thereof, and the participation in any such system of any or all persons or the trading therein of any or all securities and [(ii)] (2) the operation of any or all member firms' offices or systems, if, in the opinion of the Board or the Committee hereby constituted, such action is necessary or appropriate for the protection of investors or the public interest or for the orderly operation of the marketplace or the system.

(b) Unchanged.

(c) Unchanged.

Composition of Board

Sec. 4. (a) The management and administration of the affairs of the Corporation shall be vested in a Board of Governors composed of from twenty-five to twenty-nine Governors as determined from time to time by the Board. The Board shall consist of: [(i)] (1) at least thirteen but not more than fifteen Governors to be elected by the members of the various districts in accordance with the provisions of subsection (b) hereof; [(ii)] (2) at least eleven but not more than thirteen Governors to be elected by the Board in accordance with the provisions of subsection (c) hereof; and [(iii)] (3) the President of the Corporation to be selected by the Board in accordance with the provisions of Article X, Section 2 of the By-Laws. The Board, in exercising its power to determine its size and composition under this subsection (a), shall be required to select its members in a manner such that when all vacancies, if any, are filled, the number of Governors elected by the members of the various districts in accordance with subsection (b) hereof shall exceed the number of Governors (including the President) not so elected.

(b) Unchanged.

(c) The Board shall elect [(i)] (1) at least three Governors representative of investors, none of whom are associated with a member or any broker or dealer; [(ii)] (2) at least three Governors representative of issuers, at least one of whom is not associated with a member or any broker or dealer; [(iii)] (3) at least three Governors chosen from members; [(iv)] (4) at least one Governor representative of the principal underwriters of investment company shares or affiliated members; and [(v)] (5) at least one Governor representative of insurance companies or insurance company affiliated members.

* * *

Election of Board Members

Sec. 7. The Governors elected under subsection (b) of Section 4 of this Article shall be chosen as follows:

Procedure for Nominations by Nominating Committees

(a) Unchanged.

Nomination of Additional Candidates

(b) Unchanged.

Contested Elections

(c) If any additional candidate or candidates are nominated, as provided in subsection (b) of this Section, the District Committee shall forthwith cause the names of the regular candidate and of all other duly nominated candidates for each office to be placed upon a ballot, which shall be sent to all members of the Corporation eligible to vote in the district. Each member of the Corporation having its principal place of business in the district shall be entitled to one vote, and each member having one or more registered branch offices in the district shall be entitled to vote as provided in Section [8] 9 of Article III. The District Committee shall fix a date before which ballots must be returned to be counted. All ballots shall be opened and counted by such officer or employee of the Corporation as the Chairman of the District Committee may designate and in the presence of a representative of each of the candidates if such representation is requested in writing by any candidate named on the ballot. The candidate for each office to be filled receiving the largest number of votes cast shall be declared elected to membership on the Board of Governors, and certification thereof shall be made forthwith to the Board of Governors. In the event of a tie, there shall be a run-off election. In all elections held under this subsection voting shall be made by secret ballot, the procedure for which shall be prescribed by the Board of Governors.

Transitional Procedures

(d) Unchanged.

Filling of Vacancies on Board

Sec. 8. All vacancies in the Board other than those caused by the expiration of a Governor's term of office, shall be filled as follows:

(a) Unchanged.

(b) Unchanged.

(c) If the unexpired term is that of a Governor elected by the Board such vacancy shall be filled in accordance with the provisions of subsections [(c)(i)] (c)(1) through [(c)(v)] (c)(5) of Section 4 of this Article as the case may be.

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ARTICLE VIII

District Committees

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Election of District Committee Members

Sec. 4. Members of the District Committees shall be elected as follows:

Procedure for Nominations by Nominating Committees

(a) Unchanged.

Nomination of Additional Candidates

(b) Unchanged.

Contested Elections

(c) If any additional candidate or candidates are nominated, as provided in paragraph (b) of this Section, the District Committee shall forthwith cause the names of the regular candidate for any contested office and of all other candidates for such office to be placed upon a ballot, which shall be sent to all members of the Corporation eligible to vote in the district. Each member of the Corporation having its principal place of business in the district shall be entitled to one vote, and each member having one or more registered branch offices in the district shall be entitled to vote as provided in Section [8] (9) of Article III. The District Committee shall fix the date before which ballots must be returned to be counted. All ballots shall be opened by such officer or employee of the Corporation as the Chairman of the District Committee may designate, and in the presence of a representative of each of the candidates if such representation is requested in writing by any candidate named in the ballot. The candidate for each office to be filled receiving the largest number of votes cast shall be declared elected to membership on the District Committee, and certification thereof shall be made forthwith to the Board of Governors. In the event of a tie, there shall be a run-off election. In all elections held under this Section, voting shall be by secret mail ballot, the procedure for which shall be prescribed by the Board of Governors.

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ARTICLE IX

Nominating Committees

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Election of Nominating Committees

Sec. 3. Members of the Nominating Committee shall be elected as follows:

Procedures for Nominations by Nominating Committees

(a) Unchanged.

Nomination of Additional Candidates

(b) Unchanged.

Contested Elections

(c) If additional candidates are nominated, as provided in paragraph (b) of this Section, the District Committee shall forthwith cause the names of the regular candidate and all other candidates for any contested office to be placed upon a ballot, which shall be sent to all members of the Corporation eligible to vote in the District. Each member of the Corporation having its principal place of business in the District shall be entitled to one vote, and each member having one or more registered branch offices in the District shall be entitled to vote as provided in Section [8] (9) of Article III. The District Committee shall fix the date before which ballots must be returned to be counted. All ballots shall be opened by such officer or employee of the Corporation as the Chairman of the District Committee may designate, and in the presence of a representative of each of the candidates, if such representation is requested in writing by any candidate named in the ballot. The candidate for each office to be filled receiving the largest number of votes cast shall be declared elected to membership on the Nominating Committee and certification thereof shall be made forthwith to the Board of Governors. In the event of a tie, there shall be a run-off election. In all elections held under this Section, voting shall be by secret mail ballot, the procedure for which shall be prescribed by the Board of Governors.

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ARTICLE XII

Rules [of Fair Practice]

Sec. 1. To promote and enforce just and equitable principles of trade and business, to maintain high standards of commercial honor and integrity among members of the Corporation, to prevent fraudulent and manipulative acts and practices, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, to protect investors and the public interest, to collaborate with governmental and other agencies in the promotion of fair practices and the elimination of fraud, and in general to carry out the purposes of the Corporation and of the Act, the Board of Governors is hereby authorized to adopt such Rules [of Fair Practice] for the members and persons associated with members, and such amendments thereto as it may, from time to time, deem necessary or appropriate. If any such Rules [of Fair Practice] or amendments thereto are approved by the Commission as provided in the Act, they shall become effective Rules [of Fair Practice] of the Corporation as of such date as the Board of Governors may prescribe. The Board of Governors is hereby authorized, subject to the provisions of the By-Laws and the Act, to administer, enforce, suspend, or cancel any Rules [of Fair Practice] adopted hereunder.

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ARTICLE XVII

Procedure for Adopting Amendments to By-Laws

Sec. 1. Any member of the Board of Governors by resolution, any District Committee by resolution, or any twenty-five members of the Corporation by petition signed by such members, may propose amendments to these By-Laws. Every proposed amendment shall be presented in writing to the Board of Governors and a record shall be kept thereof. The Board of Governors may adopt any proposed amendment to these By-Laws by affirmative vote of a majority of the members of the Board of Governors then in office. The Board of Governors, upon adoption of any such amendment to these By-Laws, except <u>as to spelling or numbering corrections or</u> as otherwise provided in these By-Laws<u>,</u> shall forthwith cause a copy to be sent to and voted upon by each member of the Corporation. If such amendment to these By-Laws is approved by a majority of the members voting within thirty (30) days after the date of submission to the membership, and is approved by the Commission as provided in the Act, it shall become effective as of such date as the Board of Governors may prescribe.

NASD Notice to Members 94-53

SEC Proposes Amendments To Regulation T

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Corporate Finance
- ■ Government Securities
- ■ Institutional
- ☐ Internal Audit
- ■ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ■ Operations
- ☐ Options
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☐ Training

Executive Summary

The Board of Governors of the Federal Reserve System is seeking comments on proposed amendments to Regulation T (Credit by Brokers and Dealers) regarding settlement of securities purchases and the status of government securities transactions. Comments on the proposed changes should be received by August 15, 1994.

Background

On August 18, 1992, the Board of Governors of the Federal Reserve System (Board) published an advance notice of proposed rulemaking requesting public comments in connection with a general review of Regulation T. The review is not yet complete, but the Board believes that certain developments warrant the publication of three proposed amendments in two areas.

Proposed Amendment

Three Day Settlement (T+3)

In light of the adoption by the Securities and Exchange Commission (SEC) of a rule shortening the standard settlement period for securities transactions from five to three business days (T+3), the Board proposes to shorten the time periods specified in Regulation T for customers to meet margin calls or make full cash payment by a corresponding two days. Related amendments would raise the de minimis amount below which liquidation of unpaid transactions is not required from $500 to $1,000, require brokers seeking extensions of the payment periods to obtain them from their designated examining authority (DEA), and clarify that foreign settlement periods are used to calculate when restrictions in the cash account are applied to foreign securities.

Regulation T has always required cash payment for securities purchases within seven business days of trade date. The seven-day period was initially chosen for the cash account because it was felt that a customer should have no obligation to pay for securities before they were delivered. The two days permitted beyond settlement date provide a short period of time for resolution of problems before the broker is required to act under Regulation T, that is, either obtain an extension on the customer's behalf (if it is determined that a valid reason exists) or sell out the customer's position.

The Board's advance notice was issued before the SEC proposed its rule adopting a T+3 settlement period. The advance notice mentioned the Group of Thirty's recommendation of a world-wide settlement standard of T+3 and said the Board "may consider shortening the time for customer payment once the settlement period is shortened from the current five days." The Board supported the SEC when it proposed requiring T+3 settlement, calling the proposal "an important and achievable step" to reduce potential systemic disturbances to financial markets and to the economy. The SEC also received several comment letters stating that the implementation of T+3 settlement will require the Board to address the possible shortening of its Regulation T payment periods. Those letters were forwarded to Board staff for consideration in the context of the ongoing Regulation T review.

The Board proposes to reword Regulation T to specifically incorporate the standard settlement cycle and the current two-day cushion. Instead of requiring payment within "seven business days," the regulation would require payment within "one payment period," with "payment period" being defined as the standard settlement period in the United States plus two business days. This will not change the operation of the rule at this time, but once the new language is put into place the conversion to T+3 next year will automatically result in a reduction in the amount of time brokers can give their customers to pay for securities or to meet initial margin calls. Future changes in settlement periods by the SEC will similarly be automatically reflected in the Board's rule without the necessity of further amendment.

The payment periods in Regulation T can be extended for exceptional circumstances if the broker applies to a self-regulatory organization (SRO) for an extension. In 1988, the New York Stock Exchange (NYSE) sought SEC approval of a rule that would require a broker seeking a Regulation T extension to obtain the extension from the NYSE if the NYSE is the broker's designated examining authority (DEA). The proposal was noted by the Board in the advance notice, as was a suggestion by the Credit Division of the Securities Industry Association that brokers be permitted to grant customer extensions without approval of an SRO. The SEC approved the NYSE rule filing in May 1994. In its approval order, the SEC stated that it does not agree with assertions that the objectives of the Securities Exchange Act of 1934 (the Act) could be better met by implementing a uniform system of sharing extension information. As to the other objections raised by commenters (and also raised with the Board pursuant to the advance notice), the SEC found that "the regulatory benefits from the NYSE rule outweigh any competitive concerns raised by the commenters." Finally, the SEC said it does not agree with those commenters who argue that broker/dealers should not be required to submit requests for extensions of time to either their DEA or any SRO. The Board believes, along with the SEC, that a good case has been made to restore to the broker's DEA sole responsibility for granting and monitoring extensions of time and the language proposed by the Board today reflects this conclusion.

Government Securities

In light of the recent enactment of the Government Securities Act Amendments of 1993, the Board proposes to exempt most transactions involving government securities from the restrictions of Regulation T. This would be accomplished with two separate but related actions. First, Regulation T would exclude government securities brokers and dealers who register with the SEC under section 15C of the Act from the definition of "creditor" in Regulation T. Second, general broker/dealers effecting customer transactions that could be effected by a section 15C broker/dealer could record the transactions in a new government securities account in which the other restrictions in Regulation T would not apply.

Before the enactment of the Government Securities Act of 1986, broker/dealers who limited themselves to transactions in government securities were not subject to a comprehensive regulatory scheme and were not required to be registered with the SEC. Although such brokers were within the definition of "creditor," there was no practical way to enforce Regulation T for them. The Government Securities Act of 1986 required SEC registration of all nonbank government securities brokers and dealers under a new section 15C of the Act. The Government Securities Act of 1986 also added the term "government securities" to the Act.

The advance notice invited comment on two areas involving government securities: repurchase agreements (repos) and the borrowing and lending of securities. The advance notice explained that the Board has not specified the exact treatment of repos while noting that repos of government securities do not raise credit issues under Regulation T because the good faith loan value of such securities is often close to 100 percent of their current market value. Many of the commenters suggested that the Board create a new account for exempted securities that could be used for transactions such as repos and forward transactions. Most of the commenters supported exemption of government securities from §220.16 of Regulation T. This would allow loans of government securities without the current requirement that a broker document the reason for the borrowing stems from a short sale or failure to receive securities required for delivery.

Under today's proposal, whenever a general broker/dealer effects a transaction for a customer that could be effected by a section 15C broker, the transaction could be recorded in a new government securities account. The account would allow these transactions to be effected without regard to other restrictions in Regulation T. The account would be permissive; brokers could continue to let customers who wish to use the cash or margin account for transactions involving government securities do so. It would allow institutional customers who cannot or will not use a margin account to engage in government securities transactions not specifically authorized in the cash account. For example, the government securities account could be used to effect purchases of government securities on credit or for cash as well as repos and reverse repos. Borrowing and lending of government securities could also be effected in the proposed account without being subject to the "permitted purpose" requirement in §220.16 of Regulation T that requires brokers to limit and document the reasons for their securities borrowings. The account would also permit net settlement of offsetting purchases and sales of government securities. Government securities purchased or deposited in a margin account would still be subject to the current Regulation T rules and would therefore still be available to finance the purchase of other securities in a margin account.

The Board is not proposing to include additional types of exempted securities, such as municipal securities, in the proposed government securities account. Government securities constitute an unusually deep and liquid market and are subject to a unique scheme of regulation, as evidenced by the Government Securities Act of 1986.

NASD members that wish to comment on the proposed amendments should do so by August 25, 1994. Comments should refer to Docket R-0840 and should be sent to:

William Wiles, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution
Avenue, NW
Washington, DC 20551

Members are requested to send copies of their comment letters to:

Joan Conley, Corporate Secretary
National Association of Securities
Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Questions concerning this Notice may be directed to Derick Black, District Coordinator, NASD Compliance Department, at (202) 728-8225.

NASD Notice to Members 94-54

NASD Solicits Public Comment On Approaches Governing Award Of Punitive Damages In Arbitration

Suggested Routing

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Executive Summary

At its May 1994 meeting, the NASD Board of Governors approved the issuance of a Notice to Members soliciting comment on the *Report of the Subcommittee on Punitive Damages of the NASD Legal Advisory Board.* The Report proposes a number of approaches that the NASD might adopt for the award of punitive damages in arbitration. Comments received on or before September 1, 1994, will be considered. The complete text of the Report follows this Notice.

Background

Since November 1992, a subcommittee of the NASD Legal Advisory Board (LAB)* has studied possible approaches to the award of punitive damages in arbitration, a difficult area with which both the NASD and its National Arbitration Committee (NAC) have grappled for a number of years. Set forth below is the final report of the LAB subcommittee.** Although the Board of Governors (Board) has yet to determine whether to endorse any or all of the recommendations contained in the report, the Board believes the Report, which is thoughtful and well researched, provides a useful framework for discussing this controversial area.

Accordingly, the Board has determined to publish the Report for public comment.

In reviewing the Report, several points should be borne in mind. First, it is the NASD's objective to develop an approach toward the award of punitive damages that will be fair to all arbitration participants, whether they are investors, associated persons, or member firms. The NASD urges commenters to consider the manner in which implementation of the individual recommendations would affect both claimants and respondents. In addition, the NASD welcomes any additional approaches that commenters believe would help achieve a fair balance of the interests of arbitration participants.

Second, the Report is the product of a LAB subcommittee. Neither the full subcommittee nor the LAB as a whole necessarily agrees with any or all of the recommendations in the Report. Nonetheless, the LAB believes the Report's recommendations provide a useful discussion vehicle, and the Board shares this view.

Third, the Report's recommendations should not be viewed as a "package." Rather, the recommendations represent alternatives that the LAB subcommittee believes the NASD should consider adopting, whether individually or in combination.

Fourth, in reviewing the Report, commenters should bear in mind that certain changes have occurred since the Report was finalized in October 1993. These changes relate to the following portions of the Report:

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* The LAB was created in 1988 as a standing committee of the Board of Governors to offer advice to and initiate ad hoc assignments for the Board. Prominent members of the private securities bar, in-house counsel for Nasdaq issuers, and academicians who specialize in securities law have served on the LAB since the group's formation. The current chairman of the LAB is David S. Ruder, former Chairman of the Securities and Exchange Commission and a former member of the NASD Board of Governors.

** Sanford Krieger (Fried, Frank, Harris, Shriver & Jacobson, New York, New York), Robert N. Rapp (Calfee, Halter & Griswold, Cleveland, Ohio), and John R. Worthington (MCI Communications Corporation, Washington, D.C.) have served on the subcommittee, which is chaired by Arthur F. Mathews (Wilmer, Cutler & Pickering, Washington, D.C.).

• Section III(D) of the Report recommends that the NASD establish a system for referring arbitration cases to an enforcement body as an alternative to awarding punitive damages. Since the Report was finalized, the Board approved an NAC recommendation to amend Section 5 of the Code of Arbitration Procedure so as to reinforce arbitrators' inherent authority to initiate disciplinary referrals. The amendment, filed with the Securities Exchange Commission (SEC), is awaiting approval.

• Section III(E) of the Report recommends the creation of an offer of judgment rule that would be modeled after Rule 68 of the Federal Rules of Civil Procedure. As proposed by the subcommittee, the offer of judgment rule would entitle the defending party to make an offer of judgment until several days before an arbitration hearing. If such an offer were declined and the final award assessed were less than the offer of judgment, the arbitration claimant would be required to reimburse the offeror for costs incurred after the date of the offer. As noted in the Report, the NASD has requested SEC approval of a rule change that would establish a variant of the offer of judgment procedure recommended in the Report. Since the Report was finalized, the SEC published the NASD's proposal for comment. The comments received were overwhelming negative, and the SEC staff requested that the NASD consider withdrawing the proposal. On May 27, 1994, the proposal was withdrawn to permit the NASD to review possible revisions to the proposal that could be made with a view toward resubmission.

NAC Action

Commenters should be aware that since early 1991 the NAC has been studying the issue of punitive damages, and has independently considered several of the approaches discussed in the Report. As summarized below, the NAC has reached conclusions that are in varying degrees consistent or inconsistent with the recommendations of the LAB subcommittee.

• Rationale for Award of Punitive Damages—The NAC has recommended that all awards of punitive damages articulate the legal standard applied in determining to award such damages, as well as the facts that the arbitrators found to constitute a basis for the award. The NAC believes that requiring such articulation will, among other things, alert members of the securities industry to the types of conduct that can lead to punitive damages, and thereby deter similar conduct in the future. Thus, the views of the NAC are generally consistent with those set forth in Section III(A) of the Report.

On a related issue, the NAC has recommended that arbitrators be deemed to have exceeded their authority when the facts they cite as warranting the award of punitive damages fail to satisfy the applicable legal standard. This recommendation is intended to facilitate vacatur of punitive damage awards under existing juridical standards, which generally preclude appeals of arbitration awards.

• Appeals—The NAC has proposed making an appellate review process available within the NASD for awards of punitive damages that exceed $200,000, or the denial of punitive damages when compensatory damages exceed $200,000. In contrast, Section III(B) of the Report proposes that only decisions to award punitive damages (not decisions to deny requests for such damages) be appealable.

• Arbitration Training–Section III(C) of the Report recommends enhancements to arbitrators' qualifications and training. Based on an NAC recommendation, mandatory arbitrator training has been in effect since early 1993. Topics covered in the mandatory training include assessment of damages (including punitive damages and the relevant standards). In addition, an accelerated training program implemented in 1993 gives particular emphasis to the training of persons who chair arbitration panels. Thus, commenters should be aware that the NASD has already undertaken steps to improve the quality of arbitrator training.

• Standard for Award of Punitive Damages—The NAC, like the LAB subcommittee, recommends standardization of the level of scienter that must be demonstrated before punitive damages may be awarded. Further, both the NAC and the LAB subcommittee generally agree that punitive damages should not be awarded on the basis of vicarious liability. *See* Section III(F) of the Report.

• Bifurcation—Section III(H) of the Report recommends bifurcating arbitration proceedings so as to separate consideration of punitive damages from other aspects of the arbitration proceeding. The NAC has previously rejected this concept on grounds that it would increase costs and delay the arbitration process.

• Caps on Awards of Punitive Damages—Section III(I) of the Report recommends imposing caps on punitive damages. Although the NAC initially rejected caps out of concern that they might increase the incidence of punitive damage awards, the NAC subsequently revisited the issue, and now believes that caps would be acceptable if tied to a formula, such as a stated multiple of compensatory damages.

• Sharing Punitive Damage Awards with Regulators—Section III(J) of the Report recommends requiring arbitration complainants to share a portion of punitive damage awards with state, federal, or quasi-governmental regulators. The NAC has rejected such a requirement based on questions that certain courts have raised as to the permissibility of such sharing, as well as indications that SEC staff would not be supportive of such a proposal.

Request for Comments

The Board is soliciting comments from members and interested persons to assist the NASD in arriving at standards governing the award of punitive damages that will be fair to all arbitration participants. Comments must be submitted no later than September 1, 1994, and be addressed to Joan C. Conley, Corporate Secretary, National Association of Securities Dealers, Inc., 1735 K Street, N.W., Washington, D.C. 20006.

Report Of The Subcommittee On Punitive Damages Of The NASD Legal Advisory Board

Introduction

The Subcommittee on Punitive Damages recommends that the NASD place significant limitations on the award of punitive damages in NASD arbitrations. Awards of punitive damages in securities arbitration have associated costs that often outweigh their benefits. The NASD should establish stringent guidelines to ensure that arbitrators only award punitive damages in the most meritorious cases, and award them only in accordance with a procedure that properly and fairly affords respondents sufficient procedural due process to protect against excessive and arbitrary punitive awards.

Part I of this Report provides background on recent trends in securities arbitration including the award of punitive damages and surveys the issues that courts have been struggling with in connection with the award of punitive damages by courts and juries, as well as in arbitration. Part II presents the reasons we believe punitive damages should be circumscribed. Finally, Part III sets forth a series of guidelines that we recommend the NASD should adopt to govern the award of punitive damages in securities arbitration.

I. Recent Trends in Securities Arbitration Law

A. Recent General Trends in Securities Arbitration

The number of securities arbitrations has grown by leaps and bounds in recent years. In 1992 alone, the number of customer arbitrations filed with self-regulatory organizations ("SRO's") was between 5,000 and 6,000.[1] This contrasts sharply with approximately 800 filed in 1980. Although this increase may be due in part to the rise in business activity over that time, it is clear that there is a trend toward both customers and brokerage firms choosing arbitration over litigation as a forum for resolving securities disputes.[2]

The growth in arbitration is rooted in the Supreme Court's sanction of securities arbitration in recent years. Until the late 1980's, disputes under the federal securities laws could not be subject to compulsory arbitration because there was no assurance that the rights prescribed by the federal securities laws would be vindicated through arbitration.[3] In 1987, however, the Supreme Court ruled that Congress had expanded the power of the Securities and Exchange Commission sufficiently to ensure the adequacy of arbitration procedures and to ensure that arbitration would do justice to plaintiffs' rights under the securities statutes.[4] The Court's ruling, coupled with a longstanding federal policy favoring arbitration, guaranteed that courts would interpret arbitration agreements liberally.[5]

In addition to the jump in the volume of arbitrations, the dollar amounts of the awards in securities arbitrations have been rising as well. The total dollar value of punitive damages awarded in the first half of 1992 more than doubled from that of previous six-month periods, although the total number of awards remained relatively constant. The proportion of punitive to compensatory awards rose as well from .7-to-1 to 1.3-to-1.[6] Examples of large punitive awards from NASD arbitrators in 1992 alone are awards of \$3.5 million,[7] \$1.7 million,[8] \$1 million,[9] and \$505,000.[10] This trend is likely to continue. On October 11, 1993, an NASD arbitration panel ordered Dean Witter to pay \$700,000 in punitive damages to a former branch manager, who alleged that he was defamed and that he was terminated for refusing to condone certain illegal activities.[11]

B. The Murky Law of Punitive Damages in Securities Arbitration

The award of punitive damages in securities arbitration, like arbitration itself, is a hybrid. The Securities Exchange Act of 1934, the principal federal statute relied upon in most securities litigation, expressly prohibits the award of punitive damages.[12] However, punitives are permitted under most states' laws. In fact, all states, except nine, provide that punitive damages may be awarded to civil plaintiffs in addition to compensatory damages.[13]

A much more murky area of the law is whether and under what circumstances arbitrators of securities disputes may award punitive damages. The Federal Arbitration Act ("FAA") does not specifically provide for punitive damages in arbitration. The FAA, enacted in 1947,[14] codified the United States Arbitration Act passed originally in 1925.[15] The purpose of the 1925 Act was to "make valid and enforcible [sic] agreements for arbitration contained in contracts involving interstate commerce . . . or which may be the subject of litigation in the Federal courts."[16]

The current version of the FAA provides that arbitration agreements shall be "valid, irrevocable and enforceable,"[17] and courts have interpreted the FAA as a "congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary."[18] In light of this federal policy, courts have given "precedence to the contract provisions allowing punitive damages" even if the parties apply a state's law that bars punitive damages in arbitration.[19]

In addition to the FAA and the courts' interpretations of that statute, the Uniform Code of Arbitration and the Securities Industry Conference on Arbitration ("SICA") have sanctioned punitive damages. SICA, which is composed of representatives of the SRO's, the Securities Industry Association and members of the public, is responsible for formulating the Uniform Code of Arbitration. The Uniform Code is the model arbitration code available for use by SRO's. SICA discusses the Code in its Arbitrator's Manual, which states that "arbitrators can consider punitive damages as a remedy."[20]

The American Arbitration Association, which is the primary arbitral forum that is not operated by an SRO, and the NASD, have both approved of punitive damages, at least tacitly. The NASD itself has stated that pre-dispute arbitration agreements should not limit the ability of arbitrators to make "any award."[21] The AAA has stated that arbitrators may grant "any remedy or relief" which they deem "just and equitable and within the scope of the agreement of the parties. . . ."[22]

The confusion over whether arbitrators may award punitive damages arises when state law bans or limits punitive damages in arbitration or otherwise. Often, parties contract to apply New York law, or another state's law that prohibits punitive damages in arbitration, and at the same time, contract to apply the rules of the AAA, which allows them. A court reviewing an award of punitives rendered in an arbitration must reckon it with the relevant state law, and when that law disallows punitives, many judges are left scratching their heads. The leading case proscribing punitive damages in arbitration is the New York case of Garrity v. Lyle Stuart, Inc.[23]

In Garrity, the court ruled that, under New York law, an arbitrator is not permitted to award punitive damages, even if the parties choose to allow them.[24] The court based its reasoning first on the notion that the power to award punitive damages is reserved to the state, and second, on procedural defects in the arbitration process such as the lack of a mechanism to review awards and arbitrators' unbridled discretion in making them.[25]

After the decision in Garrity, courts have split on whether to allow punitives in arbitration when state law prohibits them. Some courts have held that punitive damages are permitted in arbitration, even if the parties explicitly apply New York law, because the parties explicitly or implicitly agreed to punitive damages in their agreement.[26] The rationale of these courts is that a choice of law provision merely designates the substantive law to be applied in determining whether the conduct of the parties was illegal. The choice of law provision does not deprive the arbitrators of their power to award punitive damages. According to these courts, this power is vested in arbitrators by dint of their choice to arbitrate in accordance with the rules of the AAA, and the FAA gives force to the wishes of the parties.[27] Conversely, courts have held that if the parties do not explicitly or implicitly agree to punitive damages, then they are not permitted in arbitration.[28]

Other courts have backed away from a requirement of express or implied agreement for punitives. One court held that, even if the parties contract to apply New York law, the plaintiff has a right to punitive damages unless the parties specifically waive that right.[29] Another held that because the arbitration contract was broad as to the matters subject to arbitration, the broad agreement included claims for punitive damages, thereby authorizing the arbitrator who heard the matter to grant punitives.[30]

Thus, there is a tension, indeed a clash, between the rules of the AAA (and the FAA, which gives force to the rules), and state laws that bar or impede punitive damages. FAA rules govern an arbitration if three conditions are met: (1) the transaction involves interstate commerce;[31] (2) the parties have signed a written agreement;[32] and (3) there is an independent basis for federal jurisdiction.[33] The FAA does not independently grant federal jurisdiction to plaintiffs in arbitration.[34] Thus, if jurisdiction is based solely on diversity, state law governs the dispute, absent an agreement to the contrary.[35]

Notwithstanding the applicability of the FAA to arbitration, the Act in and of itself does not guarantee the availability of punitive damages if the parties are silent on the question of punitive damages.[36] In much the same way, the FAA does not confer an independent right to arbitration.[37] It merely provides the right to arbitration according to the wishes of the parties as expressed.[38] Thus, if an arbitration agreement applies state law, and is silent on the question of punitives, then state law governs the availability of punitive damages.[39] However, if the parties evince an intent to allow punitive damages, then, as long as the FAA applies, punitive damages are allowed, even if state substantive law governs the arbitration.

C. Constitutional Attacks on Punitive Damages, and the Supreme Court's Unclear Guidance

Law reform advocates in a potpourri of recent law journal articles,[40] as well as business defendants in a troika of Supreme Court cases commencing in 1989,[41] have argued that "punitive damages punish defendants without employing the procedural safeguards of criminal law, thereby blurring the distinction between public and private law," and that "punitive damages raise due process concerns because the awards are irrational and unpredictable."[42] Indeed, during the Bush Administration, measures to limit punitive damages were key features of former Vice-President Quayle's proposed Agenda for Civil Justice Reform.[43]

In 1989, in Browning-Ferris Industries v. Kelco Disposal, Inc.,[44] the Supreme Court rejected a constitutional claim that an award of punitive damages violated the Eighth Amendment's prohibition against excessive fines. In an antitrust suit based on predatory pricing allegations, plaintiff Kelco obtained a jury award of $51,000 in compensatory damages and $6 million in punitive damages.[45] The Supreme Court did not address the question of whether punitive damages that are grossly disproportionate to compensatory damages violate traditional judicial principles of proportionality in punishment, that is, a rule of criminal law that insists that we "let the punishment fit the crime." Nor did the Supreme Court determine whether the magnitude of a punitive damage award is reviewable under the Due Process Clause of the Fourteenth Amendment. The Court expressly reserved the issue of "proportionality review" of punitive damage awards for a future case, acknowledging in dicta, however, that "[t]here is some authority in our opinions for the view that the Due Process Clause places outer limits on the size of a civil damages award made pursuant to a statutory scheme."[46]

In Pacific Mutual Life Insurance Co. v. Haslip[47] the Supreme Court affirmed a judgment where the jury awarded plaintiff Haslip a total damages award of $1,040,000, of which at least $840,000 was attributed to punitive damages. The punitive damages were more than four times the amount of compensatory damages and more than 200 times plaintiff Haslip's out-of-pocket expenses of approximately $3,500 to $4,000.[48] The Supreme Court indicated that the Due process Clause puts limitations on punitive damage awards, and suggested that the punitive damages awarded plaintiff Haslip — four times greater than compensatory damages — were "close to the line" of constitutional impropriety.[49]

In essence, the Haslip Court held that due process requires that any system, or scheme accommodating the award of punitive damages, contain sufficient procedural safeguards to assure that the size of "a punitive award is reasonably related to the goals of deterrence and retribution."[50] In finding that Alabama's punitive damages scheme complied with requisite constitutional due process concerns, the Haslip Court considered the following important criteria[51]:

(i) The conduct in question "evidenced intentional malicious, gross, or oppressive fraud."[52]

(ii) The jury was not given unlimited discretion in determining whether to award punitive damages. The jury was instructed about (a) the discretionary nature of punitive damages, (b) the purpose of punitive damages (not to compensate the plaintiff, but rather to punish the defendant and to deter future misconduct), and (c) its duty to focus on the character and degree of the wrong. "The instructions thus enlightened the jury as to the punitive damages' nature and purpose, identified the damages as punishment for civil wrongdoing of the kind involved, and explained that their imposition was not compulsory."[53]

(iii) There was sufficient post-trial review by the trial judge including procedures requiring the judge to reflect in the record the court's reasons for sustaining a punitive verdict or for setting it aside as excessive.[54]

(iv) Appellate review in Alabama requires both a "comparative analysis" with other punitive awards allowed in similar cases, and an application of substantive standards including consideration of the following seven standards to assure that the punitive award does not "exceed the amount that will accomplish society's goals of punishment and deterrence."

(a) whether there is a reasonable relationship between the punitive damages award and the harm likely to result from the defendant's conduct as well as the harm that actually has occurred; (b) the degree of reprehensibility of the defendant's awareness, any concealment, and the existence and frequency of similar past conduct; (c) the profitability to the defendant of the wrongful conduct and the desirability of removing that profit and of having the defendant also sustain a loss; (d) the "financial position" of the defendant; (e) all the costs of litigation; (f) the imposition of criminal sanctions on the defendant for its conduct, these to be taken in mitigation; and (g) the existence of other civil awards against the defendant for the same conduct, these also to be taken in mitigation.[55]

(v) Even though the defendant's wealth was relevant to appellate review, the jury in Alabama was not allowed to consider defendant's wealth. "The fact finder must be guided by more than the defendant's net worth. Alabama's plaintiffs do not enjoy a windfall because they have the good fortune to have a defendant with a deep pocket."[56]

The Haslip Court also noted in dicta that "there is much to be said in favor" of state legislatures creating rules regarding punitive damages, including the adoption of a heightened burden of proof — a standard of "clear and convincing evidence."[57] Since 1991, at least four courts have found state punitive damages systems unconstitutional in light of the due process requirements articulated in Haslip.[58]

Last term, the Court affirmed — by a plurality — a punitive damages award with a compensatory/punitive ratio of 526-to-1 in TXO Production Corp. v. Alliance Resources Corp.[59] Notwithstanding the ruling, substantive and procedural due process protections for defendants who must pay punitives are alive and well.

In the TXO case, the plaintiff, TXO, filed a declaratory judgment action against Alliance in West Virginia state court. The declaratory judgment was to remove a cloud on title to an interest in oil and gas development rights on a tract of land known as Blevins Tract. Earlier, Alliance agreed to assign its interest in the tract to TXO in exchange for royalties and agreed further to return the consideration paid if TXO's attorney determined that "title had failed."[60] TXO brought the declaratory judgment action, when, according to the West Virginia Supreme Court of Appeals, TXO knew that it was a frivolous action and TXO's real intent was to reduce its royalty payments to Alliance.[61] In addition to defending the declaratory judgment action, Alliance counterclaimed for slander of title. A West Virginia jury returned a verdict in Alliance's favor for $19,000 in actual damages and $10 million in punitive damages — 526 times the actual damages.[62]

In upholding the award, Justice Neely of the West Virginia Supreme Court of Appeals ruled that punitive damages of this magnitude were suitable if the defendants were really mean, but punitives of only five times compensatory damages were suitable if the defendants were not "really mean" but merely "really stupid."[63] Not surprisingly, the really mean defendants in TXO challenged the award on both substantive and procedural due process grounds.[64]

The United States Supreme Court rejected both challenges and affirmed the award.[65] The plurality opinion by Justice Stevens upheld the award based on the harm that was likely to occur, had TXO's scheme been successful, as opposed to the harm that actually occurred.[66] Notwithstanding the fact that the Court affirmed the award, the Court left open the door to challenges to punitives damages under both substantive and procedural due process grounds.[67] With respect to substantive due process, the plurality stated that whether a punitive damages award violates due process rests on a reasonableness test.[68] In TXO, the award was appropriate based on four factors: (1) the amount at stake; (2) the bad faith of the party being punished; (3) the presence of a larger pattern of fraud, trickery and deceit; and (4) the wealth of the party being punished.[69] Thus, defendants against whom punitive damages are imposed may argue that absent any one of these factors, an award of punitive damages that is highly disproportionate violates the substantive Due Process Clause.

On the procedural due process front, the Court had less to say. The important point, however, is not that the plurality found no violation, but rather that it performed an analysis in the first place.[70] In fact, earlier in the opinion, the plurality stated, "Assuming that fair procedures were followed, a judgment that is a product of that process is entitled to a strong presumption of validity."[71] In addition, all of the Justices seemed to believe that a process that includes the availability of some sort of appeal of a punitive damages award is constitutionally necessary.[72] Thus, there is no doubt that under existing Supreme Court precedent punitive damages are susceptible to procedural due process attacks.

II. Arguments For and Against Punitive Damages in Securities Arbitration

The Subcommittee believes that the NASD should strictly limit punitive damages in arbitration.[73] Although there are certain justifications for them, punitive damages are, as a general rule, costly to administer and provide little deterrence above and beyond the civil, administrative and criminal enforcement provisions of federal and state securities laws. Thus, the NASD should limit punitive damages, as discussed in Part III below, to the few cases in which they would be most appropriate.

A. Reasons to Limit Punitive Damages

1. Due Process Guarantees, Required for Punitive Damages, are Inefficient to Administer

In light of the Supreme Court decisions in Haslip and TXO, and their progeny in federal and state courts, an award of punitive damages in securities arbitration triggers application of the due process guarantees of the United States Constitution. These guarantees are costly and difficult to administer and their application is reason enough to severely limit punitive damages in this forum. The Fourteenth Amendment applies when the state deprives "any person of life, liberty, or property, without due process of law . . . ." Thus, in order for due process protections to apply, there must be so-called state action.[74] The state action must go beyond mere acquiescence of private action in a state or federal statute;[75] there must be "something more" than that.[76] The award of punitive damages in arbitration is state action that meets the "something more" test for at least two reasons: imposing punitive damages is a public function, and, the government compels membership in an SRO.

According to the public function theory, if private persons engage in governmental functions — assume the role of the state — their activities are subject to the same Constitutional restrictions that are imposed on the state itself.[77] Awarding punitive damages — awarding any damages —is a traditional public function reserved to the state and accomplished through judges and juries.[78] Performing this public function satisfies the "something more" required by the Supreme Court. An award of punitives, by its nature, is state action.

The second reason the award of punitives is state action is because the government compels participation in self-regulatory organizations. Federal law requires broker/dealers to be members of SRO's, and as a result, to be subject to the SROs' rules of arbitration.[79] The government may compel membership in an organization, but it may not do so if the organization's procedures would violate the Constitution if the procedures were imposed by the government itself.[80] Private actors acting under state compulsion are considered state actors.[81] Since the government could not impose punitive damages without providing the defendant due process guarantees, it cannot compel membership in the NASD unless the NASD provides similar guarantees.

Although the Supreme Court held long ago that due process rights may be waived,[82] the waiver process itself is cumbersome. Any waiver must be clear — voluntary, knowing and intelligent — and the consequences of the waiver must be disclosed.[83] Thus, in order to obviate due process requirements in the arbitration context, each and every predispute agreement would have to contain, at a minimum, a statement explaining what rights the defendant is waiving and the consequences of that waiver.

Moreover, Congress intended that self-regulatory organizations, in another context, provide due process protections. In section 15A of the Securities Exchange Act of 1934, Congress set forth elaborate procedural protections, to be provided by the SRO, for persons who are denied membership in the SRO and for members who are disciplined by it.[84] Although disciplinary proceedings brought by an SRO is a different context than arbitration, the analogy makes it clear that Congress did not intend the SRO's to be immune from providing due process guarantees.[85]

2. Effective Enforcement of the Securities Laws Reduces the Need for Punitive Damages in Arbitration

Although there may be certain areas of the law where punitive damages are a necessary part of law enforcement, the securities area is not one of them. The capital markets in the United States are governed by a highly developed and technical set of laws and regulations enforced by federal and state law agencies, as well as by SRO's. Thus, punitive damages add little deterrence to the present system.

First, the NASD itself is an effective regulator. NASD enforcement governs all aspects of the business of member firms and ensures that they "observe high standards of commercial honor and just and equitable principles of trade . . . ."[86] NASD sanctions include fines, censure, suspension, bars, expulsion, restitution or any other fitting measure.[87] The task of ensuring compliance with NASD rules rests with the NASD's District Business Conduct Committees (DBCCs) — the NASD's primary enforcement arm — located in each of the NASD's eleven districts. Responsibility for compliance also falls on the Market Surveillance Committee (MSC), which is similar to the DCBBs, but is a central review for cases involving possible violations of market-related NASD and SEC rules.[88]

There are many avenues to trigger the NASD disciplinary process. Under the NASD Rules of Practice,[89] any person who feels aggrieved by an act of a member may file a complaint with a DBCC. Arbitrators themselves may refer a matter to an SRO for disciplinary action if they feel that a rule or statute has been violated.[90] Finally, according to the NASD's By-Laws, NASD members must report most allegations of misconduct to a Central Registration Depository, which the NASD monitors monthly.[91] It is no wonder that NASD enforcement is rigorous. In fact, on several occasions, the SEC has approved of, and praised, the NASDs' disciplinary program.[92]

Regulation by the SROs is only one level of securities enforcement. Also important is the web of federal securities laws enforced by the SEC (and other federal law enforcement officials). These statutes, and the SECs' historic enforcement program, are very effective. The SEC's enforcement powers have recently been augmented by passage of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.[93] Among other things, the SEC may now bring an action in federal district court for civil penalties, assess monetary penalties in administrative proceedings against regulated entities, issue cease and desist orders, require disgorgement of ill-gotten gains, and seek orders prohibiting persons from serving as officers or directors of public companies. Although the SEC does not prosecute criminal violations of the securities laws, the Commission refers matters to the Department of Justice for criminal prosecution.[94]

In addition to the federal statutes and regulations, the states have developed a wholly separate regime to regulate securities transactions. Today, virtually every state has blue sky laws administered by a state official who performs enforcement functions similar to those performed by the SEC.[95]

3. The Present System Provides Sufficient Deterrence to Limit the Need for Punitive Damages in Arbitration

Not only is there no enforcement gap in the regulation of securities, but the presence of punitive damages serves little purpose when viewed in light of the penalties that already exist. Many of the penalties for securities laws violations have multipliers built into them that serve the same function as punitive damages. For example, the Remedies Act provides for enhanced civil monetary penalties if a violation involves fraud, deceit, manipulation, or deliberative or reckless conduct; it provides for even further enhancement if the harm resulted in substantial loss, or created a significant risk of substantial loss, to other persons.[96] Similarly, the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 provide for treble civil monetary penalties in some cases.[97] Because these enhanced penalties exceed the net harm that the defendant caused, this provides the extra pinch required for deterrence; there is no reason to make further adjustments through punitive damages in private arbitration cases.[98]

In addition, punitive damages are hardly necessary because other intangible costs, which are associated with any action brought against a broker-dealer, serve as a deterrent. The purpose of punitive damages is to penalize the defendant above and beyond punishment provided by compensatory damages alone. Although this rationale may be sensible in some contexts, it does not make sense here because the defendants are in the business of providing a service to the public. As a result, they face intangible costs every time they lose an arbitration: damage to their reputations — perhaps their most valuable asset.[99] As providers of services, their reputations are essential to attract new business and maintain the old. Any firm's reputation is damaged by cases brought against it by disgruntled investors. This is sufficient incentive, above and beyond compensatory damages, to deter misconduct.

4. Public Policy Concerns Are Implicated When Arbitrators Are Granted the Power to Award Punitive Damages

One of the strongest reasons to limit punitive damages, and the one adopted by the court in Garrity, is that the power to punish as a general rule should belong to the state, not to an independent panel of arbitrators. As the Supreme Court has noted, punitive damages "are not compensation for injury. Instead, they are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence."[100] The fines are quasi-criminal,[101] and, as such, public policy concerns favor that they should be levied by the state. The jury that awards punitive damages is, at a minimum, carefully controlled by the judge in the case, and presumably given a series of considerations to take into account in deciding whether to award punitives. An arbitration panel, however, has unlimited discretion to punish as it sees fit. Such discretion is anathema to our system of civil and criminal justice.

B. Justification for Allowing Punitive Damages

As discussed above, the deterrent value of punitive damages, and their contribution to the effective enforcement of the securities laws, or other rules governing brokers, have never been clearly demonstrated. Still, some members of the Subcommittee believe that justification for allowing punitive damages may be found in the marginal increase in deterrence that punitive damages provide. Federal and state legislative bodies have vested regulatory agencies and self-regulatory organizations with substantial disciplinary powers, and enforcement has historically been aggressive. Nevertheless, misconduct and disregard of duties owed to the investing public do continue to occur. The availability of punitive damages in securities arbitrations may be an incentive to sue, and, as such, increase the costs associated with particular misconduct and thus impact the incidence of wrongdoing.

To be sure, there is an economic justification for allowing punitive damages.[102] In an economic context, setting damages above the quantifiable harm can make sense. The cost of avoidance should be borne by the wrongdoer. The expected damages associated with a particular choice of action — presumably a reckless or intentional act — should be set higher than the actual harm if the result is a decrease in the probability that the offense will be committed. Blatant disregard of supervisory responsibility is one example of relative costs associated with choices of action that produce economic injury to investors. Compensating injured investors for actual loss associated with misconduct does not efficiently deter when viewed in relation to the cost of avoidance not incurred by the perpetrators and their organizations.

It is not within the scope of this Report to engage in debate over an economic analysis of punitive damages. It must be recognized that there is an economic justification for such awards in securities arbitrations where the improper conduct is preventable at a cost. At the same time, it is possible to provide so many sanctions that brokers will be "overdeterred." Such overdeterrence will chill them from efficiently executing orders, providing new services, and so forth. This Subcommittee is not in complete agreement on the applicability and force of the arguments on either side. There is no doubt, however, that the continuing debate over the proper role of punitive damages in securities arbitrations must take into account notions of deterrence of intentional malicious, and reckless acts, compensation to the victim for such acts, and the smooth functioning of the securities markets.

III. Recommendations to Govern the Award of Punitive Damages in Securities Arbitration

For the above reasons, we recommend that the NASD limit punitive damages in arbitration and institute a series of procedures to guide their award. The following procedures would serve this purpose by making the award of punitive damages fairer and less arbitrary, and by ensuring that arbitrators award punitives in only the most appropriate cases.[103]

A. Require Written Decisions in All Cases of Punitive Damages

Arbitration panels awarding punitive damages should set forth in writing their reasons for doing so. There are several reasons for this seemingly mundane task. First, it will facilitate any appeal of the award of punitives, discussed below, which seems to be required after TXO and Haslip. Second, it is necessary to ensure that the public is clear on why the defendant is being punished. Although the written decision may not facilitate "specific" deterrence — the defendant will smart from any award of punitive damages and is unlikely to forget about it — it is necessary for "general" deterrence. The written decision is also important to ensure that there has been no due process violation. The defendant should fully comprehend why it is paying a punitive fine.

The current NASD Code of Arbitration Procedure provides for only a cursory written decision. Although the awards must be in writing, they must include only the names of the parties and counsel, a summary of issues, the relief requested and awarded, a statement of issues resolved, and other names and dates.[104] Similarly, the Securities Arbitration Rules of the AAA provide only that the award "shall be in writing, signed by a majority of the arbitrators, and shall include a statement regarding the disposition of any statutory claims."[105] These requirements are insufficient. The NASD should demand a more detailed written decision providing the basis for the decision to award punitives, the basis for the amount, and findings of fact and conclusions of law.

B. Institute a Right to Appeal an Award of Punitive Damages

Any award of punitive damages should be appealable by the party against whom the award is rendered. The current system offers a very limited right to appeal in arbitration. The FAA authorizes review and vacatur under circumstances limited to procedural defects,[106] and courts have interpreted this section narrowly.[107] Errors of fact and law are not reviewable and thus cannot be the basis to vacate an arbitrator's award.[108] However, after the TXO and Haslip decisions, it is arguably unconstitutional to impose any punitive damages award that is not appealable. Although the TXO decision itself was a plurality, all of the Justices seem to agree that an appeal is constitutionally necessary.[109]

The right to appeal an award of punitive damages should include an appeal of the amount of the award as well as the decision itself to award punitives.[110] The right of appeal should belong only to the party against whom the damages are assessed. Since punitive damages are discretionary, it is always in the power of the arbitrators to withhold an award of punitives.[111]

The appellate body should consist either of a three person committee of the NASD Board of Governors or of a panel of three experienced arbitrators drawn from a pool. The committee or panel would be available at all times to review the award of punitives. The appellate board will have to ensure itself, by using a standard of "clearly erroneous," that the arbitrators below found the requisite level of culpability — malicious intent — and that the intent was proven by clear and convincing evidence. If the appellate board is reviewing findings of law, the standard to be applied, as always, should be de novo. If the appellate panel also is reviewing the amount of damages, which may not be necessary if punitive damages are capped, it would have to employ another standard such as grossly or clearly excessive.

C. Enhance Arbitrator Qualification, Training and Guidance

The NASD must enhance arbitrator qualification. In order to resolve a case properly, the arbitrators need to conduct an inquiry usually done by experts. The SRO's, however, currently lack the controls necessary to ensure that arbitrators are well-qualified.[112] The SRO's fail to verify background information provided by arbitrators, and they lack formal standards of education and experience necessary to qualify an arbitrator. The SRO's make no effort to determine the arbitrators' training needs and lack mandatory training for them.[113] Thus, the NASD should focus carefully on qualification and establish a system to carefully select and train arbitrators. The system should focus on their backgrounds and experiences, as well as their performance in previous arbitrations. In addition, the NASD should provide to all arbitrators as guidance a written statement of the elements that must be found and the analysis that must occur, in determining whether, and if so, in what amount, punitive damages should be awarded. Such written statement of guidance presumably would summarize and synthesize all of the relevant factors noted in the Haslip and TXO cases.

D. Establish a System of Referral to an Enforcement Body

The NASD should require arbitrators to refer cases, in which they have awarded punitives, to an enforcement body, and to weigh whether referral to an enforcement body in lieu of awarding punitive damages is more apt in a particular case.[114] This would not be a review or appeal of the arbitrator's decision, rather it would provide for a separate look at the defendant to make sure that it was properly sanctioned. The referral system could take several forms. For example, it could be limited to cases where arbitrators award punitive damages over a certain amount, or greater than a certain proportion to the compensatory award;[115] or to cases where arbitrators feel referral to an enforcement authority, in lieu of granting punitives to a single private plaintiff, better serves the interests of deterrence and retribution. Limiting referral to only large punitive awards might encourage arbitrators to keep their awards low so that additional enforcement action is not taken against the defendant, yet some measure of punitives is awarded.

The infrastructure for a referral system is already in place. Arbitrators could refer their cases to the NASD's District Business Conduct Committees. The DBCC's district examiners already report to the DBCC's on member compliance based on information collected through examination and surveillance.[116] Thus, they are equipped to pursue reports filed by arbitrators.

E. Institute an "Offer of Judgment" Rule

The NASD should establish an "offer of judgment" procedure similar to Rule 68 of the Federal Rules of Civil Procedure.[117] An offer of judgment rule would entitle the defending party to make an offer of judgment at any time up until several days prior to the arbitration. If the final judgment assessed against the defendant is less than the offer of judgment, the claimant would pay the costs incurred after the date of the offer. In order to have the intended effect, punitive damages would have to be included in determining the final judgment.[118]

This rule would limit punitive damages to the cases in which they are truly called for. Unless plaintiffs are fairly certain that they will succeed in a claim for punitives, they will settle their claim for an offer of judgment of compensatory damages plus one cent. If the defendant makes this offer and the plaintiff refuses it, the only way the plaintiff can avoid paying costs is if the arbitrators award punitives. Otherwise, even a judgment in the full amount of compensatory damages requested by the plaintiff will be less than the offer of judgment. However, if plaintiffs are convinced that they will receive punitives, they can refuse the offer and hope for the best, knowing that they may be stuck paying all costs incurred after the day of the offer.

Several variations on an offer of judgment are possible. If costs are small, one alternative is to require the plaintiff to pay, in addition to costs, part of the difference between the amount of the offer and the final judgment as a penalty.[119] In most cases, this difference would likely be insignificant since the defendant has no incentive to make an offer of judgment far greater than the compensatory award, lest it actually be accepted. Moreover, this system unfairly penalizes plaintiffs who receive less than full compensatory relief for reasons that have nothing to do with punitive damages.[120]

F. Increase the Level of Misconduct — Scienter —Required for Punitive Damages

The NASD should standardize the level of scienter defendants must have before arbitrators can award punitives. The level required should be greater for punitives than for other types of damages; after all, the point is to punish the defendant above and beyond the punishment inflicted by compensatory damages. Thus, the defendant should have done something especially egregious to deserve an enhanced punishment. In TXO, the Supreme Court upheld the award of punitives based, in part, on TXO's bad faith and on the fact that the scheme employed was "part of a larger pattern of fraud, trickery and deceit . . . ."[121] Furthermore, many states' laws provide for a heightened level of scienter for punitive damages.[122]

The level of scienter arbitrators presently require in cases where they award punitives is varied. In one recent arbitration, the arbitrators found that the misconduct was "reckless and callous" and found that the defendant showed "blatant disregard" for firm rules and industry rules and regulations.[123] In several other cases the arbitrators found willful or intentional misconduct.[124] In still others, the misconduct was merely "grossly negligent."[125] In one case, the arbitration panel found only that the defendant violated an undefined "standard of supervision."[126]

The standard should be increased to willful, wanton and malicious conduct before arbitrators may impose punitive damages. Anything short of this is not justified in light of TXO,[127] and should not give rise to the serious sanction of punitive damages. Punitive damages are intended to target the few bad apples who purposefully harm the investing public for their own personal gain. They should not punish unduly the brokerage firm that acted negligently, or even recklessly. The compensatory damages that the defendant will no doubt have to pay in cases of negligence or recklessness will be sufficient to deter such conduct.

A related question is whether arbitrators can award punitive damages vicariously against employers or whether the plaintiff must prove complicity. Broker/dealers may in some cases try to defend investor suits on the grounds that they were unaware of the conduct of their employees. It is not clear when courts will credit such defenses in federal securities law cases. Under section 20 of the Exchange Act[128] and section 15 of the Securities Act[129] liability extends to controlling persons such as employers, but both controlling person provisions contain good faith or "lack of knowledge" defenses. Furthermore, there is no clear guidance as to when principles of respondent superior or "duty to supervise" will trigger derivative liability.[130] Whether punitive damages may be imposed vicariously is a question of state law,[131] and most states allow it.[132] Indeed, in Haslip, the Supreme Court sanctioned imposition by an Alabama state court of punitive damages against the defendant insurance company on a respondeat superior strict liability basis.[133] A better approach, however, is the one at which Justice Kennedy hints in his concurring opinion in TXO. According to Justice Kennedy, the reason that the punitive damages in TXO were not violative of due process is because TXO acted with such extreme malice. Kennedy stated explicitly that a situation of vicarious liability would be different.[134] Thus, punitives should not be imposed unless the employer itself acted maliciously.

G. Increase the Standard of Proof Required Before Punitive Damages are Awarded

In addition to enhancing the level of misconduct plaintiffs must prove before arbitrators may impose punitive damages, the NASD should enhance the standard of proof for that misconduct. Arbitrators do not generally enunciate a standard by which they find certain facts to be true; there is no reason to do so because the findings are not appealable. The standard which arbitrators should employ is "clear and convincing evidence." This standard is higher than "preponderance of the evidence" used generally for factual determinations in civil cases, but lower than "beyond a reasonable doubt" commonly associated with criminal cases. The standard is justified because of the nature of punitive damages: they are a punishment beyond compensatory damages but do not rise to the level of criminal fines. Approximately one-half the states, including New York, employ the heightened standard of proof of "clear and convincing evidence" for punitive damages.[135] Colorado goes even further and requires proof "beyond a reasonable doubt."[136]

H. Bifurcate the Proceeding for the Determination on Punitive Damages

In order to implement a heightened standard for punitive damages — for both the level of misconduct required as well as the standard of proof of that misconduct — the NASD should bifurcate the arbitration proceeding and separate the decision to award punitives. In addition to the advantage of employing different standards for the award of punitives, bifurcation also would allow the parties to introduce evidence bearing on punitive damages that is not relevant — and may be prejudicial — to a determination of liability, such as evidence of the wealth of the defendant.[137] Schwartz and Behrens in their recent law review article on Punitive Damages Reform[138] point out that bifurcation "meets the spirit of the Haslip case and is supported by the American Law Institute . . . the American Bar Association, and the American College of Trial Lawyers."[139] Recently, this concept has been accepted by the Tennessee Supreme Court in Hodges v. S.C. Toof & Co.[140]

I. Place a Cap on Awards of Punitive Damages

The NASD should place a cap on punitive damages. Caps on damages meet the competing goals of allowing arbitrators to award punitives where they deem them necessary while making sure that other arbitrators do not abuse their discretion and award punitive damages beyond a reasonable amount. Many state systems have limited punitive damages either by imposing an absolute dollar cap, or by limiting punitive damages in proportion to the compensatory award.[141]

Similarly, in the arbitration context, the NASD could limit awards to a given dollar amount or anchor them to the compensatory award, or both. One possible scheme would be to limit punitive damages in all cases to a maximum of $250,000.[142] In fact, 86 percent of all punitives awarded in securities arbitration over the past three years were less than $250,000. A cap of that amount seems more than adequate.[143]

Another possible scheme would be to limit punitive damages to the amount of the compensatory award (a 1-to-1 cap). In fact, over the past three years, punitive damage awards averaged only 1.1 times compensatory awards.[144] Thus, a cap of 1-to-1 would not unduly limit the arbitrator's discretion. If a 1-to-1 cap is not acceptable, the cap should in no case be greater than 2-to-1. A 2-to-1 cap is equivalent, in total damages, to the current treble damages structure of both the Clayton Antitrust Act[145] and the Racketeer Influenced and Corrupt Organizations Act.[146]

Finally, another scheme would be to institute the cap of the amount of the compensatory award <u>and</u> adopt a rule that in no case could the punitive award be over $500,000. The theory behind the two pronged limitation is that if the defendant is already paying over $500,000 in a <u>compensatory</u> award, the possibility of paying another $500,000 in addition to that is sufficient punishment and deterrence.[147]

J. <u>Divide the Award Between Plaintiff and Regulator</u>

The purpose behind punitive damages is to punish the broker-dealer, not to provide a windfall to the plaintiff. Thus, the NASD should provide that a portion of each award, such as sixty, seventy or even eighty percent, go to the state or federal government or to another quasi-governmental regulator. For example, portions of all punitive awards could be paid into the S.I.P.C. Fund. This system would alleviate the misguided incentives that drive certain undeserving plaintiffs (or their counsel) to seek punitive awards. In fact, nine states have similar schemes in place.[148] The portion of the award to go to the public could be directed to the NASD itself or to any federal or state governmental agency including the federal or state treasury. Arbitration panels should be instructed that it would be improper to circumvent this scheme by enhancing an award so that the plaintiff receives the same award he would have received absent such a rule.

K. <u>Prioritize Payment so that Compensatory Damages are Paid First</u>

Defendants should pay punitive damages arising out of an action <u>after</u> paying all compensatory damages. Cases may arise where a broker/dealer has claims pending against it from multiple plaintiffs for both compensatory and punitive damages. In those cases, the defendant should pay all of the compensatory awards before paying the punitive awards.[149] If a defendant is insolvent, or nearly insolvent, it is improper for one plaintiff to receive compensatory damages, plus a windfall of punitive damages, while a second plaintiff receives nothing.

Conclusion

The NASD should carefully limit punitive damages because they are costly and difficult to administer, and the purported benefits are not particularly well served in the securities arbitration context. The securities laws, and the sanctions they provide through SEC, SRO, and DOJ enforcement, at administrative, civil and criminal levels, are adequate to deter would-be violators of those laws. Thus, the NASD should adopt the guidelines, restrictions and procedures discussed in this Report to govern the award of punitive damages in securities arbitrations. These procedures would guarantee that any award of punitive damages does not violate due process under the Constitution and ensure that awards of punitives are fair, reasonable, and limited to appropriate cases.

Endnotes

1 See Howard Spierer, Explosion in Securities Arbitration Cases Explored by Section Panel, Litigation News, Feb. 1993 at 8; Jonathan M. Moses, Federal Prosecutors, in Rare Step, File Charges in Securities Arbitration Case, Wall Street Journal, Jan. 29, 1993 at A6; Carole Gould, Securities ADR: Is it Fair to Investors? 10 Alternatives to the High Cost of Litigation 165 (Nov. 1992).

2 See, e.g., Edward W. Morris, Punitive Damages in Securities Arbitration, Rev. Sec. & Comm. Reg. at 167 (Sept. 21, 1988) (noting decision in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) and overburdened civil dockets caused shift from litigation to arbitration). According to a GAO Report, since arbitration clauses were first deemed enforceable in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), many fewer securities disputes are being litigated in the courts. See United States General Accounting Office, Securities Arbitration: How Investors Fare 48-49 (May 1992).

3 See, e.g., Wilko v. Swan, 346 U.S. 427 (1953), overruled by, Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

4 McMahon, 482 U.S. at 238 (Exchange Act rights adequately vindicated under arbitration). Two years later, the Supreme Court expanded the holding in McMahon to include claims under the Securities Act. Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 484 (1989).

5 Rodriguez de Quijas, 490 U.S. at 481; see also Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

6 5 Securities Arbitration Commentator, Chart D (May 1993).

7 Gage v. CIGNA Sec., Inc., No. 90-01371, 1992 WL 123187, at *2 (NASD Mar. 10, 1992).

8 Hickman v. PaineWebber, Inc., No. 90-03354, 1992 WL 390284, at *2 (NASD Sept. 9, 1992).

9 Harper v. Shearson Lehman Bros., Inc., No. 91-00508, 1992 WL 233396, at *4 (NASD Mar. 26, 1992).

10 Kelly v. PaineWebber, Inc., No. 91-03187, 1992 WL 389966, at *4 (NASD Sept. 15, 1992).

11 Michael Siconolfi, Dean Witter Ordered to Pay Fired Manager, Wall St. J., Oct. 12, 1993, at C1.

12 Section 28(a) of the 1934 Act expressly states that "no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." See also, 5D Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5, § 260.03[e] (2d ed. 1986); Green v. Wolf Corp., 406 F.2d 291, 303 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969) (rejecting argument that punitives were available for an implied cause of action under Rule 10b-5).

13 The nine states are Connecticut, Michigan, Nebraska, Washington, Georgia, Louisiana, Massachusetts, Indiana and New Hampshire. 1 James D. Ghiardi and John J. Kircher, Punitive Damages Law and Practice § 4.01 (1985 & Supp. 1992); See One Year After 'Haslip,' State Systems for Awards Mostly Withstand Challenge, 24 Sec. Reg. & L. Rep. 347 (March 13, 1992); Stipanowich, Punitive Damages in Arbitration: Garrity v. Lyle Stuart, Inc. Reconsidered, 66 B.U. L. Rev. 953, 955 n.10 (1986).

14 9 U.S.C. §§ 1-14 (1947).

15 Pub. L. 68-401, 43 Stat. 883 (Feb. 12, 1925).

16 Committee on the Judiciary, Report to Validate Certain Agreements for Arbitration, H. Rep. No. 96, 68th Cong., 1st Sess. 1 (1924).

17 9 U.S.C. § 2 (1988).

18 Cone Memorial Hosp., 460 U.S. 1 at 24.

19 Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378, 1387 (11th Cir. 1988) (footnote omitted).

20 SICA, The Arbitrator's Manual at 26 (May, 1992).

21 NASD Manual, Rules of Fair Practice, Article III § 21(f)(4) ¶2171 (1993).

22 American Arbitration Association, Securities Arbitration Rules § 43 (Sept. 1, 1987).

23 353 N.E.2d 793 (N.Y. 1976).

24 Garrity, 353 N.E.2d at 794.

25 Id. at 796.

26 See Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056 (9th Cir. 1991) (punitives allowed based on FAA, even though parties contracted to apply New York law); Bonar, 835 F.2d 1378 (same).

27 Lee v. Chica, 983 F.2d 883, 888 (8th Cir. 1993) (when the parties "agree to arbitrate under the rules of AAA and the arbitration issues involve interstate commerce, the FAA gives force to the rules of the AAA"); Bonar, 835 F.2d at 1387; Todd Shipyards, 943 F.2d at 1062-63.

28 See Mastrobuono v. Shearson Lehman Hutton, Inc., 812 F. Supp. 845, 848 (N.D. Ill. 1993) (vacating $400,000 punitive award where New York law governed and the agreement did not explicitly or by incorporation authorize punitives); Complete Interiors, Inc. v. Behan, 558 So. 2d 48, 51 (Fla. Dist. Ct. App. 1990) ("the better view is that punitive damages may not be awarded by an arbitrator absent an express provision authorizing such relief in the arbitration agreement or pursuant to a stipulated submission").

29 See Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334, 337 (7th Cir. 1984).

30 Willis v. Shearson/American Express, Inc., 569 F. Supp. 821, 823, 824 (M.D.N.C. 1983).

31 9 U.S.C. §§ 1, 2, 4 (1988); Willis, 569 F. Supp. at 823 ("the Court must be satisfied that there is a written agreement . . . and that the contract . . .evidences a transaction involving interstate commerce") (citation omitted).

32 9 U.S.C. §§ 1, 2, 4 (1988); see Willis, 569 F. Supp. at 823.

33 9 U.S.C. §§ 1, 2, 4 (1988).

34 Dorn v. Dorn's Transp., Inc., 562 F. Supp. 822, 824 (S.D.N.Y. 1983).

35 Fahnestock & Co. v. Waltman, 935 F.2d 512, 518 (2d Cir.), cert. denied, 112 S. Ct. 380 (1991); cf. Barbier v. Shearson Lehman Hutton, Inc., 948 F.2d 117, 120 (2d Cir. 1991) (court first applied FAA because there was diversity jurisdiction and transaction involved interstate commerce, then, since FAA preserves wishes of the parties, court applied state law because that was their stated desire).

36 Fahnestock, 935 F.2d at 519.

37 Mastrobuono, 812 F. Supp. at 847.

38 Fahnestock, 935 F.2d at 517. In fact, the legislative history to the original 1925 Act explains that the need for the law stemmed from English courts attempting to safeguard their own jurisdiction; they refused to enforce arbitration agreements because, they felt, such agreements deprived them of their jurisdiction. This attempt became embedded in English common law courts and was adopted by their American counterparts. It was this tendency that the FAA countered.

"The [arbitration] bill declares simply that such agreements for arbitration shall be enforced, and provides a procedure in the Federal courts for their enforcement." H. Rep. No. 96, 68th Cong., 1st Sess. 2 (1924).

39 See Barbier, 948 F.2d at 121-22 (punitives not permitted if choice of law provision cites New York law).

40 See, e.g., Stephen Daniels & Joanne Martin, Myth and Reality in Punitive Damages, 75 Minn. L. Rev. 1 (1990); Theodore B. Olson & Theodore J. Boutrous, Jr., Constitutional Restraints on the Doctrine of Punitive Damages, 17 Pepp. L. Rev. 907 (1990); Michael Rustad & Thomas Koenig, The Historical Continuity of Punitive Damages Awards: Reforming the Tort Reformers, 42 Am. U. L. Rev. 1269 (1993); 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 (1993); Victor E. Schwartz & Liberty Magarian, Challenging the Constitutionality of Punitive Damages: Putting Rules of Reason on an Unbounded Legal Remedy, 28 Am. Bus. L. J. 485 (1990); David G. Owen, The Moral Foundations of Punitive Damages, 40 Ala. L. Rev. 705 (1989); see also, John C. Jeffries, Jr., A Comment on the Constitutionality of Punitive Damages, 72 Va. L. Rev. 139 (1986); Malcolm E. Wheeler, The Constitutional Case for Reforming Punitive Damage Procedures, 69 Va. L. Rev. 269 (1983).

41 See Browning-Ferris Indus. v. Kelco Disposal, Inc., 492 U.S. 257 (1989); Pacific Mutual Life Ins. Co. v. Haslip, 499 U.S. 1 (1991); TXO Production Corp. v. Alliance Resources Corp., 113 S. Ct. 2711 (1993).

42 Foreword, Symposium On Civil Justice Reform, 42 Am. U. L. Rev. 1245, at 1250 (1993).

43 See President's Council on Competitiveness, Agenda For Civil Justice Reform in America, 8, 22 (Aug. 1991); see also Dan Quayle, Civil Justice Reform, 41 Am. U. L. Rev. 559, 561-69 (1992).

44 492 U.S. 257.

45 Id. at 282.

46 Id. at 276. Several Supreme Court Justices had previously invited future due process challenges to high punitive damage awards. See Bankers Life & Casualty Co. v. Crenshaw, 486 U.S. 71, 86-89 (1988).

47 111 S. Ct. 1032 (1991).

48 Id. at 1037 and n.2.

49 Id. at 1046.

50 Id. at 1045.

51 This analysis of Haslip is adopted from Schwartz & Behrens, Punitive Damages Reform, 42 Am. U. L. Rev. at 1374-82.

52 Haslip, 111 S. Ct. at 1046.

53 Id. at 1044.

54 Id. at 1044.

55 Id. at 1045 (citing Green Oil Corp. v. Hornsby, 539 So. 2d 218, 222 (Ala. 1989)).

56 Haslip, 111 S. Ct. at 1045.

57 Id. at 1046 n.11.

58 See Johnson v. Hugo's Skateway, 974 F.2d 1408 (4th Cir. 1992) (Virginia); Mattison v. Dallas Carrier Corp., 947 F.2d 95 (4th Cir. 1991) (South Carolina); Alexander & Alexander, Inc. v. B. Dixon Evander & Assocs., 596 A.2d 687 (Md.

Ct. Spec. App. 1991), cert. denied, 605 A.2d 137 (1992); Garnes v. Fleming Landfill, Inc., 413 S.E. 2d 897 (W. Va. 1991). See also Owens-Illinois, Inc. v. Zenobia, 601 A.2d 633 (Md. 1992) (raising burden of proof for punitive damages to showing of "actual malice"); Gamble v. Stevenson, 406 S.E. 2d 350 (S.C. 1991) (adopting more detailed post-verdict review); Hodges v. S.C. Toof & Co., 833 S.W. 2d 896 (Tenn. 1992) (raising burden of proof, developing new review standards, and tightening standard for assessing punitive damages).

59 113 S. Ct. 2711 (1993)

60 Id. at 2715.

61 Id. at 2714-2716.

62 Id. at 2717.

63 TXO Production Corp. v. Alliance Resources Corp., 419 S.E. 2d 870, 887 (W. Va. 1992).

64 Petition for Writ of Certiorari Granted, 113 S. Ct. 584 (1992). Justice Neely's motives in upholding the award of punitive damages may have been suspect. Justice Neely has stated previously his penchant for transferring money from out of state defendants to injured local plaintiffs. Richard Neely, The Product Liability Mess 4 (1988) ("As long as I am allowed to redistribute wealth from out-of-state companies to injured in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone else's money away, but so is my job security, because the in-state plaintiffs, their families, and their friends will reelect me"). In her dissent, Justice O'Connor explained in detail why it is quite likely that the jury was influenced by the fact that TXO is a large, out-of-state corporation. TXO, 113 S. Ct. at 2736-2739 (O'Connor, Jr., dissenting).

65 Id. at 2718. The Court spun a web of confusion on this case. The controlling decision was a plurality by Justice Stevens and joined by Justices Rehnquist and Blackmun. Justice Kennedy joined only in parts I and IV and filed an opinion concurring in part and concurring in the judgment. Justices Scalia and Thomas filed a concurring opinion, and Justice O'Connor filed a dissenting opinion in which Justice White joined and in which Justice Souter joined as to parts II-B-2, II-C, III, and IV.

66 Id. at 2721-2723.

67 Seven justices agreed, in one way or another, that the Due Process Clause imposes substantive limits on excessive punitive damages awards. See Id. at 2731 (speaking for Chief Justice Rehnquist, and Justices Stevens and Blackmun); Kennedy, J., concurring in part at 2724; O'Connor, J., dissenting at 2740-2741 (joined by Justices White and Souter).

68 Id. at 2720. In a concurring opinion, Justices Scalia and Thomas disagree that the substantive due process clause has any bearing on excessive punitive damages. Id. at 2727 (Scalia, J., concurring).

69 Id. at 2722.

70 Presumably Justices Scalia and Thomas agree as well as they state that the since the jury was instructed on the purposes of punitive damages and the award was reviewed, it should be upheld. Id. at 2726 (Scalia, J., concurring).

71 Id. at 2720.

72 See Id. at 2719-2720; Kennedy, J., concurring in part at 2724; Scalia, J., concurring at 2727; O'Connor, J., dissenting at 2740.

73 Indeed, one member of the Subcommittee believes that punitive damages should be proscribed outright in all private arbitration schemes. He realizes, however, that this view may be politically unacceptable.

74 National Collegiate Athletic Ass'n v. Tarkanian, 488 U.S. 179,191 n. 11 (1988) (citation omitted).

75 Flagg Bros., Inc. v. Brooks, 436 U.S. 149, 164 (1978) (statute declaring warehouseman's lien legal not state action).

76 Lugar v. Edmondson Oil Co., 457 U.S. 922, 939 (1982).

77 John Nowak, Ronald Rotunda, J. Nelson Young, Constitutional Law, 502 (2d ed. 1984). See also Smith v. Allwright, 321 U.S. 649, 663 (1944) (selection of party nominees for general election was state action); Marsh v. Alabama, 326 U.S. 501, 509 (1946) (first and fourteenth amendments applied to company owned town).

78 See Garrity, 353 N.E.2d 793; Edmonson v. Leesville Concrete Co., 111 S. Ct. 2077, 2085 (1991).

79 15 U.S.C. § 78o(b)(8) (1988).

80 See Keller v. State Bar of California, 496 U.S. 1 (1990) (state bar association); Abood v. Detroit Bd. of Educ., 431 U.S. 209 (1977) (labor unions).

81 Adickes v. S.H. Kress & Co., 398 U.S. 144, 170-71 (1970).

82 D.H. Overmyer Co. v. Frick Co., 405 U.S. 174, 185 (1972).

83 Fuentes v. Shevin, 407 U.S. 67, 94-97 (1972).

84 Exchange Act § 15A(h), 15 U.S.C. § 78o-3(h) (1988). For example, in any proceeding by a registered securities association to determine if a member, or person associated with a member, should be disciplined, the association must bring specific charges, give notice of the charges, provide an opportunity to defend, and keep a record. Any disciplinary action must be accompanied with a statement setting forth the wrongful acts committed, the provision of the law violated, and the sanction imposed. Id.

85 See also Silver v. NYSE, 373 U.S. 341 (1963); InterContinental Indus. v. American Stock Exchange, 452 F.2d 935 (5th Cir. 1971), cert. denied, 409 U.S. 842 (1972).

86 NASD Manual, Rules of Fair Practice, Art. III § 1 (1993).

87 NASD Notice to Members 93-32 at 201 (May 1993).

88 See Id.

89 NASD Manual, Art. IV § 2 (1993).

90 SICA, The Arbitrator's Manual at 33 (May, 1992).

91 NASD By-Laws, Article IV and Schedule C, Part V.

92 See SEC 1990 Annual Report at 42 (National Business Conduct Committee "operates an effective and thorough program"); SEC 1991 Annual Report at 41-42 (inspection revealed that MSC was performing its duties properly and districts conduct effective regulatory programs).

93 Pub. L. No. 101-429, 104 Stat. 931 (Oct. 15, 1990).

94 Securities Act of 1933 §§ 21(e), 24, 15 U.S.C. §77 (1988); Securities Exchange Act of 1934 § 34, 15 U.S.C. §§ 78u, 78u-1, 78ff (1988).

95 See generally 2 Marc I. Steinberg and Ralph C. Ferrara, Securities Practice: Federal and State Enforcement § 12:03 (1992); Hazen at §§ 8.1-8.5.

96 Securities Act of 1933 § 20(d)(2), 15 U.S.C. § 77t(d)(2) (1988); Exchange Act of 1934 § 21(d)(3)(B), 15 U.S.C. § 78u(d)(3)(B) (1988); Investment Company Act of 1940 § 42(e)(2), 15 U.S.C. § 80a-41(e)(2) (1988); Investment Advisers Act of 1940 § 209(e)(2), 15 U.S.C. § 80b-9(e)(2) (1988).

97 Exchange Act § 21A(3), 15 U.S.C. § 78u-1 (1988).

98 Frank H. Easterbrook and Daniel R. Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611, 633-34 (1985).

99 See 1 Marc I. Steinberg and Ralph C. Ferrara, Securities Practice: Federal and State Enforcement § 5:10 (1992) (tarnishing of reputation "may well have negative, if not a fatal, impact on one's current as well as prospective business affairs and opportunities") (injunction context).

100 International Brotherhood of Elec. Workers v. Foust, 442 U.S. 42, 48 (1979) (citation omitted). See also Garrity, 353 N.E.2d at 796.

101 Jeffrey W. Grass, The Penal Dimensions of Punitive Damages, 12 Hastings Const. L.Q. 241, 247 (1985) (concluding punitives are "penal in nature, spirit, and jurisprudence, and thus mandate higher standards of procedural protection") (footnote omitted); John C. Jeffries, Jr., A Comment on the Constitutionality of Punitive Damages, 72 Va. L. Rev. 139, 151 (1986) (asserting that punitives are quasi-criminal form of punishment).

102 See, e.g., David Friedman, An Economic Explanation of Punitive Damages, 40 Ala. L. Rev. 1125 (1989).

103 Any procedures to govern punitive damages should be adopted by all SRO's to ensure consistency. Thus, the NASD should work with the other SRO's to develop uniform standards.

104 NASD, Code of Arbitration Procedure § 41 (1992).

105 American Arbitration Association, Securities Arbitration Rules § 42 (Sept. 1, 1987).

106 9 U.S.C. § 10 (1988). The circumstances are: (a) the award was procured by corruption, fraud or undue means; (b) there was evident partiality or corruption by the arbitrator; (c) the arbitrator was guilty of misconduct by refusing to postpone a hearing or hear certain evidence; (d) misbehavior prejudiced the rights of a party; or (e) arbitrators exceeded their power or failed to execute a mutual, final, and definite award. Id.

107 Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056, 1060 (9th Cir. 1991).

108 Associated Teachers of Huntington, Inc. v. Board of Educ., 306 N.E.2d 791, 795 (N.Y. 1973); Amicizia Societa Navegazione v. Chilean Nitrate and Iodine Sales Corp., 274 F.2d 805, 808 (2d Cir.), cert. denied, 363 U.S. 843 (1960) (arbitrators' findings of fact and law are conclusive and unreviewable); cf. United Steelworkers of America v. Enterprise Wheel & Car Corp., 363 U.S. 593, 596 (1960) ("refusal of courts to review the merits of an arbitration award is the proper approach to arbitration under collective bargaining agreements"). See also SICA, The Arbitrator's Manual at 29-32 (May, 1992) (adopting FAA's limited scope of review); NASD Code of Arbitration Procedure § 41(b) (1992) ("[u]nless the applicable law directs otherwise, all awards rendered pursuant to this Code shall be deemed final and not subject to review or appeal").

109 See TXO, 113 S. Ct. at 2719-20, 2724, 2727, 2740.

110 If the NASD institutes a cap on punitive damages, discussed below, it may not be necessary to provide a right to appeal the amount of the award.

111 William L. Prosser & W. Page Keeton, The Law of Torts § 2 at 14 (5th ed. 1984); see also Baghdady v. Sadler, No. 92-1214, 1992 U.S. App. Lexis 23571 (1st Cir. Sept. 9, 1992) (no review appropriate for claimant's dissatisfaction with award), cert. denied, 113 S. Ct. 1815 (1993). One possible exception to this rule would be if one member of an arbitration panel states that an appealable issue exists.

112 United States General Accounting Office, Securities Arbitration: How Investors Fare 55-59 (May 1992). Since the issuance of the cited GAO report, the NASD has undertaken several steps to enhance and reinforce arbitrator qualification and evaluation. These steps include the establishment of: a subcommittee of the NASD's National Arbitration Committee to review arbitrator credentials; minimum experience and qualification criteria; procedures for verifying the qualifications of potential arbitrators; mandatory arbitrator training programs; and a regularized arbitrator evaluation process to assess competency.

113 Id.

114 Currently, arbitrator training materials describe the NASD's disciplinary process, and arbitrators are asked whether they believe information revealed in an arbitration record should be the subject of a disciplinary referral.

115 This limit may not be necessary if the NASD chooses to place a cap on all punitive damages, discussed below.

116 See NASD Notice to Members 93-32 at 204 (May 1993) ("District examiners in the field report to the DBCC regarding member compliance with the aforementioned rules and regulations based on information collected through various examination and surveillance programs").

117 The members of the Subcommittee are not unanimous with regard to the recommendation to establish an "offer of judgment" procedure. One member of the Subcommittee disapproves of this recommendation in its entirety.

In June 1993, the NASD proposed establishing an offer of judgment procedure, which would be available in cases in which compensatory damage claims exceeded $250,000. Under the proposal, either party (not merely the defending party) would be permitted to submit an offer. The SEC is currently revising the proposal.

118 See generally Jay N. Varon, Promoting Settlements and Limiting Litigation Costs by Means of the Offer of Judgment: Some Suggestions for Using and Revising Rule 68, 33 Am. U. L. Rev. 813, 834 (1984) ("courts should include items such as statutory penalties, treble or punitive damages, and prejudgment interest as permitted in computing the plaintiff's final judgment") (footnote omitted).

119 See generally Roy D. Simon, Jr., The Riddle of Rule 68, 54 Geo. Wash. L. Rev. 1, 58 n.271 (1985). Variations on this scheme are to limit the percentage of the difference to be paid to a small amount, such as five percent, or to institute a sliding scale, similar to the Rule in Alaska. The Alaska rule is five percent of the difference up to $100,000, three percent of the difference for the next $400,000 and one percent of any additional difference. Id.

120 An offer of judgment rule conceivably could apply equally to defendants as well as plaintiffs so that defendants would be required to pay a percentage of the difference between the judgment and their own offer. Such a rule, however, would serve only to turn a punitive damages award into a super-punitive award as the defendant would have to pay the punitive award itself plus a percentage of the punitive award on top of that, which would be the difference between the offer and the final judgment.

121 TXO, 113 S. Ct. at 2722

122 Ala. Code § 6-11-20 (1992); Cal. Civil Code § 3294 (Deering 1993); Colo. Rev. Stat. § 13-25-127(2) (1992); Minn. Stat. § 549.20(1) (1992); Or. Rev. Stat. § 30.925 (1991); see also Tuttle v. Raymond, 494 A.2d 1353, 1363 (Me. 1985); Wangen v. Ford Motor Co., 294 N.W.2d 437 (Wis. 1980).

123 Pon v. Shearson Lehman Hutton Am. Express, No. 1990-001920, 1992 WL 426433 (NYSE Sept. 10, 1992).

124 See Peters v. Princeton Financial Group, Nos. 90-02932, 90-03202, 91-00066, 91-00353, 91-00536, 91-00537, 1992 WL 123203, at *3 (NASD Feb. 13, 1992) ("intentional, fraudulent, willful, wanton, and malicious" conduct"); Gage v. CIGNA Sec., Inc., No. 90-01371, 1992 WL 123187 at *2 (NASD Mar. 10, 1992) ("willful, wanton, and methodical" conduct); Griffin v. Graystone Nash, Inc., No. 91-03069 (NASD Oct. 6, 1992) (intentional fraud).

125 Bialilew v. Shearson Lehman Hutton, Inc., No. 90-03245, 1992 WL 233307, at *2 (NASD Apr. 6, 1992) (gross negligence); Hickman v. PaineWebber, Inc., No. 90-03354, 1992 WL 390284, at *2 (NASD Sept. 9, 1992) (gross negligence in supervising employee who committed "egregious breach" of fiduciary duty).

126 Mendez v. J. Alexander Sec., Inc., No. 91-00236, 1992 WL 124369, at *1 (NASD Mar. 10, 1992) (undescribed "standard of supervision").

127 TXO, 113 S. Ct. at 2722 (stating that the jury may reasonably have determined that TXO "set out on a malicious and fraudulent course" to win back royalty payments it ceded to Alliance).

128 15 U.S.C. § 78(t) (1988).

129 15 U.S.C. § 77(o) (1988).

130 See, e.g., Ferrara & Sanger, Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior and Aiding and Abetting, 40 Wash. & Lee L. Rev. 1007 (1983); Fitzpatrick & Carman, Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole, 12 Hofstra L. Rev. 1 (1983); Note, Section 20(a) or Respondeat Superior?: An Update, 44 Wash. & Lee L. Rev. 919 (1987); Kuehnle, Secondary Liability Under the Federal Securities Laws — Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and The Statutory Scheme, 14 J. Corp. L. 313 (1989); c.f. Branson, Collateral Participant Liability Under the Securities Laws - Charting the Proper Course, 65 Ore. L. Rev. 327 (1986); Daniel R. Fischel, Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934, 69 Cal. L. Rev. 80 (1981); David S. Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution, 120 U. Pa. L. Rev. 597 (1972).

131 See Aldrich v. Thomson McKinnon Sec., Inc., 756 F.2d 243, 247 (2d Cir. 1985) (applying New York law); Davis v. Merrill Lynch, 906 F.2d 1206 (8th Cir. 1990) (applying South Dakota law); Malandris v. Merrill Lynch, 703 F.2d 1152, 1174 (10th Cir. 1981), cert. denied, 464 U.S. 824 (1983)(applying Colorado law).

132 See Dan B. Dobbs, Handbook on the Law of Remedies 214 (1973); William L. Prosser, The Law of Torts §§ 2, 12 (1971).

133 Haslip, 111 S. Ct. at 1041.

134 TXO, 113 S. Ct. at 2725-26 (Kennedy, J., concurring).

135 See, Victor E. Schwartz and 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, at 1380-81 and nn.98, 99 (1993). The American Bar Association in 1987, the American College of Trial Attorneys in 1989, and the American Law Institute in 1991 have all recommended that the "clear and convincing evidence" standard be used for punitive damages cases. Id. at 1381 and nn.95-97.

136 1 James D. Ghiardi and John J. Kircher, Punitive Damages Law and Practice § 9.12 (1985 & Supp. 1992).

137 See Ga. Code Ann. § 51-12-5.1(d)(2) (1987); Md. Cts. and Jud. Proc. Code Ann. § 10-913 (1987); Mo. Rev. Stat. § 510.263(2)(3) (1987); Mont. Code Ann. § 27-1-221(7)(a) (1987); N.J. Stat. Ann. § 2A:58C-5 (1987); Utah Code Ann. § 78-18-1(2) (1989) (evidence of wealth not admissible until finding of liability for punitives); see generally Punitive Damages § 5.36. See also Haslip, 111 S. Ct. 1032.

138 Schwartz and Behrens, Punitive Damages Reform, 42 Am. U.L. Rev. 1365.

139 Id. at 1382-83 and nn.105-109.

140 833 S.W. 2d 896 (Tenn. 1992).

141 States that have placed caps on punitive damages are Colorado, Connecticut, Florida, Kansas, Oklahoma, Texas, and Virginia. See, e.g., Colo. Rev. Stat. § 13-21-102; Tex. Civ. Prac. & Rem. §§ 41.001-41.008 (West Supp. 1992). The

Alabama Supreme Court recently held unconstitutional a state statute, Ala. Code § 6-11-21 (1992), which limited punitive damages to $250,000. Henderson v. Alabama Power Co., Nos. 1901875, 1901946, 1993 LEXIS 584 (June 25, 1993).

142 The Subcommittee is not in complete agreement on this point. One member would recommend instituting caps on punitive damages based only on the amount of the compensatory award and avoid any cap of a specific dollar amount.

143 The American College of Trial Attorneys recommended limiting punitive damages to twice the amount of compensatory damages or $250,000, whichever is greater. The American Law Institute favors a somewhat similar approach. See Schwartz and Behrens, Punitive Damages Reform, 42 Am. U. L. Rev. at 1379 and nn.83-84. See also, 5 Securities Arbitration Commentator at 5 (May 1993). One concern with instituting this type of cap is that arbitrators who normally set awards far less than the cap may gravitate toward it, assuming it to be an acceptable amount.

144 Securities Arbitration Commentator at chart A (May 1993).

145 Clayton Antitrust Act § 4, 15 U.S.C. § 15(a) (1988).

146 Racketeer Influenced and Corrupt Organizations Act § 901(a), 18 U.S.C. § 1964(c) (1988).

147 The larger the punitive award the greater the deterrent value will be. At one point, however, the punishment must be limited. If firms are "overdeterred" their very business operations will be chilled from operating effectively.

148 The nine states are Colorado, Florida, Georgia, Illinois, Iowa, Montana, New York, Oregon and Utah. See, e.g., Colo. Rev. Stat. § 13-21-102(4) (1992); Fla. Stat. Ann. § 768.73 (West Supp. 1993); Mo. Rev. Stat. § 537.675 (1991).

Several states have recently overturned their statutes on constitutional or discriminatory grounds. Kirk v. Denver Pub. Co., 818 P.2d 262 (Colo. 1991) (violates takings clause); McBride v. General Motors Corp., 737 F. Supp. 1563 (M.D. Ga. 1990) (law discriminates against plaintiffs). Recently, the Eleventh Circuit certified to the Florida Supreme Court the question of whether a statute directing a portion of punitive awards to the state applies to arbitration. Miele v. Prudential Bache Sec., 986 F.2d 459 (11th Cir. 1993).

149 Cf. Abate v. AC&S, Inc., Baltimore City Circuit Court, Consolidated File No. 89236704 (insurance context).