View from the West

Unpaid Securities Arbitration Awards: Proposed Solutions to the Problem

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That this article is necessary is a travesty. The problem it addresses should not exist.

The Problem of Unpaid Awards

Let's start with rock-bottom basics. People work hard. They accumulate wealth. They need help from people they can trust to manage that wealth and help them invest appropriately and avoid unnecessary risk. They need that level of service because they need and want financial security and the ability to retire or to stay retired. They need that level of service because they don't have the time, the training, the knowledge or the self-confidence to perform those tasks on their own.

An industry exists to serve that need. It is called the securities industry. The securities industry holds itself out as providing exactly what people need—knowledgeable advice that they can trust and rely on, with investments carefully selected to provide the financial security or rewards they need. The industry's advertisements give assurances of "traditions of trust," personal care and solid results that allow people to enjoy life instead of worrying about their money. People who entrust their financial affairs to the securities industry will say, "Thank you, Mr. Broker."

Unfortunately, members of the securities industry often do not act on a par with the trust that their clients repose in them. Disputes arise. Sometimes the misconduct is simply negligent; sometimes it is downright criminal.

A system exists for adjudicating disputes about securities industry members' conduct. It is called "securities arbitration." Almost without exception,

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[1] This article reflects the views of its author and does not necessarily reflect the views of the Public Investors Arbitration Bar Association or its directors or officers.

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clients of securities firms are forced to use securities arbitration to resolve any disputes regarding their accounts. Industry members have incorporated arbitration clauses in the basic documents they use to open securities accounts. As a condition of doing business with a securities firm, the documents require people to give up their right to go to court, where the dispute would be decided by a judge and jury.

But the whole point of trusting someone with your finances is lost if the industry does not assure that its members are themselves financially responsible and that, if you prevail in your dispute, your award will be paid. It is the height of hypocrisy for members of the securities industry to advertise that they will be responsible with people's money and financial security when they themselves are financially irresponsible.

Yet that is the inexcusable situation in which we find ourselves. For 2001, the last full year for which data are available, more than half of the dollar volume of arbitration awards remains unpaid.[3] For the first three months of 2003 alone, awards totaling more than $30 million remain unpaid.[4] This is not a new problem, and it does not depend on the strength of the stock market. The GAO found more than $129 million of unpaid awards in 1998, during the height of the 1990s' bull market.[5] Whether the market is up or down, consumers are getting stiffed by securities industry members to whom they entrusted their finances.

In the 1930s, the securities industry persuaded Congress to permit it to "self-regulate."[6] The need for strict regulation of the securities industry was glaringly obvious at the time. The nation was in the midst of the Great

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[3] *Follow-up Report on Matters Related to Securities Arbitration*, U.S. General Accounting Office Letter to Congressional Requesters John D. Dingell and Edward J. Markey, GAO 03-162R, p. 3, 9 (April 11, 2003) ["GAO 2003"]. GAO 2003 was a follow-up to the GAO's earlier report, *Securities Arbitration: Actions Needed to Address the Problem of Unpaid Awards*, U.S. General Accounting Office, GAO/GGD-00-115 (June 2000) ["GAO 2000"].

[4] Susan Pulliam, Susanne Craig and Randall Smith, *How Hazards for Investors Get Tolerated Year After Year: Corporate Board Minutes are Altered; Judgments in Arbitration Go Unpaid*, WSJ Online (Feb. 6, 2004), p.1.

[5] GAO 2000 at p. 34.

[6] The Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified at 15 U.S.C. § 78o-3), gave legislative authorization to the establishment of a national securities association, the NASD. The NASD proudly proclaims that it "is not an organization which was imposed upon the investment banking and securities business by Congress or by the Securities and Exchange Commission. The privilege of self-regulation was actively sought by the securities business." NASD MANUAL (CCH) ¶ 101 (History and Organization of the NASD). The SEC stated in its Special Study in 1963, "There are, no doubt, many other instances in which the policy of entrusting a degree of social control to 'private' groups has been adopted, but securities regulation is unique in featuring self-regulation as an essential and officially sanctioned part of the regulatory pattern." SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H. R. Doc. No. 88-95, pt. 4, at 501 (1963) ["SPECIAL STUDY"].

Depression, which was brought about in part by the securities industry's excesses.[7]

"Self-regulation" does not mean that each broker-dealer regulates itself. It means that the whole industry must regulate each and all of its participants. Self-regulation is regulation. If the industry does not regulate itself – including its worst actors – it is not doing the job.

Part of the regulatory job is assuring the financial responsibility of members in all contexts, including dispute resolution in arbitration or elsewhere. Those who wish to manage the financial security of others must demonstrate financial responsibility themselves. Allowing a company capitalized with $5,000 to manage millions of dollars for consumers shocks the conscience. That the current regulatory scheme can allow that company to walk away without paying for the consequences of its misconduct is unfathomable.

Consumers are shocked when they discover that the company they trusted has no money to repay them. They are shocked to learn that companies in a supposedly "highly regulated industry" are permitted manage tens and hundreds of millions of dollars for the public without any insurance. The typical financial consumer carries liability insurance through homeowner's and auto policies at a minimum. Business owners carry liability insurance and a variety of other coverages. In most states, drivers are required to provide evidence of financial responsibility in order to keep their drivers licenses. Yet the securities industry permits its members and employees to risk people's life savings without any insurance or investor guarantee fund at all.

As a result, part of the self-regulatory function is failing critically: all too often, people who prove that an industry member erred receive nothing back.

Unpaid awards are glaring evidence of a "market failure" in self-regulation. Neither the free market nor the securities industry's self-regulatory "conscience"

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[7] The U.S. 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, 366, 83 S.Ct. 1246, 1262, 10 L.Ed.2d 389 (1965) (footnotes omitted):

> "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."

has protected consumers against or compensated them for the errors and predations of securities industry participants.

Self-regulation is both a privilege and a responsibility. If the industry wants to self-regulate, it must fix what is broken in its system of financial accountability. If the securities industry is unwilling (and this clearly is a failure of will, not of ability) to fix the problem from within, the SEC, state regulators, and ultimately Congress must impose discipline from outside.

In 1963, the SEC's Special Study argued that "those entering the securities business as entrepreneurs should have such sense of commitment to their business as is likely to produce responsible, reliable operations."[8] The SEC also found that broker-dealers operating with limited capital committed a "disproportionate number" of SEC rule violations.[9]

Forty years later, the industry still lacks financial accountability to the public. The GAO found in 2003, just as the SEC did in 1963, that firms with limited capital and little sense of responsible, reliable operations produced the greatest number of problems. "The majority of unpaid awards in both 1998 and 2001 resulted from brokers leaving the securities industry."[10] The GAO acknowledged the seriousness of the situation: "[T]he extent to which awards are unpaid by defunct brokers shows that unpaid awards … [are] still a serious problem that can affect investors' confidence in arbitration and potentially the securities markets and discourage attorneys from taking investors' cases."[11]

Make no mistake: allowing an award to go unpaid does not mean that nobody bears the cost of the miscreant behavior that led to it. That cost, that loss, always will be borne by somebody. The only question is who.

Right now, if the miscreants themselves do not pay the awards, the costs of their misconduct are borne by their victims.[12] And who are the victims? Ordinary Americans. Some are elderly. Some are retired. Some are in their working years. Some want to put their children through college. What they have in common is that they made one mistake: they trusted the wrong brokerage firm, the wrong broker, the wrong adviser. They did nothing to deserve the churning, the pump-and-dump schemes, the Ponzi schemes and the other forms of theft and wrongdoing that the industry perpetrated upon them. They had no duty or power to regulate the securities industry or to prevent misconduct from

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[8] SEC SPECIAL STUDY, at 48.
[9] Id. at 84-85, 91.
[10] GAO 2003, at 3. The GAO calculated in both studies that around 80% of unpaid consumer awards involved defunct brokerage firms or individual brokers.
[11] GAO 2003, at 14.
[12] The Securities Industry Association ("SIA") and the SEC have argued that various methods of guaranteeing payment of unpaid awards would increase costs for broker-dealers and investors. See GAO 2000, at 40-43. The argument is cynical and disingenuous. Who do the SIA and the SEC think is bearing the cost of unpaid awards currently?

happening. They should not have to bear the cost of the industry's self-regulatory failures.

The time has come to end the industry's harmful and insulting self-regulatory failure. Securities laws and regulations exist to protect consumers, not to punish them. America's ninety-one million investors demand accountability. Self-regulation is a means to an end, not an end in itself. If the securities industry cannot or will not self-regulate appropriately and competently, it must give up the privilege.

Securities markets depend on investor confidence. Payment of securities arbitration awards is essential in the immediate sense to compensate the victims of the securities industry's missteps. It is essential over the longer term to deter the misconduct that caused the losses. Most importantly, public knowledge that wrongs will be compensated and deterred is essential to long-term investor confidence in the integrity of the capital markets themselves.[13] Without that critical mass of investor confidence, the markets cannot exist and cannot do their job.

If investor confidence is to be maintained, it is essential that there be absolute assurance that arbitration awards will be paid, that the industry will pay the full price when it harms investors through its own wrongdoing, and that no investor who wins an arbitration award ever will be turned away empty-handed while a laughing securities industry malefactor displays its empty pockets. The current nonsense must stop.

Proposed Solutions to the Problem of Unpaid Awards

Investor representatives and regulators have proposed a number of possible solutions to the problem of unpaid arbitration awards. I address six of those approaches in a non-quantitative way below. The first two are utterly worthless. I mention them only in the interest of completeness. The third and fourth have potential but have problems that render them incomplete or otherwise limit their usefulness as solutions. The fifth and sixth, in contrast, offer practical and thorough solutions to the unpaid award problem, a problem that never should have been allowed to exist.

1. Increasing Broker-Dealers' Minimum Net Capital Requirements. This proposed "solution" is ridiculous. What makes it a non-starter is that the minimum net capital cannot be increased to anything approaching the level necessary to fund a smaller firm's potential liabilities. Put differently, most any figure that anyone can suggest will be simultaneously too small and too large.

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[13] "[C]ontinued unpaid awards, regardless of how effective and fair the arbitration process may be, could negatively affect investors' confidence in arbitration and potentially the securities markets in general." GAO 2003, at 13, 14.

Some examples will make this clear. Picture, if you will, a firm that has minimum net capital of $5,000. How high will the new minimum be set? $50,000? That would be inadequate to pay any but the smallest awards. But you can bet your bottom dollar that a $50,000 minimum net capital requirement would bring forth a hailstorm of protest from the horde of small firms that make up the majority of the NASD's membership. An attack on small business, they'd charge.[14] How about $500,000? That would cover most awards but would not touch the damage that can be done to multiple customers by a single rogue broker. And at half a million dollars, it would be surprising if more than a tiny percentage of small broker-dealers could even stay in business. In short, any figure that is proposed will be simultaneously too small to solve the problem and too large to be affordable to those who must pay it.

At its best, the proposal to solve the unpaid awards problem by increasing minimum net capital is nothing more or less than a requirement that everyone in the industry self-insure by having sufficient net capital to fund all reasonably foreseeable liabilities. It is to that extent archaic. The idea that individuals and entities should self-fund all potential adverse consequences of their activities was solved long ago by the invention of insurance and the creation of markets in risk.[15] No one would suggest seriously that the problem of unpaid automobile accident verdicts should be solved by requiring all drivers to set aside $300,000 cash as a reserve for liability. Instead, mandatory insurance has been the obvious solution to that problem. It is one of the approaches with some promise here as well, as described in item 5.

As bad as this proposal is, it is better than the status quo, in which the entire cost of unpaid awards is paid, in effect, by defrauded investors. There is no justification for requiring those individuals to fund the industry's failures. They should not be punished for reposing trust in an industry that invites trust. They should not be impoverished for attempting to claim the economic benefits of specialization by delegating the task of managing their savings.

As mindless a "solution" as increasing minimum net capital is, it is not the worst. For that, you have to read about . . .

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[14] The smaller firms would have a point. While many recidivist offenders ply their trade at small firms with low minimum net capital requirements, there are legitimate firms in that category as well. Such firms ought to be able to exist, lest the industry become even more of an oligopoly than it already is. But the bill for protecting small business should not be paid by the most vulnerable and defrauded of investors. Rather, a more socially responsible approach would be to adopt risk-spreading approaches that make it possible to keep entry barriers low while simultaneously assuring that the industry as a whole is financially responsible on a level commensurate with the harm it can cause. See potential solutions 5 and 6, below.

[15] Insurance first appeared thousands of years ago, by at least one account. See Gareth Marples, *The History of Insurance: Risk Through the Ages,* http://www.the-history-of.net/the-history-of-insurance.html.

2. "Investor Education." The U.S. General Accounting Office's 2003 report on matters related to securities arbitration[16] contains a discussion of the unpaid award problem. It also contains, as an attachment, a comment letter from the SEC. The SEC's comment letter – I'm not making this up – contains the following statement:

> "In addition, SEC, NASD and New York Stock Exchange educational materials were amended to alert investors to the risk of unpaid awards, and to reinforce the message that investors should investigate before they do business with a particular firm."[17]

The SEC evidently thinks it's doing its job as long as it informs investors that, if they are ripped off and they prove it by winning an arbitration award, they might not get any actual money back. Apparently, investors – not all investors, just the few who actually will receive and read and understand the implications of the "educational materials" – are supposed to investigate firms' finances and guess whether the firms will be able to respond in damages in the event they bring a claim and obtain an award years in the future.

A non-securities analogy will help put this in perspective. Houses occasionally catch on fire, with resulting losses of lives and property. What do fire departments do about this? They fight fires. They actually go out and extinguish fires and rescue people, sometimes at substantial risk to themselves.

Fire departments prevent fires, too. If their inspections reveal that individuals or businesses are doing things that increase the risk of a fire, they point out the problem and require that the dangerous condition be corrected to comply with fire regulations. In other words, they actually apply their expertise to the suppression and prevention of fires.

Now suppose a fire department, aware that houses were burning down occasionally, decided to fulfill its obligations to the public by doing an "educational outreach." This time, though, instead of telling people what they were required to do to prevent fires, the entire program would consist of warning the public that houses occasionally catch on fire and that lives and property can be lost as a result. What would people think about a fire department that thought it was fulfilling its obligations by doing that?

Does the SEC put out fires by rooting out the worst frauds and ousting their perpetrators from the industry? It does occasionally. But it's significant that the worst scandals of the last decade – boiler room pump-and-dump schemes, Wall Street stock analysts lying to the public to increase their firms' investment

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[16] GAO 2003.
[17] Id. at 18.

banking profits, mutual fund late trading violations – have been caught by state securities regulators and law enforcement authorities rather than the SEC.[18]

The SEC has let some big fires burn out of control. Has it at least taken steps to make sure that those who are burned have a reliable way to be compensated for the harm done by the SEC's errant charges? No. It thinks it can do its job by telling people they might get burned.

The most troubling aspect of this is that there are people who have no chance of being reached by the "investor education."[19] Those individuals most in need of protection, those most vulnerable to depredation by the industry's miscreants, will have "investor education" to thank for their poverty. It would be more honest for the SEC simply to announce that, with respect to frauds committed by underinsured and undercapitalized broker-dealers, it has decided to abrogate the securities laws and return to the bad old days of *caveat emptor*.

Now that we've discussed and dismissed two ridiculous proposals, let's look at some solutions that actually have some potential.

3. SIPC Reform. Reforming the Securities Investor Protection Corporation ("SIPC") to require its insurance pool to pay all unpaid arbitration awards has at least some theoretical appeal. SIPC's risk pool currently exceeds $ 1.2 billion,[20] more than twenty times the total unpaid awards for the last full year for which data are available.[21] And it already has administrative staff in place. (This latter point has a serious downside that will be discussed below.)

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[18] State regulators' effectiveness and the SEC's ineffectiveness may be the real reason for Morgan Stanley's and other large Wall Street firms' attempt last summer to tie the hands of state enforcement authorities. The measure, which appeared in HR 2179 at the subcommittee level, would have preempted state securities laws. It was stopped by a vigilant public. But at a time when the securities industry is crawling with scandal, it is appalling that the measure got as far as it did. That the SEC took "no position" on the measure is disgusting as well. Perhaps it would be better if the SEC were more concerned with protecting investors and less concerned with protecting its turf against state regulators who obviously are doing a better job at protecting the public. See Kathleen Day, *Brokerage Settlement Leaves Much Unresolved*, Washington Post (April 30, 2003), page E01; and Gretchen Morgenson, *As Scandals Still Flare, Small Victories for Investors*, New York Times (September 21, 2003).

[19] Readers should ask themselves if they were aware of the SEC's education initiative. The author of this article was not. If lawyers who emphasize securities arbitration matters in their practices were not aware of the SEC's educational materials, what are the chances that an actual investor, the kind of investor who is vulnerable to predation by bucket shops and the like, will be protected by them?

[20] Securities Investor Protection Corporation 2003 Annual Report, available online at http://www.sipc.org/pdf/2003_Annual_report.pdf and http://www.sipc.org/pdf/2003_Fin_Statements.pdf.

[21] GAO 2003, at 3, 9.

Exposing SIPC to losses from more generalized brokerage industry wrongdoing could have the potential additional salutary effect of ousting the worst miscreants from the industry. For this to work, however, SIPC would need the right to deny coverage to a broker-dealer whose practices or personnel it deemed excessively risky and thereby to render it unlawful for the broker-dealer to operate.

Covering additional exposures might be expected to require an increase in broker-dealers' SIPC premiums. Given the enormous size of SIPC's existing reserves, however, the amount of the increase might be quite small. More importantly, it is both fairer and better for public confidence in the markets for the securities industry to bear the costs of its self-regulatory failures than for it to be permitted to dump those costs on an unsuspecting public.

The more nettlesome problem – the one mentioned parenthetically in the first paragraph of this section – is SIPC's pervasive corporate culture of denying claims. In its liquidations of broker dealers, SIPC frequently spends more money on lawyers' fees, trustees' fees and other administrative costs than it spends compensating investors.[22] Thus, if SIPC is going to be taken seriously as a solution to the problem of unpaid awards, reform will have to include a radical change in its corporate culture. Given the resistance of corporate cultures to change, that may require significant personnel changes as well as unambiguous legislative and regulatory directives.

4. Clearing Firm Liability. Clearing firms often escape liability for introducing firms' misconduct in customers' accounts. Broadening their liability for introducing firm misconduct is another potential solution to the unpaid award problem. It is, however, an incomplete solution.

While most broker-dealers that fail to pay awards probably utilize the services of clearing firms, not all do. Even among those that do, not all problem transactions involve the clearing firm.[23] Thus, many claims will not implicate clearing firms at all. To the extent that those claims turn into unpaid awards, that portion of the unpaid award problem will not be remedied by any amount of clearing firm liability reform.

That incompleteness as a solution does not mean that clearing firms should continue to receive preferential treatment from courts and arbitrators. Preferential treatment never made sense from a logical, legal or policy

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[22] Securities Investor Protection Corporation 2003 Annual Report, available online at http://www.sipc.org/pdf/2003_Annual_report.pdf and http://www.sipc.org/pdf/2003_Fin_Statements.pdf.

[23] For example, a sale of limited partnership interests or unregistered promissory notes would be unlikely to involve the clearing firm.

perspective. Rather, it is a judicial error that, once established, has proven tenacious.

The clearing firms' favored treatment, where it occurs, does not arise from any statutory recognition of a difference between clearing broker-dealers and other broker-dealers. Federal and state securities statutes make no such distinction. In fact, they do not even define "clearing firm."

Instead, the preferential treatment finds its roots in the clearing agreement's allocation of duties and responsibilities between the clearing firm and the introducing broker. The NYSE has given an imprimatur of respectability to those agreements through its Rule 382. But that allocation is a matter between the two firms, one clearing and one introducing. In and of itself, it cannot bind third parties, such as public customers, who have not assented to it.

Indeed, in its enforcement action against Bear Stearns Securities Corporation for its role in the AR Baron fraud, the SEC determined that Rule 382 has no bearing on investors' rights under the federal securities laws. The SEC stated as follows:

> While these rules permit an allocation of responsibility for various functions between the introducing firm and the clearing firm, the Commission has emphasized in the release adopting the 1982 amendments to New York Stock Exchange Rule 382, that "no contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under the federal securities laws and applicable SRO rules." Exchange Act Rel. No. 18497 (Feb. 19, 1982).[24]

Investors' rights under most states' securities laws should be similarly unaffected, because the New York Stock Exchange rules do not preempt state securities laws.

Generally, however, the customer's agreement with the introducing firm contains an express agreement to the allocation of responsibilities. Clearing firms argue that that agreement acts as a limitation on the kinds of errors for which the clearing firm will be liable. By making that argument, however, they are asserting that the agreement acts as a pre-dispute waiver of the clearing firm's liability for harm arising from its violations of state and federal securities laws.

The problem with the clearing firms' argument is that waivers of liabilities arising under federal and state securities laws are unenforceable. See, *e.g.*,

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[24] *In re Bear, Stearns Sec. Corp.*, 1999 WL 569554 at 4 (SEC Aug. 5, 1999).

section 14 of the Securities Act of 1933 (17 U.S.C. section 77n)[25]; section 29(a) of the Securities Exchange Act of 1934 (17 U.S.C. section 78cc(a))[26]; California Corporations Code section 25701[27]; and Uniform Securities Act section 509(l).[28]

Waivers of common law rights in California do not fare much better.[29] Thus, as a matter of law and the clear legislative policy choice the law reflects, exculpatory language should not protect clearing firms even if customers agree

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[25] Section 14 of the Securities Act provides as follows: "Any 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 Commission shall be void."

[26] Section 29(a) of the Exchange Act provides as follows: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."

[27] California Corporations Code section 25701 provides as follows: "Any condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law or any rule or order hereunder is void." And see *Hall v. Superior Court* (1983) 150 Cal.App.3d 411, 197 Cal.Rptr. 757 (rejecting choice of law agreement that would have displaced California securities law).

[28] Uniform Securities Act section 509(l) provides as follows: "(l) [**No contractual waiver.**] A condition, stipulation, or provision binding a person purchasing or selling a security or receiving investment advice to waive compliance with this [Act] or a rule adopted or order issued under this [Act] is void."

[29] California Civil Code section 1668 states as follows: "All contracts which have for their object, directly or indirectly, to exempt one from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law."

See *Blankenheim v. E.F. Hutton & Co., Inc.* (1990) 217 Cal.App.3d 1463, 266 Cal.Rptr. 593: "a contract which exempts a party from liability for his own positive assertions, made in a manner not warranted by the information, which are untrue, is against the policy of the law. In the present case, the hold-harmless agreements attempted to exempt E.F. Hutton from all responsibility for its own misrepresentations. It follows that such an agreement is void as against the policy of the State of California."

See also California Civil Code section 3513: "Any one may waive the advantage of a law intended solely for his benefit. But a law established for a public reason cannot be contravened by a private agreement."

Additionally, see *County of Riverside v. Superior Court* (2002) 27 Cal.4th 793, 42 P.3d 1034, 118 Cal.Rptr.2d 167 (construing the statute and concluding, "The waiver of an important right must be a voluntary and knowing act done with sufficient awareness of the relevant circumstances and likely consequences.").

Furthermore, California applies the longstanding principle disfavoring attempts to gain immunity: "The law does not look with favor on attempts to avoid liability or secure exemptions for one's own negligence, and such provisions are strictly construed against the person relying on them." *Basin Oil Co. of Cal. v. Baash-Ross Tool Co.* (1954) 125 Cal.App.2d 578, 271 P.2d 122.

to the limitation. Casting the illegal waiver as an "allocation of responsibilities" should not change the result. All that should matter is the legal effect. Courts should not be fooled by the way in which it is phrased.

Clearing firms made the micro cap stock frauds of the 1990s possible. In an extensive report on micro cap fraud, New York Attorney General Dennis Vacco stated that "[m]icro-cap brokerage firms can only exist by processing their transactions through the road provided by the clearing firms."[30] The key to those operations was the ability to spring up, steal money from customers through pump-and-dump schemes, and disappear before significant numbers of customers could collect on their arbitration awards. If they had been more broadly liable for the misconduct of their introducing firms, the clearing firms might have been far more reluctant to lend their names, reputations, services and market access to those boiler rooms. The result undoubtedly would have been far less micro cap fraud than actually occurred. And even if, contrary to intuition, that broader liability had not reduced the volume of fraud, it would have compensated savers for losses they incurred as a result of the frauds that the clearing firms made possible.

Like the recovery fund, mandatory insurance and SIPC reform (proposed solutions 6, 5 and 3), broader clearing firm liability has the potential to prevent harm. If clearing firms had greater liability for misconduct in their customers' accounts, they would be forced either (1) to be far more cautious about entering into clearing arrangements with introducing firms or (2) to require their introducing firms to purchase liability insurance. Either way, miscreant firms and new firms staffed excessively by personnel with undesirable compliance histories would find it impossible or prohibitively expensive to establish the clearing relationships necessary to their existence. Thus, certain kinds of frauds – including micro-cap / boiler room frauds like those of the 1990s – would become far more difficult to perpetrate. But the benefit would be short-lived if other frauds not dependent on clearing services took their place. Thus, the reform could turn out to morph fraud rather than reducing it.

There is no reason in law or social policy for the preferential treatment of clearing firms to continue. Reform is desirable on that ground alone. For the reasons above, however, this cannot serve and should not be viewed as an acceptably complete solution to the problem of unpaid awards.

5. Mandatory Insurance. This approach has the advantages of being familiar, conceptually simple and reasonably well understood. While it does not

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[30] New York State Attorney General Dennis C. Vacco, *Report on Micro-cap Stock Fraud*, Bureau of Investor Protection and Securities (December 1997), Chapter 0. See also the extensive discussion of clearing house practices in chapter 8 of that document. And see *Clearing Firms, the Uniform Securities Act and Koruga v. Fiserv Correspondent Services, Inc.*, PLI Securities Arbitration 2001 (August 2003).

offer all of the advantages of the recovery fund (approach number 6, below), it is a practical and potentially complete solution to the problem of unpaid awards.

There are no real arguments against this approach. Lacking factual or rational objections, some detractors have tried to suggest in meetings between industry representatives and the investor bar that no insurance company would be willing to write errors and omissions policies for brokerage firms. The fallacy of that position is evident on its face: broker-dealer liability policies already exist. Several large insurance carriers write them. They have been available for years.

Many broker-dealers and representatives already are covered by errors and omissions policies.[31] "High-payout" brokerage firms are particularly likely to have insurance coverage.[32] So are responsible smaller firms. The suggestion that the insurance industry will not be interested in an even larger book of business is absurd.

Indeed, making coverage mandatory should make the field more attractive to insurers, because it would eliminate the adverse selection problem that arises when insureds are permitted to decide who buys coverage and who does not.

A representative of Marsh & Co., a huge insurer interested in this market, stated at the NASD's Fall Securities Conference in 2002 that Marsh's actuaries calculate that premiums per registered representative would drop industry-wide under a program of mandatory insurance. She also said that Marsh and other insurers have been trying for years to interest the NASD in such a program, but that they have met with indifference and rejection.[33]

The reasons why the NASD does not require all of its members to carry errors and omissions insurance or otherwise show proof of financial responsibility appear to be inertia and politics. Enhancing investor protection has not entered the discussion. It's time that it does.

Some firms undoubtedly would be exempt from a mandatory insurance program by virtue of their ability to self-insure. That is acceptable as long as the financial standards are appropriate.[34]

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[31] See, generally, Scot Bernstein, *Broker Liability Insurance from the Claimant's Perspective*, *PLI Securities Arbitration 2003*, August 2003.

[32] It is easy to understand why high-payout firms frequently make sure that they are covered by errors and omissions insurance. High-payout broker-dealers typically have numerous small (often one-person) offices that pay all of their own expenses and, in return, receive eighty to ninety percent of the commissions that they generate. The broker-dealer, with its correspondingly small percentage of the commissions from its representatives' operations, understandably will insist upon having the risks of those operations covered by insurance.

[33] C. Thomas Mason, personal communication.

[34] For an analysis of the interplay between assets and insurance, see Steven Shavell, *Minimum Asset Requirements and Compulsory Liability Insurance As Solutions to the Judgment-Proof Problem,* NBER Working Paper No. w10341, http://papers.nber.org/papers/W10341, March 2004.

The fact that insurance for some firms will be very expensive because of their disciplinary and/or claims histories or the histories of their personnel is acceptable as well. If the discipline of insurance underwriting prevents rogue firms and problem brokers from remaining in the industry and mishandling people's life savings, it will solve a large problem that the SEC has been unable to fix. And it will be using a market mechanism to achieve its result, leaving regulatory budgets unimpaired.[35]

The mandatory insurance approach is consistent with public expectations. I cannot count the number of times that my potential and new clients – and numerous others in casual conversations – were astonished to learn that stockbrokers are not required to carry liability insurance.

A further advantage is that a mandatory insurance requirement, once adopted, may be more secure in its continued existence than other proposed solutions to the problem of unpaid awards. It would not be surprising to see the securities industry attempt to end any solution that is adopted as soon as it senses that the political heat is off or that the public is otherwise occupied. After all, the securities industry collectively saves tens of millions of dollars each year by not paying awards. But if the securities industry attempts to terminate a mandatory insurance requirement, it will face a hurdle in addition to public opposition: the insurance industry's financial incentive to keep its market intact.

For mandatory insurance to succeed as a long-term solution, regulators and the public would have to prevent it from acquiring characteristics contrary to its purpose. For example, insurance companies' corporate culture of denying claims whenever and wherever possible would have to be subjected to tight controls. One such control would be to adopt a standard policy form with very limited exclusions.

But insurance companies will only go so far in eliminating exclusions. Traditional concerns of insurance economics, most notably moral hazard,[36] will

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[35] Regulators would need to share relevant information with the insurers. Shavell reminds us, "Liability insurance requirements tend to improve parties' incentives to reduce risk when insurers can observe levels of care, but dilute incentives to reduce risk when insurers cannot observe levels of care." Id.

[36] One participant in discussions among regulators, securities industry representatives and the investor bar has suggested that the possible increased willingness of investors' lawyers to accept cases made collectible by successful reform of the unpaid award problem (such as cases against bucket shops and the like) would constitute a "moral hazard." The remark demonstrates a misunderstanding of the meaning of moral hazard. Moral hazard refers to the increased tendency of individuals and entities to engage in loss-prone activities when insurance will cover the resulting losses. Any increase in attorneys' willingness to represent victims of securities industry fraud and wrongdoing clearly does not fit the definition. More importantly, if regulators or the industry are suggesting that it is somehow immoral to represent victims of securities industry predation – many of whom are elderly retirees – something is very wrong. Indeed, if there is a moral hazard at all, it is on the part of an industry that begged for the opportunity to self-regulate

govern their willingness to accept certain policy provisions. Deliberate fraud is commonly excluded from insurance on the reasonable public policy ground that a wrongdoer should not be able to shift the burden of his own intentional misconduct. Yet fraud, theft, and other commonly excluded wrongs are among the very harms against which consumers need protection.

Some litigation over coverage issues will be inevitable, and some investors will be left with uncollectible awards as a result. Further, coverage battles and political and regulatory controversies over the contents of the standard policy might be expected to increase over time, as insurance companies slowly and inexorably pressure regulators to allow policies that are ever more protective of the insurers' interests and correspondingly less protective of investors.

Other coverage gaps may arise as well. Consider, for example, the lack of coverage and the unpaid awards that will result when a broker-dealer does not keep its insurance in force and continues its operations illegally for a period of time. A license suspension for nonpayment of premiums, even if quick, will not be instantaneous. The result will be that some awards will go unpaid.

Mandatory insurance also shares one of the problems discussed above regarding net capital requirements: How much is enough? Arbitrary coverage amounts, like $1 million per incident and $5 million per year, inevitably will be too little to provide compensation when the representative or firm has multiple victims or when the misconduct harmed large accounts, like pension funds. Securities regulators evaluating a mandatory errors and omissions insurance program should not repeat the mistakes made in mandatory auto insurance programs. More complex formulae, such as uniform basic levels with increased coverage amounts based on assets under management, would provide better investor protection. However, insurance coverages that depend on individual members' self-reporting of fluctuating values are inevitably fraught with trouble.

Coverage disputes, policy cancellations, policy limits, and policy restrictions have the potential to make mandatory insurance a less complete and less desirable solution than the recovery fund approach described below in item 6. That said, however, mandatory insurance remains a good and relatively thorough approach, probably the second best solution to the securities industry's absurd problem.

6. Recovery Fund. The simplest, most thorough, and probably best approach would be to require each of the more than 650,000 registered representatives in the United States to contribute annually to a recovery fund for

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and then failed abjectly in doing so because defrauded investors were absorbing the cost of (and thus were acting as a *de facto* insurance policy covering) many of the industry's self-regulatory failures.

unpaid awards.[37] Even an annual contribution of just $200 per registered representative would raise more than $130 million each year.[38] That number will exceed the total unpaid awards if the problem continues at the first-quarter 2003 rate of $120 million per year.

Thus, the per capita contribution that enables the industry to clean up its own mess is minimal – a small price to pay for the privilege of participating in a lucrative industry.[39] That alone makes the recovery fund a desirable solution to the problem. It is difficult to imagine, for example, that an insurance policy offering broad coverage and high limits could be offered at a lower per-capita cost.

The recovery fund approach will work on a long-term basis, however, only if it has political permanence. It must become something of a sacred cow, an essential component of capital markets that want to remain the envy of the world. Regulators and America's 91 million investors[40] therefore must demand that the industry not be permitted to reduce or eliminate mandatory recovery fund contributions, something the industry otherwise might be expected to attempt as soon as the political heat is off.

Further, exemptions from the obligation to contribute to the fund must be nonexistent or extremely limited. Large Wall Street firms undoubtedly will argue that, because they can afford to pay the awards against them, their representatives should not be required to contribute.[41] But if too many registered

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[37] The NASD website states that "[r]oughly 5,500 brokerage firms, nearly 90,000 branch offices, and more than 650,000 registered securities representatives come under our jurisdiction." The page so stating is available at http://www.nasd.com/member_info/member_ov.asp.

[38] The entire first year's funding could be satisfied by a contribution from the salary of a single securities industry professional: NYSE president Richard Grasso.

[39] The website for Registered Rep magazine, a securities industry magazine catering to registered representatives of broker-dealers, states as follows: "Generally speaking, brokers are rewarded well for their efforts, according to the survey. Respondents have an estimated average income of $180,300 and an estimated average household net worth of $1,072,000." Samaripa, Janis, *Your World*, Registered Rep (Nov. 1, 2000), available at http://registeredrep.com/mag/finance_world/index.html.

[40] The Investment Company Institute states that mutual funds alone boast 91 million American investors: "Today, more than 91 million investors in over 53 million U.S. households own mutual fund shares." *Statement of the Investment Company Institute on the U.S. Securities and Exchange Commission's Appropriations for Fiscal Year 2005*, Investment Company Institute Mutual Fund Connection (March 31, 2004). The statement is available online at http://www.ici.org/issues/fserv/04_house_budg_tmny.html.

[41] The large firms can be expected to trot out their usual "moral hazard" argument as well. They will assert that a fund that covers liabilities of small firms creates an incentive for those who run small firms to take excessive risks. The weakness of the large firms' argument is self-evident: it

representatives are exempted from making contributions to the fund, the contributions required of those remaining in the pool may become so large as to make the concept nonviable. This is the proposed fund's analog to the classic problem of insurance pool economics known as adverse selection. Breadth of the pool is essential to its survival.

It also is fair. If the industry is to be allowed to continue to self-regulate, it cannot selectively impose the cost of its most inexcusable mess on those members of the public whose only mistake was to trust miscreants that represent the failure of that self-regulation. Indeed, any scheme of self-regulation that does not include a means of covering those losses is inherently incomplete and thus defective.

An additional characteristic necessary to keep the fund viable will be some sort of size limit on single-case recoveries. Otherwise, one or a few very large awards could bankrupt the fund.

Consistent with limitations on claim size, the fund's design also should include a decision regarding whether and to what extent punitive damages will be treated differently from compensatory damages. One approach would be to provide that the fund would pay punitive portions of awards only after it had satisfied all of its other payment obligations for the calendar year. A modified version of this would subject only a portion of punitive damages – for example, the amount of punitive damages exceeding one hundred percent of the compensatory portion of an award – to such a limitation.

Apart from limitation rules with relatively automatic and non-subjective application, however, the fund's administration should be kept as simple and inexpensive as possible. Second-guessing of arbitration awards should not be permitted; the fund's procedures should not create new standards for *de facto* vacatur not found in the Federal Arbitration Act. Rather, arbitration awards that are not paid by respondents should be paid by the fund as a matter of course.

The fund, in turn, should become the owner of the portion of the award that it has paid and should have a priority lien against the respondents' assets for those sums. That will enable the fund to pursue miscreant brokers aggressively for the amounts it has paid, much as an insurance company is subrogated to the claims of its insureds. Further, nonpayment of the subrogated claim to the fund should carry the same consequences for the nonpaying respondent as nonpayment of any other award: suspension from the industry.[42]

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was the firms themselves that asked for the right to self-regulate. With the benefits of the right to self-regulate go the burdens. It will be incumbent upon the industry to exercise its self-regulatory power to prevent the abuse that purportedly will be incentivized by the supposed "moral hazard." What is not acceptable is the status quo, in which the industry expects those it defrauds to bear the burden of its self-regulatory failures.

[42] Some industry participants will object to this feature because it offers them no protection against liability, and they may prefer mandatory insurance for that reason. But that preference

Perhaps most importantly, the staffing and corporate culture of the fund should reflect unyieldingly its purpose of making good on the industry's obligations. Personnel trained in a corporate culture of denying claims should have no role in the fund's organization or structure and should be kept far, far away.

Geographic Scope of the Proposed Solutions

Investors nationwide are harmed and unable to collect on arbitration awards. Because of that, there might be a tendency to think that the solutions described above must be adopted on a national or industry-wide basis. Apart from reforming SIPC, however, that isn't necessarily so. Indeed, the demonstrated glacial speed and general ineffectiveness of the SEC and the federal government in protecting investors, particularly since the midterm-elections of 1994, make it imperative that states explore actions they may be able to take to protect their own citizens.

That exploration should include careful consideration of the potential impact of NSMIA. A state adoption of the recovery fund approach, for example, might need to be funded through registered representatives' state license fees, rather than being funded separately. What is clear, though, is that states need to take whatever action they can to protect their citizens from predation by an industry that refuses to take responsibility for the harm that some of its members inflict on the public.

Conclusion

This article has explored six proposed solutions to a problem that should not even exist: the inability of the industry that handles people's life savings to pay for fully half of the judgments against it for its misconduct. The last two approaches – mandatory insurance and a recovery fund – are the most all-encompassing, thorough and practical. They are the most beneficial to the investing public and, by virtue of the legitimate trust they will engender, the securities industry and the capital markets. That does not mean, however, that at least one of the other approaches – an expansion of clearing firms' liability for the harm they make possible – should not occur simultaneously.

Unpaid awards are a huge and inexcusable problem – a problem that must be solved.

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should not drive the choice. Those industry participants who desire protection against risk are free to purchase insurance voluntarily.

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