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Working Toward Fair Treatment for Retail Investors

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INTRODUCTION: WORKING TOWARD FAIR TREATMENT FOR RETAIL INVESTORS

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Twenty years ago, in *Shearson/American Express, Inc. v. McMahon*,[1] the Supreme Court held that brokerage firms could require their customers to arbitrate all their disputes in industry-sponsored fora—a decision that had great significance for the law of arbitration as well as securities regulation. In 1996, a blue-ribbon task force released its report,[2] assessing the securities arbitration process at National Association of Securities Dealers, Inc. (NASD) the principal securities arbitration forum,[3] and the report led to several symposia on the topic coinciding with the tenth anniversary of *McMahon*.[4] Since then, arbitration scholars and practitioners have intensified the debate over the fairness of arbitration, both generally[5] and specifically in the context of brokerage customers' disputes.[6] In addition, in the last ten years, the stock market has undergone a boom and bust cycle that generated a record number of customers' claims filed at NASD;[7] the securities

* Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law. My gratitude goes to all the Symposium participants, each of whom causes me to think more deeply about these issues, and to the Corporate Law Fellows and members of the *University of Cincinnati Law Review*, for their assistance in putting on this Symposium.

1. 482 U.S. 220 (1987).

2. SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (1996). This report is commonly referred to as the Ruder Report, after the name of its Chair, David S. Ruder, a former Securities and Exchange Commission (SEC) Chair. *See* Press Release, NASD, Arbitration Task Force Issues 70 Recommendations in Largest Revamping of Securities Arbitration Since Its Start More Than a Century Ago (Jan. 22, 1996), *available at* http://www.finra.org/PressRoom/NewsReleases/1996NewsReleases/p010550.

3. Effective July 2007, the arbitration functions of NASD and the New York Stock Exchange were consolidated as part of the Financial Industry Regulatory Authority (FINRA), the largest non-governmental regulator for securities firms doing business in the United States. *See* FINRA, About the Financial Industry Regulatory Authority, *available at* http://www.finra.org/AboutFINRA/CorporateInformation/index.htm (last visited Feb. 21, 2008).

4. *See, e.g.*, Symposium, *Securities Arbitration: A Decade After* McMahon, 62 BROOK. L. REV. 1329 (1996).

5. *See* Jeffrey W. Stempel, *Mandating Minimal Quality in Mass Arbitration*, 76 U. CIN. L. REV. 383 (2008) (reviewing the literature).

6. *See Bibliography of Selected Securities Arbitration Resources from 1997–2007*, 76 U. CIN. L. REV. 599 (2008).

7. A record 8945 customers' claims were filed in 2003, in contrast to 5631 claims filed in 1996. *See* FINRA, Dispute Resolution Statistics, http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/Statistics/index.htm (last visited Jan. 30, 2008).

industry has continued to market new investment products, strategies, and services for retail investors;[8] and the aging population has increasingly become aware of the importance of investing for retirement, but has also become susceptible to deceptive promises offering freedom from financial worries.[9] As a result of these developments, now is an opportune time for a re-examination of arbitration and investors' remedies. The March 31, 2007 Symposium provided just such an opportunity, and I am proud to introduce the participants' Articles, each of which is an important contribution to the scholarship in this area.

Professor Jeffrey Stempel and Professor Stephen Ware address the question of fairness in "mass," or consumer, arbitration, of which securities arbitration is a prime example. Professor Stempel is a forceful advocate of government-mandated procedural and substantive ground rules to ensure the fair and effective operation of mass arbitration. In particular, he argues that the judicial process should be the benchmark for measuring the quality of arbitration.[10] Professor Stephen Ware focuses on an often-overlooked mandatory aspect of securities arbitration that conflicts with the contractual basis for arbitration.[11] Under NASD rules, brokerage firms are required to arbitrate customers' disputes if the customer so chooses.[12] As a result, even if a brokerage firm wished to resolve customers' disputes in court, it would still be required to arbitrate at an individual customer's request. Professor Ware raises the intriguing possibility that at least some firms might be willing to drop their arbitration agreements if NASD did not impose a duty on brokerage firms to arbitrate, allowing a customer for whom judicial resolution of disputes was important to select a brokerage firm on that basis.

Professor Jennifer Johnson and Professor Edward Brunet, on the one

8. One example is the marketing of fee-based accounts instead of the traditional commission-based accounts. The D.C. Circuit struck down the SEC's controversial rule that would have exempted brokers offering fee-based accounts from regulation as investment advisers. *See* Financial Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

9. According to the SEC, "Nearly one-third of all U.S. investors are between 50 and 64 years of age, and approximately 5 million senior citizens succumb to financial abuse each year." SEC, For Seniors, http://www.sec.gov/investor/seniors.shtml (last visited Jan. 30, 2008). In 2004, NASD Investor Education Foundation awarded a research grant to WISE Senior Services in Los Angeles to investigate fraud that targets older Americans. Its counter-intuitive finding was that investment fraud victims demonstrated a better understanding of basic financial literacy than non-victims. *See* NASD INVESTOR EDUC. FOUND., INVESTOR FRAUD STUDY FINAL REPORT (2006), *available at* http://www.finrafoundation.org/WISE_Investor_Fraud_Study_Final_Report.pdf.

10. *See* Stempel, *supra* note 5.

11. *See* Stephen J. Ware, *What Makes Securities Arbitration Different from Other Consumer and Employment Arbitration?*, 76 U. CIN. L. REV. 447 (2008).

12. Similarly, Professor Ware also objects to the SRO requirement that securities employees arbitrate their employment disputes. *See id.*

hand, and Professor Jill Gross, on the other, deal specifically with the issue of fairness in securities arbitration. Professor Johnson and Professor Brunet assert that the greatest defect in the securities arbitration process is the failure of the NASD forum to require its arbitrators to apply substantive law, with the result that the application of substantive law occurs sporadically and inconsistently in present-day securities arbitration.[13] In contrast, Professor Gross argues that criticisms of the fairness of securities arbitration stem primarily from misunderstandings of the law, not from defects in the process or failures of the arbitrators.[14] Investors' dissatisfaction with the securities arbitration forum may well result not from deficiencies in the forum's procedures or with its arbitrators, but from the application of anti-investor laws. Accordingly, since current law severely limits investors' remedies in court, investors may actually fare better in arbitration.

I have outlined above the major issues on which the professors disagree, but I am struck by the major areas of agreement as well. In contrast to many investors' perceptions as reported in the media,[15] all the professors reflect, to varying degrees, a consensus that NASD procedures are fair, setting aside the controversy over the presence of a non-public, or "industry," arbitrator on every three-person arbitration panel.[16] Thus, the debate crystallizes around the application of substantive law in securities arbitration and the appropriate role for judicial review. Requiring arbitrators to apply the substantive law would have significant impact on the arbitration forum. First, the role of the arbitrators would be primarily that of judges and not that of a jury. Accordingly, arbitrators would need additional training in the applicable law. This, however, presupposes the existence of applicable law, which is problematic since *McMahon*'s privatization of the law. Second, the composition of the arbitration panels would also need to change and consist primarily, if not exclusively, of lawyers. Certain investors' advocates, however, would not welcome these developments, as they believe that more favorable outcomes are likely when arbitrators reflect

13. *See* Edward Brunet & Jennifer J. Johnson, *Substantive Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 459 (2008).

14. *See* Jill I. Gross, McMahon *Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 493 (2008).

15. *See, e.g.*, Gretchen Morgenson, *Dear S.E.C., Reconsider Arbitration*, N.Y. TIMES, May 6, 2007, § 3, *available at* http://select.nytimes.com/2007/05/06/business/yourmoney/06gret.html?pagewanted=1&n=Top/Reference/Times%20Topics/People/M/Morgenson,%20Gretchen&_r=1#.

16. Rule 12402 of the NASD Customer Code of Arbitration requires that every three-person arbitration panel include one non-public (commonly referred to as "industry") arbitrator, as defined in Rule 12100(p). NASD CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES, R. 12402 (Nat'l Ass'n Sec. Dealers, Inc. 2007), *available at* http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p018365.pdf.

the real-life experiences of their investor-clients.[17]

Moreover, all of the professors agree that the current level of judicial involvement does not provide for meaningful review of the substance of the arbitrators' decisions; they disagree, however, on whether it should. Allowing for greater judicial review of the substance of the arbitrators' decision would require not just the preservation of the arbitration record (which NASD already requires), but also at least some statement by the arbitrators of the reasons for their decision as well as development of a judicial standard of review more searching than "manifest disregard of the law."[18] However, when NASD proposed a rule change requiring arbitrators to give reasons for their decision if requested by the customer, the response from investors' advocates was lukewarm.[19] As a practical matter, greater judicial review of arbitration awards would increase the workload of the judiciary, a result that is at odds with the Supreme Court's pro-arbitration policy. As a matter of policy, more judicial involvement in the arbitration process would also mark the culmination of efforts to transform the arbitration process into a minor league judicial system. While the advisability of this policy is worthy of debate, adoption of this approach, with its attendant greater responsibilities on arbitrators, is unlikely to work under the current securities arbitration system of nonprofessional arbitrators who serve on an occasional basis, with minimal compensation.[20]

Since much of the current debate centers around the role of substantive law in securities arbitration, the contributions of Professor Jennifer O'Hare and Professor Mercer Bullard permit useful comparisons of the judicial and arbitration systems with their thoughtful analyses of the law on remedies as it affects two categories of retail investors whose claims are litigated in court: the investor who sues the corporate issuer for securities fraud and the mutual fund investor who sues the fund and its affiliates for mispricing and sales abuses. Professor O'Hare explores the "distinctly anti-investor flavor" to federal securities laws that disadvantages, in particular, defrauded retail investors and demonstrates that anti-investor bias is real and, given the deregulatory climate, unlikely to change.[21] Her conclusion—that retail investors have

17. The Public Investors Arbitration Bar Association (PIABA) has encouraged recruitment of arbitrators from diverse segments of the community. *See* Public Investors Arbitration Bar Association, https://secure.piaba.org/piabaweb/html/index.php (last visited Jan. 31, 2008).

18. *See* Gross, *supra* note 14 (noting the limits of the "manifest disregard" standard).

19. *See* Barbara Black & Jill Gross, *The Explained Award of Damocles: Protection or Peril in Securities Arbitration*, 34 SEC. REG. L.J. 17 (2006).

20. *See* Barbara Black, *Do We Expect Too Much From NASD Arbitrators?*, SEC. ARB. COMMENTATOR, Oct. 2004, at 1.

21. Jennifer O'Hare, *Retail Investor Remedies under Rule 10b-5*, 76 U. CIN. L. REV. 521 (2008).

no choice but to view false corporate disclosure as just another cost of investing or to invest in mutual funds—is especially disturbing, in light of Professor Bullard's examination of the legal obstacles confronting mutual fund investors.[22]

Professor Bullard explores the possible impact of *Dura Pharmaceuticals, Inc. v. Broudo*[23] and its interpretation of loss causation on claims asserted by mutual fund investors. He warns that *Dura* could foreclose all private claims against mutual funds, if applied consistently with loss causation involving operating companies. Courts would have to treat "value" and "loss" differently in the mutual fund context to permit claims based on misleading information about their services and sales practices. Professor Bullard concludes that courts should interpret the loss causation requirement in a way that treats mutual funds as both investments and service providers and recognizes that they are fundamentally different from operating companies. Unfortunately, the courts' consistent track record of failing to recognize mutual fund investors' claims[24] gives little reason to be optimistic about how they will apply *Dura* to mutual fund claims.

Why are both categories of retail investors disfavored in the law? Two obvious explanations are politics and policy. Congress and the Securities and Exchange Commission (SEC) are subject to political pressure by well-organized and well-funded groups representing business interests,[25] and retail investors do not have lobbyists on K Street. It may also reflect a decision that strong government enforcement to deter violations is a better policy choice than private securities litigation. In the last twenty years, Congress has consistently increased SEC enforcement remedies[26] and created substantial barriers to private securities litigation.[27]

More fundamentally, I believe that the disfavored treatment of retail investors reflects a deep cynicism not only in our judicial system but

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22. Mercer E. Bullard, Dura, *Loss Causation and Mutual Funds: A Requiem for Private Claims?*, 76 U. CIN. L. REV. 559 (2008).

23. 544 U.S. 336 (2005).

24. *See* Bullard, *supra* note 22, at nn.5–6 and accompanying text.

25. Former SEC Chair Arthur Levitt described the intense pressure he experienced from members of Congress who received political contributions from the accounting industry when he attempted to tighten accounting rules. *See* ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW, WHAT YOU CAN DO TO FIGHT BACK 236–239 (2002).

26. *See, e.g.*, Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified in scattered sections of 15 U.S.C.); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7246 (Supp. V 2005)).

27. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

more generally in our society. In her recent book, *Trust and Honesty*, Professor Tamar Frankel writes of the creation of a culture where fraud and dishonesty become pervasive, accepted, and glorified. [28] In this culture, "*[b]laming the victims establishes a reciprocal arrangement, in which both parties are at fault*."[29] The truth of this statement is illustrated by the law's lack of sympathy for the gullible, unsophisticated investor.[30] According to the law, reasonable investors are expected to possess a certain level of understanding and sophistication to withstand broker-dealer conduct. They should understand the time-value of money, principles of diversification and risk, the securities industry's compensation structure,[31] as well as the differences between securities brokers, investment advisers, and financial planners.[32] Reasonable investors should not succumb to brokers' advertising claims,[33] even though brokerage firms spend millions of dollars in advertising to convince investors that they should be their trusted financial advisors.[34]

Another tactic to shift the blame to investors is to call them "greedy." New York City Mayor Michael Bloomberg, after the bubble burst in the early 2000s, was quoted as condemning as a "disgrace" the alleged fraudulent accounting, but he went on to say that those who have been buying stocks at multiples that "never made any sense" should also look in the mirror: "*They're as responsible, I think, as those who actually committed the crimes of misstating earnings and fudging the numbers.*"[35]

Most illustrative is the late Judge Irving Pollack's dismissal of a securities fraud class action brought by investors who alleged that they were harmed by deceptive recommendations made by securities analysts.[36] Although the plaintiffs' case had difficulties, the vehemence

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28. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD (2006).

29. *Id.* at 35 (emphasis added).

30. *See, e.g.*, Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1033 (2d Cir. 1993) (holding that a widow with a tenth grade education and no prior investment experience could not recover damages from her broker who put her in a limited partnership interest that was unsuitable for her investment objectives because she should have read and understood the prospectus).

31. *See* Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1037 (2002).

32. *See* Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 35–39 (2005).

33. For a devastating critique of the "puffery" 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).

34. *See* Black, *supra* note 32, at 32 (describing how "prime time television advertising extolling the services of brokerage firms has become part of American culture").

35. FRANKEL, *supra* note 28, at 35–36 (emphasis added).

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

in his opinion was stunning. He stated that the plaintiffs wanted:

> to twist the federal securities laws into a scheme of cost-free speculators' insurance. . . . [P]laintiffs 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.[37]

This "blame the investor" sentiment is not new, as this statement from the House of Representatives debate on the Securities Exchange Act of 1934 illustrates: "I also recognize another man who is very largely responsible for the misfortunes of the country and the excessive stock speculation and debacle. That is Mr. American Citizen who wants to get something for nothing."[38] To what extent this unsympathetic treatment of the retail investor is bound up in our culture of rugged individualism[39] or instead is the result of conscious governmental policies[40] is beyond the scope of this brief introduction.

The central theme of this Symposium is fair treatment for investors. All the professors at the Symposium emphasize the importance to the capital markets that investors perceive that they are treated fairly;[41] all of them express, to varying degrees, concerns about investors' fair treatment. Yet retail investors continue to open brokerage accounts and invest in corporate stocks directly or through mutual funds. This raises an issue that may be more sociological than legal. How can we explain investors' continued confidence in the capital markets given the abysmal record of investor protection, particularly in the area of mutual funds, which, at least until the recent market-timing scandals,[42] enjoyed a reputation as the best investment strategy for the retail investor to achieve a well-diversified, well-managed portfolio at low cost? Are they, as Professor O'Hare suggests, simply accepting it as a cost of investing, just like commissions or mutual fund fees? Perhaps, then, as

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37. *Id.* at 358.

38. 78 CONG. REC. 7861, 7862 (1934) (statement of Rep. Lea), *reprinted in* 1 FED. BAR ASS'N, FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933–1982, at 853 (1983).

39. *See, e.g.*, Puckett v. Rufenacht, Bromagen & Hertz, Inc., 587 So.2d 273, 278 (Miss. 1991) (holding that a self-directed investor who lost over $2 million, including his retirement fund, in commodities futures trading had no claim against his broker, reasoning, "One word encompasses all the grandeur and majesty of western civilization. That word is 'freedom.' . . . Not as well recognized, but equally true is that the absolute concomitant of freedom is responsibility.").

40. FRANKEL, *supra* note 28, at 58.

41. On the importance of the participants' perceptions that the process is fair, see Nancy A. Welsh, *Remembering the Role of Justice in Resolution: Insights from Procedural and Social Justice Theories*, 54 J. LEGAL EDUC. 49, 52 (2004).

42. *See* Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 ANN. REV. BANKING & FIN. L. 235, 236 (2006).

Professor Gross states, investors' perceptions that they are being treated unfairly cause them to focus their dissatisfaction on the securities arbitration process as an outlet for their frustration.[43] Accepting these realities, then, it is incumbent that (1) the securities arbitration process is a fair process and is perceived as such, and (2) regulators are vigilant in promulgating investor protection measures and enforcing them aggressively.

The Symposium concluded with a roundtable discussion as a distinguished panel of regulators and practitioners assessed the current state of securities arbitration. I include an annotated synopsis[44] of the participants' remarks because of the importance of the topic. Each participant discusses the current "hot" issues from his or her vantage point and demonstrates that, whatever the drawbacks in the current system, it does not lack for continual reevaluation from the regulators and practitioners in the field.

43. *See* Gross, *supra* note 14. Many investors' claims involving mutual funds are brought in arbitration against the brokers who recommended particular funds to their customers. *Id.*

44. *The Current State of Securities Arbitration*, 76 U. CIN. L. REV. 589 (2008). In addition, the Symposium issue includes a bibliography of selected securities arbitration resources from 1997–2007, updating an earlier bibliography included in the Brooklyn Law Review 10th Anniversary Symposium.