

Nebraska Law Review

Volume 83 | Issue 3

Article 4

2005

After the Ball Is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals

Daniel J. Morrissey
dmorrissey@lawschool.gonzaga.edu

Follow this and additional works at: <https://digitalcommons.unl.edu/nlr>

Recommended Citation

Daniel J. Morrissey, *After the Ball Is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals*, 83 Neb. L. Rev. (2004)
Available at: <https://digitalcommons.unl.edu/nlr/vol83/iss3/4>

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in Nebraska Law Review by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.

After the Ball Is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals

TABLE OF CONTENTS

I. The Bursting Bubble	732
II. A String of Corporate Scandals	734
III. Regulating the Conflicted Securities Industry	737
IV. The Supreme Court Turns Away from Investor Protection	739
V. Some Promise of Investor Relief in the Enron Litigation	741
VI. Mixed Results in Market Fraud Litigation	745
VII. Customer Claims Against Brokers	748
VIII. Arbitration as a More Promising Forum	751
IX. Claims That May Not Prevail in Arbitration	760
X. Conclusion	761

I. THE BURSTING BUBBLE

The technology and telecommunications boom made fools of all of us. From the corporate executives who promised results that in hindsight seem absurd to the ordinary day traders . . . all were overcome with a complex mixture of credulity, jealousy, vanity, and greed. In between were the enablers—the regulators, bankers, analysts, consultants, accountants, lawyers, credit agencies

© Copyright held by the NEBRASKA LAW REVIEW.

* Visiting Professor, Seattle University Law School; Professor and former Dean, Gonzaga University School of Law. B.A. 1971, Georgetown University; J.D. 1974, Georgetown University. This Article is dedicated to my mother, Katherine C. Morrissey, with love and gratitude, on the occasion of her eightieth birthday.

I would also like to thank Susan Harmon and research assistants Jason Leviton, Stephen Stubbs, and Greg Christianson for their invaluable assistance in the preparation of this Article. Thanks as well to colleagues Marc Steinberg, David DeWolf, Robert Araujo, S.J., and Doug Siddoway for their helpful comments.

and journalists who could have done something to stop the madness, but did nothing until way too late.¹

As the millennium approached, about half the households in the United States owned stock² and many of them had substantial savings and retirement funds invested either directly or indirectly in the equity markets.³ Some of those investors had experienced phenomenal gains during the run-up of share prices during the late 1990s, while others were only just getting into the market, enticed by the rapid stock appreciation that looked like it would never end.⁴

But beginning in April 2000, a swift downturn left investors reeling. The Dow would eventually lose almost one-third of its value, and the high-flying NASDAQ index would crash unbelievably worse, tumbling from over 5,000 to just about 1,100. It left shareholders in the tech companies traded there with, on average, only about twenty percent of the value they had had several years earlier.⁵

At first, the bursting bubble just seemed like another chapter of the manic-depressive cycle of stock trading,⁶ a long-overdue correc-

-
1. Jonathan A. Knee, *House of Gas*, N.Y. TIMES, Oct. 26, 2003, § 7, at 14 (reviewing BETHANY McLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003); REBECCA SMITH & JOHN R. EMSHWILLER, *24 DAYS: HOW TWO WALL STREET JOURNAL REPORTERS UNCOVERED THE LIES THAT DESTROYED FAITH IN CORPORATE AMERICA* (2003)).
 2. Andrew Leckey, *Damage Claims Rising Among Hard-Hit Investors*, MILWAUKEE J. SENTINEL, Mar. 13, 2003, available at <http://www.jsonline.com/byim/invest/mar03/125085.asp>.
 3. Richard Dooling, *A Fraud by Any Other Name*, N.Y. TIMES, May 4, 2003, § 4, at 13.
 4. Ruth Simon, *With Wall Street on the Defensive, Claims Against Brokers Surge*, WALL ST. J., May 27, 2003, at A1. For a confessional tale by a prominent mathematician who suffered substantial losses during this period because of his hapless investment in WorldCom stock, see JOHN ALLEN PAULOS, *A MATHEMATICIAN PLAYS THE STOCK MARKET* (2003).
 5. For an in-depth analysis of the performance of the Dow Jones index, see DOW JONES & CO., *DOW JONES INDEXES* (2005), at <http://www.djindexes.com>. For similar information on the NASDAQ, see NASDAQ STOCK MARKET, INC., *NASDAQ: MARKET STATISTICS* (Jan. 27, 2005), at <http://www.nasdaq.com/newsroom/stats/main.stm>.
 6. See Kurt Eichenwald, *After a Boom, There Will Be Scandal, Count on It*, N.Y. TIMES, Dec. 16, 2002, at C3 (quoting CHARLES R. GEISST, *WHEELS OF FORTUNE: THE HISTORY OF SPECULATION FROM SCANDAL TO RESPECTABILITY* (2002)). Geisst, a Wall Street historian, finance professor, and author, stated: "I can't think of a previous boom period, whether it was the 20's, the 60's or the 80's, where it hasn't ended up a bloody mess, with declining asset values and cases of fraud." *Id.*

The stock market's surge in late 2003 made some feel that things had never changed. As one commentator wrote:

At times it felt as if the bubble of the 1990s had never burst and investors had not learned the lessons the collapse was supposed to have imparted. Once again, investment bankers were peddling unproven stocks and brokers and their clients were panting to get a crack at quick profits.

Patrick McGeehan, *What Bubble? Wall Street's Fever Spikes Again*, N.Y. TIMES, Dec. 14, 2003, § 4, at 2.

tion for all the “irrational exuberance”⁷ that had led purchasers to bid the price of stocks in unproven companies to exorbitant heights. But then commentators began to focus more intensely on what had driven the speculative surge of the late 1990s and the groups that had engineered and profited from it. Under that analysis, it seemed that ordinary investors had been the victims of a pervasive “pump and down” sting that took \$6 trillion of the wealth they had placed in the capital markets and transferred it to corporate and securities-industry insiders.⁸

That devastating indictment, however, provoked a contrary explanation premised on W.C. Fields’ famous insight that “you can’t cheat an honest man.”⁹ According to that theory, greedy investors had no one to blame but themselves by expecting astronomical returns and had gotten their just deserts for failing to exercise the ordinary prudence required when entrusting money to high-risk ventures.¹⁰

II. A STRING OF CORPORATE SCANDALS

Then in the fall of 2001 came revelations of an unprecedented string of corporate and accounting malfeasance that had fraudulently fueled the market boom. It began with the disclosure that Enron had

7. The famous phrase, of course, comes from a speech by Federal Reserve Chairman Alan Greenspan in December 1996. Among other things, it provided the title of a fine book on the boom years, ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (2000). Cf. Knee, *supra* note 1 and accompanying text (describing that the “madness” of the technology and telecommunications boom made “fools” of everyone).

8. Simon, *supra* note 4. See also James Surowiecki, *In Wall Street We Trust*, NEW YORKER, May 26, 2003, at 40 (commenting on a recent “\$1.4-billion settlement between Wall Street and state and federal regulators”).

Public filings have disclosed large-scale selling by corporate insiders and early-stage investors in technology stocks in the months immediately before the NASDAQ crash. Mark Maremont et al., *First in Line: Founding Investors and Insiders Unloaded Tech Shares Before Fall*, WALL ST. J., Apr. 19, 2000, at A1. A follow-up story told of a “\$100 million club,” an elite group of at least fifty insiders at NASDAQ companies who collected immense fortunes in such sales. As one commentator described the phenomenon: “It amounts to a huge transfer of wealth from ordinary investors to those on the inside. . . . The little old lady in Dubuque, Iowa, with the mutual fund in tech stocks is financing the Internet entrepreneur’s mansion on the Pacific Palisades.” Mark Maremont & John Hechinger, *If Only You’d Sold Some Stocks Earlier*, WALL ST. J., Mar. 22, 2001, at A1 (quoting William Braman, Chief Investment Officer at John Hancock Funds in Boston).

9. The movie *YOU CAN’T CHEAT AN HONEST MAN* (Universal Pictures 1939), starred Fields as the quick-witted, mean-spirited, degenerate drunk Larson E. Whipsnade.

10. See *supra* note 1 and accompanying text; see also Stan O’Neal, *Risky Business*, WALL ST. J., Apr. 24, 2003, at A16 (noting that the CEO of Merrill Lynch, Inc. discussed the need for investors to accept the risks inherent in our economic system); PAULOS, *supra* note 4 (detailing a prominent mathematician’s experience suffering substantial losses due to his ill-fated investment during this period).

manipulated its profits by improperly hiding debt in off-book partnerships at the same time that it was manipulating the California and Texas energy markets.¹¹

By the end of 2002, over two dozen large public companies admitted to inflating their revenues by improper accounting practices,¹² while many of their top executives, like Dennis Koslowski of Tyco,¹³ lived opulent lifestyles at their shareholders' expense. Such chicanery was facilitated by the firms' outside accountants, such as Arthur Andersen, which shredded documents when the Securities Exchange Commission ("SEC") began investigating the firm's auditing of Enron.¹⁴

As these shenanigans were exposed, it became increasingly more apparent that they were condoned by captive boards of directors¹⁵ and were abetted by the deregulation of two sectors that had led the spiking market—telecommunications and finance.¹⁶ The recent resignation of New York Stock Exchange ("NYSE") chairman Richard Grasso reinforced outrage about such lax oversight when it came to light that the Big Board's directors had only a vague understanding of how the

11. See BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003); REBECCA SMITH & JOHN R. EMSHWILLER, *24 DAYS: HOW TWO WALL STREET JOURNAL REPORTERS UNCOVERED THE LIES THAT DESTROYED FAITH IN CORPORATE AMERICA* (2003). For good discussions of the criminal charges pending against various Enron executives, see Kurt Eichenwald, *Enron's Many Strands: The Strategy*, N.Y. TIMES, Oct. 3, 2002, at C4; John R. Emshwiller & Ann Davis, *Deal's Wake: Tiny Transaction Is Big Focus of Prosecutors in Enron Case*, WALL ST. J., Nov. 10, 2003, at A1; and Jeffrey Toobin, *End Run at Enron*, NEW YORKER, Oct. 27, 2003, at 48.

In November 2004, a Houston federal jury found four former Merrill Lynch bankers and one former Enron executive guilty of fraud for inflating the company's 1999 earnings. John R. Emshwiller & Kara Scannell, *Enron Trial Results in Five Guilty Verdicts—Convictions of Merrill Bankers Show Advisers Can Be Held Liable for Helping to Mislead Investors*, WALL ST. J., Nov. 4, 2004, at C1.

12. Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES.COM (Aug. 26, 2002), at <http://www.forbes.com/2002/07/25/accountingtracker.html>. For a good description of one of the most notorious of these accounting scandals, WorldCom, see Peter Elstrom, *How to Hide \$3.8 Billion in Expenses*, BUS. WEEK, July 8, 2002, at 41.

13. Andrew Ross Sorkin, *Tyco's Ex-Chief Going to Court In 'Greed Case'*, N.Y. TIMES, Sept. 29, 2003, at A1.

14. For that action, Andersen was convicted of obstruction of justice. Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron*, N.Y. TIMES, June 16, 2002, § 1, at 1.

For a discussion of the general reliability of audited financial reports, see Kurt Eichenwald, *Pushing Accounting Rules to the Edge of the Envelope*, N.Y. TIMES, Dec. 31, 2002, at C1.

15. See *Corporate Boards: The Way We Govern Now*, ECONOMIST, Jan. 11, 2003, at 59 (asserting that "[t]oo many boards are stuffed with yes men who question little that their chief executives suggest.>").

16. John Cassidy, *Goodbye to All That: Who Killed the Boom? Two Economists Make Their Cases*, NEW YORKER, Sept. 15, 2003, at 94.

lush compensation package they had unwittingly handed Grasso might compromise the man charged with policing their industry's trading practices.¹⁷

But the most shocking disclosures of deceitful conduct by the securities industry came in the spring of 2002 in a long-awaited global settlement spearheaded by New York Attorney General Eliot Spitzer.¹⁸ Ten of Wall Street's largest investment banking firms agreed to pay \$1.4 billion in penalties to settle charges of fraudulent practices in which they had engaged during the go-go market of the late 1990s.¹⁹ Spitzer's investigation found myriad instances where

17. Kurt Eichenwald, *In a String of Corporate Troubles, Critics Focus on Boards' Failings*, N.Y. TIMES, Sept. 21, 2003, § 1, at 1; Gretchen Morgenson, *As Scandals Still Flare, Small Victories for Investors*, N.Y. TIMES, Sept. 21, 2003, § 3, at 1.

18. See Press Release, Office of New York State Attorney General Eliot Spitzer, Statement by Attorney General Eliot Spitzer Regarding the "Global Resolution" of Wall Street Investigations (Apr. 28, 2003), available at http://www.oag.state.ny.us/press/statements/global_resolution.html. The basic facts that Spitzer's investigation of Merrill Lynch, Inc. uncovered are laid out in an affidavit of Eric R. Dinallo, Assistant Attorney General of New York, Chief of the Investment Protection Bureau of the New York State Department of Law. Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, *In re Spitzer v. Merrill Lynch & Co., Inc.* (N.Y. Sup. Ct. Apr. 2002), [hereinafter Affidavit of Eric C. Dinallo], available at <http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf>. See also Press Release, Office of New York State Attorney General Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest: Spitzer Obtains Court Order Requiring Key Disclosure (Apr. 8, 2002), available at http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html (containing links to related items, including the affidavit of Eric Dinallo and the court order requiring certain disclosures by Merrill Lynch and other Wall Street professionals).

For a fine article on the work by Spitzer, Dinallo, and the New York Attorney General's Office, see John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street*, NEW YORKER, Apr. 7, 2003, at 54.

Spitzer's state investigation outdid the work of the federal agency charged with protecting investors—the Securities and Exchange Commission. As one commentator has recently noted about the SEC's lagged enforcement efforts: "[I]n recent years the Securities and Exchange Commission lost its watchdog soul to the interests it was created to regulate and is currently in search of it" Michael Janeway, *The Lord of Springwood*, N.Y. TIMES, Dec. 21, 2003, § 7, at 14 (reviewing CONRAD BLACK, FRANKLIN DELANO ROOSEVELT: CHAMPION OF FREEDOM (2003)).

19. Stephen LaBaton, *10 Wall St. Firms Reach Settlement in Analyst Inquiry*, N.Y. TIMES, Apr. 29, 2003, at A1; Gregory Zuckerman & Susanne Craig, *Wall Street's Payout: Too Little and Late?: Settlement Establishes \$387.5 Million Fund, But Check Isn't in Mail*, WALL ST. J., Apr. 29, 2003, at C1.

Reviewing the settlement, one commentator put it bluntly: "What jumps off the page in these documents is the Wall Street firms' disregard for the individual investors in pursuit of personal benefit." Gretchen Morgenson, *In a Wall Street Hierarchy, Short Shrift to Little Guy*, N.Y. TIMES, Apr. 29, 2003, at C1.

The settlement created a \$387.5 million restitution fund for investors and mandated that the firms pay \$432.5 million over five years into an independent research fund designed to provide unbiased research to investors. Jeff D. Opydke

market analysts had distorted their research reports or stock ratings to win investment-banking business for their firms or in other ways curry favor with their corporate clients.²⁰ For their deceit, the analysts were awarded huge bonuses.²¹

The most prominent examples of this unscrupulous activity were the activities of two analysts who had become financial celebrities during the market bubble—Henry Blodget and Jack Grubman.²² Blodget, Merrill Lynch's leading tracker of Internet stocks, was publicly touting shares in companies that he was privately deriding in his personal e-mails as "junk."²³ And proving that there are all sorts of ways to be bribed, one of Grubman's many inflated stock valuations was a rating he gave to a company in exchange for admission of his children to an elite private school.²⁴

III. REGULATING THE CONFLICTED SECURITIES INDUSTRY

In the largest sense, these pervasive fraudulent practices can be seen as the invidious results of the inherently conflicted position occupied by investment bankers and brokers. Stock traders and jobbers make money—very good money—by selling the shares of companies to the public, thus purporting to serve two masters with very different interests. Their corporate clients want to sell their shares for the highest price, while the public customers who buy them want fairly-valued, quality investments.²⁵

Securities, unlike other items of investment property such as real estate, have no intrinsic value in themselves. Rather, they represent the right to something of value.²⁶ Stock purchasers, therefore, must

& Ruth Simon, *How You Come Out in Wall Street's Deal*, WALL ST. J., Apr. 29, 2003, at D1.

20. Randall Smith & Suzanne Craig, *Wall Street's Payout: Too Little and Late?: Spitzer Views Notes For Salomon Meeting As Crucial in Probe*, WALL ST. J., Apr. 29, 2003, at C1.

Five of the brokerage firms actually paid others to issue glowing research reports of companies the firms had underwritten. Gretchen Morgenson, *Shopping Spree By the Famous 5*, N.Y. TIMES, May 4, 2003, at C1.

21. One senior analyst receiving a \$160,000 salary earned a bonus of \$3.8 million. Another analyst with a similar salary earned a \$3 million bonus. Bert Caldwell, *Wall Street Practices Maddening*, SPOKESMAN-REV., May 11, 2003, at D1.

22. Editorial, *Finding Fraud on Wall Street*, N.Y. TIMES, Apr. 29, 2003, at A28. Both Grubman and Blodget agreed to lifetime bans from the securities industry in the global settlement and paid fines totalling \$19 million. *Id.*

23. Affidavit of Eric C. Dinallo, *supra* note 18, at 12. See also *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 381 (S.D.N.Y. 2003) (noting that Blodget "continued to recommend companies that he internally described as a 'piece of crap,' 'piece of junk' or 'piece of [expletive].'").

24. Cassidy, *supra* note 18.

25. Surowiecki, *supra* note 8.

26. THOMAS LEE HAZEN & DAVID L. RATNER, SECURITIES REGULATION 1 (6th ed. 2003).

have particular confidence in their brokers, and those salesmen, in turn, seek to foster such a relationship of reliance. For instance, in its promotional material Merrill Lynch speaks of its "tradition of trust" where the interests of clients come first.²⁷ Yet brokers are typically compensated by commission.²⁸ As the skeptical insight goes, when a broker recommends a stock, the purchaser does not know whether the broker thinks it is in the purchaser's best interest to buy it, or whether the broker just needs the sale to make a car payment.

Because of this obvious conflict of interest and because securities are such intricate merchandise (*i.e.*, a pure bundle of rights, not a discrete piece of solid property),²⁹ the law has heavily regulated the sale of securities. The basic legal mandate is that anyone participating in the marketing of securities must reveal all relevant facts about them.³⁰

This regime of full disclosure is encapsulated in the SEC's renowned Rule 10b-5,³¹ promulgated under the authority of the Securities Exchange Act of 1934.³² Rule 10b-5 is a criminal provision prohibiting all deceitful practices and schemes to defraud in connection with the purchase and sale of securities.³³ For almost sixty years, courts have also implied a private right of action from that rule, allowing defrauded investors to use it to recover damages.³⁴ In addition, the practices of brokers and all who underwrite the sale of securities are highly regulated by the SEC and by the self-regulatory agencies of which they are members, most prominently the New York

27. Pat Huddleston II et al., *Fraud in the Boardroom: Protect Investors From Brokers*, 39 TRIAL 38 (Apr. 2003).

The brokerage business usually involves a personal relationship. "An investor who has his money with Merrill Lynch forms a bond with his broker, not the firm." Surowiecki, *supra* note 8, at 40.

Of late, brokerage firms have taken to a new form of advertising, purchasing the rights to name football stadiums, *e.g.*, Edward D. Jones Stadium, where the St. Louis Rams play, and Raymond James Stadium, home of the Tampa Bay Buccaneers.

28. Stephen J. Friedman, *A Comment on Judge Selya's Arbitration Unbound?: The Legacy of McMahon*, 62 BROOK. L. REV. 1495, 1496 (1996).

29. See HAZEN & RATNER, *supra* note 26, at 1, and accompanying text.

30. HAZEN & RATNER, *supra* note 26, at 2.

31. 17 C.F.R. § 240.10b-5 (2004).

32. 15 U.S.C. §§ 78a-78mm (2000). The enabling section of the Securities Exchange Act of 1934 is section 10(b). *Id.* § 78j(b).

33. For a good general discussion of the jurisprudence of Rule 10b-5, see THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 568-628 (4th ed. 2002).

34. The first such case was *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), and the Supreme Court upheld that right in *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971), and *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983).

Stock Exchange and the National Association of Securities Dealers ("NASD").³⁵

As Holmes famously observed, all our notions of civil and criminal liability are probably rooted in a primal desire to take revenge on those who have injured us.³⁶ In that vein, the reasons to allow investors to recover from those who have cheated them are obvious. In addition, one does not have to cite the Ten Commandments³⁷ or the categorical imperative³⁸ to prove that fraud is bad. Furthermore, it seems that law-and-economics types belabor the obvious when they assert that situations involving asymmetrical understandings of information distort markets.³⁹

IV. THE SUPREME COURT TURNS AWAY FROM INVESTOR PROTECTION

In roughly the two decades between the mid-1970s and the mid-1990s, however, the federal securities laws became progressively less friendly to the claims of investors.⁴⁰ This occurred through both new legislation and judicial interpretation of existing statutes.

First, in a string of opinions in the 1970s, the Supreme Court imposed new restrictions on private claims brought under Rule 10b-5. Those cases required that the plaintiff allege that an actual purchase or sale of securities had occurred,⁴¹ that the defendant acted with sci-

35. See generally, HAZEN, *supra* note 33, at 758–68 (providing an overview of SEC regulation, self-regulation, NASD, and the national exchanges).

36. OLIVER WENDELL HOLMES, *THE COMMON LAW* 39 (Mark DeWolfe Howe ed., Harvard Univ. Press 1963) (1881).

37. The eighth commandment states: "You shall not steal." *Exodus* 20:15 (New King James). Of course, many moral teachers have warned against the corrupting force of personal avarice. For an eloquent modern treatment, see Pope Paul VI, *Populorum Progressio: Encyclical on the Development of Peoples* (Mar. 26, 1967), available at http://www.vatican.va/holy_father/paul_vi/encyclicals/documents/hf_p-vi_enc_26031967_populorum_en.html.

38. "I should never act in such a way that I could not will that my maxim should be universal law." Immanuel Kant, *Introduction to the Metaphysics of Morals*, in *ETHICS* 194–95 (Oliver Johnson ed., 8th ed. 1999).

39. Cassidy, *supra* note 16 (citing the work of Nobel-award-winning economist Joseph E. Stiglitz for that proposition). Cassidy also discusses JOSEPH E. STIGLITZ, *THE ROARING NINETIES* (2003), a book on the boom and bust. Cassidy summarizes Stiglitz's writing about the evils that propelled the market's surge in the late 1990s with this statement: "Accounting standards were allowed to slacken, deregulation was mindlessly pursued, and corporate greed indulged." Cassidy, *supra* note 16, at 94.

40. For an excellent summary of these trends, see Marc I. Steinberg, *Securities Arbitration: Better for Investors Than the Courts?*, 62 *BROOK. L. REV.* 1503 (1996).

41. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

enter,⁴² and that deception had been involved by way of either a misrepresentation or a nondisclosure of material fact.⁴³

The first decision ruled out 10b-5 claims arising from a fraud that caused an investor to refrain from selling or buying a particular security.⁴⁴ The second meant that mere negligent misrepresentation was no longer actionable under that provision of the federal securities laws.⁴⁵ And the third decision, demanding actual deception, seemed to preclude claims not involving actual misstatement or concealment of material fact.⁴⁶

Later rulings from the High Court and lower federal appellate courts provided additional barriers to investor suits. For instance, a ruling from the Supreme Court shortened statutes of limitations in securities fraud cases.⁴⁷ A decision from the Second Circuit condoned egregious puffery by a broker—like, “this is a marvelous investment”—on the grounds that it was either not material or the investor’s reliance on such statements was unjustified.⁴⁸ And an opinion from the Seventh Circuit appeared to apply a very narrow version of the parol evidence rule to disregard blatantly false oral statements by a broker that were negated by boiler-plate disclosures in written documents supplied to the investor.⁴⁹

Those unhelpful rulings were capped off by two Supreme Court decisions in the mid-1990s that further slammed the courthouse door on meaningful investor claims. First, the Court gave an overly restrictive interpretation to an express cause of action that might have provided liability for fraud in the sale of securities upon a lesser showing of intent than the scienter requirement of Rule 10b-5.⁵⁰ Then, it interpreted Rule 10b-5 itself as precluding a remedy against those who are

42. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

43. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977).

44. *Blue Chip Stamps*, 421 U.S. at 755.

45. The *Hochfelder* Court left open the possibility that reckless behavior might be sufficient for civil liability under Rule 10b-5. *Hochfelder*, 425 U.S. at 194 n.11.

46. *Santa Fe Indus.*, 430 U.S. at 475-76. As to how this might affect certain claims against brokers for breach of fiduciary duty or under the “shingle theory,” see *infra* notes 111-14 and accompanying text.

47. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

48. *Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984). For a fine critique of this defense, see Jennifer O’Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697 (1998).

49. *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317, 1325 (7th Cir. 1988); see also *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983) (holding that warnings and statements contained in private placement memorandum would be imputed to the purchaser even though the purchaser had not read the memorandum).

50. *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). The provision interpreted in *Gustafson* is section 12(2) of the Securities Act of 1933. 15 U.S.C. § 77l(a)(2) (2000). In *Gustafson*, the Court held that provision only applicable to material misstatements or omissions in SEC-registered public offerings. 513 U.S. at 584.

secondarily responsible for a securities fraud, directly ruling out aiding and abetting liability⁵¹ and, according to most readings, respondent superior claims as well.⁵²

On top of all these judicial wounds, a newly Republican-controlled Congress also stepped in to give investors the federal *coup de grace* with the passage, over President Clinton's veto, of the Private Securities Litigation Reform Act ("PSLRA") in 1995.⁵³ The legislation contained a host of restrictions on claims under the federal securities laws, particularly a more stringent legislative reinforcement of the requirement in Federal Rule of Civil Procedure 9(b) that fraud be plead with particularity.⁵⁴

V. SOME PROMISE OF INVESTOR RELIEF IN THE ENRON LITIGATION

Those restrictive developments put up some stiff barriers for investors seeking relief for the egregious frauds perpetrated during the recent market bubble. Yet, preliminary results in one such suit arising out of the Enron scandal⁵⁵ evince a residuum of judicial sympathy for shareholder rights.

Investors there who had purchased Enron's publicly-traded securities for a period of time before the firm's collapse brought a class action against a host of defendants connected with the company.⁵⁶ Included were not only the bankrupt firm's former lead officers and directors, but also its lawyers and auditors. Particularly targeted were banks that had provided a myriad of financial services to Enron, such as underwriting its securities and making loans to many of the

51. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

52. See *id.* at 200 n.12 (Stevens, J., dissenting).

53. 15 U.S.C. § 78(a), amended by Pub. L. No. 104-67, 109 Stat. 737 (1995). The legislation amends the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000) ("Securities Act"), and the Securities Exchange Act of 1934, 15 U.S.C. § 78a-78mm (2000) ("Exchange Act").

54. FED. R. CIV. P. 9(b). The PSLRA added that provision to the Exchange Act as new section 21D(b). Pub. L. No. 104-67, 109 Stat. 737, 747 (1995) (codified as 15 U.S.C. § 78u-(4)(b)(1) (2000)). Among other restrictions, the PSLRA requires that discovery be stayed while any motion to dismiss is pending. 15 U.S.C. § 78u-(4)(b)(1) (2000). In effect, it thus forecloses a plaintiff from satisfying the "specificity" provision by ascertaining facts through discovery.

In 1998, Congress preempted class action suits for securities fraud in state courts by enacting the Securities Litigation Uniform Standards Act (SLUSA) Pub. L. No. 105-353, 112 Stat. 3227 (1998), thus making the restrictive provisions of the PSLRA applicable to all such suits.

55. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

56. *Id.* at 563.

so-called “special purpose entities” (“SPEs”) that had important, but undisclosed relationships with the company.

Counsel for lead plaintiffs, the renowned Bill Lerach, filed a complaint of nearly 500 pages⁵⁷ that characterized Enron’s operations as “an enormous Ponzi scheme, the largest in history.”⁵⁸ It alleged that the company purported to be generating income from arms-length transactions with SPEs that it in fact controlled.

The resulting phony revenue kept the company’s stock price artificially high. It was thus able to sustain its operations by constantly raising fresh cash through a number of public securities offerings. In addition to vastly enriching all the Enron insiders, those bogus dealings generated huge fees for the company’s bankers, lawyers, and outside accountants—all allegedly complicit in the ongoing fraud.⁵⁹

Lerach has publicly stated that the banks, lush with cash from the boom times, are his principal target, and he has set his sights on a multi-billion-dollar recovery.⁶⁰ Thus, the motions to dismiss filed by the secondary defendants constituted a crucial phase in the litigation. There, the secondary defendants raised a raft of arguments that their liability was precluded by the jurisprudence of securities litigation as it had developed over the last several decades. Chief among the arguments was that their status as secondary defendants made them, at most, “aiders and abettors” of the fraud and thus impervious to a Rule 10b-5 federal claim under the *Central Bank* decision.⁶¹

The lead plaintiff countered that argument with this assertion: “The key to the Enron mess is that the company was allowed to give misleading financial information to the world for years.”⁶² And that could only be done by the “active and knowing involvement”⁶³ of the company’s lawyers, accountants, and bankers. Further, as motivating evidence of their full participation in the fraud, the lead plaintiff cited the spectacular fees gained by those defendants, particularly by the

57. Jeffrey Toobin, *The Man Chasing Enron*, NEW YORKER, Sept. 9, 2002, at 86. Lerach, a partner in the firm of Lerach, Coughlin, Stoia, Geller, Rudman & Robbins, LLP, has issued his own report on the recent scandals, WILLIAM S. LERACH, PLUNDERING AMERICA: HOW AMERICAN INVESTORS GOT TAKEN FOR TRILLIONS BY CORPORATE INSIDERS (2002), available at http://www.lerachlaw.com/pdf/news/plundering_america.pdf.

58. *In re Enron*, 235 F. Supp. 2d at 613.

59. *Id.* at 614.

60. Toobin, *supra* note 57.

61. *In re Enron*, 235 F. Supp. 2d at 582. See generally *supra* note 51 and accompanying text (describing how the interpretation of 10b-5 in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), ruled out aiding and abetting liability).

62. *In re Enron*, 235 F. Supp. 2d at 637.

63. *Id.*

banks, from their "long gravy train of lucrative underwriting of Enron stock and bond offerings."⁶⁴

In response to those arguments, the district court, in a lengthy opinion, analyzed the allegations of wrongful conduct made in the complaint against each of the defendants. It found, for the most part, that the plaintiffs had met their pleading standards by alleging, with the requisite particularity,⁶⁵ that each defendant was potentially culpable for its primary involvement in the fraud. As to most of the banks, that was evidenced by the charges that they knew Enron was falsifying its publicly-reported financial results, yet they actively kept the scheme going by making loans to the company to keep it afloat and underwriting the sale of its securities to the public to bring in fresh cash.⁶⁶

Similarly, the court refused to dismiss both Enron's lawyers⁶⁷ and its auditors,⁶⁸ finding that, according to the allegations stated, they also could have knowingly participated in the fraud. Not only did the attorneys provide advice on the structuring of almost every bogus transaction, but they also publicly condoned them by giving their opinion that they were *bona fide* dealings.

As to the auditors, the firm of Arthur Andersen, which reaped approximately \$50 million in annual fees from Enron,⁶⁹ gave clean opinions to the company's financial statements, despite allegedly knowing that they contained numerous falsehoods. Most blatantly, Andersen condoned the nondisclosure of the various SPEs that Enron created to hide its debt, even though those obligations would become an immediate liability for Enron if the company's stock price fell below a certain level. Enron's audited financial statements contained no mention of those potential liabilities.⁷⁰

In a subsequent opinion, the court held that the partners of Andersen who had worked on the Enron account could not be held liable individually under Rule 10b-5.⁷¹ The facts of their personal participation and putative scienter had not been alleged with the heightened pleading standards required by the PSLRA.⁷² Yet, those individual partners would nonetheless be held in the case as defendants, because they could be responsible as control persons of Andersen under section

64. *Id.*

65. *See supra* note 54 and accompanying text.

66. *See In re Enron*, 235 F. Supp. 2d at 636-56.

67. *Id.* at 656-69.

68. *Id.* at 673-85.

69. *Id.* at 673.

70. *Id.* at 680-84.

71. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, Nos. MDL-1446, Civ.A. H-01-3624, 2003 WL 230688, at *1-7 (S.D. Tex. Jan. 28, 2003).

72. *See supra* note 54 and accompanying text.

20(a) of the Exchange Act.⁷³ Such liability required no actual showing of personal fraud that would necessitate particularized pleading under the PSLRA.⁷⁴

In like fashion, a later opinion also refused to dismiss Enron's outside directors, even though no specific facts of their knowing participation in the fraud had been alleged.⁷⁵ Like the individual Andersen partners,⁷⁶ they also could be held liable as control persons of Enron. In addition, they still could face liability under section 11 of the Securities Act⁷⁷ for the false statements contained in Enron's SEC registration statements under a mere negligence standard.⁷⁸

One month later, the court issued an additional ruling refusing to dismiss key members of Enron's day-to-day management team.⁷⁹ In addition to ample particularized pleading of their knowing involvements in the company's multiple fraudulent transactions,⁸⁰ they, like the outside directors, were also potentially liable as control persons of Enron.⁸¹ Further, substantial evidence existed that those individuals had made enormous profit from personal sales of Enron stock that could constitute insider trading.⁸²

73. 15 U.S.C. § 78t(a) (2000).

74. *In re Enron*, 2003 WL 230688, at *8–20.

75. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576 (S.D. Tex. 2003).

76. *See supra* notes 71–74 and accompanying text.

77. 15 U.S.C. § 77k (2000).

78. *In re Enron*, 258 F. Supp. 2d at 595–96. To escape such liability, defendants in a section 11 claim must prove affirmatively that they acted with the requisite “due diligence” to investigate the truth of the assertions made in the registration statement. 15 U.S.C. § 77k(b)(3) (2000).

79. *In re Enron Corp. Sec. Derivative & ERISA Litigation*, No. CIV.A.H-01-3624, 2003 WL 21418157, at *19 (S.D. Tex. Apr. 24, 2003).

80. *Id.* at *3.

81. *Id. passim*.

82. *Id.* at *7, *10, *15. The allegation here is that the insider defendants sold stock after becoming aware of adverse information about the company's scheme to defraud when such information was not available to the public. This violates Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (2000), and Rule 10b-5. 17 C.F.R. § 240.10b-5 (2004).

In response to disclosure of the Enron fraud, the federal government launched a massive white-collar criminal investigation. Although Enron's former treasurer has pled guilty, one noted commentator is skeptical that the government will be able to obtain criminal convictions of Enron's top management. Toobin, *supra* note 11. In addition, Andrew Fastow, Enron's Chief Financial Officer, has pled guilty to wire and securities fraud and agreed to cooperate with the government in its prosecutions of Enron's chairman Kenneth Lay and its Chief Operating Officer Jeffrey Skilling. *See* Press Release, U.S. Sec. & Exch. Comm'n, Press Release No. 2004-6, Andrew S. Fastow, Former Enron Chief Financial Officer, Pleads Guilty, Settles Civil Fraud Charges and Agrees To Cooperate with Ongoing Investigation, (Jan. 14, 2004), available at <http://www.sec.gov/news/press/2004-6.htm>.

VI. MIXED RESULTS IN MARKET FRAUD LITIGATION

In another series of federal court actions growing out of such corporate scandals, however, plaintiffs have not fared so well. Those suits targeted Merrill Lynch, one of the major securities firms that sponsored and allegedly profited from fraudulent research reports by its analysts, among them the notorious Henry Blodget.

In one action, nonclients of Merrill Lynch alleged that the firm's fraudulent reports about stocks they held caused them substantial losses when the prices of those securities collapsed with the "bursting of the Internet bubble."⁸³ In another, investors in mutual funds sponsored by Merrill Lynch sought damages for losses, which they claimed resulted from the firm's misleading and compromised research reports on stocks in the fund.⁸⁴

The district court began its opinion in the action by Merrill Lynch's nonclients by leaving no doubt that it regarded their claims with scant sympathy:

The record clearly reveals that plaintiffs were among the high-risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance.⁸⁵

The court went on to note that none of the investors claimed to have actually read the allegedly false reports.⁸⁶ Instead, they sought to establish their reliance on the misleading information by the fraud-on-the-market theory, which holds that most publicly-available information is reflected in a stock's market price.⁸⁷ Yet, the court found

For an interesting report on how prosecutors are focusing on one small transaction as the heart of their case against some of the top insiders, see Emshwiller, *supra* note 11.

83. *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003).

84. *In re Merrill Lynch & Co.*, 272 F. Supp. 2d 243 (S.D.N.Y. 2003).

85. *In re Merrill Lynch*, 273 F. Supp. 2d at 358. The remainder of the Court's opening remarks are even more scathing:

Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. Those few lucky winners, who are not before the Court, now hold the monies that the unlucky plaintiffs have lost—fair and square—and they will never return those monies to plaintiffs. Had plaintiffs themselves won the game instead of losing, they would have owed not a single penny of their winnings to those they left to hold the bag (or to defendants).

Id.

86. *Id.* at 359.

87. *Id.*

that the plaintiffs' complaint lacked many elements of a cognizable claim under Rule 10b-5.

Principal among those deficiencies was a failure to plead loss causation with specificity. Even though the alleged misrepresentations may have artificially inflated the price of the securities, there was no showing that they caused the stock's precipitous decline in value.⁸⁸ That happened when the Internet bubble burst, well before the fraudulent nature of Merrill Lynch's reports became known.⁸⁹

In addition, the court found that, since the research reports were statements of opinion, the plaintiffs had not met the standards of specificity in their pleading to establish that the defendants did not reasonably believe them to be true.⁹⁰ Also flowing from the reports' nature as opinions, the "bespeaks caution" doctrine protected them from liability if inaccurate, because they were accompanied by cautionary language.⁹¹

Even the fraud-on-the-market theory was at least partially inapplicable, the court said, because the market was fully aware of many of the conflicts tainting the recommendations that the defendant allegedly failed to disclose.⁹² The court also took a narrow view of the one-year statute of limitations, finding that the plaintiffs were on inquiry notice of the basic facts underlying their claim before that time and were therefore precluded from legal action now.⁹³

The investors in Merrill Lynch's mutual funds fared no better in their suit, where they too claimed damages based on the firm's false research reports and undisclosed conflicts of interest.⁹⁴ Once again, the district court found that the plaintiffs had not proven that their losses were caused by the alleged misrepresentations as required in Rule 10b-5 actions.⁹⁵

The court there likewise held that the plaintiffs had failed to state claims under certain provisions of the federal securities laws because, among other things, the defendants had no duty to disclose the alleg-

88. *Id.* at 361-64.

89. *Id.* at 358-59.

90. *Id.* at 368-75.

91. *Id.* at 375-77. See *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317 (7th Cir. 1988), for a judicial opinion on a similar issue where the Seventh Circuit found that cautionary language in the documents furnished to investors negated certain oral misrepresentations made in connection with the sale of securities. For a fine article on this topic, see Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind*, 58 U. PITT. L. REV. 619 (1997).

92. *In re Merrill Lynch*, 273 F. Supp. 2d at 375.

93. *Id.* at 378-82. See generally *supra* note 47 and accompanying text (stating that *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), shortened statutes of limitations in securities fraud cases).

94. *In re Merrill Lynch & Co.*, 272 F. Supp. 2d 243 (S.D.N.Y. 2003).

95. *Id.* at 260-61.

edly omitted information⁹⁶ and the complaint did not plead their scienter with the requisite specificity.⁹⁷ Similar actions based on allegedly false statements in other research reports⁹⁸ and in connection with other Merrill-sponsored funds⁹⁹ were also dismissed by the court for much the same reasons.

Investors found more promise of relief in a major consolidated action challenging the practices of a number of investment banks that drove up the price of initial public offerings that they underwrote.¹⁰⁰ At issue were the actions of those financial institutions in connection with over three hundred high-tech and Internet companies which they took public during the boom.

The plaintiffs alleged a widespread scheme to allocate the initial shares in those "hot issues" that required the purchasers to resell the stock in the aftermarket to artificially push up their prices.¹⁰¹ The plan also obliged those sellers to kick back part of their profit to the allocating underwriters. To cover up the scheme, the defendants allegedly made misleading statements in their offering documents.

The district court sustained a majority of the plaintiffs' claims, finding that the "scheme offends the very purpose of the securities laws."¹⁰² Since the fraud occurred in connection with false and misleading statements made in SEC registration statements, claims under section 11 of the Securities Act were proper, as were actions under section 15 against those who controlled violators of that provision.¹⁰³

In similar fashion, the court also upheld claims under section 10(b) for both material misstatements and market manipulation. As to most of the defendants, the plaintiffs met their burden of pleading with particularity, both as to the underlying fraudulent statements and practices and the requisite scienter. Plaintiffs were also able to show to the court's satisfaction that they suffered significant financial loss based on the inflated prices they paid for the securities as opposed to their true value.¹⁰⁴

96. *Id.* at 248-52.

97. *Id.* at 262.

98. *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 416 (S.D.N.Y. 2003).

99. *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 429 (S.D.N.Y. 2003).

100. *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003).

101. *Id.* at 293-95.

102. *Id.* at 295.

103. *Id.* at 296.

104. *Id.* at 296-98. In a news commentary after the ruling, one prominent Wall Street analyst ventured the opinion that the 50 financial firms named in the case might be willing to settle the matter for \$3 billion in total damages. Steve Maich, *Wall Street Readies to Pay Up—Again: IPO Class Actions: Brokerages May Pay \$3-Billion to Settle Suits Quickly*, NAT'L POST, Feb. 21, 2003.

VII. CUSTOMER CLAIMS AGAINST BROKERS

In light of the uncertainty of shareholder recovery in the class action suits discussed *supra*, a more promising alternative for individual investors may be a direct claim against the broker who sold them the securities. Brokers, of course, are agents for their customers (the principals) and therefore have the legal duties incumbent in such relationships.¹⁰⁵ But many courts have gone beyond agency law to find that a fiduciary relationship exists in this context¹⁰⁶—particularly when an unsophisticated client places his trust in a broker expecting that she has superior knowledge and skill about investments.¹⁰⁷

Such a duty is reinforced when a broker is in control of the client's account.¹⁰⁸ This can exist either explicitly, as when the customer has given the broker discretionary trading authority,¹⁰⁹ or, more often, by a state of affairs giving the broker effective control as when she knows that the customer is inexperienced and will be relying on her recommendations.¹¹⁰

These considerations are augmented by a parallel supposition that takes into account the professional nature of the securities business. It recognizes that brokers hold themselves out as implicitly representing that they will deal fairly with their customers.¹¹¹ For instance, customers have a right to expect that brokers will have a reasonable basis for the stock purchases they recommend.¹¹² The SEC has dubbed this the "shingle theory."¹¹³ Using its authority under the

-
105. Those duties include "loyalty and good faith, obedience to instructions, and the use of reasonable skill, care, and diligence." Carol R. Goforth, *Stockbrokers' Duties to Their Customers*, 33 ST. LOUIS U. L.J. 407, 410 (1989) (footnotes omitted); see also Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 75 (1997) (discussing the duties of brokers).
106. Goforth, *supra* note 105, at 417-31; Weiss, *supra* note 105. On the fiduciary obligations of brokers generally, see HAZEN, *supra* note 33, at 828-31.
107. Goforth, *supra* note 105, at 422-29; see also Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1249-50 (1983) (discussing the duties and responsibilities of fiduciaries in general).
108. Goforth, *supra* note 105, at 427-29; Mark C. Jensen, *Abuse of Discretion Claims Under Rule 10b-5: Churning, Unsuitability and Unauthorized Transactions*, 18 SEC. REG. L.J. 374, 377-80 (1991).
109. Goforth, *supra* note 105, at 422-25.
110. *Id.* at 425-27.
111. Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1006 (2002); Weiss, *supra* note 105, at 88.
112. Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1276 (1995).
113. The term was originally coined by Professor Louis Loss: "The theory is that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public." Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 518 (1948).

anti-fraud provisions of the Exchange Act, the Commission has applied the shingle theory to discipline securities professionals for a host of abusive activities toward their clients.¹¹⁴

Almost all customer actions charge that brokers have breached their legal duties to customers. In addition, they usually involve one or more of the following four substantive claims, which can be conveniently, albeit a bit prejudicially, summarized under the acronym SCUM.¹¹⁵ They are: (1) suitability, (2) churning, (3) unauthorized trading, and (4) misrepresentation.

Suitability claims typically charge that a broker has recommended that a client invest in securities that are inappropriate for her financial situation—usually because the securities were too risky, given the client's age and resources.¹¹⁶ Relevant here are NYSE¹¹⁷ and NASD¹¹⁸ rules that require, respectively, that brokers know their customers and have reasonable grounds to believe that their recommendations are appropriate for their customers' needs.

But how far does this responsibility go? Some decisions appear to hold brokers to the highest duty, making them liable for the losses caused by customers' unsuitable investments even when the clients had voluntarily chosen to disregard the brokers' advice that the securities were inappropriate for them.¹¹⁹ This has been called the "dram

114. See generally HAZEN, *supra* note 33, at 831–33 (giving a general overview of the "shingle theory" and its uses); Karmel, *supra* note 112, at 1278–92 (analyzing numerous cases in which courts applied the "shingle theory" in finding liability for securities violations).

115. Black & Gross, *supra* note 111, at 1008–09.

116. See generally HAZEN, *supra* note 33, at 833–39 (discussing a broker's obligation to customers with regard to the suitability of recommendations); Jensen, *supra* note 108, at 380–86 (describing the origin, development, and application of the unsuitability claim); Janet E. Kerr, *Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy*, 16 PAC. L.J. 805 (1985) (reviewing suitability rules governing brokers based on traditional legal guidelines as well as current economic thought).

For more specialized approaches to this problem taking into account the sophisticated nature of certain investors, see Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU L. REV. 1493 (2001), and Stuart D. Root, *Suitability—The Sophisticated Investor—And Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287 (1991).

117. N.Y. STOCK EXCHANGE R. 405 (1970) (providing that members must "[u]se due diligence to learn the essential facts relative to every customer"), *reprinted in* 2 N.Y.S.E. Guide (CCH) ¶ 2405 (Sept. 2004).

118. NAT'L ASS'N SEC. DEALERS CONDUCT RULES § 2310 (1996) (providing that in recommending a security transaction to a customer, "a member shall have reasonable grounds for believing that the recommendation is suitable for such customer"), *reprinted in* [1996] NASD Manual (CCH) 4261 (Dec. 2003). As to when a Rule 10b-5 private right of action may arise under these provision, see HAZEN, *supra* note 33, at 835–36.

119. Lewis D. Lowenfels & Alan R. Bromberg, *Beyond Precedent: Arbitral Extensions of Securities Law*, 57 BUS. LAW. 999, 1011–13 (2002). Such an approach could be

shop" approach, analogizing to the old common law rule that made tavern owners liable for all resulting damages if they continued to serve obviously inebriated patrons.¹²⁰

The SEC recently came close to approving that understanding when it held the following in a disciplinary proceeding:

Even if we were to accept [the broker's] view that these clients wanted to speculate and were aware of the risks . . . the Commission has held on many occasions that the test is not whether [the customers] considered the transactions in their account suitable, but whether [the broker] "fulfilled the obligation he assumed when he undertook to counsel [them], of making only such recommendations as would be consistent with [their] financial situation and needs."¹²¹

Churning is the second typical complaint made by customers against their brokers. It is evidenced by a pattern of large or frequent trading in accounts over which brokers have actual or *de facto* discretionary power.¹²² Such trades typically make little profit for the customer but garner substantial commissions for the broker and his house.¹²³ This allegation is closely tied to a claim that the broker has breached his fiduciary duty, because in both he must be said to control the account.¹²⁴

Unauthorized trading claims frequently arise out of the same facts that give rise to a charge of churning.¹²⁵ Such activity, of course, directly violates a broker's duty as an agent to execute only those transactions authorized by his principal, the client.¹²⁶

Misrepresentation is the fourth typical claim brought against brokers. Outright misstatements and omissions of material facts are di-

considered paternalistic. See Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983).

120. Lowenfels & Bromberg, *supra* note 119, at 1001, 1011.

121. *In re Application of Rangen*, 52 S.E.C. 1304, 1308 (1977) (quoting *In re Phillips & Co.*, 37 S.E.C. 66, 70 (1956)).

122. Jensen, *supra* note 108, at 377-80.

123. In the words of one court, evidence of excessive trading showed at best "a reckless disregard for the client's investment concerns, and, at worst, an outright scheme to defraud the plaintiff." *Mihara v. Dean Witter Co.*, 619 F.2d 814, 821 (9th Cir. 1980).

124. Even when the customer exercises formal control over the account, churning is actionable upon a showing of *de facto* control by the broker "if [the] customer is unable to evaluate [the broker's] recommendations and to exercise an independent judgment." *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 676-77 (9th Cir. 1983).

125. Jensen, *supra* note 108, at 376.

126. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976). An agent is liable for misuse of his principal's money or property including conduct which deviates substantially from the agent's authority in a sale or purchase. RESTATEMENT (SECOND) OF AGENCY § 402(g) (1958).

Failure to disclose such trading also constitutes fraud under section 10(b) of the Exchange Act and Rule 10b-5 implemented under the same Act. *Nye v. Blyth Eastman Dillon & Co.*, 588 F.2d 1189, 1192 (8th Cir. 1978).

rectly actionable under federal securities law if there is a showing of scienter.¹²⁷ That state of mind may be established by either intentionally or recklessly fraudulent activity by the broker.¹²⁸

The Supreme Court of California has gone a step further, however, and recently upheld its common law rule that an action may be maintained for negligent misrepresentation in the sale of corporate stock.¹²⁹ Such a claim does not require a showing of scienter, but only an "assertion as a fact, of that which is not true, by one who has no reasonable grounds for believing it to be true."¹³⁰

VIII. ARBITRATION AS A MORE PROMISING FORUM

In the middle of delivering plenty of bad news to securities plaintiffs over the last several decades,¹³¹ the Supreme Court seemed to further exacerbate investor woes by relegating all claims against brokers to an arbitration system run by the securities industry. In a line of cases from the 1980s, the foremost of which was *Shearson/American Express, Incorporated v. MacMahon*,¹³² the High Court held that the mandatory arbitration provisions contained in virtually all agreements between brokerage houses and their customers are enforceable.

That was an about-face by the Court from a previous decision in the early 1950s, *Wilko v. Swan*,¹³³ where it had ruled that such contractual clauses were void as contrary to certain provisions in the securities acts. Those sections nullified any stipulations "to waive

127. Black & Gross, *supra* note 111, at 1007. *But see supra* notes 48–49 and accompanying text.

128. *See supra* note 42 and accompanying text.

129. *Small v. Fritz Cos.*, 65 P.3d 1255, 1257 (Cal. 2003).

130. *Id.* at 1258. For a parallel definition of the common law tort of negligent misrepresentation, see RESTATEMENT (SECOND) OF TORTS § 552 (1965). For additional state securities provisions that are more investor-oriented than federal law, see *infra* notes 162–67 and accompanying text.

131. *See supra* notes 40–52 and accompanying text.

132. 482 U.S. 220 (1987). A harbinger of the *MacMahon* ruling was *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985), where the Court ruled that when federal securities claims and state claims are brought in one suit, a contract to arbitrate the state claims will be enforced.

The question whether customers actually consent to arbitration when entering into these agreements with their brokers has become a nonissue. *See* Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOK. L. REV. 1335 (1996); Jeffrey W. Stempel, *Bootstrapping and Slouching Toward Gomorrah: Arbitral Infatuation and the Decline of Consent*, 62 BROOK. L. REV. 1381 (1996).

133. 346 U.S. 427 (1953). Since *Wilko* technically dealt with a claim brought under the Securities Act of 1933, it was distinguishable from the *MacMahon* action which was a 10b-5 claim under the Securities Exchange Act of 1934. Two years after *MacMahon* however, the Court directly overruled *Wilko* by holding that claims under the Securities Act were also subject to arbitration in *Rodriguez de Quijas v. Shearson American Express*, 490 U.S. 477 (1989).

compliance with any provision"¹³⁴ of those statutes. The *Wilko* Court buttressed its ruling by citing the avowed policy of the securities acts to protect investors from the disadvantageous nature of their relationship with the securities industry.¹³⁵

Such an outlook, according to *Wilko*, contemplated that disgruntled investors should have a wide choice of fora where they could seek relief apart from compulsory arbitration that could lessen the effectiveness of their potential remedies.¹³⁶ Among other things, such a nonjudicial venue might put investors at the mercy of the subjective opinions of arbitrators by not affording them any written record of their proceedings and leaving them with a sharply limited right to appeal adverse decisions.¹³⁷

But the *MacMahon* Court held that the no-waiver provisions were only applicable to the substantive rights afforded securities purchasers under the Acts.¹³⁸ Its broader interpretation of such provisions in *Wilko* as also covering procedural rights had to be understood in light of the then-prevalent mistrust of arbitration.¹³⁹ For years, the SEC believed that arbitration would not adequately protect investor rights, the Court noted. However, the Commission had recently adopted a more favorable view of that process, premised in part on the expanded power that Congress had given it to oversee arbitration.¹⁴⁰

Likewise, the Court itself found in *MacMahon* that "the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights."¹⁴¹ It concluded its opinion by finding that concerns over the limited nature of appellate review were unwarranted, because "there is no reason to assume at the outset that arbitrators will not follow the law."¹⁴²

Justice Harry Blackmun, who had frequently dissented from the Court's earlier rulings that narrowed investor rights,¹⁴³ also spoke for the four justices in *MacMahon* who opposed the majority's ruling.¹⁴⁴ As Professor James Fanto, one of Justice Blackmun's former law clerks, has noted, Blackmun's opinion expressed a "populist skepti-

134. 15 U.S.C. § 77n (2000); *id.* § 78cc(a).

135. *Wilko*, 346 U.S. at 430-31.

136. *Id.* at 431.

137. *Id.* at 435-37.

138. *Shearson/Am. Express, Inc. v. MacMahon*, 482 U.S. 220, 227-28 (1987).

139. *Id.* at 221.

140. *Id.* at 233.

141. *Id.* at 232.

142. *Id.*

143. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 215 (1976) (Blackmun, J., dissenting).

144. 482 U.S. at 242 (Blackmun, J., dissenting).

cism of the securities industry”¹⁴⁵—as appropriate then as ever, the Justice believed, in the late 1980s era of abusive merger mania. Justice Blackmun also remained unconvinced that the streamlined procedures of arbitration would give plaintiffs a fair shake, and he expressed his belief that the industry-run process was “slanted” against investors.¹⁴⁶

Perhaps telling tales out of school, Professor Fanto wrote how Justice Blackmun would discuss the opinions of his judicial colleagues with his clerks.¹⁴⁷ Apparently drawing on insights garnered there, Fanto analyzed the majority opinion in *MacMahon* as the product of an “activist conservative majority” that had solidified with the appointment of Justice Scalia just before the case was argued.¹⁴⁸

The SEC’s own flip-flop to now support compulsory arbitration, which the Court found persuasive, was itself a product of political forces, added Fanto. It came at a time when the Commission was actively pursuing a policy of deregulation to counter charges that its stringent rules were hindering capital formation.¹⁴⁹

But contrary to Justice Blackmun’s dire intuition, the law of unintended consequences appears to have gone into operation here to save investors. Five years after *MacMahon*, a study by the United States General Accounting Office (“GAO”) found that investors were not being disadvantaged by the process of compulsory arbitration.¹⁵⁰ And most studies since that time have only reinforced that view.¹⁵¹ Arbi-

145. James A. Fanto, *Justice Blackmun and Securities Arbitration: McMahon Revisited*, 71 N.D. L. REV. 145, 158 (1995) (construing *McMahon*, 482 U.S. at 242–68 (Blackmun, J., dissenting)).

146. *Id.* at 159 (construing *McMahon*, 482 U.S. at 260 (Blackmun, J., dissenting)).

147. *Id.* at 157.

148. *Id.* at 159.

149. *Id.*

150. U.S. GENERAL ACCOUNTING OFFICE, GAO/GGD-92-74, HOW INVESTORS FARE 6 (May 1992).

151. *The Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc.* was the most prominent of these studies. [1995–1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,735 (Jan. 1996) [hereinafter *The Ruder Report*] (authored by a committee chaired by former SEC Chairman David Ruder). Although *The Ruder Report* recommended a number of changes to the arbitration process, including better training for arbitrators, it found that “securities arbitration continue[s] to provide clear and significant advantages over the civil litigation system it has replaced.” *Id.* ¶ 87,433. See also Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?* 31 WAKE FOREST L. REV. 183, 202 (1996) (“The arbitration process is geared towards a fast, inexpensive, and fair means of resolving . . . disputes. . . . [N]o study has shown any bias in results obtained through SRO arbitrations.”); Steinberg, *supra* note 40, at 1505 (“[M]ounting evidence shows that many investors emerge victorious from arbitration, even recovering punitive damages in appropriate cases.”).

tration has turned out to be a forum quite favorable for investors,¹⁵² and the reason for that surprising outcome is largely owing to the nature of that method itself.

Seeking to allay fears that this industry-run course of action would be unfair to petitioners, the *MacMahon* Court stated that it had no reason to believe that arbitration panels would not follow the law.¹⁵³ However, that bow to the "rule of law" was really no help to investors, since the trend in securities law had been moving against them. As discussed *supra*,¹⁵⁴ federal appellate decisions and legislative enactments had been steadily unfavorable to plaintiffs since at least the mid-1970s.

For instance, the scienter element now required by federal courts in 10b-5 claims precludes actions there based on mere negligence,¹⁵⁵ and the strict pleading standards codified by Congress make it difficult for plaintiffs to state a sustainable cause of action for securities fraud.¹⁵⁶ Most troubling for disgruntled investors bringing SCUM claims against brokers is the fact that respondeat superior liability seems to be ruled out against deep-pocket respondents like the houses that employed the brokers as their sales force.¹⁵⁷

The distinct advantage of arbitration over litigation, however, is its equitable nature. The Arbitrator's Manual published by the Securities Industry Conference on Arbitration ("SICA"), which all arbitrators receive, begins with this quote from that great philosopher of justice Aristotle:

Equity is justice in that it goes beyond the written law. . . . [I]t is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view,

152. Approximately sixty percent of the shareholder claims filed in arbitration in the 1990s were settled by brokerage houses. Paul Joseph Foley, *The National Association of Securities Dealers' Arbitration of Investor Claims Against its Brokers: Taming the Fox that Guards the Henhouse*, 7 N.C. BANKING INST. 239, 253 (2003). But as Foley has noted, "With the number of claims rising and bottom lines shrinking due to the bear market, brokers and their firms are defending themselves against investors' claims more vigorously than ever. In 2002, the percentage of claims settled fell to 37% as compared to 44% in 2001." *Id.* Foley also noted that when claims proceed to full adjudication before NASD arbitration panels, investors were awarded compensation "between 53% and 61% of the time in each of the past five years." *Id.*

153. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 232 (1987).

154. *See supra* Part IV.

155. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *supra* notes 42 & 45 and accompanying text.

156. *See supra* notes 53-54 and accompanying text.

157. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 200 n.12 (1994) (Stevens, J., dissenting); *supra* notes 51-52 and accompanying text.

whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.¹⁵⁸

Following that *dictum*, a seasoned Wall Street practitioner gave this current description of the jurisprudence of arbitration: “It’s rough justice. . . . If they want to give an award to someone they feel was victimized, they’ll find a way,’ even if prior cases don’t clearly support their decision.”¹⁵⁹

In addition, state securities and common law claims that would be precluded by current federal law are viable in arbitration. For instance, liability by negligent misrepresentation apart from any showing of scienter¹⁶⁰ and recovery under a common law respondeat superior theory are perfectly valid there, despite federal caselaw that might not permit them.¹⁶¹

Furthermore, most state securities codes ease the burden of pleading and proof that federal plaintiffs must establish to recover in such cases. Most importantly, the federal element of loss causation¹⁶² is substantially lessened under most state law. For instance, section 509(b) of the Uniform Securities Act¹⁶³ parallels section 12(a)(2) of the Securities Act of 1933, but unlike the federal law,¹⁶⁴ it provides for civil liability for all kinds of fraudulent statements, not just those contained in a registered public offering.¹⁶⁵ Moreover, unlike the current

158. SEC. INDUS. CONFERENCE ON ARBITRATION, *THE ARBITRATOR’S MANUAL 2* (2004) (quoting Domke on Aristotle), available at http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_009668.pdf.

Aristotle’s notion was that equity had to exist to remedy situations where the law produced an unjust result. ARISTOTLE, *THE NICOMACHEAN ETHICS* 315–17 (T.E. Page et al. eds., H. Rackham trans., new & rev. ed. 1934); see also Roger A. Shiner, *Aristotle’s Theory of Equity*, 27 *LOY. L.A. L. REV.* 1245 (1994).

As a great American writer summed up the inadequacies of our legal system, “The law isn’t justice. It’s a very imperfect mechanism. If you press exactly the right buttons and are also lucky, justice may show up in the answer. A mechanism is all the law was ever intended to be.” RAYMOND CHANDLER, *THE LONG GOODBYE* 48 (Pocket Books 1955) (1954).

159. Brooke A. Masters, *Investors v. Brokers: Meting Out Quick Justice in Murky World of Arbitration*, *WASH. POST*, July 15, 2003, at E1 (quoting Gregory J. Wallace of the law firm Kaye Scholer LLP).

160. See *Small v. Fritz*, 65 P.3d 1255, 1258 (Cal. 2003); *supra* notes 129–30 and accompanying text.

161. See *Cent. Bank*, 511 U.S. at 200 n.12 (Stevens, J., dissenting); *supra* notes 40 & 51–52 and accompanying text.

162. See, e.g., *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 358–62 (S.D.N.Y. 2003); *supra* notes 88–89 and accompanying text.

163. UNIF. SEC. ACT 2002 § 509(b), 7C U.L.A. 77 (Supp. 2004).

164. See *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995); *supra* note 50 and accompanying text.

165. See UNIF. SEC. ACT 2002 § 509(b) cmt. 3, 7C U.L.A. 77, 79 (Supp. 2004).

requirements of federal 10b-5 actions,¹⁶⁶ numerous cases under the precursor to section 509(b) hold that neither reliance nor causation is an element of that action.¹⁶⁷

This wide discretion afforded arbitrators is buttressed by the limited review to which their rulings are subject. Panels are not even required to write opinions justifying their decisions,¹⁶⁸ making it even harder for the losing party to show that they have acted with manifest disregard of the law, the only real substantive basis for appeal.¹⁶⁹

Also arguing in petitioners' favor is the expedited and relatively inexpensive nature of this form of dispute resolution.¹⁷⁰ As opposed to full-blown litigation, where the "search for exquisite procedural fairness . . . has produced a judicial process so cumbersome that ordinary people want to avoid using it,"¹⁷¹ there is not much motion practice in securities arbitration,¹⁷² and discovery is limited. Arbitration rules mandate an exchange of prescribed documents,¹⁷³ but depositions are rare.¹⁷⁴

In addition, arbitrators are disposed to hear out the stories of the parties in person in a relatively informal setting, where the strict rules of evidence do not apply.¹⁷⁵ As a former SEC Commissioner has approvingly stated, the system is designed to deal with "the very

-
166. See, e.g., *In re Merrill Lynch*, 273 F. Supp. 2d at 361–64 (discussing the requirement of pleading loss causation with specificity in Rule 10b-5 actions); *supra* notes 88–91 and accompanying text.
167. *Rich v. Robinson-Humphrey Co.*, 748 So. 2d 861 (Ala. 1999); *Kaufman v. I-Stat Corp.* 754 A.2d 1188 (N.J. 2000); *Gerhard W. Gohler, IRA v. Wood*, 919 P.2d 561 (Utah 1996).
168. *Masters, supra* note 159. Along those lines, the arbitrators are only required to state in their award "a summary of the issues including the type(s) of any security or product in controversy." SEC. INDUS. CONFERENCE ON ARBITRATION, ARBITRATION PROCEDURES 23–24 (2001), available at http://www.nasdaq.com/pdf-text/arb_procedures.pdf. In fact, a large majority of arbitration awards do not contain any legal opinion justifying the decision. *Black & Gross, supra* note 111, at 1030.
169. *Black & Gross, supra* note 111, at 1030–35. Other grounds include bias or malfeasance. See *Masters, supra* note 159.
170. *The Ruder Report, supra* note 151, ¶ 87,431; see also David S. Ruder, *Elements of a Fair and Efficient Securities Arbitration System*, 40 ARIZ. L. REV. 1101, 1101 (1998) (stating that "generally, the parties to arbitration seek a fair, relatively speedy, and relatively inexpensive means of resolving disputes").
171. *Friedman, supra* note 28, at 1500.
172. See generally *MARILYN BLUMBERG CANE & PATRICIA A. SHUB, SECURITIES ARBITRATION: LAW AND PROCEDURE* 58–61 (1991) (discussing motions allowed during arbitration and the procedure for filing motions at arbitration).
173. See generally SEC. INDUS. CONFERENCE ON ARBITRATION, *supra* note 168, at 17–21 (discussing preparation for arbitration hearings and the procedure for exchanging documents prior to hearings).
174. *CANE & SHUB, supra* note 172, at 63.
175. *Id.* at 64.

human kind of problems" arising from "the special relationship between retail securities firms and their customers."¹⁷⁶

Furthermore, since the securities industry subsidizes the cost of arbitration proceedings and other savings arise from the limited pre-trial practice and rights to appeal,¹⁷⁷ this forum is more hospitable than litigation to the small financial disputes that are often likely to crop up in the securities context.¹⁷⁸ Arbitration thus offers investors not only a relatively speedy forum to resolve their claims and recover their losses,¹⁷⁹ but it also holds out the possibility of a therapeutic remedy¹⁸⁰ by giving them a meaningful "day in court" to seek vindication for what may be a highly personalized breach of their trust.¹⁸¹

The results of these adjudications are most likely to turn on the particular dynamics that have been established between the individual customers and their brokers. The number of trades and the quality of investments can easily be shown by indisputable records and rating systems. Where these cases get interesting and can present some real drama is in determining the nature of the customers' consents to the trades or their after-the-fact ratification of the transactions.¹⁸²

As noted *supra*, brokers are typically compensated by commission, and, therefore, their financial interest, at least in the short run, is on

176. Friedman, *supra* note 28, at 1496.

177. See J. KIRKLAND GRANT, *SECURITIES ARBITRATION FOR BROKERS, ATTORNEYS, AND INVESTORS* 96-98 (1994).

178. The arbitration process run by the Securities Industry also offers a Simplified Arbitration Procedure for small claims. See SEC. INDUS. CONFERENCE ON ARBITRATION, *supra* note 168, at 8; see also Ruder, *Elements of a Fair and Efficient Securities Arbitration System*, *supra* note 170, at 1105 (describing the three-tier securities arbitration system for relatively small claims used by the NASD and the subsequent recommendation for the adoption of this system by the Arbitration Policy Taskforce of the NASD).

179. See *supra* note 170 and accompanying text.

180. See generally JUDGING IN A THERAPEUTIC KEY: THERAPEUTIC JURISPRUDENCE AND THE COURTS (Bruce J. Winick & David B. Wexler eds., 2003) (providing a broad discussion on the therapeutic merits of litigating a claim); Amy D. Ronner, *Songs of Validation, Voice, and Voluntary Participation: Therapeutic Jurisprudence, Miranda and Juveniles*, 71 U. CIN. L. REV. 89 (2002) (providing a discussion of the merits of therapeutic jurisprudence and specifically how this sort of jurisprudence can positively impact the juvenile justice system).

181. Friedman, *supra* note 28, at 1496.

182. For an example of a case testing the limits of an investor's consent to a brokerage firm's investment decisions, see *Thompson v. Smith Barney*, 709 F.2d 1413 (1983). See also Langevoort, *supra* note 107, at 1281 (noting that even though the broker has complete discretion to make a trade, he continues to be accountable to the client for any fraudulent conduct such as churning). For a good general discussion about other defenses that may be raised here such as laches, estoppel, and waiver, see Thomas E. Geyer et al., *Civil Liability and Remedies in Ohio Securities Transactions*, 70 U. CIN. L. REV. 939, 993-96 (2002).

“making the sale.”¹⁸³ Federal securities laws have, from their earliest days, recognized that reality. In his message accompanying the proposed legislation that would become the Securities Act of 1933, President Franklin Roosevelt urged Congress to recognize that “every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information.”¹⁸⁴ Because of the intricate nature of those financial instruments,¹⁸⁵ federal law therefore reverses the traditional presumption of *caveat emptor* and makes sellers disclose to any potential purchasers all material facts about the investments they offer.¹⁸⁶

In SCUM claims, the volitional nature of the customers’ decisions is often the ultimate issue.¹⁸⁷ The age, education, and business experience of the particular investor are all relevant.¹⁸⁸ However, a customer may have been seeking a higher return than would have been prudent, given the concomitant risk.¹⁸⁹ Deeply philosophical questions may then arise about just what constitutes a freely chosen course of conduct and how much individuals should be held accountable for their own initial decisions or for their failure to promptly object to improper treatment.¹⁹⁰

Further complicating that question are the many documents, such as prospectuses, research reports, confirmations, and monthly statements, that customers typically get from brokers.¹⁹¹ Such documents require careful reading if they are to be fully understood, and, even

183. Friedman, *supra* note 28, at 1496; *see supra* text accompanying note 28.

184. Franklin D. Roosevelt, Message from the President of the United States (Mar. 29, 1933), in 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 item 15, at 1 (compiled by J.S. Ellenberger & Ellen P. Mahar, 1973). Despite its current soul searching, “the S.E.C. remains one of Franklin D. Roosevelt’s and his New Deal’s most signal and durable achievements.” Janeway, *supra* note 18, at 10.

185. *See HAZEN & RATNER, supra* note 26, at 1.

186. *See id.* at 1–2.

187. Many times this comes back to the issue of whether the broker has “control” over the account. *See supra* notes 108–10 and accompanying text.

188. *See Leckey, supra* note 2. Thus the investment sophistication of the claimant is often at issue in these disputes. *See* Howard L. Nations, *Fraud in the Boardroom: Remedies for Defrauded Investors*, 39 TRIAL 44, 45 (Apr. 2003).

189. As one securities litigator put it: “Cases turn on whose idea it was at the time to make the investments. We find investors were happy when the stock market was high, but then they develop amnesia.” Edward Mason, *Brokers Face Rash of Angry Investors*, BOSTON BUS. J., June 6, 2003 (quoting Gerald Rath, Bingham McCutchen LLP, Boston, Mass.), available at <http://www.bizjournals.com/boston/stories/2003/06/09/story2.html?page=1>.

190. *See supra* notes 119–21 and accompanying text.

191. *See Black & Gross, supra* note 111, at 1038.

then, despite the SEC's recent plain-English crusade,¹⁹² their jargon may be incomprehensible to the lay investor.¹⁹³

In addition, clients who have trusting relationships with their brokers, or are preoccupied with other matters, are not likely to give full consideration to the information supplied by brokers.¹⁹⁴ Only when the investments have declined in value will such customers or their lawyers carefully examine the relevant documents.

Against that background, the judgment of the arbitrators takes on paramount importance. Many who serve on these panels are retired lawyers or other business professionals.¹⁹⁵ They are thus typically much better informed about the securities industry and its relevant law than an ordinary jury, and they often take an active role in the proceedings, asking questions of both sides during the hearing.¹⁹⁶

Many arbitrators say they try to bring common sense and community standards, as they understand them, to the disputes before them.¹⁹⁷ One member of each three-person panel must be from the securities industry.¹⁹⁸ Even then, however, any professional empathy such a panelist might have with the respondents may be counterbalanced by a desire to rout out the "bad apples"¹⁹⁹ in their business to maintain public confidence in the system.

The global settlement reached against analysts and their firms in 2003 should also aid petitioners in their claims, because it lays out many of the deceitful recommendations actually made by the brokerage firms.²⁰⁰ Documentation of those findings is available to the public. In the SEC consent decree, the firms agree to sanctions without admitting violations, so no formal issue preclusion will apply. Yet, if an investor can show that she bought a particular stock from a broker-

192. 17 C.F.R. § 230.421 (2004) (requiring presentation of information in prospectuses to be in plain English).

193. See, e.g., *Davis v. Merrill Lynch, Pierce, Fenner & Smith*, 906 F.2d 1205, 1213 (9th Cir. 1990) (refusing to relieve a broker of liability because the customer lacked the skill to interpret various documents associated with their investments); *Mihara v. Dean Witter Co.*, 619 F.2d 814, 822 (9th Cir. 1980) (quoting *Hecht v. Harris Upham*, 430 F.2d 1202, 1212 (1970)) ("[W]hile confirmation slips were sufficient to inform plaintiff of the specific transactions made, they were 'not sufficient to put her on notice that the trading of her account was excessive.'").

194. As pointed out earlier, brokerage firms encourage such a trust relationship. See *supra* notes 26–27 and accompanying text. In *Mihara*, the brokerage firm put this statement in the manual it distributed to its account executives: "Our client has a right to believe and trust you." 619 F.2d at 822.

195. *Masters*, *supra* note 159, at E1.

196. *Id.*

197. *Id.*

198. See SEC. INDUS. CONFERENCE ON ARBITRATION, *supra* note 168, at 6.

199. *Friedman*, *supra* note 28, at 1497.

200. See *Mason*, *supra* note 189; *supra* notes 18–21 and accompanying text.

age house that induced her purchase by means of such a fraudulent research report, liability can be almost a certainty.²⁰¹

Additionally, even if a securities firm was not directly involved in the initial distribution of such a stock, a showing of any reliance by a broker on such tainted reports can at least raise an inference of negligent misrepresentation.²⁰² The lack of extensive discovery in these proceedings may handicap petitioners from adducing evidence that a particular brokerage firm participated in a scheme to defraud its customers or was at least negligent in protecting their interests.²⁰³ Each case, of course, will turn on its individual facts concerning such issues as well as the particular customer's sophistication and appetite for risk.²⁰⁴

IX. CLAIMS THAT MAY NOT PREVAIL IN ARBITRATION

Certain cases, however, may elicit little sympathy from an arbitration panel. One such instance would be a mere "holding claim," where the customer's only charge is that his broker failed to get him out of a stock at its historic high.²⁰⁵ While the customer may have been induced to make an investment in such a security by a breach of the broker's fiduciary duty, it may be hard to prove that all his losses were caused when the stock price collapsed.²⁰⁶ A burst bubble is, after all, just a stock gone back to its rightful price.

Nor may customers who were sucked in at the market's high points be able to show actual ill-gotten profits by their brokers. The customers at that time most likely bought their stock from knowledgeable insiders—potentially the real culprits in the transaction—who were taking their profits.²⁰⁷ In the same vein, it may be hard for disgrun-

201. Huddleston II et al., *supra* note 27, at 38. Lowenfels & Bromberg, *supra* note 119, at 1022, point out that this type of liability can also be established when a broker relying on such a fraudulently optimistic report advises a client not to sell a stock in a declining market.

202. Masters, *supra* note 159, at E1.

203. See *supra* notes 171–74 and accompanying text.

204. As one commentator put it: "If the investor said in his opening document his objective was speculation, there won't be a strong case against a broker who put him in high-risk stocks. . . . But if the investment objective was retirement security and preservation of capital and he was put in high-risk stocks, it's a strong case." Leckey, *supra* note 2 (quoting Harry Miller, securities attorney and founder of the Securities Fraud and Investor Protection Resource Center in Boston).

205. *But see* Lowenfels & Bromberg, *supra* note 119, at 1022 (discussing a different result when a broker induces a customer to hold a stock relying on a tainted research report).

206. Under many state securities laws, however, loss causation is not an element required for recovery. See *supra* notes 162–67 and accompanying text. Yet the equities of such a situation would not seem to favor recovery.

207. See *supra* note 8 and accompanying text.

bled investors to show that their brokers had any reason to disbelieve the tainted research reports received from corrupt stock analysts.²⁰⁸

X. CONCLUSION

Nonetheless, a pervasive aura of lax practices existed throughout the securities industry during the late 1990s boom, especially among brokerage firms that underwrote the high-flying stocks of that era. Notorious examples have come to light of analysts who were fired for their skepticism about the value of companies like Enron because such honest assessments might have caused their firms to lose millions of dollars in investment banking fees.²⁰⁹

How, then, can we separate the “[truly] dishonest from the [merely] delusional”?²¹⁰ Arbitration panelists, like Supreme Court justices, read the newspapers. As financially savvy individuals, they will be aware of all this background as they sort through the claims of investors, seeking to give an appropriate recovery to those who were fraudulently drawn into this maelstrom.

The \$1.4 billion settlement fine is just a small portion of the gigantic profits earned by the securities industry during this extraordinary bubble. Awarding rightful remedies to investors will be complicated, but the arbitration process, as it has evolved in the last decade, offers the best opportunity for aggrieved investors to find swift and meaningful justice.

208. Such a showing of fault would be required to prove negligent misrepresentation. See Black & Gross, *supra* note 111, at 1006.

209. The story of John Olson, an analyst from Merrill Lynch who appears to have been fired for his pessimistic views about Enron, is a sad case in point. MCLEAN & ELKIND, *supra* note 11, at 234–35.

210. Knee, *supra* note 1, at 14.