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Securities Arbitration: Better for Investors Than the Courts?

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SECURITIES ARBITRATION: BETTER FOR INVESTORS THAN THE COURTS?*

Marc I. Steinberg†

I. TO HOWARD BARTNICK

This Article is dedicated to my good friend Howard Bartnick who died suddenly a year ago. Howard had a successful career—in the Division of Market Regulation and General Counsel's Office at the SEC and in the financial services industry at Bank of America, Prudential and PaineWebber. More important, Howard was a devoted husband and father to his delightful wife Libby and two wonderful children. He also was one of the best friends I've ever had. I trusted him implicitly and we had many great times together. Why he who was so genuine and well liked would be taken from us in his early forties is hard to understand. Although we did not visit as frequently in the last few years, due to distance and seemingly more pressing matters, our good friendship remained intact. I miss Howard, and hope that this Article dealing with a subject that he knew meets with his approval and smile.

II. SECURITIES ARBITRATION—SOME INTRODUCTORY REMARKS

Nearly a decade has passed since the U.S. Supreme Court handed down its decision in *Shearson/American Express, Inc. v. McMahon*,[1] upholding the validity of pre-dispute arbitration agreements under the Securities Exchange Act (Exchange Act or 1934 Act) between brokerage firms and their customers.[2]

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1 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987).

2 15 U.S.C. § 78a (1994). The Court in *McMahon* also upheld the validity of

Shortly thereafter, the high court in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[3] gave its approbation to the validity of such agreements under the Securities Act (Securities Act or 1933 Act).[4]

These decisions generated hurrahs from the brokerage industry[5] and anguish from public investors (and, of course, their legal counsel).[6] Arbitration between brokerage firms and their public customers, epitomized by the unsophisticated individual investor, was seen by many as stacked in the industry's favor.[7] Indeed, this perception prevails today as evidenced by a relatively recent front-page Wall Street Journal article highlighting the pitfalls of arbitration for investors.[8]

This perception was (and continues to be) based on the apparent unfairness of the customer-broker arbitration process. Many brokerage firms compel their clients, even in cash accounts, to execute arbitration agreements as a condition to doing business.[9] The presence of industry representatives who

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such predispute arbitration provisions with respect to claims brought under the Racketeer Influenced and Corrupt Organizations Act ("RICO"). For further discussion, see *infra* notes 28-38 and accompanying text.

[3] 490 U.S. 477 (1989).

[4] 15 U.S.C. § 77a. For further discussion, see *infra* notes 39-40 and accompanying text. *See generally* MARILYN CANE & PATRICIA SHUB, SECURITIES ARBITRATION: LAW AND PROCEDURE (1991); C. EDWARD FLETCHER, ARBITRATING SECURITIES DISPUTES (1990); RALPH S. JANVEY, REGULATION OF THE SECURITIES AND COMMODITIES MARKETS ¶¶ 8.01-8.04 (1992).

[5] *See, e.g.*, Stephen Bedell & Brian Bosch, *The* Rodriguez *Decision: A New Tradition in the Arbitration of Securities Disputes*, 18 SEC. REG. L.J. 53 (1990).

[6] *See, e.g.*, Robert Gregory, *Arbitration: It's Mandatory But It Ain't Fair*, 19 SEC. REG. L.J. 181 (1991); *see also* Lee Applebaum, *Predispute Arbitration Agreements Between Brokers and Investors: The Extension of* Wilko *to Section 10(b) Claims*, 46 MD. L. REV. 339 (1987); Neal M. Brown et al., *Arbitration of Customer-Broker Disputes Under the Federal Securities Laws and RICO*, 15 SEC. REG. L.J. 3 (1987).

[7] *See, e.g.*, Gregory, *supra* note 6, at 184 (asserting that "arbitration as currently conducted by the NASD, NYSE or . . . AMEX is not fair"); *see also* authorities cited *infra* notes 42-47.

[8] *See* Margaret Jacobs & Michael Siconolfi, *Investors Fare Poorly Fighting Wall Street—and May Do Worse*, WALL ST. J., Feb. 8, 1995, at A1 (stating that "arbitration has earned a reputation for being stacked squarely against brokerage-firm customers").

[9] *See* Linda D. Fienberg & Matthew S. Yeo, *The NASD Securities Arbitration Report: A View from the Inside*, INSIGHTS, Apr. 1996, at 7, 8 (stating that "[s]ince *McMahon*, broker-dealers have required almost all individual investors who open margin or option accounts to sign a predispute arbitration agreement, and most broker-dealers require it for all customer accounts"); *see also* Anne Brafford, Com-

may favor brokerage firms (as well as industry employees),[10] the inconsistency in the quality of arbitrators,[11] the lack of a written decision justifying the award,[12] the near impossibility of persuading a court to overturn an arbitration decision under the "manifest disregard" standard,[13] and the lack of investor success when pursuing seemingly meritorious claims[14] all contribute to the belief that public investors receive callous treatment in this process.[15]

Nonetheless, mounting evidence shows that many investors emerge victorious from arbitration, even recovering punitive damages in appropriate cases.[16] The lack of intensive pre-

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ment, *Arbitration Clauses in Consumer Contracts of Adhesion: Fair Play or Trap for the Weak and Unwary*, 21 J. CORP. L. 331 (1996).

[10] *See* Gregory, *supra* note 6, at 184-85. A majority of the arbitration panel must be comprised of public arbitrators. Generally, an industry arbitrator is an individual who:

> 1. Is currently associated with a broker dealer, municipal securities dealer or has been associated with one in the last three years;
> 2. Is retired . . . ;
> 3. Has a spouse or other household member associated with a securities entity; or
> 4. Is a professional outside of the securities industry who has devoted 20% or more of his or her individual work effort to securities industry clients within the industry during the previous two years.

SECURITIES INDUSTRY CONFERENCE ON ARBITRATION ("SICA"), UNIFORM CODE OF ARBITRATION § 8(a)(2) (1994) [hereinafter UCA]; *see* NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. ("NASD"), CODE OF ARBITRATION PROCEDURE Rule 19(c)-(d) (1996) [hereinafter NASD ARBITRATION CODE].

[11] *See* Report of the Arbitration Policy Task Force to the Board of Governors, National Association of Securities Dealers, Inc., [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,735, at 87,475 (Jan. 1996) [hereinafter Ruder Report] (stating that "it is essential for the NASD to improve the overall quality, training, and effectiveness of NASD arbitrators").

[12] *See* NASD ARBITRATION CODE, *supra* note 10, at Rule 41; *accord*, New York Stock Exchange ("NYSE") Rule 627; American Stock Exchange ("AMEX") Rule 618. For further discussion, see *infra* notes 65-70 and accompanying text.

[13] *See* CANE & SHUB, *supra* note 4, at 336-38; FLETCHER, *supra* note 4, at 392.

[14] See Jacobs & Siconolfi, *supra* note 8, at A1.

[15] *See* authorities cited *supra* notes 7-8. *But see* Norman Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1111 (1993) (stating that "it would not be fair to describe [arbitration] as a deck stacked in favor of the brokerage firms").

[16] *See, e.g.*, Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995) (holding that an arbitration clause containing a New York choice of law provision was not designed to incorporate that state's prohibition of punitive damages in arbitrations); Poser, *supra* note 15, at 1097 (stating that "[a]rbitration panels have frequently given investors very substantial awards, sometimes including punitive damages"); Margo Reder, *Punitive Damages Are a Necessary Remedy*

trial discovery—at least as compared to the court setting[17]—and the more expeditious time frame in which arbitration proceeds may favor the public investor who cannot match the brokerage firm's litigation resources.[18] Moreover, the inapplicability of strict pleading rules, along with the informality of arbitration, may result in the arbitrators seeking to be "fair" whereas such claims may have been dismissed by a court.[19]

These reflections are particularly poignant in view of relatively recent federal court decisions, including in the Second Circuit,[20] that significantly restrict the viability of investors'

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in Broker-Customer Securities Arbitration Cases, 29 IND. L. REV. 105, 130 (1995) (stating that "[p]unitive damages must be available as a remedy in securities arbitration [and that they] must never be considered waived absent clear evidence of an affirmative intent to do so"); Quinton F. Seamons, *Punitive Damages in Securities Arbitration: Jokers, Deuces, and One-Eyed Jacks Are Wild!*, 21 SEC. REG. L.J. 387 (1994) (stating that in securities arbitration "[p]unitive damages during 1992 were significant, ranging from $250,000 to $3.5 million"); Milo Geyelin, *Smith Barney, Broker Ordered to Pay $1 Million in Mostly Punitive Damages*, WALL ST. J., Sept. 16, 1996, at B2 (levying of $750,000 in punitive damages); Michael Siconolfi, *Stock Investors Win More Punitive Awards in Arbitration Cases*, WALL ST. J., June 11, 1990, at A1 (stating that "the clearest sign of trouble for Wall Street is a surge in punitive-damage awards").

[17] Historically, securities arbitration was "a model of informal, expeditious, and inexpensive dispute resolution." Ruder Report, *supra* note 11, at 87,433. Today, "[t]he increasingly litigious nature of securities arbitration has gradually eroded [its] advantages [and there now is] concern that SRO arbitration has incorporated too many characteristics of civil litigation . . . ." Ruder Report, *supra* note 11, at 87,433. Nonetheless, the Task Force "believe[s] it is essential that securities arbitration continues to provide clear and significant advantages over the civil litigation system it has replaced." Ruder Report, *supra* note 11, at 87,433.

[18] *See* Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183, 188-89 (1996) (stating that during 1994, the average length of time a case took was 10.4 months, with the average hearing lasting 2.5 days, thereby prompting the author to assert "[t]hese are remarkable figures when compared to the time for resolution in crowded court dockets nationwide").

[19] *See infra* notes 70-150 and accompanying text; *see also* Shelly James, *Arbitration in the Securities Field: Does the Present System of Arbitration Between Small Investors and Brokerage Firms Really Protect Anyone?*, 21 J. CORP. L. 363, 369 (1996) (stating that qualitative analysis therein denies the existence of bias in arbitration).

[20] *See, e.g.*, Oppenheimer v. Prudential Sec., Inc., 94 F.3d 189 (5th Cir. 1996) (dismissing investor's case against brokerage firm and registered representative for failing to allege fraud with adequate particularity); Dodds v. Cigna Sec., Inc., 12 F.3d 346 (2d Cir. 1993) (dismissing investor's case pursuant to 1934 Act § 10(b) statute of limitations); Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020 (2d Cir. 1991) (holding plaintiff did not satisfy justifiable reliance requirement under § 10(b)); Wexner v. First Manhattan Co., 902 F.2d 169 (2d Cir. 1990) (dismissal of

claims.[21] Enactment of The Private Securities Litigation Reform Act of 1995 ("PSLRA")[22] also spells "gloom" for uninitiated investors.[23] These developments portend that the availability of a federal court forum may be particularly unattractive to brokerage firm customers today. Hence, investors now may well be in a better position bringing their claims in arbitration rather than in federal court.[24]

Depending on the particular state, however, public investors compelled to arbitrate are in a worse position after *McMahon*. In states such as California and Texas, whose statutes provide for broad relief,[25] investors lose a favorable judicial forum to bring their grievances. On the other hand, in a state such as New York which declines to provide a private remedy for violation of its securities laws,[26] investors may well be content to proceed in arbitration.[27]

This Article will expand on the concepts set forth above. After discussing *McMahon*, *Rodriguez* and their aftermath, the Article examines the arbitration process today. Thereafter, both the federal and state court forums will be analyzed from the perspective of the prospective investor-litigant. The Article concludes by addressing whether investors in the brokerage firm setting are in a better or worse position by being relegated to arbitration rather than the courts.

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investor's case pursuant to interpreting Federal Rule of Civil Procedure 9(b) in context of § 10(b) pleading requirements).

[21] *See* Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489 (1995) [hereinafter *Ramifications*].

[22] *See Senate Overrides President's Veto; Securities Litigation Reform Bill Now Law*, 28 Sec. Reg. & L. Rep. (BNA) 3 (1996); *see generally* Stephen F. Black et al., *The Private Securities Litigation Reform Act of 1995: A Preliminary Analysis*, 24 SEC. REG. L.J. 115 (1996); John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975 (1996).

[23] *See* Marc I. Steinberg, *Litigation Reform Act Will Have Major Impact*, 24 SEC. REG. L.J. 115 (1996).

[24] *See infra* notes 71-150 and accompanying text.

[25] *See* Steinberg, *Ramifications*, *supra* note 21, at 509-16; discussion *infra* notes 156-162 and accompanying text.

[26] *See* CPC Int'l v. McKesson Corp., 70 N.Y.2d 268, 514 N.E.2d 116, 519 N.Y.S.2d 804 (1987).

[27] *See infra* notes 151-155 and accompanying text.

III. A LOOK AT *MCMAHON* AND *RODRIGUEZ*

In *Shearson/American Express, Inc. v. McMahon*,[28] the Supreme Court held that predispute arbitration agreements between brokerage firms and their customers did not contravene the Exchange Act and the Racketeer Influenced and Corrupt Organizations Act ("RICO"). Hence, such claims ordinarily are arbitrable consistent with the terms of the applicable arbitration agreement. The following discussion focuses on the validity of such predispute arbitration agreements under the securities laws.

In *McMahon*, the Supreme Court relied in large part on the Federal Arbitration Act ("FAA")[29] which establishes a "federal policy favoring arbitration."[30] This policy applies even when a claim is based on a federal statutory right. As a consequence, the burden is on the party opposing the validity of the arbitration agreement to show that Congress intended to preserve the availability of a judicial forum, irrespective of the terms of an arbitration agreement.[31] Hence, to preclude application of the FAA, according to the Court, the party seeking to avoid arbitration "must demonstrate that Congress intended to make an exception to the Arbitration Act for claims arising under . . . the Exchange Act, an intention discernible from the text, history, or purposes of the statute."[32]

Upon examining section 29(a) of the Exchange Act, which renders void any stipulation whereby a person waives compliance with any 1934 Act provision, the Court opined that section 29(a) only proscribes waiver of the Exchange Act's *substantive* obligations. By contrast, section 29(a) does not preclude parties from waiving a judicial forum in favor of an arbitral tribunal.[33]

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[28] 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987). The discussion herein, notes 28-47 and accompanying text, derives from my student reference text. MARC STEINBERG, UNDERSTANDING SECURITIES LAW § 12.02 (2d ed. 1996).

[29] *McMahon*, 482 U.S. at 242; *see* 9 U.S.C. § 1 (1994).

[30] Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

[31] *McMahon*, 482 U.S. at 227 (relying on Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985); Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985); Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974)).

[32] *Id.*

[33] *Id.* at 228-38.

The Court's holding in *McMahon* takes a far different view of arbitration than its 1953 decision in *Wilko v. Swan*.[34] In holding that predispute arbitration agreements were not enforceable in actions brought pursuant to section 12(2) (now section 12(a)(2)) of the Securities Act, the *Wilko* Court invoked the antiwaiver provision of the Securities Act, section 14, which is section 29(a)'s counterpart. Underlying the *Wilko* Court's holding was its hostility to the arbitration process. Succinctly put, the Court believed that arbitration would fail to protect an investor's substantive rights. As a consequence, a judicial forum was necessary to ensure that the statutory rights created by section 12(2) would be adequately protected.[35]

Although declining to overrule *Wilko* at that time,[36] the Supreme Court in *McMahon* asserted that, in view of the increased regulatory oversight of arbitration since *Wilko* was handed down, a party's 1934 Act substantive rights are not waived by enforcing a predispute arbitration agreement. Pursuant to the 1975 amendments to the 1934 Act, the SEC now "has broad authority to oversee and to regulate the rules adopted by the [self-regulatory organizations] relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights."[37] Accordingly, the *McMahon* Court held:

> We conclude, therefore, that Congress did not intend for § 29(a) to bar enforcement of all predispute arbitration agreements. In this case, where the SEC has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights, enforcement does not effect a waiver of "compliance with any provision" of the Exchange Act under § 29(a).[38]

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[34] 346 U.S. 427 (1953).

[35] *Id.* at 432-37.

[36] *McMahon*, 482 U.S. at 234 ("[S]*tare decisis* concerns may counsel against upsetting *Wilko*'s contrary compulsion under the Securities Act . . . .").

[37] *Id.* at 233-34.

[38] *Id.* at 238 (citing Scherk v. Alberto-Culver Co., 417 U.S. 506, 520 (1974)). *But see id.* at 252-68 (Blackmun, J., concurring in part and dissenting in part).

Subsequently, in *Rodriguez De Quijas v. Shearson/American Express, Inc.*,[39] the Supreme Court overruled *Wilko*. Holding that predispute agreements to arbitrate claims under the Securities Act are enforceable, the Court stated:

> [I]n *McMahon* the Court declined to read § 29(a) of the Securities Exchange Act of 1934, the language of which is in every respect the same as that in § 14 of the 1933 Act, to prohibit enforcement of predispute agreements to arbitrate. The only conceivable distinction in this regard between the Securities Act and the Securities Exchange Act is that the former statute allows concurrent federal-state jurisdiction over causes of action and the latter statute provides for exclusive federal jurisdiction. But even if this distinction were thought to make any difference at all, it would suggest that arbitration agreements, which are "in effect, a specialized kind of forum-selection clause," . . . should not be prohibited under the Securities Act, since they, like the provision for concurrent jurisdiction, serve to advance the objective of allowing buyers of securities a broader right to select the forum for resolving disputes, whether it be judicial or otherwise.[40]

[39] 490 U.S. 477 (1989).

[40] *Id.* at 482-83 (citation omitted). Also, the Court in *Rodriguez* relied on the "strong language of the Arbitration Act" under which "the party opposing arbitration carries the burden of showing that Congress intended in a separate statute to preclude a waiver of judicial remedies, or that such a waiver of judicial remedies inherently conflicts with the underlying purposes of that other statute." *Id.* at 483.

Recently, the Supreme Court has decided a number of cases in the securities arbitration area. *See, e.g.*, First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 1920 (1995) (holding that (i) the issue of whether parties agreed to arbitrate a certain matter is a question for the court to decide, and (ii) the standard that a court of appeals should apply when reviewing a district court decision confirming an arbitration award "should proceed like review of any other district court decision . . . , i.e., accepting findings of fact that are not 'clearly erroneous' but deciding questions of law de novo"); Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995) (holding that award of punitive damages in arbitration proceeding not precluded by terms of broker firm-client agreement where agreement did not expressly refer to punitive damages and was ambiguous in this regard, resulting in such ambiguity being construed against the drafter of the agreement, the brokerage firm); authorities cited *supra* note 16; *see also* Nielsen v. Piper, Jaffray & Hopwood, Inc., 66 F.3d 145 (7th Cir. 1995) (applying NASD rule placing class actions outside the purview of otherwise enforceable arbitration agreements).

IV. AFTERMATH OF *MCMAHON* AND *RODRIGUEZ*

In the aftermath of *McMahon* and *Rodriguez*, many believed that securities arbitration favored the industry.[41] As stated in a 1987 *New York Times* article, "the [brokerage] houses basically like the current system because they own the stacked deck."[42] A 1992 U.S. General Accounting Office ("GAO") Report on Securities Arbitration, however, concluded that its "statistical analysis of case results . . . showed no evidence of pro-industry bias at industry-sponsored forums."[43] Nonetheless, as Professor Perry Wallace points out, "[g]iven the prominence that securities arbitration is likely to enjoy in the future, probing questions must be asked now regarding the effectiveness [and] basic fairness . . . of the procedures that effectuate it."[44]

Even though not finding a pro-industry bias, the GAO report nonetheless was critical of the current process, stating that its "review of arbitration procedures showed that arbitration forums lacked internal controls to provide a reasonable level of assurance regarding either the independence of the arbitrators or their competence in arbitrating disputes."[45] Needless to say, such lack of internal controls, as found by the GAO, brings into question the integrity of the arbitration process.

Fortunately, certain improvements have been made since 1987. For example, in cases involving public customers, an arbitration panel consists of a majority of public arbitrators. The new rules more rigorously define those who qualify as public arbitrators.[46] The rules also call for preservation of a

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[41] *See, e.g.*, Gregory, *supra* note 6, at 184-86.

[42] William Glaberson, *When the Investor Has a Gripe*, N.Y. TIMES, Mar. 29, 1987, at 1, 8. A 1995 *Wall Street Journal* article reached a similar conclusion. *See* Jacobs & Siconolfi, *supra* note 8, at A1.

[43] UNITED STATES GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 60 (GAO/GGD-92-74) (May 1992) [hereinafter GAO REPORT]. *But see* Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327, 367 (1996) (stating that GAO "data may now be stale and in any event cry out for amplification").

[44] Perry E. Wallace, *Securities Arbitration After* McMahon, Rodriguez, *and the New Rules: Can Investors' Rights Really Be Protected?*, 43 VAND. L. REV. 1199, 1202 (1990).

[45] GAO REPORT, *supra* note 43, at 6.

[46] *See supra* note 10; *see also* Ruder Report, *supra* note 11, at 87,468-87,479.

record of the proceeding and for disclosure to the parties of certain past or existing affiliations of the arbitrators that are likely to affect their impartiality. Moreover, the statement of award must contain the arbitrators' and parties' names, a summary of the relevant issues in controversy, the damages and/or other relief sought and awarded, a statement of any other issues resolved, and the signatures of the arbitrators who concurred in the award.[47]

V. ARBITRATION TODAY

Arbitration today, although more complex than in yesteryear,[48] remains a relatively informal process. Rather than burdensome pleading requirements as frequently mandated by federal law,[49] a complainant in arbitration "need only specify

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[47] *See* Exchange Act Release No. 26,805, 1989 SEC LEXIS 843 (May 10, 1989); *see generally* C. Edward Fletcher III, *Learning to Live with the Federal Arbitration Act—Securities Litigation in a Post-*McMahon *World*, 37 EMORY L.J. 99 (1988); Mahlon M. Frankhauser & Linda M. Gardner, *An Up-to-Date Review of Judicial, Legislative, and Regulatory Developments in Arbitration with Financial Institutions*, 46 WASH. & LEE L. REV. 583 (1989); William A. Gregory & William J. Schneider, *Securities Arbitration: A Need for Continued Reform*, 17 NOVA L. REV. 1223 (1993); Constantine N. Katsoris, *Securities Arbitration After* McMahon, 16 FORDHAM URB. L.J. 361 (1987-88); Poser, *supra* note 15; G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C. L. REV. 517 (1989); Wallace, *supra* note 44.

[48] *See* Ruder Report, *supra* note 11, at 87,463-87,468; *supra* note 17.

[49] *See, e.g.*, FED. R. CIV. P. 9(b) (requirement of pleading fraud with particularity). Moreover, pursuant to the PSLRA, new § 21D(b) of the Exchange Act sets forth:

> (1) A requirement that a plaintiff in the complaint in any private securities fraud action alleging material misstatements and/or omissions "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."
> (2) A requirement that in any private action under the 1934 Act in which the plaintiff "may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each such act or omission alleged to violate [the 1934 Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

See PSLRA of 1995, 15 U.S.C.A. § 782, *amended by* Pub. L. No. 104-67, 109 Stat. 737 (1995) (Joint Explanatory Statement of the Committee on Conference, observing that the language contained in § 21D(b) derives "in part" from the Second Circuit's pleading requirement which is "regarded as the most stringent pleading standard," but also stating that "the Conference Committee intends to strengthen existing pleading requirements"); *infra* notes 81-88 and accompanying text.

the relevant facts and the remedies sought."[50] Although discovery is permitted to an increasing extent,[51] including written requests for information[52] and document requests,[53] a number of the more costly and time consuming aspects of discovery found in federal and state court litigation usually are not present.[54] Hence, depositions are rarely permitted[55] and

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[50] UCA, *supra* note 10, § 13. This provision is included in the NASD, NYSE and AMEX arbitration rules. *See* NASD ARBITRATION CODE, *supra* note 10, Rule 25(a); NYSE Rule 612(a), *supra* note 12; AMEX Rule 606(a), *supra* note 12. Moreover, the American Arbitration Association's ("AAA") Securities Arbitration Rules similarly require that the demand for arbitration "shall contain a statement setting forth the nature of the dispute, the amount involved, if any, the remedy sought, and the hearing locale requested." AAA Rule 5; *see* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Robert & Barchman, 916 F. Supp. 845 (N.D. Ill. 1996) (holding that arbitrators, not the courts, determine claim specificity under NYSE Rule 612(a)); David E. Robbins, *Securities Arbitration from the Arbitrators' Perspective*, 23 REV. SEC. & COMM. REG. 171, 171-72 (1990), stating:

> Most arbitrators just glance at the statement of claim after being appointed, and, unless they are chairmen and have to rule on pre-hearing discovery issues, arbitrators only read the pleadings carefully shortly before the first hearing[,] [that] [c]omplaint-like drafting rarely elicits an emotional response from arbitrators, . . . [and that] [i]n the claim, arbitrators do not like reading every possible cause of action.

[51] *See* Ruder Report, *supra* note 11, at 87,463 (referring to concerns that "NASD arbitration has become too litigious [along with] the proliferation of discovery requests and disputes").

[52] *See* UCA, *supra* note 10, § 20(a)-(c); NASD Rule 32(a)-(c), *supra* note 10.

[53] *See* sources cited *supra* note 52. Generally, "discovery disputes are resolved either on written submission to the arbitrators or at the pre-hearing conference, which is conducted by one or more of the arbitrators selected for the case." Ruder Report, *supra* note 11, at 87,464.

[54] For example, depositions are rarely allowed and motion practice is not as complex. *See infra* notes 55-56 and accompanying text. Nonetheless, as the NASD Task Force observed, "[p]arties frequently abuse the present NASD discovery rules." Ruder Report, *supra* note 11, at 87,464; *see* Seligman, *supra* note 43, at 351 (pointing out that lack of guidance, inconsistency and abuse in the arbitration discovery process should prompt corrective action).

[55] Ruder Report, *supra* note 11, at 87,463 ("Although the [Arbitration] Code does not set forth criteria for deciding requests for depositions, the Arbitrator's Manual suggests that depositions should be permitted only under fairly narrow circumstances."); SICA, ARBITRATOR'S MANUAL 10 (1992), stating:

> Access to depositions should be granted to preserve the testimony of ill or dying witnesses, or of persons who are unable or unwilling to travel long distances for a hearing and may not otherwise be required to attend the hearing, as well as to expedite large or complex cases, and in other situations as deemed appropriate by the arbitrator . . . .

Note, however, the view of one authoritative source:

> It has generally been recognized . . . that the absence of deposition usually works to the advantage of brokerage firm respondents who have most of the information necessary to prove a claim in their possession

dispositive motions prior to the formal hearing are not encouraged.[56]

At the formal hearing, the panel is comprised of a majority of "public" arbitrators.[57] Unlike a judicial proceeding, formal rules of evidence do not apply,[58] thereby allowing the introduction of "hearsay."[59] Relevance and materiality are key criteria in the arbitrators' determination relating to the admissibility and weight given to evidence proffered.[60]

Arbitrators, not being bound by precise legal standards in their decisions,[61] may render awards premised on applicable

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> (often in a form that is not comprehensible to the ordinary claimant or his counsel) and who do not have to bear the burden of proof in establishing a claim.

Lewis D. Lowenfels & Alan R. Bromberg, *Securities Industry Arbitrations: An Examination and Analysis*, 53 ALB. L. REV. 755, 811 (1989).

[56] *See* CANE & SHUB, *supra* note 4, at 114 (stating that generally there is no opportunity "to raise a motion to dismiss for failure to state a cause of action or a motion for summary judgment in arbitration"). Nonetheless, several pre-hearing motions are permitted, including:

> (1) a request for more definite statement of claim; (2) motion to consolidate; (3) motion to sever; (4) motion for lack of timeliness; (5) motion to decline jurisdiction; (6) motion to bar certain facts or defenses when a respondent only pleads a general denial or when it fails to answer; and (7) motion to bar certain facts or defenses when not raised in the answer.

Robbins, *supra* note 50, at 175 (citing SICA, ARBITRATOR'S MANUAL, *supra* note 55, at 2). Note, moreover, that with respect to particular legal issues, the *Arbitrator's Manual* allows "the submission of briefs in reference to a particular legal issue setting forth a law or statute and how it applies to the facts of the case." CANE & SHUB, *supra* note 4, at 115 (citing SICA, ARBITRATOR'S MANUAL, *supra* note 55, at 6); *see* FLETCHER, *supra* note 4, at 302-08; David E. Robbins & Michael H. Stone, *Discovery Panel, New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry*, 63 FORDHAM L. REV. 1551 (1995).

[57] *See supra* note 10 and accompanying text.

[58] *See* UCA, *supra* note 10, § 21; SHELDON M. JAFFEE, BROKER-DEALERS AND SECURITIES MARKETS: A GUIDE TO THE REGULATORY PROCESS 19 (1977) (stating that arbitrators "do not rigidly adhere to the rules of evidence and allow the introduction of documentary and other evidence, if, in a general sense, it appears reliable").

[59] *See* CANE & SHUB, *supra* note 4, at 37 (stating that "arbitrators routinely consider hearsay and other testimony not admissible in a court of law and give it whatever weight they feel it deserves under the circumstances").

[60] *See* UCA, *supra* note 10, § 21; ALAN R. BROMBERG & LEWIS D. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 16.01-16.05 (1994 & Supp.); sources cited *supra* notes 58-59.

[61] *See* SICA, ARBITRATOR'S MANUAL, *supra* note 55, at i (stating that arbitrators "keep equity in view"); Jaffee, *supra* note 58, at 338 (stating that "arbitrators are not bound to precise legal standards in their decisions"); Lowenfels &

self-regulatory organization ("SRO") standards, industry custom, or even concepts of equity and fairness.[62] Indeed, damages may be awarded to claimants for violations of SRO rules where no monetary remedy is provided for such misconduct under federal or state securities law.[63] Moreover, many arbitrators are not attorneys and, even for those who are lawyers, they may not have expertise in securities law.[64]

No written decision is required by the arbitration rules;[65] only the names of the parties, a summary of the issues presented, the relief sought and awarded, a statement of other

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Bromberg, *supra* note 55, at 784 (stating that "arbitration panels are not bound by precise legal standards in their decisions"); Margaret Pedrick Sullivan, *The Scope of Modern Arbitral Awards*, 62 TUL. L. REV. 1113 (1988) (stating that arbitrators are not strictly required to apply substantive law).

[62] *See* Lowenfels & Bromberg, *supra* note 55, at 784; *see also* sources cited *supra* notes 60-61. Such claims normally assert state common law grounds for relief.

[63] *See* Lowenfels & Bromberg, *supra* note 55, at 784-88; Poser, *supra* note 15, at 1108-10. Examples include claims relating to unsuitability, unauthorized trading, proper execution of customer orders, and margin deficiencies. Generally, these claims are actionable under § 10(b) of the Exchange Act only if deception, materiality, scienter and other elements are proven. As stated in Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Goldman, 593 F.2d 129, 134 (8th Cir.), *cert. denied*, 444 U.S. 838 (1979), "the courts have typically found no private right of action exists for violation of exchange or dealer rules in the absence of a finding of fraud." Moreover, courts have held that no private right of action exists on behalf of investors for violation of the margin requirements. *See, e.g.*, Bennett v. United States Trust Co. of New York, 770 F.2d 308 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986). For further discussion, see MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 9.03 (1996).

[64] *See* Ruder Report, *supra* note 11, at 87,468-87,479.

[65] *See* NASD Rule 41, *supra* note 10; *see also* Masucci, *supra* note 18, at 190-91. Note, however, that for large and complex cases, upon a party's request, a written decision must be provided that will be made public. Upon refusal by the arbitrators to produce written findings of fact and conclusions of law, such arbitrators will be replaced. *See Rules Changed to Make Written Findings Easier to Obtain in Larger Arbitrations*, 22 Sec. Reg. & L. Rep. (BNA) 816 (1990). Cases that qualify for large and complex status are determined on a case by case basis. Such cases may include "class actions, cases involving multiple parties, cases dealing with a novel legal theory, and disputes involving potentially large sums of money." Lynn Katzler, *Should Mandatory Written Opinions Be Required in All Securities Arbitrations?: The Practical and Legal Implications to the Securities Industry*, 45 AM. U. L. REV. 151, 167 (1995) (relying on *Ruder Urges Rules to Allow Arbitrators to Refer Complex Cases to Court System*, 20 Sec. Reg. & L. Rep. (BNA) 1087 (1988)); *see Arbitration Reforms Hearing Before the Subcomm. on Telecomm. and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. 99-100 (1988) (statement of Theodore Krebsbach) (stating that the vast majority of arbitrations are typical broker-customer disputes).

issues resolved (e.g., jurisdictional rulings), the names of the arbitrators, and the signatures of the arbitrators who concur in the award are necessary.[66]

The rationale frequently provided for not requiring written opinions is that mandating such opinions would contravene the policies underlying arbitration, which are to provide an expeditious, efficient, and informal forum of alternative dispute resolution.[67] Another argument advanced is that requiring written opinions would be time consuming and burdensome, thereby deterring many qualified individuals from agreeing to serve as arbitrators.[68] Nonetheless, there may well be another key reason why arbitrators avoid writing opinions: Because the panel's decision can be overturned by a federal court only on narrow grounds, such as bias, misconduct, or manifest disregard of the law,[69] the writing of an opinion draws a "road map" by which

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[66] *See, e.g.*, NASD ARBITRATION CODE, *supra* note 10, at Rule 41.

[67] *See, e.g.*, Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 903 F.2d 1410, 1413 (11th Cir. 1990); Sargent v. Paine Webber Jackson & Curtis, Inc., 882 F.2d 529, 532 (D.C. Cir. 1989), *cert. denied*, 494 U.S. 1028 (1990); Sobel v. Hertz, Warner & Co., 469 F.2d 1211, 1214 (2d Cir. 1972); Quick & Reilly, Inc. v. Jacobson, 126 F.R.D. 24, 26 (S.D.N.Y. 1989).

[68] *See* Katzler, *supra* note 65, at 164 n.92 (asserting that requiring written opinions "could very well hinder, rather than enhance, the administration of arbitration proceedings in that it would be time consuming and burdensome and thus may discourage many qualified individuals from serving as an arbitrator") (citing *Securities Arbitration Group Opposes Mandatory Written Opinions in All Cases*, 19 Sec. Reg. & L. Rep. (BNA) 1952, 1953 (1987)).

[69] Section 10 of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 10 (1994), allows for vacating an arbitral award based only on:

> 1. [T]he award was procured by corruption, fraud, or undue means;
> 2. [E]vident partiality or corruption in the arbitrators or either of them;
> 3. [T]he 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;
> 4. [T]he arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the matter submitted was not made.

Although error of law is not provided as a basis for vacating an award pursuant to § 10, several courts have embraced a standard focusing on "manifest disregard of the law" by the arbitrators as a ground for vacating an award. *See* CANE & SHUB, *supra* note 4, at 326-39 (citing cases). Nonetheless, the burden to show "manifest disregard" is a high one for aggrieved parties. *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros, 70 F.3d 418, 421 (6th Cir. 1995); Advest, Inc. v. McCarthy, 914 F.2d 6, 10 n.6 (1st Cir. 1990); Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930, 934 (2d Cir. 1986). Succinctly stated, "[c]hallenging an arbitration award is usually fruitless." Lowenfels & Bromberg, a disgruntled party will have greater likelihood of upsetting the arbitral award. Moreover, being pressed for time, inadequately paid, and not accomplished in authoring written opinions (particularly in a complex area like securities law), any written decision incurs the risk as being viewed with disfavor by a learned federal court. Because arbitrators perceive that they act in good faith, follow the spirit if not the letter of the applicable law, and seek to do justice, they thus are reluctant to explain their rationale in a written opinion. The end product is one that reaches a defined result with no reasoning provided to support such result and with the losing party having little likelihood of overturning such result.[70]

VI. FEDERAL LAW: TO THE LIKING OF THE INDUSTRY

In the era prior to the Supreme Court's decision in *McMahon*, disgruntled brokerage firm customers eagerly sought protection in the federal courts.[71] The principal provision invoked was section 10(b) of the Exchange Act. Due to the fact that the Exchange Act (unlike the Securities Act[72]) pro-

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supra note 55, at 864. Or, as stated by Professor Fletcher, "it is nearly impossible to argue successfully that an arbitration panel was guilty of manifest disregard of the law." FLETCHER, *supra* note 4, at 389. On occasion, however, courts have vacated arbitration awards, even under the "manifest disregard of the law" standard. *See, e.g.*, Ainsworth v. Skrunick, 909 F.2d 456 (11th Cir. 1990), *cert. denied*, 507 U.S. 915 (1993); *see also* FAA, 9 U.S.C. § 11(a) ("evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award basis for modifying or correcting arbitral award"); *see generally* David A. Lipton, *The Standard on Which Arbitrators Base Decisions*, 16 SEC. REG. L.J. 3 (1988).

[70] *See* Jaffee, *supra* note 58, at 339 (stating that "[w]here the facts are in dispute, testimony contradictory, and blame not entirely one-sided, arbitration forums have been known to compromise verdicts [and that] [s]uch verdicts . . . often represent a sense of justice which fits the facts of the case"); authorities cited *supra* notes 64-69; *see also* McIlroy v. Paine Webber, Inc., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,659 (5th Cir. 1993) (arbitral award of $40,000 where more than $1 million sought not "evident material miscalculation" under FAA § 11(a), therefore denying investors request that court modify award).

[71] *See* Ralph C. Ferrara & Marc I. Steinberg, *A Reappraisal of* Santa Fe: *Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980). Note that, even prior to *McMahon*, investor-customers had the option of arbitrating rather than seeking relief in the courts. *See, e.g.*, NASD ARBITRATION CODE, *supra* note 10, Rule 12(a) ; NYSE Constitution art. III; NYSE Rule 600(a), *supra* note 10 (all providing that any subject claim may be arbitrated upon the customer's demand).

[72] Section 22(a) of the Securities Act, 15 U.S.C. § 77v(a) (1994).

vides for exclusive federal jurisdiction, these actions were instituted in federal court.[73] Moreover, key Securities Act provisions asserted in this context included sections 12[74] and 17(a).[75] In addition, secondary liability doctrines seeking to hold brokerage firms and supervisory personnel liable encompassed aiding and abetting,[76] controlling person,[77] and respondeat superior.[78]

Beginning with the mid 1970s and continuing to the present, investors generally have fared progressively worse under federal law.[79] This observation, particularly when compared to the expansionist decisions of the 1960s and early 1970s,[80]

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[73] Section 27 of the Exchange Act, 15 U.S.C. § 78aa.

[74] 15 U.S.C. § 77l (Supp. 1995); *see, e.g.*, Davis v. Avco Fin. Serv., Inc., 739 F.2d 1057 (6th Cir. 1984), *cert. denied*, 474 U.S. 1012 (1985).

[75] 15 U.S.C. § 77q(a). Prior to the late 1970s, several courts recognized an implied private right of action for damages under § 17(a). *See, e.g.*, Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975), *rev'd*, Newcome v. Esrey, 862 F.2d 1099 (9th Cir. 1988); Marc I. Steinberg, *Section 17(a) of the Securities Act of 1933 After* Naftalin *and* Redington, 68 GEO. L.J. 163, 172-82 (1979).

[76] *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978).

[77] Section 15 of the Securities Act, 15 U.S.C. § 77o; § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a); *see, e.g.*, Haynes v. Anderson & Strudwick, Inc., 508 F. Supp. 1303 (E.D. Va. 1981).

[78] *See, e.g.*, Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied sub nom.*, Wood Walker & Co. v. Marbury Management, Inc., 449 U.S. 1011 (1980); *see generally* Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983). *But see infra* notes 118-127 and accompanying text.

[79] *See, e.g.*, Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 359-61 (1991) (adopting statute of limitations of one year after discovery and no longer than three years after the violation for § 10(b) actions); Chiarella v. United States, 445 U.S. 222, 235 (1980) (holding that absent a duty to disclose based on a fiduciary or similar relationship, silence does not give rise to liability); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (requiring that scienter be shown in § 10(b) private actions); *see generally* Lewis D. Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977). *But see* Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (approving use of fraud-on-the-market theory for purposes of establishing presumption of reliance in § 10(b) actions).

[80] *See, e.g.*, Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) (implied private cause of action for damages exists under § 10(b) of Exchange Act and rule 10b-5); SEC v. National Sec., Inc., 393 U.S. 453, 460-61 (1969) (recognizing SEC's authority to regulate securities activities of insurance companies); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (implied private right of action under § 14(a) of Exchange Act); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 197 (1963) (requiring under Investment Advisers Act of 1940 that registered investment adviser disclose personal financial interest in securities

may well signify that uninitiated investors would prefer arbitration today, even if they could elect to proceed in federal court. The following discussion, highlighting restrictions that investors today face in federal court, emphasizes this point.

A. *Pleading Requirements*

Federal Rule of Civil Procedure 9(b) requires that fraud "be stated with particularity."[81] In construing whether complaints alleging securities fraud pass muster under Rule 9(b), the Second Circuit mandates that specific facts be set forth supporting a "strong inference of fraud."[82] This standard, for example, was applied in *Wexner v. First Manhattan Co.*[83] There, Susan Wexner (a relative of The Limited, Inc. founder Les Wexner) brought suit under section 10(b) against the brokerage firm. She alleged that the firm had perpetrated deception in the sale of her Limited stock, resulting in damages of several million dollars. Although she detailed the alleged scheme and underlying motive and was not entitled to discovery at the pleading stage, the Second Circuit upheld the dismissal of her complaint for failing to satisfy Rule 9(b).[84]

The Second Circuit's strict pleading requirement generally has been codified by Congress in the PSLRA.[85] Hence, facts

recommended to clients).

[81] FED. R. CIV. P. 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

[82] *See, e.g.*, Wexner v. First Manhattan Co., 902 F.2d 169, 172 (2d Cir. 1990) ("Where pleading is permitted on information and belief, a complaint must adduce specific facts supporting a strong inference of fraud or it will not satisfy even a relaxed pleading standard."); *accord, In re* Time Warner Inc. Sec. Litig., 9 F.3d 259 (2d Cir. 1993).

[83] 902 F.2d 169 (2d Cir. 1990).

[84] *Id.* at 172-73 (holding that Wexner's allegations were "conclusory" and "unsupported"); *see* Oppenheimer v. Prudential Sec., Inc., 94 F.3d 189 (5th Cir. 1996) (holding investor's complaint failed to allege fraud with adequate particularity). For a more relaxed interpretation of Rule 9(b) prior to PSLRA, see, e.g., Shapiro v. UJB Fin. Corp., 964 F.2d 272 (3d Cir. 1992); *see generally* Richard G. Himelrock, *Pleading Securities Fraud*, 43 MD. L. REV. 342 (1984); William M. Richmond et al., *The Pleading of Fraud: Rhymes Without Reason*, 60 S. CAL. L. REV. 959 (1987); Note, *Pleading Securities Fraud Claims with Particularity Under Rule 9(b)*, 97 HARV. L. REV. 1432 (1984).

[85] Exchange Act § 21D(b) (quoted *supra* note 49); *see* Joint Explanatory Statement, *supra* note 49 (stating that standard adopted in PSLRA is stronger than

giving rise to a strong inference of fraud must be alleged with particularity in section 10(b) litigation.[86] Moreover, no discovery during the pleading stage generally is allowed under the PSLRA,[87] and sanctions under Rule 11 of the Federal Rules of Civil Procedure are more likely to be assessed against losing parties (and their attorneys).[88]

B. *Limitations on the Shingle Theory*

Traditionally, the federal courts have recognized the applicability of the "shingle" theory.[89] The theory posits that by "hanging out its shingle," a broker-dealer impliedly represents that its conduct and the behavior of its employees will be fair and will comport with professional norms.[90] As the Second

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Second Circuit test).

[86] Exchange Act § 21D(b)(2) (quoted *supra* note 49).

[87] *See* Securities Act § 21(c); Exchange Act § 21D(b)(2)(B). Hence, the Litigation Reform Act amends the 1933 and 1934 Acts to provide for (i) a stay of discovery during the pendency of any motion to dismiss unless the court finds that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to a party, and (ii) the preservation of the evidence that is relevant to the allegations of the complaint during the pendency of any stay or discovery. A party aggrieved by the willful failure of an opposing party to comply with the provisions requiring preservation of evidence may seek appropriate sanctions. Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. at 747 (Dec. 12, 1995). These provisions will undoubtedly eliminate some of the burden of expenses incurred by defendants who succeed in having the complaint in question dismissed.

[88] *See* Securities Act § 27(c); Exchange Act § 21D(c). The PSLRA amends the 1933 and 1934 Acts to mandate court review, upon final adjudication of private securities actions thereunder, of the parties' or their attorneys' compliance with Rule 11(b) of the Federal Rules of Civil Procedure requirements for a good faith factual and legal basis as to any pleading or dispositive motion. Securities Act § 27(c); Exchange Act § 21D(c). If the court finds that there is a "substantial failure" of the parties or attorneys to comply with these provisions, the court is directed to impose mandatory sanctions in accordance with Rule 11. Pub. L. No. 104-67, 109 Stat. at 747 (Dec. 12, 1995). The provisions set forth a rebuttable presumption in favor of the award being the reasonable attorneys' fees and costs incurred as a direct result of the violation. This presumption may be rebutted by the sanctioned party or attorney only upon proof that (i) the award will present an unreasonable burden, or (ii) the violation was de minimis. *See generally* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996).

[89] *See, e.g.*, Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); *see generally* BROMBERG & LOWENFELS, *supra* note 60, § 5.7; ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5, § 210.03 (1992); Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247 (1983).

[90] *See* authorities cited *supra* note 89.

Circuit stated in *Hanly v. SEC*,[91] "[a] securities dealer occupies a special relationship to a buyer of securities in that by his position he impliedly represents he has an adequate basis for the opinions he renders."[92] One aspect of this duty, labeled the suitability theory, recognizes an implied representation by the broker that it will recommend only those securities suitable for each customer's investment objectives and economic status.[93]

A number of other implied representations have been recognized as coming within the shingle theory, including:

> (1) an implied representation of fair pricing, including any markup or markdown;
> (2) an implied representation that the broker-dealer will execute only authorized transactions for its customers;
> (3) an implied representation to disclose any special consideration that influences the broker-dealer's recommendation;
> (4) an implied representation to execute promptly customers' orders; and
> (5) an implied representation that any recommendation made by a broker-dealer to a customer has a reasonable basis.[94]

One may inquire, however, whether aspects of the shingle theory still provide the basis for a section 10(b) right of action in light of the Supreme Court's holding in *Santa Fe Industries, Inc. v. Green* that deception or manipulation must be shown.[95] A number of courts have taken the position that certain components of the shingle theory no longer are viable.[96] For example, in *Pross v. Baird, Patrick & Co., Inc.*,[97] a section 10(b) claim based on unauthorized trading by a broker was dis-

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[91] 415 F.2d 589 (2d Cir. 1969).

[92] *Id.* at 596 (citations omitted).

[93] *See* NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION: PRIVATE RIGHTS OF ACTION (1995); Janet E. Kerr, *Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy*, 16 PAC. L.J. 805 (1985); F. Harris Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFF. L. REV. 435 (1977); Denis T. Rice, *Recommendations by a Broker-Dealer: The Requirement for a Reasonable Basis*, 25 MERCER L. REV. 537 (1974); Arvid E. Roach II, *The Suitability Obligations of Brokers: Present Law and the Proposed Federal Securities Code*, 29 HASTINGS L.J. 1067 (1978).

[94] MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 2:17 (1985 & Supp. 1996).

[95] Santa Fe Indus. Inc. v. Green, 430 U.S. 462 (1977).

[96] *See* Langevoort, *supra* note 89.

[97] 585 F. Supp. 1456 (S.D.N.Y. 1984).

missed. The court reasoned that the claim was in actuality one for breach of fiduciary duty not involving the element of deception necessary to invoke section 10(b).[98]

Moreover, courts allow brokers to engage in certain nonactionable puffery. Such statements as "[t]his deal will make you rich" and "I'm the best broker in Kansas City" are not actionable due to lack of materiality and lack of justifiable reliance.[99] On the other hand, where specific and realistic percentages are communicated to the investor, such as "your return will be 15 percent annually," many courts will find such a statement to constitute actionable misrepresentation.[100]

C. *Non-Actionability of Certain Oral Communications*

In the brokerage setting, it is not uncommon for a broker to make optimistic statements concerning a recommended security to one's client. Such oral communications may be conveyed in situations where the written materials adequately set forth the risks associated with the investment. Under such circumstances, is the broker subject to liability for the allegedly false oral statements? When analyzing this question, the federal courts have focused on section 10(b)'s reliance and materiality components.[101] In most jurisdictions, the fact that the written disclosure documents are accurate is not dispositive.[102]

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[98] *Id.* at 1460-61.

[99] *See, e.g.*, Zerman v. Ball, 735 F.2d 15, 21 (2d Cir. 1984); Newman v. Rothschild, 651 F. Supp. 160, 163 (S.D.N.Y. 1986); Frota v. Prudential-Bache Sec. Inc., 639 F. Supp. 1186, 1190 (S.D.N.Y. 1986).

[100] *See, e.g.*, Cohen v. Prudential-Bache Sec. Inc., 713 F. Supp. 653, 658 (S.D.N.Y. 1989); Newman v. Rothschild, 662 F. Supp. 957, 959 (S.D.N.Y. 1987).

[101] *See, e.g.*, Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020 (2d Cir. 1993); Myers v. Finkle, 950 F.2d 165 (4th Cir. 1991); Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317 (7th Cir. 1988).

[102] Thus, most courts apply the following factors in this context:

> (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983); *accord*, Myers v. Finkle, 950 F.2d 165, 167 (4th Cir. 1991); Bruschi v. Brown, 876 F.2d 1526, 1529

Nonetheless, in the Second Circuit, when the written documents are accurate, the broker's allegedly false oral statements generally will not be actionable, with the proviso that the existence of a fiduciary relationship between the broker and the customer may dictate otherwise.[103] This is the case even when the customer is known by the broker to be unsophisticated.[104] Moreover, the Seventh Circuit adheres to an even more restrictive approach premised on a "materiality"[105] analysis. Under that court's interpretation, the written word trumps the oral, thereby mandating that a broker's verbal lies that contradict an accurate disclosure document are deemed inactionable as a matter of law.[106]

D. *Statute of Limitations*

Under section 13 of the Securities Act,[107] the statute of limitation for section 11[108] and 12(a)(2)[109] claims is one year after constructive knowledge of the facts constituting the violation and in no event more than three years after the transaction.[110] In *Lampf*,[111] the Supreme Court construed section

(11th Cir. 1989); Kennedy v. Josephthal & Co., Inc., 814 F.2d 798, 804 (1st Cir. 1987). *But see* Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317, 1325 (7th Cir. 1988) (stating that "written words govern oral ones in order to reward truthful disclosures and facilitate accurate assessment of risk").

[103] *See* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031-33 (2d Cir. 1993) (noting that "none of the Limited Partners allege the existence of a fiduciary relationship or of a longstanding business or personal relationship with Hutton or its brokers").

[104] *Id.* ("presum[ing] that the Limited Partners are unsophisticated investors").

[105] *See, e.g.*, Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1131-32 (7th Cir. 1993), *cert. denied*, 510 U.S. 1073 (1994); *Acme Propane*, 844 F.2d at 1325.

[106] *Acme Propane*, 844 F.2d at 1325. A somewhat related doctrine is the "bespeaks caution" doctrine which provides that "where an offering statement, such as a prospectus, accompanies statements of future forecasts, projections and expectations with adequate cautionary language, those statements are not actionable as securities fraud." *In re* Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *see In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 185 (1995); Rubinstein v. Collins, 20 F.3d 160 (5th Cir. 1994); Mayer v. Mylod, 988 F.2d 635, 639 (6th Cir. 1993); Donald C. Langevoort, *Disclosures that "Bespeak Caution,"* 49 BUS. LAW. 481 (1994).

[107] 15 U.S.C. § 77m (1994).

[108] *Id.* § 77k.

[109] *Id.* § 77l(a)(2), *as amended by* Pub. L. No. 104-67, 109 Stat. at 747 (1995). Prior to the PSLRA, § 12(a)(2) was § 12(2).

[110] 15 U.S.C. § 77k (setting forth that suit must be brought within one year

10(b) to have a similar statute of limitations.[112] In *Lampf*, the Court departed from lower court precedent that section 10(b) claims were subject to equitable tolling.[113]

Accordingly, section 10(b) claims have, at most, a limitations period of three years.[114] Significantly, however, the statute, as construed by the lower courts, also has a one-year inquiry notice period.[115] Thus, this one-year period commences after the plaintiff discovered or should have discovered the facts constituting the violation.[116] In construing this one-year period, courts have applied the mythical "reasonable person" standard, refusing to consider the plaintiff's actual knowledge or lack of investment acumen. In the Second Circuit, this approach is exemplified by *Dodds v. Cigna Securities, Inc.*, where a widow with a tenth-grade education and four dependent children was denied her day in court because the one-year inquiry notice period was held to have elapsed.[117]

E. *Secondary Liability Theories*

Prior to the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*,[118] aiding and abetting liability under section 10(b) was overwhelmingly recog-

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after the facts constituting the violation were known or should have been known to the plaintiff and in no event more than three years after the alleged violation).

[111] Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991).

[112] *Id.* at 359-64.

[113] *See* James W. Beardsely, Jr., Committee on Federal Regulation of Securities, *Report of the Task Force on Statute of Limitations for Implied Actions*, 41 BUS. LAW. 645 (1986); Gordon W. Stewart, *Statutes of Limitation for Rule 10b-5*, 39 WASH. & LEE L. REV. 1021 (1982).

[114] *Lampf*, 501 U.S. at 364.

[115] Some authorities suggest that this one-year period should commence upon actual notice, not inquiry notice. *See* Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b-5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court*, 51 BUS. LAW. 309 (1996); Steinberg, *supra* note 63, § 7.09[2]. Nonetheless, cases subsequent to *Lampf* have applied the one-year inquiry notice standard. *See infra* notes 116-117 and accompanying text.

[116] *See, e.g.*, Tregenza v. Great Am. Communications Co., 12 F.3d 717 (7th Cir. 1993), *cert. denied*, 114 S. Ct. 1837 (1994); Dodds v. Cigna Sec. Inc., 12 F.3d 346 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1401 (1994); Kaplan v. Kahn, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,623 (N.D. Cal. 1995); cases cited in Lowenfels & Bromberg, *supra* note 115, at 314-25.

[117] Dodds v. Cigna Sec. Inc., 12 F.3d 346, 349-53 (2d Cir. 1993).

[118] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

nized by the lower federal courts.[119] In addition, the doctrine of respondeat superior liability was invoked by the vast majority of federal courts to hold broker-dealers vicariously liable for their agents' securities law misconduct.[120]

In *Central Bank of Denver*, the Supreme Court, utilizing a strict linguistic interpretation, held that aiding and abetting liability may not be imposed in private actions under section 10(b).[121] The high Court's holding precludes aiding and abetting liability in private actions under other securities law provisions that do not expressly provide for such liability.[122] In addition, the tenor of the Court's language in *Central Bank*[123] signifies to many, including Justice Stevens in his dissent,[124] that vicarious liability premised on principles of conspiracy and respondeat superior no longer survives.[125] While this perception has come to fruition with respect to conspiracy claims,[126] the continued viability of the doctrine of respondeat superior has not yet been resolved.[127]

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[119] *See id.* at 192-93 n.1 (Stevens, J., dissenting) (citing cases).

[120] *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1576-78 (9th Cir. 1990) (en banc) (citing cases), *cert. denied*, 499 U.S. 976 (1991).

[121] 511 U.S. at 170-92. The Court's language may well have signified that its rationale extended to SEC enforcement actions. *See* Steinberg, *supra* note 21, at 497-98. In 1995, however, Congress gave the SEC express authority to pursue aiders and abettors for 1934 Act violations. *See* Exchange Act § 20(f), 15 U.S.C. § 78t(f) (1994).

[122] *See* STEINBERG, *supra* note 63, § 10.02 n.5.

[123] 511 U.S. at 173-78.

[124] *Id.* at 200 n.12 (Stevens, J., dissenting) (stating that lower court decisions recognizing theories of conspiracy and respondeat superior "appear unlikely to survive the Court's decision").

[125] *Id.* at 173-78.

[126] Hence, after *Central Bank of Denver*, the vast majority of lower courts have rejected the propriety of conspiracy claims in private securities litigation. *See, e.g.*, Otto v. Variable Annuity Life Ins. Co., No. 82 C 4762, 1995 U.S. Dist. LEXIS 3352 (N.D. Ill. Mar. 17, 1995); *In re* Faleck & Margolies, Ltd., Civ. Nos. 89-8548 & 90-1356, 1995 U.S. Dist. LEXIS 970 (S.D.N.Y. Jan. 27, 1995); *In re* Medimmune Inc. Sec. Litig., 873 F. Supp. 953 (D. Md. 1995).

[127] *See, e.g.*, Pollack v. Laidlow Holdings, Inc., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,741, ¶ 92,509 (S.D.N.Y. 1995) (stating that "[u]nlike aiding and abetting liability, . . . liability of a principal based upon apparent authority has long been recognized by federal courts"). *But see Central Bank of Denver*, 511 U.S. at 200 n.12 (Stevens, J., dissenting); *see also* American Telephone and Telegraph v. Winback and Conserve Program, Inc., 42 F.3d 1421, 1430-31 (3d Cir. 1994) (construing applicability of doctrine of respondeat superior under Lanham Act), *cert. denied*, 115 S. Ct. 1838 (1995); *see generally* Richard A. Booth, *Vicarious Liability and Securities Fraud*, 22 SEC. REG. L.J. 347 (1995); Alan R. Bromberg,

F. *Section 12(a)(2) Claims*

Section 12(2) (now 12(a)(2))[128] provides a potentially attractive remedy. Contrary to section 10(b), section 12(a)(2) does not require a plaintiff to prove reliance or loss causation.[129] Moreover, unlike section 10(b), which mandates that the plaintiff establish the defendant's scienter,[130] section 12(a)(2) imposes liability for actionable disclosure deficiencies unless such defendant affirmatively shows that he or she acted with reasonable care.[131]

Prior to the Supreme Court's decision in *Gustafson v. Alloyd Co.*,[132] the lower federal courts were unanimous in their view that section 12(a)(2) applied to initial private and public offerings[133] and were divided as to whether the statute extended to secondary market transactions.[134] In *Gustafson*, to the surprise of many,[135] the Supreme Court held that the term "prospectus" in section 12(a)(2) is limited to that used in a "public" offering[136] and that the term "oral communication" in the statute is confined to those communications which relate

Aiding and Abetting: Sudden Death and Possible Resurrection, 24 REV. SEC. & COMM. REG. 133 (1994); Joel Seligman, *The Implications of* Central Bank, 49 BUS. LAW. 1429 (1994).

[128] 15 U.S.C. § 77l(a)(2) (Supp. 1995).

[129] *See, e.g.*, Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222, 1226 (7th Cir. 1980). Section 12(b) contains an affirmative defense, allowing the defendant to show that the disclosure deficiency did not cause the loss (in whole or in part). 15 U.S.C. § 77l(b).

[130] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[131] 15 U.S.C. § 77l(a)(2); *see generally* Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 NOTRE DAME L. REV. 57 (1993).

[132] 115 S. Ct. 1061 (1995).

[133] *See generally* Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908 (1992).

[134] *Compare* Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir.) (limiting § 12(2) to initial offerings), *cert. denied*, 502 U.S. 820 (1991), *with* Pacific Dunlop Holdings, Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993) (extending § 12(2) to secondary transactions), *cert. dismissed*, 510 U.S. 1160 (1994).

[135] *See* Harold S. Bloomenthal, *Liability Does Not Extend to Private Offerings or Secondary Trading*, 17 SEC. & FED. CORP. L. REP. Nos. 14, 15 (Apr./May 1995).

[136] 115 S. Ct. at 1073-74 (construing the term "prospectus" as a "term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder").

to such prospectus.[137] Hence, section 12(a)(2)'s scope is now confined to public offerings by issuers or their controlling shareholders.[138]

The Court's holding greatly reduces the applicability of section 12(a)(2) in the brokerage firm setting. No longer may the statute be invoked by investors against brokerage firms (and their agents) in the initial private offering context or in secondary trading transactions. Hence, financial intermediaries today are not subject to section 12(a)(2) liability exposure for misstatements made in a Rule 506 Regulation D[139] offering memorandum or for oral misrepresentations made by their agents in connection with such offering.[140] The same holds true for recommendations made with inadequate disclosure in a brokerage firm's newsletters concerning outstanding securities, as well as an agent's verbal misrepresentations made to a client in connection with the sale of outstanding securities.[141]

G. *Section 17(a)*

Prior to about 1980, Securities Act section 17(a) was perceived by some authorities as an attractive remedy for plaintiffs.[142] If construed broadly, the statute extended to offerees (even if they were not purchasers), applied to the secondary

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[137] *Id.* at 1066.

[138] *Id.* at 1066-67, 1072-74. Hence, after *Gustafson*, § 12(a)(2) applies to registered offerings and to offerings that are public in nature (such as pursuant to SEC Regulation A, 17 C.F.R. § 230.251 *et seq.*) that otherwise would mandate registration but for the availability of an exemption under § 3 of the Securities Act.

[139] Rule 506 is a safe harbor to the Securities Act § 4(2) private placement exemption from registration, and, hence, offerings conducted in accordance with Rule 506 are private. *See* 17 C.F.R. § 230.506 (1996); Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225 (1990).

[140] *See, e.g.*, ESI Montgomery County, Inc. v. Montenay Int'l Corp., 899 F. Supp. 1061 (S.D.N.Y. 1995); Komanoff v. Mabon, Nugent & Co., 884 F. Supp. 848 (S.D.N.Y. 1995).

[141] *See* cases cited *supra* note 140; Ted J. Fiflis, Gustafson v. Alloyd Co., *Judicial vs. Legislative Power*, 23 SEC. REG. L.J. 423 (1996); Therese Maynard, *The Impact of* Gustafson *and Its Methodology*, 24 SEC. REG. L.J. 61 (1996); Richard A. Booth, *The Scope of Section 12(2) After* Gustafson, INSIGHTS, July 1995, at 8.

[142] *See, e.g.*, Thomas L. Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978).

trading markets, and imposed liability for negligence.[143] Today, by contrast, section 17(a) serves solely as a government enforcement resource.[144] This consequence is due to the lower courts overwhelmingly holding that no private right of action exists under section 17(a).[145]

H. *Construing State Securities Claims*

Although not without exception,[146] a number of federal courts have construed applicable state securities laws consistent with and no broader than their perceived federal counterparts.[147] The result is the dismissal of the state as well as the federal securities claims. One may question whether state courts would join in this interpretation.[148]

I. *Summation*

The foregoing discussion illustrates that brokerage firm customers today are rarely in a worse position in arbitration than they would be in a federal court. In the last two decades, the federal courts have construed the securities statutes and pleading rules in a restrictive fashion. In conjunction there-

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[143] *See* Steinberg, *supra* note 75, at 175-86 (discussing issues and citing authorities).

[144] Today, the SEC frequently elects to institute enforcement actions alleging § 17(a) violations in addition to or in lieu of § 10(b) violations. *See* STEINBERG & FERRARA, *supra* note 94, § 2:05; WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 10.4 (1996); *see also* Aaron v. SEC, 446 U.S. 680 (1980); United States v. Naftalin, 441 U.S. 768 (1979).

[145] *See, e.g.*, Newcome v. Esrey, 862 F.2d 1099 (4th Cir. 1988); *In re* Washington Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349 (9th Cir. 1987); Landry v. All Am. Assurance Co., 688 F.2d 381 (5th Cir. 1982); STEINBERG, *supra* note 63, § 6.03(2), at n.57 (collecting cases).

[146] *See, e.g.*, Akin v. Q-L Invs., Inc., 959 F.2d 521, 532 (5th Cir. 1992) (interpreting Texas Securities Act broader than federal law); Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1048-51 (11th Cir. 1987) (interpreting Florida common law broader than U.S. or Florida securities law).

[147] *See, e.g.*, Haralson v. E.F. Hutton Group, 919 F.2d 1014, 1032 (5th Cir. 1990) (interpreting Texas securities law); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1130-31 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989) (interpreting Louisiana securities law), *cert. denied*, 492 U.S. 918 (1989); Capri v. Murphy, 856 F.2d 473, 479 (2d Cir. 1988) (interpreting Connecticut securities law).

[148] *See* Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 427-28 (1993).

with, a number of federal courts have registered their disdain for perceived strike suit litigation.[149] And, as a more recent example, enactment of the PSLRA imposes still greater burdens on plaintiffs.[150] Thus, today investors are likely to fare better in the arbitral forum.

VII. THE STATE COURTS—DEPENDS ON THE "STATE"

Whether investors would fare better in state court rather than arbitration depends largely on the applicable state. For example, New York may be viewed as a pro-securities industry state, at least insofar as private actions are concerned. Indeed, that state's securities act has been held by the New York high court not to provide a private right of action for defrauded purchasers or sellers.[151] Although actions for breach of fiduciary duty and fraud may be instituted in certain contexts,[152] recovery for punitive damages is severely curtailed.[153] Given this perceived pro-industry position, plaintiffs may prefer to arbitrate their claims.[154]

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[149] *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975) (stating that "[t]here has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"), *reh'g denied*, 423 U.S. 884 (1975); DiLeo v. Ernst & Young, 901 F.2d 624, 628 (7th Cir.) (affirming dismissal of complaint based on "fraud by hindsight"), *cert. denied*, 498 U.S. 941 (1990).

[150] *See supra* notes 49, 85-88 and accompanying text.

[151] See CPC Int'l, Inc. v. McKesson Corp., 70 N.Y.2d 268, 274-75, 514 N.E.2d 116, 117-18, 519 N.Y.S.2d 804, 806 (1987) (refusing to recognize private right of action under New York's blue sky laws, despite the nearly unanimous recognition by other states that private civil suits are available for violations of such laws).

[152] *See, e.g.*, Independent Order of Forresters v. Donaldson, Lufkin & Jenrette, Inc., 28 Sec. Reg. & L. Rep. (BNA) 447 (S.D.N.Y. 1996) (under New York law, dismissing claims for negligent and fraudulent misrepresentation but allowing claim for express breach of warranty to proceed); *see also* Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1214-17 (8th Cir. 1990) (observing that whether fiduciary relationship exists is matter of state law and holding that nondiscretionary securities accounts may give rise to fiduciary relationship under South Dakota law).

[153] *See, e.g.*, Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976) (holding that under New York law punitive damages cannot be awarded in arbitrations); Franklin D. Ormsten, Garrity *and* Mastrobuono: *A Continuing Tale of Two Cases*, N.Y. ST. B.J., Dec. 1995, at 32.

[154] *See* Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995) (holding that in spite of New York choice of law provision in arbitration agreement at bar punitive damages nonetheless may be awarded). For further discussion, see *supra* notes 48-70 and accompanying text.

A number of other states, however, provide for more meaningful redress for investors. Many state securities statutes provide for recovery based on a brokerage firm's negligence in both the primary and secondary trading markets,[155] dispense with the reliance and loss causation requirements,[156] provide for collateral participant liability,[157] and contain longer statutes of limitations than their federal counterparts.[158] In addition, the doctrine of respondeat superior has been applied by state courts in the brokerage firm setting.[159] Moreover, attorneys' fees and punitive damages may be awarded.[160]

The procedural rules in state courts also are more favorable. The rigorous federal pleading fraud with particularity standards normally are not present in the state courts.[161] Moreover, motions seeking dismissal are granted with less frequency in state courts. Hence, juries appear to be the ulti-

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[155] *See, e.g.*, Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 920 n.7 (6th Cir. 1991); Kittilson v. Ford, 608 P.2d 264, 265 (Wash. 1980); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bryne, 320 So. 2d 436, 440 (Fla. Dist. Ct. App. 1975), *writ discharged*, 341 So. 2d 498 (Fla. 1976); Fakhrdai v. Mason, 696 P.2d 1164, 1166-67 (Or. Ct. App. 1985).

[156] *See, e.g.*, E.F. Hutton & Co. v. Rouseff, 537 So. 2d 978, 981 (Fla. 1989), *discussed in* Marilyn Cane, *Proximate Causation in Securities Fraud Actions for Rescission*, FLA. BAR Q. REP., Spring 1989, at 14. As stated by Professor Cane: "It would seem that a plaintiff bringing a suit under [the Florida statute] could rescind [the transaction] without a showing of proximate cause, or any damages, or any scienter on the part of the defendant." Cane, *supra*, at 14.

[157] *See, e.g.*, UNIFORM SECURITIES ACT § 410(a) (1956) (amended 1958); ARIZ. REV. STAT. ANN. § 44-2003 (1994); OHIO REV. CODE ANN. § 1707.43 (Anderson 1992); OR. REV. STAT. § 59.115(3) (1980); TEX. REV. CIV. STAT. ANN. art. 581-33F (West 1994); 7B U.L.A. 643 (1985), *reprinted in* 1 Blue Sky L. Rep. (CCH) ¶ 5500, at 156 (1985); *see generally* Douglas M. Branson, *Collateral Participant Liability Under State Securities Laws*, 19 PEPP. L. REV. 1027 (1992); Long, *supra* note 151, § 7.08; Steinberg, *supra* note 21, at 512-14.

[158] *See, e.g.*, FLA. STAT. ANN. § 95.11(4)(e) (West 1982 & Supp. 1995) (two years after inquiry notice and no more than five years after the transaction—two year/five year); N.M. STAT. ANN. § 58-13B-41 (Michie 1978) (two year/five year); PA. STAT. ANN. tit. 70, § 1-504(a) (West 1993) (one year/four year); TEX. REV. CIV. STAT. ANN. art. 581-33H(2), (3) (West 1994) (three year/five year).

[159] *See* Long, *supra* note 157, *Blue Sky Law* § 7.09 (citing cases).

[160] *See, e.g.*, ARIZ. REV. STAT. ANN. § 44-2001 (1994); OHIO REV. CODE ANN. § 2315.21(B) (Anderson 1992); UTAH CODE ANN. § 61-1-22(2) (1993); WASH. REV. CODE § 21.20.430(1), (2) (West 1989).

[161] *See, e.g.*, JACK H. FRIEDENTHAL ET AL., CIVIL PROCEDURE § 5.9 (2d ed. 1993); *supra* notes 81-88 and accompanying text.

mate decisionmaker more often in the state courts, thereby exposing institutions, such as brokerage firms, to enhanced liability exposure.[162]

CONCLUSION

The final analysis is that investors today likely fare better in arbitration than they would in federal court. Nonetheless, in those states that provide a meaningful securities and common law remedial framework on a timely basis, investors seeking relief against brokerage firms and their agents likely would favor the state court forum if they had the choice.

Brokerage firm clients normally fit comfortably within the state securities framework. Such clients are purchasers of the subject securities and therefore have standing to sue under the applicable blue sky statute. Brokerage firms and their agents frequently are "sellers" and therefore come within the express terms of the statute. Even if not deemed a "seller," a brokerage firm is subject to liability under the doctrines of control person and respondeat superior. The firm's executives likewise have liability exposure as control persons. Accordingly, material misstatements and omissions, whether stated orally or in solicitation materials used in connection with investor purchases in the primary and secondary markets, expose subject brokerage firm defendants to liability unless they meet certain affirmative defenses.[163]

Of course, arbitrators apply principles of equity[164] along with applicable securities and common law. Nonetheless, it appears that most plaintiffs and their counsel bringing suit in a favorable state forum would prefer to have a jury decide these issues rather than a panel of arbitrators.

Although the final word is yet to be said on this subject, arbitration is not the catastrophe to investors that many believed after *McMahon*. Indeed, investors today should be pleased that they can present their story before arbitrators

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[162] *See* STEINBERG, *supra* note 63, § 9.06; *see generally* Matt Moffett & Thomas Petzinger, Jr., *Pennzoil Wins $10.53 Billion in Suit Against Texaco; Verdict Is Called Highest Civil Judgment in History*, WALL ST. J., Nov. 20, 1985, at 3.

[163] *See* authorities cited *supra* notes 156-162 and accompanying text.

[164] *See supra* notes 61-63, 70 and accompanying text.

rather than being relegated to federal courts restrictively construing what may be viewed as a narrow federal securities law remedial framework.

As I was provided Professor Therese Maynard's Commentary to this Article for the first time at the page-proof stage a few days ago, I offer only a few brief observations. As an initial point, I assure Professor Maynard that, contrary to her statement, she is not the only academic who came to this forum on securities arbitration with no agenda.[165]

Second, and far more disconcerting (at least to me), Professor Maynard misinterprets key points of my Article. Indeed, she reads "implicit" statements into the Article that are simply not there.[166] I do not contend in this Article that arbitration is a panacea for investors or that we can be assured that arbitrators will faithfully apply the "rule of law."[167] Indeed, I have suggested otherwise. Looking at this subject from both a practical and theoretical perspective, my fundamental premise is that investors today may well prefer arbitrating their claims in this setting rather than proceeding in the federal courts.

Third, Professor Maynard asserts that the presence of arbitration in the investor-brokerage firm context creates the possible erosion—if not the ultimate virtual extinction—of the development of precedent (or the "rule of law") in this area.[168] She is partly correct. We must remember that the SEC remains active in broker-dealer regulation (including investor-brokerage firm conduct), resulting in key administrative and judicial interpretations. Although the lack of a large number of private court actions impedes the development of precedent, the SEC's vigorous enforcement activities along with judicial interpretations help assure that the "rule of law" will continue to develop.

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[165] Therese Maynard, McMahon: *The Next Ten Years,* 62 BROOK. L. REV. 1533, 1533 (1996).

[166] *See, e.g., id.* at 1551, 1555.

[167] *Id.* at 1551-55.

[168] *Id.* Professor Maynard does recognize that the SEC and SROs will engage in enhanced rulemaking and other administrative functions in their efforts to further refine the "rule of law." *Id.* at 1556.