membership in an SRO or has had its registration as a broker-dealer revoked by the SEC. The requisite percentage varies from 40 to 20 percent, depending on the size of the firm.

4. As proposed, the Rule captures registered persons who have worked at a Disciplined Firm within the past two years. Is the proposed time frame appropriate?

5. Should the percentage of registered persons counted in the calculation exclude registered persons who have worked at a Disciplined Firm within the past two years, but who themselves have no disciplinary history or customer complaints?

6. Should the percentage of registered persons counted in the calculation include registered persons who may not have worked at a Disciplined Firm, but who have, as individuals, been barred by the Commission from association with any broker, dealer, investment adviser, investment company, or municipal securities dealer?

7. Should firms with fewer than five registered persons be excepted from the Rule?

8. As proposed, the Rule limits the taping requirement to registered representatives in conversation with existing or potential customers. Should the taping requirement apply to registered principals in conversation with existing or potential customers? Should it apply to any other associated person of a member firm?

9. What are the estimated costs to comply with the Rule? Please comment generally on the benefits and costs of the Rule, as well as ways to reduce the costs while preserving the benefits of the Rule.

Persons making written submissions should file six copies thereof with Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should File No. SR–NASD–97–69 in the caption above and should be submitted by December 29, 1997.

For the Commission, by the Division of the Market Regulation, pursuant to delegated authority.[30]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97–31846 Filed 12–4–97; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39371; File No. SR–NASD–97–47]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Punitive Damages in Arbitration

November 26, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''), 15 U.S.C. 78s(b)(1), notice is hereby given that on July 8, 1997,[1] the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD Regulation is proposing to amend the NASD's Code of Arbitration Procedure to add a new rule relating to the award of punitive damages. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

Rules of the Association

10000. Code of Arbitration Procedure

10300. Uniform Code of Arbitration

10336. Punitive Damages

This Rule explains when a party may seek punitive damages, what standards and limitations apply to the claim, and what the arbitration award must state.

(a) The Availability of Punitive Damages

(1) This Rule applies to any claim that must be arbitrated under Rule 10301 between a public customer and a member, or between a public customer and an associated person.

(2) A party may request punitive damages if, at the time the party files a claim, the party is a citizen of a state that allows its courts to award punitive damages for the same type of claim.

(3) A member or an associated person may request punitive damages from a public customer only if the public customer is a citizen of a state that allows its courts to award punitive damages for one or more of the public customer's claims.

(4) A party seeking punitive damages must state the amount in its claim.

(5) For purposes of this Rule, the term ''claim'' means any dispute or controversy described in the Statement of Claim (including Counterclaims, Third-Party Claims, and Cross-Claims) for which the claimant is seeking any form of remedy.

(b) Arbitrators to Apply State Standard

(1) When arbitrators decide whether to award punitive damages, they will apply the same standard of conduct applied by courts in the state where the requesting party is a citizen at the time a claim is filed.

(2) Arbitrators will apply this standard even if the parties signed a choice of law agreement that specifies a different state.

(c) Limitations on the Amount and Availability of Punitive Damages

(1) Punitive damages may be awarded in an amount up to two times compensatory damages or $750,000, whichever is less.

(2) For purposes of this paragraph only, compensatory damages do not include attorneys' fees, costs of arbitration, or post-award interest.

(3) Arbitrators cannot award punitive damages if they have already awarded multiple damages for the same claim under:

(A) the Racketeer Influenced and Corrupt Organizations Act (RICO), or

(B) any other federal or state statute that provides for multiple damages awards.

(4) The limitations in this Rule apply even if state laws differ.

(d) Statement in Award

If the arbitrators award compensatory and punitive damages, they must state separately the amount they awarded for each.

[30] 17 CFR 200.30–3(a)(12).

[1] The NASD filed Amendment Nos. 1 and 2 to the proposed rule filing on October 17, 1997 and November 14, 1997, respectively, the substance of which is incorporated into the notice. *See* letters from Joan C. Conley, Corporate Secretary, NASD Regulation, to Katherine A. England, Assistant Director, Market Regulation, Commission, dated October 17, 1997 (''Amendment No. 1'') and November 14, 1997 (''Amendment No. 2'') respectively.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

In January 1996, the NASD's Arbitration Policy Task Force (''Task Force'') [2] released its report on Securities Arbitration Reform. The Task Force Report made numerous recommendations to improve the arbitration process. Since the Report was released, NASD Regulation has been engaged in a major effort to implement the Task Force recommendations.

The proposed rule change relates to the Task Force recommendations concerning the availability of punitive damages in securities arbitration. In brief, the Task Force recommended that punitive damages remain available in NASD arbitration, subject to a cap. The Task Force's recommendations are described in more detail below.

Summary of Proposed Rule Change

The proposed rule change would apply only to arbitration disputes between public customers and member firms (or their associated persons).[3] The proposed rule change would allow a customer to seek punitive damages in arbitration if the state of which he or she is a citizen would allow punitive damages for the same type of claim in court. In deciding whether an award of punitive damages is warranted, the arbitration panel will look to the standard of conduct for the award of punitive damages applied in the state of which the party requesting punitive damages is a citizen at the time the claim is filed. That state's law is to be applied without regard to any contrary choice-of-law provision contained in the parties' agreement. The proposed rule requires a party requesting an award of punitive damages to specify in the claim the amount of punitive damages requested, and provides that punitive damages may be awarded in an amount up to two times compensatory damages or $750,000, whichever is less.

Background

Damages are defined as pecuniary compensation that may be recovered by any person who has suffered loss, detriment, or injury to his person, property, or rights through the unlawful act, omission, or negligence of another.[4] Damages may be compensatory or punitive, according to whether they are awarded (1) as compensation, indemnity, or restitution for harm sustained by a party (compensatory);[5] or (2) as other damages awarded against a person to punish him for his outrageous conduct and to deter him and others like him from similar conduct in the future (punitive).[6] Punitive damages usually are awarded only if compensatory damages have been sustained.[7]

For many years, courts and legal scholars debated whether punitive damages should be available in arbitration proceedings. In 1992, the Securities Industry Conference on Arbitration (''SICA'') [8] approved an amendment to the Uniform Code of Arbitration which provided that arbitrators may grant any remedy or relief that they deem just and equitable and that would have been available in a court with jurisdiction over the same dispute. This provision has not been adopted by any SRO.[9] As noted, as in 1994, the NASD formed the Task Force to study the securities arbitration process administered by the NASD and to make suggestions for reform. The NASD has followed the Task Force's recommendations, described below, in developing the proposed rule.

In 1995, the Supreme Court addressed the availability of punitive damages in securities arbitration in a case involving the NASD's arbitration forum. *Mastrobuono* v. *Shearson Lehman Hutton, Inc.*[10] The *Mastrobuono* case involved a brokerage firm's client agreement that contained a New York ''choice-of-law'' provision and a provision requiring any controversy arising out of the parties' transactions to be arbitrated according to the rules of the NASD or the NYSE.[11] The choice-of-law provision required that disputes be decided according to New York law, which allowed courts, but not arbitrators, to award punitive damages.[12] With regard to the arbitration provision, the Court examined the NASD's rules, because the parties had elected to proceed in arbitration at the NASD.[13] The Court cited an NASD rule providing that arbitrators may award ''damages and other relief,'' [14] and determined this language to be broad enough to include punitive damages.[15] In addition, the Court observed that the Arbitrator's Manual provided to NASD arbitrators stated that ''arbitrators can consider punitive damages as a remedy.'' [16] The Court concluded that the choice-of-law provision introduced an ambiguity into an agreement that would otherwise allow punitive damages awards. The Court construed the ambiguity against the brokerage firm that drafted the agreement, thus enforcing the award of

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[2] The NASD formed the Arbitration Policy Task Force in September 1994 for the purposes of studying the securities arbitration process administered by the NASD and of making suggestions for reform. The Task Force, chaired by David S. Ruder, former Chairman of the SEC, delivered its Report to the NASD Board in January 1996.

[3] The proposed rule change does not apply to industry and clearing controversies that may be arbitrated pursuant to the Rule 10200 Series, such as disputes between or among member firms, associated persons, and other industry parties. The NASD will address punitive damages for these disputes in a separate filing.

[4] *Black's Law Dictionary* 389 (6th ed. 1990).

[5] *Restatement (Second) of Torts* § 903 (1979). The word ''damages'' is used in the Restatement of Torts in the same sense in which it is used in the Restatement of Contracts. *See id.* § 902 cmt. a (1979).

[6] *Restatement (Second) of Torts* § 908 (1979). ''In assessing punitive damages, the trier of fact can properly consider the character of the defendant's act, the nature and extent of the harm to the plaintiff that the defendant caused or intended to cause and the wealth of the defendant.'' *Id.*

[7] *See Restatement (Second) of Torts* § 908 cmt. c (1979) and cases cited therein. Some courts allow recovery of punitive damages when only nominal damages have been awarded. *Id.*

[8] SICA is a group composed of representatives of the self-regulatory organizations (''SROs'') that provide arbitration forums, public investors, and the securities industry. Staff of the SEC attend as non-voting invitees. Currently, there are ten SRO representatives, three public investor representatives, and one representative from the securities industry.

[9] In 1994, the New York Stock Exchange (''NYSE'') held a symposium on issues significant in securities arbitration, including punitive damages. *Symposium: New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry*, 63 Fordham L. Rev. 1495 (1995).

[10] 514 U.S. 52, 131 L. Ed. 2d 76, 115 S. Ct. 1212 (1995).

[11] 514 U.S. at 58–59.

[12] *See Garrity* versus *Lyle Stuart, Inc.*, 353 N.E.2d 793 (1976). Since *Mastrobuono* was decided, a New York appellate court has held that, with respect to arbitrations governed by the Federal Arbitration Act, which preempts the *Garrity* rule, the arbitration of punitive damages claims is required unless the parties have unequivocally agreed otherwise. *Mulder* versus *Donaldson, Lufkin & Jenrette*, 648 N.Y.S.2d 535 (1996).

[13] 514 U.S. at 60–61.

[14] This is currently Rule 10330(e).

[15] 514 U.S. at 61.

[16] *Id.* The Arbitrator's Manual was compiled by members of SICA to explain the Uniform Code of Arbitration.

punitive damages to the customers.[17] The *Mastrobuono* decision left open the possibility that a more clearly drafted agreement might permit, exclude, or limit punitive damages.[18]

Trends in State and Federal Law

In the past few years, the United States Congress and several state legislatures have acted to place limits on the amount of punitive damages that may be recovered in court proceedings. Although many of these new laws relate to causes of action that would not normally be alleged in securities arbitrations, such as personal injury and product liability, the number of statutes restricting the award of punitive damages is an indication of growing legislative concern. Some examples of state and federal laws are provided below.

A review of NASD arbitration records indicates that about half of all claimants in the past three years have been residents of California, New York, Florida, New Jersey, Texas, Illinois, or Michigan; over 40% of all claimants lived in the first three listed states.[19] State laws are constantly evolving; however, it appears that all seven of the above states allow for the award of punitive damages for some types of tort actions;[20] five states have some statutory limitations on punitive damages;[21] and two states have no statutory limit on the amount that may be awarded, although case law allows the trial or appellate courts to reduce the amount awarded by the trier of fact.[22] Two states provide for payment of a share of the award to the state in certain circumstances.[23] In some of the states, punitive damages requests must be separately pleaded or tried, or are otherwise subject to special procedures to avoid prejudice to the defendant.[24] As noted earlier, many of the state statutes described above relate to claims that one would not expect to find in securities arbitrations.

At the federal level, Congress has acted to provide for punitive damages in two specific areas, while at the same time placing limits on the amounts that may be recovered.[25]

[17] 514 U.S. at 62.

[18] Under the NASD's rules, however, parties are not allowed to include in their arbitration agreements ''any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.'' Rule 3110(f)(4). This rule was not at issue in *Mastrobuono* because the Mastrobuonos' contract was executed prior to the effective date of the rule. 514 U.S. at 61 n.6. The NASD intends to amend Rule 3110(f) to be consistent with the proposed rule change.

[19] This informal survey of claims filed in 1994, 1995, and 1996 counted the number of separate claimants from each state; there could have been several claimants in one case. It also considered each claimant's mailing address, which may or may not have been the claimant's domicile for legal purposes. In about 2% of cases, only the address of the claimant's attorney was provided; these addresses were omitted from the survey. Furthermore, the survey did not differentiate between types of claimants, so it includes member firms and associated persons who were claimants in industry disputes. Therefore, these figures are only approximate.

[20] *California,* Cal. Civ. Code § 3294 (West Supp. 1996) (punitive damages are available for ''breach of an obligation not arising from contract, where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice. * * *''); New York, *see, e.g., Kelly* v. *Defoe,* 636 N.Y.S. 2d 123 (N.Y. App. Div. 1996) (holding that punitive damages are available under case law for certain tort actions, but are not generally awarded to redress private wrongs); Florida, Fla. Stat. Ann. § 768.73(1)(a) (1996) (punitive damages are allowed in civil actions based on negligence, strict liability, products liability, misconduct in commercial transactions, professional liability, or breach of warranty, and involving willful, wanton, or gross misconduct); New Jersey, N.J. Stat. § 2A:15–5.12 (West Supp. 1996) (punitive damages are awarded ''if the plaintiff proves, by clear and convincing evidence, that the harm suffered was [caused] by actual malice or accompanied by wanton and willful disregard. * * *''); Texas, Tex. Civ. Prac. & Rem. Code §§ 41.002, 41.003 (1997) (punitive damages are generally allowed, unless excluded by statute, upon a finding of fraud or malice, and must be proven by clear and convincing evidence); Illinois, 735 Ill. Comp. Stat. Ann. 5/2–1115.05(b) (1997) (punitive damages are available for certain tort actions involving injury to person or property where it is proven ''by clear and convincing evidence that the defendant's conduct was with evil motive or with a reckless and outrageous indifference to a highly unreasonable risk of harm and with a conscious indifference to the rights and safety of others''), *see, e.g., Siegel* v. *Levy Org. Dev. Co.,* 607 N.E. 2d 194, 200 (Ill. 1992) (''If a plaintiff can demonstrate gross deception or willful and wanton misconduct, the determination as to whether plaintiff is entitled to exemplary damages lies with the trier of fact.''); Michigan, *see, e.g., Veselenak* v. *Smith,* 327 N.W.2d 261 (Mich. 1982) (exemplary damages are awardable where the defendant commits a voluntary act that inspires feelings of humiliation, outrage, and indignity, and where the conduct was malicious or so willful and wanton as to demonstrate a reckless disregard of the plaintiff's rights); punitive damages are also available in Michigan under specific statutes for causes of action inapplicable in securities arbitration. *See infra* note 22.

[21] In Florida, punitive damages may be awarded in an amount up to three times compensatory damages in certain civil actions involving willful, wanton, or gross misconduct. Fla. Stat. Ann § 768.73(1)(a) (1996). Florida law requires, however, that 35% of the punitive damages award be payable to the state or a medical trust fund. *See id.* § 768.73(2)(b). This effectively reduces the amount payable to the winning party to less than two times compensatory damages. In New Jersey, the cap on punitive damages is five times the compensatory damages or $350,000, whichever is greater. N.J. Rev. Stat. § 2A:15–5.14(b) (1996) (certain causes of action are exempted from the cap). In Texas, the cap on punitive damages is the greater of two times ''economic'' damages plus one times non-economic damages up to $750,000, or $200,000. Tex. Civ. Prac. & Rem. Code § 41.008 (1997). For purposes of this provision, economic damages are defined as ''compensatory damages for pecuniary loss'' and exclude damages for ''physical pain and mental anguish, loss of consortium, disfigurement, physical impairment, or loss of companionship and society.'' *See id.* § 41.001. In Illinois, punitive damages are available for physical injury or property damage in an amount up to three times economic damages, 735 Ill. Comp. Stat. Ann. 5/2–1115.05(a) (1997) (as noted below, the court may apportion this amount among the plaintiff, the attorney, and a state agency). In Michigan, there is a cap for flagrant or repeated wage law violations of two times wages and benefits due, Mich. Stat. Ann. § 17.277(18) (Law. Co-op. 1996), and a treble damages provision for violations of the funds transfer facilities law resulting in injury to business or property. *See id.* § 23.1137(28).

[22] The two states with no specific cap on punitive damages are California, Cal. Civ. Code § 3294 (West Supp. 1996), and New York. In California, however, courts requires a ''reasonable relationship'' between actual and punitive damages. *Torres* v. *Automobile Club of Southern California,* 15 Cal. 4th 771, 781, 937 P. 2d 290 (Ca. 1997). *See infra* note 38. In addition, Michigan courts have held that the purpose of exemplary damages is not to punish the defendant, but to render the plaintiff whole; therefore, when compensatory damages can make the injured party whole, exemplary damages must not be awarded. *See, e.g., Jackson Printing Co.* v. *Teresa,* 425 N.W.2d 791, 794 (Mich. Ct. App. 1988) (citations omitted).

[23] In Florida, 35% of the award is payable to the state's General Revenue Fund. Fla. Stat Ann § 768.73(2)(b) (1996). In cases of injury or death, 35% is paid to a medical fund instead. In Illinois, for cases involving physical injury, the court may apportion the award among the plaintiff, the plaintiff's attorney, and the Illinois Department of Rehabilitation Services. 735 Ill. Comp.Stat. Ann. 5/2–1207 (1997).

[24] California's Civil Code prohibits claims for punitive damages from stating the amount sought, Cal. Civ. Code § 3295(e) (West Supp. 1996), and provides that a court ''shall, on application of any defendant, preclude the admission of evidence of that defendant's profits or financial condition until after the trier of fact returns a verdict for plaintiff awarding actual damages and finds that a defendant is guilty of malice, oppression, or fraud in accordance with Section 3294.'' *See id.* § 3295(d). These restrictions safeguard defendants by ensuring that they are not coerced into settlements to avoid unwarranted intrusions into their private financial affairs, and by minimizing potential prejudice to them in front of a jury. *Torres* v. *Automobile Club of Southern California,* 15 Cal. 4th 771, 777, 937 P. 2d 290 (Ca. 1997). In Florida, the Supreme Court has recently issued revised Standard Jury Instructions—Civil Cases for use in bifurcated proceedings in which, during the second stage of the proceeding, evidence is presented and argued that will allow the jury to determine the amount of punitive damages, if any, that should be awarded. 689 So. 2d 1042; 1997 Fla. LEXIS 22 (February 13, 1997). In New Jersey, punitive damages must be specifically ''prayed for'' in the complaint. N.J. Stat Ann. § 2A:15–5.11 (West Supp. 1996). In cases involving a punitive damages claim, the defendant may seek a bifurcated trial. *See id.* § 2A:15–5.13(a). A Michigan statute provides that punitive damages may not be recovered in libel actions unless the plaintiff has first given the defendant notice and an opportunity to publish a retraction. Mich. Stat. Ann. § 27A.2911(2)(b) (Law. Co-op. 1996).

[25] In the Civil Rights Act Amendments of 1991 (P.L. 102–166), Congress agreed to a compromise in which compensatory and punitive damages became available for violations of Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act of 1990, and the Rehabilitation Act of 1973, conditioned on the right to a jury trial on the underlying claim, proof of intentional discrimination (as opposed to disparate impact), a finding (for the award of punitive damages) that the employer acted with ''malice or with reckless indifference to the federally protected rights of an aggrieved individual,'' and a cap of $50,000 to $300,000 for combined compensatory and punitive

Task Force Report

In its Report, the Task Force noted that the subject of punitive damages has generated widespread controversy and polarization between the investor and broker/dealer communities.[26] The Task Force observed that about 50% of all new arbitration claims include a claim for punitive damages, although punitive damages are awarded in only about 1% of cases. The Task Force Report expressed the opinion that the existence of a punitive damages claim can lead to more adversarial litigation, as respondents use every available tactic to defend themselves against a potentially enormous award. The Task Force Report also noted the views of some claimants' lawyers that it could be considered malpractice for them to omit punitive damages claims. After interviewing many interested groups and individuals, and after numerous discussions, the Task Force recommended that:

- punitive damages remain available in NASD arbitration, subject to a cap;
- the cap on punitive damages be the lesser of two times compensatory damages or $750,000;
- damages under the Racketeer Influenced and Corrupt Organizations Act (''RICO'')[27] and punitive damages not be awarded for the same claim;
- punitive damages be available to an investor where they would be available in court for the same types of claims, in the state where the investor is domiciled;
- the standard of conduct justifying the award of punitive damages be based on state law where the investor is domiciled;
- the award specify the amount given for compensatory damages and the amount given for punitive damages; and
- where requested by the party against whom the award is rendered, the award describe the conduct giving rise to the award.[28]

The Task Force noted that the cap on punitive damages finds support by analogy to recently enacted state and federal statutes imposing limitations on punitive damages.[29] The Task Force recommended further that any predispute arbitration agreement between the parties expressly provide for the award of punitive damages (subject to their availability for the same types of claims in state court), refer to the relevant NASD Rule, and provide that the parties' agreement to permit punitive damages in arbitration preempts any state arbitration law to the contrary.[30] The Task Force's research indicated that this type of agreement would comport with existing law under the Federal Arbitration Act (''FAA''),[31] which has been held to preempt conflicting state law.[32]

Positions of Interested Organizations

In order to carry out the recommendations of the Task Force, NASD Regulation considered the views of various organizations and reviewed relevant federal and state law. In particular, NASD Regulation considered letters from and conversations with representatives of the Public Investors Arbitration Bar Association (''PIABA''), SICA, and the Securities Industry Association (''SIA'').

Attorneys and groups representing investors argued that arbitration should afford the same types of relief as would be available in court, including punitive damages. These groups contended that, since virtually all firm agreements with their customers contain a clause mandating arbitration of disputes arising under the agreement, customers are unable to take their claims to court but must proceed in arbitration. Such groups generally oppose any limitation on punitive damages, such as ceilings on the amount that may be awarded, or ratios of punitive damages to compensatory damages. For example, PIABA expressed the initial opinion that there should be no cap on punitive damages, as such damages provide a ''significant and important curb on customer abuse.''[33]

Public members of SICA, *i.e.*, those not affiliated with the securities industry or with the SROs, sent a letter to the Chairman of the NASD shortly before the NASD Board of Governors met to consider the proposed rule change,[34] In the letter, the public members stated their view that the proposed punitive damages rule would result in an arbitrary limitation of arbitrators' authority to award punitive damages, and would conflict with an NASD rule prohibiting arbitration agreements from containing limitations on arbitrators' authority. The public members also expressed the opinion that the issue should be returned to SICA for development of an acceptable resolution.

Representatives of the broker-dealer community, however, recommended limiting or prohibiting the award of punitive damages in arbitration. The SIA expressed the views that: (i) Arbitration claimants do not have an absolute right to punitive damages; rather, punitive damages are purely discretionary on the part of the jury or arbitrator in order to punish a person for conduct that is outrageous to society as a whole; (ii) punitive damages were devised to serve the purposes of punishment and deterrence, but, in the securities industry, state and federal regulators already have a broad arsenal of weapons to use against wrongdoers; (iii) arbitration does not offer the due process safeguards that are available in court; for example, the rules of evidence do not apply in arbitration; there are no set standards of proof, such as preponderance of the evidence, clear and convincing evidence, or reasonable doubt; and there is no right to appeal the award except on very narrow grounds; (iv) arbitration cases are difficult to settle due to the threat of punitive damages; because claimants hope for larger awards in arbitration through an award of punitive damages, they are less willing to settle cases at what firms consider a ''reasonable'' amount; and (v) the chief advantage of arbitration, its relatively speedy resolution of a dispute by ordinary individuals using notions of simple justice, will be lost as the process becomes more complex and more like the court system.

The SIA stated that its Board had recommended that the cap be reduced to $250,000 or one times compensatory damages, whichever is less.[35] The SIA noted that $750,000 is greater than the total net capital of half of the member firms of the SIA and of an additional several thousand firms that are members of the NASD. The SIA contended that, since arbitration awards are very difficult to appeal, there should be reasonable restraints on punitive damages to avoid endangering the viability of the vast majority of NASD members.

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damages, depending on the number of persons employed by the defendant. 42 U.S.C. § 1981a. In the Futures Trading Practices Act of 1992, Congress provided for the award of punitive damages in the amount of two times actual damages for certain violations of the future trading laws. Under that Act, punitive damages are only available for certain claimants who prove a ''willful and intentional'' violation in the execution of an order on the floor of a contract market. 7 U.S.C. § 25(a)(3).

[26] *See* Task Force Report at 35 *et seq.*

[27] 18 U.S.C. 1961 *et seq.*

[28] *See* Task Report at 40–46.

[29] *Id.* at 43.

[30] The Task Force's recommendations concerning the contents of predispute arbitration agreements are under consideration by NASD Regulation.

[31] 9 U.S.C. 1 *et seq.* (Supp. 1997).

[32] *See, e.g., Allied-Bruce Terminix Cos., Inc.* v. *Dobson,* 513 U.S. 265, 130 L. Ed. 2d 753, 115 S. Ct. 834 (1995).

[33] Letter from L. Jerome Stanley, 1995–96 PIABA President, to Deborah Masucci, Vice President and Director of Arbitration (March 15, 1996).

[34] Letter from SICA Public Members to Daniel P. Tully (December 9, 1996).

[35] Letter from A.B. Krongard, SIA Chairman, to Mary Alice Brophy, Chairman, NASD Regulation (June 7, 1996).

Other suggestions made by the SIA were that the term ''compensatory damages'' be defined as ''out-of-pocket losses,'' based upon the difference in price between purchases and sales of the investment (or current value, if still held); that the term ''exemplary damages'' be used instead of ''punitive damages''; that a uniform national standard of conduct be used to determine when punitive damages are appropriate; that the rule specify that exemplary damages may be awarded ''up to'' the stated cap, to clarify that the cap is not an automatic amount; that the applicable state law to determine whether punitive damages are available be that of the investor's domicile at the time the transaction occurred; and that the award of punitive damages be considered in a separate proceeding from the rest of the case (a process often referred to as ''bifurcation'').

Purpose of Proposed Rule Change

During the past several years, interested parties have been unable to reach a consensus on punitive damages, and NASD Regulation believes that it must take action at this time to implement a punitive damages rule. After reviewing the positions of various interested groups, NASD Regulation adopted an amendment to the code of Arbitration Procedure that generally follows the Task Force recommendations, with minor changes considered appropriate. NASD Regulations believes that the proposed rule change best effectuates the interests of providing a forum to investors that provides appropriate relief while limiting the potential for awards that are disproportionate based on the claims alleged.

NASD Regulation recognizes that it is not appropriate or feasible to eliminate the availability of punitive damages in arbitration so long as public customers are required by most member firms to sign predispute arbitration agreements. At the same time, NASD Regulation realizes that some of the safeguards against excessive punitive damages awards that may be available to defendants in court are not available in arbitration, such as special pleading requirements for requests of punitive damages,[36] separate hearings for the liability and damages phases of the case,[37] post-trial review of the award by a judge,[38] and judicial appeals on the merits of the decision rather than on the narrower grounds for overturning an arbitration award.[39] Therefore, NASD Regulation believes it has balanced these considerations fairly in endorsing the recommendation of the Task Force that a cap on punitive damages is necessary and appropriate if punitive damages are to be permitted in the NASD Regulation forum.

The cap on punitive damages of the lesser of two times compensatory damages or $750,000 is believed to be appropriate in an industry that is already subject to extensive regulatory oversight. As discussed above, the $750,000 amount is larger than the net capital requirement of many NASD member firms.[40] Therefore, a cap of $750,000 provides a significant deterrent to egregious behavior, since it could threaten a firm's continued operations. Considering the fact that arbitration by its nature is more informal than a court proceeding, with relaxed rules of evidence and procedure, and the fact that arbitration awards may be modified or vacated only on very narrow grounds, NASD Regulation believes that the limitation on the amount of punitive damages is reasonable.

Description of Proposed Rule Change

The proposed rule has been drafted using the ''plain English'' principles of written communication that the Commission has encouraged. NASD Regulation believes the proposed rule will be easier for all arbitration participants to understand, most notably participants who represent themselves (*pro se* parties). Unlike the NASD's Membership and Conduct Rules, which are mainly referred to and applied by member firms, their compliance officers, and their attorneys, the Code of Arbitration Procedure is often used by *pro se* parties who are not attorneys and who are usually coming into contact with the dispute resolution process for the first time.[41] In such circumstances, plain English rules are particularly important. In conformity with plain English principles, the term ''arbitrators'' has been used instead of ''arbitration panel'' in the proposed rule change. This usage is not meant to imply that the proposed rule change applies only to cases heard by more than one arbitrator; rather, it applies to any arbitration panel, which may be composed of one or more arbitrators.

Proposed new Rule 10336 provides in paragraph (a)(1) that it applies only to disputes between a public customer and a member or between a public customer and an associated person. Therefore, the proposed rule will not apply to disputes between or among members and associated person (''industry disputes'').[42]

Proposed paragraph (a)(2) states that a party may request an award of punitive damages if a court (not an arbitration panel) of the state of which that party is a citizen, at the time the claim is filed, could award punitive damages for the same type of claim.[43] A party seeking punitive damages may, either at the party's option or at the request of the arbitrators, brief the applicable state law in order to demonstrate to the arbitrators that his or her state does allow the award of punitive damages in its courts for the same type of claim. Thus, the party's citizenship at the time of filing, rather than at the time of the underlying transaction(s), determines the applicable state law. This facet of the proposed rule follows the Task Force's recommendation rather than the SIA's suggestion. NASD Regulation believes this provision will be considerably easier to administer, especially where

[36] *See supra* note 24.

[37] *See supra* note 24.

[38] *See, e.g., Brewer* v. *Second Baptist Church*, 197 P. 2d 713 (Cal. 1948) (if a jury awards excessive exemplary damages, there is an adequate remedy by way of an appropriate motion before the trial court or by appeal).

[39] Under the Federal Arbitration Act, for example, arbitration awards may be vacated on the following grounds: (1) Where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made. 9 U.S.C. § 10(a) (Supp. 1997).

[40] The $750,000 amount is also larger than the annual revenue of most member firms. The Report of the Select Committee on Structure and Governance of the NASD Board of Governors (''Rudman Report'') observed that, ''Most NASD member firms are relatively small. Approximately 55% report gross revenues from their securities business below $680,000. 80% report gross securities revenues under $4 million. Fewer than 5% report gross revenues over $80 million. The number of NASD member firms that generate securities revenues over $375 million is only 43, or 0.8% of the membership.'' Rudman Report at C–11 (Sept. 15, 1995).

[41] NASD Regulation estimates that as many as one-third of all claims filed involve a *pro se* party. *See* Securities Arbitration Commentator, Vol. VIII, No. 9 (February 1997). The number of *pro se* parties is much higher for smaller claims; more than three-quarters of claims involving $10,000 or less involved *pro se* claimants. *Id.*

[42] *See supra* note 3.

[43] This may mean that punitive damages will become available under the proposed rule change when they were not previously available in arbitration proceedings in a particular state. For example, in Illinois, courts have held that punitive damages may be awarded in arbitration, but only where the parties have expressly agreed to the arbitrators' authority to award punitive damages. *City of Chicago v. American Federation of State, County and Municipal Employees*, 1996 WL 496825 at *3, 669 N.E. 2d 1311 (Ill. App. Ct. 1996), *citing Edward Electric Co. v. Automation, Inc.*, 593 N.E. 2d 833, 843 (Ill. App. Ct. 1992).

several transactions or events take place over a long period of time, during which time the party seeking punitive damages could have moved one or more times.

Proposed paragraph (a)(3) was added to address the situation in which an investor lives in a state that does not allow the recovery of punitive damages for the investor's claims. In that situation, the rule would prevent a member firm (or associated person) which is a citizen of a state that permits punitive damages from seeking punitive damages against the investor. If the investor has several claims and is able to request punitive damages for any one of them, then the member or associated person may also request punitive damages as allowed under relevant state law.

Proposed paragraph (a)(4) requires a party requesting an award of punitive damages to specify in its claim the amount of punitive damages it is requesting. Specification is required because the amount of the claim determines the size of the arbitration panel appointed, the member surcharge, the claimant's filing fees, and the hearing session fees.

Proposed paragraph (a)(5) defines the term ''claim'' for purposes of the proposed rule as including any dispute or controversy described in a Statement of Claim (including Counterclaims, Third-Party Claims, and Cross-Claims) for which the claimant is seeking any form of remedy, in order to reduce the verbiage needed each time the term ''claim'' is used.

Proposed paragraph (b)(1) provides that the standard of conduct to be applied is that of the state of which the party requesting punitive damages is a citizen at the time the claim is filed. This follows the Task Force recommendation and conforms to paragraph (a)(2) in looking to state law to determine what conduct justifies an award of punitive damages.

Proposed paragraph (b)(2) specifies that the standard of paragraph (b)(1) applies regardless of any choice-of-law provision in the parties' predispute arbitration agreement. This provision is intended to avoid the situation in which a member firm inserts a choice-of-law clause in its customer agreements that specifies use of the law of a state that does not allow, or that strictly limits, the award of punitive damages in arbitration. Often that state is the one in which the member firm is headquartered, but it may not be the state in which the customer lives or in which the customer did business with the member firm. The NASD believes it is fairer to apply the law of the state in which the customer is a citizen at the time the claim is filed, rather than to apply the law of a state specified in a choice-of-law provision that the customer may not have noticed or understood when opening an account some months or years earlier. Paragraph (b)(2) applies only to the availability of punitive damages, and not to the substantive claims, which would still be subject to applicable choice-of-law and conflicts of law principles to the extent not inconsistent with other NASD rules.

Proposed paragraph (c) sets out the limitations discussed earlier, stating in (c)(1) that punitive damages may be awarded in an amount up to two times compensatory damages or $750,000, whichever is less. The use of the phrase ''up to'' makes clear that the limitation is not a standard amount to be awarded in every case. The amount of the cap is the same as contained in the Task Force's recommendation.

The Task Force intentionally did not define compensatory damages, leaving it to the discretion of the arbitrators. This choice reflected the fact that there are different theories of loss for compensatory damages, such as out-of-pocket loss or lost opportunity costs, that may be appropriate in different circumstances. The proposed rule deviates only in a minor respect from this recommendation. The definition of compensatory damages set out in proposed paragraph (c)(2) excludes attorneys' fees, other costs of arbitration, and post-award interest. Such amounts may continue to be awarded, but simply are not considered for purposes of the formula in paragraph (c)(1) for punitive damages. Arbitrators, however, may include pre-award interest in compensatory damages for purposes of paragraph (c)(1) if they have awarded such interest.

Proposed paragraph (c)(3) makes clear that punitive damages are not to be awarded in addition to the multiple damages allowed by RICO or other similar statutes for the same claim.[44] This recommendation is in accordance with the Task Force's recommendation that arbitrators be precluded from awarding both RICO damages and punitive damages for the same claim. The term ''multiple'' was used instead of ''treble'' to be more comprehensive, since there may be state and federal statutes that provide for automatic doubling, tripling, or other multiples of compensatory damages. For purposes of the proposed rule, a statute providing for punitive damages in an amount equal to (one times) compensatory damages would not be considered to be ''multiple.'' Likewise, a statute providing for punitive damages in an amount ''up to'' a certain multiple of compensatory damage would not be considered to be ''multiple'' for purposes of paragraph (c)(3) because the actual amount of punitive damages is discretionary rather than automatic. In the latter two cases, the amount of punitive damages would be subject to the cap in the NASD rule.

Proposed paragraph (c)(4) states that the limitations of paragraph (c) supersede any applicable state law on the size of punitive damage awards. This may result in a higher or lower award of punitive damages in arbitration than would be available under state law. As noted above, NASD Regulation believes this result is fair, in that it provides uniform remedies for claimants in different states (if there state allows punitive damages), as well as a consistent limit of liability for member firms with offices in several states. In addition, the disciplinary processes of NASD Regulation (as well as of the SEC, the state securities regulators, and federal and state criminal authorities) remain available to customers who feel they have been wrongly treated by their broker-dealers.

Finally, proposed paragraph (d) requires the arbitrators to set forth separately in their award the amounts awarded for compensatory and punitive damages. This requirement is in accordance with the Task Force's recommendation and not opposed by the SIA and PIABA. The paragraph does not require arbitrators to describe the facts and conduct upon which the award of punitive damages was based, or to set forth their reasons for not awarding punitive damages. The Task Force had recommended that, where requested by the party against whom the award is rendered, the arbitrators should describe the conduct giving rise to the award. NASD Regulation believes such explanations could slow the completion of the arbitration. They also would create uncertainly as to the date of the award for appeal purposes. However, parties will continue to be allowed to request an opinion of the arbitrators as described in the Arbitration Procedures booklet compiled by SICA and distribution to all public customer claimants. Under this practice, a party must make any such request no later than the date of the hearing, and the arbitration panel

[44] NASD Regulation did not agree with the SIA's suggestion that RICO awards be limited to the formula for other punitive damages, and believes that the same RICO damages should be available in arbitration as in court. We note, however, that federal RICO damages for fraud in the purchase or sale of securities are available when a criminal conviction has been obtained for the same conduct. 18 U.S.C. § 1964 (1995).

has the discretion to grant or deny the request.

All newly approved NASD arbitrators who have not presided at a hearing are required to attend a training program, which includes information on the awarding of punitive damages. If the proposed rule change is approved, Office of Dispute Resolution staff will make appropriate changes to the arbitrator training and education materials to reflect the requirements of the new rule.

NASD Regulation is requesting that the proposed rule change be effective within 45 days of SEC approval.[45]

2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act[46] in that it will promote just and equitable principles of trade by providing an additional remedy for wrongdoing by broker/dealers and their associated persons, and it will protect investors and the public interest by clarifying that punitive damages are available in the NASD Regulation arbitration forum, where they would be available under relevant state law for similar court proceedings.

B. Self-Regulatory Organization's Statement on Burden on Competition

The NASD does not believe that the proposed rule change will impose any inappropriate burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were either solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organizations consents, the Commission will:

(A) by order approve the proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR–NASD–97–47 and should be submitted by December 29, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39365; File No. SR–ODD–97–2]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Accelerated Approval of Proposed Supplement to Options Disclosure Document Regarding Mutual Fund Index Options

November 26, 1997.

On November 13, 1997, The Options Clearing Corporation (''OCC'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Rule 9b–1 under the Securities Exchange Act of 1934 (''Act''),[1] five definitive copies of a Supplement to its options disclosure document (''ODD''), which describes, among other things, the risks and characteristics of trading in options on mutual fund indexes.

The Commission has approved an options exchange proposal to list and trade options on particular mutual fund indexes.[2] OCC now proposes this Supplement, which is to be read in conjunction with the more general ODD entitled ''Characteristics and Risks of Standardized Options,'' that provides disclosures to specifically accommodate the introduction of mutual fund index options and to reflect current rules of options markets on which mutual fund index options are approved for trading. Pursuant to Rule 9b–1, the Supplement will have to be provided to investors in mutual fund index options whose account is approved for trading standardized options.

The Commission has reviewed the ODD Supplement and finds that it complies with Rule 9b–1 under the Act. The Supplement is intended to be read in conjunction with the ODD, which discusses the characteristics and risks of options generally. The Supplement provides additional information regarding mutual fund index options sufficient to further describe the special characteristics and risks of these products.

Rule 9b–1 provides that an options market must file five preliminary copies of an amended ODD with the Commission at least 30 days prior to the date definitive copies of the ODD are furnished to customers, unless the Commission determines otherwise, having due regard to the adequacy of information disclosed and the protection of investors.[3] The Commission has reviewed the Supplement, and finds that it is consistent with the protection of investors and in the public interest to allow the distribution of the Supplement as of the date of this order.

It is therefore ordered, pursuant to Rule 9b–1 under the Act,[4] that the proposed Supplement (SR–ODD–97–2) regarding mutual fund index options is approved, on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[5]

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45 NASD Regulation consents to an extension of the time projects specified in Section 19(b)(2) of the Act until the SEC is prepared to approve NASD Regulation's yet-to-be-filed rule filing proposing to amend Rule 310(f) to revise the requirements for customer predispute arbitration agreements used by members. NASD Regulation intends to amend the rules governing customer predispute arbitration agreements to give effect to the punitive damages rule proposed herein and the eligibility rule proposed in SR–NASD–97–44. The purpose of the extension is to permit the SEC to act simultaneously on this rule filing, the yet-to-be-filed rule filing proposing to amend Rule 3110(f), and the eligibility rule proposed in SR–NASD–97–44.

46 15 U.S.C. 78*o*3(b)(6).

1 17 CFR 240.9b–1.

2 *See* Securities Exchange Act Release No. 39244 (October 15, 1997) (order approving proposed rule change by the Chicago Board Options Exchange, Incorporated, relating to the listing and trading of options on the Lipper Analytical/Salomon Brothers Growth and Growth & Income Fund Indexes).

3 This provision is intended to permit the Commission either to accelerate or extend the time period in which definitive copies of a disclosure document may be distributed to the public.

4 17 CFR 240.9b–1.

5 17 CFR 200.30–3 (a)(39).