View from The West

Things Every Arbitrator Should Know

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

Mark Twain

We hear too often about an arbitration award that seems to depart dramatically from the correct outcome of a case. You could call it an "anomalous" award, but these things happen too frequently to be considered anomalies. [1]

Notwithstanding our ability to model arbitration outcomes statistically – to say, for example, that customers win 57% of the time -- arbitration awards are not random events. Arbitrators make their decisions deliberately. Some wrong outcomes are inevitable, bred of bias or the hard reality that the wrong witness sometimes will be believed.

But some wrong awards are avoidable. Some wrong awards are the result of an arbitrator's misunderstanding of fundamental legal concepts. Appropriate education has a chance of preventing those incorrect outcomes.

But exactly what education is needed? What don't the arbitrators know?

Maybe arbitrators know that securities markets are not ruled by *caveat emptor* or "let the buyer beware." Certainly most know that. But some undoubtedly do not. Out of thousands of arbitrators, there inevitably will be some who are under the misimpression that the investor bears all risk of loss in an account. That is disturbing because it raises the very real possibility that an investor with a valid claim will be denied recovery unfairly.

Sometimes the gaps or errors in an arbitrator's knowledge will result from simple mistakes about the law – mistakes about matters so fundamental that we as lawyers cannot imagine anyone making them. Other times, the arbitrator's misunderstanding may be more subtle or sophisticated. Either way, if we do not correct the error, we run the risk that an investor who should recover will be sent away empty-handed while a broker-dealer or associated person is left to profit from illegal acts.

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[1] My thanks to Tom Mason for his invaluable thoughts and insights regarding the issues addressed by this article. Thanks as well to Andrew Stoltmann for his excellent ideas regarding areas of arbitrator misunderstanding of the law. And many thanks to aeronautical engineer Charles A. Lindley, Ph.D., for confirming that my quarter-century-old memories from my aerodynamics class would not make a Machery of the article.

Worse still, incorrect outcomes are a societal problem. A free, self-governing people have a right to see their laws carried out. If any dispute resolution forum routinely ignores those laws -- including laws meant to protect people from predation -- the result is an erosion of democracy and self-governance and is cause for serious concern.

All of this is a greater problem in an arbitral forum than in a judicial one. Arbitrators are far more likely than judges to harbor misconceptions about fundamental legal principles. More importantly, arbitrators' decisions almost always are final and nonreviewable.

Whatever their source, incorrect preconceived notions that may lead to incorrect outcomes need to be rooted out and eliminated through education. The first step in that process is to identify them. In this article, I will attempt to spotlight a few of the more obvious misconceptions.

Before I begin, however, let me note that this article is not intended as a formal legal treatment of the issues that follow. That would detract from the intended brevity of each point. Moreover, a formal treatment would be impractical for at least some of those issues because of variations in state laws.

Rather, the thrust of this article will be to spotlight the problem areas briefly, to give a sense of the general direction of the law, and to address the underlying logic of the law's position on an issue. In other words, the discussion will focus more on the ***why*** of the law than the ***what.*** My hope is that this article will be approachable for lawyers and nonlawyers alike.

One more thing: this article is not complete. Readers undoubtedly will think of arbitrator misconceptions that I have not addressed here. I encourage those who do to let me know about them. This article is intended as a work in progress.

1. Investments are not *caveat emptor*. "Buyer beware" is not the law.

Brokers have duties to their clients. It is true that nearly any investment can result in a loss. But that fact, taken alone and emphasized beyond its significance, can lead to wrong results. The reality is that there is some predictability to the different risks of different investments. Brokers, who hold themselves out as having expertise in the area, are required to make their recommendations with those risks solidly in mind.

Thus, an investor who needs safety can be given safety – or not. When a broker who knows or should be presumed to know about the relative risks of various investments sells a risky investment to a person who knows less than the broker and is looking to the broker for advice, and/or cannot afford to lose money, the broker should be required to make good the loss. Any other rule takes away the broker's incentive to do his or her job correctly. Any other rule teaches the public that fiduciaries cannot be trusted and that financial services are one area where the nation's economy will not be permitted to enjoy the benefits of specialization.

Occasionally you will hear someone – generally someone not educated in these matters or someone who has a romantic longing for the simple *laissez faire* of the 1800s – suggest that people know investments go up and down and therefore cannot complain when that happens.

It is a position that is patently ridiculous. One may as well suggest that people know driving is dangerous and therefore cannot complain when a drunk driver causes them harm. Our society has been intelligent enough to impose on the parties in the best position to avoid wrongdoing or prevent harm the cost of any harm that their conduct or neglect inflicts on others. That principle is not limited to motorists. It applies to everyone, including stockbrokers.

The only difference between stockbrokers and the others is that fewer people are aware of stockbrokers' liability for their wrongdoing. Perhaps that is because investments generally and the rules surrounding them are less familiar than automobiles and the rules of the road.

Capital markets are the life-blood of the economy. Horrible dislocations and economic harm have been visited on the nation and its people when those markets have failed. The Great Depression is a prominent example.

Thus, the laws governing securities issuers and broker-dealers and their associated persons are particularly stringent. Part of that body of regulation is the right of investors to recover their losses when those laws have been violated. Without that essential component of the enforcement mechanism, the laws are toothless.

The United States Supreme Court explained the importance of this body of law – the importance of ***not*** allowing *laissez faire* or *caveat emptor* to govern capital markets – in *Silver v. New York Stock Exchange*, 373 U.S. 341, 83 S.Ct. 1246, 10 L.Ed.2d 389:

> **"The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's.** It was preceded by the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act of 1940. **A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry. As we recently said in a related context, 'It requires but little appreciation ... of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry."**

373 U.S. at 366, 83 S.Ct. at 1262 [footnotes omitted, emphasis added.]

2. There is no "comparative fault" or "percentage fault" in a breach of fiduciary duty case or a fraud case or a breach of contract case or a claim for violating securities statutes or regulations.

Arbitration awards sometimes have the appearance of “splitting the baby.”

In a pure negligence case, percentage apportionment of fault might be appropriate. In an automobile accident in which a party is thirty percent at fault, for example, that party will receive only the remaining seventy percent of his or her damages. The name of the legal doctrine under which that percentage reduction of damages occurs is “comparative negligence.” The doctrine of comparative negligence replaced the older and less sensible doctrine of contributory negligence, under which a person who had the slightest fault, even if it was less than one percent of the total, would recover nothing by way of damages.

But apportionment of fault and the resulting reduction in the investor’s recovery are not appropriate with many kinds of claims. Examples include breach of fiduciary duty, fraud, breach of contract, and violations of securities or “blue sky” laws.

Claims involving breach of fiduciary duty are an ideal illustration. In a breach of fiduciary duty claim, a brokerage firm may be held liable because it held the client’s trust and did not act in manner worthy of that trust. The client’s claim is not supposed to be reduced in proportion to the client’s fault because the client has no fault. ***Rather, the client is allowed to trust the broker***. The client under those circumstances is not the one with the obligation to prevent losses. Instead, it is incumbent upon the broker to shoulder the entire task of handling the account appropriately. The broker who fails to do that should pay in full for the harm it has done.

One way of looking at this is to focus on the parties’ degrees of culpability. Negligence is a relatively innocent level of error. It is a mistake. One is liable for the results of one’s own negligence – making a mistake and causing an accident while changing lanes in traffic, for example – and comparable fault by the injured party can be offset against the defendant’s fault in determining the plaintiff’s recovery.

But breach of fiduciary duty and fraud are much more serious forms of wrongdoing. Our society decided long ago to require those who invite trust to behave in a manner worthy of that trust and to protect those who trust. People who defraud others or who breach others’ trust do not deserve the subsidy of comparative fault. They are not allowed to profit by blaming their victims. Society does not offset the faithless fiduciary’s greater transgressions with the victim’s relatively innocent mistakes. Imposing a duty of care on the fiduciary's client would defeat the law's purpose of permitting clients to trust fiduciaries and to concentrate their efforts on other things.

The analysis of liability under state securities law or “blue sky law” claims is even simpler. With blue sky law claims, there is no apportionment for the investor’s contributing fault for a very simple reason: the statute does not provide for it. That is part of the stringent regulation discussed in item 1 above. It reflects a self-governing people's collective wisdom about the importance of having laws that promote and protect trust, particularly where investments and the nation's capital markets are concerned.

Similarly, claims for breach of contract have no comparative fault provision because fault is not even an issue. Breach is the issue. If a contract has been breached, the non-breaching party is entitled to the benefit of its bargain. If a brokerage firm has a contractual obligation to follow securities industry rules and it fails to do so, its client is entitled to be put into the position that the client would be in if the firm had lived up to its contractual obligations.

The bottom line in all of these cases is the same: if there has been wrongdoing more serious than mere negligence, the customer must be compensated in full for the harm the wrongdoing has brought about. Arbitrators must steel themselves to bringing about that result, even if the numbers are large enough to appear intimidating and even if the broker seems cordial and nice in the hearing room. Anything less is dereliction of the arbitrators' responsibility.

3. Brokers often have fiduciary duties to their clients. In some states, including California[2], a fiduciary relationship is presumed. In others it must be proven, and what must be shown to establish a fiduciary relationship will be a matter of state law. In general, however, proof that a client or customer reposed trust and confidence in a broker may be all that is needed establish the existence of a fiduciary relationship.

This is as it should be. An economy based on specialization will work only if people are free to trust the honesty and competence of those who specialize. Any other rule, taken to its extreme, drags us all the way back to subsistence.

A fiduciary relationship is significant because it imposes on the fiduciary the highest duty known to the law. ***A fiduciary has the duties of a trustee***:

> "An agent is a fiduciary. His obligation of diligent and faithful service is the same as that imposed upon a trustee." "The relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal."

Twomey v. Mitchum, Jones & Templeton Inc. (1968) 262 C.A. 2d 690, 708

Once a fiduciary relationship is established, the relationship no longer is a business relationship at arm's length. This is so despite brokerage firms' and other fiduciaries' attempts to pretend otherwise. The fiduciary must put the client's interest first and

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[2] *Twomey v. Mitchum, Jones & Templeton Inc.* (1968) 262 C.A. 2d 690; *Duffy v. Cavalier* (1989) 215 Cal.App. 3d 1517; *Hobbs v. Bateman Eichler, Hill Richards, Inc.* (1985) 164 Cal.App.3d 174, 210 Cal.Rptr. 387.

foremost – ahead of the fiduciary's own interests. Fiduciaries have a duty of absolute honesty and fidelity to their clients. If they breach that duty, they must pay for the damages caused by their breach.

The law imposes that higher duty on fiduciaries for the same reason it imposes a higher duty on common carriers. There are some people and entities whose activities are so important and whose errors are so potentially harmful that the law imposes a heightened duty of utmost care and diligence upon them. Society and the economy suffer if consumers cannot trust those people and entities implicitly and go about their affairs free of the weight of the corresponding worries.

That applies to those who transport our things and our selves. And it applies as well to those whom we agree to trust with our money. Widespread fear of self-dealing and incompetence on the part of common carriers could immobilize people and property and grind the economy to a halt. Widespread fear of fiduciary defalcation could have the same effect on the flow of capital, the economy's life-blood.

Breach of fiduciary duty entitles the person to whom the duty is owed to receive ***all*** damages caused by the breach. If that result seems harsh, it is because the law has little tolerance for those who invite trust and then abuse it. A modern economy depends upon trust in more ways than any of us can name. Abusing that trust victimizes the economy as a whole.

Thus, treating a breach of fiduciary duty claim like an ordinary arm's-length business squabble is a misapplication of the law. Doing so is a disservice both to the aggrieved party and to the society whose laws are being ignored. It harms us all.

4. Mere negligence is enough. Brokers are obligated to be competent.

Broker-dealers often attempt to create in the hearing room an atmosphere that suggests that a customer who doesn't show actual, deliberate fraud doesn't have a case. Often, their approach is to show that the broker purchased the disputed investment for his or her own account or for the account of a close relative. But that whole approach often is a defense against a claim that was not even asserted, a verbal sleight of hand.

If the arbitrators are not paying attention, the brokerage firm's ploy might work. But if they are alert, they will realize the obvious: that the customer need not prove an un-made and unnecessary claim in order to be entitled to recover.

If a taxicab crashes into the rear end of an automobile stopped at a red light, the motorist whose car was struck will be entitled to recover for any resulting personal injury or property damage. The injured motorist is not required to prove that the accident was a deliberate ramming. Indeed, counsel defending a negligence case in court would be unlikely to insult a judge's or jury's intelligence by asserting that the defendant did not collide with the other vehicle deliberately and therefore should not pay for the harm caused. That lack of intent is presumed and is not a defense to a negligence claim.

People understand that collisions happen and that deliberate rammings generally are not the cause. Negligence or carelessness – the failure to act as a reasonably prudent person would act under the circumstances – is the basis of a negligence claim. Attempts to defend by pretending that the plaintiff must prove more than that will not be well-received.

Similarly, it is no defense for the broker to show that he was duped. The broker is one with the purported expertise. A customer who paid for that expertise – especially from a full-service broker – is entitled to recover if the broker, even with good intentions, made a mistake and fell below the standard of care. The broker is the one who is being hired to handle money competently. The broker has a duty of reasonable care and, failing that, must pay the damages caused by the failure.

5. The broker-dealer is liable for the stockbroker's wrongdoing. The law makes employers liable for the harm caused by their employees acting in the course and scope of their employment. Thus, if a stockbroker's misconduct causes harm in an account, the employing brokerage firm is liable side-by-side with the stockbroker.

The legal principle that imposes liability on employers for losses caused by their employees is ancient enough to be known primarily by a Latin name: "*respondeat superior."* The principle makes sense for two reasons. First, it recognizes the reality that the employer, who controls the purse strings and otherwise has the ability to exercise control over the employee's conduct, is in the best position to prevent the employee from causing harm. The employer clearly is in a better position to prevent harm than is the customer or an uninvolved third party, for example.

Second, *respondeat superior* is consistent with the ancient and widespread legal principle that, as section 3521 of the California Civil Code puts it, "he who takes the benefit must bear the burden." Employers benefit a great deal by being able to hire employees. By accepting that benefit, they take on the obligation to pay for the harm their employees cause in the course and scope of employment.

Respondeat superior liability is important because the employee who harms a customer or third party seldom has sufficient assets to compensate the victim for the loss. Without an employer (or an employer's insurance policy) to pay for the loss, the loss goes uncompensated and the misconduct that caused it goes undeterred. Neither result is desirable in a civilized society.

Classic defenses to *respondeat superior* liability include attempts to define everything the employee did to cause the loss as being "outside the scope of employment." But attempts to define "getting into an accident" as being outside the scope of a truck driver's employment seldom fool the courts, and analogous arguments about stockbrokers should not fool arbitrators. Allowing arguments like that to prevail would write *respondeat superior* out of the law and would disable the law as an effective tool for deterring socially undesirable conduct.

Brokerage firms attempting to avoid their responsibility for a stockbroker's misconduct often will attempt to sidetrack the arbitrators with arguments about "controlling person" liability. Under state and federal securities laws, persons who control an entity that is liable for violating those laws can be liable themselves to the same extent as the offending entity.[3] But the standards for imposing controlling person liability are different from and in some respects more stringent than the very broad standards applicable to common law *respondeat superior*. It follows that a defense to controlling person liability is not a defense to *respondeat superior* liability, and arbitrators should not be fooled by a firm's attempt to equate or confuse the two.

In securities arbitration, we occasionally read awards that are not "joint and several" -- *i.e.*, awards that hold the stockbroker and the brokerage firm liable for different sums, indicating that the arbitrators ignored the age-old principle of "*respondeat superior*." That is something that never should happen. When it does, a brokerage firm that is liable is a matter of law is permitted to retain money belonging to a customer who has been harmed by the firm's business operations. No arbitrator with a conscience and a sense of duty should be willing to countenance that miscarriage of justice. If a stockbroker did something that results in liability, the employing firm is liable with the stockbroker and in the same amount.

6. An investor who wants a hearing is entitled to a hearing. No "motion to dismiss" or "motion for summary judgment" is possible without the investor's consent.

Ten years ago, pre-hearing "dismissal motions" were seldom if ever seen in securities arbitration proceedings. That has changed. In the mid-1990s, securities industry respondents began filing "motions to dismiss" under section 15 (now known as Rule 10304) with increasing frequency. Next came motions asserting that statutes of limitation barred recovery. Now we are seeing motions to dismiss asserting every imaginable theory. While arbitrators almost never grant one of these "motions," they frequently waste the parties' time and their own by entertaining them. That should not happen.

The absurdity of all of this is that there is no such thing as a "motion to dismiss" under the Code of Arbitration Procedure. The Code contains no procedure for pre-hearing dispositive motion practice. Indeed, granting a pre-hearing "motion to dismiss" would violate the public customer's right to a hearing. That right is contained in NASD Rule 10303(a), which provides as follows:

> **Any dispute, claim or controversy** except as provided in Rule 10203 (Simplified Industry Arbitration) or Rule 10302 (Simplified Arbitration), **shall require a hearing** unless all parties waive such hearing in writing and request that the matter

[3] See, for example, section 15 of the Securities Act of 1933, 15 U.S.C. section 77o; section 20 of the Securities Exchange Act of 1934, 15 U.S.C. section 78t. And compare the broader vicarious liability provision of section 25504 of the California Corporations Code.

> be resolved solely upon the pleadings and documentary evidence. [Emphasis added.]

The New York Stock Exchange and the Pacific Exchange have identical rules. See NYSE Rule 602 and Pacific Exchange Rule 12.3.

The rules establishing the right to a hearing set forth the lone exception to that right: a situation in which ***all parties*** have waived the hearing in writing and requested that the matter be resolved upon the pleadings and documents. Without that consent, there can be no "motion to dismiss." An investor who wants a hearing gets a hearing.

The rules providing for a hearing in each case where an investor wants one make sense. In arbitration, unlike court, pre-hearing discovery is limited in several ways. First and most importantly, there are no depositions or interrogatories. Second, document discovery proceeds without the enforcement powers of the court and, as a result, the process frequently is flouted by securities industry respondents. As a result, the evidentiary record that could form the basis for summary judgment motion practice in court is wholly lacking in arbitration. Deciding a case in an evidentiary vacuum -- throwing a case out before the investor has had an opportunity to put on any evidence -- may be the kind of "justice" that would pass muster in a third-world dictatorship, but it should not be accepted here.

Parties making "motions to dismiss" and other dispositive motions, when confronted with the illegitimacy of those motions, invariably make a variety of facially invalid arguments to try to legitimize them. Usually, when the arguments are not just plain arm-waving, they center on case law that allows dispositive motions in court. Those arguments are invalid for a variety of reasons including the most obvious: arbitration is not court. The codes of civil procedure that apply in court do not apply in arbitration. The codes of arbitration procedure that apply in NASD, NYSE and Pacific Exchange arbitration, in turn, do not apply in court. The Code of Arbitration Procedure provides a hearing for any investor who wants one. That is the beginning and end of the matter.

7. Statutes of limitation are not always simple calculations beginning on the transaction date. Time limitations often do not start running until the claimant discovers the wrongdoing. Securities industry respondents are fond of arguing that cases must be dismissed on statute of limitations grounds because they were filed more than the specified number of years – the length of the statute of limitations -- after the purchase of the disputed securities. But that does not follow.

For many kinds of claims, the statute of limitations, by its own terms, does not even ***start*** running until the aggrieved party learns of the wrongdoing or should have known about it with the exercise of reasonable diligence. Statutes of limitation for fraud uniformly work that way. In California, for example, the statute of limitations for fraud is three years from the discovery of the wrongdoing. See California Code of Civil Procedure section 338. A date three years after the transaction itself is a meaningless point in time.

There is an excellent reason for this rule: any other rule would reward wrongdoers for "lulling" their victims and keeping them in the dark. The law avoids setting up incentives to engage in continuing fraud.

The rule is a bit more complex in breach of fiduciary duty cases. Where a fiduciary relationship exists, the investor's duty of inquiry is relaxed. Thus, the things that would be expected to put an investor on notice of misconduct in an arm's-length relationship do not put an investor on notice if the broker is a fiduciary. This rule is consistent with other rules described above. Like those rules, this one allows people to place their faith in fiduciaries; it does not permit itself to be twisted into a tool for faithless fiduciaries to get away with the fruits of their wrongs.

Thus, in most investor/broker disputes, determining when statutes of limitation run out depends upon a determination of when they started. That, in turn, requires an inquiry into when the investor learned of the wrongdoing, when the investor should have learned of the wrongdoing with the exercise of reasonable diligence, the nature of the relationship between the investor and the broker and its impact upon the degree of diligence required of the investor, and other factors.

Far from being the simple, bright-line calendar calculations advocated by respondents, therefore, statutes of limitation require intensely factual inquiries before they can cause a claim to be barred as untimely. Statute of limitations questions often are inextricably intertwined with the merits of the underlying controversy.

As a point of cross-reference, the complexity of disputes about time limitations precludes their being resolved without resort to the relevant evidence. That does not stop respondents from asserting their supposed simplicity and arguing for pre-hearing dismissals, of course. But the complexity of these matters would make dismissal motions inappropriate and unfair even if a hearing were not guaranteed under the Code of Arbitration Procedure.

7a. Rule 10304 -- the NASD's "six-year rule" -- does not start automatically on the transaction date. Like statutes of limitation, Rule 10304 can present complex factual issues. This is because numerous cases have held that Rule 10304 begins running when the cause of action "accrues" -- *i.e.*, when a case first can be brought. That date often differs from the transaction date.

Limited partnership cases presented the classic example of a deviation between transaction date and the date of accrual of a cause of action. Many limited partnerships were doomed from the start, a fact obvious to the firms that sold them. Nonetheless, investors were lulled into a state of complacency by brokerage statements that carried the limited partnership interests at their original purchase price. That practice of keeping investors ignorant turned the partnership interests into the financial equivalent of unexploded ordnance.

Thus, it was obvious that it would be patently unfair to start the various time limitations before the limited partnership interests had exploded in their owners' portfolios, putting the investors on notice of the wrong that had been done.

Federal appellate decisions from circuits that regarded the interpretation of Rule 10304 to be a matter for the courts (as opposed to a matter for the arbitrators) are consistent with this interpretation. Those circuits have adopted the view that **it is the *accrual* of a cause of action that starts the six-year period with respect to that cause of action. In other words, purchase date is not dispositive.** *PaineWebber, Inc. v. Hofmann* 984 F.2d 1372 (3d Cir. 1993); *Osler v. Ware* 114 F.3d 91 (6th Cir. 1997); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer* 49 F.3d 393 (7th Cir. 1995); *J.E. Liss & Co. v. Levin*, 201 F.3d 848 (7th Cir. 2000); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cogswell* 78 F.3d 474 (10th Cir. 1996); and, most recently, *Kidder Peabody v. Brandt* 131 F.3d 1001 (11th Cir. 1997).

In *Kidder Peabody v. Brandt,* the court stated as follows:

> Therefore, we reject Kidder's interpretation of the "occurrence or event giving rise to the ... claim" language of Section 15 [now known as "Rule 10304"]. **Instead, we hold that under Section 15 the "occurrence or event" which "gives rise to the ... claim" is the last occurrence or event necessary to make the claim viable.**

8. There often is a contract between the customer and the firm. In more cases than I can count, respondents have asserted that a breach of contract claim is without basis because there is no contract between the customer and the firm. Often, the defense is just plain false.

Sometimes, it is false because an oral or implied contract has arisen between the brokerage firm and its client. More often, however, it is false because there is a margin agreement, a new account form, or another writing setting forth the brokerage firm's obligations.

Agreements between brokerage firms and investors often expressly provide that the brokerage firm will obey the rules and standards of the securities industry. Failure to follow those rules – for example, failure to follow the suitability rule or the supervision rules – becomes a breach of contract under those circumstances. The result is that the firm's client is entitled to the benefit of its bargain – *i.e.*, to be placed where he or she would be if the firm had not breached the contract.

9. The "no private right of action" defense is a ruse. Securities industry respondents often argue that a claimant cannot recover for violations of securities statutes or regulations or for violations of other securities industry rules or standards because of the lack of so-called "private rights of action." They assert, for example, that a customer who suffers losses because of a broker's unsuitable investment recommendations cannot recover his or her losses because the suitability rule does not expressly say that a victim of a violation can sue. It's a ridiculous argument.

But people, even intelligent people, sometimes are tricked into going down a wrong path. An example of this, if I can offer a brief and interesting analogy, was the so-called "sound barrier." In the years before Chuck Yeager flew the Bell X-1 past the speed of sound, many in aeronautical circles believed that the "sound barrier" was an absolute. The idea was that drag – the force that pushes backward against an aircraft – would become infinite as the speed of an aircraft approached "Mach one," the speed of sound. And there was some elaborate development of theory to support that point of view. The problem with the theory, though, was that rifle bullets left the barrel at twice the speed of sound or more. That simple fact was widely known, and should have prevented people from believing in an absolute sound barrier.

Speed – in this case, the speed of automobiles rather than airplanes – helps return the analysis to earth. Every state's laws include speed limits. California's Vehicle Code, for example, has a "basic speed law." The law contains no "express private right of action." So, to be consistent with their "no private right of action" defense in securities cases, securities industry defense counsel would have to argue that one cannot sue a speeding motorist for injuries caused by excessive speed. Put into an automotive analogy, the absurdity of the defense is clear.

The reality is that securities industry arguments about the supposed nonexistence of private rights of action for rule violations are a red herring. Even though they are wrong, it would not matter if they were right, because industry rules set up a standard of care. Violation of those rules violates the standard of care. That gives rise to a case for negligence and, in many states, for violation of state securities acts. If the broker is a fiduciary, the suitability violation establishes a breach of fiduciary duty as well. If a new account form or other contract between the customer and the brokerage firm obligates the firm to comply with securities industry rules and regulations, the firm's violation of industry rules will be a breach of contract. And if the act was deliberate, the customer may have a claim for fraud and/or violation of Rule 10b-5.

10. Income, growth, speculation: problems with new account forms and the meanings of words. New account forms that do not reflect investors' actual or appropriate goals are a growing problem in recent years. So are brokerage firm defenses based upon seemingly deliberate misinterpretation of those goals and objectives. Here are some examples:

10a. "Growth" is not a broker's carte blanche to invest in absolutely anything. Brokerage firms occasionally attempt to use a "growth" objective to justify all kinds of inappropriate, speculative investments in an account. But growth and speculation are not the same thing. Clearly, any investment ***might***

grow. But that doesn't make the investment any more appropriate for an account with a growth objective than a Petri dish with a bacterial colony that ***might*** grow.

The reality is that a "growth" objective has a specific meaning in the securities industry. It is what is known as a "term of art." Some investors might not know what it means, but brokerage firms and stockbrokers are required to know.

That meaning comprehends a range of acceptable levels of risk and excludes risks that are greater. A level of risk that is appropriate for an account with a "speculation" objective is not acceptable for an account with a "growth" objective, regardless of whether the speculative investment might grow.

Why does this defense run the risk of tricking arbitrators? What is behind the confusion? The difference between the broad, ordinary English meaning of "growth," on the one hand, and the very specific securities industry meaning of "growth" as an account objective, on the other. If respondents can get away with blurring those distinctions, they may succeed in fooling the arbitrators into making an incorrect decision.

10b. Many investors do not know what the terms mean. The securities industry and its defense counsel will use terms like "speculation" and "growth" correctly when it suits them, and the arbitrators often will understand the meanings. What arbitrators who have investment sophistication may not know is that many less-educated investors may have very different ideas about the meanings of those terms.

Many people, for example, use the term "speculate" as though it applies to any stock position. Indeed, that is the historical use of the term. Yet those with investment sophistication in modern times would not regard a purchase of Procter & Gamble shares to be speculative. Still, when an unsophisticated investor checks boxes, misunderstandings about the meanings of the words – not necessarily the plain English meanings, but the securities industry's term-of-art meanings – may prevent those checkmarks from indicating what truly is intended by and suitable for the investor.

10c. Rankings that include all possible account objectives can be inherently misleading. Another problem is the tendency of stockbrokers to fill out new account forms in such a way as to assign a ranking number to every one of the potential account objectives. Worse still is the listing of objectives without ranking. For purposes of illustration, though, let us assume that the four possible objectives are preservation of capital, income, growth and speculation. A new account form for an elderly client with a conservative profile should not rank those as 1, 2, 3 and 4, respectively. Rather, that client's form should leave speculation off the list entirely.

The problem has to do with what message is sent by having speculation on the list at all. Does having speculation as the customer's fourth choice mean that speculation is the fourth best thing and therefore still in the running and still a legitimate goal for part of the portfolio? Or does it mean that speculation is the last thing the investor would want, something that never should be done? Industry respondents invariably will argue for the former interpretation, although it virtually never will be consistent with the customer's true intent.

Menu items may be a good way to illustrate this concept for an arbitration panel. Suppose one is asked to rank the following items in order of preference: pizza, mashed potatoes, ice cream and contaminated cheese. Most people would know immediately that they would want only the first three items on the list.

Alas, securities are less susceptible of intuitive wisdom than is food. So the arbitrators may have to be educated about this ambiguity and the need to focus upon the client's real goals rather than upon the misleading picture of those goals that defense counsel paints at the hearing. Perhaps a start is to question the stockbroker about whether it is his or her custom and practice to give some ranking, however low, to each possible account objective.

11. Damages are not limited to a "net out-of-pocket" measure. Arbitrators often are confronted with defense arguments that the only permissible measure of damages is a net out-of-pocket measure. The argument is may be enticing because of its simplicity; but it is wrong. Many decades of well-reasoned statutes and case law hold otherwise, and for good reason. The net out-of-pocket damage measure, like the oversimplification inherent in industry arguments about statutes of limitation, calls to mind the admonition that everything should be as simple as possible, but not simpler.

Taken at its extreme, the net out-of-pocket measure leads to bizarre results. Suppose a 25-year-old client opened an account with $50,000 in 1960, seeking growth with the idea of having the money available beginning in his late 60s. 43 years later, growth at a 10% annual rate has produced an account worth approximately $3,200,000. Now, suppose the broker does something very wrong with disastrous results on the eve of the client's retirement – it could be an unauthorized trade, grossly unsuitable recommendations, a period of wild churning or a host of other abuses. If the account is reduced to $40,000, what is the customer's loss? Is it $10,000, as the industry respondent might assert on a net out-of-pocket damage theory? Or is the mere suggestion of that damage figure just a nauseating injustice when the real damages are $3,160,000? One would hope that the arbitrators would be able to see that the real harm to a retiree who very reasonably relied on his prudently invested nest egg to see him through for the rest of his life is far closer to three million dollars than to ten thousand dollars.

Clients damaged by the negligence of others are entitled to be made whole. They are entitled to be placed where they would be if the negligence had not occurred. The example above illustrates one of the classic injustices of the net out-of-pocket measure: it assumes that the investor wanted a zero rate of return. If an investor truly wanted a zero rate of return, what would possess the investor to place his or her savings in the hands of a full-service broker? Indeed, if investors were interested in a zero rate of return on savings, why would brokerage firms exist at all?

Different causes of action allow for different damage measures. The damages for breach of contract are the "benefit of the bargain." This requires that the claimant be placed in the position he or she would be in if the contract had not been breached. Breach of fiduciary duty allows the same damage measure in California.

Statutory claims under state and federal securities laws provide still other measures of damages.

And then there are attorneys' fees – necessary if the investor is to be made whole, that is, placed in the same position he or she would be in if the wrongdoing had not occurred. Arbitrators who are disinclined to award attorneys' fees to an investor should ask themselves why they are subsidizing a wrongdoer by allowing it to pay for less then the total harm it has caused. One thing is certain: an investor who has to retain counsel to pursue a claim for something that never should have happened in the first place cannot be made whole without being compensated for his or her attorneys' fees.

And then there are punitive damages, controversial though they may be. Punitive damages solve the classic problem of remedies. Awarding damages to those who have been harmed by the misconduct of others serves two purposes long recognized by courts and legislators: compensating victims; and deterring others from engaging in misconduct.

Compensation is not difficult so long as the proper compensatory damage measure is used. But compensation alone may not deter wrongdoing of the kind that led to the claim, because there are some people who will not assert claims and others who will assert them ineffectively.

What is the solution that will prevent wrongdoers from using the unevenness and inconsistency of litigation to retain the profits of their unlawful acts? Punitive damages. Punitive damages are necessary to take the profit out of wrongdoing. Without them, compensatory damage payments to injured parties are a mere tax on wrongdoing. The wrongdoing – the misconduct that the people, through their elected representatives, decided to eliminate from society -- must be stopped by the arbitrators, because the courts are out of the picture. It is essential that arbitrators uphold the laws of a self-governing people.

Conclusion

The problem areas described above are a start. But this list is far from complete. I encourage readers to think and write about other gaps in arbitrators' legal knowledge that might lead to incorrect and unfair results.