William & Mary Law Review

Volume 40 (1998-1999)
Issue 4

Article 2

April 1999

Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous

Steven A. Ramirez

William and Mary Law Review

VOLUME 40 APRIL 1999 NUMBER 4

ARBITRATION AND REFORM IN PRIVATE SECURITIES LITIGATION: DEALING WITH THE MERITORIOUS AS WELL AS THE FRIVOLOUS

STEVEN A. RAMIREZ*

INTRODUCTION

An important debate is raging regarding the federal regulatory role in the securities markets. On one side of this debate are those arguing that private securities litigation is dominated by greedy attorneys who use protracted litigation to extort large settlements from legitimate business, imposing a pernicious "litigation tax" upon the cost of capital in America and flooding our courts;[1] on the other side are those arguing that private litiga-

* Steven A. Ramirez is an Associate Professor of Law at Washburn University School of Law, and a former enforcement attorney with the Securities and Exchange Commission. He also serves occasionally as an arbitrator for the National Association of Securities Dealers. This Article was presented to the Washburn University School of Law Faculty, through a faculty development seminar organized by Professor William Rich. Many helpful comments from that presentation served to improve this paper. Bobby J. Hiebert and Thomas Bayles provided excellent research assistance.

1. *See, e.g.*, REPRESENTATIVE NEWT GINGRICH ET AL., CONTRACT WITH AMERICA 150 (Ed Gillespie & Bob Schellhas eds., 1994) ("Since class-action lawyers can make decisions that are not in the best interest of the clients . . . shareholders are often exploited. Strike suits are money-makers for the lawyers but such frivolous claims destroy jobs and hurt the economy."); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 500 (1991) (arguing that lawsuits are filed very frequently against companies whose stock

tion is the only realistic means of enforcing federal regulation, that the American financial markets are widely perceived to be the fairest and most efficient in the world, and that there is little, if any, evidence that the system has been abused.[2] The stakes in this debate are huge.[3] American fortunes ride upon the success of our financial markets as never before because of increased international economic competition and important demographic trends.[4] Unfair financial markets are a breeding

---

declines significantly, that most cases settle, and that settlements are not based upon merits but rather upon legal costs and other nonmerit factors); Curt Cutting, *Turning Point for Rule 10b-5: Will Congressional Reforms Protect Small Corporations*, 56 OHIO ST. L.J. 555, 583 (1995) (concluding that frivolous lawsuits amount to a "tax on innovation," particularly for small corporations); Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 976 (1993) (concluding that derivative and class actions benefit only lawyers and raise the cost of capital in America).

2. *See, e.g.*, D. Brian Hufford, *Deterring Fraud vs. Avoiding the "Strike Suit": Reaching an Appropriate Balance*, 61 BROOK. L. REV. 593, 635-36 (1995) (arguing that because American capital markets are "'the largest and most vibrant in the world'" any reform measures should be based on proven needs (quoting S. REP. NO. 104-98, at 37 (1995))); Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 HARV. L. REV. 438, 457 (1994) ("What has been most lacking in the legislative debate to date has been authentic data that provides empirical or theoretical support for particularized law revision. If there is a case for significant changes in federal securities class action law, it simply has not been presented to date."); *see also* GARY W. SHORTER, CONGRESSIONAL RESEARCH SERVICE, SECURITIES LITIGATION REFORM: HAVE FRIVOLOUS SHAREHOLDER SUITS EXPLODED?, CRS-34 (May 16, 1995) ("On balance the evidence does not appear to be compelling enough for one to conclude that warrantless class action suits have exploded."); John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 339-40 (1996) ("At Senate hearings . . . much of the testimony focused on the perception of a securities litigation crisis. Many of the witnesses gave anecdotal evidence of widespread abuses in the private litigation system, but the empirical evidence was inconclusive." (footnotes omitted)).

3. Senator Arlen Specter pointed out, for example, in debates on the Senate floor relating to the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.), that: "The gross national product of the United States . . . amounts to $7 trillion . . . the sale of stock, approximate[s] $4 trillion." 141 CONG. REC. S19046 (daily ed. Dec. 21, 1995) (statement of Sen. Specter).

4. For example, from 1965 to 1997, the frequency of stock ownership rose from 10.4% of Americans to 43% of Americans. These investors frequently rely on such investments for their retirement savings. *See* PETER D. HART RESEARCH ASSOCIATES, A NATIONAL SURVEY AMONG STOCK INVESTORS, CONDUCTED FOR THE NASDAQ

ground for panic.[5] Inefficient markets, like those that impose arbitrary costs upon capital, stunt economic growth.[6] Most importantly, the public must have confidence in the integrity of our financial markets in order to insure a stable and inexpensive source of capital for American business growth.[7]

STOCK MARKET (1997).

5. *See, e.g.*, 15 U.S.C. § 78b (1994) (stating that trading in securities is "affected with a national public interest" demanding the maintenance of "fair and honest markets" because unfair markets can lead to "national emergencies" resulting in "widespread unemployment" and "dislocation of trade").

6. Congress has long recognized that the securities markets of the United States must be both *fair* and *efficient*:

> The securities markets of the United States are indispensable to the growth and health of this country's and the world's economy. In order to raise the enormous sums of investment capital that will be needed in the years ahead and to assure that that capital is properly allocated among competing uses, these markets must continue to operate fairly and efficiently. In the Committee's view, the increasing tempo and magnitude of the changes that are occurring in our domestic and international economy make it clear that the securities markets are due to be tested as never before. Unless these markets adapt and respond to the demands placed upon them, there is a danger that America will lose ground as an international financial center and that the economic, financial and commercial interests of the Nation will suffer.

S. REP. NO. 94-75, at 3 (1975).

7. *See* I LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 217-18 (3d ed. 1998) ("[I]ncreasing investor confidence . . . may have important economic consequences. By reducing the perceived risk of corporate securities, compulsory disclosure would tend to reduce the risk premia that issuers . . . would have to pay, thus increasing the funds available for economic growth."). The supporters of PSLRA would not dispute this. In fact, according to the Statement of Managers in the Conference Report accompanying the PSLRA, "Congress has been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets." H.R. REP. NO. 104-369, at 31 (1995).

The purported congressional concern that investor confidence was suffering from abusive securities litigation seems to be somewhat overstated. As part of the PSLRA, Congress directed the Securities and Exchange Commission (SEC) to study the need for further protections of senior citizens and retirement plans from securities fraud and abusive securities litigation. *See* Private Securities Litigation Reform Act §§ 106, 109. When the SEC conducted this study, it solicited comments from the public and received over 600 comment letters, many of which raised concerns about protection from fraud; comments raising concerns about abusive litigation were given very short shrift. *See* U.S. Securities and Exchange Commission, *Summary of Comments and Discussion Regarding Protections for Senior Citizens and Qualified Retirement Plans* (visited July 8, 1996) <http://www.sec.gov./news/studies/study.txt>.

Recently, those arguing in favor of restricting private enforcement of the federal securities laws have scored near-fatal restrictions in the scope of private remedies available under the federal securities laws. In late 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA),[8] which restricted private claims generally and class actions in particular.[9] Congress enacted this legislation for the purpose of restricting "strike suits."[10] Congress viewed these suits as a threat to the ability of financial markets to finance start-up companies and generate jobs.[11] One notable effect of these "reforms" is that

8. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

9. The degree to which the PSLRA restricts private claims appears to be worse than intended. Initially, some experts contended that the degree to which private claims were narrowed was somewhat uncertain. *See* John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975 (1996). Other experts had predicted that the Act would "effectively . . . destroy the private enforcement capacities that have been given to investors to police our nation's marketplace." 141 CONG. REC. S19040 (daily ed. Dec. 21, 1995) (letter from Professor Arthur R. Miller of Harvard Law School); *see also* 141 CONG. REC. S19041 (daily ed. Dec. 21, 1995) (letter from Dean John Sexton of New York University School of Law). As discussed in this Article, courts have thus far interpreted the PSLRA in a fashion that may well be the death knell of private claims under the federal securities laws.

"Although the original focus of the litigation reform debate was a concern in Congress that there had been an explosion of meritless securities lawsuits, particularly class actions, filed solely for their settlement value, the final bill to emerge from Congress extends far beyond frivolous litigation." Avery, *supra* note 2, at 336 (footnote omitted). The vast overbreadth of the PSLRA belies any stated intention that one of its goals was investor protection. After all, the federal securities laws reach even privately negotiated sales of the entire stock of small businesses. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 697 (1985) (rejecting sale of a business exemption from definition of a security). Congress, however, made no attempt to limit its "reforms" only to the cases that supposedly involve abuses—class action "strike suits." There was no evidence of abuses in other scenarios.

10. The PSLRA was designed "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." H.R. REP. NO. 104-369, at 32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731. Congress believed that strike suits, filed in order to extract quick settlements from defendants hoping to avoid the costs of defending such suits, were causing serious damage to the economy. *See id.* at 31, *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

11. "[T]he investing public and the entire U.S. economy have been injured by the unwillingness of the best qualified persons to serve on boards of directors and of issuers to discuss publicly their future prospects, because of fear of baseless and extortionate securities lawsuits." *Id.* at 31-32, *reprinted in* 1995 U.S.C.C.A.N. 730, 731.

securities litigation has shifted to state courts.[12] Consequently, Congress has recently preempted state law claims when raised in class action suits involving publicly-held companies.[13] Perhaps

---

Much of the PSLRA's policy foundation is based on the idea that the merits in securities litigation do not matter because companies are forced to settle or face large costs of defense. This argument seems at odds with reality, however, because many of these complex cases settle on the "eve . . . of trial." *In re* Oracle Sec. Litig., 131 F.R.D. 688, 689 (N.D. Cal. 1990). With a merit-based adjudication so close at hand, and with most discovery costs sunk, it makes little sense to settle at such a point except based primarily upon merits. *See* Steven P. Marino & Renée D. Marino, *An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters*, 22 SEC. REG. L.J. 115, 142 (1994) (concluding that settlements in securities class actions are merit driven); Sherrie R. Savett, *The Merits Matter Most and Observations on a Changing Landscape Under the Private Securities Litigation Reform Act of 1995*, 39 ARIZ. L. REV. 525, 525 (1997) ("As a practitioner of more than twenty years in the field representing investors and investor classes, the merits matter enormously."); Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 959, 961 n.13 (1996) (quoting Professor John C. Coffee, Jr. (in testimony before Congress) that the conclusion that merits do not matter is a "myth").

12. *See* Hope Viner Samborn, *Fear of Filing*, A.B.A. J., May 1997, at 28 (reporting on a study by Joseph A. Grundfest and Michael A. Perino that showed the PSLRA left overall litigation rates little changed in 1996, but that about 26% of litigation activity had moved from federal to state court); *see also* U.S. SECURITIES AND EXCHANGE COMMISSION, OFFICE OF THE GENERAL COUNSEL, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (1997), *reprinted in* PRACTICING LAW INSTITUTE, SAILING IN "SAFE HARBORS": DRAFTING FORWARD LOOKING DISCLOSURES 61, 72 (1997) [hereinafter SEC REPORT]. The Report claimed:

> The number of securities class actions filed in state court has reportedly increased. Moreover, many of the state cases are filed parallel to a federal court case in an apparent attempt to avoid some of the procedures imposed by the Reform Act, particularly the stay of discovery pending a motion to dismiss. This may be the most significant development in securities litigation post-Reform Act. While the allegations contained in state court complaints are generally similar to those of the federal complaints, state complaints having no parallel federal action are more likely to be based solely on forecasts which have not materialized and less likely to include insider trading allegations.

Id.

13. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353 (1998); *see also* Rachel Witmer, *Levitt Eshews 'Broad-Based Preemption' of Private Securities Actions Under State Law*, 66 U.S.L.W. 2269, 2270 (Nov. 4, 1997) ("There are three bills (HR 1653, HR 1689, S 1260) pending in Congress that would . . . extend PSLRA's standards by requiring certain state court actions to be brought in federal court, thus preempting such state actions.").

the most critical effect of the PSLRA, however, is that it leaves private enforcement of the federal securities laws in near terminal condition.[14] This Article proposes an approach to resolving the tension between weeding out frivolous securities claims and permitting meritorious claims to proceed that neither side in this debate is likely to embrace.[15] Specifically, this Article proposes that private securities claims relating to public companies be arbitrated to the maximum extent possible.[16] Arbitration has a long and successful history in the securities broker-dealer industry, in which it is the dominant form of dispute resolution.[17]

Federal law exists in this area because nearly seven decades ago Congress sought to use federal power to enhance the rights of investors in the nation's financial markets through the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. One of Congress's primary objectives in enacting the federal securities laws was to "rectify perceived deficiencies in the available common-law protections." Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983). The power of the states over securities-related claims, and remedies available to investors under state law, has been preserved since the very incipiency of federal securities regulation. *See, e.g.*, Securities Exchange Act of 1934 § 28 (codified as amended at 15 U.S.C. § 78bb (1994)).

14. *See, e.g.*, 141 CONG. REC. S19040 (daily ed. Dec. 21, 1995) (letter from Professor Arthur R. Miller of Harvard Law School).

15. Some commentators have recognized, however, that a balanced proposal is precisely what is needed in this vital area. "[T]he appropriate policy response is to search for strategies that can filter out weaker claims earlier in the process while allowing more meritorious claims to proceed." Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 728 (1995).

16. As used in this Article, arbitration entails the use of small panels of industry experts, both lawyers and lay persons, to resolve complex securities disputes quickly and informally by making binding decisions or adjudications. *See generally* PHILIP J. HOBLIN, JR., SECURITIES ARBITRATION: PROCEDURES, STRATEGIES, CASES 2-2 to 2-5 (2d ed. 1992) (defining arbitration and giving a broad overview of advantages and disadvantages, including discussion of "compulsory" arbitration, which requires a party to "agree" to arbitration).

17. *See* C. EDWARD FLETCHER, ARBITRATING SECURITIES DISPUTES xviii (1990) ("[I]t is undeniable that, guided by the Securities Industry Conference on Arbitration (SICA) and goaded from time to time by the SEC, arbitration [is] . . . a relatively low-cost, usually expeditious, and generally fair means of resolving customer . . . disputes with broker-dealer firms."); Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183, 183 (1996) ("Despite media criticism of the [arbitration] process, specifically allegations of a pro-industry bias at forums sponsored by self-regulatory organizations (SROs), the process and its performance have been largely successful."). This is not to say that securities arbitration is never controversial. *See generally* Constantine N. Katsoris, *The Betrayal of* McMahon, 24 FORDHAM URB. L.J. 221 (1997) [hereinafter Katsoris, *McMahon*] (demonstrating controversy surrounding the issue of punitive damages in arbitration).

Arbitration is capable of achieving rapid adjudications that undermine the possibility of extortionate settlements.[18] Arbitration can reduce defense costs[19] and permit meritorious claims to be resolved quickly by expert panels[20] at little or no net cost to

---

A 1988 SEC study of 65 brokerage firms found that 39% of all cash securities account agreements provided for arbitration of disputes, 94% of margin account agreements had arbitration provisions, and 95% of options accounts had arbitration agreements. In addition, every broker-dealer must arbitrate disputes upon the demand of customers pursuant to the rules of the SROs, in which membership is mandatory for all broker-dealers. *See* Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 486 nn.8-9 (1996) [hereinafter Katsoris, *SICA*].

18. Conventional litigation allows delay to be transformed into settlement leverage. *See* Arthur R. Miller, *The Adversary System: Dinosaur or Phoenix*, 69 MINN. L. REV. 1, 9 (1984). Miller writes:

> In many ways, contemporary federal litigation is analogous to the dance marathon contests of yesteryear. The object of the exercise is to select a partner from across the "v," get out on the dance floor, hang on to one's client, and then drift aimlessly and endlessly to the litigation music for as long as possible, hoping that everyone else will collapse from exhaustion.

Id. Arbitration can avoid such delays. For example, the NASD, which handles the vast majority of securities arbitrations and handled 85% of all new customer complaints in 1994, has achieved a remarkable track record for resolving often complex broker-customer disputes. *See* Masucci, *supra* note 17, at 188 ("During 1994, the NASD closed 4,561 cases. The average length of time it took a case to close in 1994 was 10.4 months with the average hearing lasting 2.5 days." (footnote omitted)). It is difficult to argue with Ms. Masucci's assertion that "these are remarkable figures when compared to the time for resolution in crowded court dockets nationwide." *Id.* at 188-89. *Compare* THOMAS E. WILLGING, ET AL., EMPIRICAL STUDY OF CLASS ACTIONS IN FOUR FEDERAL DISTRICT COURTS: FINAL REPORT TO THE ADVISORY COMMITTEE ON CIVIL RULES 117 (1996) (finding that the median time from filing to ultimate disposition for a sample of 103 federal class action securities fraud cases was 21.7 months), *with* Marino & Marino, *supra* note 11, at 127 (sampling 229 federal securities class actions and finding average time period of 3.9 years to settlement).

19. As one scholar noted:

> Arbitration is . . . considerably cheaper than litigation—about one-third the cost, even taking into consideration that both parties may be represented by counsel. . . . The parties are not the only beneficiaries of [arbitration]. Arbitration promotes important societal interests as well. Because of the crowded court dockets, for every claim that is litigated, another is left waiting. Thus, to the extent more cases go to arbitration, more claimants who may not have agreed to arbitrate their claims will have access to the federal courts. In addition, the unnecessary litigation of cases in federal court carries with it enormous dollar costs for society as a whole.

C. Edward Fletcher, III, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393, 458 (1987) (footnote omitted).

20. *See* Anthony DeToro, *Waiver of the Right to Compel Arbitration of Investor-*

taxpayers.[21] Most importantly, industry-sponsored arbitration in the securities broker-dealer industry under Securities and Exchange Commission (SEC) supervision provides investors with a fair process for the resolution of securities claims.[22] In short, arbitration can enhance the quality of justice available in this vital area as well as protect incipient capital formation from the costs of "strike suits." This Article recognizes that proposing an arbitration regime to resolve these claims raises a host of issues and it attempts to address the most important of these problems as well as to open a dialogue on alternative methods of resolving securities claims. This Article thus endeavors to begin a process. Indeed, one thesis of this Article is that lawmakers should proceed cautiously in addressing the proposal advanced here and implement any arbitration process in a gradual fashion in order to avoid unintended consequences. For example, the creation of a system of arbitration that becomes mired in litigation regarding its legitimacy would be counterproductive.

The Article concludes that Congress or the SEC should begin to implement an arbitration program that ultimately would require agreements to arbitrate all securities disputes involving publicly-traded companies before a SEC-sponsored forum. Under the authority and supervision of the SEC, arbitration of these disputes can be regulated and monitored to preserve substantive

---

Broker Disputes, 21 CUMB. L. REV. 615, 618-19 (1991) (noting benefits of arbitrator expertise).

21. Indeed, SROs work hard to assure that the procedures for the arbitration of broker-customer disputes are constantly refined, updated, and monitored. For example, former SEC Chairman David S. Ruder chaired an Arbitration Policy Task Force, appointed in 1994, that thoroughly assessed the need for improvements in the arbitration process. *See* ARBITRATION POLICY TASK FORCE, REPORT ON SECURITIES ARBITRATION REFORM 1-3 (1996). Although the so-called "Ruder Report" has not been without controversy, it generally is acknowledged to have been "quite constructive." *See* Katsoris, *McMahon*, *supra* note 17, at 225. The NASD recovers approximately 70% of its direct expenses of operating an arbitration forum from expenses paid by parties. The other 30% is covered through general assessments paid by its members. *See* ARBITRATION POLICY TASK FORCE, *supra*, at 141.

22. *See, e.g.*, FLETCHER, *supra* note 17, at 98-104 (reviewing all available data regarding the fairness of arbitration procedures in the securities context and concluding that there is no evidence of a pro-industry bias); *see also* Letter from Richard G. Ketchum, Director of Division of Market Regulation, SEC, to SICA Members (Sept. 10, 1987), *reprinted in* HOBLIN, *supra* note 16, at XVI-2 (concluding, after an 18 month examination, that "securities industry arbitration generally operates fairly").

fairness while securing the benefits of arbitration, especially lower costs, speedier resolutions, and the elimination of frivolous claims.[23] This Article does not propose to modify the substantive law applicable to such disputes or to preempt any relevant state law. Rather, this Article posits that simply changing the *way* such disputes are resolved may enhance the quality of justice achieved, as well as eliminate abuses stemming from the pursuit of frivolous claims. Although no state law would be preempted, this Article does propose that an investor's ability to pursue state law remedies in state court be restricted pursuant to arbitration agreements. In other words, this Article proposes a more limited, less formal preemption than the proposal recently adopted by Congress. Investors could pursue all substantive claims, both state and federal, but only in arbitration.

Part I of this Article traces the evolution of private enforcement of the federal securities laws, including recent developments restricting private enforcement. Part I of the Article concludes that policymakers recently have given inadequate weight to the overall success of federal regulation of the securities markets and the role of private enforcement in that success. As a result, recent initiatives to restrict private enforcement expose our securities markets to unjustified risks of deregulation. On the other hand, the Article notes that frivolous lawsuits present other risks to the securities markets and should be deterred in a balanced manner.

Part II of this Article demonstrates that arbitration of securities-related claims against publicly-traded companies can be used to help extinguish frivolous suits while permitting private enforcement to function properly to remedy investor injuries and deter misconduct. First, the arbitration of securities claims in

23. The SEC has a long history of supervising the arbitration of securities claims in broker-customer disputes. For example, in 1983, the SEC enacted a regulation prohibiting the use of predispute arbitration agreements. *See* 17 C.F.R. § 240.15c2-2 (1984). In 1987, the SEC began to support such agreements and rescinded this rule. *See* Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements, Exchange Act Release No. 25034, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,163, at 88,886 (Oct. 15, 1987). These releases are exemplary of the SEC's plenary power over SRO arbitration rules.

the context of broker-customer disputes provides a sound basis for concluding that arbitration can be an effective means of resolving disputes in this vital area. Second, there is now a wealth of knowledge regarding the efficacy of Alternative Dispute Resolution (ADR) that suggests that arbitration of these types of claims is a prudent policy course. Third, this mode of resolution is inimical to frivolous suits. Finally, both the SEC and Congress have broad powers to implement this kind of arbitration regime. The Article concludes that the SEC and Congress should take all necessary steps to encourage the development of a system of arbitration of securities-related claims involving publicly-held companies.

I. THE PSLRA: WRONG REFORM IN THE WRONG INDUSTRY AT THE WRONG TIME

Any discussion of the proper method of resolving private securities claims must begin with the historical basis of such litigation. Private securities litigation under federal securities laws is only a part of the overall enforcement of the federal regulatory regime.[24] This regulatory regime includes the imposition of registration requirements designed to achieve full disclosure of material facts to the financial markets,[25] the regulation of the securities brokerage industry,[26] and the prohibition of fraudulent conduct through the broad antifraud provisions of the federal securities laws.[27] Enforcement mechanisms consist of SEC civil enforcement proceedings and penalties,[28] including administrative sanctions,[29] criminal sanctions,[30] and the extension of private

24. The Supreme Court, however, has consistently recognized that private enforcement is "'a most effective weapon'" in the enforcement of the federal securities laws and "'a necessary supplement'" to government enforcement. *See* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)).

25. *See, e.g.*, 15 U.S.C. §§ 77e, 77f, 77g (1994) (requiring registration statements for distributions of securities, which must include disclosure of material facts).

26. *See, e.g.*, *id.* §§ 78f, 78o (requiring registration of exchanges and broker-dealers).

27. *See, e.g.*, *id.* §§ 77l, 78j.

28. *See, e.g.*, *id.* §§ 78u, 78u-1.

29. *See, e.g.*, *id.* § 78u-2.

30. *See, e.g.*, *id.* § 78ff.

remedies to injured investors.[31] The broadest private remedy and antifraud provision is Rule 10b-5, which the SEC promulgated pursuant to statutory authority under the Securities Exchange Act of 1934 ("Exchange Act").[32] Although Congress has tightened this regulatory regime periodically, Congress had left its basic structure largely intact until it enacted the PSLRA.[33] Before that, this regulatory scheme had functioned successfully for over sixty years.[34]

---

31. *See, e.g., id.* § 77l.

32. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1998). Courts have implied a private remedy under Rule 10b-5 for over 50 years. *See, e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

33. *See* Simon & Dato, *supra* note 11, at 960 ("Congress recently passed the most sweeping revision of the federal securities laws since 1933-34.").

34. *See* S. REP. NO. 104-98, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 715 (presenting comments by Sens. Sarbanes, Bryan, and Boxer that "[o]ur securities markets have been operating under the Federal securities laws since those laws were enacted 60 years ago . . . [and] our markets today are the largest and most vibrant in the world . . . not in spite of the Federal securities laws, but in part because of the Federal securities laws"); U.S. Securities and Exchange Commission Chairman Arthur Levitt, Remarks at 22nd Annual Securities Regulation Institute, *in* PRACTICING LAW INSTITUTE, 1 SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAW 300, 304 (1996) ("Our markets are the best in the world, partly because our securities laws are the best in the world."). In fact, the adjustments Congress has made to the basic federal regulatory scheme since the 1930s have almost uniformly been to extend the regulatory reach of the federal securities laws. For example, in the 1960s, the Williams Act expanded the reach of the federal securities laws to extend to tender offers for controlling blocks of stock. *See* Williams Act of 1968, Pub. L. No. 90-439, 82 Stat. 454 (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1994)). In the 1970s, Congress also expanded the SEC's regulatory power over broker-dealers. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.).

A. *A Short History of Private Securities Litigation*

The federal role in securities regulation has its roots in the ultimate financial catastrophe—The Great Depression.[35] Shortly after taking office, as one of the earliest New Deal initiatives, President Franklin Roosevelt proposed legislation that ultimately became the Securities Act of 1933 ("Securities Act").[36] The Securities Act required the registration (and accompanying full disclosure) of initial distributions of securities.[37] The Securities Act focused only upon initial offerings of securities, therefore Congress enacted the Exchange Act, which provided for regula-

---

35. In a time when some speak of a new economic paradigm, in which low inflation and low unemployment may co-exist indefinitely, it is difficult to capture the trauma of The Great Depression. Unemployment went from 3.2% in 1929 to 25.2% in 1933 and stayed above 10% until 1941. Real Gross National Product plunged from $709.6 billion in 1929 to $498.5 billion in 1933. The economy did not return to 1929 levels until 1939. *See* ROBERT J. GORDON, MACROECONOMICS 190-94 (5th ed. 1989). Similarly, investor confidence was so low before the enactment of the federal securities laws that the issuance of new corporate securities had plummeted from $9.4 billion in 1929 to $380 million in 1933. *See* I LOSS & SELIGMAN, *supra* note 7, at 216. This is the reason lawmakers pursued aggressive policies to restore confidence, including enacting the federal securities laws.

Much debate surrounds the efficacy of the federal securities laws. *Compare* George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) ("[S]tudies suggest that the S.E.C. registration requirements had no important effect on the quality of new securities sold to the public.") *with* Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382, 389 (1964) ("We doubt that any person reasonably well acquainted with the evolution of stockmarket practices between the pre- and post-SEC periods could lament or underrate the success of the new legislation in eradicating many of [the] weaknesses in our capital markets."). This Article does not attempt to resolve this debate, but confidence is dependent upon human perception and investors do not wander about with confidence indicators blinking on their foreheads. This is clear: the period of 1935 (the first full year after the enactment of the Exchange Act) to the present has been marked by steady economic growth. *See* GORDON, *supra*, at A1-A3 and 585-88; *see also* Friend & Herman, *supra*, at 386 ("Stigler of course is aware . . . that since the advent of the S.E.C. the stockmarket has had no debacle corresponding to that in the early 1930's."). Given this fact, this Article posits that caution is warranted until reliable empirical evidence demonstrates a need for change and there is some indication of the efficacy of specific proposals.

Today, issuance of new securities is soaring, especially for issuers accessing the public markets for the first time. *See* Seligman, *supra* note 2, at 440 (reporting that initial public offerings went from $43.6 billion in 1991, to $66.5 billion in 1992, to $112 billion in 1993).

36. *See* H.R. REP. NO. 73-85, at 1-2 (1933).

37. *See* Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a to 77z-3 (1994)).

tion of the securities industry and required periodic disclosure for publicly-held companies.[38] Roosevelt made clear that these acts were designed to heighten fiduciary obligations in securities transactions in order to restore public confidence in the nation's financial markets.[39] Congress joined the President in emphasizing the importance of investor confidence within a modern economic system.[40]

The courts initially embraced the remedial nature of the federal securities laws and broadly interpreted their provisions to achieve those ends.[41] Further, the courts, as well as the SEC, recognized the crucial role of private securities enforcement proceedings as an essential supplement to the SEC's limited enforcement resources.[42] Indeed, in 1946, the federal courts began to imply private rights of action under the federal securities laws.[43] Since then, the Supreme Court has determined the exis-

38. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a to 78mm (1994)).

39. "This proposal adds to the ancient rule caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." H.R. REP. NO. 73-85, at 2 (quoting letter from President Franklin Roosevelt).

40. The House Report accompanying the Exchange Act stated:

> Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.

H.R. REP. NO. 73-1383, at 5 (1934).

41. *See, e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (noting that the intent of the Exchange Act was to "'achieve a high standard of business ethics in the securities industry'" and must "be construed . . .'flexibly to effectuate its remedial purposes'" (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186, 195 (1963))); Silver v. New York Stock Exchange, 373 U.S. 341, 366 (1963) ("It requires but little appreciation of . . . what happened in . . . the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail as to every aspect of the [securities business].").

42. *See, e.g.*, Berner v. Lazzaro, 730 F.2d 1319, 1322 (9th Cir. 1984) ("[T]he resources of the [SEC] are adequate to prosecute only the most flagrant abuses."); *see also* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) (stating that private actions are indispensable for the enforcement of securities laws).

43. *See* Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

tence of a private action under Rule 10b-5 to be "beyond peradventure,"[44] and has proceeded to define this implied private right of action in a series of opinions.[45] The Court, with the support of the SEC,[46] allowed the private remedy under Rule 10b-5 to thrive, and no Justice has ever seriously questioned the propriety of recognizing such a remedy.[47]

After many decades of remarkable success,[48] and with fading memories of the cataclysm of the Great Depression, the judicial

---

The SEC filed a brief in *Kardon* demonstrating its intent that Rule 10b-5 give rise to a private right of action. *See* Grundfest, *supra* note 15, at 990 n.130. The SEC filed this brief only four years after it had promulgated Rule 10b-5. *See id.*

44. Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983). *See generally* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 13.1 (3d ed. 1996) (discussing evolution of private action under Rule 10b-5).

45. *See, e.g.*, Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 358-61 (1991) (defining statute of limitations for Rule 10b-5 action); *Herman & MacLean*, 459 U.S. at 387-90 (defining standard of proof for Rule 10b-5 action); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-214 (1976) (defining state of mind required for a Rule 10b-5 violation).

46. The SEC has consistently asserted that the private remedy under Rule 10b-5 is a "necessary supplement" to the SEC's enforcement powers and a "most effective" enforcement tool. *See* Brief for the Securities and Exchange Commission as *Amicus Curiae* at 1, *Gilbertson* (No. 90-333); Brief for the Securities and Exchange Commission as *Amicus Curiae* at 6, *Herman & MacLean* (Nos. 81-680 and 81-1076); Brief for the Securities and Exchange Commission as *Amicus Curiae* at 10 n.2, *Ernst & Ernst* (No. 74-1042).

47. The growth of the private remedy under Rule 10b-5 has been called a "judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

48. The general satisfaction with the regulatory approach of the federal securities laws has been stated best, over the decades, by Congress itself. For example, in 1964 Congress (through the House Committee on Interstate and Foreign Commerce) stated:

> The Securities Act of 1933, relating to truthful disclosure of information about new security offerings; the Securities Exchange Act of 1934, relating to disclosure of information about listed securities and regulating practices in exchange and over-the-counter operations; and succeeding legislation which is administered by the Securities and Exchange Commission; represent legislation of which this committee and the Congress are justly proud. These statutes have gone a long way in the mitigation and elimination of undesirable practices in the securities field, in the restoration of confidence in securities markets, and in the protection of the investing public.

H.R. REP. NO. 88-1418, at 4 (1964), *reprinted in* 1964 U.S.C.C.A.N. 3013, 3016.

view of private securities litigation "evolved" from a "necessary enforcement supplement" to a positively vexatious tool.[49] In an era of pervasive demonization of attorneys, the private securities lawyer became the caricature of the greedy, self-serving destroyer of upstanding captains of industry.[50] Courts began to take a more restrictive approach to private securities claims.[51]

By the 1990s, the Supreme Court in particular seemed determined to reign in private securities claims. In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[52] the Court dramatically shortened the statute of limitations applicable to private claims under Rule 10b-5.[53] In *Central Bank of Denver, N.A. v.*

Congress has emphasized investor protection and investor confidence as an important, even compelling, policy objective because "[i]t is a basic teaching of this nation's financial history that continued economic health fundamentally depends upon the maintenance of investor confidence." H.R. REP. NO. 94-123, at 43-44 (1975); *see also* S. REP. NO. 91-1218, at 2 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5256; H.R. REP. NO. 88-1418, at 6-7 (1964), *reprinted in* 1964 U.S.C.C.A.N. 3013, 3019-20 (demonstrating congressional determination to maintain investor confidence).

In fact, each of the above legislative reports relates to legislation specifically designed to enhance the investor protection elements of the federal securities laws. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.) (expanding SEC oversight of self-regulatory organizations that supervise broker-dealers); Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (codified as amended at 15 U.S.C. §§ 78aaa-78lll (1994)) (extending insurance to balances held by securities broker-dealers); Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified as amended in scattered sections of 15 U.S.C.) (extending the regulatory power of the federal securities laws and the SEC to over-the-counter markets).

49. *See Blue Chip Stamps*, 421 U.S. at 739 ("[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.").

50. One particularly graphic critic of securities lawyers was former Senator Alfonse D'Amato of New York, who stated that plaintiffs' securities lawyers were "sharks, sharks for hire" and "bandits." 141 CONG. REC. S17935-36 (daily ed. Dec. 5, 1995) (statement of Sen. D'Amato).

51. *See* Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 479-80 (1977) (holding that mere breaches of fiduciary duties are not actionable under Rule 10b-5); *Ernst & Ernst*, 425 U.S. at 206 (holding that scienter must be proven as part of Rule 10b-5 claim); *Blue Chip Stamps*, 421 U.S. at 731-55 (holding that only securities purchasers or sellers have standing under Rule 10b-5).

52. 501 U.S. 350 (1991).

53. *See id.* at 360-62 (holding that the limitations period for 10b-5 claims is one year from discovery, but in no event more than three years from the date of the transaction).

First Interstate Bank of Denver, N.A.,[54] the Court eliminated aiding and abetting liability in private actions under Rule 10b-5.[55] In *Gustafson v. Alloyd*,[56] the Court restricted the availability of rescission claims under the Securities Act by engrafting a requirement that a plaintiff in such an action be a purchaser in a public offering.[57] These are only the most recent judicial retrenchments. Some commentators have noted that the Court has been scaling back investor protections under the federal securities laws for twenty years.[58]

The lower federal courts, taking a cue from the Supreme Court, have developed broad doctrinal rules that have resulted in an increasing number of early dismissals or summary judgments in private securities cases.[59] For example, the federal courts used Federal Rule of Civil Procedure 9(b) as a means of terminating private securities claims, often in ways that turned that rule on its head.[60] Similarly, the lower courts developed doctrines that effectively robbed juries of the ability to determine if

---

54. 511 U.S. 164 (1994).

55. *See id.* at 191 (holding that aiding and abetting liability was not statutorily authorized after 25 years of lower courts imposing such liability).

56. 513 U.S. 561 (1995).

57. *See id.* at 1068 (stating that when Congress enacted § 12(2) of the Securities Act; it could not have intended to create "vast additional liabilities").

58. *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, 6 (1996-97) ("In forty federal securities law decisions, the Court decided thirty-two cases for defendants and, in almost every one, significantly narrowed the reach of federal securities laws.").

59. *See* Avery, *supra* note 2, at 341-47 (collecting and discussing lower federal court opinions that dispose of private securities claims on various grounds before trial).

60. *See* Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1130 (2d Cir. 1994) ("[P]laintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold."); *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 263-64 (2d Cir. 1993) (reasoning that some examples of fraud may go unpunished because the law cannot eliminate all opportunities for unremedied fraud without creating opportunities for "undeserved settlement[s]"); DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (stating that "[a]n accountant's greatest asset is its reputation" and it would be "irrational" to trade it merely for auditing fees); *see also* Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994) (dismissing allegations against underwriter that fraud was motivation to generate fees because all underwriters are fee seekers).

the given conduct constituted fraud by granting judicial discretion over the issue, which invariably resulted in claim termination.[61] Securities claims were blamed for much of the flood of litigation allegedly swamping the federal courts.[62] The tone of many judicial opinions changed as well, from open sympathy for the purposes of the federal securities laws to open hostility toward private claims.[63] Securities plaintiffs, beginning in the 1980s, began facing the frequent imposition of sanctions.[64] Although the Court has continued to interpret the federal securities laws broadly in areas dominated by public enforcement

61. One such example is the so-called "bespeaks caution" doctrine. This doctrine "holds that economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the document adequately discloses the risks involved." *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1413 (9th Cir. 1994). This doctrine is difficult to square with the Supreme Court's view that whether a misrepresented fact is material is a question for the jury. *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 450 n.12 (1976). Some courts go even further, holding that predictions not cast in terms of a guarantee are not actionable under the federal securities laws. *See, e.g.*, Raab v. General Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993).

62. *See* 138 CONG. REC. S12599 (1992) (statement of Sen. Domenici) (commenting that the litigation explosion has reached "epidemic dimensions" in the securities area); *see also* Securities Indus. Ass'n v. Connolly, 883 F.2d 1114, 1116 (1st Cir. 1989) (stating that arbitration of securities disputes would stem the "rampant growth of the civil docket" in federal court). The whole concept of a "litigation explosion" is rather controversial. *See, e.g.*, Jack B. Weinstein, *After Fifty Years of the Federal Rules of Civil Procedure: Are the Barriers to Justice Being Raised?*, 137 U. PA. L. REV. 1901, 1909 (1989) (questioning the existence of a litigation explosion and noting that federal judges have about the same number of cases as in 1960).

63. *See, e.g.*, *In re* Glenfed, Inc. Sec. Litig., 42 F.3d 1541, 1557 (9th Cir. 1994) ("The driving force behind securities fraud suits filed to extract early settlements disproportionate to the merits is the expectation that once plaintiffs get past the pleading stage, they will automatically gain access to virtually unlimited discovery."); *Time Warner Sec. Litig.*, 9 F.3d at 263 (stating that securities plaintiffs use the litigation process to "extract undeserved settlements" because defendants are faced with large costs of defense); *In re* Mobile Telecomm. Tech. Corp. Sec. Litig., 915 F. Supp. 828, 832 (S.D. Miss. 1995) ("[T]he Fifth Circuit [has] recognized the important screening function which this more stringent pleading requirement serves in securities fraud suits . . . ."); Katz v. Household Int'l, Inc., 897 F. Supp. 1106, 1110 (N.D. Ill. 1995) ("We note that our expressed concern was to be faithful to the teachings of the Seventh Circuit that we should not tolerate the filing of frivolous complaints under Section 10(b) and Rule 10b-5.").

64. *See, e.g.*, GEORGENE M. VAIRO, RULE 11 SANCTIONS: CASE LAW PERSPECTIVES AND PREVENTIVE MEASURES § 6.06[e] (2d ed. 1992 & Supp. 1995) (stating that Rule 11 is increasingly involved in securities fraud cases).

action, it recently has expressed little support for private enforcement of the federal securities laws.[65]

In 1995, Congress significantly curtailed the availability of private securities claims under federal law by enacting the PSLRA.[66] The PSLRA modifies the sanctions available against private securities claimants in a manner approaching a "loser pays" regime.[67] Under Federal Rule of Civil Procedure 11, federal courts are granted discretion to impose sanctions against those pleading claims that are not legally warranted, supported by evidence, or pursued for a proper purpose.[68] Under the special

---

65. *Compare* United States v. O'Hagan, 521 U.S. 642, 650 (1997) (holding that misappropriation theory could apply as the basis of criminal liability for insider trading), *with* Central Bank v. First Interstate Bank, 511 U.S. 164, 189 (1994) (highlighting the "vexatiousness" of private enforcement).

66. Professors Loss and Seligman has provided an excellent summary of the PSLRA, as well as an analysis of all available empirical data supporting the Act. *See* X LOSS & SELIGMAN, *supra* note 7, at 4636-69 (concluding that data is not consistent with a finding of abusive class action securities litigation).

67. *See* 15 U.S.C.A. §§ 77z-1(c), 78u-4(c) (1997).

68. FED. R. CIV. P. 11. Even before the PSLRA, plaintiffs in securities and RICO cases were the targets of sanction motions in 84.3% of cases, and actually sanctioned 45.5% of the time. *See* Georgene M. Vairo, *Rule 11: Where We Are and Where We Are Going*, 60 FORDHAM L. REV. 475, 485 (1991). Despite Dean Vairo's efforts to educate Congress on how actively Rule 11 is used in Securities/RICO cases, the Congressional Research Service (CRS) stubbornly insisted that only "three cases in the history of 10b-5" had actually resulted in the imposition of sanctions under Rule 11. *See Securities Litigation Reform Proposals S. 240, S. 667, and HR 1058, Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing and Urban Affairs*, 104th Cong. 425 (1995) [hereinafter *Securities Litigation Reform Proposals*] (containing CRS response to letter from Dean Vairo). The CRS must not have looked very hard. *See* Garr v. U.S. Healthcare, Inc., 22 F.3d 1274, 1280 (3d Cir. 1994) (affirming Rule 11 sanctions in 10b-5 action); Samuels v. Wilder, 906 F.2d 272, 276 (7th Cir. 1990) (affirming award of Rule 11 sanctions against 10b-5 plaintiff for motion to reconsider summary judgment entry against 10b-5 claims); Unioil, Inc. v. E.F. Hutton & Co., 809 F.2d 548, 558-59 (9th Cir. 1986) (imposing sanctions of $294,000 under Rule 11 in 10b-5 case); *In re* Itel Sec. Litig., 791 F.2d 672, 676 (9th Cir. 1986) (imposing Rule 11 sanctions in 10b-5 case); Moss v. Morgan Stanley Inc., 719 F.2d 5, 9 (2d Cir. 1983) (affirming Rule 11 sanctions in Rule 10b-5 case); Kushner v. DBG Property Investors, Inc., 793 F. Supp. 1161, 1182 (S.D.N.Y. 1992) (sanctioning fraud plaintiff bringing claims under the Exchange Act); Wielgos v. Commonwealth Edison Co., 123 F.R.D. 299, 304 (N.D. Ill. 1988) (imposing Rule 11 sanctions of $150,000 in 10b-5 action). Even if the CRS had carefully done their job, they apparently rigged their results by excluding cases on electronic databases, securities cases resulting in sanctions but not explicitly mentioning Rule 10b-5, and hundreds of unreported decisions. *See* Admiral Capital Venture, I, Ltd. v. Pelczarski, Nos. 88-2639,

sanctions provisions now applicable to securities claims, courts *must* scrutinize pleadings for compliance with Rule 11 at the end of a case and *must* assess sanctions if a violation is found.[69] The PSLRA also creates a presumption that the appropriate sanction for a complaint that violates Rule 11(c) is an award of all attorneys' fees and costs incurred by the defendants during the entire action.[70] There is no similar provision for answers that violate Rule 11(c).

Ironically, Congress amended Rule 11 in 1993 specifically because it had led to abusive "satellite" litigation.[71] Congress unin-

---

88-15594, 1989 WL 150583 (9th Cir. Dec. 11, 1989) (imposing sanctions on 10b-5 plaintiff); Gold v. Fields, No. 92 Civ. 6680 (KMW), 1993 WL 212672 (S.D.N.Y. June 14, 1993) (imposing sanctions for violation of Rule 9(b) in securities fraud action); Mirman v. Berk & Michaels, P.C., 91 Civ. 8606 (JFK), 1992 U.S. Dist. LEXIS 16707 (S.D.N.Y. Oct. 26, 1992) (imposing sanctions for bringing time-barred 10b-5 claim); Steele v. Polymer Research Corp. of America, No. 85 Civ. 5563 (CSH), 1987 U.S. Dist. LEXIS 5270 (S.D.N.Y. June 18, 1987) (imposing sanctions relating to Exchange Act allegations); *see also* Fox v. Acadia State Bank, 937 F.2d 1566, 1570 (11th Cir. 1991) (imposing sanctions in § 17(a) claim under the Securities Act); Crookham v. Crookham, 914 F.2d 1027, 1030 (8th Cir. 1990) (pursuing sanctions for claim under §17(a)); Aizuss v. Commonwealth Equity Trust, 847 F. Supp. 1482 (E.D. Cal. 1993) (imposing Rule 11 sanctions for claims brought under the Securities Act). The false conclusions of the CRS are of great importance.

69. *See* 15 U.S.C.A. §§ 77z-1(c)(1), (2), 78u-4(c)(1), (2). Congress has passed a law that has made Rule 11 sanctions more likely in securities litigation. If Dean Vairo is right and the CRS is wrong, as demonstrated above, *see supra* note 68, securities litigation has gone from merely hazardous for plaintiffs to practically fatal. Indeed, it now appears that only the richest law firms can afford to pursue federal claims. *See* Samborn, *supra* note 12, at 28 (noting that 59% of all post-reform cases were brought by the firm of Milberg Weiss Bershad Hynes & Lerach). Moreover, Congress consistently relied upon the CRS findings in debating this legislation, and congressional reliance on this erroneous finding was further reflected by the statement in the Conference Report that judges impose Rule 11 sanctions reluctantly. *See* H.R. REP. NO. 104-369, at 31 (1995).

70. *See* 15 U.S.C.A. §§ 77z-1(c)(3)(A)(i), 78u-4(c)(3)(A)(i).

71. As Arthur Miller has stated:

> In the course of deliberations within the Judicial Conference during the revision of Rule 11, the Federal Judicial Center performed a survey of Federal judges, which showed that the vast majority of them did not believe that frivolous lawsuits were a major problem. The survey also demonstrated that Federal judges believed that the most expedient way of dealing with frivolous lawsuits was not through the imposition of sanctions under Rule 11, but through prompt and decisive judicial action on motions to dismiss under Federal Rule 12(b)(6) and for summary judgment under Federal Rule 56. A decade of practical experience under Rule

tentionally dealt a near fatal blow to private securities enforcement with this provision because it miscalculated the frequency of sanctions in securities litigation.[72] Private enforcement is so perilous now that few lawyers seem to be pursuing federal class action claims.[73]

The PSLRA imposes heightened pleading standards in actions under the Exchange Act's antifraud provisions that are a dramatic departure from the notice pleading standards generally imposed under the Federal Rules of Civil Procedure.[74] Under the Federal Rules of Civil Procedure, allegations as to a defendant's state of mind may be alleged generally, at least if one takes a plain meaning approach to the statute.[75] Now, for private claims under the federal securities laws, a plaintiff must plead facts "giving rise to a strong inference" of scienter.[76] Judicial interpretations of this new pleading requirement have raised the question of whether it can be satisfied at all, short of explicit admissions of an intent to defraud. For example, courts have held that pleading a mere motive and opportunity to commit fraud fails

> 11 also demonstrated that post-1983 expanded "fee shifting" itself spawned satellite litigation about sanctions and created unnecessary adversariness between counsel, which in turn impeded cooperation and settlement.

Securities Litigation Reform: Hearings before the Subcomm. on Telecomms. and Finance of the House Comm. on Energy and Commerce, 103d Cong. 148 (1994) [hereinafter *Securities Litigation Reform: Hearings*] (prepared statement of Professor Arthur R. Miller, Harvard Law School).

72. At the very least, the PSLRA has led to an unhealthy concentration of private enforcement at a single firm, which, after the PSLRA went into effect, appeared in 59% of all securities class actions. *See* Samborn, *supra* note 12, at 28. Congress should hardly be surprised by this. Before Congress overrode President Clinton's veto, a leading expert in federal practice and procedure, as well as Rule 11 sanctions stated: "It is inconceivable that any citizen, even one with considerable wealth and a strong case" would bring private securities claims because of the risks posed by the PSLRA's fee-shifting provisions. 141 CONG. REC. S19040 (daily ed. Dec. 21, 1995) (letter from Professor Arthur R. Miller, Harvard Law School).

73. *See* Samborn, *supra* note 12, at 28. The PSLRA also provides that, in class actions filed under the Exchange Act, courts may require plaintiffs to post security for costs or sanctions. *See* 15 U.S.C.A. § 78u-4(a)(8).

74. Just how dramatic the PSLRA is on this point is a hotly contested issue in the federal courts. *See* Malin v. Ivax Corp., 17 F. Supp. 2d 1345, 1353 (S.D. Fla. 1998) (collecting cases).

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

76. 15 U.S.C.A. § 78u-4(b)(2).

this heightened pleading standard.[77] Even before the PSLRA, courts had used Rule 9(b) to terminate claims that seemed improbable to them;[78] now it seems courts are eager to use the PSLRA as a basis for even wider terminations.[79]

This heightened pleading standard endangers important securities law principles, such as the "group-published" information doctrine, which had operated to preclude defendants with joint drafting responsibility for documents from shifting the responsibility to some other drafter.[80] Under the PSLRA, a court could

---

77. *In re* Baesa Sec. Litig., 969 F. Supp. 238, 242 (S.D.N.Y. 1997) (holding that pleading motive and opportunity to defraud is no longer sufficient to comply with PSLRA pleading standards). Some courts have gone even further, holding that the PSLRA requires more than just reckless misrepresentations, and that plaintiffs must plead "specific facts that 'create a strong inference of knowing misrepresentation on the part of defendants.'" Norwood Venture Corp. v. Converse Inc., 959 F. Supp. 205, 208 (S.D.N.Y. 1997) (quoting *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 757 (N.D. Cal. 1997)).

78. *See, e.g.*, DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (holding that accountants would not engage in fraud in exchange for audit fees and dismissing claim under Rule 9(b)).

79. *See Silicon Graphics*, 970 F. Supp. at 757 (holding that "[m]otive, opportunity, and non-deliberate recklessness may provide some evidence of intentional wrongdoing, but alone are not sufficient to support scienter unless the totality of evidence creates a strong inference of fraud"); *see also* Havenick v. Network Express, Inc., 981 F. Supp. 480, 524 (E.D. Mich. 1997) (holding that PSLRA requires plaintiff to plead facts showing a "strong inference" of fraud and that motive and opportunity alone are insufficient). These courts seem to be interpreting the PSLRA in a manner that would make securities fraud virtually impossible to plead; "state of mind never proves itself directly, or it does so only in Perry Mason reruns in which, under withering cross examination, the defendant cries out, 'Yes, I knew (or intended) it all along.'" Branson, *supra* note 58, at 16. *But see* Zeid v. Kimberley, 930 F. Supp. 431, 434 (N.D. Cal. 1996) (following *Chantal* approach); Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1308 (C.D. Cal. 1996) (holding that either pleading motive and opportunity to commit fraud, or pleading facts that constitute circumstantial evidence of conscious misbehavior or recklessness, satisfies the PSLRA pleading standards).

80. The "group-published" information doctrine provides:

> [W]hen the plaintiff is alleging corporate fraud perpetrated on investors through the use of "group-published information," such as prospectuses, registration statements, annual reports, and press releases, . . . "it is reasonable to presume that these are collective actions of the officers." Thus, "[u]nder such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading the misrepresentations with particularity and when possible the roles of the individual defendants in the misrepresentations."

Maywalt v. Parker & Parsley Petroleum Co., 808 F. Supp. 1037, 1047 (S.D.N.Y.

conceivably hold that a plaintiff must allege facts giving rise to a strong inference of scienter against each defendant.[81] The PSLRA also denies a plaintiff discovery until this pleading standard is satisfied.[82] Thus, not only must a plaintiff allege facts "giving rise to a strong inference" of fraud, the plaintiff also is denied discovery in aid of uncovering such facts.

The PSLRA creates a safe harbor for certain fraudulent misstatements in "forward looking statements."[83] Specifically, the PSLRA protects specified persons from liability for such statements if the statement is accompanied by "meaningful cautionary statements" that identify important factors that could cause actual results to diverge from projections, even if the statements are made with a fraudulent intent.[84] Persons who enjoy this insulation from liability include issuers, underwriters, and reviewers of information provided by issuers.[85] The PSLRA provides various exemptions from the applicability of the safe harbor and limits the application of the safe harbor to statements relating to issuers that are required to register under the Exchange Act.[86]

The PSLRA statutorily prescribes causation standards that may be interpreted to support broad pretrial terminations of

---

1992) (quoting Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1440 (9th Cir. 1987)).

81. Such a result would be absurd. Surely, group fraud is not exempt from the scope of the federal securities laws, and there is no basis for denying a plaintiff relief simply because it may be difficult to attribute a group statement to a particular defendant.

82. *See* 15 U.S.C.A. §§ 77z-1(b)(2), 78u-4(b)(3)(B) (1997). Prior to the Act, courts disfavored stays of discovery. *See, e.g., In re* Lotus Dev. Corp. Sec. Litig., 875 F. Supp. 48, 51 (D. Mass. 1995) (stating that a party seeking a stay of discovery bears a "stiff" burden).

83. 15 U.S.C.A. §§ 77z-2, 78u-5.

84. *Id.* §§ 77z-2(c)(1)(A)(i), 78u-5(c)(1)(A)(i) (exempting certain statements from liability); *see also* 141 CONG. REC. S19,042 (daily ed. Dec. 21, 1995) (letter from Professor John C. Coffee, Jr. stating that safe-harbor would give issuers a "license to lie").

85. *See* 15 U.S.C. § 77z-2(a) (1994).

86. *See id.* §§ 77z-2(a), 78u-5(a) (limiting safe harbor to reporting companies under 15 U.S.C. § 78o(d) or 15 U.S.C. § 78m(a)). The Exchange Act requires companies with more than 500 shareholders and $10 million in assets to register with the SEC and file periodic financial information under section 77n(a). *See* 15 U.S.C. § 78l(g); 17 C.F.R. §240.12g-1 (1998).

securities actions.[87] It requires that plaintiffs plead loss causation in all claims brought under the Exchange Act.[88] Similarly, defendants now may avoid rescission liability under section 12(2) of the Securities Act if they can prove an absence of loss causation.[89] Loss causation is a form of proximate cause that requires a plaintiff to allege and prove that, but for the defendant's wrongdoing, the plaintiff would not have incurred the damages that form the basis of the suit.[90] Thus, if a plaintiff invested because a securities promoter did not disclose his criminal background, but the plaintiff suffers damages because of a crash in oil prices, the plaintiff can show only transaction causation and not loss causation.[91]

This provision of the PSLRA directly overruled many federal decisions that required only "but for" causation or "substantial factor" causation for claims under the federal securities laws.[92] For example, under the proxy rules, courts have long held that materiality satisfied causation requirements for private litigants.[93] Loss causation generally is a form of proximate cause that cuts off claims for injuries that are deemed too remote from the alleged misconduct.[94] As a result of the PSLRA, courts will

---

87. *See* Bastian v. Petren Resources Corp., 892 F.2d 680, 686 (7th Cir. 1990) (affirming dismissal based upon loss causation).

88. *See* 15 U.S.C.A. § 78u-4(b)(4).

89. *See id.* § 77l(b).

90. *See id.*

91. *See Bastian*, 892 F.2d at 685 (determining that dismissal is appropriate based on "speculation" that oil ventures run by honest promoters could not have succeeded and that plaintiffs would have invested in another oil venture if they had known the promoters were dishonest).

92. *See* Rowe v. Maremont Corp., 850 F.2d 1226, 1242 (7th Cir. 1988) (stating that defendant must show loss caused by factors other than Rule 10b-5 violation). The PSLRA also throws the "fraud on the market" theory into question. *See In re* Control Data Corp. Sec. Litig., 933 F.2d 616, 619-20 (8th Cir. 1991) (demonstrating that under "fraud on the market" theory, plaintiff may rely on the market price of a publicly traded stock, and if a defendant's misrepresentations artificially affect the price, "causation is presumed").

93. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970) ("Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury [where] . . . he proves that the proxy solicitation itself . . . was an essential link in the accomplishment of the transaction.").

94. *See Bastian*, 892 F.2d at 686.

now dismiss more claims of securities fraud for failure to demonstrate causation.[95] State courts generally have been far more lenient in dealing with causation in the securities area, leaving the issue to the jury.[96]

Prior to the PSLRA, securities violators were jointly and severally liable.[97] Under the PSLRA, only defendants who knowingly commit violations of the Exchange Act are jointly and severally liable.[98] Other defendants are liable only for the proportion of damages for which the trier of fact finds them responsible.[99] Thus, under the PSLRA, the trier of fact must determine each defendant's liability. The PSLRA includes certain exceptions to the operation of the modified system of proportionate liability it imposes,[100] such as preserving joint and several liability against those who commit knowing violations of law.[101] This "reform," which essentially shifts the risk of an insolvent or judgment-proof defendant to the plaintiff, specifically operates *only* with respect to meritorious claims.[102]

The PSLRA also takes aim at private class actions brought under the federal securities laws.[103] Class actions frequently

95. The PSLRA's provisions regarding loss causation have not been a source of much controversy. This is surprising given that causation has generally been treated as a question of fact for the jury. *See* RESTATEMENT (SECOND) OF TORTS § 328C (1965). To use "loss causation" to make fact-intensive inquiries at the motion to dismiss stage seems to be a perversion of the proximate cause doctrine.

96. Indeed, even in Illinois, loss causation is not required to recover under the state blue sky law. *See* Lucas v. Downtown Greenville Investors, Ltd., 671 N.E.2d 389, 400 (Ill. Ct. App. 1996); *see also* Davey v. Hedden, 920 P.2d 420 (Kan. 1996) (stating that the issue of proximate cause is normally a question of fact for jury).

97. *See* Marc J. Steinberg & Christopher D. Olive, *Contribution and Proportionate Liability Under the Federal Securities Laws in Multidefendant Securities Litigation After the Private Securities Litigation Reform Act of 1995*, 50 SMU L. REV. 337, 341 (1996).

98. *See* 15 U.S.C.A. § 78u-4(g)(2)(A) (1997).

99. *See id.* § 78u-4(g)(2)(B).

100. *See id.* § 78u-4(g)(4).

101. *See id.* § 78u-4(g)(2)(A).

102. *See* Donald C. Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects*, 51 BUS. LAW. 1157, 1174 (1996) (concluding that because this reform applies to meritorious, non-class action claims, it is overbroad).

103. *See generally* 7B WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 1806 (2d ed. 1986 & Supp. 1998).

have been the subject of scholarly analysis and have been criticized for creating divergent interests between class members and class counsel.[104] The PSLRA presents a multi-pronged attack upon private securities class actions. First, individuals are restricted from acting as lead plaintiffs in such actions without certifying that they meet certain eligibility requirements and have received no payments for serving as class representatives.[105] Congress intended these eligibility requirements to eliminate "professional plaintiffs."[106] Second, the incentives for initiating class actions are diminished because control over such actions now generally vests in a lead plaintiff, who is presumed to be the person with the greatest economic stake in the litigation.[107] Congress intended this provision to encourage institutional investors, or other significant investors, to control class counsel and to assure that the litigation is pursued for the benefit of the class.[108] Third, class settlements of securities claims must be supported by far more extensive disclosures than those required for other claims.[109] This provision serves to assure settlements are fair to investors. These provisions have a common thread: Congress wanted a check on the power of class counsel to manage the litigation in their own interest.[110] Along these lines, Congress also required that attorneys' fees awarded pursuant to any class settlement not exceed a reasonable percentage of the damages awarded the class.[111]

---

104. *See* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 671-72 (1986); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

105. *See* 15 U.S.C.A. §§ 77z-1(a)(2), 78u-4(a)(2).

106. *See* H.R. REP. NO. 104-369, at 32-33 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 732-33.

107. *See* 15 U.S.C.A. §§ 77z-1(a)(3), 78u-4(a)(3) (requiring publication of notice of class proceeding to encourage lead plaintiffs to come forward); *id.* §§ 77z-1(a)(3)(B)(i), 78u-4(a)(3)(B)(i) (specifying the process for appointment of lead plaintiff); *id.* §§ 77z-1(a)(3)(B)(v), 78u-4(a)(3)(B)(v) (stating that lead plaintiff retains counsel).

108. *See* H.R. REP. NO. 104-369, at 34, *reprinted in* 1995 U.S.C.C.A.N. 730, 733.

109. *See* 15 U.S.C.A. §§ 77z-1(a)(7), 78u-4(a)(7).

110. *See* Avery, *supra* note 2, at 374.

111. *See* 15 U.S.C.A. §§ 77z-1(a)(6), 78u-4(a)(6).

The PSLRA has a very controversial history. The Supreme Court's restrictive approach to the statute of limitations under Rule 10b-5 triggered the process of legislative reform. At first, opponents of the restoration of a more realistic statute of limitations resisted, claiming that frivolous claims also must be addressed.[112] After the congressional elections of 1994, efforts to extend the statute of limitations disappeared and the prevention of frivolous suits became the primary motivation for reform.[113] Congress held extensive hearings on the issue of frivolous lawsuits[114] and eventually passed the PSLRA over President Clinton's veto.[115] President Clinton objected on three grounds: first, the PSLRA's pleading standards were too stringent; second, the sanctions provisions too closely resembled a "loser pays" system, particularly for plaintiffs; and third, the safe harbor for forward-looking frauds was too broad.[116]

B. An Assessment of the PSLRA

One effect of the PSLRA is that many plaintiffs have pursued securities claims in state court.[117] Thus, the "reforms" wrought by the Court and Congress have resulted in the *de facto* de-federalization of private securities claims.[118] Another result is sure to be weaker enforcement of the federal securities laws and, therefore, less incentive for compliance. Despite its likely effects, the PSLRA was passed with little debate of the risks of returning to a pre-Depression regime of investors being relegated to

---

112. *See* Avery, *supra* note 2, at 338 n.12.

113. *See id.*

114. *See, e.g., Securities Litigation Reform Proposals*, *supra* note 68; *Securities Litigation Reform: Hearings*, *supra* note 71.

115. *See* 141 CONG. REC. H15,214 (daily ed. Dec. 20, 1995) (veto message of President Clinton).

116. *See id.*

117. *See* Samborn, *supra* note 12, at 28.

118. *See* Branson, *supra* note 58, at 40-41 ("[T]hey—conservative federal judges, lobbyists for corporate American and other defense interests, and Congress—have joined together to destroy completely the federal courts as places of refuge and protection for defrauded investors.").

state law remedies,[119] or the dangers of deregulation in the financial services industry.[120]

With federal regulation emasculated, discussion of the prospects for a "race to the bottom" among the states in securities regulation takes on a new importance.[121] Every state would want to encourage business development within its borders, especially if the costs of doing so can be shifted to out-of-state investors.[122] In fact, Arizona already has passed legislation modeled on the PSLRA.[123]

One also must question whether Congress really is prepared to increase the resources allocated to the SEC or to rely on the states to increase regulation to compensate for decreased private enforcement.[124] Indeed, Congress recently preempted state law

---

119. *See* H.R. REP. NO. 73-85, at 2 (1933) (stating that between 1920 and 1930 about one-half of the $50 billion of new securities issued were worthless). Moreover, if leaving investors to state remedies has proven such a failure, it is doubtful that using federal law to *restrict* state remedies is likely to fare better. *See* Levitt, *supra* note 34, at 2 ("In my judgment, draconian denials of the right of private action represent as tangible [a] danger to our markets as" the dangers underlying the PSLRA).

120. Perhaps the most notorious example of precipitous deregulation in the financial services industry is the savings and loan crisis of the 1980s. *See* Michael Waldman, *The S&L Collapse: The Cost of a Congress for Sale*, STAN. L. & POL'Y REV., Spring 1990, at 47, 48 (discussing the impact of "reckless deregulation"). The total cost of the massive federal bailout of this industry exceeds $1 trillion. *See* Steven A. Ramirez, *The Chaos of 12 U.S.C. Section 1821(k): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 FORDHAM L. REV. 625, 629 (1996) (quantifying the losses from bank crisis of the 1980s).

121. *Cf.* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (arguing that Delaware has led a "race to the bottom" by adopting corporation law provisions designed to attract managers to Delaware as a place of incorporation). Certainly, underwriters, high tech firms, brokers, accountants, and lawyers may hold sway over state legislatures, especially if express or implied threats are made to move the center of their operations elsewhere, where they may be able to avail themselves of friendlier laws.

122. *See id.* at 698 (discussing the problem of locally generated revenues creating nationwide problems and costs). Broker-dealers or other businesses often will be able to specify contractually that the law of their domicile will govern a given dispute. *See* RESTATEMENT (SECOND) OF CONFLICTS § 187 (1971); *see also* Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 59-60 (1995) (interpreting a contractual choice of law provision to govern the applicability of state law and determine the availability of punitive damages in arbitration).

123. *See* The Arizona Securities Litigation Reform Act, 1996 Ariz. Sess. Laws Ch. 197, art. 18 (codified at ARIZ. REV. STAT. §§ 44-2081 to 2087 (1996)).

124. *See* I LOSS & SELIGMAN, *supra* note 7, at 146-51 ("As a practical matter parsi-

remedies in certain cases, and now forces plaintiffs to run the gauntlet in federal court in some cases involving publicly-traded companies.[125] This is a further move toward the risky strategy of financial deregulation.[126] The original conception of federal securities regulation—that the nation needed federal regulation to create more stringent standards of conduct than those prevailing under state law—seems to have been lost in the shuffle.[127]

Additionally, to the extent that Congress has now joined the Court in a bias away from private enforcement, such a bias seems fundamentally misguided. First, virtually all experts working in securities law enforcement recognize the crucial role private enforcement plays in assuring compliance with the federal securities laws.[128] Second, private enforcement, unlike public

---

monious state budgets have meant understaffing of state securities law programs."); *see also* Avery, *supra* note 2, at 378 ("Depending on the SEC to fill any void caused by a decrease in meritorious private litigation may be unrealistic in an era of government austerity.").

Experience has taught that the funding of the SEC is, unfortunately, subject to political caprice. For example, during the 1980s, when regulation of all sorts was not in vogue, the SEC was chronically underfunded. It was not until the end of the decade, when the pervasive crime in our financial markets began to manifest itself, that Congress authorized appropriate funding. *See The Market Reform Act of 1989: Joint Hearings before the Subcomm. on Sec. of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 101st Cong. 11 (1989) [hereinafter *Market Reform Act Hearings*] (statement of Sen. Sasser) (noting approval of 18% increase in SEC funding after it was "underfunded throughout the 1980's at a time when volume and complexity in the markets has increased enormously").

125. *See supra* note 13.

126. *See supra* note 118.

127. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (noting that the fundamental purpose of federal securities laws is to "'achieve a high standard of business ethics in the securities industry'" (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963))). The "purpose of the [federal securities laws] is to expand, not restrict the public's remedies." Sennott v. Rodman & Renshaw, 414 U.S. 926, 929 (1973) (Douglas, J., dissenting from order denying certiorari).

128. The former SEC chief of enforcement stated: "Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetrate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection." *Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Secs. of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 113 (1993) [hereinafter *Private Litigation Hearings*] (statement of William R. McLucas, Director, Division of Enforcement, SEC); *see also* David S. Ruder, *The Development of Legal Doctrine Through Amicus Participation: The SEC Experience*, 1989 WIS. L. REV.

enforcement, is fundamentally remedial in nature,[129] reflecting one of the basic goals of the federal securities laws—to provide remedies to injured investors.[130] Third, the compensatory nature of the federal securities laws is fundamental to investor confidence.[131] Investors are most sensitive to their pocketbooks and only private enforcement truly protects this interest. Moreover, stacking the deck against securities plaintiffs is a sure-fire way of destroying the confidence of investors in the fairness of financial markets.[132] The preservation of investor confidence is another foundational goal of the federal securities laws.[133]

The system that worked so well appears to have been taken for granted. Indeed, Congress appears never to have really considered issues of investor confidence, de-federalization, enforcement costs, and remediation of investors' losses.[134] In sum, federal

---

1167, 1168 (pointing out, as former Chairman of the SEC, that "private securities litigation plays an essential role in federal securities regulation" and that approximately 90% of securities cases were privately pursued in 1988); Levitt, *supra* note 34, at 2 ("[T]he longtime SEC belief [is] that private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program."). Indeed, a representative of the North American Securities Administrators Association, an organization representing all 50 state securities regulators, stated: "[P]rivate actions . . . are essential to deter prospective criminals, compensate the victims of fraud, and maintain public confidence in the marketplace." *Private Litigation Hearings*, *supra*, at 124 (statement of Mark J. Griffen, Director, Division of Securities, Utah Department of Commerce).

129. "The Commission is not authorized to . . . act as a collection agency for an individual. Investors must seek a financial judgment through civil litigation or binding arbitration." U.S. SECURITIES AND EXCHANGE COMMISSION, THE WORK OF THE SEC 36 (1980).

130. *See supra* note 41 and accompanying text.

131. *See* S. REP. NO. 104-98, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 715 (statement of Sens. Sarbanes, Bryan, and Boxer) (stating that investor "confidence is maintained because investors know they have effective remedies against persons who defraud them").

132. *See Securities Litigation Reform Proposals*, *supra* note 68, at 184-93, *reprinted in* 1995 U.S.C.C.A.N. 730, 730 (statement of David J. Guin, on behalf of the National Association of Securities and Commercial Law Attorneys) (stating that "reform" measures "unreasonably tip scales of justice in favor of defendants" and that this will undermine investor confidence and hurt capital markets).

133. *See supra* note 40 and accompanying text.

134. Certainly, Congress did pay lip service to these goals, stating:

> The private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and

law, originally promulgated to enhance the rights of investors relative to state law[135] now serves only to diminish the rights of investors. The recent "reforms" of private securities litigation are a betrayal of several fundamental goals of the federal securities laws and expose our financial system to risks that are not fully appreciated.[136] A more reactionary cycle could hardly have been imagined by the promulgators of the federal securities laws in the early 1930s.[137]

> meritless suits. Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. REP. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730. The lack of balance and overbreadth of the PSLRA, however, betrays congressional concern for these values. *See supra* note 9 and accompanying text.

135. *See supra* note 13 and accompanying text.

136. In fact, the SEC has gone on record that it cannot assess whether the PSLRA is adversely affecting the ability of the federal securities laws to protect investors because it is too soon after the passage of the Act to assess its impact. *See* SEC REPORT, *supra* note 12, at 63.

137. One visionary was Ferdinand Pecora. Pecora served for 17 months, from January 1933 to July 1934, as counsel to the Senate Committee on Banking and Currency, during the time of hearings on the Securities Act and the Exchange Act. *See* FERDINAND PECORA, WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS 3 (1939) (Augustus M. Kelley ed., 1973). Pecora published a summary of those congressional hearings because "[a]fter five short years, we may now need to be reminded what Wall Street was like before Uncle Sam stationed a policeman at its corner." *Id.* at xi.

Pecora was prescient in predicting a failure of public memory:

> Under the surface of the governmental regulation of the securities market, the same forces that produced the riotous speculative excesses of the "wild bull market" of 1929 still give evidences of their existence and influence. Though repressed for the present, it cannot be doubted that, given a suitable opportunity, they would spring back into pernicious activity.
>
> Frequently we are told that this regulation has been throttling the country's prosperity. Bitterly hostile was Wall Street to the enactment of the regulatory legislation. It now looks forward to the day when it shall, as it hopes, reassume the reins of its former power.
>
> . . . .
>
> The public, however, is sometimes forgetful. As its memory of the unhappy market collapse of 1929 becomes blurred, it may lend at least one ear to the persuasive voices of The Street subtly pleading for a re-

The federal securities laws have been a success. For six decades after their promulgation, panics largely have disappeared and American capital markets have successfully fueled the demand for start-up capital, thereby aiding the economy's ability to generate continued growth through innovation.[138] The market disruptions that have occurred have not damaged the economy and have been temporary in nature.[139] America's financial system has served as a model for the world.[140]

With such a successful record, any argument for a substantial structural change should be supported by compelling evidence.[141] After all, public participation in the securities markets is at very high levels.[142] Initial public offerings are soaring.[143] The stock market is booming.[144] The economy is enjoying low inflation, low unemployment, high growth, and surging productivity.[145] The defederalization of private securities litigation and the virtual elimination of private enforcement are substantial structural

---

> turn to the "good old times." Forgotten, perhaps, by some are the shattering revelations of the Senate Committee's investigation.

Id. at ix-x.

138. "By every measure, the United States capital markets are the largest and strongest in the world." S. REP. NO. 104-98, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 715.

139. *See Market Reform Act Hearings, supra* note 124, at 8 (statement of Sen. Gramm) (noting that the market shock of October 19, 1987 did not damage the economy).

140. *See, e.g.*, Levitt, *supra* note 34, at 5 ("Our markets are the best in the world, partly because our securities laws are the best."); Dr. Gerhard Wegen, *Congratulations from Your Continental Cousins, 10b-5: Securities Fraud Regulation From the European Perspective*, 61 FORDHAM L. REV., Annual Survey Issue, May 1993, at S57, S74 (inviting Rule 10b-5 to "visit" both Western and Eastern Europe); *Going for the Golden Egg*, ECONOMIST, Sept. 28-Oct. 4, 1996, at 89-90 (stating that "America has been much better than Europe at hatching small firms" and detailing European efforts to imitate American securities markets).

141. Or, as the SEC Chairman has said: "You shouldn't fix what ain't 'broke'." Levitt, *supra* note 34, at 5.

142. *See supra* note 4.

143. *See supra* note 34.

144. *See* Jeffery M. Laderman, *There's Only One Way to Ride an Aging Bull: Carefully*, BUS. WEEK, Dec. 29, 1997, at 88 (stating that the S&P 500 stock index had produced historically unique average annual gains of 28% from 1994-97).

145. *See generally New Thinking About the New Economy*, BUS. WEEK, May 19, 1997, at 50 (associating recent economic growth with technology-driven increases in productivity).

changes.[146] The evidence supporting a finding that the federal securities laws were in need of repair, however, is based largely on anecdotal evidence and unproven theories.[147]

The putative problem is that federal securities laws are abused by "entrepreneurial" attorneys bent upon extracting extortionate settlements from innocent issuers and associated persons.[148] The leverage for these sharp practices is the large costs of defending such claims through endless pleading and discovery squabbles to trial.[149] Supposedly the merits of these claims do not matter, and settlement is achieved based upon the costs of the litigation.[150] Stock price volatility invariably leads to claims of fraud.[151] Thus was born the "litigation explosion" that impaired American capital formation, discouraged risk taking, and enriched lawyers at the expense of American workers.[152] The story currently makes excellent politics, but there is little or no evidence to support it.[153] Scholars have shown an utter absence of a "litigation explosion," have demonstrated that any evidence that capital formation has been stunted is weak, and have opined that the merits matter very much to the price paid for

---

146. *See* Simon & Dato, *supra* note 11, at 960 ("Congress recently passed the most sweeping revision of the federal securities laws since 1933-34.").

147. *See, e.g.*, Avery, *supra* note 2; Seligman, *supra* note 2.

148. *See generally* H.R. REP. NO. 104-369, at 31-48 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-47 (discussing the role attorneys play in the problems with excessive litigation in the securities context).

149. *See id.* at 31-32, *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31.

150. *See id.* at 32, *reprinted in* 1995 U.S.C.C.A.N. 730, 731.

151. *See id.* at 31, *reprinted in* 1995 U.S.C.C.A.N. 730, 730.

152. *See* 141 CONG. REC. S19,053-54 (daily ed. Dec. 21, 1995) (statement of Sen. Hatch). Senator Hatch stated:

> These lawyers are filing these lawsuits so that they can terrorize American companies into paying exorbitant settlements because they know these companies cannot afford the high legal fees that would be required to defend themselves even against meritless lawsuits.
>
> When companies must pay for needless litigation settlement and insurance costs with dollars that could be going to create jobs or to further research and development, consumers and stockholders, virtually all Americans in fact are hurt. Due to wasted resources, profits and stock prices are lower than they would otherwise be and the shareholders in the end lose out. That should not be lost in this debate.

Id.

153. *See supra* notes 2, 11 and accompanying text.

settlement of claims.[154] Indeed, this was abundantly clear at the time the PSLRA became law.[155] The growing perception is that the PSLRA is not about "merits" at all, but rather is simply about money and influence peddling.[156] This is a dangerous perception.

Moreover, there is even less evidence that the putative solution to the putative problem will work.[157] The solution embodied in the PSLRA simply makes it much more difficult and expensive for plaintiffs to prevail and, ironically, makes a merits-based adjudication even more difficult to obtain.[158] For example, PSLRA's class action reforms will lead to even more litigation regarding who will serve as "lead plaintiff."[159] The PSLRA has the obvious side-effect of throwing out the meritorious with the frivolous. This is problematic inasmuch as it sacrifices justice in order to chill the pursuit of weak claims.[160] Worse yet, it appears

154. *See, e.g.*, Marino & Marino, *supra* note 11; Savett, *supra* note 11.

155. *See* 141 CONG. REC. S19,057 (daily ed. Dec. 21, 1995) (statement of Sen. Bryan) (summarizing the empirical evidence showing no securities litigation explosion and healthy increases in capital formation).

156. *See, e.g.*, Branson, *supra* note 58, at 24 (examining supposed policy arguments in favor of PSLRA and concluding that none was sound and that "[i]nstead, money ($12 million, mostly from the accounting profession) and politics (What politician can oppose . . . high-tech America?) fueled the rush to enact [the] draconian" PSLRA); Hufford, *supra* note 2, at 641 ("Ultimately, the evidence does not support the securities reform advocates . . . the [PSLRA] arises from . . . well-funded public relations and lobbying efforts . . . ."); *see also* 141 CONG. REC. S19,057 (daily ed. Dec. 21, 1995) (statement of Sen. Bryan) (referring to the PSLRA as a "classic case of overreaching, and . . . an extravagence"). The press has reported widely on the PSLRA as a prime example of influence peddling. *See, e.g.*, Ann Reilly Dowd, *Look Who's Cashing in on Congress*, MONEY, Dec. 1997, at 132 (listing the PSLRA as the top example of the relationship between laws, money, and lobbying, and noting that PSLRA was backed by a $29.6 million war chest).

157. As one scholar notes: "Ironically, although the legislation was intended in large part to reduce what has been perceived by many as an excess of private securities litigation, the impending clarification and refinement by the courts of the Act's more novel (and controversial) provisions will likely entail years of litigation." Avery, *supra* note 2, at 337.

158. *See* Savett, *supra* note 11, at 531 ("The Reform Act produces great delay in getting the case moving to the merits."). A federal law that seems to extend litigation is particularly inappropriate in a context in which the government subsidizes defense costs but not plaintiff costs. *See* JEROLD S. AUERBACH, JUSTICE WITHOUT LAW? 144 (1983) (terming deductibility of legal fees for businesses "a gigantic government subsidy").

159. *See* Avery, *supra* note 2, at 374.

160. *See id.* at 377-78 ("To the extent the Act makes meritorious claims more diffi-

that the "reforms" fail to curb the supposed abuses. Each of the primary "reforms" suffers from an inherent flaw in logic: increasing the risks of sanctions for claims that fail is useless against frivolous claims that settle[161] and fails to recognize that discovery often is needed even to assess the merits of claims.[162] Similarly, the PSLRA safe harbor has failed to encourage more meaningful forward-looking disclosures.[163] Increasing the pleading standards of claims certainly will prevent many claims from proceeding, but there is no assurance that only the weak claims will fail to clear this hurdle.[164] Proportionate liability requires a specific finding by the trier of fact (as to whether the defendant committed a "knowing" violation of the federal securities laws); therefore, outside professionals still are faced with the risk of

---

cult to pursue, it will not have served a worthwhile purpose. The strength of our markets depends on investor confidence that those markets operate honestly and fairly.").

161. The sanctions provisions apply only to a "final adjudication." *See* 15 U.S.C.A. §§ 77z-1(c)(1), 78u-4(c)(1) (1997).

162. As Mr. Cutting has stated:

> The practical effect of fee shifting would be to deter not only frivolous suits, but meritorious ones as well. This is because the only sensible way for plaintiffs' attorneys to locate potentially meritorious suits is by filing suit whenever there is a sudden and significant decrease in stock price. There is no way to evaluate the merits of a case before filing, because the essence of the claim is that the managers of the corporation had knowledge of adverse information that they withheld from the shareholders. The only method for determining whether a violation actually occurred is through the tools of discovery.

Cutting, *supra* note 1, at 573 (footnotes omitted).

163. *See* SEC REPORT, *supra* note 12, at 75. The SEC continued:

> Companies have been reluctant to provide significantly more forward-looking disclosure beyond what they provided prior to enactment of the safe harbor. Companies are primarily concerned about the lack of judicial guidance as to the sufficiency of the required "meaningful" cautionary language and about potential liability under state law where the statements may not be protected by the federal safe harbor.

Id.

164. *See* Cutting, *supra* note 1, at 582. Cutting elaborated:

> Like the fee shifting provision, however, the requirement that scienter be pled with particularity disposes of meritorious claims as well as meritless ones. Evidence indicating a defendant's state of mind is virtually impossible to discover without conducting [discovery]. Requiring plaintiffs to produce such evidence before discovery is "putting the cart before the horse."

Id.

huge jury awards and, thus, pressure to settle.[165] Even if the existence of a problem is conceded, the solutions offered thus far, specifically the PSLRA, are not narrowly tailored to meet the problem identified.[166] Indeed, they simply seem to be an arbitrary means of terminating or chilling claims. In all, far from facilitating a merits-based adjudication, the PSLRA seems certain to further delay any merits reckoning.

Any argument in favor of the PSLRA garners no support from the record of the securities industry over the past ten or fifteen years. Although empirical evidence on this score is hard to come by, most commentators agree that the business of issuing, selling, or buying securities has not advanced to such an ethical and fair level that traditional regulatory strictures should be relaxed.[167] In fact, many believe the contrary to be the case.[168]

Indeed, the 1980s and early 1990s were a sordid time for financial markets in the United States.[169] Regulators uncovered massive insider trading scams.[170] Outlaws built a new market

---

165. *See* Avery, *supra* note 2, at 378.

166. As one commentator has noted:

> Reformers of securities litigation, however, must be ever wary of the danger of overcompensating for current problems and discouraging the private actions necessary to enforce the federal securities laws. The current proposals are not well tailored to meet the needs of either investors or small businesses. Perhaps this is because these bills were introduced more as a political response to a societal perception of excessive litigation than out of concern over the particular problems of shareholders suits.

Cutting, *supra* note 1, at 583 (footnote omitted).

167. In the mid-1980s, Texas debated the issue of relaxing securities regulations and commentators across the country condemned the plan. *See* Jan Rich, *State May Relax Security Regulations*, HOUS. CHRON., Apr. 15, 1985, at 1, *available in* 1985 WL 3648252. Some, however, supported the plan. *See id.*

168. *See Private Litigation Hearings*, *supra* note 128, at 318 (statement of Ralph Nader on behalf of Public Citizen) (discussing the increase in corporate crime during the 1980s).

169. Senator Specter provided a few cases of massive frauds over the past 15 years as examples of situations in which private claims under the federal securities laws assisted large numbers of injured investors. *See* 141 CONG. REC. S19,046-47 (daily ed. Dec. 21, 1995) (statement of Sen. Specter) (citing specifically the Washington Public Power Supply litigation, involving 26,000 investors who lost $2 billion from the fraudulent sale of bonds, but who recovered $800 million under pre-PSLRA law).

170. As stated in *United States v. Mulheren*, 938 F.2d 364 (2d Cir. 1991):

> In the late 1980's a wide prosecutorial net was cast upon Wall Street. Along with the usual flotsam and jetsam, the government's catch included some of Wall Street's biggest, brightest, and now infamous—Ivan

for a new kind of security—junk bonds—on a foundation of fraud and manipulation.[171] This, in turn, extended to corporate takeover artists the necessary financial firepower to run roughshod over, dismantle and dismember long-established businesses.[172] Rogue divisions of previously respected broker-dealers systematically channeled retirees and IRA funds into reckless limited partnership investments in blatant breach of all standards of law and the securities profession.[173] Prestigious Wall Street

---

> Boesky, Dennis Levine, Michael Milken, Robert Freeman, Martin Siegel, Boyd L. Jeffries, and Paul A. Bilzerian—each of whom either pleaded guilty to or was convicted of crimes involving illicit trading scandals.

Id. at 365; *see also* JAMES B. STEWART, DEN OF THIEVES 16 (1991) (noting that Dennis Levine confessed to $12.6 million in insider-trading profits, Ivan Boesky agreed to pay $100 million in sanctions, and Michael Milken agreed to pay $600 million); Dennis B. Levine, *The Inside Story of An Inside Trader*, FORTUNE, May 21, 1990, at 80 (admitting that Dennis Levine "built $39,750 into $11.5 million" through 7 weeks of insider trading); *The Insider-Trading Case's Cast of Characters*, WASH. POST, Sept. 8, 1988, at E4 [hereinafter *Insider-Trading*] (detailing law enforcement activity against the web of inside traders on Wall Street).

171. Michael Milken arguably had the most significant impact on the financial markets of anyone in his generation:

> The 42-year-old Drexel Burnham executive is credited with turning junk bonds into a financing mechanism for corporate growth, restructurings and takeovers, and his salesmanship and long work days have kept the market in these securities humming.
>
> In the last several years, Milken has helped corporate raiders raise the cash to take over some of America's largest corporations, thereby affecting the fate of their employees, communities and shareholders. Along the way he has attracted a large group of individual and institutional investors who constitute a ready market for the high-yielding bonds.

Insider-Trading, *supra* note 170, at E4; *see also* BENJAMIN J. STEIN, A LICENSE TO STEAL: THE UNTOLD STORY OF MICHAEL MILKEN AND THE CONSPIRACY TO BILK THE NATION 15 (1992) (discussing the impact of Milken's use of junk bonds as a "landscape . . . littered with the ruins of a number of other financial giants").

172. Two such businesses are Pacific Lumber Company and Fischbach Corporation. *See In re* Ivan F. Boesky Sec. Litig., 888 F. Supp. 551 (S.D.N.Y. 1995) (recounting the fate of Pacific Lumber); SEC v. Drexel Burnham Lambert, Inc., 837 F. Supp. 587 (S.D.N.Y. 1993) (recounting the fate of Fischbach).

173. As the SEC chairman has noted:

> Take the sale of $8 billion of limited partnerships during the 1980s by Prudential Securities. Sadly, many people saving for retirement were misled about the risks of these investments. The SEC, with the help of state regulators, investigated and reached a settlement with Prudential at the end of last year, which has already returned almost $825 million to more than 100,000 defrauded investors.

firms bilked savings and loans, banks, insurance companies, and even municipalities on a scale previously thought impossible.[174] No market was safe from such skulduggery, as one pillar of Wall Street even manipulated the market for U.S. Treasury obligations.[175] This pervasive run of fraud, theft, and malfeasance imposed astounding costs upon our economy; trillions were lost,[176] much of which is still being paid off. Such frauds militate strongly against relaxing any sanctions available under the federal securities laws.[177]

Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Speech to National Association of Investors Corporation, Memphis, Tenn., Aug. 27, 1995, *available in* 1995 WL 520185; *see also* KURT EICHENWALD, SERPENT ON THE ROCK 7 (1995) ("More than $8 billion worth of risky partnerships packaged by Prudential-Bache collapsed after they had been falsely sold as safe and secure."); Chuck Hawkins, *The Mess at Pru-Bache: Questions About the Broker's Dealings Could Cause Long Term Damage, Investigations*, BUS. WEEK, Mar. 4, 1991, at 66 (stating that Prudential-Bache Securities, Inc. sold more than $6 billion in limited partnerships to 100,000 investors, who suffered huge losses without disclosing conflicts of interest, or criminal convictions of key promoters).

174. *See, e.g.*, STEIN, *supra* note 171, at 181-82.

175. On May 2, 1992, Salomon Brothers agreed to pay fines and civil sanctions totaling $290 million to compensate those damaged by violations of law in connection with Salomon's submission of false bids at Treasury securities auctions. Chairman Breeden commented:

> Salomon's numerous violations of the securities laws were extremely serious and involved huge amounts of securities purchases in a wrongful manner. Salomon's pattern of submitting false bids created a risk to the integrity of the government securities market, which is a market on which the federal government, and ultimately all federal taxpayers, depend. The failure of Salomon's senior management to alert the appropriate regulatory authorities when they first learned of the violations significantly compounded the gravity of the violations.

U.S. SECURITIES AND EXCHANGE COMMISSION, NEWS RELEASE, *SEC Files and Settles Salomon Brothers Case*, May 20, 1992, *available in* 1992 WL 110972; *see also The Activities of Salomon Brothers, Inc. in Treasury Bond Auctions: Hearings before the Subcomm. on Sec. of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 16 (1991) (statement of Sen. Jim Sasser) (recounting fallout from the deregulation of the 1980s).

176. The bank crisis of the 1980s alone cost about $1 trillion. *See* Ramirez, *supra* note 120, at 629. While not all of this is attributable to misconduct in connection with securities transactions, at least 55 of the federally insured savings and loans that failed were Drexel Burnham clients, including the largest and costliest failure, the notorious Charles Keating dominated Lincoln Savings & Loan Association. Also, of the 25 largest bankruptcies between 1980 and 1991, 14 were Drexel Burnham clients. *See* STEIN, *supra* note 171, at 206-07.

177. As one state enforcement officer argued:

Other economic developments support the argument against imposing restrictions upon investor remedies. In fact, public participation in, and reliance upon, the financial markets is greater than ever.[178] When the baby-boom generation begins to retire at the end of the next decade, the capital markets will be expected largely to finance this huge claim on capital.[179] This could well begin an unstable economic era that will test investors' confidence in the financial system.[180] When Congress was debating the PSLRA, this issue caused concern among some members.[181] Consequently, the PSLRA included a provision directing the SEC to study the impact of the PSLRA upon the investments of senior citizens.[182] Ironically, that study concluded that, while seniors may be susceptible to fraud and abuse, it was "too soon"

> The excesses of the 1980's and early 1990's in the financial services arena have left investors with a deep—and all too well justified—sense of concern. During the last decade, we witnessed financial frauds and scandals of historic proportions: The Salomon Brothers fraud in the government securities marketplace; Steven Wymer, BCCI and BNL; Charles Keating and Lincoln Savings; taxpayer bailouts for the savings and loan debacle; the FBI sting operation at the Chicago commodities markets; and the so-called "Den of Thieves" ring of junk bond king Michael Milken, Ivan Boesky, Dennis Levine and Marty Siegel. And, every day small investors are victimized in less notorious—but equally devastating—cases of fraud and abuse.
>
> It is against this backdrop that the broader and more complex issues raised by proponents of litigation "reform" must be considered.

Private Litigation Hearings, *supra* note 128, at 123 (statement of Mark J. Griffen, Director, Division of Securities, Utah Department of Commerce).

178. *See supra* note 4.

179. *See* SEC REPORT, *supra* note 12, at 1-2.

180. Economists recognize that the baby boom generation has rocked our economy for nearly 50 years. First came the school shortage. Then, the cultural phenomenon of the 1960s. During the 1970s, this population surge reached maturity and depressed productivity and savings, as the baby boom generation struggled to finance homes and education, and entered the labor market. Now, in their prime, the baby boom has discovered the stock market. *See generally Economic Implications of Changing Population Trends*, 72 FED. RESERVE BULL. 815, 821 (1986) (contending that many older people derive a portion of their income from their assets). If they rock the capital markets early next century, the PSLRA may come to be viewed as an unmitigated disaster.

181. *See* 141 CONG. REC. S19,040 (daily ed. Dec. 21, 1995) (statement of Sen. Sarbanes).

182. *See* 141 CONG. REC. S9224 (daily ed. June 28, 1995) (instructing the SEC to determine whether investors who are senior citizens require greater protection against securities fraud).

to determine the impact of the PSLRA upon this important group of investors.[183] This is, however, an issue that cannot be left to chance. These investors must have the highest degree of confidence in the fairness of our financial markets because they will control a large source of capital. Even now, investors over sixty-five own, directly or indirectly, one-third of all shares; by 2020, there will be more than twenty million new seniors.[184] The aging population also means that there is no crisis in the securities industry, as profits are at record levels.[185]

Neither the regulatory record of the securities industry nor the economic circumstances facing that industry can justify the restriction of investor rights that has occurred as a result of recent court decisions and the PSLRA. Moreover, even if there is a problem with abusive class actions, the PSLRA is hopelessly overbroad and does not really address how to stem such abuses. Instead, the PSLRA merely rigs private securities claims so that defendants almost always win. The PSLRA is a betrayal of the policy foundations of the federal securities laws and a threat to the long term stability of our securities markets.

C. *Why the Merits of the PSLRA Matter*

This Article does not argue that frivolous lawsuits do not exist, or that such lawsuits do not cause injuries to innocent defendants, investors, the marketplace, and the economy generally. Discouraging frivolous lawsuits is a laudable goal. Allowing investors to have greater control over class actions also is laudable and the PSLRA includes innovative provisions for achieving this goal.[186] Although empirical evidentiary support for an explosion of frivolous litigation is weak,[187] the anecdotal evidence that

183. *See* SEC REPORT, *supra* note 12, at 1.

184. *See id.*

185. *See* David Henry, *Street Warning: Business is Really Bustling*, USA TODAY, Nov. 11, 1996, at 2B ("Pretax profit for the industry is climbing to a record this year . . . toward $13.3 billion.").

186. For example, even staunchly pro-investor regulators expressed support for reigning in professional plaintiffs and improving disclosure of settlement terms in class actions. *See Securities Litigation Reform Proposals*, *supra* note 68, at 209-12 (statement of Mark J. Griffin on behalf of the North American Securities Administrators Association).

187. It is noteworthy that securities law is not the only area in which the debate

there are some abuses is strong.[188] Expert after expert testified to serious problems emerging in the private securities litigation arena.[189] A parade of SEC commissioners attested to strong indications that the private securities enforcement system was not operating correctly.[190] In fact, President Clinton did not oppose the goals of the PSLRA, only certain provisions that he thought would "have the effect of closing the courthouse door on investors who have legitimate claims."[191] The PSLRA simply goes too far given the scope of the problem.

Regardless of the evidentiary support for the PSLRA, the constituency that supported it is unlikely to disappear anytime soon. Indeed, it appears that the movement is toward more insulation from liability rather than less.[192] This constituency has broad bipartisan support and is well funded.[193] Forcing industries to shoulder large litigation expenses because of the riskiness of their activities serves no interest, particularly not the interest of shareholders and investors whose profits decline as a result.[194] In the final analysis, shareholders of corporations pay-

---

of a litigation explosion is raging: "Reformist advocacy based upon the existence of a litigation crisis, therefore, is founded upon impressionistic accounts that cannot be corroborated (and are, in fact, contradicted) by hard evidence." THOMAS E. CARBONNEAU, ALTERNATIVE DISPUTE RESOLUTION 242 (1989) (citing Marc Galanter, *Reading the Landscape of Disputes: What We Know And Don't Know (And Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4 (1983)).

188. As Senator Dodd, one of the PSLRA's sponsors, pointed out, "the record is replete" with examples of abuse. *See Securities Litigation Reform Proposals, supra* note 68, at 2-3 (statement of Sen. Dodd).

189. *See id.*

190. Richard M. Phillips and Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1025-26 (1996) (summarizing testimony of SEC Chairman Arthur Levitt, former Chairman Richard C. Breeden, former Chairman John Shad, former Acting Chairman Charles C. Cox, and former Commissioner J. Carter Breese, Jr.).

191. 141 CONG. REC. H15,214 (daily ed. Dec. 20, 1995) (veto message of Pres. Clinton).

192. *See supra* note 14 and accompanying text.

193. *See supra* note 156 and accompanying text.

194. *See* S. REP. NO. 104-98, at 9 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688 ("[L]ong-term investors ultimately end up paying the costs associated with the [frivolous] lawsuits.").

ing large securities settlements also are punished even though they may not have participated in the conduct giving rise to the claims.[195]

Moreover, perceptions are important for issuers of securities as well as for investors. If the perception is that "going public" is accompanied by an arbitrary litigation tax, more costly sources of capital may be utilized and inefficiencies created. Similarly, if the perception is that there is an "innovation tax," some companies, especially new or smaller companies, may be more risk averse than is necessary.[196] To the extent that the PSLRA addresses these concerns, it is difficult to argue that the Act has no merit. Quite simply, it is a salutary goal to eliminate frivolous litigation, and the securities business, because of its complexity and economic importance, may justify special litigation rules to quell such suits.

The issue therefore, becomes one of balance. The benefits of private enforcement must be balanced against the dangers of "strike suits." Any special litigation rules for securities claims must be tested against this balance, and the set of special rules that achieves the most promising balance should be implemented. The next section of this Article will demonstrate that arbitration is the special litigation procedure that achieves the best balance. Arbitration can thrust the merits onto center stage and

195. This concern often seems to influence the judiciary. *See* Eckstein v. Balcor Film Investors, 58 F.3d 1162, 1168 (7th Cir. 1995) (stating that securities claims are often "no favor to investors as a whole (who in the end must pay anticipated judgments)"). PSLRA supporters relied on this point: "The overall point . . . is . . . there is no division between companies and investors . . . that which damages the company, damages the owners . . . who are the investors." 141 CONG. REC. S17,942 (daily ed. Dec. 5, 1995) (statement of Sen. Bennett).

196. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 189 (1994). The Supreme Court stated:

> Newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.

Id.

slash defense costs—these benefits are fatal to strike suits and can restore fairness and efficiency to capital markets.

II. ARBITRATION: THE ROAD NOT TAKEN

Arbitration has been a favored method of dispute resolution, as a matter of federal law, since 1925 when Congress enacted the Federal Arbitration Act (FAA).[197] After the FAA, many courts remained skeptical that arbitration was an appropriate means of achieving substantial justice, and they were wary of imposing arbitration in situations in which parties did not enjoy equal bargaining power.[198] By the 1980s, however, the Supreme Court's attitude towards arbitration had changed.[199] The Court has stated that because of the strong federal policy favoring arbitration, "any doubts concerning the scope of arbitrable issues" in a given case "should be resolved in favor of arbitration."[200] Consequently, the Court has held that in areas involving interstate commerce, such as securities,[201] state laws restricting

197. United States Arbitration Act, ch. 213, 43 Stat. 883 (1925) (codified as amended at 9 U.S.C. §§ 1-14 (1994)). The United States Arbitration Act came to be known as the Federal Arbitration Act (FAA) following Congress's deletion in 1947 of the section naming the statute the United States Arbitration Act. *See* IAN R. MACNEIL, AMERICAN ARBITRATION LAW: REFORMATION, NATIONALIZATION, INTERNATIONALIZATION 231 n.48 (1992). The FAA states that "[a] written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (1994). The FAA further provides that federal courts shall "stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement." 9 U.S.C. § 3. Congress enacted the FAA to extinguish judicial hostility toward arbitration. *See, e.g.*, H.R. REP. NO. 96, at 1, 2 (1924).

198. *See, e.g.*, Bernhardt v. Polygraphic Co. of Am., 350 U.S. 198, 202-03 (1956) (holding that arbitration substantively affects parties' rights because arbitration procedures do not provide sufficient safeguards); Wilko v. Swan, 346 U.S. 427, 435 (1953) (stating that arbitration does not comport with the fact that the Securities Act "was drafted with an eye to the disadvantages under which buyers labor").

199. *See generally* Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 644-74 (1996) (tracing the evolution of the Court's approach to arbitration).

200. Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp, 460 U.S. 1, 24-25 (1983) (recognizing a "liberal federal policy favoring arbitration").

201. *See Wilko*, 346 U.S. at 430 (stating that a margin agreement governing a securities transaction involves interstate commerce). The Court has held that "involving

arbitration are preempted if they interfere with the arbitration of suits.[202]

A. *A Short History of Securities Arbitration*

The New York Stock Exchange (NYSE) began to offer an arbitration forum for the resolution of securities disputes in 1872.[203] The National Association of Securities Dealers (NASD) adopted its securities arbitration procedures in 1968.[204] The NYSE and NASD are the two largest self-regulatory organizations (SROs) registered under the Exchange Act.[205] Operating under the close supervision of the SEC, they provide pervasive regulation of the broker-dealer industry.[206] Investors initially did not use either of these arbitration fora frequently. First, the SROs created these fora to address a narrow universe of securities disputes—those between securities brokers and their customers.[207] Second, even with respect to this limited universe, the use of these arbitration procedures was voluntary until the 1980s.[208]

---

commerce," as used in the FAA, is the functional equivalent of "affecting commerce"—meaning that Congress has exercised its commerce power to its fullest extent. *See* Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 277 (1995).

202. *See, e.g.*, Doctor's Assocs. v. Casarotto, 517 U.S. 681, 688 (1996) (holding that the FAA preempted a Montana statute requiring that a predispute arbitration clause be on the first page of a contract); Securities Indus. Ass'n v. Lewis, 751 F. Supp. 205 (S.D. Fla. 1990) (holding that a Florida statute requiring parties to provide an option for nonindustry arbitration violated the Supremacy Clause).

203. *See* HOBLIN, *supra* note 16, at 1-2.

204. *See id.*; Masucci, *supra* note 17, at 185.

205. *See* Katsoris, *McMahon*, *supra* note 17, at 1130.

206. *See generally* 15 U.S.C. §§ 78f, 78o-3, 78s (1994) (providing the statutory basis for the self-regulatory power of national securities exchanges and registered securities organizations, as well as the close supervision of such SROs by the SEC). The SEC is given broad powers over SRO rules. *See* 15 U.S.C. § 78s(c) ("The [Securities and Exchange] Commission, by rule, may abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate . . . ."); *see also* VI LOSS & SELIGMAN, *supra* note 7, at 2713-23 (discussing generally the process and potential limitations of this power).

207. *See* HOBLIN, *supra* note 16, at 2-3 to 2-4 ("SROs by rule require that their members consent to arbitrate disputes . . . with their customers. . . . [Account Agreements] with arbitration clauses very often exist between members and their customers . . . .").

208. *See generally* Wilko v. Swan, 346 U.S. 427 (1953) (holding predispute arbitration agreements unenforceable under the Securities Act).

The Court's decision in *Wilko v. Swan*, which held that claims under the Securities Act were not arbitrable pursuant to predispute arbitration agreements, limited widespread arbitration of securities disputes in the brokerage industry.[209] The *Wilko* decision evinced judicial hostility toward arbitration. The Court seemed uncertain that an arbitration panel could protect a plaintiff's rights under the federal securities laws because the arbitrators were not required to issue rulings in compliance with law, did not have to explain their decisions, and were not subject to meaningful judicial review.[210] The Court held that the federal securities laws guaranteed court-based judicial proceedings and that this guarantee could not be waived.[211]

More recently, in *Shearson/American Express, Inc. v. McMahon*,[212] the Supreme Court held that securities claims could be subject to predispute arbitration agreements.[213] The Court based its reversal of the *Wilko* approach on the fact that commercial arbitration had become more common and that securities arbitration involving SROs operated under the close supervision of the SEC.[214] Fundamentally, the Supreme Court rejected

---

209. *See id.* at 427, 438.

210. *See id.* at 436-37 (stating that "the protective provisions of the Securities Act require the exercise of judicial direction" and arbitrators unbound by law are not adequate to secure the protections of the Securities Act for investors); *see also* Daniel R. Waltcher, Note, *Classwide Arbitration and 10b-5 Claims in the Wake of* Shearson/American Express, Inc. v. McMahon, 74 CORNELL L. REV. 380, 382 (1989).

211. *See Wilko*, 346 U.S. at 434-35. Section 14 of the Securities Act provides that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the [Securities and Exchange] Commission shall be void." 15 U.S.C. § 77n.

212. 482 U.S. 220 (1987).

213. *See id.* at 238. The Supreme Court had signaled a retreat from *Wilko* in two cases that were decided between *Wilko* and *McMahon*. *See* Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 221, 223-24 (1985) (holding that the FAA requires courts to compel arbitration of pendent arbitrable claims); Scherk v. Alberto-Culver Co., 417 U.S. 506, 519-20 (1974) (holding that an international contract provision requiring arbitration applies to Rule 10b-5 claims).

214. *See Wilko*, 482 U.S. at 233. For example, the 1975 amendments provide that

> the [Securities and Exchange] Commission, by rule, may abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purpose of this chapter.

the suspicion of arbitration evinced in *Wilko* and clearly stated that arbitration, particularly under the watchful eye of the SEC, is a reliable and fair means of adjudicating broker-customer disputes.[215] It is difficult to take issue with this conclusion. In fact, plaintiffs in such actions are increasingly comfortable arbitrating these claims.[216] Although it is impossible to determine with precision whether investors are treated "fairly" in arbitrating claims against brokers, all of the available evidence suggests that investors fare at least as well as dealers in federal court.[217]

Currently, virtually all customers may compel their brokers to submit disputes to industry-sponsored arbitration by virtue of their required membership in various SROs and the rules of such organizations.[218] Additionally, the majority of customers

---

15 U.S.C. § 78s(c). The Court's holding is limited to cases in which the SEC exercises oversight over the arbitration forum rules. *See Wilko*, 482 U.S. at 234. Given that *McMahon* involved claims under the Exchange Act and not the Securities Act, *see id.*, *Wilko* was not actually overturned until 1989. *See* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 481, 483 (1989) (holding that predispute arbitration agreements are enforceable as to claims under the Securities Act).

215. *See McMahon*, 482 U.S. at 231-34; *see also Rodriguez de Quijas*, 490 U.S. at 486 ("[R]esort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act.").

216. Indeed, the evidence is mounting that investors actually prevail more often in arbitration against broker-dealers than they do in court, especially given the recent "reforms" promulgated by both Congress and the Court. *See* Marc I. Steinberg, *Securities Arbitration: Better for Investors than the Courts?*, 62 BROOK. L. REV. 1503, 1531 (1996) ("The final analysis is that investors today likely fare better in arbitration than they would in federal court."); *see also* Lloyd S. Clareman, *The New Rules of Suing a Broker*, FORTUNE, 1991 Investor's Guide, Fall 1990, at 207-08 ("Arbitration today offers more advantages than disadvantages to aggrieved investors."); Kristen Davis, *Battle Your Broker and Win*, CHANGING TIMES, May 1991, at 41-43 (quoting sources as stating that arbitration is the "preferred" means of pursuing claims against brokers). *But see, e.g.*, Daniel McGinn, *Can't Get No Satisfaction*, NEWSWEEK, Aug. 29, 1994, at 41 (stating that both investors and brokers are dissatisfied with securities arbitration); Jane Bryant Quinn, *Seeking Justice*, NEWSWEEK, Sept. 4, 1995, at 37 (arguing that brokers have the "upper hand" in securities arbitration).

217. *See supra* notes 22, 216 and accompanying text; *infra* note 235 and accompanying text.

218. *See* 15 U.S.C. § 78o(b)(8) (requiring membership in either a national securities exchange or a registered securities association, such as the NASD). The SEC has approval authority over all SRO rules, including provisions relating to arbitration procedures. *See* 15 U.S.C. § 78s(b)(1), (c). All SROs require their member broker-dealers to submit to arbitration at the request of a customer. *See* UNIF. CODE OF

generally are required to agree to arbitrate disputes with their brokers by operation of arbitration clauses within account securities agreements.[219] Thus, insofar as broker-customer disputes are concerned, arbitration is the pervasive means of dispute resolution. The NASD sponsors the most important arbitration forum, processing eighty-five percent of all broker-customer arbitration disputes.[220] The NASD closed 4,561 cases in 1994, and the average time for resolution of a case was 10.4 months.[221] In addition, a study commissioned by the NYSE showed that arbitration in the securities brokerage industry has achieved a significantly lower cost for parties in resolving these kinds of disputes.[222] The most recent data also suggest that plaintiffs prevail as much in arbitration as in court.[223]

Arbitration between brokers and customers in the securities brokerage industry has had a long period to develop; therefore, the rules now governing such arbitrations are uniform. In addition, the SROs have adopted the Uniform Code of Arbitration promulgated by SICA.[224] The Uniform Code provides that the rules of evidence do not apply,[225] but may serve as a guideline to arbitrators to exclude evidence.[226] The Code authorizes virtually

---

ARBITRATION §1(a) (1996). The SEC sponsored the creation of SICA, which assesses the efficacy of arbitration at the SROs and proposes improvements. *See id.* at 488-90. SICA has promulgated the Uniform Code of Arbitration for securities disputes, which has been adopted, in all major aspects, by every SRO. *See id.* at 489-90.

219. *See supra* note 17; *see also* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 13 ("[M]ost individual investors have entered into agreements that contain predispute arbitration clauses.").

220. *See* Masucci, *supra* note 17, at 188.

221. *See id.*

222. *See* FLETCHER, *supra* note 17, at § 4.7 (citing studies showing that arbitration costs only 40% of court litigation); *see also* G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C. L. REV. 517, 521 n.24 (1989) (revealing that defending a suit in arbitration costs an average of $8,000 compared to the average $20,000 spent in court).

223. *See* FLETCHER, *supra* note 17, § 4.2 (showing that plaintiffs recover more money and prevail more often in arbitration than in court).

224. *See generally* Katsoris, *SICA*, *supra* note 17, at 490 (commenting that it is the role of the arbitrator to determine the admissibility of evidence, unconstrained by the Federal Rules of Evidence).

225. *See id.* at 513 (discussing UNIF. CODE OF ARBITRATION § 21).

226. *See* Mary Margaret L. O'Donnell, Note, *The Future of Mandatory Arbitration Agreements in Employment Contracts: What* Huertebise v. Reliable Business Com-

no motion practice, discourages depositions, and allows for other discovery by informal means.[227] The Code provides for conferences with an arbitrator to resolve any discovery disputes.[228] A panel of three arbitrators eventually hears the underlying dispute[229] and issues an award within thirty days, which must then be paid within thirty days of the panel's decision.[230] The arbitrators are individuals with substantial securities experience and are required to undertake significant arbitration training.[231] The Rules also regulate the composition of arbitration panels: no more than one out of three arbitrators may be from the securities industry, and parties may challenge arbitrators peremptorily or for cause.[232] As with all arbitrations, appeal rights are quite limited. Absent a manifest disregard of the law, the arbitrators' decision typically will stand.[233]

---

puters *Will Mean For Michigan*, 44 WAYNE L. REV. 231, 252 (1998) (arguing that those people who would prefer to have arbitrators follow the Federal Rules of Evidence should include a provision to that effect in their contracts).

227. *See* Katsoris, *SICA*, *supra* note 17, at 511-13 (discussing UNIF. CODE OF ARBITRATION § 20).

228. *See id.*

229. *See* UNIF. CODE OF ARBITRATION § 8(a)(1).

230. *See id.* § 28(d),(g).

231. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 107-13 (reviewing arbitrator training programs and making suggestions for improvement).

232. *See* UNIF. CODE OF ARBITRATION §§ 8, 10.

233. The "manifest disregard of the law" standard of review has evolved from dicta in *Wilko v. Swan*, 346 U.S. 427, 436-37 (1953). The majority of courts of appeals have adopted this standard. *See, e.g.*, Willemijn Houdstermaatschappij, BV v. Standard Microsystems Corp., 103 F.3d 9, 12 (2d Cir. 1997) (reversing district court's vacatur of award); Health Services Management Corp. v. Hughes, 975 F.2d 1253, 1267 (7th Cir. 1992) (sustaining award); A.G. Edwards & Sons, Inc. v. McCollough, 967 F.2d 1401, 1402-03 (9th Cir. 1992) (reversing district court's vacatur of award); Kanuth v. Prescott, Ball & Turben, Inc., 949 F.2d 1175, 1182 (D.C. Cir. 1991) (sustaining award); Upshur Coal Corp. v. UMWA, Dist. 31, 933 F.2d 225, 228-29 (4th Cir. 1991) (reversing district court's vacatur of award); Advest, Inc. v. McCarthy, 914 F.2d 6, 10 (1st Cir. 1990) (upholding award because the correct legal interpretation was not glaringly obvious, even if the arbitrators committed legal error); Tanoma Mining Co. v. Local 1269, UMWA, 896 F.2d 745, 749 (3d Cir. 1990) (reversing district court's vacatur of award); Federated Dep't Stores, Inc. v. J.V.B. Indus., Inc., 894 F.2d 862, 866 (6th Cir. 1990) (holding that errors in interpretation do not constitute manifest disregard); Jenkins v. Prudential-Bache Sec., Inc., 847 F.2d 631, 634 (10th Cir. 1988) (sustaining award). In addition, section 10 of the FAA provides certain statutory bases for vacating arbitration awards involving procedural deficiencies. *See* 9 U.S.C. § 10 (1994).

The system of securities arbitration for broker-customer disputes has been under intense scrutiny for many years. The General Accounting Office (GAO) has studied the fairness of the system and has concluded that it is not inherently biased in favor of the industry.[234] Other scholarly studies of the fairness of arbitration in the SRO fora generally have concluded that investors are given "fair" treatment.[235] Over the years, the success rate for claimants in SRO arbitration proceedings has remained remarkably close to fifty percent.[236] This seems to rebut any systematic unfairness in these proceedings, even though a more telling comparison would be a comparative analysis between results

---

234. *See* U.S. GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION—HOW INVESTORS FARE 60 (1992). The GAO also assessed the fairness of arbitration at the SROs in the specific context of employment discrimination claims involving employees of brokers-dealers. Again, it found no unfair bias. *See* U.S. GENERAL ACCOUNTING OFFICE, EMPLOYMENT DISCRIMINATION—HOW REGISTERED REPRESENTATIVES FARE IN DISCRIMINATION SUITS 2 (1994).

235. *See* Shelly R. James, Note, *Arbitration in the Securities Field: Does the Present System of Arbitration Between Small Investors and Brokerage Firms Really Protect Anyone?*, 21 J. CORP. L. 363, 376-84, 389 (1996) (undertaking a quantitative and qualitative analysis of 293 randomly selected arbitration awards and concluding that, statistically, arbitration appears "fair" and that a "rhetorical" analysis "denies the existence of bias in arbitration"). Although the James sample is limited, and the "rhetorical" analysis somewhat novel, its conclusions are consistent with other studies. *See, e.g.*, William A. Gregory & William J. Schneider, *Securities Arbitration: A Need for Continued Reform*, 17 NOVA L. REV. 1223, 1241 (1993) (finding that customers prevailed in 56% of arbitrations in 1989 and 59% in 1990). Gregory & Schneider conclude:

> It may be that a fifty percent win ratio paying out 30 cents on the dollar is quite generous to customers based on the facts of the individual cases. Unfortunately, there is no way of telling without the written opinions of arbitrators. Under the present state of securities arbitration, our intuition may be the only guiding light. The industry's actions do not seem to support its contention that investors fare better in industry arbitration. With the securities industry feverishly fighting to uphold [Predispute Arbitration Agreements] at every turn . . . it would seem that investors are the ones getting the short end of the stick . . . .

Id. at 1242-43. The inference that arbitration is unfair because the securities industry "feverishly" fights to uphold it seems suspect. It may be that because of lower costs and quicker resolutions, arbitration is both fair and less costly to defendants and plaintiffs than conventional litigation. *See* James, *supra*, at 375. James also found that in cases in which a claimant was represented by counsel, claimants enjoyed a 60% success rate. *See id.* at 380.

236. *See* Katsoris, *SICA*, *supra* note 17, at 564 (showing that public investors prevailed at a rate of 50.29% from 1993 to 1995).

reached in litigation and arbitration.[237] The SEC also has conducted several studies of the broker-customer arbitration system and has not found any inherent unfairness. For example, the SEC concluded a review of the fairness of arbitration procedures used at the SROs in 1987 and made specific recommendations for improving the process. These recommendations ultimately led to a number of revisions that the SEC approved.[238] In addition, the accounting firm of Deloitte, Haskins & Sells conducted a comprehensive study of the fairness of industry-sponsored arbitration in 1988 on behalf of the NYSE.[239] The study found arbitration to be less costly and speedier than litigation.[240] The SEC made its own independent examination of the Deloitte study, and found that there was "no significant difference in the amount recovered by plaintiffs in litigated cases *vis-a-vis* arbitrated cases."[241] SICA, an organization comprised of members of the public and representatives of the securities industry that helps monitor and improve the arbitration system, has produced a series of reports to the SEC to further such fairness goals.[242]

---

237. *See supra* note 223.

238. *See* Order Approving SRO Arbitration Rules, Exchange Act Release No. 34-26805, 54 Fed. Reg. 21,144 (May 16, 1989).

239. *See* Deloitte, Haskins & Sells, Study on Behalf of New York Stock Exchange (1988), *reprinted in* HOBLIN, *supra* note 16, at XXIII-10 to XXIII-16.

240. *See id.* at XXIII-12.

241. 2 SECURITIES ARBITRATION COMMENTATOR No. 4, at 4 (Apr. 1989) (citing Memorandum from Kenneth Lehn, Chief Economist for the SEC, to Catherine McGuire, Division of Market Regulation (Feb. 24, 1989)).

242. More precisely:

> In . . . comments to the Commission, several self-regulatory organizations and [others] proposed that a securities industry task force be established to consider the matter of developing a uniform arbitration code and the means for establishing a more efficient, economic and appropriate mechanism for resolving investor disputes involving small sums of money. In accordance with such proposals and at the initiative of the self-regulatory members, a Securities Industry Conference on Arbitration . . . was established in early 1977. Subsequently the Commission invited proposals from the Conference which would address, among other matters, improved methods for the resolution of investors' small claims.

SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, THIRD REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION TO THE SECURITIES AND EXCHANGE COMMISSION 2 (Jan. 31, 1980) (on file with author) (citing Implementation of an Investor Dispute Resolution System, Exchange Act Release No. 34-13470, [1977-1978

In 1978, SICA proposed the Uniform Arbitration Code.[243] SICA has also continuously proposed revisions to arbitration procedures, written public education brochures, and monitored statistics relating to industry arbitration results.[244] In addition, the NASD, as the sponsor of the largest industry-sponsored arbitration forum, appointed a task force headed by former SEC Chairman David Ruder to study the securities arbitration process and make suggestions for its improvement.[245] This task force also found arbitration to be a "fair" method for the resolution of disputes.[246] Even Congress has been involved in scrutinizing the fairness and appropriateness of industry-sponsored arbitration.[247] The intense scrutiny of the securities arbitration process in the brokerage industry has made it increasingly more acceptable to the public.[248]

The SEC specifically has addressed the need for ADR proposals, such as the one in this Article, to serve as a means of resolving the tension inherent in discerning frivolous suits from meritorious ones.[249] The SEC has long supported arbitration as a means of fairly resolving securities disputes, at least in the securities brokerage industry.[250] No one, however, has promul-

---

Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,136 (Apr. 26, 1977)).

243. *See* Katsoris, *SICA*, *supra* note 17, at 490.

244. *See generally* SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, EIGHTH REPORT OF THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION (June 1994) (on file with author).

245. *See* Katsoris, *SICA*, *supra* note 17, at 528.

246. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 1.

247. In fact, the House Committee on Energy and Commerce requested the GAO study. *See* HOBLIN, *supra* note 16, at XXXV-2.

248. *See supra* note 214 and accompanying text.

249. *See Securities Litigation Reform Proposals*, *supra* note 68, at 247, 250 (statement of Arthur Levitt, SEC Chairman).

250. *See* Brief for Securities and Exchange Commission as Amicus Curiae at 13-21, Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44). The SEC argued:

> The view of arbitration on which *Wilko* rested is today inappropriate in cases involving disputes between registered broker-dealers and their customers. . . . [Given the SEC's broad regulatory authority], the suspicion of arbitration on which *Wilko* rested is inappropriate, and an agreement to arbitrate accordingly should not be deemed a waiver of rights under the Exchange Act.

Id. at 13. The SEC has not always been so pro-arbitration. In 1983, the SEC progated a serious proposal for expanded ADR of private securities claims. Certainly Congress has given short-shrift to the potential improvements that ADR can bring to this vital area.[251] The experience from arbitration in the broker-dealer industry, however, demonstrates that securities disputes can be resolved fairly and efficiently through ADR, particularly when regulated by a prominent administrative agency with recognized expertise such as the SEC.[252]

The key issue is whether it is possible to implement an ADR mechanism that can deal well with both frivolous claims and meritorious claims in the context of securities disputes involving

---

mulgated 17 C.F.R. § 240.15c2-2 to regulate predispute arbitration clauses in broker-dealer customer agreements. *See* Recourse to the Courts Notwithstanding Arbitration Clauses, Exchange Act Release No. 34-20397, 48 Fed. Reg. 53,404 (Nov. 28, 1983). After the *McMahon* decision, the SEC rescinded this Rule. *See* Rescission of Rule Governing Use of Predispute Arbitration Clauses, Exchange Act Release 34-25034, 52 Fed. Reg. 39,216 (Oct. 21, 1987).

251. *See* STAFF REPORT ON PRIVATE SECURITIES LITIGATION, STAFF REPORT PREPARED AT THE DIRECTION OF SEN. CHRISTOPHER DODD, CHAIRMAN, SUBCOMM. ON SEC. OF THE SEN. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE 51 (May 12, 1994), *reprinted in Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing and Urban Affairs*, 103d Cong. (1994) (stating that ADR does not always succeed).

252. As one scholar commented:

> Congress created the Commission as an expert agency with the capacity to address significant problems affecting the nation's securities markets. Congress also created the Commission as an agency that could thoughtfully address problems too politically charged to be easily resolved on Capitol Hill. Congress then delegated to the Commission substantial authority to define the contours of market activity that would create liability for fraud. In light of the rationales for the Commission's existence and the scope of the relevant Congressional delegation, and in light of the Commission's expertise in litigation matters and the contentious nature of the underlying policy claims, the private securities litigation debate is "precisely the sort of intricate, labor-intensive task for which delegation to an expert body is appropriate."

Joseph A. Grundfest, *Disimplying Private Rights of Action under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 966-67 (1994) (quoting Mistretta v. United States, 488 U.S. 361, 379 (1989)); *see also* SEC v. Chenery Corp., 332 U.S. 194, 207, 209 (1947) (arguing that the SEC's judgments deserve the most deference when they arise out of administrative experience, an understanding of legislative policy, and a fair treatment of the facts); Board of Trade v. SEC, 923 F.2d 1270, 1273 (7th Cir. 1991) (explaining that the SEC is better equipped than judges to interpret broadly worded statements that govern the securities industry).

publicly-held companies. The thesis of this Article is that, in light of the PSLRA, arbitration is the best means of resolving these securities claims.

B. The Advantages and Disadvantages of Broadening the Role of Securities Arbitration

The search for effective ADR mechanisms has intensified over the last few decades.[253] Concerns of cost, access, and conservation of judicial resources have spawned a re-evaluation of traditional court-based adjudication.[254] Some have even observed that the litigation system, burdened by endless procedural and substantive legal technicalities and fundamentally adversarial in its nature, is collapsing upon itself and taking law and justice with it.[255]

---

253. Indeed, the calls for reform of the prevailing dispute resolution system have come from the highest echelons of the legal profession. *See, e.g.*, Derek C. Bok, *A Flawed System of Law Practice and Training*, 33 J. LEGAL EDUC. 570 (1983) (pushing for reform programs that simplify rules and procedures and provide greater access to the legal system to the poor and middle class); Warren E. Burger, *Agenda for 2000 A.D.—A Need for Systematic Anticipation*, 70 F.R.D. 83, 93-96 (1976) (suggesting alternatives to litigation); Warren E. Burger, *Isn't There a Better Way?*, 68 A.B.A. J. 274 (1982) (advocating assessment of alternatives to litigation).

254. *See* William Twining, *Alternative to What? Theories of Litigation, Procedure and Dispute Settlement in Anglo-American Jurisprudence: Some Neglected Classics*, 56 MOD. L. REV. 380, 380 (1993) (stating that three primary concerns behind the drive for ADR in the American legal system are: the perception of overburdened courts, the need for specialized private fora, and issues of cost and access). The cost of litigation is central to the PSLRA debate. Congress legislated on the assumption that the "Big Six" accounting firms, major law firms, nationwide securities underwriters, and the largest corporations in the country had inadequate resources to defend themselves, and were "victimized" by plaintiffs who could impose large legal costs, forcing them to settle otherwise frivolous claims. *See* H.R. REP. NO. 104-369, at 31 (1995). With respect to judicial resources, Chief Justice Burger stated: "[we are] on our way to a society overrun by hordes of lawyers, hungry as locusts, and brigades of judges in numbers never before contemplated." John Lang, *Courting Disaster: Some See Lawyers As Gross Domestic Product*, ROCKY MOUNTAIN NEWS, Sept. 8, 1998, at 1B, *available in* 1998 WL 7959617.

255. *See* CARBONNEAU, *supra* note 187, at 4. Carbonneau claims:

> Legal adjudicatory institutions are paralyzed by the intricacies and sophistication of their own processes. The analytical rigor of legal reasoning and the complex formalism of legal procedure are inadequate substitutes for individual rationality, personal understanding, and mutual cooperation in the quest to gain the civil resolution of conflictual circumstances.

ADR has served as a primary means of dispute resolution within the financial services industry.[256] In addition to broker-customer arbitration in the securities industry, the futures industry maintains a parallel process for arbitration of customer disputes arising from dealings with futures commission merchants.[257] The Commodity Futures Trading Commission (CFTC) also maintains an administrative procedure for the resolution of disputes involving industry professionals charged with violating provisions of law administered by the CFTC.[258]

This Article proposes the implementation of a system of arbitration modeled on the arbitration systems governing broker-customer disputes. This kind of arbitration is characterized by: the use of small panels of adjudicators with legal and nonlegal expertise in the securities industry; informal procedural rules providing for expedited discovery and adjudication; limited appeal rights; elimination of juries; the restriction of extended motion practice; standardized discovery provisions; and minimal technical requirements, such as particularity in pleading.[259] Under such a system of arbitration, the emphasis shifts from tech-

---

> Antihumanistic both in its principle and in its practice, the adversarial ethic works a subterfuge on society. It is deceitful not only as to its concern for individual interests, but also in its regard for legality and the integrity of substantive law.

Id.

256. *See, e.g.*, Gammaro v. Thorp Consumer Discount Co., 15 F.3d 93 (8th Cir. 1994) (using arbitration in the context of borrower-lender relationship); Myron v. Hauser, 673 F.2d 994 (8th Cir. 1982) (employing ADR in commodities dispute). The use of arbitration agreements in the financial services industry seems particularly appropriate. First, this industry would benefit from the use of expert adjudicators because of the complex nature of many financial transactions. Second, the quicker these disputes are resolved, the quicker uncertainty is eliminated and financial resources can be deployed for investment. Third, low cost adjudications are appealing in this area because fewer resources are thereby diverted from financial markets. Fourth, investors will respond to quick and fair remedies by demanding lower risk premia on their investments. *See supra* note 7.

257. *See, e.g.*, Geldermann, Inc. v. CFTC, 836 F.2d 310 (7th Cir. 1987).

258. The CFTC is charged with enforcement of the Commodity Exchange Act. *See* 7 U.S.C. § 15 (1994).

259. *See supra* note 16.

nical legal analysis to doing that which is just.[260] Arbitrators may not ignore the law, but they are not bound by it either.

1. Potential Pitfalls of Wider Securities Arbitration

Much has been written about the desirability of ADR as an alternative to traditional court-based adjudications.[261] No clear consensus has emerged, however, on a general theory of dispute resolution. The empirical evidence from evaluations of when, and to what extent, ADR can deliver on its promises is mixed.[262]

---

260. *See* University of Alaska v. Modern Constr., Inc., 522 P.2d 1132, 1140 (Alaska 1974) ("[A]rbitrators need not follow otherwise applicable law when deciding issues properly before them, unless they are commanded to do so by the terms of the arbitration agreement."); *see also* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 259 (1987) ("[A]rbitrators are not bound by precedent . . . ."); Lentine v. Fundaro, 278 N.E.2d 633, 635 (N.Y. 1972) ("Absent provision to the contrary in the arbitration agreement, arbitrators are not bound by principles of substantive law . . . ."). In fact, arbitrators rarely provide a written opinion in support of their awards. *See* Lynn Katzler, Comment, *Should Mandatory Written Opinions Be Required in All Securities Arbitrations?: The Practical and Legal Implications to the Securities Industry*, 45 AM. U. L. REV. 151, 156 (1995) (noting that securities arbitrators usually complete a standard award form and give little rationale for their decision). Obviously, the lack of a written opinion, combined with no mandate to follow legal principles, makes it exceedingly difficult to challenge an arbitration award under the "manifest disregard of the law" standard of review. *See supra* note 233.

261. *See, e.g.*, John P. Esser, *Evaluations of Dispute Processing: We Do Not Know What We Think and We Do Not Think What We Know*, 66 DENV. U. L. REV. 499 (1989); Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353 (1978); Laura Nader, *Disputing Without the Force of Law*, 88 YALE L.J. 998 (1979); Frank E.A. Sander, *Alternative Methods of Dispute Resolution: An Overview*, 37 U. FLA. L. REV. 1 (1985); Susan Silbey & Austin Sarat, *Dispute Processing in Law and Legal Scholarship: From Institutional Critique to the Reconstruction of the Juridical Subject*, 66 DENV. U. L. REV. 437 (1989).

262. *See* Esser, *supra* note 261, at 542-43 (outlining the precepts of a "New Formalism" regarding ADR and concluding that "the results of the research . . . inspired [by the assumptions of the New Formalism] have not substantiated the intellectual coherence which these assumptions promise and predict"); Sander, *supra* note 261, at 15 ("Despite all of the recent developments in alternative modes of dispute settlement, relatively little is known about the critical questions of [alternative dispute resolution mechanisms]."). Discussions of the need for such a general theory of dispute resolution mechanisms date as far back as the problems giving rise to the search for alternatives to traditional litigation. *See generally* Panel Discussion, *Let the Tribunal Fit the Case—Establishing Criteria for Channeling Matters into Dispute Resolution Mechanisms*, 80 F.R.D. 166, 166 (1977) (discussing possible solutions for the "pains of the rapidly growing volume of cases in our courts" that "breed delay, require mass production methods, produce de-humanized 'processing' and badly strain

This Article does not attempt to contribute to a *general* theory of dispute resolution; it instead posits that expansion of securities arbitration to all securities disputes involving publicly-traded companies is a *specific* area of law in which the benefits of ADR easily outweigh the detriments.[263] This Article demonstrates that the criticisms leveled at ADR generally do not apply with full force to the kind of securities arbitration proposed herein.

One of the most persuasive criticisms of arbitration, and of the Supreme Court's willingness to enforce almost all arbitration agreements, is that it allows powerful interests to use superior resources and bargaining power to impose unfair restrictions on the legal rights of the weak.[264] Critics have termed this shortcoming "disempowerment."[265] Specifically, critics argue that ADR is "no more likely to enhance . . . [the] delivery of justice in practice and that the net effect of the [ADR] movement would be to discourage the disadvantaged from trying to assert their legal rights."[266] Indeed, the courts have been quite reluctant to void arbitration agreements on grounds of unconscionability or unfairness.[267] Instead, courts have allowed parties to impose unfair

the machinery of justice").

263. In this regard, this Article follows the path of others who have argued in favor of expanding ADR in specific areas. *See* Robert Coulson, *Family Arbitration—An Exercise in Sensitivity*, 3 FAM. L.Q. 22, 22 (1969); Ronald L. Goldfarb & Linda R. Singer, *Redressing Prisoners' Grievances*, 39 GEO. WASH. L. REV. 175, 314-16 (1970); Timothy S. Hardy & R. Mason Cargill, *Resolving Government Contract Disputes: Why Not Arbitrate?*, 34 FED. B.J. 1, 19-20 (1975); Paul Gerhardt George, Note, *Arbitration of Attorney Fee Disputes: New Direction for Professional Responsibility*, 5 UCLA-ALASKA L. REV. 309, 327-52 (1976).

264. *See* Sternlight, *supra* note 199, at 637 ("Large companies such as banks, hospitals, brokerage houses and even pest exterminators are increasingly including mandatory binding arbitration clauses in the fine print [of] contracts they require all customers, employees, franchisees and other little guys to sign.").

265. *See* AUERBACH, *supra* note 158, at 144-45. Professor Auerbach argues that ADR ultimately is a tool for powerful interests to emasculate opposition. According to Auerbach, ADR diffuses political organization, discourages the implementation of litigation strategies, and debases the justice available to commoners. *See id.* at 144. This certainly may be true in particular contexts, but in the securities context the reader can decide whether any plaintiff faced with the gauntlet of federal court is disempowered by relegation to a system of fair arbitration.

266. Twining, *supra* note 254, at 380-81.

267. *See, e.g.*, Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984) (reversing district court holding that arbitration clause was unconscionable); Northcom, Ltd. v. James, 694 So. 2d 1329, 1339 (Ala. 1997) (finding that there was

conditions on remedies such as the ability to select arbitrators, restrict the statute of limitations, and eliminate punitive damages, all under the guise of arbitration agreements.[268]

This Article does not propose an unregulated arbitration regime. Indeed, the Court has approved of securities arbitration only because of the SEC's oversight.[269] This Article proposes a highly regulated arbitration process in which the SEC and Congress ultimately would determine how arbitrators are selected, which procedures apply, which methods of discovery are available, and which remedies are authorized. The SEC and Congress already have been successful in regulating securities industry arbitration.[270] The proposed arbitration system simply would allow the SEC (with congressional oversight) to expand its supervisory role and to apply arbitration procedures to a larger universe of securities disputes. Given the SEC's reputation as a tough but fair regulator[271] and an effective pro-investor advo-

---

no evidence of a lack of voluntariness and that the subsequent arbitration agreement was not unconscionable).

268. *See* Sternlight, *supra* note 199, at 638. *But see* Teleserve Systems, Inc. v. MCI Telecomm. Corp., 659 N.Y.S.2d 659, 664 (App. Div. 1997) (holding $204,000 arbitration filing fee to be unconscionable on its face). Professor Sternlight has raised serious concerns regarding the due process implications of unregulated arbitration. *See* Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TUL. L. REV. 1, 40-100 (1997).

269. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 225-38 (1987). As Carbonneau has stated:

> According to the *McMahon* interpretation of *Wilko* and *Scherk*, statutory language providing for the nonwaiver of judicial remedies will be effective only when arbitration, the alternative, is deemed to be an inadequate remedial process for adjudicating statutory rights. Expressed more forthrightly, the syllogistic logic yields the following new rule of law: express statutory language attributing exclusive jurisdiction to the courts will defeat a private agreement to arbitrate only when the courts determine that arbitration is an inadequate remedy to protect the statutory rights in question. The Court's review of the relevant precedent amounts to a reconstruction of the prior law.

CARBONNEAU, *supra* note 187, at 131.

270. *See supra* note 218. For example, in response to legislative pressure, the SROs enacted Section 31 of the Uniform Code of Arbitration. *See* Katsoris, *SICA*, *supra* note 17, at 520. Section 31 regulates the use of predispute arbitration agreements mandating that such provisions be clearly disclosed to customers. *See id.* Congress also was responsible for the GAO's study of the fairness of arbitration. *See id.* at 488 n.27.

271. *See* Katharine Barrett & Richard Greene, *The Big Vision Meets the Real*

cate,[272] as well as its track record in regulating industry arbitration procedures,[273] there simply is no reason to suspect that the evils of unregulated arbitration would infect wider securities arbitration under the auspices of the SEC.[274] The proposed expansion of securities arbitration also must be tested against the currently existing system (i.e., the system under the PSLRA), which has undergone a severe restriction of investor remedies, instead of against a historical ideal securities adjudication system. Viewed in that light, arbitration hardly disempowers investors, who currently have few rights under federal law.[275] If the SEC can provide a fair forum, investors will benefit greatly from arbitration because it would provide a quick, nonappealable remedy. Consequently, the proposed arbitration would empower, not disempower, consumers of securities.

Delegalization is another criticism that persistently has been leveled against ADR.[276] The idea of delegalization raises two concerns: first, that movement to ADR retards the ability of the law to evolve creatively to meet new problems or to craft new solutions on behalf of society,[277] and second, that the movement of disputes from the courts to ADR has the effect of denying legal rights because arbitrators are not bound by law.[278] Although the

---

World, FIN. WORLD, Oct. 26, 1993, at 32.

272. *See* Douglas J. Darsch, *The National Securities Market Improvement Act: How Improved is the Securities Market?*, DUQ. L. REV., Winter 1998, at 365, 367-68 (stating that the SEC is described accurately as the investor's advocate).

273. *See supra* note 23.

274. *See supra* note 206.

275. *See generally* Branson, *supra* note 58 (discussing the pro-defendant Burger and Rehnquist courts).

276. *See, e.g.*, Michael D.A. Freeman, *Questioning the Delegalization Movement in Family Law: Do We Really Want a Family Court?*, *in* THE RESOLUTION OF FAMILY CONFLICT: COMPARATIVE LEGAL PERSPECTIVES 7, 14-20 (Jenn M. Eekelaar & Sanford N. Katz eds., 1984); Austin Sarat, *Informalism, Delegalization, and the Future of the American Legal Profession*, 35 STAN. L. REV. 1217 (1983) (reviewing THE POLITICS OF INFORMAL JUSTICE (Richard L. Abel ed., 1982)). This also has been a concern of commentators in the securities arbitration area. *See generally* David A. Lipton, *Generating Precedent in Securities Industry Arbitration*, 19 SEC. REG. L.J. 26 (1991) (questioning whether the subterranean development of law in the securities industry is appropriate).

277. *See* Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1085-87 (1984) (arguing that promotion of early or alternative dispute resolution robs society of the benefits of judicial law making); Twining, *supra* note 254, at 381.

278. This is a concern that was present in the Supreme Court's debate on the pro-

Court no longer views the second point as valid,[279] it is sound in theory. Specifically, it is true that because arbitrators are not bound by law they may deny relief in circumstances in which legal remedies otherwise may exist. It is just as true, however, that there may be circumstances in which the law denies remedies and arbitration extends them. Arbitrators are charged to do what is just and fair; this is, after all, the end game of law. If arbitrators ignore law to achieve justice, has the purpose of law been frustrated? This Article takes the position that choosing justice over formalistic law is the superior result.[280]

With respect to the first concern identified above, securities arbitration supervised by the SEC need not lead to any atrophied area of law.[281] First, the expansion of arbitration advocated in this Article would have no impact on the development of the antifraud provisions of the federal securities laws in the criminal context, in the context of SEC enforcement actions, or in securities disputes not involving public companies.[282] In many ways, the criminal and enforcement context is the context in which the SEC's regulatory influence is most prominent.[283] For

---

priety of arbitration in the context of broker-customer disputes in *McMahon*. Justice Blackmun, in dissent, pointed to the lenient requirements for the preparation of a record, the continued disinterest in announcing reasons for arbitral decisions, and the substantially limited judicial review of arbitration rulings as the reasons against compelling arbitration of 10b-5 claims in which plaintiffs had signed predispute arbitration agreements. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 258-59 (1987) (Blackmun, J., dissenting).

279. *See* Rodriguez de Quijos v. Shearson/American Express, Inc., 490 U.S. 477, 480-81 (1989).

280. *See* MACNEIL, *supra* note 197, at vii, 171-80 (lamenting "Bureaucratic Formalism" and pathological adjudicatory patterns in court-based litigation); *see also* CARBONNEAU, *supra* note 187, at 237-41 (summarizing reasons why litigation fails to deliver on truth-finding promises and urging a more creative dispute resolution mechanism).

281. *See* Lipton, *supra* note 276, at 36.

282. *See supra* notes 29-31.

283. One commentator has discussed the threat that arbitration can pose to effective regulatory schemes, such as securities or antitrust laws:

> Arbitrators cannot be expected to sacrifice the most equitable resolution of the dispute between the parties in favor of the economic needs of society as expressed in the antitrust laws. This is not because arbitrators are any less capable or unbiased than judges or because they have fewer resources at their disposal, but because the task of arbitration is inconsistent with the purposes and functions of the antitrust laws. Arbitrators

example, a criminal action recently enabled the SEC to expand liability for insider trading to persons who are not classic "insiders."[284] The antifraud provisions could continue to develop in these contexts and be applied to SEC-sponsored arbitration proceedings. Second, all other areas of law that could be subject to the proposed arbitration jurisdiction would continue to develop in state proceedings not involving publicly held companies.[285] Again, these developments could be applied to SEC arbitration proceedings. Third, the antifraud provisions are committed to the discretion of the SEC.[286] The SEC therefore is in a position to redefine the antifraud provisions administratively in response to new frauds.[287] Similarly, if the SEC sees fit to modify existing obligations in light of new circumstances, there is no sound reason why it should not be able to do so.[288] Finally, the SEC could require written opinions, and publish those of widespread importance or those addressing novel issues.[289]

> are entrusted with the responsibility of working justice between the parties as it appears to them and without explaining their conclusions. Antitrust laws, by contrast, have little to do with justice between the parties. Thus, there is a choice to be made. Either arbitrators should be permitted to resolve disputes that implicate antitrust issues as they do other disputes—unbound by rules of law and at the possible sacrifice of antitrust policies—or they must be prohibited entirely from arbitrating such disputes. There is no middle ground consistent with the arbitration process as it has developed in this country.

Stewart E. Sterk, *Enforceability of Agreements to Arbitrate: An Examination of the Public Policy Defense*, 2 CARDOZO L. REV. 481, 503-04 (1981).

284. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2214-19 (1997).

285. The proposed arbitration regime is senseless unless the SEC arbitration forum can take entire disputes, including state and federal claims. Otherwise, these disputes would be splintered among adjudicatory forums. Thus, this Article proceeds on the premise that any state law claims would be adjudicated under the SEC's arbitration regime.

286. *See* Grundfest, *supra* note 252, at 966.

287. *See id.* at 966-67.

288. This raises an interesting question. If the SEC is responsible for the publication of important opinions or interpretative releases, is this superior to the chaotic and arbitrary method by which opinions are now selected for publication? For example, how many cases that may have spawned innovative judicial opinions have settled? *See* Twining, *supra* note 254, at 382 (stating that only a "tiny" fraction of all cases lead to an appellate opinion).

289. The downside to requiring written opinions is that it invariably facilitates an appeal. *See* ROBERT COULSON, BUSINESS ARBITRATIONS—WHAT YOU NEED TO KNOW 30 (4th ed. 1991) ("Written opinions . . . identify targets for the losing party to

Commentators also have contended that ADR mechanisms may tend to gravitate toward the very system they replace.[290] For example, the system of arbitration used to resolve securities disputes between customers and brokers has developed in a direction that resembles traditional litigation.[291] It appears, however, that much depends on the rules and administration of the particular forum. Ultimately, the securities arbitration system has maintained its flexibility, fairness, and efficiency because it has been subject to detailed oversight.[292] There is no reason why the SEC would not be able to preside over a system of securities arbitration with similar success.

The study of the strengths and weaknesses of ADR is still an evolving process. Nevertheless, after several decades of increasing use of ADR, far more advanced data exists on its successes and failures.[293] Essentially, this data shows that specific ADR mechanisms can work if properly implemented and monitored.[294] This Article proposes that the SEC implement a closely moni-

---

attack."). The SROs have left to the arbitrators the decision of whether a written opinion should support an award. *See* HOBLIN, *supra* note 16, at 12-16. Allowing the SEC to decide whether awards should be supported by written opinion and published would recognize the agency's unique authority to define securities fraud under Rule 10b-5. *See* Grundfest, *supra* note 252, at 966 n.9.

290. *See* Twining, *supra* note 254, at 391 (stating that benefits of ADR cannot ever be taken for granted); Todd B. Carver & Albert A. Vondra, *Alternative Dispute Resolution: Why it Doesn't Work and Why it Does*, HARV. BUS. REV., May-June 1994, at 120 ("The bad news is that ADR as currently practiced too often mutates into a private judicial system that looks and costs like the litigation it's supposed to prevent.").

291. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 7 ("The increasingly litigious nature of securities arbitration has gradually eroded the advantages of SRO arbitration.").

292. *See generally* Perry E. Wallace, Jr., *Securities Arbitration After* McMahon, Rodriguez *and the New Rule: Can Investor's Rights Really Be Protected?*, 43 VAND. L. REV. 1190 (1990) (discussing the SEC role in the development of securities arbitration).

293. *See* Esser, *supra* note 261, at 500.

294. In a recent assessment of arbitration, Professor Sternlight demonstrated that arbitration is not universally speedier, cheaper, and fairer than conventual litigation. *See* Sternlight, *supra* note 199, at 701-02. Instead, she concluded that arbitration "*can be* superior" in certain circumstances, such as when the parties to arbitration have equal bargaining powers. *See id.* at 702. This Article posits that in circumstances in which parties, ex ante, have radically unequal positions (e.g., investors under the PSLRA) *regulated* arbitration can replace the balance.

tored and tightly regulated arbitration system. All of the data available regarding ADR tends to support the viability of this concept, especially in the analogous broker-customer context.[295] Thus, it appears that implementing an arbitration system for claims involving publicly-traded companies is sound. Certainly, there are potential procedural pitfalls in imposing an arbitration regime in this context, but these are hardly insurmountable.

For example, the SROs that sponsor customer-broker arbitration have chosen not to exercise arbitration power over class-action disputes, and the SEC has concurred in this judgment.[296] This does not mean that class action securities disputes cannot be resolved in arbitration.[297] Class adjudications and arbitration are not inherently inconsistent. In fact, many courts have ordered class-wide arbitration.[298] The "class arbitration" ordered by

295. *See supra* notes 234, 250, 256.

296. *See* Katsoris, *SICA*, *supra* note 17, at 492 (citing UNIF. CODE OF ARBITRATION § 21(d)). According to Professor Katsoris, the prohibition of class action arbitration was added only "[a]fter much debate and discussion." Constantine N. Katsoris, *Should* McMahon *be Revisited?*, 59 BROOK. L. REV. 1113, 1122 (1993); *see also* Order Approving Rule Excluding Class Actions from Arbitration, Exchange Act Release No. 34-31371, 52 SEC Docket 2189, 2189-90 (Oct. 28, 1992). The assessment of the SEC and NASD that class claims should be excluded from arbitration does not turn on any determination that any such disposition cannot be ordered in arbitration in accordance with due process, or that arbitrators could not handle such issues as class certification. *See id.* Instead, the SEC and NASD were concerned with the possibility of duplicative and wasteful proceedings, apparently resulting from some groups of plaintiffs being bound to arbitrate while others were free to litigate. *See id.* These objections can be overcome by achieving universal agreements to arbitrate within agreements with the entire class of plaintiffs—if, for example, the agreement to arbitrate was within all subscription agreements for stock in an initial public offering.

297. *See* FLETCHER, *supra* note 17, at 292-95 ("Clearly, arbitration of class actions is possible, but the potential pitfalls are many."). In *Southland Corp. v. Keating*, 465 U.S. 1 (1984), the Supreme Court declined to rule on the issue of whether class-wide arbitrations are inconsistent with the Federal Arbitration Act when the arbitration agreement does not provide for class disposition of claims. *See id.* at 17. Thus, the California Supreme Court's order requiring class-wide arbitration, *see* Keating v. Superior Court, 645 P.2d 1192, 1209 (Cal. 1982), *rev'd sub nom.* Southland Corp. v. Keating, 465 U.S. 1 (1984), was not reversed.

298. *See* Izzy v. Mesquite Country Club, 231 Cal. Rptr. 315, 322 (1986); Lewis v. Prudential Bache Secs., Inc., 225 Cal. Rptr. 69, 76 (1986); Boynton v. Carswell, 233 S.E.2d 185 (Ga. 1977); Stevenson v. Commonwealth, 413 A.2d 667, 669 (Pa. 1980). *But see* Champ v. Siegel Trading Co., 55 F.3d 269, 276-77 (7th Cir. 1995) (holding that class arbitration is not permitted in the absence of an authorizing provision in arbitration agreement); Gammaro v. Thorp Consumer Discount Co., 828 F. Supp.

a court that is most analogous to the proposed arbitration is in the context of shareholder derivative claims.[299] If fundamental notions of due process are observed, arbitration rules can provide for class-wide adjudication of claims.[300] As long as class action parties have notice that their claims are being adjudicated, their rights can be determined despite their absence.[301] This is a very important issue because securities claims generally, and those involving public companies in particular, are uniquely appropriate for class-wide adjudication.[302] Moreover, much of the

---

673, 674 (D. Minn. 1993) (same).

299. *See In re* Salomon Inc. Shareholders' Derivative Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,454 (S.D.N.Y. Sept. 25, 1994) (ordering arbitration of shareholder derivative claims pursuant to stock exchange membership of corporation); *see also* G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C. L. REV. 517, 558-60 (1989) (noting courts' efforts to manage class-wide arbitration); Jeffery A. Sanborn, Note, *The Rise of "Shareholder Derivative Arbitration" in Public Corporations: In Re* Salomon Inc. Shareholders' Derivative Litigation, 31 WAKE FOREST L. REV. 337, 341-42 (1996) (analyzing the holding of *Salomon*, and proposing the adoption of shareholder derivative arbitration).

300. Due process rights in the class action context center around notice requirements and adequacy of representation. *See, e.g., In re* Four Seasons Sec. Laws Litig., 502 F.2d 834, 842 (10th Cir. 1974); 7B WRIGHT ET AL., *supra* note 103, § 1786 (2d ed. 1986); *see also* FLEMING JAMES, JR. ET AL., CIVIL PROCEDURE §§ 10.20-10.24 (4th ed. 1992) (discussing due process considerations of class adjudication, including adequacy of representation, notice of pendency of action, opportunity to opt out, and judicial scrutiny of settlements). In *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974), the Court held that "[i]ndividual notice must be sent to all class members whose names and addresses may be ascertained through reasonable effort." *See id.* at 173. The Court further asserted that notice to "class members is not a discretionary consideration to be waived." *Id.* at 176.

301. *See* Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 313-15 (1950).

302. *See* 7B WRIGHT ET AL., *supra* note 103, § 1781, at 4 ("With apparent increasing frequency, Rule 23(b)(3) is being utilized in . . . securities fraud suits."). In addition:

> Rule 10b-5 cases typically satisfy all of the prerequisites for a class action enumerated in Rule 23(a) of the Federal Rules of Civil Procedure. First, the plaintiffs tend to be so numerous that it would be impractical for a court to hear each of their claims individually. Second, the class members usually share identical questions of law or fact. Third, the alleged claims or defenses of the class representatives often typify the claims and defenses of the other class members. Fourth, the representatives usually are able to provide adequate representation to absent class members.
>
> Upon satisfying these prerequisites, the class then must fall under one of the 23(b) categories in order to be certified. Courts often employ

efficiency to be gained from arbitration would be lost without class-wide adjudication. A company would, in fact, face the nightmare of seriatim adjudication. It is crucially important, therefore, that the efficiency advantages of class-wide adjudication be utilized in arbitration of securities claims involving publicly held companies.[303] Judicial authority indicates that language in the arbitration agreement can address many of the issues relating to class arbitration.[304]

Numerous avenues are available to assure that, in claims against publicly-held companies, notice to class members is provided in accordance with due process.[305] Shareholders of publicly-held companies already are the recipients of numerous corporate communications, such as proxy statements, annual reports, and filings with the SEC.[306] This same communication machinery could be used to require shareholder notification of pending class action arbitrations.[307]

> Rule 23(b)(3) in securities litigation because subdivision (b)(3) "encompasses those cases in which a class action would achieve economies of time, effort, and expense, and promote uniformity of decision as to persons similarly situated, without sacrificing procedural fairness or bringing about other undesirable results."

Waltcher, *supra* note 210, at 392 (footnotes omitted) (quoting FED. R. CIV. P. 23 advisory committee's notes, 39 F.R.D. 69, 102-03 (1966)).

303. *See* Eisenberg v. Gagnon, 766 F.2d 770, 785 (3d Cir. 1985); FED. R. CIV. P. 23, advisory committee's notes, 39 F.R.D. 69, 102-03; 7B WRIGHT ET AL., *supra* note 103, § 1781, at 51.

304. *See* Champ v. Siegel Trading Co., 55 F.3d 269, 274-75 (7th Cir. 1995) (stating that a provision in an arbitration agreement may authorize class-wide arbitration); *see also* First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 943 (1995) (holding that the parties to an arbitration agreement may provide that the arbitrators can determine whether given issue is arbitrable); Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 64 (1995) (holding that the parties to arbitration may determine the law applicable to a dispute, including the availability of punitive damages). Given the broad power the arbitration agreement holds over the contours of the arbitration procedure, that agreement surely would be enforced, in accordance with its terms, regarding the availability and process of class-wide arbitrations. *See* Federal Arbitration Act, 9 U.S.C. § 2 (1994).

305. *See, e.g.*, *In re* Warner Communications Secs. Litig., 618 F. Supp. 735, 746 (S.D.N.Y. 1985).

306. *See, e.g.*, 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13, 240.14a-3 (1998) (stating periodic reporting requirements to shareholders); *see also Warner Communications*, 618 F. Supp. at 746 (concluding that notice sent to brokers, banks, and other nominees for mailing to class members, combined with publication in financial publications, complied with due process requirements).

307. For example, notice could be attached to the information that issuers of secu-

A final potential pitfall to the proposal of this Article is cost. Arbitration, like any dispute resolution system, is costly. The NASD relies on filing fees and cost assessments to defray about seventy percent of the costs of the securities arbitration forum that it operates.[308] Given the cost savings to parties of arbitration over litigation, SEC-regulated arbitration could have a similar fee structure. A realistic assessment of the costs must look at net costs. Money saved from court administrative costs could be used to offset costs of arbitration at the SEC. Overall, moving cases from court dockets to the SEC arbitration docket will cost much less due to restricted motion practice, appeals, and discovery disputes.

2. Advantages of Wider Securities Arbitration

Certain types of disputes are more amenable to arbitration than others,[309] and securities disputes appear to be ideally suited to arbitration. First, this is an area where expert adjudicators have the ability to extend a higher quality of justice because of the complexity and specialized nature of these disputes. Courts have recognized the shortcomings of juries in the context of sophisticated business litigation. One court even held that in certain cases due process could be denied if a case is of sufficient complexity as to be beyond the ken of a typical jury.[310] Securities litigation often may qualify as such a case. It often demands knowledge of sophisticated business techniques and financial analysis, as well as how such factors may affect a company's securities. Highly qualified experts with advanced business degrees may be called upon to testify. Depending upon the business involved, a case may require expertise in biotechnology, computer engineering, or the oil industry. Arbitration seeks to

rities send to security holders pursuant to 17 C.F.R. § 240.14a-3 (1998).

308. *See supra* note 21.

309. *See supra* note 256.

310. *See In re* Japanese Elec. Prods. Antitrust Litig., 631 F.2d 1069, 1086-87 (3d Cir. 1980) (holding that the due process clause prohibits juries from hearing exceptionally complex cases). Many of these "shortcomings" flow from the fact that these disputes, if tried, consume weeks of trial time. This, too, imposes strains upon the ability to dispense justice. *See id.*

substitute expert fact finders for lay fact finders. This may not only enhance the quality of justice available but also lower the cost of adjudications.[311] Using experts in this way does not in any way call into question the abilities of jurors. In fact, specialized arbitrators also may be preferable to judges. An arbitrator who is an accountant is likely to know what motivates accountants better than a judge without an accounting background.[312] In any event, comparisons between juries and arbitrators are misplaced. Under the PSLRA, juries only rarely hear securities claims. Arbitration of these disputes thus is more democratic than the current dispute resolution regime.

Second, this is an area that can limit litigation costs by requiring standardized discovery. Transactions involving the securities of publicly-traded companies produce predictable sources of documentary evidence.[313] For example, investment bankers and other professionals usually are involved in material transactions and compile extensive "due diligence" files containing the findings of their investigations.[314] Similarly, attorneys and accountants maintain detailed files containing relevant, nonprivileged information.[315] These documents can be produced

311. *See* Kenneth R. Davis, *When Ignorance of the Law is No Excuse: Judicial Review of Arbitration Awards*, 45 BUFF. L. REV. 49, 132 (1997); Ann C. Hodges, *The Steelworkers Trilogy in the Public Sector*, 66 CHI-KENT L. REV. 631, 678 (1990).

312. *See generally* DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990) (holding as a matter of law that an accountant would not engage in fraud in exchange for fees).

313. Publicly traded companies are required to submit reports to the SEC and their shareholders. *See* 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13, 240.14a-3 (1998).

314. *See* 15 U.S.C. § 77k(a) (1994) (providing a cause of action to any purchaser of securities for misrepresentations in a registration statement filed with respect to the securities under the Securities Act). This liability applies to issuers and those who sign registration statements, as well as experts, like underwriters, accountants, or other professionals, who allow their statements to be used in the registration statement. A person, other than an issuer, escapes liability by showing "after reasonable investigation" that there was no ground for believing that the registration statement was materially misleading. *See id.* § 77k(b)(3). Thus, this liability creates an incentive for professionals, directors of an issuer, and senior officers to undertake a "due diligence" investigation of the offering. *See* Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 682-98 (S.D.N.Y. 1968) (applying section 77k to underwriters, accountants, officers, and directors).

315. *See* Apex Mun. Fund v. N-Group Sec., 841 F. Supp. 1423, 1430-32 (S.D. Tex. 1993) (discussing "due diligence" and waiver of privilege).

at the outset of every securities dispute, thereby greatly reducing discovery squabbles, lowering expenses, and increasing efficiency.[316]

Third, speedy adjudications would provide unique benefits to the parties to these kinds of disputes.[317] Business risks and uncertainties would remain unresolved for less time. For companies that have engaged in no wrongdoing, quick adjudication and lower defense costs eliminate pressure to settle otherwise meritless claims.[318] If a defendant is faced with a weak claim that can be economically and quickly resolved, the leverage of an "extortionate" settlement evaporates.[319] Granting arbitrators the express power to sanction parties for pursuing frivolous claims or maintaining frivolous positions can strengthen this aspect of arbitration.[320] As an additional tool to deter frivolous litigation, courts have recognized that arbitrators retain discretion to award attorneys' fees to prevailing parties.[321] Even in the absence of a provision within the agreement commanding arbitration or a rule of the arbitration forum, courts have upheld awards of attorneys' fees.[322] In short, arbitration can eradicate the ills that formed the basis for enacting the PSLRA.[323]

In this respect, the experience of securities arbitration in the broker-customer dispute arena is instructive. For example, during 1994, the NASD was able to achieve an average resolution time of 10.4 months for securities disputes referred to it.[324] Arbitration of securities claims costs only one-third of the cost of

---

316. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 82-86.
317. *See supra* note 17.
318. *See supra* note 254.
319. *See* Miller, *supra* note 18.
320. *See id.* at 17-19; Thomas J. Stipanowich, *Rethinking American Arbitration*, 63 IND. L.J. 425, 483 (1987-1988).
321. *See, e.g.*, Marshall & Co. v. Duke, 114 F.3d 188, 189 (11th Cir. 1997) (upholding an award of $634,107 in attorneys' fees in favor of brokerage firm), *cert. denied*, 118 S. Ct. 1043 (1998).
322. *See* Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056, 1064 (9th Cir. 1991) (holding that arbitrators may sanction "bad faith" conduct); First Interregional Equity Corp. v. Haughton, 842 F. Supp. 105, 112-13 (S.D.N.Y. 1994) (same). *But see* McDaniel v. Berhalter, 405 So. 2d 1027, 1029 (Fla. Dist. Ct. App. 1981) (holding that absent statute or specific agreement, arbitrators may not award attorneys' fees).
323. *See supra* note 1 and accompanying text.
324. *See* Masucci, *supra* note 17, at 188-89.

adjudication of securities claims.[325] In addition, NASD arbitrators in these disputes have imposed sanctions in appropriate circumstances, even absent explicit authority in the rule governing industry arbitration.[326]

On the other hand, requiring the arbitration of disputes should not close the doors of justice to meritorious claims. In fact, because awards must be paid thirty days after decisions, investors with meritorious claims receive compensation swiftly.[327] Even though arbitrations in the broker-customer context are sponsored by industry-controlled SROs, each study of the fairness of arbitration has concluded that there is no evidence of systematic unfairness to investors.[328] Similarly, although plaintiffs originally were suspicious of industry-sponsored arbitration, many prominent plaintiffs' counsel now have embraced arbitration.[329] The SROs that sponsor arbitration in the securities industry have strived to maintain the perception of impartiality and fairness. Over the years, they appear to have achieved just that.[330]

If the SEC were responsible for overseeing the arbitration of investor claims involving publicly-traded companies, it would

---

325. *See supra* note 19.

326. *See infra* note 328.

327. "It is axiomatic that justice delayed is justice denied"; therefore, investors in arbitration achieve a high quality of justice, at least to the extent that, all other things being equal, they receive quicker compensation. Miller, *supra* note 18, at 1.

328. One study stated:

> First, we conclude, along with the vast majority of those who presented their views to us, that, even with its flaws, securities arbitration is clearly preferable to civil litigation. Arbitration offers investors a more efficient, faster, and cheaper process than court litigation.
>
> Second, although many investor representatives claim that SRO sponsored securities arbitration is unfair, neither the independent studies conducted, nor the statistics on the results of customer-broker arbitrations, support this conclusion. In 1992, for example, the GAO concluded, after an extensive survey, that arbitration results at SRO sponsored forums "show no indication of a pro-industry bias." Between 1991 and 1995, arbitrators awarded damages to customer claimants in 50 percent of all cases they decided. These results are not consistent with a systemic bias in favor of industry parties.

ARBITRATION POLICY TASK FORCE, *supra* note 21, at 18 (footnotes omitted).

329. *See supra* note 216.

330. *See supra* note 22.

begin with some key advantages. The SEC is widely perceived to be a tough, fair, and efficient industry watchdog.[331] The SEC has established itself generally as a pro-investor agency over the years.[332] The SEC already has a long history in supervising arbitration in a balanced fashion.[333] With this reputation, any SEC-operated arbitration forum would start out as presumptively fair. The SEC also has a specific mandate from Congress to use its expertise to stem fraud in the securities markets: Rule 10b-5.[334] If the SEC concluded that the best policy to pursue in such efforts is arbitration, it is not likely that any court would interfere with that exercise of discretion.[335]

In all, arbitration can provide a means for a fair and efficient resolution of private securities claims involving publicly-held companies. Speed and low cost can eliminate frivolous claims. The SEC, because of its reputation, expertise, administrative powers, and experience, is uniquely qualified to administer and regulate this system of dispute resolution.

331. *See* Barrett & Greene, *supra* note 271, at 32, 49 ("The [SEC] defies all stereotypes. Members of the securities industry, academics, even attorneys who are suing the SEC speak about it in glowing terms."). Barrett & Greene analyzed eight government agencies that regulate business. The average grade was a C; the SEC was rated the highest with an A-. *See id.* at 33, 49. Even the critics of federal securities regulation have recognized that the Commission has achieved a degree of stature as a fair and effective regulator. *See* Stigler, *supra* note 35, at 117 ("It is doubtful whether any other type of public regulation of economic activity has been so widely admired as the regulation of the securities markets by the Securities and Exchange Commission.").

332. Recently, Chairman Levitt stated: "The Commission remains dedicated to the protection of investors, efficient capital formation, enhanced disclosure, and the diligent oversight of the securities markets." SEC REPORT, *supra* note 12, at 64.

333. *See supra* note 23.

334. *See supra* note 32.

335. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2217-18 (1997) (stating that where the SEC has prescribed legislative rules, courts must accord such rules "controlling weight" unless it has acted "manifestly contrary to the statute." (quoting Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984))).

C. *The Authority for, and Legality of, Expanded Securities Arbitration*

The arbitration of disputes generally results from an agreement of the parties to waive their right to a court adjudication and limit their remedies to those available in arbitration. This Article proposes that Congress or the SEC take steps to impose agreements to arbitrate securities disputes and that the SEC provide a securities arbitration forum for securities disputes involving publicly-held companies. This section focuses on two key questions: whether there are significant limits on congressional power to impose such agreements in this context, and whether Congress has granted power to the SEC to provide such an arbitration forum and to encourage such agreements. For the proposed arbitration scheme to achieve its goals effectively, it must take jurisdiction over entire disputes, not just claims under the federal securities laws. In other words, the arbitration forum must have jurisdiction over all claims and persons arising from shareholder claims in which a publicly-held company (and/or affiliated individuals or professionals) failed to provide information properly in connection with investment decisions. In the parlance of federal civil procedure, the arbitration forum must be endowed with "supplemental jurisdiction."[336] Without this authority, fragmented parallel litigation could offset any cost savings.

1. *Limitations on Congressional Power*

The question of congressional power to impose arbitration really requires two inquiries. The first involves assessing the limits on congressional power to deny a party an Article III court proceeding and the right to a trial by jury for federal statutory claims. Private remedies under the federal securities laws exist in tandem with a detailed regulatory scheme.[337] Courts have

---

336. *See* 28 U.S.C. § 1367 (1994) (defining the circumstances in which federal courts have jurisdiction over state claims even though diversity jurisdiction requirements are not met).

337. *See* Thomas v. Union Carbide Agric. Prods. Co., 473 U.S. 568, 593-94 (1985) ("Congress, acting for a valid legislative purpose pursuant to its constitutional powers under Article I, may create a seemingly 'private' right that is so closely integrat-

long held that these types of claims do not require a trial by jury and that Congress has the power to entrust their enforcement to administrative adjudication.[338] In addition, Congress has the power to deny access to the public securities markets to those who fail to consent to arbitration of disputes.[339] Courts have upheld congressional power limiting access to certain business activities to those who consent to arbitrate disputes.[340] These principles give Congress full authority to impose arbitration agreements, as a matter of legislative requirement, between investors and public companies.

The second inquiry is whether Congress can create an arbitration forum to resolve entire disputes, including those involving state common-law claims. This implicates Article III of the Constitution, which requires that the judicial power of the United States be vested in courts staffed by judges with life tenure and undiminishable compensation.[341] Whether the current proposal offends Article III is not free from doubt; consent is not dispositive of the issue.[342] The Supreme Court has held, however, in *Commodity Futures Trading Commission v. Schor*,[343] that Congress may provide for alternative dispute resolution without offending Article III if the parties consent to the use of the forum, and the forum has narrowly tailored powers and jurisdiction

---

ed into a public regulatory scheme as to be a matter appropriate for agency resolution with limited involvement by the Article III judiciary.").

338. *See* Myron v. Hauser, 673 F.2d 994, 1003 (8th Cir. 1982) (citing Atlas Roofing Co. v. Occupational Safety & Health Review Comm'n, 430 U.S. 442, 460 (1977)).

339. *See generally* Liest v. Simplot, 638 F.2d 283 (2d Cir. 1980) (upholding the power of CFTC to restrict access to the futures market).

340. *See* Geldermann, Inc. v. Commodity Futures Trading Comm'n, 836 F.2d 310, 317 (7th Cir. 1987); *see also* Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 848 (1986) ("[A]s a personal right, Article III's guarantee of an impartial and independent federal judication is subject to waiver . . . ."). Arbitration is based upon at least nominal consent; therefore, it is the best means for securing the creation of a specialized adjudicatory forum for disposing of securities disputes.

341. *See* U.S. CONST. art. III, § 1.

342. *See Geldermann*, 836 F.2d at 321 ("Article III, § 1 not only preserves to litigants their interest in an impartial and independent federal adjudication of claims within the judicial power of the United States, but also serves as 'an inseparable element of the constitutional system of checks and balances.'" (quoting Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 58 (1982)).

343. 478 U.S. 833 (1986).

aimed at a congressional purpose that creates a necessity for the alternative forum.[344]

At issue in *Schor* was the CFTC's reparations jurisdiction. Section 14 of the Commodity Exchange Act provides that any person injured by a commodity broker's violation of the Act or of CFTC regulations may apply to the CFTC for an order to pay reparations, which the complainant may then enforce in federal district court.[345] The CFTC promulgated a rule that allowed it to adjudicate counterclaims arising out of the same transactions or occurrences as those set forth in the reparations complaint.[346] Schor challenged the CFTC's authority to exercise such jurisdiction on Article III grounds.[347] The Court stated that there are no bright line tests for determining when Congress impermissibly authorizes the adjudication of Article III business in a non-Article III forum.[348] Instead, the Court focused on several factors. First, the Court examined the allocation of power between the CFTC and Article III courts over such disputes and concluded that the essential attributes of judicial power were not ceded because the CFTC required the courts to enforce its awards, its awards were subject to nondeferential judicial review, and the CFTC did not exercise all the ordinary powers of federal district courts.[349] Second, the Court gave weight to the fact that the CFTC's jurisdiction was limited to a particular area of the law instead of being endowed with broad general civil jurisdiction.[350] Third, the Court looked at the nature of rights subject to the CFTC's jurisdiction and concluded that although those rights

344. *See id.* at 851-52 (holding that CFTC's exercise of alternative dispute resolution jurisdiction over commodities-related state counterclaims did not violate Article III of the Constitution).

345. *See* 7 U.S.C. § 18 (1994).

346. The regulation challenged in *Schor* was 17 C.F.R. § 12.23(b)(2) (1983).

347. Schor also challenged the CFTC's jurisdiction on federalism grounds because the CFTC purported to exercise jurisdiction over state claims. *See Schor*, 478 U.S. at 857-58. The Court concluded that there was no basis for challenging an agency's exercise of adjudicatory power over state claims because the Court had long recognized the federal government's ancillary jurisdiction over state counterclaims asserted in federal court. *See id.* at 858.

348. *See id.* at 851.

349. *See id.* at 852-53.

350. *See id.* at 852.

were traditionally enforceable in courts, the CFTC was exercising its jurisdiction only as a "narrow . . . incident" of its primary jurisdiction.[351] Fourth, the Court viewed Congress's purpose as being the creation of an inexpensive and expeditious dispute resolution mechanism, not a reallocation of power from federal tribunals.[352] Finally, the Court noted that the CFTC had "obvious expertise" and was administering a reparations scheme of "unquestioned constitutional validity," in which supplemental jurisdiction was needed to ensure the effectiveness the congressional alternative dispute resolution scheme.[353] It is fair to say, then, that in the context of financial institution regulation, the Supreme Court already has held that the creation of an alternative forum with specialized expertise, for the expeditious resolution of entire disputes, and with limited powers in a particularized area of law, is not contrary to Article III.

2. *Limitations on SEC Power*

The SEC already has sufficient administrative power to implement broad arbitration initiatives that could go a long way toward ultimately achieving the arbitration of all securities claims involving publicly-held companies.[354] The first step in this process is the creation of an arbitration forum. Initially, the SEC could provide a forum for the submission of such claims to arbitration. Congress appears to have authorized expenditures made in connection with such a forum.[355] The mere existence of such a forum is likely to attract the voluntary submission of pending and prospective cases.

Another source of the SEC's discretion to encourage arbitration is the SEC's power to accelerate the effectiveness of registration statements under the Securities Act.[356] For example, the

351. *See id.* at 854.
352. *See id.* at 855.
353. *Id.* at 855-56.
354. *See generally* Pearce v. E.F. Hutton Group, Inc., 828 F.2d 826, 829 (D.C. Cir. 1987) (noting that the SEC has "'expansive power to ensure the adequacy of . . . arbitration procedures'" (quoting Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 233 (1987))).
355. *See* 15 U.S.C. §§ 78d, 78d-1 (1994).
356. *See id.* § 77h (allowing the SEC to accelerate the effectiveness of a securities

SEC historically has refused to accelerate the effectiveness of registration statements when the issuer has an indemnification agreement that is inconsistent with SEC policy on indemnification.[357] Nothing would prevent the SEC from using that authority to require new registrants to insert arbitration provisions into relevant agreements with the purchasers of the securities, thereby requiring the arbitration of any securities dispute before the SEC. In other words, investors would agree to arbitrate based on arbitration agreements with issuers; issuers and related parties would agree to arbitrate based on those same agreements through the coercion of the SEC. The SEC has broad discretion to promulgate regulations "as may be necessary to carry out the provisions" of the Securities Act.[358] Many registrants view acceleration as important to the distribution of the securities. Over time, such a regulation could have the effect of committing many securities claims to SEC arbitration.[359]

---

registration statement if in the "public interest").

357. *See* 17 C.F.R. §§ 229.512(h), 230.461(c) (1998). *See generally* I LOSS & SELIGMAN, *supra* note 7, at 550-58 (discussing both the history of the SEC's use of its power to accelerate and objections that the SEC may use this power only to further the goal of disclosure).

358. 15 U.S.C. § 77s(a) (1994).

359. Professors Cary and Eisenberg have concisely summarized the importance of acceleration:

> Section 8 of the 1933 Act provides that "Except as hereinafter provided, the effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the Commission may determine . . . ." Present SEC practice calls for the staff to thoroughly review registration statements that fall into certain categories, such as first-time registration statements on Form S-1. Almost invariably such a review will turn up matters the staff considers to be problems. Although the SEC has the power to issue a "stop order" suspending the effectiveness of a registration statement, that is considered a rather drastic remedy, and is seldom invoked. Instead, the staff will typically send a letter of comment, or deficiency letter, pointing out the problems the staff finds with the registration statement as filed. The process of comment, response, and revision may result in delay long past the original twenty days. Moreover, the twenty-day period begins running every time an amendment to the registration statement is filed. This creates a potential Catch-22. The registration statement must include the price of the securities. For a variety of reasons, the price usually cannot be set until the last minute. But setting the price is an amendment, which causes the twenty days to start running again. To get around the Catch, it has become accepted industry practice to request from the SEC, an acceleration

The SEC also holds sway over issuers who do not request acceleration. The SEC has relied on an informal process of dialogue with issuers in reviewing registration statements.[360] The SEC could suggest the use of arbitration provisions during these conversations; many issuers likely would follow this suggestion. Over time, an increasing percentage of securities disputes would be subject to arbitration.

Another mechanism the SEC can use to encourage arbitration of securities claims is section 10(b) itself.[361] This broad grant of administrative power essentially allows the SEC to define rights and obligations arising under section 10(b) so long as it does not stray beyond the text of the statute.[362] Given the breadth of authority granted to executive agencies under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[363] the SEC has generous latitude to promulgate rules to effectuate the purposes of section 10(b).[364] Commentators generally have recognized that this gives the SEC sufficient power even to "disimply" private remedies under Rule 10b-5.[365] If the SEC "has the power to disimply private rights of action" under Rule 10b-5, certainly the SEC could commit the resolution of such claims to a reasonable forum, such as arbitration. The SEC thus appears to have the power to require arbitration of claims under this section.[366]

> of the effective date of the registration statement, so that it will become effective immediately after the pricing. Although acceleration requests are routinely granted, the SEC has often used its power to grant or withhold acceleration as a vehicle to make registrants comply with various SEC policies. In addition, the fear of nonacceleration may lead a registrant to be responsive even to those comments in a deficiency letter with which it disagrees.

WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1491-92 (7th ed. 1995).

360. *See* HAZEN, *supra* note 44, at 135-41.

361. *See* Securities Exchange Act of 1934 § 106, 15 U.S.C. § 78j(b) (1994).

362. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2214-18 (1997) (upholding SEC authority to promulgate 17 C.F.R. § 240.14(e)(3) (1996)) (citing Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)).

363. 467 U.S. 837 (1984).

364. Section 10(b) is inoperative without Commission "rules or regulations." *See* 15 U.S.C. § 78j(b).

365. Grundfest, *supra* note 252, at 975; Seligman, *supra* note 2, at 438.

366. By requiring the arbitration of Rule 10b-5 claims, the SEC would be forcing investors either to bring the entire dispute to arbitration or to forego the Rule 10b-5

The SEC could impose the broadest arbitration of securities disputes pursuant to its authority over national securities exchanges and the NASD.[367] The SEC has very broad power over the rules of these entities.[368] Each exchange and the NASD, however, imposes its own requirements upon issuers listed on their trading facilities.[369] Congress has empowered the SEC to assure that the rules of SROs "prevent fraudulent and manipulative acts and practices," "promote just and equitable principles of trade," and "protect investors and the public interest."[370] The SEC could require SROs to force listees to enter arbitration agreements as a condition of being listed with the SRO.[371] SROs traditionally have imposed substantive requirements upon listed companies.[372] These rules certainly seem more substantively

---

claim. Thus, investors who pursue Rule 10b-5 claims would be agreeing to arbitrate. Presumably, public companies (and affiliated parties) would be willing to submit to arbitration in exchange for a requirement that such companies' investors could only bring Rule 10b-5 claims in arbitration. Alternatively, Rule 10b-5 could be amended to provide that companies executing arbitration submission agreements are subject to Rule 10b-5 claims only in arbitration.

367. *See* 15 U.S.C. §§ 78f, 78o-3.

368. *See id.* § 78s; *supra* note 206 and accompanying text.

369. *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (reviewing limits on the SEC's regulatory powers over exchange listing requirements). The Rules of the NYSE, for example, served as the basis for compelling the arbitration of a shareholders' derivative suit, including allegations of securities fraud under the federal securities laws. *See In re* Salomon Inc. Shareholders' Derivative Litig., Fed. Sec. L. Rep. (CCH) ¶ 98,454 (S.D.N.Y. Sept. 25, 1994). This case is really a fluke. It just so happened that Salomon Inc. was affiliated with a broker-dealer that had agreed to arbitrate disputes arising from its business that involved its employees. The defendants in the case were three Salomon Inc. employees. Very few publicly held companies are broker-dealers, and thereby subject to the arbitration rules of an SRO. Nevertheless, the case is significant because it demonstrates that these kinds of cases are amenable to arbitration.

As one commentator stated: "After over seventy-five years of commercial arbitration in the United States, *In re Salomon Inc. Shareholders' Derivative Litigation* has broken the judiciary's monopoly over the resolution of public shareholder disputes by opening the door to 'shareholder derivative arbitration' in public corporations." Sanborn, *supra* note 299, at 337 (footnotes omitted).

370. 15 U.S.C. §§ 78f(b)(5), 78o-3(b)(6).

371. The SEC has both the power to approve SRO rules and direct SROs to adopt certain rules. *See* 15 U.S.C. § 78o(b) (giving the SEC broad power over the rules of any national securities exchange desiring to be registered with the SEC); *id.* § 78s(c) (giving the SEC power to "abrogate, add to or delete from" the rules of SRO "in furtherance of the purposes" of the Exchange Act).

372. *See* IV LOSS & SELIGMAN, *supra* note 7, at 1826-54.

intrusive on the rights of securities issuers than merely defining the process of dispute resolution. By utilizing this power, however, the SEC runs the risk of proceeding in a nongradual fashion. Moreover, the SEC would risk a court's holding that it had overstepped its bounds; one court already has imposed significant limitations on this particular SEC power.[373]

As previously discussed, any arbitration regime that failed to ensure that entire disputes are arbitrated in a unified proceeding would fail to achieve the proposal's cost-cutting and adjudication-accelerating objectives. If significant numbers of disputants are beyond the reach of SEC arbitration mandates, parallel court adjudications could undermine the arbitration system. This means that the SEC must insist not just that issuers and investors agree to arbitrate, but also that all professionals (including accountants, attorneys, underwriters, directors, and officers) agree to arbitrate. This raises the following question: under any means of obtaining agreements to arbitrate from issuers, is it appropriate for the SEC to insist that affiliated professionals agree to arbitrate? The SEC already exercises sufficient jurisdiction over most professionals (including directors and officers) involved in the securities activities of publicly-held companies, and would not exceed its authority by requiring such professionals to arbitrate securities disputes.

For example, Rule 102(e) of the SEC's Rules of Practice allows the SEC to bar attorneys and accountants from practice before it if they are unqualified to represent persons before the SEC, violate ethical standards, or violate the federal securities laws.[374] The SEC's authority to regulate professional conduct in this manner springs from section 23(a)(1) of the Exchange Act, which provides that the SEC may make "such rules and regulations as may be necessary or appropriate to implement the provisions of this [Act]."[375] The courts have upheld the SEC's authority to reg-

373. *See Business Roundtable*, 905 F.2d at 415 (invalidating an SEC rule banning stock exchanges from listing companies that restrict per-share voting rights because the rule interfered with the allocation of substantive powers, which is a matter for state law).

374. *See* 17 C.F.R. § 201.102(e) (1998) (formerly 17 C.F.R. § 201.2(e)).

375. 15 U.S.C. § 78w(a)(1).

ulate accountants and attorneys under Rule 102(e), pursuant to this authority.[376] Rule 102(e) is not without its critics, however.[377] There are clear limits to how far the SEC may go in regulating professional conduct.[378] Still, courts have ruled that regulations such as Rule 102(e) must be sustainable when they are a "necessary adjunct . . . to protect the integrity of . . . administrative procedures and the public in general."[379] The SEC therefore appears to have sufficient power to enact narrowly-crafted rules, indirectly encouraging (or even requiring) listed companies to secure arbitration agreements from affiliated parties, including attorneys and accountants. The SEC could defend this rule by arguing that extension of its clear power over SROs (and thus listed companies) or its power to accelerate is necessary to preserve the integrity of its administratively-supervised arbitration forum and to protect the investing public.[380] This method of assuring that entire disputes are arbitrated seems no more intrusive than Rule 102(e), and as an exercise of legislative authority cannot be deemed arbitrary, capricious, or contrary to law.

Unlike the CFTC's reparations jurisdiction, SEC-sponsored arbitration would benefit from additional considerations that support its constitutionality. Arbitration is consensual, even the somewhat "mandatory" arbitration this Article proposes.[381]

---

376. *See* Sheldon v. SEC, 45 F.3d 1515, 1518 (11th Cir. 1995) (rejecting an argument that using SEC Rule 102(e) to discipline attorneys is improper); Davy v. SEC, 792 F.2d 1418, 1421-22 (9th Cir. 1986) (addressing the criticism that Rule 102(e) should not apply to attorneys or accountants and stating that "[n]o court has adopted the view espoused in this literature"); Touche Ross & Co. v. SEC, 609 F.2d 570, 579 (2d Cir. 1979) (stating that "the Rule is not inconsistent with the Commission's statutory authority").

377. *See* Ralph C. Ferrara, *Administrative Disciplinary Proceedings Under Rule 2(e)*, 36 BUS. LAW. 1807 (1981); *see also* Judah Best, *In Opposition to Rule 2(e) Proceedings*, 36 BUS. LAW. 1815 (1981) (asserting that the SEC is not competent to judge lawyer conduct); Robert A. Downing & Richard L. Miller, Jr., *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979) (arguing that Rule 2(c) has been misused to regulate accounting profession).

378. Certainly the SEC could not require an agreement to arbitrate disputes as a specific condition of admission to practice before it. *See* 5 U.S.C. § 500.

379. *Touche Ross*, 609 F.2d at 582.

380. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2217-18 (1997).

381. *See* Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 855 (1986)

Indeed, the Supreme Court has held that requiring an agreement to arbitrate as a condition of engaging in a certain business is sufficient consent for purposes of Article III.[382] Thus, a commodities broker or a securities broker may be required to "agree" to arbitrate customer disputes as a condition of doing business.[383] Moreover courts have recognized the strong federal policy in favor of arbitration.[384] Therefore, there is a strong legal basis to support SEC or congressionally-mandated arbitration of securities disputes involving publicly-held companies.

The SEC does not really have the power to impose an alternative dispute resolution regime without the support of Congress. The SEC may promulgate a regulatory initiative without specific legislative authority, but if Congress is opposed to the initiative, it may preclude the SEC's exercise of its rulemaking powers.[385] As a practical matter, then, any SEC action in this area would be undertaken only with congressional approval.[386] Second,

(noting that "the decision to invoke this forum is left entirely to the parties and the power of the federal judiciary to take jurisdiction of these matters is unaffected").

382. *See* Thomas v. Union Carbide Agric. Prods. Co., 473 U.S. 568 (1985) (holding that legal requirement that manufacturers submit certain disputes to binding arbitration in order to conduct certain business does not obviate the consensual nature of arbitration).

383. *See* Geldermann, Inc. v. Commodity Futures Trading Comm'n, 836 F.2d 310, 318 (7th Cir. 1987) (holding that economic compulsion has no impact on the question of whether a broker has consented to arbitrate); Patten Secs. Corp. v. Diamond Greyhound & Genetics, Inc., 819 F.2d 400, 406 (3d Cir. 1987) (finding that a stockbroker can be compelled to arbitrate by virtue of membership in SRO). Of course, as previously noted, *all* stockbroker-dealers must associate with an SRO and *all* SROs require members to arbitrate disputes at the request of customers. *See supra* note 218 and accompanying text. Thus, in order to be a broker-dealer, one must "consent" to arbitrate.

384. *See Geldermann*, 836 F.2d at 322 ("The fact that the non-Article III forum challenged is arbitration is also of importance. Recently in a case arising in the . . . securities industry, the Supreme Court reaffirmed that the Federal Arbitration Act . . . establishes a 'federal policy favoring arbitration.'" (quoting Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987)); *see also* Pearce v. E.F. Hutton Group, Inc., 828 F.2d 826, 829 (D.C. Cir. 1987) (stating that the federal policy favoring arbitration "is at its strongest where the arbitration will be governed by procedures specifically tailored to the context from which the agreement to arbitrate arises, and will be conducted by arbitrators who are expert in the . . . relevant industry").

385. *See McMahon*, 482 U.S. at 226 ("Like any statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command.").

386. This is particularly so in light of the intense congressional scrutiny over the

courts and commentators have recognized the enormous power of the SEC over implied private actions arising out of the federal securities laws.[387] Combined with the broad delegation of powers to the SEC,[388] it would seem reasonable that the courts defer to the SEC and turn back challenges to its power to encourage the arbitration of such claims. Thus, if the SEC sponsored an arbitration forum for securities disputes involving publicly-held companies and used its discretion to encourage its use, it seems unlikely that courts would hold this to be beyond the SEC's authority. Companies that insert arbitration provisions in relevant corporate documents, with or without SEC compulsion, are certain to oblige securities holders to arbitrate disputes. Indeed, courts have bound consumers to far flimsier agreements to arbitrate.[389]

The broadest power to require agreements to arbitrate, however, rests with Congress. Attempts by the SEC to impose wider arbitration could create confusion and uncertainty, and lead to more, not less, wasteful litigation. The SEC therefore would be best served by first implementing a more narrow form of arbitration, such as a purely voluntary forum. The creation of such a forum would be an important first step in demonstrating to Congress the viability and efficacy of arbitration in the context of securities disputes. After this step, the SEC could informally request that new publicly-held companies include arbitration provisions in their subscription agreements, and the SEC could even promulgate model provisions. Next, the SEC could condition acceleration upon the inclusion of arbitration provisions. These preliminary steps would contribute to congressional analysis of the desirability of broader arbitration. As previously discussed, much about the relative advantages of arbitration is unknown. Any experience that the SEC can accumulate about the arbitration of these disputes could only assist legislative initia-

private securities litigation system. *See* Avery, *supra* note 2, at 347-53.

387. *See supra* note 252.

388. *See supra* note 368 and accompanying text.

389. *See, e.g.*, Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1148-50 (7th Cir. 1997) (enforcing an agreement to arbitrate placed in a computer box and delivered to a computer purchaser).

tives in this area. This Article calls for exploratory steps, as opposed to a leap. The imposition of full arbitration of securities disputes should be based on experience. It is noteworthy, however, that this process will not deter any publicly-held company from requiring arbitration of securities disputes before the SEC as a means of protecting itself from "strike suits." This provides immediate relief from frivolous litigation.

D. Some Suggestions on Implementation

The proposed arbitration regime is not a simple solution. It is precisely because of this complexity that this Article argues in favor of gradually implementing this ADR regime. Beyond the utility of gradualism, some of the problems and issues discussed in this Article suggest that any arbitration regime pursued in the securities law context should include several important features. Specifically, in order to exploit fully the advantages of arbitration and minimize the negative consequences, any arbitration regime should include several basic elements.

First, the SEC must ensure the involvement of all key constituencies in all phases of this ADR system.[390] This includes public investors, institutional investors, plaintiff and defense counsel, representatives of publicly-held companies, affiliated professionals, and members of the securities industry. Any SEC rules establishing an arbitration forum, requiring arbitration provisions in agreements between public investors and companies, or setting the guidelines of the arbitration forum, would, as a matter of administrative procedure, extend to all these parties the opportunity to comment. The SEC must do more, however. Only with the involvement of all these actors can a system of ADR in

390. The NASD has been quite careful to include all important constituencies in its Task Force on Securities Arbitration. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 1 ("The Task Force is composed of eight persons who have various backgrounds in the area of securities arbitration."). Indeed, the Task Force included two former SEC Commissioners, general academics, industry executives, defense attorneys, a plaintiffs' attorney, and individuals who had served as mediators or arbitrators. *See id.* at app. 1-1 to 1-11. SICA took the same approach. SICA was created under the auspices of the SEC to structure arbitration rules in a fair and uniform manner. SICA draws its members from the securities brokerage industry, academia, and representatives of the public. *See* Katsoris, *SICA*, *supra* note 17, at 488-89 n.28.

this area achieve a widespread perception of fairness.[391] Thus, any body charged with promulgating or supervising this arbitration system should be comprised of all these constituencies. Similarly, the pool of arbitrators must be drawn from these groups. Arbitrators also must be reasonably compensated, selected on a competitive basis, and required to undertake periodic training. The SRO arbitration fora provide an excellent model in this respect, by imposing training requirements and undertaking new recruitment and compensation initiatives.[392] Additionally, arbitration panels must not be dominated by industry-affiliated individuals. Again, the SROs have dealt effectively with this issue by generally requiring panels to have at least three public arbitrators.[393] Qualified and impartial arbitrators are the key to assuring that the public accepts, and has confidence in, any system of mandatory arbitration.[394]

Second, like the SROs, the SEC should provide specific mechanisms for the ongoing evaluation and improvement of the arbitration process it supervises. The Arbitration Task Force, the SEC's creation of SICA, and other studies of the fairness and efficiency of arbitration at the SROs undoubtedly have contributed to the generally favorable perception of arbitration among the public.[395] One reason why the SRO arbitration process has been so successful and has achieved public acceptance is that the SROs have monitored and improved their arbitration procedures. These procedures have been modified based on the comments of the public, experts in the area, and industry representatives.[396]

---

391. *See generally* Katsoris, *SICA*, *supra* note 17 (discussing SRO arbitration rules).

392. See ARBITRATION POLICY TASK FORCE, *supra* note 21, at 102-13 (specifying the training regimen for arbitrators, recommending specialized training of arbitration panel chairs, recommending that additional recruitment efforts be undertaken, and recommending that compensation be raised).

393. *See* Katsoris, *SICA*, *supra* note 17, at 546 (reprinting UNIFORM CODE OF ARBITRATION § 8(a)(1)).

394. *See generally* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 107-12 (offering suggestions for better trained arbitrators as a response to concerns regarding arbitrator quality).

395. *See supra* text accompanying note 214.

396. *See* Katsoris, *SICA*, *supra* note 17, at 537.

Third, because of the nature of the disputes subject to the arbitration proposal of this Article—complex disputes, often involving class action issues—the rules governing this arbitration procedure must be able to reach rapid adjudication even with complex subject matter. SRO arbitration is of limited utility in this context because SRO arbitration rules do not provide for class action resolutions. While this goal may present challenges, they are not insurmountable. For example, the SROs are currently considering requiring Early Neutral Evaluation (ENE).[397] Although the empirical evidence with respect to ENE is sparse, it seems particularly helpful in cases with complex discovery phases.[398] The primary goal of ENE is to facilitate settlement by

---

397. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 51. The Task Force commented:

> Early neutral evaluation (ENE), while less well known than mediation, is an equally valuable approach to early dispute resolution. Unlike mediation, its primary purpose is not to settle the dispute, but rather to apprise the parties of the strength of their cases. Nevertheless, settlement is often a beneficial outcome of ENE. In ENE, a skilled evaluator with considerable experience in the subject matter of the dispute reviews the parties' initial submissions and key documents. In some circumstances, the ENE also asks the parties for a brief written submission that summarizes the main issues in the dispute. The parties then confer with the evaluator, either in person or by conference call, and each side presents a very abbreviated version of its case. This presentation is similar to an offer of proof at the beginning of a trial. Occasionally, the parties may offer abbreviated testimony from witnesses or experts. During and after the presentations, the evaluator may ask questions of the parties, seek stipulations on agreed issues, clarify the remaining issues in dispute, or discuss discovery issues. At the end of the presentations, the parties may choose to enter into direct settlement negotiations, often facilitated by the evaluator.
>
> Barring settlement discussions, however, the evaluator then delivers a brief and candid assessment of the strengths and weaknesses of each side's case. Typically, the evaluator provides a brief written summary of this assessment, which might include an attempt to predict likely case outcomes. As noted, unlike a mediator, the evaluator is not necessarily trying to direct the parties toward a possible settlement. Rather, the purpose is to offer a candid appraisal of the case. Often, this "reality check" compels each side to undertake a more dispassionate and realistic assessment of its case. In light of this experience, parties may approach settlement discussions or arbitration within a more constructive and well informed framework.

Id.

398. *See* Joshua D. Rosenberg & H. Jay Folberg, *Alternative Dispute Resolution: An*

exposing each side of a dispute to a "reality check."[399] Secondary goals include facilitating discovery, focusing parties on key issues, obtaining stipulations, and finding efficient ways to dispose of disputes.[400]

Fourth, any process for arbitrating securities claims involving publicly-held companies must be quick and inexpensive in order to achieve the goal of deterring frivolous lawsuits. Several ideas may prove successful in this context. For example, the use of neutral experts can slash costs.[401] Although the Federal Rules of Evidence include a provision authorizing the use of court-appointed experts,[402] this provision has been used infrequently. Of course, this is of no concern in arbitration, in which there is no jury and the Federal Rules of Evidence do not apply.[403] Arbitrators should be given authority to appoint neutral experts in appropriate circumstances. Depositions should be avoided because they are quite costly, and often serve only to delay proceedings.[404] In 1993, the federal courts specifically limited the availability of depositions in federal court because of cost and delay concerns.[405] Another means of controlling litigation costs (and streamlining proceedings) is an early prehearing conference

---

Empirical Analysis, 46 STAN. L. REV. 1487, 1511 (1994).

399. The North American Securities Administrators Association, comprised of 50 state securities agencies, already has endorsed ENE as a method of dealing with securities class actions. *See Securities Litigation Reform Proposals*, *supra* note 68, at 209.

400. *See* JAY E. GRENIG, ALTERNATIVE DISPUTE RESOLUTION WITH FORMS § 30 (2d ed. 1997).

401. *See, e.g.*, Carver & Vondra, *supra* note 290, at 128 (stating that the use of a neutral expert can create pressure upon parties to negotiate).

402. *See* FED. R. EVID. 706.

403. Indeed, even in the context of jury-tried issues, the Supreme Court has recently encouraged the use of court-appointed experts. *See* General Elec. Co. v. Joiner, 118 S. Ct. 512, 521 (1997) (Breyer, J., concurring) (citing FED. R. EVID. 706).

404. The current Uniform Code of Arbitration commands parties to use informal information exchanges to the maximum extent possible. The Arbitration Policy Task Force has proposed restricting depositions even further in securities industry arbitration. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 85 ("The Task Force also recommends that the rules permit depositions in standard arbitration only in exigent situations.").

405. *See* FED. R. CIV. P. 30(a)(2) advisory committee's notes. Rule 30 was amended in 1993 with the specific objective of addressing the costliness of civil litigation. *See id.*

between parties and at least one arbitrator through whom an exchange of information can be facilitated, issues narrowed, and the need for briefs discussed.[406] Arbitrators should be given broad authority to identify issues within a dispute, order the production of key documents or information, request briefs, and make scheduling orders designed to resolve disputes quickly and fairly.[407] There should be provisions for standardized, mandatory exchange of documents, shortly after pleadings are completed, in order to minimize discovery costs and delays.[408]

Fifth, there must be a system for achieving class-wide adjudications, at least for issues that are most appropriate for class disposal.[409] The very nature of securities disputes involving publicly-held companies mandates this treatment because shareholders often have interests in issues of common facts or law. This means the rules governing such arbitrations must provide a mechanism for class certification similar to Federal Rule of Civil Procedure 23.[410] Unfortunately, this is one area in which there is little experience upon which to draw, but the concept appears sound, so long as due process requirements are met.[411] One

406. *See* ARBITRATION POLICY TASK FORCE, *supra* note 21, at 127 (noting the importance of streamlining and issue narrowing to success of the ADR).

407. This suggestion also is consistent with the recommendations of the Arbitration Policy Task Force. *See id.* at 86 (recommending that the chair of the arbitration panel be given a greater role in the prehearing process).

408. The Arbitration Task Force suggested this very method for expediting and streamlining discovery in the context of securities industry arbitration. *See id.* at 82 ("Unlike civil litigation generally, securities arbitration claims routinely present recurring issues that require the same types of evidence.").

409. It should be noted that because there is some authority that, absent a specific agreement, arbitrations may not be consolidated, the SEC must include class action provisions in any agreements to arbitrate securities disputes involving public companies. *See, e.g.*, Weyerhauser Co. v. Western Seas Shipping Co., 743 F.2d 635 (9th Cir. 1984).

410. *See* FED. R. CIV. P. 23. The certification process is extensive and its primary purpose is to protect absentee class members from entry of binding judgment when their interests have not been adequately represented. *See, e.g., In re* Mid-Atlantic Toyota Antitrust Litig., 564 F. Supp. 1379 (D. Md. 1983) (approving temporary settlement class); Vecchione v. Wohlgemuth, 80 F.R.D. 32, 50 (E.D. Pa. 1978) (holding that any alleged antagonisms between interests of two groups, certified for settlement as a class, were outweighed by unities of interest).

411. Commentators differ on the degree of court involvement in class arbitration. *Compare* FLETCHER, *supra* note 17, at 292-95 (noting that "courts are instructed to ensure adequate procedural safeguards to protect the rights of class members"), *with*

method for accommodating these concerns could be to empower administrative law judges to handle class certification issues and other class problems. Arbitration provisions within agreements must address these concerns so that all members of the class agree to be bound by class-wide adjudications.

Sixth, the procedures for arbitrating these disputes must provide for enforcement referrals to the SEC in appropriate cases. This recognizes that a major purpose of private rights is to supplement the SEC's enforcement efforts.[412] SRO arbitration forums have addressed this issue and concluded that arbitration awards should be routinely forwarded to enforcement authorities.[413] The fact that arbitration has traditionally enjoyed a high degree of privacy raises confidentiality concerns.[414] Given the basis of private enforcement, however, arbitrators must have the power to refer completed cases to enforcement personnel.

Finally, any system of SEC-sponsored arbitration should address another problem inherent in securities litigation involving publicly-held companies. Specifically, courts frequently have approved settlement agreements in which shareholders pay the settlement costs.[415] When a company is forced to pay shareholders claiming to be victims of fraud, all shareholders bear the costs.[416] This result cannot sharpen the deterrence value of the

---

Waltcher, *supra* note 210, at 400-04 (advocating a moderate level of judicial oversight). *See also* Thomas J. Stipanowich, *Arbitration and the Multiparty Dispute: The Search for Workable Solutions*, 72 IOWA L. REV. 473, 491 (1987) (discussing types of disputes submitted to ADR and reasons given for doing so).

412. *See generally* HOBLIN, *supra* note 16, at 2-6 (commenting on the regularity with which disputes resulted not only in a filing for arbitration, but also are referred to an SRO committee for disciplinary action).

413. *See id.* at XVII-1.

414. One of the objectives of SICA has been to provide educational materials to arbitrators to assist them in discharging their duties. *See id.* at XVI-22. One such item is the Arbitrators Manual. Included in this manual is the American Bar Association's and American Arbitration Association's Code of Ethics for Arbitrators in Commercial Disputes. *See id.* at XXXII-21. Canon VI of this code mandates confidentiality of all proceedings and decisions. *See id.* at XXXII-28.

415. This is a problem that Chairman Levitt acknowledged in his Congressional testimony, when he pointed out that the SEC's primary constituents—investors—are usually present on both sides of securities fraud litigation involving public corporations. *See Securities Litigation Reform: Hearings*, *supra* note 71, at 34 (testimony of Arthur Levitt, SEC Chairman).

416. *See supra* notes 194-95 and accompanying text.

federal securities laws and does not serve the policies underlying those laws. The SEC therefore must give arbitrators significant authority to probe settlements for substantial fairness and to approve only settlements in which wrongdoers bear the costs.

Before any detailed rules can be promulgated for such an arbitration regime, much must be settled. The point is that this system of dispute resolution is workable, and can be designed specifically to facilitate the fair and efficient resolution of securities claims.

CONCLUSION

This Article proposes that Congress or the SEC implement a regime of broad arbitration of private securities disputes involving publicly-held companies. The Article posits that arbitration will sound the death knell of "strike suits" and extortionate settlements because such arbitration should specifically emphasize the quick and inexpensive resolution of these claims. Further, arbitration may utilize a pool of expert adjudicators, with securities expertise, as a means of expediting disputes and increasing the quality of justice available. The prospect of quick, low cost adjudications would hardly chill meritorious claims. Consequently, this Article urges the adoption of broader securities arbitration as the best means of dealing with *both* meritorious and frivolous claims.

Moreover, the Article demonstrates that broader arbitration, properly implemented under the auspices of the SEC, reduces the risks inherent in deregulating or defederalizing the capital markets and thereby eroding investor confidence. Either Congress or the SEC could implement such a regime consistent with the Constitution and, in the case of the SEC, its administrative powers. Finally, the Article illustrates that most of the perceived problems with broader arbitration in the securities area may be addressed and resolved through the promulgation of specific rules to govern such arbitrations.

This Article is an effort to find an alternative to the polarized debate currently surrounding private securities litigation. It recognizes the value of deterring frivolous litigation in a balanced manner. Most of all, this Article is a search for some means of avoiding the problems inherent in leaving investors victimized by unfair markets with no real remedy.