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Ruder Report is a Delicate Compromise

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Alternatives

to the High Costs of Litigation

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DIGEST

Securities ADR. With much fanfare, an NASD task force recently issued proposals to reform securities arbitration. **Constantine N. Katsoris**, a professor at Fordham University School of Law and a public member of the Securities Industry Conference on Arbitration, critiques the group's key recommendations. ..... *Page 29*

Mediation Methods. Many mediators will assess the strengths and weaknesses of the parties' legal claims and propose settlements. **Kimberlee K. Kovach**, a professor at South Texas College of Law and **Lela P. Love**, a professor at Cardozo School of Law, say these "evaluative" techniques jeopardize a mediator's neutrality. ..... *Page 31*

Court ADR. What does court-ordered ADR require? Must the parties just attend a settlement conference, or do they have a broader obligation to "participate?" **Edward F. Sherman**, a professor at the University of Texas School of Law, analyzes the statutes and cases in this relatively uncharted legal territory. ..... *Page 33*

Practice Notes. Parties who wish to have their awards reviewed for errors of law can expressly provide for that in their agreements, notes **William J. Nissen**, a partner with Sidley & Austin. ..... *Page 36*

Conflict of Interest? In chit-chat during a break, an arbitrator told a story that sounded unprofessional to one of the parties. Then it seemed he hadn't disclosed a (very remote) potential conflict. Any bias or partiality was speculative, said the 11th Circuit, refusing to vacate the award. **Jarril F. Kaplan**, of Snell & Wilmer, reports. ..... *Page 36*

Employment ADR. A federal court in New York has rejected the argument that employees must understand what they're signing when they agree to arbitrate employment disputes. ..... *Page 39*

Mandatory Arbitration. Two federal agencies—the National Labor Relations Board and the Equal Employment Opportunity Commission—oppose mandatory arbitration in employment cases. ..... *Page 39*

Departments

Ruder Report Is A Delicate Compromise

By Constantine N. Katsoris

Two years ago, the National Association of Securities Dealers launched an ambitious mission: to propose broad reforms that would improve the efficiency and reduce the costs of its own arbitration process.

The NASD appointed an eight-member task force for this purpose, including practitioners and academics with strong backgrounds in arbitration, business and public interest law. David S. Ruder, former Chairman of the SEC, and a professor at Northwestern University School of Law, headed the effort.

After numerous closed sessions, which included testimony by the public members of the Securities Industry Conference on Arbitration or SICA, the task force issued its report in January. More than 150 pages long, the so-called Ruder Report contains dozens of recommendations, some very significant, and some less so.

Overall, the Report brokers a delicate compromise between brokerage houses and investors. But parts of its

(continued on page 37)

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Routing Slip • See Back Page

In Delicate Compromise Between Brokers, Investors Task Force Proposes Reforms in Arbitration System

(continued from front page)
proffered package don't serve the public interest.

The most controversial of the suggestions is to cap punitive damages at two times compensatory damages, up to a maximum of $750,000. Among the Report's many other recommendations is that parties choose arbitrators from lists the NASD supplies; under the current system, the NASD selects the panel. The Report also proposes to: establish mandatory lists of discoverable items; eliminate the so-called "six-year rule," which automatically bars consideration of a claim if more than six years have elapsed; and consider consolidating all arbitrations at the self-regulatory organizations, or SROs, into one forum under the oversight of the NASD.

What made such proposals necessary? By the time the NASD assembled its task force, complaints had surfaced that securities arbitration had lost its way and was becoming more like litigation. One cause was the explosion in the number of securities arbitrations SROs needed to handle. As the stakes increased, securities arbitrations became less economical and speedy and more like the courthouse they were designed to avoid.

Both the NYSE and the NASD announced plans to address the troublesome issues facing SRO arbitrations. The NYSE, after holding a two day symposium, issued a report and recommendations last year. The Ruder Report is the NASD's effort to calm the troubled waters. Here is my critique of its most important recommendations.

Cap on Damages

The Ruder Report proposes a two-tiered ceiling on punitive damages: a cap of $750,000, or a limit of two-times compensatory damages, whichever is less. A rigid limit of $750,000 should be rejected out of hand since it is totally inadequate in situations involving large compensatory awards. By placing an arbitrary ceiling on awards, no matter how grievous the wrong, it condones unconscionable conduct.

The task force justifies its two-tiered cap, saying that it "will protect broker-dealers from 'runaway' awards that have no relationship to compensatory damages." Yet the task force fails to apply the same standard to its own proposed remedy. For example, what relationship does a $750,000 punitive damage award have to a $10 million compensatory award?

In addition, the Report suggests that claimants should not be entitled to punitives if RICO damages are awarded for the same claim. However, it does not recommend a $750,000 cap on damages in RICO claims. Indeed, the Report reasons that "RICO awards are capped by a treble damage provision, thus alleviating the concern of a 'runaway' award." How does this differ from punitives?

An arbitrary ceiling on punitive damages, no matter how grievous the wrong, "condones unconscionable conduct."

If the industry fears large punitive damage awards in arbitration (even when punitives reasonably relate to compensatory damages), then perhaps claims for punitive damages of more than $750,000—or all punitive damage claims—should be removed from arbitration and returned to the courts. There parties have the procedural safeguard of an appeal more readily available. On the other hand, if brokerage agreements force the public into arbitration with a $750,000 cap on punitives, then it's time to revisit the issue of whether these contracts of adhesion are enforceable.

Nor would I necessarily impose a cap of two-times compensatory damages. Courts don't usually have such a restriction; their chief limitation in awarding punitive damages is that the award shouldn't offend constitutional sensibilities.

Still, several federal statutes, such as the Clayton Act, RICO and the Futures Trading Practices Act, limit overall treble damages (for both compensatory and punitive damages). Therefore, capping punitive damages at a reasonable multiple of compensatory damages might be palatable if it was part of an overall tradeoff: for example, in exchange for predispute arbitration agreements that didn't require the parties to waive punitives.

Arbitrator Selection

Under the current system, SROs select the arbitrators, giving each side one peremptory challenge, and an unlimited number of challenges for cause. The Ruder Report recommends adopting the American Arbitration Association system in which the forum supplies lists of arbitrators, from which the parties select a panel.

Both systems have their advantages and disadvantages. Although the suggested change does not necessarily result in a better-qualified panel, it has the attraction of letting the parties pick their own panel. However, the system might not work in a geographic area where there aren't many qualified arbitrators. If the parties reject all the arbitrators on the list, it might be necessary to shift the arbitration to another locale, less convenient for the claimant.

Discoverable Items

Discovery controversies are beginning to sap the vitality of the SRO arbitrations. Often those controversies are unnecessary and represent posturing on the part of either, or both, parties. Mandatory lists of discoverable items would help eliminate unnecessary delay and expense. Still, the required lists

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should be presumptive only: arbitrators should retain ultimate authority to decide what's discoverable, based on the circumstances of a case.

Six-Year Rule

Section 4 of SICA's Uniform Code of Arbitration (making claims ineligible for SRO arbitration if six years has elapsed from the event giving rise to the claim) was initially a matter of administrative convenience; the drafters thought that in cases arising out of events more than six years old, the pre-hearing disclosure procedures of arbitration were inadequate. The AAA has no similar rule.

SICA never intended to foreclose litigation when a claim was too stale for arbitration. Unfortunately, some courts have done just that. Other courts have ruled that the issue of eligibility should first be decided by the courts, not by the arbitrators.

In effect, the six-year eligibility rule has caused havoc with claimants by subjecting them to unnecessary delay, expense, and prejudice. The Ruder Report takes a giant step toward simplifying securities arbitration by recommending that this distorted rule be eliminated.

Single Forum

A more controversial proposal raises the possibility of establishing a single forum within an existing SRO. This proposal isn't new. Several years ago, some observers in the securities industry recommended that—in the interest of uniformity and economy—all the SROs leave public securities arbitration to the NASD. The Ruder Report echoes their suggestion, but ignores the general mistrust of the public and the courts in SRO arbitrations. SICA helped to overcome that mistrust.

Ideally, securities arbitration should be moved from the SROs to a totally separate and *independent* forum, as I recommended more than a decade ago. To have credibility with the public, such a forum must be independent from actual, inferential, subtle, practical or any other kind of imaginable pressure. To the extent possible, it should be independent of the industry, independent of the plaintiff's bar, and, to some extent, independent of the SEC—except when the SEC is exercising its general oversight role. A single SRO forum under the NASD umbrella, no matter how well intentioned, could not possibly be totally independent.

"If brokerage agreements force the public into arbitration with a $750,000 cap on punitives, then it's time to revisit the issue of whether these contracts of adhesion are enforceable."

In the past, the SEC has opposed the idea of a single forum, preferring the competitive choices offered by the various SROs. Perhaps a truly independent single forum is a Utopian dream; but until such a forum can be created, the SEC's theory of competitive forces is preferable—particularly in an atmosphere where arbitration is basically mandatory. Why should public customers be forced to arbitrate before an NASD forum when the disputes are with brokers who are members of other SROs, and involve transactions executed solely at the other SROs?

What Next?

Unlike the NYSE Report, which flowed from an open debate, the Ruder Report grew out of a broad spectrum of opinions presented in numerous closed sessions. The two reports give enlightened insight into the problems facing securities arbitration, and on many points reach similar conclusions. Now, an independent SICA—consisting of ten SROs, four public members, the Securities Industry Association and many invited guests (such as the SEC and the AAA)—should assess the suggestions of these two reports, and decide what to do next.

Will the NASD implement the Ruder Report suggestions, or will it first seek the advice and consent of SICA and the other SROs? Unfortunately, the Report suggests that the NASD might choose the lone-ranger approach. The present system of checks and balances, in place for 20 years, has worked relatively well. It has resulted in steady and meaningful change from the Balkanized procedures of the past. It also has prevented some ill-conceived ideas from finding their way into securities arbitration.

Under the present system, SICA, an independent body, proposes rule changes. The SRO boards approve and file them with the SEC. The SEC then decides what the rule will be. By that time, all participants have had at least two bites at the apple: the public at the SICA level, and at the 19(b) filing; the various SROs at the SICA level, and at their board's level; the industry at the SICA level, at the SRO level (where it lobbies intensely), and again at the 19(b) filing; and, the SEC at the SICA level (where SEC representatives and others are invited guests), and as the final word at the 19(b) filing.

This pattern for rule changes in securities arbitration should be preserved. As an independent body, SICA establishes and maintains a level playing field. Its presence, like a cop on the beat these past 20 years, has been reassuring to regulators, the courts, and the investing public.

FURTHER READING

Like the NASD, the New York Stock Exchange has investigated the troublesome aspects facing SRO arbitrations.

Edited proceedings of the NYSE's two-day symposium on the subject appear in 63 *Fordham Law R.* 1495-1695 (1995).