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Making It Up as They Go Along: The Role of Law in Securities Arbitration

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INTRODUCTION

Because of the Supreme Court's 1987 opinion in *Shearson/American Express v. McMahon*[1] validating pre-dispute arbitration agreements ("PDAAs") in customers' brokerage account contracts, most customer disputes[2] are resolved in arbitration in a dispute resolution forum sponsored by a securities self-regulatory organization ("SRO").[3] Self-described as speedy and inexpensive alternatives to litigation,[4] these SRO forums—principally NASD Dispute Resolution ("NASD-DR")[5] and the

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The authors gratefully acknowledge the assistance of the staff of NASD Dispute Resolution, Inc., members of PIABA (Public Investors Arbitration Bar Association) and the general counsel's office of the SIA (Securities Industry Association) in preparing this article. The genesis of this article is a comment regarding the irrelevance of the law made by an arbitrator during a hearing of one of the clinic's securities arbitrations.

1 482 U.S. 220 (1987).

2 *See* GEN. ACCT. OFF., REP. NO. GGD-00-115, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS 30 (2000) [hereinafter 2000 GAO REPORT]. It is sometimes asserted that investors can choose to do business with a broker-dealer firm that does not require an agreement to resolve disputes through arbitration as a condition of opening an account. In the authors' experience, such firms are exceedingly rare. The U.S. General Accounting Office ("GAO") found, since its 1992 report, an increase in the number of broker-dealers that required PDAAs even to open retail cash accounts. *See id.* Nine broker-dealer firms that responded to its survey reported that they required individual investors to agree to resolve their disputes through SRO-sponsored arbitration as a condition of opening most types of accounts. *See id.*

3 SROs are defined in Section 3(a)(26) of the Securities Exchange Act of 1934 ("SEA"), 15 U.S.C. § 78c(a)(26) (1994), and include the national securities exchanges and the National Association of Securities Dealers, Inc. ("NASD"), the largest SRO.

4 NASD Dispute Resolution: What is Dispute Resolution?, *available at* http://www.nasdadr.com/whatdr.asp (last visited Mar. 31, 2002) (touting arbitration as a benefit to parties because it provides a "prompt, inexpensive alternative . . . to litigation in the courts").

5 *See* Press Release, NASD Dispute Resolution, NASD Launches New Dispute

New York Stock Exchange Arbitration Department—have become virtually the only playing fields for resolving customers' disputes with their brokers.[6] Administrators of these forums idealize a system where arbitrators are freed from cumbersome procedural and legal requirements and arrive at fair and just resolutions accepted as final by the parties.[7] In fact, as a consequence of the *McMahon* decision, the arbitration process has come to resemble litigation more closely in terms of its procedures and attendant delays.[8]

Little attention has been paid to the issue of whether, as a result of *McMahon*, arbitrators, in fact, do apply the law to decide disputes. While the Supreme Court assumed that arbitrators could and did apply the law, there is now considerable evidence that they do not. SRO arbitrators receive virtually no training on the complex law governing customer-broker disputes, have no obligation to justify their decisions with sound legal reasoning, and their awards are subject to judicial review on the merits only for "manifest disregard" of the law. Additionally, their awards do not serve as precedent—future arbitration panels cannot rely on previous awards as a source of authority. Indeed, in recent years it has become evident that there are areas where the "law is clear," but arbitrators are regularly arriving at results that appear contrary to the law.[9]

The privatization of the law through securities arbitration since 1987 has serious implications for the orderly and systematic development of the law resolving customer disputes.[10] While development of the law has not yet, at least, been "frozen," courts

Resolution Subsidiary (July 17, 2000), *available at* http://www.nasdadr.com /news/pr2000/ ne_section00_160.html (last visited Mar. 31, 2002). In July 2000, the NASD spun off as a subsidiary company the NASD Regulation Office of Dispute Resolution to administer NASD alternative dispute resolution services, including arbitration and mediation. *See id.* The new company was re-named NASD Dispute Resolution, Inc. ("NASD-DR"). *See id.* NASD-DR also administers dispute resolution for the American Stock Exchange, the Philadelphia Stock Exchange and the Municipal Securities Rulemaking Board. *See id.*

[6] *See* 2000 GAO REPORT, *supra* note 2, at 23. The American Arbitration Association's ("AAA") securities caseload declined significantly after 1990. *See id.* The GAO found 121 securities-related disputes between investors and broker-dealers at five federal district courts; in only fifteen cases did the courts decide the dispute. Seventy percent of the 121 cases were dismissed. *See id.* at 7.

[7] *See, e.g.*, Robert S. Clemente & Karen Kupersmith, *Pillars of Civilization: Attorneys and Arbitration*, 4 FORDHAM FIN. SEC. & TAX L. F. 77, 79-80 (1999).

[8] The increasingly litigious nature of securities arbitration was a principal concern of the Ruder Report. *See* sources cited *infra* notes 78-83 and accompanying text.

[9] *See infra* notes 312-23 and accompanying text.

[10] See Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703 (1999) for an interesting discussion of the privatization of law through arbitration.

have few opportunities to generate relevant precedent.[11] Judicial and administrative opinions generated by the enforcement functions of the Securities and Exchange Commission ("SEC") and the SROs—although they do address standards governing broker-dealer conduct[12]—do not address the legal issues that are frequently the most contested in private suits: whether the relationship between the customer and broker is fiduciary or contractual;[13] the investor's obligation to use diligence (often phrased as "justifiable reliance");[14] and how to measure the investor's damages.[15] Moreover, at a time when the industry is dramatically changing—e.g., sizable increase in the number of retail traders and the volume of retail trading, proliferation of discount brokers, increased volatility in the trading markets, new products, new methods of trading (online) bringing in new customers with different expectations—there are few occasions for the courts to address the issues in dispute among today's customers and brokers. Consequently, the small number of post-1987 precedents assume a disproportionate importance given their scarcity.[16]

These limits on the arbitrators' ability to apply the law raise the question as to whether—despite the Supreme Court's assurances in its *McMahon* decision[17] that investors could vindicate their statutory rights in arbitration—investors are treated fairly in arbitration. At the time of the *McMahon* decision, there was widespread consensus that arbitration was harsh for investors and investors' rights would get lost in the process of removing customer disputes to SRO arbitration.[18]

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[11] *See infra* notes 143-69 and accompanying text. Exceptions generating judicial opinions include decisions on motions to vacate an arbitration award, class actions, and the extraordinary situation where the parties do not invoke the PDAA. *See id.*

[12] *See, e.g.*, SEC v. First Jersey Securities Inc., 101 F.3d 1450 (2d Cir. 1996) (boiler room operations; excessive markups); SEC v. Sayegh, 906 F. Supp. 939 (S.D.N.Y. 1995) (stock manipulation); In the Matter of Joseph Barbato, 69 SEC Docket 169 (Feb. 10, 1999) (material misrepresentations and omissions, unsuitable recommendations and churning).

[13] *See infra* notes 103-07 and accompanying text.

[14] *See infra* notes 110-15 and accompanying text.

[15] *See infra* notes 134-42 and accompanying text.

[16] *See infra* note 169 and accompanying text.

[17] *See infra* notes 34-35 and accompanying text.

[18] The following statement by Justice Blackmun, in his dissenting opinion in *McMahon*, epitomizes this view: "[t]he Court thus approves the abandonment of the judiciary's role in the resolution of claims under the Exchange Act and leaves such claims to the arbitral forum of the securities industry at a time when the industry's abuses toward investors are more apparent than ever." Shearson/Am. Express v. McMahon, 482 U.S. 220, 243 (1987).

Investors' advocates urged Congress to enact legislation to overturn the result. *See, e.g.*, *McMahon Decision Should be Overturned to Protect Investors, House Panel Told*, 20 Sec. Reg. & L. Rep. (BNA) 492 (Mar. 31, 1988). Massachusetts adopted regulations to

Current perceptions about the fairness of these arbitrations vary dramatically. Regulators and attorneys affiliated with the securities industry extol, in particular, the virtues of an efficient and inexpensive alternative to litigation by knowledgeable arbitrators.[19] In contrast, many attorneys who represent investors object to arbitration because of suspicions about the independence of the SRO forums[20] and a belief that arbitration reduces investors' substantive rights.[21] Finally, the perception of some is that arbitration is simply a "total crapshoot."[22]

Congressional concerns about fairness occasioned two studies by the U.S. General Accounting Office ("GAO") in the past decade. In a 1992 report, the GAO reported no findings of a pro-industry bias, but recommended improvements to arbitrator selection and training to provide investors assurance that the

prohibit brokers from insisting on a PDAA as a condition of opening an account, but the SIA was successful in striking them down on preemption grounds. *See* Securities Indus. Ass'n v. Connolly, 883 F.2d 1114 (1st Cir. 1989).

McMahon, however, had many supporters other than the securities industry, many viewing it as necessary to alleviate congestion in the courts, particularly in the aftermath of the October 1987 market crash and the anticipated increase in the number of investors' complaints. See *Connolly*, 883 F.2d at 1116, for an expression of these views.

19 *See, e.g.*, SECURITIES INDUSTRY CONFERENCE ON ARBITRATION ("SICA"), *What is Arbitration?*, *in* ARBITRATION PROCEDURES § 2, *available at* http://www.sec.gov/investor/pubs/arbit2.htm (last visited Mar. 31, 2002) ("dispute... resolved by impartial persons who are knowledgeable in the areas of controversy," and "a prompt and inexpensive means of resolving complicated issues"); Letter from Paul J. Dubow, Chairman of the Arbitration Subcomm. of the Litigation Comm. of the SIA, to Jonathan G. Katz, Secretary, SEC (Dec. 23, 1997), *available at* http://www.sia.com/1997_comment_letters/html/sec97-25.html (last visited Mar. 31, 2002) ("It is widely accepted that arbitration provides both claimants and defendants with an efficient, expedient, lower-cost alternative to litigation.").

20 *See* Seth Lipner, *Ideas Whose Time Has Come: The Single Arbitrator and Reasoned Awards*, SECURITIES ARBITRATION 2000, at 659, 661 (PLI Corporate Law & Practice Course, Handbook Series No. 659, 2000).

21 Whether investors have a right to recover punitive damages has been the issue that the sides have fought over most vociferously. The firms' efforts to enforce PDAAs, culminating in the 1987 *McMahon* decision (discussed *infra* notes 27-40 and accompanying text) is largely explainable by the fact that, until recently, New York law (the choice of law in many broker-dealer agreements) did not permit arbitrators to award punitive damages. *See* Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354 (1976). In *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995), however, the Supreme Court ruled that a general choice of law provision did not provide clear notice to investors that they were giving up a right to claim punitive damages. While the New York Court of Appeals has not yet overruled *Garrity*, most Appellate Division cases have abandoned the *Garrity* rule and have allowed for the award of punitive damages. *See, e.g.*, Americorp Sec., Inc. v. Sager, 239 A.D.2d 115 (1st Dep't 1997). Amicable resolution of the punitive damages issue has not yet been achieved. The Ruder Report recommended a cap on punitive damages, and a proposed NASD rule sought to implement this recommendation, but the rule has not been adopted.

22 Julie Rawe, *Broker Poker*, TIME, June 25, 2001, at Y15 (quoting Deborah Bortner, Washington State's chief securities regulator).

arbitrators were fair and competent.[23] Subsequently, a 2000 report stated there was no basis to make any conclusions about the fairness of SRO arbitration proceedings.[24] The GAO noted that investors did not receive as high a percentage of favorable arbitration awards during any year from 1992 through 1998 as they had during the previously surveyed period of January 1989 through June 1990, and that the percentage of the amounts claimed that was awarded also declined during this period. However, the Report also noted that the increase in the percentage of cases settled during the latter period may have changed the mix of cases advancing to final award.[25] Moreover, the GAO stated that it could not assess the fairness of SRO arbitration by comparing it to other forums, because the caseloads at an independent forum (AAA) and at the courts were too small.[26]

What is the current role of the law in securities arbitration? Given the difficulties investors would encounter in pleading and proving their claims in court, they may well be better off in a system where less attention is paid to the law and more to the equities of the actual dispute before the arbitration panel. While this is not a system where accountability and predictability of results can be achieved, investors may, in fact, fare better than they might expect. It follows then that if equitable considerations enhance rather than subtract from investors' chances of recovery, then investors need not worry about the consequences of the arbitrators' failure to apply the law.

I. DO ARBITRATORS HAVE TO APPLY THE LAW?: *MCMAHON*

In its 1987 opinion, *Shearson/American Express Inc. v. McMahon*,[27] the Supreme Court overturned long-standing precedent and held that PDAAs were legally binding, despite section 29(a) of the Securities Exchange Act ("SEA") invalidating "any condition, stipulation, or provision binding any person to waive compliance" with any provision of the statute.[28] Section

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[23] GEN. ACCT. OFF., REP. NO. GGD-92-74, SECURITIES ARBITRATION: HOW INVESTORS FARE 6-9 (1992).

[24] *See* 2000 GAO REPORT, *supra* note 2, at 4.

[25] *See id.* at 23-25.

[26] *See id.* at 5.

[27] 482 U.S. 220 (1987).

[28] *McMahon's* holding technically applied only to SEA claims. Two years later, the Court, as expected, extended its holding to claims arising under the Securities Act of 1933. *See* Rodriguez de Quijas v. Shearson/Am. Express Inc., 490 U.S. 477 (1989).

29(a), in the view of the Court, prohibits waiver of the statute's substantive obligations[29] and has no applicability to section 27, which confers exclusive jurisdiction for violations of the SEA and its rules on federal courts. The Court explained its 1953 decision in *Wilko v. Swan*,[30] in which it reached the opposite conclusion in interpreting similar language in the Securities Act ("SA"), as based on its previous judgment that arbitration was inadequate to enforce the substantive rights created by the statute. The *Wilko* Court specifically noted aspects of the arbitration process that may lessen the Act's substantive protections: arbitration proceedings were not suited for cases requiring "subjective findings on the purpose and knowledge of an alleged violator"; arbitrators must make legal determinations "without judicial instruction on the law"; an arbitration award "may be made without explanation of [the arbitrator's] reasons and without a complete record of their proceedings"; the "power to vacate an [arbitration] award is limited," and "interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation."[31]

Thirty-six years later, the Court looked at the current arbitration process and concluded that it now provided an adequate means of enforcing the statutory provisions.[32] The Court noted that it more recently had recognized, in opinions enforcing arbitration clauses in other areas of the law,[33] that arbitral tribunals can handle factual and legal complexities without judicial instruction and supervision and that the streamlined procedures did not curtail the claimant's substantive rights.[34] Thus, in rejecting McMahon's contention that the arbitration process could not fairly vindicate his federal statutory rights, the Court stated that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum."[35]

[29] Therefore, a provision in the customer's agreement explicitly stating that federal securities law would not be applicable in resolving disputes between the customer and the broker would violate this provision.

[30] 346 U.S. 427 (1953).

[31] *Id.* at 435-37.

[32] The *McMahon* Court characterized the *Wilko* Court's concerns as "reflect[ing] a general suspicion of the desirability of arbitration and the competence of arbitral tribunals," a view not specifically related to federal securities claims and no longer adhered to by the Court. *McMahon*, 482 U.S. at 231.

[33] *See, e.g.*, Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985) (upholding the arbitrability of federal antitrust claims).

[34] *See McMahon*, 482 U.S. at 229-30.

[35] *Id.* (quoting *Mitsubishi*, 473 U.S. at 628). The Court frequently has repeated this very phrase to endorse arbitration of other federal statutory claims. *See, e.g.*, Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 23 (1991) (ADEA claims); Rodriguez de

In support of this conclusion, the Court observed: "there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute."[36] The Supreme Court had flipped: in *Wilko* the lack of meaningful judicial review (other than for "manifest disregard" of the law[37]) supported its view that arbitration could not preserve investors' rights under the law, whereas in *McMahon* the limited amount of judicial review ensured that investors could be protected.

Crucial to the Supreme Court's opinion was the assumption that arbitrators must and do apply the law, at least with respect to federal statutory claims.[38] However, this assumption loses some force when considered in the context of the state law rule, that, at least in some states, unless the parties agree otherwise, arbitrators are **not** bound by the law and need **not** apply substantive principles of law when deciding disputes. Rather, these states acknowledge that an arbitrator "may do justice as he sees it, applying his own sense of law and equity to the facts as he finds them to be and making an award reflecting the spirit rather than the letter of the agreement [to arbitrate]. . . ."[39]

The Court's views on arbitration had changed from distrust to acceptance of the process. Moreover, in the specific area of securities arbitration, the Court pointed to changes in the SEC's regulatory authority since *Wilko* to ensure the adequacy of the SROs' arbitration procedures.[40] One explanation is that the Justices believed that the characteristics (principally, speed and informality) that previously made arbitration deficient because it was not the functional equivalent of a judicial proceeding had

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Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 483-84 (1989) (SA claims).

[36] *McMahon,* 482 U.S. at 232.

[37] *See infra* notes 262-64 and accompanying text.

[38] In fact, this assumption has been widely challenged since the *McMahon* opinion. *See, e.g.*, Ware, *supra* note 10, at 719-25; John F.X. Peloso & Stuart M. Sarnoff, *Whether Arbitrators Have a Duty to Apply the Law*, N.Y. L.J., Apr. 18, 1996, at 3.

[39] Silverman v. Cooper, 61 N.Y.2d 299, 308 (1984); *accord* Moncharsh v. Heily & Blasé, 832 P.2d 899 (Cal. 1992); Schnurmacher Holding, Inc. v. Noriega, 542 So.2d 1327, 1328 (Fla. 1989). This may explain why at least one firm has added language to its PDAA expressly requiring arbitrators to "resolve the dispute in accordance with applicable law." PDAA, New Account Form, Raymond James Financial Services, Inc. (on file with authors).

[40] *See McMahon*, 482 U.S. at 233-35. For example, the Court noted that, in 1975, Congress amended the SEA to allow the Commission to reject any proposed SRO rule change if not consistent with the objectives of the statute. *See id.* at 233 (citing 15 U.S.C. § 78s(b)(2) (1994)). The Court added: "[e]ven if *Wilko's* assumptions regarding arbitration were valid at the time *Wilko* was decided, most certainly they do not hold true today . . . ." *Id.*

become virtues that made arbitration an attractive alternative. If this explanation is true, we would expect subsequent regulatory developments to focus on enhancing the virtues of the process yet ensuring that arbitrators apply the law. In fact, this is not what has happened. Instead, the regulatory approach has been to make the arbitration process more closely resemble a judicial proceeding and to ignore the issue of the application of the substantive law.[41]

The following section tracks the evolution of the arbitration process, through amendments to the pertinent securities arbitration codes of procedure, from an informal proceeding into a quasi-judicial one. Subsequently, the authors examine the practical difficulties arbitrators encounter in their efforts to apply the law.

II. ARBITRATION PROCEDURES BECOME MORE LIKE LITIGATION

A. *Arbitration Procedures at the Time of* McMahon

In 1977, the SEC asserted a need for a nationwide investor dispute resolution system to resolve expeditiously small claims; it noted that investors with large claims apparently found litigation a feasible method of seeking redress.[42] As a result the Securities Industry Conference on Arbitration ("SICA")[43] was organized, consisting of representatives of the SROs, the public, and the Securities Industry Association ("SIA").[44] SICA first developed a Uniform Code of Arbitration that the SROs adopted in 1979-1980.[45] While each SRO must approve changes in its procedural rules and submit the changes to the SEC for approval, and while the SROs have not always adopted all the SICA proposals, until

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41 There have been other changes in the SRO arbitration process that seek to alleviate investor distrust of the process, such as the procedure for allowing parties to select their arbitrators. While the composition and selection of arbitrators raise interesting legal issues, they are not addressed in this Article except to make the point that they also contribute to the increasing delays in the arbitration process.

42 *See* Implementation of an Investor Dispute Resolution System, Exchange Act Release No. 34-13470, 12 SEC Docket 186 (Apr. 26, 1977).

43 *See* Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 488-90 (1996) (setting forth the background on the creation of SICA).

44 *See* About SIA, Securities Industry Association Website, *available at* http://www.sia.com/about_sia/index.html (last visited Jan. 11, 2002). The SIA is the principal trade organization of securities firms in the United States and Canada, and counts more than seven hundred firms as members. *See id.*

45 *See* In re NASD, Order Approving Proposed Rule Change, Exchange Act Release No. 34-16860, 20 SEC Docket 233 (May 30, 1980).

very recently the NYSE and NASD versions of the Uniform Code remained generally the same.

Immediately prior to *McMahon*, the arbitration procedures in effect at the NASD[46] were very informal.[47] The provisions on discovery were aspirational: "prior to the first hearing session, the parties shall cooperate in the voluntary exchange of such documents and information as will serve to expedite the arbitration."[48] Moreover, the Code instructed that "the parties shall produce witnesses and present proofs to the fullest extent possible without resort to the issuance of the subpoena process,"[49] although the arbitrators and any counsel of record had the power of the subpoena process as provided by applicable law.[50] The only provisions relating to the hearing set forth what was not required: arbitrators were not bound by rules of evidence governing the admissibility of evidence,[51] and no record of the proceeding was required, unless requested by the arbitrators or a party.[52]

B. *SEC Staff Recommendations after* McMahon

Soon after *McMahon*, SEC staff sent a list of recommended changes to the arbitration procedures to SICA.[53] In the exchange between the SEC staff and SICA culminating in changes in the SRO arbitration rules approved by the SEC, the competing visions

46 This section focuses on the arbitration procedures at the dispute resolution arm of the NASD (now known as NASD-DR), because it is the SRO forum where most investors' claims are heard. NASD-DR reports that it handles more than 90 percent of all securities-related disputes through its dispute resolution services. *See* Press Release, NASD-DR, NASD Dispute Resolution To Provide Arbitration Awards Online (May 10, 2001), *available at* http://www.nasdadr.com/news/pr2001/ne_section01_019.html (last visited Mar. 31, 2002).

47 *See* Deborah Masucci & Edward W. Morris, Jr., *Securities Arbitration at Self-Regulatory Organizations: Administration and Procedure*, *in* SECURITIES ARBITRATION 1988, at 309, 399 (PLI Corp. Law & Practice Course, Handbook Series No. 601, 1988). The NASD's Code of Arbitration Procedure in effect in July 1987 is set forth as Exhibit 24. *See id.* at 399. Part III governs customers' disputes with broker-dealers. *See id.* at 406.

48 NAT'L ASSOC. OF SECURITIES DEALERS, CODE OF ARBITRATION PROCEDURE § 32(b), *in* NASD MANUAL (CCH) (1987) [hereinafter NASD CODE 1987].

49 *Id.* § 32(a).

50 *See id.*

51 *See id.* § 34.

52 *See id.* § 37.

53 Letter from Richard G. Ketchum, Director of Division of Market Regulation, SEC, to SICA members, *in* Mark D. Fitterman, Catherine McGuire, & Robert A. Love, *SEC Initiatives for Changes in SRO Arbitration Rules*, SECURITIES ARBITRATION 1988, at 257, 279 app. A (PLI Corp. Law & Practice Course, Handbook Series No. 601, 1988). In addition to those discussed in the text, many of the recommendations related to expanding the pool of arbitrators who are not affiliated with the securities industry and other issues relating to arbitrator selection and qualification.

of securities arbitration are delineated. The SEC staff contemplated a process that was more judicial than the SICA (and SRO) vision: not only would arbitration involve a hearing where the parties would present evidence obtained through a discovery process, but also the arbitrators would apply the law to arrive at a decision. The SEC, moreover, assumed that arbitration would not become the exclusive forum for resolution of investors' complaints.[54]

Specifically, the SEC staff recommended that:

- Discovery procedures should be expanded to resolve discovery disputes prior to the hearing;[55]
- Pre-hearing and preliminary conferences should be held in complex cases;[56]
- Arbitrators should be trained in the relevant state and securities law;[57]
- A record of the proceedings should be preserved for judicial review of awards, using what the SEC staff referred to as the "developing 'manifest disregard' standard;"[58]
- Arbitrators should include in the awards a summary of legal issues resolved in a dispute and to indicate whether the arbitrators concur or dissent from the award;[59]
- Awards should be made publicly available, so that investors can check the track record of arbitrators and the public can evaluate the system;[60]
- Special guidelines for administration of large and complex cases are needed, and parties could ask for opinions, so that a body of precedent could be created.[61]

C. *SICA's Response*

In its response,[62] SICA expressed its vision of the post-*McMahon* arbitration process. It agreed with the need for a

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[54] *See infra* note 70 and accompanying text.
[55] *See* Fitterman et al., *supra* note 53 at 287.
[56] *See id.*
[57] *See id.* at 282.
[58] *Id.* at 286.
[59] *See id.*
[60] *See id.*
[61] *See id.* at 290.
[62] *See id.* at 293 (letter set forth as Appendix B).

discovery rule, a pre-hearing conference in large and complex cases, and preservation of a record.[63] With respect to other recommendations, it showed less enthusiasm. SICA acknowledged generally the importance of training arbitrators, but did not directly address the SEC staff's recommendations that arbitrators receive instruction in the law.[64]

With respect to awards, SICA believed that the Commission's concerns could be addressed by maintaining a list of cases, the general subject matter of each case, the amount of the claim and award, the names of the arbitrators and a notation if the claim was dismissed on jurisdictional grounds. This list would delete the names of parties and would only be available to parties in pending cases and their counsel.[65] SICA pointed out, however, that this information "will serve little utility and may mislead parties regarding an arbitrator's track record."[66] Indeed, SICA suggested that it was "not reasonable to conclude that awards written in the manner [SEC staff] suggest could capture the decision making process of a panel."[67]

With respect to the recommendation for written opinions in large cases, SICA was blunt: "any rule which purports to require written opinions . . . could very well hinder, rather than enhance, the administration of arbitration proceedings."[68] It expressed concern that this would decrease the willingness of arbitrators to participate, and might interfere with parties' expectations that arbitration proceedings were confidential.

D. *Post-*McMahon *Arbitration Procedures*

In 1989, the SEC approved significant changes in SRO rules,[69] but made it clear that it continued to have concerns about the process. It implied that its views on the fairness of arbitration might change if it became, de facto, the exclusive forum for

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[63] *See id.* at 298-99.

[64] The letter merely commented, in response to a specific suggestion of a periodic newsletter about developments in arbitration, that this should be left to the discretion of the individual SROs. *See id.* at 296.

[65] *See id.* at 298.

[66] *Id.* at 299.

[67] *Id.*

[68] *Id.* at 303.

[69] *See* Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release 34-26805, 54 Fed. Reg. 21144 (May 10, 1989).

investors.[70] It signaled that it awaited further changes, noting that SICA was still considering its recommendations regarding the training of arbitrators, the evaluation of arbitrators' performance, and additional procedures for large and complex cases. The SEC stressed the need for development of judicial precedent in cases involving novel legal theories or challenging established industry practices.[71] To the SEC, it was also important that the public understand the arbitration process, in contrast to the SROs' traditional view of arbitration as a confidential matter between the parties.

Discovery. A new rule provided for a discovery process that would allow parties to obtain information and documents in sufficient time to prepare for a hearing.[72] Arbitrators would be involved in the discovery process through a pre-hearing conference between the parties and the arbitrators, and at least one arbitrator would participate in settling discovery disputes. Limited use of depositions was also authorized.

Record of Hearing. Another rule provided that a verbatim record of a hearing must be kept, either by stenographic reporter or tape recording,[73] for judicial review of the proceedings.

Awards. Finally, a new rule expanded both the contents and the public availability of arbitration awards,[74] but did not require that arbitrators set forth reasons for their decisions. The SEC indicated that this might be an issue that it would revisit, and it stated that it expected SICA to consider making opinions a requirement in large and complex cases.

This comparison of the pre-*McMahon* and post-*McMahon* Codes demonstrates that the changes made the process more like litigation (discovery, pre-hearing conference, publication of awards, requirement of a hearing record). SEC recommendations

[70] *See id.* At that time an SEC survey showed that only 39 percent of cash accounts required a PDAA. "The continuation of such investor access to brokerage services without having to sign a PDAA is a significant factor in the Commission's evaluation of this matter." *Id.*

[71] *See id.*

[72] *See* NAT'L ASSOC. OF SECURITIES DEALERS, CODE OF ARBITRATION PROCEDURE § 32, *in* NASD MANUAL (CCH) (1989) [hereinafter NASD CODE 1989]. The Code reflecting the 1989 rule changes is set forth as Exhibit 20 to Deborah Masucci and Edward W. Morris, Jr., *Arbitration at the National Association of Securities Dealers and the New York Stock Exchange*, SECURITIES ARBITRATION 1989, at 437, 530 (PLI Corp. Law & Practice Course, Handbook Series No. 650, 1989). For a current version of the Code that includes the 1989 amendments, see NAT'L ASSOC. OF SECURITIES DEALERS, CODE OF ARBITRATION PROCEDURE § 10321 (2002), *available at* http://www.nasdadr.com/arb_code/arb_code.asp (last visited Mar. 31, 2002) [hereinafter NASD CODE 2002].

[73] *See* NASD CODE 1989, *supra* note 72, § 37.

[74] *See id.* § 41.

that relate to training arbitrators in the law they should apply or requiring arbitrators to state the law they are applying were, in contrast, not adopted.

E. *More Recent Developments*

Securities arbitration practice has continued to become more and more like litigation. Motion practice has become standard, although controversy exists about whether pre-hearing motions to dismiss are permitted under the Code.[75] In 1995, NASD adopted a rule providing special procedures for large and complex cases.[76] The rule is designed to facilitate settlement discussions and orderly management of the arbitration process, but it does not provide a device for referring legal issues to a judicial forum, nor does it require arbitrators to set forth reasons unless all the parties specifically agree.

Moreover, at the NASD, significant rule changes have transformed the process of arbitrator selection, so that the parties mutually agree upon the arbitrators. This rule change was in response to continuing doubts about the independence of the SRO forum.[77] The NASD has described this change as the one that claimants' attorneys most wanted; an unfortunate consequence, however, has been to create further delays in the arbitration process.

F. *The Ruder Report's Recommendations*

The Board of Governors of the NASD appointed an Arbitration Policy Task Force in 1994 to study the arbitration process and make suggestions for its reform. The Task Force's report, widely known as the "Ruder Report" after its Chair, former SEC Chair David S. Ruder, confirmed that arbitration had

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[75] The controversy involves the interpretation of NASD Code § 10303 and its requirement of a "hearing." *Sheldon v. Vermonty*, 269 F.3d 1202 (10th Cir. 2001), held that a NASD arbitration panel can grant a pre-hearing motion to dismiss with prejudice based solely on the parties' pleadings, without permitting claimant discovery, so long as the dismissal does not deny a party fundamental fairness. Since the panel gave claimant an opportunity to brief and argue the motion to dismiss, the court concluded he was provided with a fundamentally fair arbitration proceeding. *See id.* at 1207.

[76] *See* NASD CODE 2002, *supra* note 72, § 10334. This rule has not been frequently used and is not viewed as a success.

[77] *See* Cheryl Nichols, *Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias*, 15 OHIO ST. J. DISP. RESOL. 63, 67 (1999).

become more litigious[78] and expressed concern that "the increasingly litigious nature of securities arbitration has gradually eroded the advantages of SRO arbitration."[79]

The Report sets forth a number of recommendations that seek to improve the efficiency of the process, including the expansion of a voluntary mediation program to prove a more informal alternative to arbitration![80] The Ruder Report attempts to find a middle ground for arbitration, retaining its traditional advantages and yet meeting the demand for increased professionalism.[81] The Report assumes, but does not closely examine the question, that arbitrators should be applying the law; this is made clear in its recommendation that arbitrators should receive more training in substantive law.[82] Its most explicit statement to this effect is found in a note: "Although we recognize that arbitration generally is considered to be an equitable forum, we believe that arbitrators *should consider* applicable statutory and common law with respect to all matters as to which they must make decisions in the arbitration forum. . . ."[83]

The Ruder Report's recommendations on punitive damages, the most hotly debated issue between the sides, illustrate its ambivalence. Investors assert that they should have the same right to recover punitive damages in arbitration as they have in court. Brokers, on the other hand, assert that punitive damages are inappropriate in arbitration because procedural safeguards and the right of appeal are limited.[84] The Ruder Report recommends that

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[78] *See* SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (1996) [hereinafter RUDER REPORT] at 7. The Report lists several factors commonly cited as contributing to litigious arbitration: (i) significant increase in motion practice relating to discovery, eligibility, statutes of limitations, and other pre-hearing matters; (ii) a "somewhat intangible, but widely perceived" increase in a lawyering approach to arbitration, illustrated by extensive discovery requests, stonewalling on responses to discovery, and attempts to delay hearings for tactical reasons; (iii) resort to the courts, frequently to challenge the eligibility of a claim for arbitration or to assert a statute of limitations defense; (iv) a departure from the relaxed evidentiary and procedural standards that were meant to guide arbitration; and (v) hearings that take longer than the one or two days expected for resolution of customer claims. *Id.*

[79] *Id.*

[80] *See id.* at 47.

[81] *See, e.g., id.* at 88 (discussing the need for a more professional corps of arbitrators).

[82] *See id.* at 108-10.

[83] *Id.* at 31 (emphasis added).

[84] Recent Supreme Court holdings announcing due process limitations on the award of punitive damages lend support to these arguments. *See* Cooper Indus., Inc. v. Leatherman Tool Group, Inc., 532 U.S. 424 (2001). Circuit courts have split on whether due process limitations are applicable in securities arbitration. *Compare* Glennon v. Dean Witter, 83 F.3d 132 (6th Cir. 1996) (assumes due process concerns are applicable), *with* Davis v. Prudential Securities, Inc., 59 F.3d 1186 (11th Cir. 1995) (asserts due process concerns are not applicable).

investors be able to recover punitive damages in arbitration in situations where courts in the relevant state would award them (even if the relevant state did not recognize the authority of arbitrators to award punitive damages), but the amount of punitive damages awarded in arbitration should be capped.[85] This result can be described as the arbitrators considering the local law, but not applying it.

In sum, the SEC and SROs have spent considerable time and effort since *McMahon* to amend procedural rules governing securities arbitrations—all in the name of neutrality and fairness. By contrast, little change has occurred in the area of substantive law; i.e., adding substantive protections to ensure that the arbitrators are in fact applying the law and thus vindicating statutory rights of claimants according to the Supreme Court's mandate. As discussed below, the current ability of arbitrators to apply the law governing customer-broker disputes is limited by numerous factors.

III. LIMITS ON THE ARBITRATORS' APPLICATION OF THE LAW

Embedded in the Supreme Court's assumption in *McMahon* that the arbitrators will apply the law is another assumption: that the law is sufficiently clear so that arbitrators, even those who are not trained as lawyers, can apply it to the facts of the individual case with some instruction by the SROs, supplemented, if necessary, with legal briefs submitted by counsel representing the parties.[86] Unfortunately, neither in 1987 nor since has the law been that clear, and the SROs provide virtually no instruction on applicable law. Even if the arbitrators request parties to brief the legal issues, an arbitrator faced with legal briefs asserting conflicting positions on the law may well be hard pressed to "apply the law." While SRO rules authorize the arbitrators to dismiss an arbitration proceeding and "refer the parties to their judicial remedies,"[87] our research has found no case where the arbitrators

[85] *See* RUDER REPORT, *supra* note 78, at 36-45.

[86] In an article predating the boom in the privatization of the law, Professor William M. Landes and Professor (now Judge) Richard A. Posner examined the dispute resolution and rule creation functions of adjudication from an efficiency perspective. William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 249 (1979) (arguing commercial arbitration works best when the rules are clear and the only issue is their application to the facts).

[87] NASD CODE 2002, *supra* note 72, § 10305(a). The Rule permits arbitrators, either upon their own initiative or at a party's request, to dismiss cases without prejudice and refer the parties to their judicial remedies. The Arbitrator's Manual indicates that

have done this because they believed that the law was too uncertain or even unknown.

A. *The Law Governing Broker-Dealer Conduct Is Complex*

The theoretical underpinnings for the law governing the relationship between broker-dealers and their customers are a complex mixture of federal securities statutes,[88] state securities statutes, and state common law principles of contract, agency, and fiduciary duties. Courts have inconsistently asserted that the relationship between a broker and its customer is largely controlled by federal securities laws, on the one hand, and principally a matter of state contract law, on the other.[89] This section first contrasts the general theories of imposing liability under federal and state law and then discusses the legal principles relating to the most common customers' claims and with respect to damages.

Federal Law. Any discussion of a broker's duties to its customers under federal securities law must start with the "shingle theory," developed by the SEC under the antifraud provisions of the federal securities laws as a unitary principle underlying the broker-dealer's responsibilities to its customers.[90] By holding itself out as a broker-dealer, the broker represents that it will treat its customers fairly and professionally. What constitutes fair and professional conduct may be embodied in the securities industry's own rules of fair conduct, as, for example, the broker's obligation to have a reasonable basis for any recommendations and a broker's obligation to charge fair prices.

The "shingle theory," with its emphasis on professional standards, however, developed prior to the Supreme Court's emphasis on the necessity of fraud under section 10(b) and Rule

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arbitrators may exercise this authority when, among other reasons, the case involves "substantial legal issues for which the establishment of a legal precedent is important." *See infra* note 246 and accompanying text at 8.

[88] For example, see Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994), and 17 C.F.R. § 240.10b-5 (1999).

[89] *Compare* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 444 (2d Cir. 1971) (characterizing customer's claim that broker improperly liquidated account to meet margin deficiency as "nothing more than a garden-variety customer's suit against broker for breach of contract") *with* Guice v. Charles Schwab & Co., 89 N.Y.2d 31, 46-47 (1996) (stating that customer's common law breach of fiduciary duty claims regarding broker's receipt of order flow payments are preempted by federal regulation; allowing the state claim would defeat congressional purpose of a "coherent regulatory structure" for a national market system).

[90] *See* Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943).

10b-5. While the Supreme Court, beginning in the mid-1970s, was actively engaged in developing the elements of the implied cause of action under Rule 10b-5, only a few of the significant cases involved allegations of broker-dealer misconduct toward customers,[91] and none of them examined the implications of securities fraud on the "shingle theory."[92]

To establish federal securities fraud under section 10(b) and Rule 10b-5, the investor must establish that the broker acted with scienter[93] and deception.[94] The Supreme Court has not yet defined what level of culpability establishes scienter, but it requires at least reckless conduct.[95] Moreover, it is not clear whether the element of deception is present if a broker's unprofessional conduct is fully disclosed.[96]

State law. Brokers may be liable for misconduct under a number of state law theories, either in tort or in contract. A broker may be liable for intentional misstatements of material fact as common law fraud[97] or under state securities law.[98] In addition, some states may allow for holding brokers liable for negligent misstatements, either under common law[99] or the state securities

[91] *See* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985) (dealing with the in pari delicto defense in inside trading); Aaron v. SEC, 446 U.S. 680 (1980) (involving failure to supervise brokers who made unfounded recommendations, although the facts played no part in the Court's abstract treatment of the legal issue, standard of culpability under § 17(a) of the Securities Act); Dirks v. SEC, 463 U.S. 646 (1983) (involving an inside trading case and the liability of "tippee"); Pinter v. Dahl, 486 U.S. 622 (1988) (involving an instance where an investor sued a broker, but the issue in the case, the definition of "seller," focused on the activities of the plaintiff).

[92] One commentator has questioned whether the shingle theory is still a viable theory of relief for private investors. *See* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995).

[93] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[94] *See* Santa Fe Indus. v. Green, 430 U.S. 462 (1977).

[95] The Supreme Court has left open the question of whether recklessness constitutes scienter. *See Hochfelder*, 425 U.S. at 193, n.12.

[96] *See* Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247 (1983).

[97] In New York, to establish fraud, plaintiff must establish (i) a misrepresentation of a material fact; (ii) the falsity of that misrepresentation; (iii) scienter, or intent to defraud; (iv) reasonable reliance on that representation; and (v) damages caused by that reliance. *See* Granite Partners, L.P. v. Bear, Stearns & Co., 58 F. Supp. 2d 228, 257 (S.D.N.Y. 1999). *But see* Gordon & Co. v. Ross, 84 F.3d 542 (2d Cir. 1996) (holding that the standard is not reasonable reliance, but justifiable reliance, which is a lower standard). A plaintiff must prove every element by clear and convincing evidence. *See* Leucadia, Inc. v. Reliance Ins. Co., 864 F.2d 964, 971 (2d Cir. 1988) (citing Hutt v. Lumbermens Mut. Casualty Co., 95 A.D.2d 255 (2d Dep't 1983)).

[98] In New York, there is no private right of action under the state securities law (the Martin Act). *See* CPC Int'l v. McKesson Corp., 70 N.Y.2d 268 (1987).

[99] In New York, the elements of negligent misrepresentation under common law are "carelessness in imparting words upon which others were expected to rely and upon which they did act or failed to act to their damage," and the author must express the information

statute.[100] A broker's liability for conduct not involving misrepresentations may be premised on breach of contract[101] or breach of fiduciary duty theories.[102]

In New York, as in many states, there is considerable discussion about the circumstances that create a fiduciary relationship between a customer and his broker.[103] There is general agreement that the ordinary broker-customer relationship, by itself, does not impose duties on the broker beyond those specifically entrusted to him.[104] A discount broker's duties to its customers are generally limited by the contract, in recognition that the customer pays reduced commissions for reduced attention.[105] In contrast, where the customer entrusts his broker with discretion over the account, courts generally find that a fiduciary relationship exists.[106] Between these two extremes, the cases are intensely fact specific and provide little predictive value. Factors—a long standing business or personal relationship, for example—may make it reasonable for the customer to expect that the relationship between him and his broker is not simply one of contract, but one of trust and confidence;[107] this is sometimes referred to as the "special circumstances" doctrine.

Common Claims of Broker Misconduct. The next section summarizes the legal issues involved in the most common customers' claims, what are frequently referred to colloquially as

"directly, with knowledge or notice that it will be acted upon, to one to whom the author is bound by some relation of duty... to act with care if he acts at all ...." White v. Guarente, 43 N.Y.2d 356, 363 (1977). The New York intermediate appellate courts have split over whether the state's securities law (the Martin Act) bars a securities claim for negligent mispresentations. *See* Cromer Finance Ltd. v. Berger, Fed. Sec. L. Rep. (CCH) ¶ 91,550 (S.D.N.Y. 2001) (discussing cases).

[100] Florida's securities statute allows recovery for negligent misrepresentations. *See* Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1046 (11th Cir. 1987).

[101] Courts sometimes also discuss claims sounding in negligence (tort), but a duty of reasonable care arises because of a contract between the parties.

[102] Breach of agency is also frequently asserted, but since that involves either a breach of contract or a breach of fiduciary duty, it is not analyzed separately here.

[103] New York cases are reviewed in De Kwiatowski v. Bear Stearns & Co., 126 F. Supp. 2d 672, 690-696 (S.D.N.Y. 2000). While there has been doubt whether New York recognized breach of fiduciary duty claims in connection with the sale of securities, recent decisions have allowed it. *See* Scalp & Blade, Inc. v. Advest, Inc., 281 A.D.2d 882 (4th Dep't 2001).

[104] *See* Bissell v. Merrill Lynch & Co., 937 F. Supp. 237, 246 (S.D.N.Y. 1996); Rush v. Oppenheimer & Co., 681 F. Supp. 1045, 1055 (S.D.N.Y. 1988) (quoting Fey v. Walston & Co., 493 F.2d 1036, 1049 (7th Cir. 1974)).

[105] *See* Unity House v. N. Pac. Inv., 918 F. Supp. 1384 (D. Ha. 1996).

[106] *See* McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 766 (3d Cir. 1990).

[107] See NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION §§ 2.01-2.02 (1995), for a good discussion on the topic. The courts sometimes talk of a "fiduciary relationship" between the broker and customer, when it seems that on a breach of contract theory the broker would be liable.

"SCUM" claims: suitability, churning, unauthorized trading and misrepresentations, and the law relating to damages. While there are many cases (most of them decided before *McMahon*) analyzing these claims, the law is far from settled.

Misrepresentations. To prevail on a fraud claim under federal law, the investor must establish that the broker, with scienter,[108] made misstatements of material facts or omitted to disclose material facts when he had a duty to do so (deception)[109] on which the investor justifiably relied in connection with the purchase or sale of securities.[110]

The investor must establish justifiable reliance as an element of his case.[111] Courts have identified numerous factors to take into account in determining whether the investor's claim should be barred because of his own lack of diligence:

> (1) the sophistication and expertise of the [investor] 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 [investor] initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.[112]

At a minimum, an investor cannot justifiably rely on a misrepresentation "where its falsity is palpable."[113]

Nevertheless, while courts state that no one factor is determinative, they do not hesitate to find as a matter of law that investor's reliance on oral statements is not justified where he has received documents disclosing the risks.[114] The level of care expected of an investor has not been authoritatively established; most cases state that an investor cannot recover if, on an objective investor standard, his conduct was reckless.[115]

Alleged misstatements of material fact by a broker may also

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[108] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

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

[110] *See* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993). Under the Private Securities Litigation Reform Act ("PSLRA") § 21D(f)(10)(A)(i)(II), to find a defendant "knowingly committed" a violation of the securities law requires not only "actual knowledge" that the statement is false, but also that "persons are likely to reasonably rely" on it. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 743.

[111] *See generally* Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985).

[112] Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983).

[113] Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976) (en banc), *cert. denied*, 430 U.S. 955 (1977).

[114] *See, e.g.*, *Zobrist*, 708 F.2d at 1511; *Brown*, 991 F.2d at 1020.

[115] *See Brown*, 991 F.2d at 1032.

give rise, as discussed above, to state law claims based on fraudulent[116] or negligent misrepresentations,[117] although the elements the investors must prove and the available defenses may vary from state to state.

Suitability. A broker, in recommending a security to a customer or in making purchases in a discretionary account, "shall have" reasonable grounds for believing that the recommendation or purchase is suitable for the customer and "shall make" reasonable efforts to obtain relevant information to make such a determination, including information concerning the customer's financial status, tax status, and investment objectives.[118]

In order to establish federal securities fraud based on unsuitable recommendations, the investor must establish more than unsuitable recommendations by a broker, he must also establish that the broker acted with scienter and that the customer justifiably relied on the broker's fraudulent conduct.[119] It is not clear whether unsuitable purchases made by a broker for a discretionary account constitute federal securities fraud where the broker had made no misrepresentations, given the Supreme Court's emphasis on "deception."[120] Claims of unsuitable recommendations or purchases may also be brought under state law either as misrepresentation claims[121] or as claims for breach of fiduciary duty.[122]

Churning. Churning is excessive trading by a broker in a

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[116] *See supra* note 97 and accompanying text.

[117] *See supra* notes 99-100 and accompanying text.

[118] NAT'L ASSOC. OF SECURITIES DEALERS, CONDUCT RULES § 2310, *Recommendations to Customers (Suitability)* (2002), *available at* http://secure.nasdr.com/wbs/NETbos.dll?RefShow?ref=NASD4;&xinfo=http://www.nasdadr.com (last visited Mar. 31, 2002). *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999).

[119] The court in Clark v. John Lamula Investors, Inc., 583 F.2d 594, 600-01 (2d Cir. 1978), set forth the elements. A plaintiff must prove (1) that the securities purchased were unsuited to the buyer's needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs; (3) that the defendant recommended or purchased the unsuitable securities anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct. *See id.* The Second Circuit reaffirmed these elements in *Brown*, 991 F.2d at 1031.

[120] *See* Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247 (1983). Some courts have found that the conduct itself is securities fraud. *See, e.g.*, O'Connor v. R.F. Lafferty & Co., 965 F.2d 893 (10th Cir. 1992) (holding investor must establish that the broker exercised control over the account to establish justifiable reliance); Clark v. Kidder Peabody & Co., 636 F. Supp. 195 (S.D.N.Y. 1986). *But see* Morlock v. Shepherd, 1999 WL 1212197 (N.D. Ill. Dec. 16, 1999) (finding no Rule 10b-5 liability where unsuitable investment strategy in discretionary account).

[121] *See supra* notes 97-99 and accompanying text.

[122] *See generally* POSER, *supra* note 107, § 3.03[C].

customer's account in order to generate commissions.[123] As with suitability allegations, churning raises the question of whether Rule 10b-5 fraud can be established by conduct alone or whether misrepresentation ("deception") is required.[124] In addition to establishing that the trading is excessive[125] in light of the investor's investment objectives[126] and that the broker had control[127] over the account, the investor must establish scienter.[128] Courts have divided on whether churning allegations can be brought as a state law breach of fiduciary duty claim.[129] Finally, the theory for calculating damages in a churning case is unsettled.[130]

Unauthorized Trading. Unauthorized trading by a broker does not constitute securities fraud,[131] but states a breach of

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[123] *See* Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1416 (11th Cir. 1983).

[124] *See supra* note 96 and accompanying text.

[125] There are different approaches for determining what is excessive trading. Many cases focus on the turnover ratio: the ratio of the total cost of purchases made for the account during a given period to the total amount invested in the account. *See, e.g.*, Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498 (11th Cir. 1985). Others look at the volume of commissions, either as a percentage of the broker's or branch's income or in relation to comparable accounts handled by other brokers. *See, e.g.*, Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *aff'd in part*, 430 F.2d 1202 (9th Cir. 1970); *see also* Donald Arthur Winslow & Seth C. Anderson, *A Model for Determining the Excessive Trading Element in Churning Claims*, 68 N.C. L. REV. 327 (1990) (discussing guidelines for turnover rates through comparison with turnover in mutual funds with a similar risk preference).

[126] In the typical case, the parties portray different pictures of the investor and his investment objectives, with the customer asserting that he is an inexperienced investor with conservative goals and the broker asserting that the customer was a sophisticated investor with speculative objectives. *See, e.g., Thompson*, 709 F.2d at 1413.

[127] SEC Rule 15c1-7 defines churning in the context of discretionary accounts, but it is clear that brokers may have de facto control over non-discretionary accounts. 17 C.F.R. § 240.15c1-7 (2001). What facts will demonstrate control is problematic. *Compare Arceneaux*, 767 F.2d at 1502 (involving a broker controlled account even though customer was well-educated and experienced options trader, because customer was "somewhat intimidated" by broker), *with* Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677 (9th Cir. 1982) (finding that the focus should be on whether the customer has the intelligence and understanding to evaluate the broker's recommendations). *See also* Patricia A. O'Hara, *The Elusive Concept of Control in Churning Cases under Federal Securities and Commodities Laws*, 75 GEO. L.J. 1875 (1987) (stating that the control test is the functional equivalent of the reliance test in misrepresentation cases).

[128] *See* O'Connor v. R.F. Lafferty & Co., 965 F.2d 893 (10th Cir. 1992).

[129] Courts that have allowed it include Mihara v. Dean Witter & Co., Inc., 619 F.2d 814 (9th Cir. 1980) (California law); *Miley*, 637 F.2d 318 (Texas law); Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968) (New York law). For a contrary view, see McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254 (8th Cir. 1984) (Minn. law). *See also* POSER, *supra* note 107, § 3.02[A].

[130] There are two possible elements of damages—the amount of the excessive commissions and the decline in the value of the portfolio, and the latter may or may not take into account the overall performance of the stock market. *Compare* Twomey v. Mitchum, Jones & Templeton, Inc., 60 Cal. Rptr. 222 (1968), *with* Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981). *See also* O'Hara, *supra* note 127, at 1896-1900.

[131] *See, e.g.*, Messer v. E.F. Hutton & Co., 833 F.2d 909 (11th Cir. 1987); Brophy v.

contract[132] or breach of fiduciary duty claim.[133] Allegations that the broker did not follow a customer's instructions to sell, whether or not accompanied by misrepresentations, also do not constitute Rule 10b-5 fraud, since it is not fraud "in connection with" a purchase or sale.[134]

Damages. There are many theories for calculating damages for broker-dealer misconduct, but little directly applicable caselaw. To illustrate the complexities, this section will focus on remedies available to an investor who purchased securities in reliance on material misrepresentations by the broker.[135]

The most common measure of damages is the tort-based out of pocket recovery—the difference between the amount paid for the security and its actual value at the time of the transaction.[136] This method ignores post-transaction events except to the extent they provide evidence as to the "actual" value; i.e., what the security is worth when the truth becomes known is evidence of what it would have been worth at the time of the transaction if the broker had not lied. Under PSLRA, whenever a plaintiff seeks to establish damages by reference to a market price, the award of damages cannot exceed the difference between his purchase price and the mean trading price of that security during the 90-day period beginning on the date on which the corrective information is disseminated to the market.[137]

Many courts allow, at least in some circumstances, damages based on rescission of the transaction—a return of the purchase

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Redivo, 725 F.2d 1218 (9th Cir. 1984).

132 Courts sometimes also talk about claims sounding in negligence (tort), but a duty of reasonable care arises because of a contract between the parties. *See* DeKwiatkowski v. Bear Stearns & Co., 126 F. Supp. 2d 672, 685 (S.D.N.Y. 2000).

133 *See, e.g.*, Baum v. Phillips, Appel & Walden, Inc., 648 F. Supp. 1518, 1525 (S.D.N.Y. 1986), *aff'd*, 867 F.2d 776 (2d Cir. 1989).

134 *See* Gambella v. Guardian Investor Services Corp., 75 F. Supp. 2d 297 (S.D.N.Y. 1999).

135 With respect to defrauded sellers, the Supreme Court, in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972), found that the correct measure of damages was the difference between the fair value of the consideration received by the seller and the fair value of what he would have received had there been no fraudulent conduct, except where the defendant received more than the seller's actual loss, in which case the seller is entitled to receive the defendant's profit. See *supra* note 130, for issues relating to churning violations. For issues arising from fraudulent conduct in managing a portfolio, see *Rolf v. Blyth, Eastman, Dillon & Co., Inc.*, 570 F.2d 38, 48-50 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978), *modified*, 637 F.2d 77, 84 (2d Cir. 1980) and *Miley*, 637 F.2d at 327-28 (both involving market-adjusted measure of damages).

136 *See, e.g.*, Harris v. Am. Inv. Co., 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976).

137 15 U.S.C. § 78u-4(e)(1) (1994). Under § 21D(e)(2), if the plaintiff sells the securities prior to the expiration of the 90-day period, that cuts off the period of time for calculating the mean trading price.

price for the securities or, if the securities have been sold by the investor, the difference between the purchase price and the value of the security upon disposition.[138] The difficulty with the rescission measure is that it may allow the plaintiff to recover for the full amount of the post-transaction decline in the value of the security, unless the defendant can prove that some portion of the decline is unrelated to the fraud. PSLRA explicitly puts the burden on the plaintiff to prove the defendant's misrepresentation "caused the loss" for which the plaintiff seeks to recover damages;[139] this would seem to preclude a plaintiff's recovery, on a rescissionary theory, for declines in value unrelated to defendant's fraud.[140]

Some courts will allow recovery on a contract-based benefit of the bargain theory—the difference between the value of the security received and the value of the security if the misrepresentations had been truthful, but only if the latter can be established with sufficient certainty.[141] Finally, state law may allow recovery of punitive damages which the federal securities laws prohibit.[142]

In sum, federal and state law applicable to broker-dealer conduct is complex and unsettled. This complexity and lack of clarity makes it difficult for arbitrators to apply the law to the disputes they resolve. In the next section, we examine another limitation on the ability of the arbitrators to apply the law: the lack of development of the law since 1987.

B. *Opportunities for Development of the Law Governing Broker-Dealer Disputes Are Limited*

With the nearly universal use by brokers of PDAAs, there are few opportunities for customers to sue broker-dealers in court, and yet there are many unresolved issues in the law regulating broker-dealer conduct.[143] This section examines judicial and

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[138] The Supreme Court, in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986), assumed that rescission may be an appropriate theory in some circumstances, since the defendant did not contest it.

[139] 15 U.S.C. § 78u-4(b)(4).

[140] Under PSLRA, defendants who have not "knowingly committed" securities fraud are not jointly and severally liable for the full amount of damages, but are liable solely for the portion of the judgment that corresponds to their percentage of responsibility as determined under the statute. 15 U.S.C. § 78u-4(f)(2)(A)-(B). The definition of "knowingly commits" excludes reckless conduct. *Id.* § 78u-4(f)(10)(B).

[141] *See* Commercial Union Assurance Co. v. Milken, 17 F.3d 608, 614 (2d Cir. 1994).

[142] *See, e.g.*, Grogan v. Garner, 806 F.2d 829 (8th Cir. 1986).

[143] *See supra* notes 88-142 and accompanying text.

administrative opportunities to review and develop standards for broker-dealer conduct in the post-*McMahon* era.

1. Motions to Vacate An Arbitration Award

As previously discussed,[144] *McMahon* assumed the judicially-created doctrine of "manifest disregard" of the law would allow limited judicial scrutiny of the merits of an arbitration.[145] As a result, opinions considering motions to vacate on this ground might have occasion to discuss the relevant substantive law, but since the court would be concerned with whether or not the arbitrators ignored or refused to apply "well-defined and clearly applicable law," it seems there would be little opportunity for a court to make new law in the resulting opinion.[146]

2. Actions Brought by Customers

Class Actions. Since the SRO arbitration rules do not permit class actions against broker-dealers,[147] brokers cannot assert PDAAs to bar investors from bringing class actions in court.[148] Since common questions of law and fact must predominate,[149] class actions are generally not appropriate vehicles where customers allege suitability or churning violations. In the post-*McMahon* years, plaintiffs have brought class actions where the allegations involve allegedly illegal business practices that affect numerous customers[150] or widely disseminated misstatements.[151] Class actions

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[144] *See supra* note 36 and accompanying text.

[145] The scope of this standard of review is discussed *infra* notes 271-75 and accompanying text.

[146] *See, e.g.*, Greenberg v. Bear, Stearns & Co., 220 F.3d 22 (2d Cir. 2000); Dawahare v. Spencer, 210 F.3d 666 (6th Cir. 2000); Sav-A-Trip, Inc. v. Belfort, 164 F.3d 1137 (8th Cir. 1999).

[147] *See* NASD CODE 2002, *supra* note 72, § 10301(d)(1).

[148] *See* Nielson v. Piper, Jaffray & Hopwood, Inc., 66 F.3d 145 (7th Cir. 1995).

[149] *See* FED. R. CIV. P. 23(b)(3). *See also* Newton v. Merrill Lynch, Pierce, Fenner & Smith, 259 F.3d 154 (3d Cir. 2001) (denying class certification to a lawsuit claiming violations of the broker's duty of best execution because individual issues of economic loss would predominate over common issues of law and fact).

[150] *See, e.g.*, Grandon v. Merrill Lynch, 147 F.3d 184 (2d Cir. 1998) (excessive markups); Ettinger v. Merrill Lynch, 835 F.2d 1031 (3d Cir. 1987) (same); Guice v. Charles Schwab & Co., 89 N.Y.2d 31 (1996) (receipt of order flow payments; complaint dismissed on grounds federal regulation preempted the field); *accord* Dahl v. Charles Schwab & Co., 545 N.W.2d 918 (Minn. 1996).

Plaintiffs' allegations are rooted in the "shingle theory." Since the broker's conduct does not meet the standards for competent professionals in the industry, the broker's failure to disclose the conduct is an implied misrepresentation that is actionable under may be appropriate vehicles for online traders to challenge discount brokers' practices.[152]

The circumstances in which courts will permit customers to bring class actions against brokers have become more difficult to predict since the enactment of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). SLUSA precludes any class action where the complaint alleges securities fraud,[153] even if based on state law, involving a "covered" security,[154] unless the complaint meets the stringent pleading requirements of PSLRA.[155] Securities fraud class actions filed in state court can be removed to federal court and then dismissed unless plaintiffs comply with the pleading requirements. Courts may dismiss class action complaints alleging state law breach of fiduciary duty or contract claims if the court finds that the gravamen is securities fraud. While Congressional intent was to protect issuers of high tech companies,[156] courts have relied on the literal language of the Act and legislative history that Congress intended the federal courts as "the exclusive venue for most securities class action lawsuits" involving nationally traded securities[157] to apply its provisions to class actions against brokers.

Abada v. Charles Schwab & Co.[158] illustrates the uncertainties. Plaintiff brought a class action in state court on behalf of online

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section 10(b) and Rule 10b-5 if made with the requisite scienter. *See supra* note 90 and accompanying text.

[151] *See, e.g.*, O'Malley v. Boris, 742 A.2d 845 (Del. 1999) (discussing adequacy of broker's disclosures about switching money market funds for "sweep" accounts); Varljen v. H.J. Meyers, Inc., [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,259 (S.D.N.Y. 1998) (noting that broker's misstatements and other conduct artificially inflated the market value of stock).

[152] As discussed *infra* notes 306-09 and accompanying text, the outcomes are not likely to be favorable to investors.

[153] SLUSA preempts "covered class actions" based on state law claims in which plaintiffs allege either a misrepresentation or omission of a material fact in connection with the purchase and sale of a covered security or that the defendant used or employed any manipulative or deceptive device or other contrivance in connection with the purchase and sale of a covered security. *See* 15 U.S.C. § 78bb(f)(2) (1994); *see also id.* § 78bb(f)(5)(B)(i)-(ii) (defining covered class actions).

[154] *See id.* § 77r(b). A "covered security" is one that either (1) is "listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the Nasdaq Stock Market (or any successor to such entities)" or (2) is issued by a registered investment company. *Id.*

[155] *See* discussion *infra* notes 289-90 and accompanying text.

[156] The Congressional purpose in enacting SLUSA and PSLRA was to protect issuers, especially those in the high tech industry, from class action "strike suits." Courts have rejected arguments that would limit its applicability to issuers. *But see* Shaw v. Charles Schwab & Co., 128 F. Supp. 2d 1270, 1274 (C.D. Cal. 2001) ("The legislative history does not indicate that Congress was especially worried about brokerage companies that have purposefully availed themselves of business opportunities in jurisdictions with onerous laws.").

[157] Prager v. Knight/Trimark Group, Inc., 124 F. Supp. 2d 229, 233 (D. N.J. 2000).

[158] 68 F. Supp. 2d 1160 (S.D. Cal. 1999), *vacated* 127 F. Supp. 2d 1101 (2000).

investors, asserting that defendant did not live up to its representations that it would provide fast, high quality execution of trades. Defendant removed the case to federal court under SLUSA and then moved to dismiss under PSLRA. The trial judge granted defendant's motion to dismiss, holding that plaintiff's claim was securities fraud within the meaning of SLUSA. A year later, a different trial judge reversed the decision, holding that plaintiff's complaint stated state law claims that were not preempted by SLUSA.[159] In the view of the second judge, plaintiff's claim did not allege securities fraud because it did not allege misrepresentations relating to the trading or value of any particular stock and did not allege misconduct like stock manipulation. Rather the claim alleged a breach of contract.[160] On this issue, ironically, the narrow interpretations of federal securities fraud worked to the benefit of the plaintiff.[161]

In contrast, the federal district court found that removal was proper in *Prager v. Knight/Trimark Group, Inc.*,[162] where plaintiff's class action alleged that defendant, a market maker, improperly used information about customers' intent to trade certain securities in order to execute its own trades for its own profit ahead of its customers' trades. Even though the plaintiff stated only state law claims, the court reasoned it was securities fraud since plaintiff alleged that over an extended period of time defendant engaged in a practice of misrepresentations with an intent to defraud.

As a result of SLUSA, investors' ability to adjudicate disputes with brokers through the mechanism of class actions may be significantly limited, depending upon how expansively courts interpret the statute's coverage.

No PDAA Asserted. A few reported decisions involving

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[159] *See Abada*, 127 F. Supp. 2d at 1101-03. The second judge thus denied the motion to dismiss and remanded the action to state court. *See id.*

[160] *See also* Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 2001 WL 1182927 (S.D.N.Y. Oct. 9, 2001) (concerning alleged misrepresentations about transaction fees); Shaw v. Charles Schwab & Co., 128 F. Supp. 2d 1270 (C.D. Cal. 2001) (concerning allegations regarding commission rate for web-based trading and the efficacy of the web-based trading system); Green v. Ameritrade, Inc., 120 F. Supp. 2d 795 (D. Neb. 2000) (concerning allegations regarding failure to provide "real time, last sales information" on options quotes).

[161] Similarly, in *Burns v. Prudential Securities*, 116 F. Supp. 2d 917 (N.D. Ohio. 2000), fifty customers of one broker survived a motion to dismiss a class action under SLUSA where the allegations were based on the broker's actions in liquidating their accounts without authorization. The court relied on federal cases holding that "unauthorized trading" was not securities fraud, but a breach of contract claim.

[162] 124 F. Supp. 2d 229 (D. N.J. 2000). *See also* Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 168 F. Supp. 2d 1352 (M.D. Fla. 2001) (preempting class action alleging broker made misrepresentations about mutual fund to induce purchases).

customer-broker disputes can be found after 1987. In most instances, the litigation was commenced before *McMahon*, or the customer's agreement predates *McMahon* and so may not have included a PDAA. In some instances, it seems clear that there was not an enforceable PDAA[163] or the broker, for strategic reasons, chose not to assert the PDAA.[164] In a few instances, it is not clear why the case is in court.[165]

In the reported cases that reach the merits of the investor's claims, the courts do not view the legal issues as novel, and the courts express no difficulty in applying the existing precedents to decide the cases. One of these cases, however, resulted in an opinion in which the judge goes to great lengths to demonstrate that the legal principles he was applying were well-settled—an opinion that has generated considerable discussion in the legal and financial communities.

In *De Kwiatkowski v. Bear Stearns & Co*,[166] the investor, who at one time had a $6.5 billion position in foreign currency contracts, recovered $111.5 million (plus pre-judgment interest of approximately $60 million) from his broker for losses incurred in the negligent handling of his accounts, principally stemming from the liquidation of plaintiff's positions necessitated by a sudden fall in the value of the dollar.[167] The district court upheld the jury's negligence verdict, finding that there was sufficient evidence to support the theory that in defendant's overall handling of plaintiff's accounts the firm failed to exercise the degree of skill and care a broker would reasonably employ under the circumstances. The court extensively discussed both the law and the evidence, in order to demonstrate that the legal principles were well settled and it is the facts that were extraordinary in this case.

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[163] *See* Kingston v. Ameritrade, Inc., 12 P.3d 929 (Mont. 2000) (involving an investor who raised a justiciable issue over whether an online broker could assert a PDAA incorporated by reference).

[164] For example, if the broker-dealer intends to assert the statute of limitations as an affirmative defense, it may prefer to do so in a legal proceeding. *See, e.g.*, Coleman & Co. Sec., Inc. v. Giaquinto Family Trust, 2000 WL 1683450 (S.D.N.Y. Nov. 9, 2000); *see also* John Hancock Life Ins. Co. v. Wilson, 254 F.3d 48 (2d Cir. 2001) (concerning a situation where, in response to initiation of arbitration proceedings by claimants, the firm brought a judicial action seeking a declaratory judgment that it was not bound to arbitrate disputes involving an associated person's sales of promissory notes to individuals who were not the firm's customers).

[165] *See, e.g.*, De Kwiatowski v. Bear Stearns & Co., 126 F. Supp. 2d 672 (S.D.N.Y. 2000). In *De Kwiatowski*, the customer was very wealthy and had negotiations with the broker about the terms of their arrangement; there well may not have been a PDAA.

[166] 126 F. Supp. 2d 672 (S.D.N.Y. 2000).

[167] The plaintiff originally asserted numerous federal and state claims, but all were dismissed except for the negligence and breach of fiduciary duty claims. The jury did not find that the defendant breached its fiduciary duty to plaintiff. *Id.*

In particular, it rejected defendant's assertion that a broker's duty of reasonable care was extremely limited in instances where the plaintiff's account was denominated nondiscretionary. Instead, the court held that, under applicable legal precedents, a broker's duty was determined in the context of the entire history of the relationship between the customer and the broker, and the jury's verdict was supportable by the evidence showing "special circumstances sufficient to remove the case from application of general rules that pertain to the ordinary broker/client relationship."[168]

Even in an era where there was a regular production of judicial opinions examining the duties owed by a securities broker to its customer, *De Kwiatowski* would probably be a noteworthy case, simply by reason of the magnitude of the losses involved. But there can be no doubt that much of the attention generated by the case results from the concern that its precedential value will be disproportionate by reason of the scarcity of legal precedents in the post-*McMahon* era.[169]

3. SEC Enforcement Actions

Additional opportunities to develop standards governing broker-dealer conduct arise from the SEC's enforcement functions. Congress created the SEC in the SEA to regulate the securities industry, enforce the federal securities laws, and protect investors.[170] The SEC is empowered to investigate and prosecute violations of the securities laws and regulations by, among others, broker-dealers.[171] The Commission may bring two types of enforcement proceedings to seek sanctions against such violations. First, the SEC can bring civil proceedings in federal district courts against brokers to ensure compliance with the federal securities laws and its rules or orders, including SRO rules.[172] Appropriate relief can include injunctions, other ancillary relief and civil

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[168] *Id.* at 701.

[169] *See id.* at 677 n.1 (citing some of the media reaction and professional commentary about the case).

[170] *See* 15 U.S.C. § 78d (1994) (establishing Commission guidelines); 17 C.F.R. § 200.1 (1999) (describing the general statement and statutory authority for the Commission); *id.* § 200.2 (describing all of the current statutory functions of the Commission). The SEC can "delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, an administrative law judge, or an employee or employee board . . . ." 15 U.S.C. § 78d-1(a). The SEC has delegated its enforcement functions to the Division of Enforcement. 17 C.F.R. § 200-30.4.

[171] 15 U.S.C. § 77h-1(a); *id.* § 78u(a)(1).

[172] *See id.* §§ 78u, 77t.

penalties. However, the Exchange Act expressly bars the SEC from bringing a federal court action for violations of SRO rules unless the SRO itself is "unable" or "unwilling" to bring enforcement proceedings itself, or "such action is otherwise necessary or appropriate in the public interest or for the protection of investors."[173]

Second, the SEC can institute administrative proceedings against broker-dealers before a hearing officer.[174] Hearing officers can impose sanctions such as revocation of registration and civil penalties comparable to those obtainable in court.[175] The hearing officer must prepare any initial decisions in writing, which must include "findings and conclusions, and the reasons or basis therefor, as to all the material issues of fact, law or discretion presented on the record and the appropriate order, sanction, relief, or denial thereof."[176] Initial decisions of hearing officers are published in the *SEC Docket*.[177]

The full Commission may review hearing officer decisions.[178] Written findings and conclusions resulting from that review must "state the reasons for the action taken and contain a clear showing that no serious argument of counsel has been disregarded or overlooked."[179] According to the SEC's Canons of Ethics, this requirement ensures that the opinion "may contribute some useful precedent to the growth of the law."[180] All Commission orders and decisions are published in the *SEC Docket*.[181]

In the last five years, the percentage of SEC enforcement actions against broker-dealers has averaged 20 percent of its caseload, most of them involving fraud against customers.[182] While

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173 *Id.* § 78u(f).

174 *See id.* §§ 77h-1, 78u(a). Pursuant to the SEC Rules of Practice, a hearing officer presides over any proceeding before the Commission. *See* 17 C.F.R. § 201.110. The Commission has delegated the hearing officer function in Commission-instituted proceedings to Administrative Law Judges chosen by the Commission's Chief Administrative Law Judge (from the SEC's Office of Administrative Law Judges). *See id.* § 200.14(a).

175 *See generally*, 15 U.S.C. §§ 78o(b)(4)-(6), 78o-4(c)(2)-(5), 78o-5(c)(1)-(2), 78q-1(c)(3)-(4), 78u-2, 78u-3.

176 17 C.F.R. §§ 201.360(a)-(b), 200.14(a)(8), 200.30-9.

177 *See id.* § 201.360(c).

178 *See id.* § 201.410; *see also id.* § 201.411; 15 U.S.C. § 78d-1(b).

179 17 C.F.R. § 200.63.

180 *Id.* The Canons of Ethics further state:

> A [Commission] member should be guided in his decisions by a deep regard for the integrity of the system of law which he administers. He should recall that he is not a repository of arbitrary power, but is acting on behalf of the public under the sanction of the law.

Id.

181 *See* 17 C.F.R. §§ 200.80, 201.140.

182 Approximately 14 civil actions and approximately 47 administrative proceedings

the SEC does bring a few "SCUM" cases each year,[183] usually it elects to go to court, either because it is seeking emergency relief, such as a TRO and a freeze of assets,[184] or because the agency wants to send a message to the industry.[185] In recent years the SEC has focused, in particular, on boiler room operations and microcap fraud,[186] excessive markups,[187] market manipulation,[188] and fraud in connection with hot IPOs.[189] It has also increased the number of enforcement actions against firms (in contrast to individual brokers) and managers for failure to supervise.[190]

Many of the SEC's enforcement actions, particularly those filed administratively, are resolved by settlement. In those settlements, the defendants or respondents generally consent to the entry of judicial or administrative orders without admitting or denying the factual allegations made against them.[191] Thus, SEC enforcement actions cannot fill the void created by the absence of regular production of precedents that would be instructive in private claims for broker misconduct. Moreover, an SEC

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against broker-dealers alleging fraud against customers are initiated by the SEC each year. These statistics are derived from examination of the SEC's Annual Reports from 1995-99. *See* 1999 SEC ANNUAL REP. 140, tb.1; 1998 SEC ANNUAL REP. 118, tb.1; 1997 SEC ANNUAL REP. 148, tb.1; 1996 SEC ANNUAL REP. 150, tb.1; 1995 SEC ANNUAL REP. 100, tb.1.

[183] *See, e.g.*, SEC v. Wolf, Litig. Release No. 16,189, 1999 SEC LEXIS 1211 (E.D.N.Y. June 16, 1999) (misrepresentations, unauthorized purchases); SEC v. Welco Sec., Inc., Litig. Release No. 16,253, 1999 SEC LEXIS 1624 (E.D. Pa. Aug. 17, 1999) (unsuitable purchases).

[184] *See, e.g.*, SEC v. First Am. Reliance, Inc., Litig. Release No. 15,931, 1998 SEC LEXIS 2166 (W.D.N.Y. Oct. 6, 1998); SEC v. Cammarano, Litig. Release No. 15,967, 1998 SEC LEXIS 2405 (S.D. Tex. Nov. 5, 1998).

[185] There are no published guidelines enumerating the factors the SEC considers in deciding whether to institute an enforcement action against a broker administratively or in court. In the cover letter transmitting the SEC's 1997 Annual Report, Arthur Levitt, Chair, stated: "The Commission consistently brings high profile cases against entities and individuals it regulates, sending a strong message to the industry that misconduct relating to the sale of securities will not be tolerated." *Cover letter, in* 1997 SEC ANNUAL REP.

[186] *See, e.g.*, SEC v. Penna, Litig. Release No. 16,270, 1999 SEC LEXIS 1766 (S.D.N.Y. Sept. 2, 1999); SEC v. HGI, Inc., Litig. Release No. 16,162, 1999 SEC LEXIS 1078 (S.D.N.Y. May 27, 1999); SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996); SEC v. Hasho, 784 F. Supp. 1059 (S.D.N.Y. 1992).

[187] *See, e.g.*, SEC v. Great Lakes Equities Co., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685 (E.D. Mich. 1990); SEC v. Feminella, 947 F. Supp. 722 (S.D.N.Y. 1996).

[188] *See, e.g.*, SEC v Monarch Funding Corp., 983 F. Supp. 442 (S.D.N.Y. 1997).

[189] *See, e.g.*, SEC v. Hughes Capital Corp., 917 F. Supp. 1080 (D.N.J. 1996); SEC v. Milan Capital Group [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,256 (S.D.N.Y. Nov. 8, 2000).

[190] "[T]he Commission is placing greater emphasis on firms and their managers, increasing the number of cases alleging failure to supervise, and imposing stiffer sanctions." SEC 1997 ANNUAL REP. 8. For a well-publicized example, see In re Olde Discount Corp., Sec. Act Release No. 7577, 1998 SEC LEXIS 1914 (Sept. 10, 1998).

[191] *See* 1999 SEC ANNUAL REP. 3.

enforcement action will necessarily only address the issue of the broker's misconduct, and not the difficult issues typically raised in a customer's complaint such as justifiable reliance and measures of damages.

4. SRO Enforcement Actions

The SEA authorized the creation of SROs, including national securities associations (such as the NASD)[192] and national securities exchanges (such as the New York Stock Exchange ("NYSE")),[193] and permitted their registration with the SEC if they adopted rules designed to, *inter alia*, prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and protect investors.[194]

NASD. Violation of NASD Rules may give rise to enforcement actions by the NASD's regulatory arm, NASD Regulation.[195] NASD Regulation's Office of Hearing Officers ("OHO") administers these disciplinary proceedings and appoints a Hearing Panel, led by a Hearing Officer, to conduct the proceeding[196] and render a written decision.[197] The decisions,

[192] *See* 15 U.S.C. § 78o-3(a) (1994). The NASD is responsible for regulating the NASDAQ stock market and the over-the-counter market. Virtually all broker-dealers are members of the NASD.

[193] *See id.* § 78f. The NYSE is the largest national securities exchange. Other exchanges include the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Cincinnati Stock Exchange, Chicago Stock Exchange, Philadelphia Stock Exchange, and the Pacific Stock Exchange.

[194] *See id.* § 78o-3 (associations); *id.* § 78f (1994) (exchanges). The Exchange Act mandates that SROs bring disciplinary proceedings against their members for violations of their Rules, or the securities laws and regulations, and to impose disciplinary sanctions, as long as such proceeding provides sufficient due process. *See id.* § 78o-3(h); *id.* § 78f(d).

[195] NASD Regulation's Department of Enforcement is its investigative and prosecutorial arm, which employs attorneys and examiners. *See* NASD Regulation, Corporate Department and Contracts, *available at* http://www.nasdr.com/2211.htm (last visited Jan. 16, 2002) (indicating that the corporate department formulates the national enforcement policy and oversees the prosecution of disciplinary proceedings at both the national and district levels). The NASD By-Laws provide that formal disciplinary actions involving members and associated persons charged with violations of NASD Rules or securities laws and regulations shall be resolved by disciplinary hearing proceedings. NAT'L ASSOC. OF SECURITIES DEALERS, NASD By-Laws, Art. XII, *in* NASD MANUAL (CCH) (2001) [hereinafter NASD By-Laws].

[196] *See* NASD By-Laws, *supra* note 195, at Art. XII; *see also* James E. Day, *Ten Steps to Understanding the New NASD Regulation Code of Procedures*, 12 INSIGHTS 11, 13 (1998). The OHO's Chief Hearing Officer appoints an NASD Hearing Officer, who is an attorney employed by NASD Regulation, as the chair of the Hearing Panel (or Extended Hearing Panel for complex cases). *See* NAT'L ASSOC. OF SECURITIES DEALERS, NASD CODE OF PROCEDURE § 9231(b)(1), *in* NASD MANUAL (CCH) (2001) [hereinafter NASD CODE OF PROCEDURE]. The Chief Hearing Officer also appoints two other independent panelists, in accordance with the criteria set forth in Rules 9230-9232. *See id.* at § 9231.

authored by an attorney employed by NASDR, are published in the Central Registration Depository.[198]

The NASDR Code of Procedure also provides for review of Hearing Officer decisions by the National Adjudicatory Council ["NAC"] (formerly the National Business Conduct Committee), the entity appointed by NASDR's Board of Directors and authorized to hear appeals from or review a disciplinary proceeding.[199] Following the prescribed appellate process, the NAC may affirm, dismiss, modify or reverse the decision of the Hearing Panel.[200] The NAC also must issue a written decision setting forth any action it takes with the respect to the Hearing Panel Decision.[201] NAC decisions are also published on the NASDR web site.

NYSE. NYSE Rule 476 provides for the use of a Hearing Panel, chaired by a hearing officer, in disciplinary proceedings brought by its Division of Enforcement.[202] Hearing Panel opinions must be in writing and set forth the basis of the decision, including the precise statute, regulation, or exchange rule violated, the sanction imposed and the supporting reasons.[203] The NYSE's Board of Directors may review any decision of a Hearing Panel.[204]

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[197] *See* NASD CODE OF PROCEDURE, *supra* note 196, § 9268(a). The Exchange Act mandates that any decision denying, barring or limiting the membership of a person in an SRO "shall be supported by a statement setting forth the specific grounds on which the denial, bar, or prohibition or limitation is based." 15 U.S.C. § 78o-3(h)(2) (1994). The Code requires that the Hearing Panel's written decision include (1) a description of the origin of the disciplinary proceeding; (2) the specific statutory or rule provisions that were alleged to have been violated; (3) findings of fact; (4) conclusions as to whether the Respondent violated any provision alleged in the complaint; (5) a statement in support of the disposition of the principal issues raised in the proceeding; and (6) a description of any sanctions imposed NASD CODE OF PROCEDURE, *supra* note 196, at § 9268(b). NASD By-Laws also require any determinations at NASD disciplinary hearings to be in writing and to set forth the basis of the decision. NASD By-Laws, *supra* note 195, at Art. XII, § 2(d).

[198] *See* NASD CODE OF PROCEDURE, *supra* note 196, § 9268(d). These decisions are also made available to the public on the NASDR web site, although they may be published in redacted form if they do not meet the criteria of NASD IM 8310-2. *See* NASD Notice to Members 00-36, *available at* http://www.nasdr.com/pdf-text/0036ntm.txt (last visited Jan. 15, 2002).

[199] *See* NASDR By-Laws, Art. V, § 5.1, *available at* http://www.nasdr.com (last visited Jan. 16, 2002); NASD CODE OF PROCEDURE, *supra* note 196, § 9300.

[200] *See* NASD CODE OF PROCEDURE, *supra* note 196, § 9349(a).

[201] *See id.* The NAC written decision must include the same elements required in the Hearing Panel written decision. *See id.* § 9349(b).

[202] *See* NYSE R. 476(b), *available at* http://www.nyse.com/regulation/regulation.html (last visited Mar. 25, 2002); *see also* NYSE Const., Art. IX, § 2, *available at* http://www.nyse.com/regulation/regulation.html (last visited Mar. 25, 2002).

[203] *See* NYSE Rule 476(e), *available at* http://www.nyse.com/regulation/regulation.html (last visited Mar. 25, 2002); 15 U.S.C. § 78f (d)(1) (1994).

[204] *See* NYSE Const., Art. IX, § 6, *available at* http://www.nyse.com/regulation/regulation.html (last visited Mar. 25, 2002).

SEC Order Affirming SRO Discipline. Section 19(d) of the SEA requires that any decision in an SRO disciplinary proceeding imposing a "final disciplinary sanction" on the SRO member " be subject to review by the appropriate regulatory agency for such member."[205] Thus, the losing party to an SRO Decision, including the NAC and the NYSE, may appeal to the SEC.[206] In reviewing the SRO action, the Commission must make a *de novo* determination of the facts and the law,[207] but may modify or cancel sanctions only if "excessive or oppressive."[208] SEC decisions are then issued pursuant to SEC Rules of Practice, as discussed above.

These administrative law decisions emerging from SRO enforcement functions allow for review of the law governing brokers' responsibilities to their customers. Recent disciplinary actions have developed the law applicable to claims of unsuitable recommendations, churning, unauthorized trading, section 10(b) violations, and supervisory liability of the firm.[209]

5. Judicial Review of SEC Order

SEC orders disciplining brokers for violations of federal securities law and rules—whether originated by an SEC or SRO enforcement action—may be appealed directly to the Circuit Court of Appeals in which the party resides or the District of Columbia Court of Appeals.[210] Findings of fact are upheld if supported by substantial evidence,[211] and a sanctions order must be upheld unless the order is a "gross abuse of discretion."[212]

Since the SEC, like private parties, must establish scienter when alleging a Rule 10b-5 violation,[213] judicial review of SEC enforcement actions provides an opportunity to examine this

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[205] 15 U.S.C. § 78s(d). Sections 19(e) and (f) set forth procedures for such a review. *Id.* §§ 78s(e)-(f).

[206] *See* 17 C.F.R. § 201.420 (1999). The Commission may also review such decisions on its own initiative. *Id.* § 201.421.

[207] *See, e.g.*, Shultz v. SEC, 614 F.2d 561, 568 (7th Cir. 1979).

[208] Krull v. SEC, 248 F.3d 907, 911 (9th Cir. 2001) (citing 15 U.S.C. § 78s(e)).

[209] *See, e.g.*, In the Matter of Canady, 69 SEC Docket 1158, 1999 WL 183600 (Apr. 5, 1999); In the Matter of Engelman, 59 SEC Docket 758, 1995 WL 315515 (May 18, 1995); Dep't of Enforcement v. Kernweis, Disc. Pro. No. C02980024, 2000 WL 33299605 (NASDR Feb. 16, 2000).

[210] *See* 15 U.S.C. § 77i; *id.* § 78y(1). This judicial review mechanism also helps to remind Commission members to "preserve the sanctity of the laws administered by them." 17 C.F.R. § 200.64.

[211] *See* 15 U.S.C. § 78y(a)(4); *see also* Isen v. SEC, 87 F.3d 1319 (9th Cir. 1996) (table).

[212] *See Isen*, 87 F.3d at 1319; *see also* Rizek v. SEC, 215 F.3d 157 (1st Cir. 2000).

[213] *See* SEC v. Aaron, 446 U.S. 680 (1980).

element.[214] In contrast, a NASD violation does not require a showing of scienter.[215] Therefore, judicial review of SRO disciplinary orders, although illustrative of typical broker misconduct,[216] does not provide the same opportunity for explication of the standard of culpability critical to an investor in establishing a fraud claim. Given judicial deference, there will likely be little opportunity for judicial development of the law and no opportunity to explore justifiable reliance.

6. SEC and SRO Rules

SEC Rules. Section 23 of the SEA provides the Commission with its general rule-making authority.[217] Under that provision, the Commission, as well as certain other related regulatory agencies, may "make such rules and regulations as may be necessary or appropriate to implement the provisions of [the SEA] for which they are responsible or for the execution of the functions vested in them by [the SEA]."[218] This section also states that no provision of the SEA "imposing any liability shall apply to any act done or omitted in good faith in conformity with a rule, regulation or order of the Commission," or other regulatory agency pursuant to this rule-making authority.[219]

SRO Rule Changes. The by-laws of the NASD authorize its Board of Governors to "adopt such rules for the members and

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[214] For example, in *Rizek*, the broker appealed an SEC order that permanently barred him from the securities industry and imposed a civil penalty because he churned the accounts of five customers in violation of Section 10(b) and Rule 10b-5. The broker did not contest the factual findings, but asserted that the sanctions were unwarranted since he lacked the requisite scienter for such a sanction—while his investment strategy may have been wrong, he had a good faith belief in it. The court affirmed the SEC order, agreeing with the SEC's conclusion that the broker's violation was egregious and that he acted with scienter. *See Rizek*, 215 F.3d at 157.

[215] *See* Holland v. SEC, 105 F.3d 665 (9th Cir. 1997) (table). The broker was found to have recommended unsuitable investments when 25 percent of an elderly woman's net worth was placed in speculative securities. The court noted that both the NASD and the SEC found that he acted in good faith. The dissenting judge noted that the finding of good faith should mean that he had "reasonable grounds" for believing his recommendations were suitable. *See id.*

[216] *See, e.g.*, Krull v. SEC, 248 F.3d 907 (9th Cir. 2001) (unsuitable switches in mutual funds).

[217] 15 U.S.C. § 78w(a) (1994). Particular sections of the SEA also provide rule-making authority to the Commission to enforce the provisions of those sections. *See, e.g.*, *id.* § 78j(b) (noting that Rule 10b-5 was promulgated pursuant to the SEC's authority in section 10(b) of the SEA, the antifraud provision, to prescribe rules and regulations "as necessary or appropriate in the public interest or for the protection of investors").

[218] *Id.* § 78w(a)(1).

[219] *Id.*

persons associated with members, and such amendments thereto as it may, from time to time, deem necessary or appropriate."[220] Any rules or rule changes proposed by the NASD must be filed with and approved by the SEC before becoming effective.[221] Certain rule changes, such as those involving a "stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule" of the SRO, may become effective upon filing.[222]

These SEC and SRO rules, regulations and Policy Statements provide the standards of conduct for all registered broker-dealers and their associated members for conducting securities business with customers. Courts uniformly reject private rights of action for customers suing on the basis of violations of SRO disciplinary rules.[223] At least one court, however, recently has refused to vacate an arbitration award based on an SRO rule violation, concluding that the well-settled law precluding private lawsuits in courts for SRO rule violations does not preclude an award to a customer suing in arbitration for damages solely based on SRO rule violations.[224] Proof of violations of these Conduct Rules may demonstrate to an arbitration panel that the broker-dealer violated a duty of care it owed to a customer.[225]

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[220] NASD By-Laws, *supra* note 195, at Art. XI, § 1; *see also id.* at Art. VII, § 1. The Board of Governors also has the authority to adopt regulations, and issue orders, resolutions, exemptions, interpretations, and directions, and make decisions "as it deems necessary or appropriate." *Id.* at Art. VII, § 1(a)(iii).

[221] *See* 15 U.S.C. § 78s(b)(1). Section 19(b) of the 1934 Act, as amended by the Securities Reform Act of 1975, and SEC Rule 19b-4 set forth the complicated process by which a proposed rule change by any SRO is filed and becomes effective. The process includes publication of the proposal to the public, a period allowing commentary by the public, and approval or disapproval by the SEC. 17 C.F.R. § 240.19b-4 (1999).

[222] 15 U.S.C. § 78s(b)(3)(A). The statutory definition of an SRO rule that is encompassed by this procedure includes "stated policies, practices and interpretations" of the SRO. *Id.* § 78c(a)(27).

[223] *See, e.g.*, *In re* VeriFone Sec. Litig., 11 F.3d 865, 870 (9th Cir. 1993); Craighead v. E.F. Hutton & Co., 899 F.2d 485, 493 (6th Cir. 1990).

[224] *See* Freeman v. Arahill, No. 111119/01 (Sup. Ct. N.Y. Co. Oct. 18, 2001).

[225] For example, the NASD recently filed with the SEC a policy statement to provide its members with guidance concerning their obligations under the NASD's suitability rule in the on-line context. NASD Notice to Members 01-23, *Online Suitability: Suitability Rule and Online Communications* (Apr. 2001), *available at* http://www.nasdr.com/pdf.text /0123ntm.pdf (last visited Jan. 30, 2002). This policy statement reflects the regulatory effort to define what constitutes a "recommendation" made by an on-line brokerage firm and thus triggers suitability obligations. *Id.* Absent judicial pronouncement, this policy statement takes on increased importance as customers and brokers struggle to understand their legal obligations in an evolving area of the securities industry.

7. State Enforcement Proceedings

Each of the fifty states has its own securities laws ("Blue Sky Laws") containing provisions governing the conduct of broker-dealers licensed to do business in the state. While recent federal legislation has somewhat reduced the role of state regulation,[226] the SEA expressly provides that state securities laws can co-exist with federal securities laws absent a direct conflict.[227] Many state securities laws impose registration, reporting and record-keeping requirements on broker-dealers and may include antifraud and anti-manipulation provisions.[228] Pursuant to those various state laws, state securities administrators may be empowered to bring enforcement proceedings against broker-dealers, or issue opinions or interpretations of state securities laws.[229]

In sum, all of the sources described above, while varied, legalistic and authoritative, do not directly address questions arising out of a civil cause of action by a customer against a broker-dealer or its registered representatives for misconduct arising out of transactions in an account. It follows then that none addresses complex questions unique to claims such as the customer's duty to investigate the broker, the measure of damages stemming from broker misconduct, and the customer's duty to mitigate. Thus, these sources of law will not provide the necessary guidance and legal development for issues arising in typical securities arbitration claims. This is particularly troublesome in an industry undergoing rapid change and evolution since *McMahon*. Given the complexities, uncertainties, and lack of development in the law, how prepared are the arbitrators to decide these issues?

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[226] *See* National Securities Markets Improvement Act of 1996, 15 U.S.C. § 78o(h) (1994 & Supp. 2002).

[227] *See* 15 U.S.C. § 78bb(a).

[228] *See generally* POSER, *supra* note 107, § 13.05.

[229] We will not attempt to individually describe the varying laws, regulations, and interpretations emerging from all 50 state securities commissions. The North American Securities Administrators Association ("NASAA"), a professional organization of state securities commissioners, maintains links on its website to each of its fifty member states' securities administrators, and interested parties may consult these agencies for applicable rules. *See* North American Securities Administrators Association, *available at* http://www.nasaa.org (last visited Jan. 16, 2002).

C. *SRO Arbitrator Training*[230]

NASD-DR recruits, screens, and trains arbitrators to serve on its panels.[231] The NASD-DR program seeks a "diverse pool of knowledgeable and qualified arbitrators to help maintain its fair, impartial and efficient system of dispute resolution."[232] In order to qualify for the NASD-DR's roster of arbitrators, a candidate must have five years of "business, professional, investing, or other related experience";[233] however, she need not be a lawyer or have any legal training.[234] Rather, NASD-DR's stated goal is "to recruit arbitrators from diverse backgrounds, including educators, accountants, medical professionals, and others, as well as lawyers and securities professionals."[235] The candidate must attend and complete the NASD-DR's introductory securities arbitrator training program to be eligible to serve on a case.[236] The program consists of review of a self-study manual and attendance at a day-long on-site classroom course. At the end of the day, the

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230 Both of the authors are arbitrators at the NASD-DR. Some of the information in this section is derived from their experiences during the application and training process.

231 *See* NASD-DR Recruitment Brochure, *available at* http://www.nasdadr.com /arb_brochure_htm.asp (last visited Feb. 1, 2002) [hereinafter NASD-DR Recruitment Brochure]. The New York Stock Exchange's Arbitration Department similarly recruits and screens applicants. *See* New York Stock Exchange, *Arbitration*, *available at* http:www.nyse.com/regulation/regulation.html (last visited Mar. 31, 2002). However, as discussed above, because NASD-DR handles the overwhelming majority of securities arbitrations, this article will focus on NASD-DR's recruitment practices.

232 Form Letter from Margaret Duzant, Neutral Relations Supervisor, NASD Regulation, to Arbitrator Applicant (Apr. 1999) (on file with authors). *See also* NASD-DR Recruitment Brochure, *supra* note 231.

233 NASD-DR Recruitment Brochure, *supra* note 231. However, applicants are disqualified if they work for, or have worked for an SRO in the last year, or if they have a spouse who is employed in the securities industry and they are not at all affiliated with the industry. *See id.* On the application, candidates must provide a basic description of their professional backgrounds so that, if approved, they can be classified as public or securities industry arbitrators. *See id.* In addition, applicants must answer some basic screening questions to ensure that they do not have a criminal or other disciplinary history. *See id.*

234 *See* The Neutral Corner, *Summary of Reader Survey Results* (Feb. 2001), *available at* http://www.nasdadr.com/neutral_corner/nc_0601f.asp (last visited Jan. 11, 2002). According to an NASD-DR executive, approximately sixty percent of its roster of arbitrators are non-attorneys. *Id.* (noting also that fifty-five percent of those responding to an informal NASD-DR survey of readers of its publication, *The Neutral Corner*, reported that they were non-attorneys).

235 *Id.*

236 In addition, the NYSE conducts its own arbitrator training programs. A newly-accepted NYSE arbitrator can also satisfy the training requirement by attending an arbitrator training program sponsored by another organization, subject to NYSE approval. That training must include "instruction in ethical considerations for arbitrators, arbitrator conduct and arbitrator procedures." Again, no instruction on substantive law is given. *See* Form Letter from R. Clemente, NYSE Director of Arbitration, to new arbitrator (Feb. 15, 2001) (on file with authors),

candidate must pass a written, multiple-choice examination.[237]

The training program strongly emphasizes process and procedure over substantive law.[238] To determine liability, NASD-DR trains its arbitrators to follow four steps: participate in panel deliberations, determine the facts of the case, apply the law to the facts, and reach a decision.[239] For the third crucial step, applying the law, the NASD-DR instructs as follows: "As arbitrators, you are not strictly bound by legal precedent or statutory law. However, it's important that you not manifestly disregard the law."[240] The NASD-DR lesson further explains that manifest disregard of the law is a possible basis, in some jurisdictions, to vacate an arbitration award.[241] Finally, the lesson notes that "the integrity of arbitration requires a degree of uniformity of result. If the panel members made up their own laws, the process would lose credibility."[242]

Clearly NASD-DR wants to provide a fair, impartial, and efficient hearing. As long as the arbitration panel provides such a hearing, the resulting award is relatively safe from attack(i.e., motions to vacate). Virtually no training materials, written or oral, are devoted to educating arbitrators about areas of substantive law they may face in a typical customer dispute. In fact, the only instructions we could locate regarding what the law is on a particular subject concerned the typical claimant's burden of proof (preponderance of evidence),[243] the different measures of actual damages,[244] and whether a claimant is entitled to punitive

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[237] *See* Form Letter from NASD Regulation to Accepted Arbitrator (Nov. 1999) (on file with authors).

[238] *See*, NASD REGULATION, INC., ARBITRATOR TRAINING PORTFOLIO 3-159 (1999) [hereinafter ARBITRATOR TRAINING PORTFOLIO]. The program is divided into three modules, which are entitled: *Prepare to Conduct a Fair and Impartial Hearing* (2.5 hours); *Conduct a Fair and Impartial Hearing* (2.5 hours); and *Decide the Outcome of the Case* (2 hours). *See id.* The first two modules are largely devoted to subjects regarding the arbitration process, such as avoiding conflicts of interest, making relevant disclosures, avoiding the appearance of impropriety, managing the discovery process fairly, refraining from *ex parte* communications, managing the behavior of the parties equitably, and facilitating testimony. *See id.* The third module is divided into four lessons: determining liability, determining awards, completing the appropriate documentation, and responding to post-award requests. *See id.* at 163-236.

[239] *See id.* at 165.

[240] *Id.* at 172.

[241] *See id.*

[242] *Id.* NASD-DR also periodically offers a chairperson training program for arbitrators to complete in order to be eligible to serve as chairpersons of a three-member panel. *See* 2002 NASD Dispute Resolution Arbitrator Training Programs, *available at* http://www.nasdadr.com/training/atp_neast.asp (last visited Feb. 1, 2002). In the authors' experience, this program again focuses solely on matters of procedure and the role of the chairperson in the arbitration, not substantive law.

[243] *See* ARBITRATOR TRAINING PORTFOLIO, *supra* note 238, at 174.

[244] *See id.* at 182-84.

damages.[245]

D. *SRO Published Materials*

Other than the Code of Arbitration Procedure, NASD-DR provides two other published sources of guidance to arbitrators to use when conducting hearings. First, *The Arbitrator's Manual*, published by SICA, was "designed to supplement and explain the Uniform Code of Arbitration as developed by SICA."[246] Similarly, this manual provides guidance to an arbitrator regarding issues of process and procedure, but does not discuss any substantive law. The inside cover of the manual states: "Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail."[247]

Second, NASD-DR publishes the *Arbitrator's Reference Guide*.[248] This guide provides checklists, scripts, and other useful quick reference tools for arbitrators to consult on procedural matters, but includes no instruction regarding substantive law. Contrasting sharply with the quote on equity contained in the manual referred to above, the guide contains the following "disclaimer":

> These materials are for training and instructional purposes only. They are not intended to be determinative or exhaustive of any issue of law or equity that you may encounter during an arbitration proceeding. The law or procedures to be applied in each case should be determined upon consideration of the facts and law as presented by the parties or which may be applicable to the case. If you have questions that are not addressed effectively by the parties, you may wish to request briefs from the parties on applicable law.[249]

These two published sources of guidance crystallize the tension between law and equity in arbitration proceedings. Arbitrators are expected to achieve an equitable resolution of the dispute before them but they may not ignore the law. However,

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245 *See id.* at 185.

246 SEC. INDUST. CONF. ON ARBITRATION, THE ARBITRATOR'S MANUAL, *Preface* (2001), *available at* http://www.nasdadr.com/sica_manual.asp (last visited Jan. 8, 2002).

247 *Id.* (quoting Domke on Aristotle).

248 NASD REGULATION, INC., ARBITRATOR'S REFERENCE GUIDE (2001), *available at* http://www.nasdadr.com/pdftext/arb_ref_guide.pdf (last visited Feb. 1, 2002) [hereinafter ARBITRATOR'S REFERENCE GUIDE].

249 *Id.* at 1.

without ample training or legal briefing by the parties on each relevant issue,[250] how can the arbitrators know what the law is or how to apply it?

IV. ARBITRATION AWARDS: IS THERE ACCOUNTABILITY?

As we have discussed, the Supreme Court in *McMahon* assumed arbitrators would apply the law and that the "manifest disregard" standard would provide sufficient judicial oversight to ensure that they did. How can courts know whether the arbitrators are applying the law or not? It has been argued that arbitrators should be required to give reasons for their awards so there will be a basis for judicial review.[251] In this section we demonstrate that there is no meaningful review of arbitration awards to assure arbitrators are applying the law.

A. *The Contents of An Award*

It is well-settled that arbitrators are not required to include in their award an opinion setting forth the factual and legal bases for the panel's decisions regarding liability or damages.[252] In fact, the vast majority of securities arbitration awards do not include an opinion. Indeed, industry participants loathe the possibility that a panel would write an opinion, as contrary to the panel's ability and mission.[253]

NASD Code of Arbitration Procedure Rule 10330 sets forth the requirements for a complete award. It must contain the following: the names of the parties; the names of counsel (or other representatives); a summary of the issues; damages, interest and other relief requested; damages, interest and other relief awarded; a statement of any other important issues considered and resolved;

[250] *See id.* at 8, ¶ K. NASD-DR instructs arbitrators to request legal briefs from the parties in advance of the hearing only if they identify "unique legal issues." *Id.*

[251] *See* David A. Lipton, *Generating Precedent in Securities Industry Arbitration*, 19 SEC. REG. L.J. 26, 41-43 (1991).

[252] *See, e.g.*, Dawahare v. Spencer, 210 F.3d 666, 669 (6th Cir. 2000); Halligan v. Piper Jaffray, Inc., 148 F.3d 197, 204 (2d Cir. 1998). However, some courts have considered the lack of a reasoned award in deciding whether to grant a motion to vacate an award for manifest disregard of the law. *See Halligan*, 148 F.3d at 204; Montes v. Shearson Lehman Bros., 128 F.3d 1456, 1462 n.8 (11th Cir. 1997).

[253] *See infra* notes 337-39 and accompanying text (regarding SIA's objections to Koruga Award). In addition, the securities industry fears that reasoned awards provide the "basis for regulatory inquiry and action." Lipner, *supra* note 20, at 674.

names of the arbitrators; the date the claim was filed; the date the award was rendered; the number and dates of hearing sessions; the location of hearings and the signatures of concurring arbitrators.[254] This list makes no mention of an opinion or other written basis for the determination of liability or damages. In fact, the "Award Information Sheet" that the NASD-DR staff asks the panel to complete, which is later used used as a basis to draft the award, contains no space for an opinion.[255]

Some parties to securities arbitration call for reasoned awards to explain the panel's seemingly inexplicable decisions.[256] Proponents of reasoned awards argue that encouraging or even forcing arbitrators to write opinions will decrease parties' suspicion that the "decision was the product of emotion or viscera, rather than reason."[257] As a result, the argument goes, parties will be less likely to challenge the award in court and courts will be less suspicious of the integrity of the award.[258] However, as discussed below, it is not entirely clear the presence of an opinion would make it easier for a losing party—whose seemingly irrefutable legal position was rejected by the panel—to prevail on a motion to vacate.

B. *"Manifest Disregard of the Law"*

The Federal Arbitration Act ["FAA"] governs agreements to arbitrate arising out of "transactions in commerce."[259] Therefore, arbitrations between customers and their brokerage firms are governed by the FAA, whether in federal or state court.[260] While the statutory bases for vacating an arbitration award listed in section 10(b) of the FAA leave room for interpretation, none of

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[254] *See* NASD CODE 2002, *supra* note 72, § 10330(e); *see also* ARBITRATOR'S TRAINING PORTFOLIO, *supra* note 238, at 202 (omitting mention of written opinions).

[255] *See* ARBITRATOR'S REFERENCE GUIDE, *supra* note 248, at 22-26. Alternatively, if the staff member asks the panel to draft the award, the Guide provides a form "Shell Award" for this purpose. *See id.* at 27-32. There is no section in this form designed to accommodate an "opinion" or other legal discussion of the basis of the panel's determinations. *Id.* at 28-32.

[256] *See* Lipner, *supra* note 20, at 670-75.

[257] *Id.* at 673.

[258] *See id.*

[259] 9 U.S.C. § 2 (1994).

[260] *See* Southland Corp. v. Keating, 465 U.S. 1 (1984) (holding that section 2 of the FAA is applicable in state and federal court); *see also* Smith Barney, Inc. v. Henry, 775 So.2d 722, 725 (Miss. 2001) (applying FAA to securities arbitration); Levine v. Advest, Inc., 714 A.2d 649, 657 (Conn. 1998) (same); Salvano v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 85 N.Y.2d 173, 180 (1995) (same); Fletcher v. Kidder, Peabody & Co., 81 N.Y.2d 623 (1993) (same).

the stated grounds explicitly provides for a review of the merits. Rather, the focus of the statutory concerns is improper conduct on the part of the arbitrators.[261]

Most Courts of Appeal have adopted the judicially created[262] "manifest disregard of the law" standard as an additional ground to vacate an award.[263] However, manifest disregard is not recognized by some state courts as a ground for vacatur, even in arbitrations governed by the FAA.[264] What happens when a customer wants to argue that an award arising out of a federal securities law claim should be vacated because the arbitrators manifestly disregarded the law? It is well-settled that the FAA does not provide an independent basis of jurisdiction in federal court.[265] Without a jurisdictional basis, such as diversity, the customer cannot proceed in federal court, and thus will lose the ability to invoke the federal judicially created doctrine of manifest disregard of the law as a ground for the attack on the award. How can this result be reconciled with the mandate in *McMahon* that the arbitrators apply the law, at least with respect to federal statutory claims?

The Second Circuit's recent decision in *Greenberg v. Bear,*

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[261] The language of the pertinent provisions of the Federal Arbitration Act is sufficiently ambiguous that creative advocates can craft arguments that it permits review on the merits. *See, e.g.*, 9 U.S.C. § 10(a)(3) ("[T]he arbitrators were guilty of... any other misbehavior by which the rights of any party have been prejudiced"); *id.* § 10(a)(4) (1994) ("[T]he arbitrators exceeded their powers . . . ."). Whatever this language means, however, it is a strained interpretation to say that it authorizes courts to review the merits. See IDS Life Ins. Co. v. Royal Alliance Assoc., Inc., 266 F.3d 645 (7th Cir. 2001), which rejects just such an interpretation.

[262] *See supra* notes 31, 36 and accompanying text (discussing the Supreme Court's creation of the "manifest disregard" standard in *Wilko* and its transformation in *McMahon*). Moreover, in *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 941-42 (1995), the Supreme Court, in *dictum*, approved the use of "manifest disregard" as a ground for vacating an award.

[263] *See, e.g.*, Montes v. Shearson Lehman Bros., Inc., 128 F.3d 1456, 1460 (11th Cir. 1997) (collecting cases and acknowledging that, except for the Fifth Circuit, every other Circuit "has expressly recognized that 'manifest disregard of the law' is an appropriate reason to review and vacate an arbitration panel's decision"). However, some Circuits interpret that standard extremely narrowly. *See, e.g.*, George Watts & Son, Inc. v. Tiffany & Co., 248 F.3d 577, 580 (7th Cir. 2001) (indicating that manifest disregard means only that arbitrators' awards cannot direct the parties to violate the law and must adhere to the legal principles specified in the parties' contract).

[264] *See, e.g.*, Byerly v. Kirkpatrick Pettis Smith Polian, Inc., 996 P.2d 771, 775 (Colo. App. 2000); *Salvano*, 85 N.Y.2d at 795. The *Salvano* court did recognize that, under the unique circumstances of that case, the arbitrators' actions constituted a "wholesale abrogation of respondent's procedural and substantive rights" which could be characterized as an "action exceeding the scope of the arbitrators' powers, and then covered by the statutorily-enumerated grounds." *Id.*; *see also* N.Y. C.P.L.R. § 7511(b)(1)(iii) (1998).

[265] *See* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 25 n.32 (1983).

Stearns & Co.[266] provides an answer. In *Greenberg*, an investor moved to vacate an arbitration award that dismissed his federal securities law claim under section 10(b) of the SEA against a clearing broker. The district court denied the motion, finding no manifest disregard.

On appeal, the Second Circuit first addressed the subject matter jurisdiction of the district court. Recognizing the general rule that the FAA does not confer subject matter jurisdiction for purposes of a motion to vacate, the Court of Appeals held that there is no federal question jurisdiction simply because the underlying claim raises a federal question.[267] However, the Court carved out an exception when disposition of the matter "necessarily depends on resolution of a substantial question of federal law."[268] In so holding, the Court was mindful of the federal interest identified by the Supreme Court in *McMahon* to ensure that arbitrators interpret and apply federal statutory law.[269] Because in this case the investor argued that the arbitrators manifestly disregarded section 10(b) of the SEA, the Court found sufficient jurisdiction.[270] Under *Greenberg*, therefore, an investor with an award based on a federal statutory claim may have the award reviewed for manifest disregard, but that may not necessarily be the case with an award based on a state law claim.

Even if an aggrieved party to an arbitration award can establish jurisdiction in federal court, the courts have severely limited the reach of the manifest disregard doctrine. This raises a question as to whether the review is sufficient to accomplish its purposes of vindicating statutory rights as set forth in *McMahon*.

The very limited scope of review under the "manifest disregard" standard is illustrated in *Merrill Lynch v. Bobker*.[271] In that case the firm moved to vacate an award of damages to a customer based on the firm's cancellation of a short sale that, in the view of the firm and the SEC, would have violated Rule 10b-4.[272] The district court found that the arbitrators, in not enforcing

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[266] 220 F.3d 22 (2d Cir. 2000).

[267] *See id.* at 26.

[268] *Id.* (citing Barbara v. New York Stock Exch., Inc., 99 F.3d 49, 54 (2d Cir. 1996)) (internal quotations omitted).

[269] *See id.*

[270] *See id.* at 27. The Court then went on to hold that the arbitrators did not manifestly disregard the law and refused to vacate the award. *See id.* at 29.

[271] 808 F.2d 930 (2d Cir. 1986).

[272] Former Rule 10b-4, now Rule 14e-4, prohibits short tendering, i.e., a person tendering securities he does not own in a tender offer. Bobker tendered all his shares and also sold short. For a fuller discussion of the rule and the SEC's response to *Bobker*, see *Prohibited Transactions in Connection with Partial Tender Offers*, Exchange Act Release No. 28,660, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,703 (Nov. 30, 1990).

the "net long" provision of the Rule, had manifestly disregarded it. It was apparent from the record that the arbitrators had a skeptical view of the policy behind the Rule, but the Second Circuit, reversing the district court, noted that the arbitration panel was aware of Rule 10b-4 and had devoted an entire hearing session to it. For an award to be in manifest disregard, the governing law must be "well defined, explicit, and clearly applicable,"[273] and the error must be "obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator."[274] Given the complexities of securities laws and the many variations of the facts that can lead to different legal conclusions, it is a rare arbitration award that will be vacated under this standard.[275]

Two Circuits have applied the "manifest disregard" standard to vacate arbitration awards in SRO proceedings, but not in proceedings involving customer disputes with brokers. In *Montes v. Shearson Lehman Brothers*,[276] involving the Fair Labor Standards Act, the arbitrators denied the employee's claim after the brokerage firm's attorney explicitly urged the arbitrators not to apply the law. Since the award noted the attorney's plea and did not explicitly state that the arbitrators rejected this plea, the court found this established "manifest disregard."

While *Montes* can readily be confined to its facts, *Halligan v. Piper Jaffray, Inc.*[277] opens the door to a more expansive judicial review under the "manifest disregard" standard. In an SRO arbitration, a former employee of respondent brokerage firm alleged he had been fired in violation of the Age Discrimination in Employment Act. The arbitrators found in favor of the firm, despite what the Second Circuit characterized as "overwhelming" evidence that the termination of the employee's employment had been unlawful.[278] Because the parties had presented the applicable law to the panel, and because the panel provided no reasons for its decision, the court concluded it must have disregarded either the law or the evidence, or both.[279] While the court states it does not require arbitrators to write opinions, its opinion implies that arbitrators should provide an explanation for an award that might otherwise appear to a court as "in manifest disregard."

On the other hand, there is substantial doubt whether *Montes*

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273 *Bobker*, 808 F.2d at 934.
274 *Id.* at 933.
275 *See* Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220, 231 (1986).
276 128 F.3d 1456 (11th Cir. 1997).
277 148 F.3d 197 (2d Cir. 1998).
278 *Id.* at 203.
279 *See id.* at 204.

and *Halligan* have had any effect in judicial review of arbitration awards involving customers' claims. In *Dawahare v. Spencer*,[280] the customer sought to vacate an award in his favor because the panel awarded him substantially less than the loss to which his expert witness had testified. The court rejected his arguments, reaffirming the limited judicial review of arbitrators' awards—"an arbitration decision 'must fly in the face of established legal precedent' for us to find manifest disregard."[281] The court also noted that if arbitrators choose not to give reasons, "it is all but impossible to determine whether they acted with manifest disregard for the law."[282] Finally, to accept the customer's suggestion for a more extensive judicial review of arbitration awards "would undermine the goal of the arbitration process: to resolve disputes efficiently while avoiding extended litigation."[283]

These opinions, taken together, suggest that as long as the panel considers the legal arguments made by the parties, no matter how far afield of the well-settled law the result apparently turns out, a court will not vacate the award on the grounds that the panel manifestly disregarded or ignored the law. This very limited standard of review suits the Supreme Court's purposes in *McMahon*. Since the premise is that sending these claims to arbitration is merely moving them to another forum and not dispensing with the law, at a minimum there must be lip service paid to a judicial review of arbitration awards. However, it cannot be more than lip service since that will destroy the perceived advantages to arbitration.

V. WOULD INVESTORS FARE BETTER IN COURT?

Because arbitrators may be limited in their ability to apply the law, the arbitration forums are more concerned with process than substance, and the courts provide little opportunity for meaningful review, investors might question whether they can get a "fair shake" in arbitration.[284] This, inevitably, raises the question:

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[280] 210 F.3d 666 (6th Cir. 2000).

[281] *Id.* at 669 (quoting Merrill Lynch v. Jaros, 70 F.3d 418 (6th Cir. 1995)).

[282] *Id.*

[283] *Id.* In a non-securities arbitration context, the Supreme Court recently said that an arbitrator's "improvident, even silly" fact-finding is not grounds for a court's refusal to enforce the award. Major League Baseball Players Ass'n v. Garvey, 532 U.S. 504 (2001).

[284] One commentator has concluded that investors may very well be better off in arbitration, at least with respect to federal statutory claims. *See* Marc I. Steinberg, *Securities Arbitration: Better for Investors Than the Courts?*, 62 BROOK. L. REV. 1503 (1996).

Compared to what?

As previously discussed, the law governing a broker's liability to a customer for misconduct is complex, stemming from both federal securities law and state common law and statutory law;[285] the uncertainties attendant in any contemporary body of law are further exacerbated by the privatization of the law. It is clear, however, that the law presents many obstacles that the investor must overcome in pursuing a judicial remedy against a broker-dealer.

To survive a motion to dismiss, investor plaintiffs must first comply with stringent pleading requirements. Prior to 1995, federal courts, and the Second Circuit in particular, enforced with vigor Rule 9(b)'s[286] requirement that plaintiffs plead fraud allegations with specificity.[287] Plaintiff must (a) allege facts to show that "defendants had both motive and opportunity to commit fraud," or (b) allege facts that "constitute strong circumstantial evidence of conscious misbehavior or recklessness."[288] The Private Securities Litigation Reform Act of 1995 ("PSLRA") codified these stringent pleading requirements.[289] To plead scienter, plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[290]

Furthermore, since 1991 investors contemplating Rule 10b-5 claims must act quickly. The Supreme Court, in one of the most significant post-*McMahon* judicial developments affecting private claims, decided that the statute of limitations for Rule 10b-5 claims should be one year from the date of discovery, but no more than three years from the date of the purchase or sale,[291] borrowing the statute of limitations for express causes of action under Section 9(e) of the SEA. Prior to this decision, the prevailing view among the Circuit courts was to borrow the statute of limitations for the closest, analogous state claim, generally a longer time period than section 9(e). As a result, investors may have no choice but to pursue state law claims.[292]

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285 See *supra* notes 88-89 and accompanying text.

286 *See* FED. R. CIV. P. 9(b).

287 *See, e.g.*, Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 444 (2d Cir. 1971).

288 Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994).

289 *See* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3 (1996).

290 15 U.S.C. § 78u-4(b)(2) (1997).

291 *See* Lampf v. Gilbertson, 501 U.S. 350 (1991).

292 Investors have the same problem in arbitration, as they must comply both with the applicable statute of limitations as well as the SROs' six-year eligibility rule. NASD CODE 2002, *supra* note 72, § 10304.

If the investor files his claim in a timely manner and survives a motion to dismiss, he faces a risk that both federal and state claims will be summarily dismissed, either for failure to state a claim or on a motion for summary judgment. We have previously discussed how the elements of fraud and deception prevent investors from holding brokers liable for conduct that may be unethical, unprofessional, or incompetent, yet not constitute fraud under either federal or state law.[293]

Moreover, today's "reasonable investors" are expected to possess a certain level of understanding and sophistication to withstand broker-dealer misconduct.[294] According to the courts, reasonable investors should understand, for example, the time-value of money,[295] diversification and risk,[296] and the securities industry's compensation structure.[297] Investors should not succumb to brokers' "puffery."[298] While courts sometimes proclaim that the plaintiffs were not "widows and orphans" when denying relief to investors they decide should have known better,[299] courts can impose equally high standards for widows—holding that one with a tenth grade education and no prior investment experience should have read and understood the prospectus for a limited partnership interest recommended by her broker.[300]

Additionally, brokers possess legal advantages because generally investors' claims are based on oral assurances or representations made by brokers, while the brokers are the possessors of the written record. For example, a plaintiff must establish justifiable reliance on a broker's misrepresentations or

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[293] *See supra* note 96 and accompanying text; *see also* McDonald v. Alan Bush Brokerage Co., 863 F.2d 809 (11th Cir. 1989); O'Connor v. R.F. Lafferty & Co., 965 F.2d 893 (10th Cir. 1992) (awarding summary judgment for the defendant due to a lack of scienter).

[294] According to the courts, some information is "so basic that any investor could be expected to know it." Zerman v. Ball, 735 F.2d 15, 21 (2d Cir. 1984) (assuming that the investor is familiar with the nature of margin accounts).

[295] *See* Levitin v. PaineWebber, Inc., 159 F.3d 698, 702 (2d Cir. 1998) (noting that an investor should know that cash or securities left with a broker may be used to earn interest for the firm).

[296] *See* Dodds v. Cigna Securities, Inc., 12 F.3d 346 (2d Cir. 1993).

[297] *See* Platsis v. E.F. Hutton & Co., Inc., 946 F.2d 38 (6th Cir. 1991) (holding that a broker did not have to explain that the firm made a profit by charging a mark-up when he, in response to an investor's question of why he was not charged commissions on his purchases of bonds, replied that commissions were not charged on sales from inventory).

[298] Bogart v. Shearson Lehman Bros., Inc., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,733 (S.D.N.Y. 1995).

[299] Granite Partners, L.P. v. Bear, Stearns & Co., 58 F. Supp. 2d 228 (S.D.N.Y. 1999); *see also* Primavera Familienstifung v. Askin, 130 F. Supp. 2d 450 (S.D.N.Y. 2001); Kennedy v. Josephthal & Co., Inc., 814 F.2d 798, 805 (1st Cir. 1987) (finding that investors are not "neophytes").

[300] *Dodds*, 12 F.3d 346 (2d Cir. 1993).

recommendations. The typical case involves oral assurances of low or no risk when the investor is given documentation disclosing the risk factors.[301] Despite what is stated to be an intensely fact-specific determination,[302] courts do not view sympathetically investors who are told lies by their brokers, if, in the view of the courts, they had enough information to expose the lie.[303]

As discussed previously, Rule 10b-5 fraud requires deception.[304] So, for example, if the broker exercises his control over the customer's account and engages in inappropriate trading activity that is set forth on the customer's account statements, and the broker has made no misstatements to the customer, the broker has a plausible defense that he has not committed securities fraud.

Unauthorized trading is another example where brokers win because of the paper record. Courts frequently find that investors cannot prevail on unauthorized trading allegations when they received confirmation slips or monthly statements indicating the allegedly unauthorized transactions and did not take prompt action to complain; this is expressed under the doctrines of laches, waiver, ratification, or, more generally, the investors' lack of due diligence.[305] The broker may be able to assert this defense more generally to other allegations of inappropriate trading activity, such as suitability and churning.

A recent opinion involving a common complaint among online investors further illustrates the difficulties. Many online trading systems generate a "confirmation" in response to an investor's attempt to cancel a previous buy order, even though the buy order was not, in fact, cancelled.[306] The district court dismissed

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301 *See, e.g.*, Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983). Another common scenario involves oral representations made when a contract contains a merger or no-oral-representations clause. *See* Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879 (1994).

302 *See supra* note 112 and accompanying text.

303 Summary judgment has been granted for defendants due to a lack of justifiable reliance. *See, e.g.*, Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1028 (4th Cir. 1997); McAnally v. Gildersleeve, 16 F.3d 1493 (8th Cir. 1994); Chance v. F.N. Wolf, 36 F.3d 1091 (4th Cir. 1994); Kennedy v. Josephthal & Co., Inc., 814 F.2d 798 (1st Cir. 1987). *See also* Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc., 157 F.3d 933 (2d Cir. 1998) (holding that disclaimers and warnings in formal disclosure documents precluded any reasonable reliance on any statements contained in other sales literature).

304 *See supra* note 94 and accompanying text.

305 *See, e.g.*, Olson v. C.F.T.C., 19 F.3d 28 (9th Cir. 1994); Modern Settings, Inc. v. Prudential-Bache Sec., Inc., 936 F.2d 640 (2d Cir. 1991); Stephenson v. Paine Webber Jackson & Curtis, Inc., 839 F.2d 1095 (5th Cir. 1988); Brophy v. Redivo, 725 F.2d 1218 (9th Cir. 1984).

306 For a fuller discussion, see Barbara Black, *Securities Regulation in the Electronic Age: Online Trading, Discount Broker's Responsibilities and Old Wine in New Bottles*, 28 SEC. REG. L.J. 15, 28-29 (2000).

a class action charging that these "confirmations" were misleading under section 10(b) and Rule 10b-5.[307] The district court relied on precedent that section 10(b)'s "in connection with" requirement means that the misrepresentation must concern either the value of the security purchased or sold, or the consideration received in return. The court could also have found, consistent with precedent, lack of scienter. The court dismissed plaintiffs' state law claims without reaching the merits, but it is unlikely that plaintiffs would fare any better in state court. Discount brokers' contracts typically disclaim liability in this situation,[308] and as discussed earlier,[309] courts generally hold that discount brokers owe no obligations to their customers beyond the contract.

With all of these difficulties in proof, it is not clear that an investor would be better off in court, where a judge would strictly apply pleading requirements and construe the elements of each claim against the plaintiff. In many ways, it is counter-intuitive that the brokers fought so hard to get investors' claims out of the courts and into arbitration, since customers' complaints are frequently stronger on the equities—hardship and betrayal—while the brokers' defenses are stronger on the law. This point is illustrated by the pleadings filed by the parties. Investors' attorneys generally draft their statements of claim as a narrative, to persuade the arbitrators that the broker violated the customer's trust,[310] while brokers' attorneys generally emphasize legal defenses in their answer.

Brokers have also become adept at using the customer's agreement to their greatest advantage. Hence, they resisted suggestions to require the customer to initial separately the clause in the contract mandating arbitration,[311] presumably recognizing that the requirement would in many instances slow down the process of opening customer agreements and might even cause

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[307] *See* Hoffman v. TD Waterhouse Investor Services, Inc., 148 F. Supp. 2d 289 (S.D.N.Y. 2001).

[308] *See* Black, *supra* note 306, at 28.

[309] *See supra* note 105 and accompanying text.

[310] According to a respected practitioner, the difference between a successful and a losing claim is establishing that the customer's trust in the broker was well-founded and then violated. *See* DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 5-1 (4th ed. 2000).

[311] Requiring initials or a signature in an agreement is common in consumer protection regulation to call the signatory's attention to it. *See, e.g.*, U.C.C. § 2-205 (1990). NASD-Regulation rejected the authors' suggestion requiring the investor to sign or initial the margin disclosure agreement as "overly burdensome for members to comply with" and "not significantly [increasing] the informational value to the customer." Self-Regulatory Organizations, Order Approving Proposed Rule Change Regarding Delivery Requirement of a Margin Disclosure Statement to Non-Institutional Customers, Exchange Act Release No. 44223, 66 Fed. Reg. 22,274 (Apr. 26, 2001).

some customer resistance to the lack of an alternative to arbitration. Yet brokers are quick to cite contractual language that limits their liability to customers.

VI. ARE ARBITRATORS MAKING LAW OR DISREGARDING IT?

While it seems that an investor may have difficulty prevailing in court under the established law, arbitration panels, on more than an occasional basis, are reaching decisions favorable to investors even where the "law is clear" that there is no basis for imposing liability on the broker. These results may be explained by the arbitrators being swayed by the equities: innocent, unsophisticated investors generate sympathy from arbitrators, in the form of an award, for tragic, seemingly avoidable losses, despite the well-established law that suggests no liability by the broker. Three areas where this is happening are margin sellouts, economic suicide, and liability of clearing brokers.

"Margin Sell Outs". One complaint that has received much attention in the financial press lately is "margin sell out" or "blowout." With the recent volatility in the stock market, customers in increasing numbers have complained about brokers selling securities in their accounts to meet margin calls, without giving the customers an opportunity to provide additional margin.[312] A frequent complaint is that brokers no longer give customers three days notice to meet a margin call as had been their previous practice.[313] The law, at least so far as the regulators are concerned, is unequivocally on the side of the broker. The regulators have stated on numerous occasions that the margin regulations are designed to protect the brokers and the stock markets from the consequences of excessive leverage.[314]

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[312] *See* Rachel Witmer, *SEC Says Suitability, Two Other Types of Complaints Against Brokers on Rise*, SEC. L. DAILY (BNA) (Apr. 27, 2001) (indicating that the SEC reported 120 complaints on margin sellouts in the first quarter of 2001, in comparison with 67 in the first quarter of 2000). Customer complaints filed at NASD-DR in the first quarter of 2001 rose fifteen percent over the first quarter of 2000, and margin calls and online trading accounted for more than ten percent of the new caseload. *See NASD Stats, in* SECURITIES ARBITRATION ALERT 2001-16 (Apr. 18, 2001).

[313] *See* Witmer, *supra* note 312.

[314] *See* Self-Regulatory Organizations Order, *supra* note 311, at 22,274. Most recently, the release approving a NASD rule change requiring delivery of a margin disclosure statement to customers discussed an increase in customers' complaints relating to margin accounts. The release finds that customers are "mistaken" in their beliefs that they are entitled to: notification of margin calls, extensions of time on margin calls, the right to dictate which security or other asset is liquidated, and advance written notice of increases in firms' maintenance margin requirements. *Id.*

Accordingly, it has long been settled that a customer has no private right of action for damages if the broker permits the account to be out of compliance with the margin regulations.[315] A broker may sell the customer's securities whenever a customer's account falls below the maintenance margin level and, because it is necessary to act fast in volatile markets, he has no obligation to provide notice before selling. Further, even if the broker does provide notice, he may still go ahead and sell off the securities in advance of the time set forth in the notice if market conditions warrant. Liquidation of the account without notice cannot constitute securities fraud under Rule 10b-5. While theoretically there could be an enforceable agreement between the customer and broker to give notice that would give rise to a breach of contract claim, the written agreement typically gives the broker broad discretion to sell off securities without notice.[316]

Yet, notwithstanding the clarity of the law, investors in increasing numbers are filing arbitration claims based on margin sellouts, and arbitration panels are occasionally awarding customers for damages in these cases.[317] While we cannot know why the arbitration panels decided in the investors' favor, conversations among investors' attorneys suggest that certain fact patterns may make a case a winner: where, for example, the broker has made oral assurances that it would not liquidate without notice; where the broker knows that the investor has always met his margin calls when given notice; or where the broker's actions in liquidating the account may seem precipitous or otherwise unreasonable.[318]

Economic Suicide. Recently, online traders have brought claims against their brokers where their basic assertion is that the

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315 *See* Bennett v. U.S. Trust Co. of N.Y., 770 F.2d 308, 312 (2d Cir. 1985).

316 *See, e.g.*, First Union Disc. Brokerage Serv., Inc. v. Milos, 997 F.2d 835 (11th Cir. 1993); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971) (involving the liquidation of a margin account where no Rule 10b-5 fraud was found); Schenck v. Bear, Stearns & Co., 484 F. Supp. 937 (S.D.N.Y. 1979) (concerning the liquidation of an account in full compliance with a customer's agreement). The court in *Conway v. Icahn & Co.*, 16 F.3d 504 (2d Cir. 1994), found that a broker has a fiduciary duty to provide a customer with notice, but in that case there was no customer's agreement authorizing it. The clear implication is that where there is an agreement authorizing liquidation, the customer has no complaint. *See id.*

317 *See* Ruth Simon, *Margin-Related Claims Seeking Arbitration Are on the Increase*, WALL ST. J., Sept. 6, 2000, at C1. Through August 2000, investors had filed 152 margin-related arbitration claims with NASD-DR, up from 117 margin claims in all of 1999 and just 44 a year earlier. *See id.*

318 *See id.* The article describes an instance where an arbitration panel awarded an investor approximately $500,000 for liquidating the investor's account without notice. *See id.* It appears that the investor's attorney emphasized that the broker knew the investor had the funds to meet margin calls and had earlier that month met margin calls. *Id.*

broker should have realized their purchases were unduly speculative or otherwise unsuitable for them. While these cases may raise difficult questions of what constitutes a recommendation,[319] in the absence of a recommendation, a discount broker owes no duty to assure that the customer's purchases are suitable.

Here again, arbitrators are occasionally awarding damages to customers.[320] In a much-publicized case,[321] a medical student alleged that he opened an online account, even though he did not understand what trading on margin was, and proceeded to lose more than $40,000 by trading Internet stocks on margin. He appears to have asserted both that the broker had a duty to warn or stop him and that the broker improperly liquidated his account. While the investor recovered only part of his alleged losses—about $22,000 (plus $17,500 in attorney's fees) out of a claim for $75,000 in compensatory damages and unspecified other relief of $150,000—the case signals a willingness on the part of at least some arbitrators to award damages to investors contrary to legal precedent.

Liability of Clearing Brokers. Investors who have claims against a defunct introducing broker may seek to impose liability on the clearing broker on the grounds it should have known that the introducing broker was engaged in illegal conduct. Here the law is clear—in the absence of active participation in the fraudulent conduct, a clearing broker owes no duty to the customer to monitor the introducing broker's conduct or to warn the customer of the introducing broker's illegal activity.[322] Nevertheless, some arbitration panels are imposing liability on clearing brokers. These awards are withstanding motions to vacate, despite the clearing brokers' strong arguments that the awards show "manifest disregard."[323]

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[319] *See* NASD Notice to Members 01-23, *supra* note 225.

[320] *See* Black, *supra* note 306, at 31-32.

[321] *See* Rebecca Buckman, *Student Awarded $40,000 from Firm in Trading Case*, WALL ST. J., Jan. 17, 2000, at C16.

[322] *E.g.*, Antinoph v. Laverell Reynolds Sec., 703 F. Supp. 1185 (E.D. Pa. 1989), *aff'd without opinion*, 911 F.2d 719 (3d Cir. 1990); Riggs v. Schappell, 939 F. Supp. 321 (D. N.J. 1996); *In re* Adler Coleman Clearing Corp., 198 B.R. 70 (Bankr. S.D.N.Y. 1996); Rivera v. Clark Melvin Sec. Corp., 59 F. Supp. 2d 297 (D. P.R. 1999); *In re* Blech Sec. Litig., 928 F. Supp. 1279 (S.D.N.Y. 1996).

[323] *See, e.g.*, McDaniel v. Bear Stearns & Co., 2002 U.S. Dist. LEXIS 762 (S.D.N.Y. Jan. 17, 2002); Koruga v. Fiserv Correspondent Serv., Inc., No. 00-1415-MA, 2001 U.S. Dist. LEXIS 2417 (D. Or. Feb. 7, 2001); RPR Clearing v. Glass, 1997 WL 460717 (S.D.N.Y. July 25, 1997). While noting that there was no case "directly on point" in holding a clearing broker liable under the facts of the arbitration at issue, the *Glass* court found that there was case law "that suggests the possibility of a duty," and this was sufficient to defeat the motion to vacate. *Id.* at *2.

The problem with these results is unpredictability. It may be that the arbitrators, hearing the facts and the law, believed there were facts that put this particular case within an existing exception to the prevailing legal principle. It may be that the arbitrators were simply moved by sympathy to award damages to the claimant, in blatant disregard of the law. It may be that the arbitrators decided this case on the facts before them, without any consideration of the law. Is there any possibility of predictability in securities arbitration?

VII. SHOULD ARBITRATION AWARDS PROVIDE PREDICTABILITY?

Attorneys, by their training, search for predictability of results and compile precedent for that purpose. Securities arbitration attorneys are no different; arbitration awards are being collected and even cited by practitioners as precedent in other arbitration hearings, both to provide predictability of result and to contribute to the development of the law. However, given the limits on the arbitrators' ability to apply the law and the lack of meaningful judicial review, arbitration awards should have no significance except to decide the actual dispute before the arbitrators.[324]

The arbitrators in a dispute heard by an NASD Dispute Resolution panel in Portland, Oregon wrote an award explaining in great detail why they imposed liability on a clearing broker.[325] While the panel's decision to provide an explanation may have stemmed from a concern that otherwise the decision would appear inexplicable and be subject to attack on a motion to vacate, it forthrightly asserted they wished to encourage other arbitrators to provide explanations for their awards and thus to create "a body of meaningful precedents."[326] The award merits careful attention to assess whether it is likely to, and whether it should, become the mechanism for development of the law.

In *Koruga*, several former customers of a defunct brokerage firm, Duke & Company ("Duke"), brought an arbitration against the firm, its principals and the customers' individual brokers for

[324] For efficiency arguments in support of these views, see Landes & Posner, *supra* note 86, at 238-39 (noting that private judges have little incentive to write opinions, and therefore there is a danger of many inconsistent precedents). The article suggests that rule-making could be committed to a public body and dispute resolution to private judges, although this may result in an inefficient system. *See id.* at 240.

[325] *See In re* Arbitration between Koruga and Wang, No. 98-04276 (Sept. 28, 2000) [hereinafter Koruga Award] (on file with authors).

[326] *Id.* at 15.

losses sustained in their securities accounts due to the Respondents' alleged fraud.[327] Claimants also named as a respondent Duke's clearing firm, Hanifen Imhoff (now known as Fiserv Correspondent Services), seeking to impose joint and several liability on the clearing firm under state securities laws for the misconduct of Duke and its principals.[328] Respondents vigorously argued that the applicable well-settled laws precluded the imposition of liability on a clearing firm for the conduct of its introducing broker.[329]

After a five day hearing, the arbitrators issued a thirty-nine-page Award, which included extensive "Findings of Fact,"[330] a three paragraph section entitled "Conclusions of Law,"[331] and a twenty-five-page "Explanation of Award" explaining the factual and legal bases for its decision.[332] The Panel awarded $1.7 million in damages to the customer-claimants, finding that, under the Washington and California securities acts, the clearing firm "materially aided" the fraud of Duke and its principals. Crucial findings of the Panel included the legal conclusion that Hannifen Imhoff was a "broker-dealer" within the meaning of pertinent state securities laws and that it "materially aided in the transactions" between Duke and the claimants.[333]

Significantly, as part of the Award, the Panel expressed its view that, due to the *McMahon* decision upholding mandatory arbitration, the law has not been sufficiently developed in the area of broker/dealer liability to customers.[334] The Panel also expressed concern that, because arbitration awards do not include

[327] Duke & Company was an alleged boiler room that encountered severe regulatory problems in 1999 when a grand jury in New York County indicted the firm, its executives and principals, and numerous employee/brokers for Enterprise Corruption under New York State's penal law. The indictment alleged, *inter alia*, that the firm and its individual employees engaged in securities fraud and theft from customers through stock manipulation and a "pump and dump" scheme. New York vs. Duke & Co. Inc., Indictment No. 3325/99 (Sup. Ct. N.Y. Co.) (filing date unavailable) (on file with authors). By the time the customers filed the arbitration, Duke was already involved in a SIPC liquidation proceeding and had no assets to satisfy customer claims. *See* Koruga Award, *supra* note 325, at 6.

[328] The claimants were residents of either Washington or California. Therefore, those state's Uniform Securities Acts applied to the dispute. Under those Acts, the relevant provisions of which were substantively similar, a "broker-dealer" who "materially aids" in the challenged transaction is jointly and severally liable to the same extent as the primary violator. *See* WASH. REV. CODE ANN. § 21.20.430(3) (West 2002); CAL. CORP. CODE § 25504 (West 2001).

[329] *See* Koruga Award, *supra* note 325.

[330] *Id.* at 8-11.

[331] *Id.* at 11.

[332] *Id.* at 13-37.

[333] *Id.* at 16-37.

[334] *See id.* at 13.

explanations for the decisions, prior awards concerning liability of clearing firms had no precedential value because they contained no reasoning.[335] As a result, the Panel announced that it was including an explanation of its Award to "encourage future NASD panels to be more forthcoming, so that a body of *meaningful precedents* . . . may become available."[336]

Subsequently, Hannifen Imhoff moved to vacate the award in the United States District Court for the District of Oregon on the grounds of manifest disregard of the law. The SIA filed an amicus curiae brief in support of the motion.[337] In its brief, the SIA argued that the arbitrators "explicitly rejected" well-settled federal and state law that clearing brokers have limited "operational or ministerial" functions and thus are not liable to customers under the securities laws (which require a party to provide "material" aid to be liable).[338] The SIA also argued that the arbitrators exceeded the scope of their authority and "trespassed upon the domain of the judiciary" by trying to create a body of meaningful precedents and make law for other arbitration panels to follow.[339]

The district court denied the motion to vacate, ruling that the arbitrators did not manifestly disregard the law.[340] The district court first re-stated the applicable Ninth Circuit standard that a "reviewing court should not concern itself with the 'correctness' of an arbitration award."[341] Instead, "[t]o vacate an arbitration award on the basis of a manifest disregard of the law, it must be clear from the record that the arbitrators recognized the applicable law, and then ignored it."[342] According to the district court, the Award demonstrated that the panel considered at length the applicable law as the parties presented it and came to a reasoned decision as

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335 *See id.* at 14-15.

336 *Id.* at 15-16 (emphasis in original). Even more troubling was the Panel's announcement that, because it considered the regulatory response to "wide-spread micro-cap fraud" to be "pathetically minimal," it felt responsible to provide "a careful and thoughtful application of state securities laws to specific cases" to "produce tangible results in reining in the continuing recycling of micro-cap fraud enterprises." *Id.* at 23.

337 *Amicus Curiae* Securities Industry Association's Memorandum of Law in Support of Motion to Vacate Arbitration Award, No. 00-1415 MA (D. Or. Dec. 8, 2000) at 2. In that brief, the SIA recognized its "institutional commitment" to the arbitration process and thus did not undertake a request to vacate an arbitration award "lightly," but claimed "the detrimental effects that will ensue if the Award is allowed to stand necessitate[d]" its filing the brief. *Id.*

338 *Id.* at 3-27.

339 *Id.* at 27-30.

340 *See* Koruga v. Fiserv Correspondent Serv., Inc., 183 F. Supp. 2d 1245 (D. Or. 2001).

341 *See id.* at 1247 (citing Thompson v. Tega-Rand Int'l, 740 F.2d 762, 763 (9th Cir. 1984)).

342 *See id.* (citing Michigan Mut. Ins. Co. v. Unigard Sec. Ins. Co., 44 F.3d 826, 832 (9th Cir. 1995)).

to how to apply that law.[343] Claimants filed an appeal, which is now pending.

The *Koruga* Award demonstrates what happens when a panel painstakingly writes an opinion explaining the factual and legal basis of its award. Despite industry concern that the panel misapplied existing law or made new law,[344] the award was immune from vacatur because the arbitrators protected themselves by reasoning through the law and writing out such reasoning explicitly. As a result, whatever the ruling, no reviewing court could say that the panel manifestly disregarded the law.

This Award further highlights the difficulty with tasking arbitrators, many of whom are not lawyers and have little training in the law, to produce reasoned awards. Arbitrators do not have the resources available to judges, primarily law libraries and law clerks, to craft reasoned opinions, and most arbitrators simply do not have the time or judicial temperament to craft reasoned opinions. The traits the NASD-DR looks for in arbitrators[345] are by no means the traits one expects a judge to possess. In this case, significantly, the panel had to rely on the parties to supply them with the relevant provisions of the law, and the panel apparently had no way to verify independently that the law provided to them was complete.

Moreover, despite the panel's views to the contrary, arbitration awards have no value as precedent for future arbitrations.[346] Accordingly, there appears to be little reason to write such an award, particularly if the end result is an award immune from challenge no matter how the panel ruled. It is neither realistic nor desirable to expect a body of law to develop through arbitrators' awards, even though, as is typical in the legal business, tremendous effort is now going into the compilation[347] and analysis of awards. Attorneys engage in this activity to glean an understanding of the mental processes or predilections of the potential arbitrators selected for their panels, and for this purpose

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[343] *See id.* at 1248. The district court did not mention the SIA's amicus brief or the arguments contained in it.

[344] *See, e.g.*, Gretchen Morgenson, *Striking a Blow for the Little Guy*, N.Y. TIMES, Feb. 11, 2001, at § 3, 1.

[345] *See supra* notes 233-35 and accompanying text.

[346] *See, e.g.*, El Dorado Technical Serv., Inc. v. Union Gen., 961 F.2d 317, 321 (1st Cir. 1992); *see also* David L. Heinemann, *Arbitrability of Claims Arising Under the Securities Exchange Act of 1934*, 1986 DUKE L.J. 548, 553-54.

[347] *See Securities Arbitration Awards To Be Available Online as of June 1*, SEC. LAW DAILY (BNA), May 11, 2001. Signaling the importance of compiling these awards for the arbitration process, the NASD-DR just entered into a formal arrangement with the Securities Arbitration Commentator to make prior securities arbitration awards available online and for no fee through a link on its website.

it may serve some utility. To the extent arbitrators' awards are reviewed for purposes of discerning development of the law, the efforts seem misguided.

CONCLUSION

The law still maintains a starring role in securities arbitration. It provides parties with guidance as to how to conduct themselves in securities business and offers arbitrators standards of conduct the parties are reasonably expected to follow. Under *McMahon*, arbitrators are required to apply the law, at least with respect to investors' rights under the federal securities laws. As for state law, to the extent certain states do not require their arbitrators to follow state law, this does not conflict with the Supreme Court's mandate in *McMahon*.

It is premature to assess whether the law governing the responsibilities of broker-dealers to their customers will remain frozen following the *McMahon* decision. While the relative scarcity of judicial opinions since *McMahon* might slow down the evolution of the law or place disproportionate importance on the opinions that are written, judges are still visiting these issues across the country.

Meanwhile, arbitrators—limited in their ability to understand and apply the law—are trained to grant paramount consideration to questions of fairness and equity. As a result, if arbitrators want to resolve a customer dispute in an area where the law is not clear or well-developed, or even overly complex, they may draw on their individualized notions of fairness rather than apply an outdated legal doctrine to a modern transaction. Yet, arbitrators are barely held accountable to any court of law for such decisions. Given the current slant of the law disfavoring investors, however, this consequence may actually create opportunities—albeit unpredictable ones—for recovery of customer losses where none existed before.

In that respect, arbitration may not be a "crapshoot" after all.