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Blue Skies Ahead: Auction Rate Securities and the Need for a Private Right of Action for New York Investors

Stephanie Myers*

The United States' failing economy is in the news every day. In response to the economic disaster looming on the horizon, the United States government passed a bailout plan. The financial industry bears partial blame for the crisis, due in part to the risky investments that the firms had backed and marketed to investors. Investments such as Auction Rate Securities ("ARS") are a prime example, as the market for ARS is upwards of $330 billion and it became illiquid as of February 2008.[1] A lay-investor has difficulty understanding this type of investment; some might even say that the brokers who sold these securities did not fully understand ARS and the way they performed in the market.

This Comment discusses ARS and the settlements that securities regulators have reached with various brokerage firms in the face of allegations that they misrepresented the risks associated with ARS to investors. The settlements will return to liquidity the ARS holdings of tens of thousands of customers. However, not all customers are covered by the settlements; those who are not must resort to filing a lawsuit or arbitration claim against their brokers and brokerage firms to recover their illiquid investments. For reasons explained below, ARS investors will be hard-pressed to bring a successful

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* Pace University School of Law, J.D. candidate, 2010. I would like to thank Professor Jill Gross both for her insight into this topic and for her continued support and encouragement in all of my endeavors.

1. *See Bank of America in Auction-Rate Securities Settlement*, PHILADELPHIA BUS. J., Sept. 10, 2008, *available at* http://www.bizjournals.com/philadelphia/stories/2008/09/08/daily22.html. *See also* Melanie Cherdack & Daniel A. Ball, *Auction Rate Securities: The New Frontier*, *in* PRACTISING LAW INST., CORPORATE LAW & PRACTICE COURSE HANDBOOK SERIES 335 (2008), *available at* WL1686 PLI/Corp335.

claim under federal securities laws and must therefore rely on state securities laws.

Due to the differing state securities laws, investors in some states will likely be able to recover their investments, while investors in New York will probably not. This is due to New York's unique Martin Act[2] and the fact that New York investors must rely on common law causes of action as the basis for their suits.[3] Is it fair that New York investors are at such an extreme disadvantage simply because the New York State legislature has failed to grant investors a private right of action? This Comment's position is that it *is* unfair; and accordingly, seeks to urge the Legislature to adopt a version of the Uniform Securities Act of 2002.[4] A hypothetical example of an entirely unsophisticated investor, Sarah, a New York resident who inherited a substantial sum of money from a family member and is convinced by a broker to invest the money in ARS, demonstrates the need for such a statute. If Sarah were a resident of almost any other state instead of New York, she would likely recover her investment. However, as a resident of New York, she will presumably have little recourse.

I. Auction Rate Securities

A. *Background*[5]

"Auction-rate securities are variable-interest rate, long-term securities that were marketed to individual, retail investors and institutional investors as cash equivalents by many of Wall Street's leading financial institutions."[6] Cash equivalents are investments many consider to be "liquid,"

2. *See generally* N.Y. GEN. BUS. LAW §§ 352-359-h (McKinney 1996).

3. *See* discussion *infra* Part III(A).

4. *See generally* UNIF. SEC. ACT (2002).

5. *See generally* STEPHANIE LEE, NERA ECON. CONSULTING, AUCTION-RATE SECURITIES: BIDDER'S REMORSE? A PRIMER 10 (2008), *available at* http://www.mmc.com/knowledgecenter/NERA_PUB_Auction_Rate_Securities.pdf ("The first ARS was registered by American Express in July 1984. The instrument was conceived by Ronald Gallatin, managing director of new product development in the Lehman Brothers Unit of Shearson Lehman/American Express.").

6. Sean T. Seelinger, *Auction-Rate Securities: A Fast & Furious Fall*, 13 N.C. BANKING INST. 287, 287 (2009).

meaning investors may sell them very easily.[7] Investors were tempted by ARS because the securities typically paid a higher yield than other "liquid" investments.[8]

> There generally are two types of ARS, bonds with long-term maturities (20 to 30 years) and preferred shares with a cash dividend. Both the interest on the bonds and the dividend on the preferred shares are variable based on rates that are set through auctions for a specified short term usually measured in days—7, 14, 28, or 35.[9]

B. *Dutch Auctions*

Holders of ARS have several choices before each auction: investors can choose to hold their current position at a specified rate, sell their ARS, or hold their ARS at the newest prevailing rate established at auction.[10] The issuers of the ARS hold dutch auctions, which are:

> [O]pen bidding process[es] in which the issuers announce[ ] [their] intention[s] to offer a fixed quantity of shares and solicit[ ] bids from investors who are interested in participating. Each potential investor submits a bid specifying how many shares he or she is willing to buy and at what price, and these bids become irrevocable and binding at the close of the bidding period.[11]

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7. *See The SEC's Recent Actions With Respect to Auction Rate Securities: Hearing Before the H. Comm. on Financial Services.*, 110th Cong. (2008) (statement of Linda Chatman Thomsen, Director, Division of Enforcement, SEC), *available at* http://www.sec.gov/news/testimony/2008/ts091808lct.htm [hereinafter *The SEC's Recent Actions*]. *See also* Eric Dash & Louise Story, *2 Banks Buying Back Securities*, N.Y. TIMES, Aug. 8, 2008, at C1.

8. Aaron Pressman, *Auction-Rate Securities: How to Get Unstuck*, BUS. WK., June 2, 2008, at 76.

9. Financial Industry Regulatory Authority, Auction Rate Securities: What Happens When Auctions Fail, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P038207 (last visited Feb. 10, 2010).

10. *Id.*

11. Lucas C. Townsend, Comment, *Can Wall Street's "Global Resolution"*

The issuer begins by accepting the bids "with the lowest interest or dividend rate . . . first, followed by successively higher bids until all the securities available for auction are sold."[12] The last bid determines the "'clearing rate,' . . . [which is the rate that will apply] to all [of] the ARS until the next auction."[13] The auction will fail if there are not enough bids to purchase all of the ARS for sale.[14]

C. *Failing Auctions*

ARS auctions began failing in February, 2008.[15] Prior to the failed auctions, "[t]o maintain liquidity, financial institutions bid on their own securities, creating a false sense of demand in the minds of investors."[16] Once the crux of the credit crisis hit, however, the demand for ARS declined and the firms no longer had sufficient capital to provide supporting bids.[17] Without the brokerage firms' bids, the auctions began to fail because there were not enough buyers to purchase all of the ARS that were up for sale at each auction.[18]

Prevent Spinning? A Critical Evaluation of Current Alternatives, 34 SETON HALL L. REV. 1121, 1163 (2004).

12. Financial Industry Regulatory Authority, *supra* note 9.

13. *Id.*

14. *Id.*

15. During the week of February 15, 2008, almost 1,000 of the ARS failed. Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, N.Y. TIMES, Feb. 15, 2008, at C6. On February 22, 2008, 258 out of 386, or 67%, of auctions failed. Jeremy R. Cooke, *Florida Schools, California Convert Auction-Rate Debt*, BLOOMBERG.COM, Feb. 22, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=awCJRyi5ngcQ&refer=us. This is an overwhelming figure considering the fact that only forty-four auctions had ever failed between the advent of ARS in 1984 and the end of 2007. *Id.*

16. *See* Seelinger, *supra* note 6, at 288. *See generally* Martin Z. Braun & William Selway, *UBS Won't Support Failing Auction-Rate Securities*, BLOOMBERG.COM, Feb. 14, 2008, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aa0bS7QZqvlk.

17. *See* Braun & Selway, *supra* note 16. *See also* Seelinger, *supra* note 6, at 295-98 (explaining in detail the economic events leading up to the failed auctions).

18. *See* Amod Choudhary, *Auction-Rate Securities = Auction Risky Securities*, 11 DUQ. BUS. L.J. 23, 30-31 (2009).

When an auction fails, investors do not "lose" their investments. The security is simply illiquid, meaning that the money is still invested in the bond or preferred share, but that the investor cannot access it.[19] As brokers often marketed the ARS as liquid, many investors counted on being able to pull out of the market at any time when they needed the invested money for other purposes.[20] When auctions fail, investors endure financial hardship because their invested money is not available for their use.[21] Investors have several options when faced with an illiquid ARS: they may hold until there is a successful auction, borrow money from the firm using the ARS as collateral, sell the security at a loss on a secondary market (if one is available), or wait for the investment to mature—which, in the case of a 20-30 year bond, is an extreme burden on the investor.[22]

None of the above alternatives are ideal for the average investor. Should the investor choose to wait until a successful auction, his or her money will be unavailable and in the market for an unspecified amount of time. While the market is illiquid, however, the investor does continue to receive interest at the highest "fail rate."[23] Borrowing money from the firm is also unadvisable. While the loan may give the investor a temporary supply of cash, some loans charge interest rates that are higher than the yield the investor would receive on the actual ARS.[24] Selling on a secondary market could cause the investor to lose a large portion of the investment, as the illiquidity of the market makes it highly unlikely that buyers would be willing to pay a fair value.[25] Firms marketed ARS to investors as a highly liquid investment, and therefore, most

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19. Financial Industry Regulatory Authority, *supra* note 9.

20. *The SEC's Recent Actions*, *supra* note 7.

21. *Id.*

22. Financial Industry Regulatory Authority, *supra* note 9. Note that for customers who can afford to hold an illiquid investment, many ARS are a great investment because the fail rates are soaring due to the failed auctions. *See* Anderson & Bajaj, *supra* note 15.

23. Financial Industry Regulatory Authority, *supra* note 9. A fail rate is "an interest rate or dividend set above market rates [that the investor continues to receive] for the next holding period—up to any maximum disclosed in the offering documents." *Id.*

24. Financial Industry Regulatory Authority, *supra* note 9.

25. *Id.*

investors are unable to wait twenty to thirty years, until the security matures in order to have access to their invested funds.

When the $330 billion ARS market froze and became illiquid in early 2008 due to failed auctions, investor complaints began flooding into federal securities regulators such as the Financial Industry Regulatory Authority ("FINRA") and the Securities and Exchange Commission ("SEC"), as well as to state securities regulators.[26] Investors claimed that the brokerage firms who sold the ARS did not explain the liquidity and investment risks associated with the product.[27] Regulators claimed that "in late 2007 and early 2008, the firms knew that the ARS market was deteriorating, causing the firms to have to purchase additional inventory to prevent failed auctions."[28] The firms, however, continued to market ARS to customers, allegedly knowing that they were not going to have sufficient capital in the long-term to continue to provide supporting bids.[29] Whether or not the firms and individual brokers knew of the repercussions that would follow a cessation of supplying supporting bids is a question that has yet to be affirmatively answered.

II. ARS Settlements

A. *Results of Regulatory Authorities*

Due to the large number of ARS investor complaints reported to securities regulators, many industry regulators and enforcement agencies began investigating the ARS markets

26. *The SEC's Recent Actions*, *supra* note 7. *See also* Press Release, Fin. Indus. Regulatory Auth., FINRA Announces Agreements in Principle With Five Firms to Settle Auction Rate Securities Violations (Sept. 18, 2008), *available at* http://www.finra.org/Newsroom/NewsReleases/2008/P117019.

27. *See* Seelinger, *supra* note 6, at 288 (explaining that brokers failed to disclose to investors that the issuing firms were supplying supporting bids at auction, and that without those bids the auctions would likely fail and the markets would be in jeopardy). *See also* Press Release, Sec. & Exch. Comm'n, SEC Finalizes ARS Settlements With Citigroup and UBS, Providing Nearly $30 Billion in Liquidity to Investors (Dec. 11, 2008), *available at* http://www.404.gov/news/press/2008/2008-290.htm.

28. Press Release, Sec. & Exch. Comm'n, *supra* note 27.

29. *The SEC's Recent Actions*, *supra* note 7.

and the firms' roles in the markets' illiquidities. After these investigations, the SEC and some state securities regulators filed complaints in federal district courts against several large firms.[30] The allegations related first to the failure of the firms to adequately explain the risks associated with ARS to investors, and second, to the firms' continued selling of ARS to investors while knowing that the market was likely to fail if the firms discontinued supplying supporting bids.[31] Several large firms have agreed to settle these charges. As of December 2008, "[t]he SEC ha[d] announced final ARS settlements with Citigroup Global Markets, UBS Financial Services and UBS Securities, while FINRA ha[d] reached final settlements with WaMu Investments and First Southwest Company.[32] In 2009, the SEC reached final ARS settlements with: Bank of America, RBC, Deutsche Bank and Wachovia.[33] The settlements and agreements vary in principle, but the main aspects of each are similar, with each firm neither denying nor admitting liability.

B. *Citigroup Global Markets Settlement With SEC*

This Comment will focus on Citigroup's ("Citi") final settlement as an example.[34] The settlement provides approximately $7.5 billion in liquidity to Citi customers.[35] "Citi

30. *See, e.g.*, *State Sues Schwab Over Auction-Rate Securities*, N.Y. TIMES, Aug. 18, 2009, at B6.

31. *Id.*

32. Press Release, Fin. Indus. Regulatory Auth., FINRA Provides Details on Special Arbitration Procedures For ARS Consequential Damages (Dec. 16, 2008), *available at* http://www.finra.org/Newsroom/NewsReleases/2008/P117557. *See also* Press Release, Fin. Indus. Regulatory Auth., *supra* note 26.

33. The Securities and Exchange Commission website provides links to access the complaints and consents pertaining to the ARS settlement it reached with each company. *See* Securities and Exchange Commission, Auction Rate Securities, http://www.sec.gov/investor/ars.htm (last visited Feb. 17, 2010).

34. Citi was the first to settle and its agreement has served as a model for other companies. However, each firm's agreement is likely to be slightly different in detail. Actual settlements are of course subject to court approval. *See* Consent Decree, Sec. & Exch. Comm'n v. Citigroup Global Mkts., No. 08 Civ. 10753, (S.D.N.Y. Dec. 11, 2008), *available at* http://www.404.gov/news/press/2008/2008-290-citiconsent.pdf.

35. *See id.* *See also* Press Release, Sec. & Exch. Comm'n, Citigroup

will offer to purchase ARS at par from individuals, charities, and small businesses that purchased those ARS from Citi, even if those customers moved their accounts."[36] Eligible customers are those who purchased ARS through Citi on or before February 12, 2008, and held those securities in a Citi account on February 12, 2008.[37] The Citi customers who took out a loan to satisfy their cash needs will be reimbursed for the interest expense that they were forced to pay for the loan, less what interest they collected from the underlying ARS.[38] ARS customers who sold their holdings on a secondary market at a loss will be reimbursed for "the difference between par and the price at which the Eligible Customer sold the auction rate securities, plus reasonable interest thereon."[39] Citi is also required to find liquidity solutions for other customers whom it will not make offers to repurchase the ARS.[40] Citi is not allowed to make its own ARS investments liquid before it does

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Agrees in Principle to Auction Rate Securities Settlement (Aug. 7, 2008), *available at* http://www.sec.gov/news/press/2008/2008-168.htm. The UBS settlement provided approximately $22.7 billion in liquidity to eligible customers who purchased ARS through UBS. Press Release, Sec. & Exch. Comm'n, *supra* note 27.

The following is a list of the firms that have reached agreements in principle with the SEC and the amount of ARS they have agreed to buy back from their customers: Bank of America, $4.5 billion, *see* Press Release, Sec. & Exch. Comm'n, Bank of America Agrees in Principle to ARS Settlement (Oct. 8, 2008), *available at* http://www.404.gov/news/press/2008/2008-247.htm; RBC, $800 million, *see* Press Release, Sec. & Exch. Comm'n, SEC Division of Enforcement Announces ARS Settlement in Principle with RBC Capital Markets, Inc. (Oct. 8, 2008), *available at* http://www.404.gov/news/press/2008/2008-246.htm; Merrill Lynch, $1.5 billion, *see* Press Release, Sec. & Exch. Comm'n, SEC Enforcement Division Announces Preliminary Settlement with Merrill Lynch to Help Auction Rate Securities Investors (Aug. 22, 2008), *available at* http://www.404.gov/news/press/2008/2008-181.htm; Wachovia, $9 billion, *see* Press Release, Sec. & Exch. Comm'n, Wachovia Agrees to Preliminary Auction Rate Securities Settlement that Would Offer Approximately $9 Billion to Investors (Aug. 15, 2008), *available at* http://www.404.gov/news/press/2008/2008-176.htm.

36. Press Release, Sec. & Exch. Comm'n, *supra* note 27.

37. Consent Decree, *supra* note 34, at 2. *See also* Morgan Stanley Smith Barney, Auction Rate Securities, Practices and Procedures of Citigroup Global Markets Inc., https://www.smithbarney.com/products_services/fixed_income/auction_rate_securities/ (last visited Feb. 10, 2010).

38. Consent Decree, *supra* note 34, at 8-9.

39. *Id.* at 9.

40. *Id.* *See also* Press Release, Sec. & Exch. Comm'n, *supra* note 27.

so for its customers.[41]

Some ARS investors turned to the secondary market when the auctions began to fail. The ARS sold for a price lower than par value, resulting in a loss to the investor.[42] Citi is required to reimburse those eligible customers for the difference between the par value of the ARS and the value the customer actually sold it for.[43] When the market froze, many brokerage firms began to allow their customers to borrow cash on margin to make up for their illiquid investments.[44] However, the interest rate on those loans may have been higher than the rate of return on the underlying ARS.[45] Citi now will reimburse its customers for the amount of the interest payments that exceeded the return on the ARS investment.[46] However, the settlement does not require Citi to reimburse customers for any consequential damages[47] they may have suffered while their investment was illiquid.[48]

C. *FINRA's Special Arbitration Procedures*

When an investor wishes to dispute an action taken by his or her brokerage firm, the investor may file a lawsuit or an arbitration claim to resolve the discrepancy. FINRA has announced special arbitration procedures for customers covered by the ARS settlements that will allow those customers to pursue claims for consequential damages.[49] Under the special procedures, the investor has the option to file for any

41. Consent Decree, *supra* note 34, at 9-10. *See also* Press Release, Sec. & Exch. Comm'n, *supra* note 27.

42. Darrell Preston, *Banks Say Auction-Rate Investors Can't Have Money*, BLOOMBERG.COM, June 6, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=aWaReGVrnTHk. *See also* Financial Industry Regulatory Authority, *supra* note 9.

43. Consent Decree, *supra* note 34, at 9. *See also* Press Release, Sec. & Exch. Comm'n, *supra* note 27.

44. *See* Financial Industry Regulatory Authority, *supra* note 9.

45. *See id.*

46. Consent Decree, *supra* note 34, at 8-9. *See also* Press Release, Sec. & Exch. Comm'n, *supra* note 27.

47. Consequential damages are those "[l]osses that do not flow directly and immediately from an injurious act but that result indirectly from the act." BLACK'S LAW DICTIONARY 333 (8th ed. 2004).

48. Consent Decree, *supra* note 34, at 10-11.

49. Press Release, Fin. Indus. Regulatory Auth., *supra* note 32.

opportunity costs he or she suffered as a result of the market becoming illiquid.[50] There are several benefits to an investor who chooses to file under the special procedures. The greatest advantage is that the "firms cannot contest liability related to the illiquidity of ARS holdings . . . including any claims of misrepresentations or omissions by the firm's sales agents."[51] The firms also may not defend against the consequential damages claim by invoking the customer's decision to refuse the loan that the firm offered him or her prior to the settlement.[52] The firms are responsible for paying all fees associated with the filing of a claim, such as filing fees and hearing session fees.[53] In addition, the forum will appoint one arbitrator to hear consequential damage claims which demand less than one million dollars.[54] Once the investor proceeds under the special arbitration procedures, he or she is barred from pursuing a claim for further relief in another forum.[55] If the investor would like to recover punitive or other damages, he or she may choose to file a claim under the standard arbitration procedures.[56]

D. *Investors Not Covered by Settlements*

While the settlements and special arbitration procedures will remedy the harm suffered by some ARS investors, "investors that bought from medium-size and online brokerages, a.k.a 'downstream sellers' in the secondary market, and those that bought structured auction rate notes, are among the investors not covered in the regulator's settlement."[57] Regulators only achieved settlements with the largest, most well-known ARS-issuing firms, while many investors

50. *Id.* An opportunity cost is "[t]he costs of acquiring an asset measured by the value of an alternative investment that is forgone." BLACK'S LAW DICTIONARY, *supra* note 47, at 295.

51. Press Release, Fin. Indus. Regulatory Auth., *supra* note 32.

52. Consent Decree, *supra* note 34, at 11.

53. *See* Press Release, Fin. Indus. Regulatory Auth., *supra* note 32.

54. *See id.*

55. Consent Decree, *supra* note 34, at 11.

56. *See* Press Release, Fin. Indus. Regulatory Auth., *supra* note 32.

57. Structured Auction Rate Notes, Downstream Sellers, Consequential Damages, Oh My!, http://www.zamansky.com/blog/2008/09/structured-auction-rate-notes.html (Sept. 5, 2008, 12:36 EST).

purchased ARS from smaller brokerage firms that are not being pushed by regulators to settle.[58] These smaller firms defend their selling of ARS by declaring that the issuing firms never explained the risks to the brokers who were actually selling ARS.[59] The "downstream" sellers claim they did not know that the issuing firms were controlling the market by providing supporting bids.[60] Some ARS customer lawyers claim that these sellers either knew or purposely shielded themselves from discovering the actual risks associated with ARS.[61] It is not yet clear whether the industry regulators will hold downstream sellers responsible for their role in customer purchases of ARS.[62]

Large institutional and corporate investors are also not covered in the ARS settlements.[63] With respect to these customers, Citi is only required to "use its best efforts to provide liquidity solutions for institutional and other customers."[64] It is questionable whether the settlements will cover other groups of investors, such as those who moved their ARS accounts between two large firms that settled during the time period that the settlements state the person must have owned the ARS with the firm.[65] For example, a customer who purchased the ARS from one broker, but then moved her

58. Liz Rappaport & Shefali Anand, *"DownStream" Sellers of Auction-Rate Securities Balk at Prospect of Buybacks*, WALL ST. J., Aug. 19, 2008, at C3.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. Lavonne Kuykendall, *Auction-Rate Securities Buy-Back Could Help Bond Insurers*, MARKETWATCH.COM., Aug. 14, 2008, http://www.marketwatch.com/news/story/auction-rate-securities-buy-backs-could-help/story.aspx?guid={00AC3D5A-8CCB-47B3-B1CD-5B34E1109297}&dist=TQP_Mod_mktwN ("Citi said it will not buy back securities owned by larger institutional clients, but will work with the securities' issuers and others to provide 'liquidity solutions' for other institutional investor clients.").

64. Press Release, Sec. & Exch. Comm'n, *supra* note 27.

65. *See* Gretchen Morgenson, *The Investors Who Can't Come in From the Cold*, N.Y. TIMES, Nov. 28, 2008, at BU1 (discussing an example where a woman who moved her ARS from UBS to Citi/Smith Barney did not qualify under either company's settlement eligibility requirements because regulators chose the ownership dates based upon when the regulators determined that the firm knew of the failing auctions).

account to Citi, is not an eligible customer under Citi's settlement.[66] These investors must contact the firms through which they purchased the ARS to determine if the firms are willing to settle or repurchase the ARS.[67]

E. *Repercussions for Those Not Covered*

Typically, brokerage firm contracts require their customers to forego their right to file a claim in court and specify that any dispute must be resolved by arbitration in a dedicated forum, such as FINRA.[68] Customers who are not eligible under the ARS settlements do not receive the benefit of FINRA's special arbitration procedures.[69] This means that these investors' only recourse is to pursue relief under the standard FINRA arbitration rules, which puts investors at a disadvantage when compared with the special arbitration procedures. First, in a standard arbitration, the brokerage firms may contest liability as to the alleged misrepresentations of ARS risks, as well as the illiquidity of the investors' ARS holdings.[70] Second, the investor is required to pay all costs of filing a claim, including but not limited to, filing fees and hearing session fees.[71] Arbitration costs may deter some investors from filing a claim, as the costs may be very high depending upon the amount of the claim and the number of arbitrators assigned to hear it.

Once in arbitration, the investor may either assert a violation of federal or state law as a basis for the cause of action. ARS investors have a potential federal claim against their brokerage firms or their individual brokers: investors can assert a violation of Section 10(b) of the Securities Exchange

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66. Morgan Stanley Smith Barney, *supra* note 37.

67. *Id.*

68. Pre-dispute arbitration clauses in customer agreements became the norm in the securities world after the Supreme Court decided, in *Shearson v. McMahon*, that the Securities Exchange Act was subject to enforcement in arbitration. Shearson v. McMahon, 482 U.S. 220, 238 (1987).

69. Press Release, Fin. Indus. Regulatory Auth., *supra* note 32.

70. *Id.*

71. *See* FINRA CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES, Rule 12900(a)(1) (2007), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4188.

Act of 1934,[72] or a violation of the rules that implement the statute.[73] Typically the two are alleged together as a Section 10(b) / Rule 10b-5 cause of action. The Securities Exchange Act of 1934 makes it

> unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[74]

Rule 10b-5 makes it unlawful for

> any person, directly or indirectly, . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit

72. Securities Exchange Act of 1934, Pub. L. No. 73-291, tit. I, § 10, 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2006)).

73. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2009). Although similar in language to Section 10 of the Securities Exchange Act of 1934, *see* § 10, 48 Stat. at 891, lower federal courts are split as to whether or not there is an implied private right of action for violations of Section 17(a) of the 1933 Act, Securities Act of 1933, Pub. L. No. 73-22, tit. I, § 17, 48 Stat. 74, 84-85 (codified as amended at 15 U.S.C. § 77q (2006)). The United States Supreme Court has yet to address the issue. For a thorough examination of the legislative history surrounding the Acts, as well as an argument as to why there is no private right of action, see CPC Int'l, Inc. v. McKesson Corp., 514 N.E.2d 116 (N.Y. 1987). *But see, e.g.*, Kirshner v. United States, 603 F.2d 234, 241 (2d Cir. 1978), *cert. denied*, 442 U.S. 909 (1979) (holding that a private cause of action does exist under section 17(a)). *See also* Choudhary, *supra* note 18, at 35-44 (examining potential federal causes of action for ARS investors).

74. 48 Stat. at 891.

> upon any person, in connection with the purchase or sale of any security.[75]

Neither the statute nor the rule expressly grants investors a private right of action for fraudulent or deceptive practices, yet the courts have implied one.[76] The elements for a violation of either Section 10(b) or Rule 10b-5 are: "(1) a material misrepresentation (or omission); (2) scienter . . . ; (3) a connection with the purchase or sale of a security; (4) reliance . . . ; (5) economic loss; and (6) 'loss causation,' *i.e.,* a causal connection between the material misrepresentation and the loss."[77] Because the courts have implied a private right of action, they strictly require proof of scienter, or intent.[78] An allegation of negligence will not support a claim for a violation of the federal securities acts or rules.[79]

The possible federal claims are inadequate for ARS investors because the investor will have difficulty proving that the brokerage firm or the individual broker had the intent to defraud investors, or to misrepresent (or omit) necessary facts to enable the investor to make a sound investment decision. The element of intent is difficult to prove, especially in the case of ARS, where many brokers claim that even they were not aware of the risks associated with ARS. It is improbable that in such circumstances an investor would be able to prove the necessary element of intent, and therefore the investor will likely be unsuccessful with his or her federal claim.

An ARS investor who proceeds to arbitration with an allegation against his or her broker for a violation of either the federal securities statute, or rule, will also need to prove the element of intent. If the broker can establish that he or she did not fully understand the ARS market, then he or she was at most negligent in not providing the investor with sufficient investment advice regarding the risks associated with ARS. A finding of negligence will not support a claimant's allegation of

75. 17 C.F.R. § 240.10b-5.

76. *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (examining the legislative history of federal securities legislation).

77. Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 341 (2005) (internal citations and emphasis omitted).

78. *See Ernst & Ernst*, 425 U.S. at 193.

79. *Id.* at 214.

a violation of federal securities laws and rules, as sciencter, or intent, is a necessary element. In the next section, this Comment will address state law that could govern such a claim.

III. State Securities Laws

State securities laws, commonly referred to as blue sky laws, vary from state to state.[80] The Uniform Securities Act ("USA"), with the most recent version enacted in 2002, has helped to reduce the variations between states by providing a suggested statutory framework.[81] Even among the states that have adopted the language of the USA, however, state courts continue to apply and interpret the statutes differently.[82]

State securities laws, regardless of the version, "share certain features in their approach to prevent sales agents from promising unrealistic returns and misinforming investors about the investment risks."[83] Most states require the security itself, the issuer, and all brokers to be registered in the state in which the securities are being offered for sale.[84] The state securities acts also contain "antifraud provisions that create liability for any fraudulent statements or failure to disclose information as required."[85] To demonstrate the potentially devastating effects that differing state blue sky laws have on possible investor claims, the following sections will compare the applicable New York law with that of Missouri.

80. The origin of the term "blue sky" is unknown. The first reference to the term was in a Supreme Court opinion written by Justice McKenna. Justice McKenna, "us[ing] the language of a cited [though unnamed] case," wrote that the phrase "blue sky" refers to "speculative schemes which have no more basis than so many feet of 'blue sky.'" Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).

81. *See generally* UNIF. SEC. ACT (2002).

82. *See* Blue Sky Law, Cornell University Law School Legal Information Institute, http://topics.law.cornell.edu/wex/blue_sky_law (last visited Feb. 10, 2010).

83. *Id.*

84. *Id.*

85. *Id.*

A. *New York's Martin Act*

New York has not adopted the USA, but instead has its own securities laws that are contained in the Martin Act ("Act").[86] The Act contains the usual provisions found in other state blue sky laws regarding the registration of brokers, dealers, salesmen, and securities.[87] The difference between New York's securities laws and those of other states lies in the provisions of the Act that deal with fraudulent sales practices and deception by brokerage firms and brokers.[88] "The Attorney General is vested with the exclusive authority to enforce the Martin Act, and is granted various investigatory, regulatory, and remedial powers aimed at detecting, preventing, and stopping fraudulent securities practices."[89] The Attorney General is not required to "allege or prove either scienter or intentional fraud to establish liability for fraudulent practices under the Martin Act"[90] Individual investors, however, do not have the same advantages.

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86. N.Y. GEN. BUS. LAW §§ 352-359-h (McKinney 1996).

87. *Id.* § 359-e.

88. *Id.* § 352-c.

> 1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices: (a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale; (b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances; (c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made . . . .

Id.

89. Caboara v. Babylon Cove Dev., 862 N.Y.S.2d 535, 537 (App. Div. 2008). *See also* § 352-d.

90. *Caboara*, 862 N.Y.S.2d at 538. *See also Martin Act Does Not Preclude Common Law Fraud Claim*, N.Y. LEGAL UPDATE, Oct. 18, 2007, http://www.nylegalupdate.com/2007/10/martin-act-does.html.

1. New York Courts' Interpretation of the Martin Act

The New York Court of Appeals held in *CPC International, Inc. v. McKesson Corp.* that there is no implied private right of action under the Martin Act.[91] "In all the other States, except one, the Legislature has expressly recognized a private civil action for violations of the . . . [state's securities fraud] provision[s]."[92] The Court held that an implied private right of action would be against the original purpose of the Act, reasoning that "the legislative scheme underlying the Martin Act . . . was to create a statutory mechanism in which the Attorney-General would have broad regulatory and remedial powers to prevent fraudulent securities practices by investigating and intervening at the first indication of possible securities fraud on the public . . . ."[93] However, an investor is not precluded from basing a claim on common law fraud simply because "the alleged fraudulent conduct is such that the Attorney General would be authorized to bring an action against the defendant under the Martin Act."[94] "[P]rivate causes of action sounding in common-law fraud and breach of contract may rest upon the same facts that would support a Martin Act violation as long as they are sufficient to satisfy traditional rules of pleading and proof."[95]

2. Possible Avenues of Recourse: A Difficult Task

A blue sky law in almost any other state would give the ARS investor a private right of action against his or her broker.[96] Instead, New York investors must rely on common law causes of action such as fraud, misrepresentation, etc. as

91. 514 N.E.2d 116 (N.Y. 1987).

92. *Id.* at 118.

93. *Id.* at 119.

94. Kramer v. W10Z/515 Real Estate Ltd., 844 N.Y.S.2d 18, 19 (App. Div. 2007), *appeal withdrawn*, 896 N.E.2d 96 (N.Y. 2008).

95. *Caboara*, 862 N.Y.S.2d at 537.

96. "[A] statutory cause of action would be consistent with the blue sky laws of the other States which, except for Rhode Island, all expressly provide for some form of civil liability." *CPC Int'l*, 514 N.E.2d at 120.

bases for their claims.

a. *Common Law Fraud*

There are five elements that an investor must prove to establish fraud in New York: "1) [r]epresentations; 2) [f]alsity; 3) [s]cienter (an intent to make misrepresentations, or reckless disregard in making it without knowledge); 4) [d]eception of the party to whom made; and 5) [i]njury due to justified reliance on the misrepresentation."[97] The statute of limitations for common law fraud is "the greater of six years from the date the cause of action accrued or two years from the time the plaintiff or the person under whom the plaintiff claims discovered the fraud, or could with reasonable diligence have discovered it."[98]

As evident by the fraud elements listed above, the investor must prove the element of scienter to prevail. This puts an investor at a tremendous disadvantage because proving that a broker intended to defraud a customer through the sale of securities is difficult. In fact, the *CPC* Court encouraged the New York State Legislature to "consider the merits of a statutorily expressed cause of action . . . [and to] add a remedy for defrauded investors in those cases where none exists in common-law fraud."[99]

b. *Negligent Misrepresentation*

It is possible that an investor could base his or her claim on negligent misrepresentation, and argue that the broker was

> "[C]areless[ ] in imparting words upon which others were expected to rely and upon which they

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97. J. KIRKLAND GRANT, SECURITIES ARBITRATION FOR BROKERS, ATTORNEYS, AND INVESTORS 185 (1994).

98. N.Y. C.P.L.R. § 213(8) (McKinney 2003).

99. *CPC Int'l*, 514 N.E.2d at 119-20. Judge Hancock, who drafted the majority opinion, actually disagreed with the rest of the majority in regard to what the purpose of the Martin Act was. Hancock believed that the broader purpose of the Act was to deter fraudulent securities practices, which in turn would be consistent with implying a private cause of action. *Id.*

> did act or failed to act to their damage," and the author must express the information "directly, with knowledge or notice that it will be acted upon, to one to whom the author is bound by some relation of duty . . . to act with care if he acts at all."[100]

As discussed below, a New York resident, as compared to a resident of a state that has adopted a blue sky law that provides a private right of action, will have much more difficulty prevailing in a law suit or arbitration proceeding based upon a common law cause of action. It is unclear why the New York legislature has taken this position. With surprisingly little written on this topic, one may only presume that it is the result of an intense lobby from Wall Street. This Comment's position is that it is not fair to have such an extreme disadvantage simply because one resides in the state where the financial markets of the world operate.

B. *Missouri Securities Act of 2003*[101]

Missouri's blue sky laws, contained in the Missouri Securities Act of 2003 ("MSA"), are premised upon the Uniform Securities Act of 2002. Missouri state courts have stated that the purpose of the Act is to protect investors.[102] "Fulfillment of that statutory purpose 'embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.'"[103]

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100. Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1007 n.99 (2002) (quoting White v. Guarente, 372 N.E.2d 315, 319 (N.Y. 1977)). The New York Court of Appeals has not yet answered the question of whether an investor may claim negligent misrepresentation when faced with a violation of the Martin Act. *See* Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452 (S.D.N.Y. 2001) (discussing cases).

101. This Comment relies on Missouri as the comparison state because it was the first state to adopt the Uniform Securities Act of 2002. MO. ANN. STAT. §§ 409.1-101 to 409.7-703 (West 2009).

102. State v. Reber, 977 S.W.2d 934, 938 (Mo. Ct. App. 1998).

103. *Id.* (citing Garbo v. Hilleary Franchise Sys., 479 S.W.2d 491, 499 (Mo. Ct. App. 1972)).

1. Private Right of Action and Statute of Limitations

In addition to the available common law causes of action, such as fraud and negligent misrepresentation, the MSA gives investors another avenue of recourse.[104] The MSA makes it unlawful for financial advisors and sellers of securities to "make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading."[105] It is also unlawful for a financial advisor to

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104. The elements for fraud and negligent misrepresentation under Missouri common law are essentially the same as in New York, although it seems Missouri courts are more willing to allow claims for negligent misrepresentation. The elements for fraud are as follows:

> 1) a false, material representation; 2) the speaker's knowledge of its falsity or his ignorance of its truth; 3) the speaker's intent that it should be acted upon by the hearer in the manner reasonably contemplated; 4) the hearer's ignorance of the falsity of the statement; 5) the hearer's reliance on its truth; 6) the hearer's right to rely thereon; and 7) the hearer's consequent and proximately caused injury.

Reding v. Goldman Sachs & Co., 382 F. Supp. 2d 1112, 1117 (E.D. Mo. 2005). The elements for negligent misrepresentation are as follows:

> (1) the speaker supplied information in the course of his or her business; (2) due to the speaker's failure to exercise reasonable care, the information was false; (3) the information was intentionally provided for the guidance of a limited group of persons in a particular business transaction; and (4) in justifiably relying on such information, the listener suffered a pecuniary loss.

Gurley v. Montgomery First Nat'l Bank, 160 S.W.3d 863, 867 (Mo. Ct. App. 2005).

105. *See* MO. ANN. STAT. § 409.5-501.

> It is unlawful for a person, in connection with the offer, sale, or purchase of a security, directly or indirectly: (1) To employ a device, scheme, or artifice to defraud; (2) To make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading; or (3) To engage in an act, practice, or

defraud an investor.[106] The MSA affords investors a private right of action based upon violations of the statute's anti-fraud provisions.[107]

In the case of ARS, the most likely claim an investor would make is that the broker made "an untrue statement of a material fact or . . . omit[ted] to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it [was] made, not misleading."[108] The MSA provides a liability provision, which states in part that:

> A person is liable to the purchaser if the person sells a security . . . by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading . . . .[109]

> course of business that operates or would operate as a fraud or deceit upon another person.

Id.

106. *Id.* § 409.5-502(a).

> It is unlawful for a person that advises others for compensation, either directly or indirectly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as part of a regular business, issues or promulgates analyses or reports relating to securities: (1) To employ a device, scheme, or artifice to defraud another person; or (2) To engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.

Id.

107. *See generally id.* § 409.5-509. "The rights and remedies provided by this act are in addition to any other rights or remedies that may exist, but this act does not create a cause of action not specified in this section [409.5 – 509] or section 409.4-411(e)." *Id.* § 409.5-509(m).

108. *Id.* § 409.5-501.

109. *Id.* § 409.5-509(b).

The purchaser, i.e., the investor, of the security has the burden of proving that he or she "did not know and, in the exercise of reasonable care, could not have known of the untruth or omission."[110] Notably, there is no provision of the MSA that requires the investor to prove that the seller of the security had a culpable mental state. The statute of limitations for violations of the MSA's provisions regarding material misstatements or omissions is "the earlier of two years after discovery of the facts constituting the violation or five years after the violation."[111]

2. Potential Remedies Under MSA

If successful, recovery may amount to:

> [T]he consideration paid for the security, less the amount of any income received on the security, and interest at the rate of eight percent per year from the date of the purchase, costs, and reasonable attorneys' fees determined by the court, upon the tender of the security, or for actual damages.[112]

An investor who "no longer owns the security may recover actual damages . . . [of] the amount that would be recoverable upon a tender less the value of the security when the purchaser disposed of it, and interest at the rate of eight percent per year from the date of the purchase, costs, and reasonable attorneys' fees determined by the court."[113]

The MSA also contains a provision for rescission.[114] The

110. *Id.*

111. *Id.* § 409.5-509(j)(2).

112. *Id.* § 409.5-509(b)(1). "Tender requires only notice in a record of ownership of the security and willingness to exchange the security for the amount specified." *Id.* § 409.5-509(b)(2).

113. *Id.* § 409.5-509(b)(2)-(3).

114. *See generally id.* § 409.5-510. Rescission is

> A party's unilateral unmaking of a contract for a legally sufficient reason, such as the other party's material breach, or a judgment rescinding the contract . . . [It] is generally

seller of the security may, prior to the purchaser filing an action, attempt to correct any previous misstatement, or omission, that was required to be given under the MSA.[115] If the basis for the investor's potential cause of action is a misstatement or omission of a material fact, the seller may "offer to repurchase the security for cash, payable on delivery of the security, equal to the consideration paid, and interest at the rate of eight percent per year from the date of the purchase, less the amount of any income received on the security."[116] The seller may also "offer to pay the purchaser upon acceptance of the offer damages in an amount that would be recoverable upon a tender, less the value of the security when the purchaser disposed of it, and interest at the rate of eight percent per year from the date of the purchase in cash" if the purchaser no longer owns the underlying security.[117]

As evidenced by the above discussion of New York's Martin Act and Missouri's blue sky laws, the remedies available to investors greatly differ depending on laws of the state in which the investor resides. An investor in one state may have a valid and sound claim based upon one set of facts, while that same investor with the same claim may have no recourse if he or she resided in another state.

IV. ARS and State Securities Laws

A. *Sarah, the Unsophisticated Investor*

To demonstrate the devastating effects of New York's law on investors, this Comment will apply both New York law and Missouri law to a hypothetical ARS case. Assume the following: in 2000, Sarah inherited approximately $50,000 from her mother's estate. Sarah wanted to make sure that the

> available as a remedy or defense for a nondefaulting party and is accompanied by restitution of any partial performance, thus restoring the parties to their precontractual positions . . . ."

BLACK'S, *supra* note 47, at 1082.

115. § 409.5-510(1)(A).

116. *Id.* § 409.5-510(1)(B).

117. *Id.*

money was safe, as she was planning to use it at some time in the future as a down payment to purchase a home. She was not investment savvy and planned on putting the $50,000 in a savings account. A friend of hers explained that if she put the money in a money market account, or a CD, she would be paid a higher rate of return than she would in a standard savings account.

Sarah entered her neighborhood brokerage firm in search of a CD. She sat down to speak with Jack, an investment advisor and broker. Jack asked Sarah several questions about her investment knowledge and history in order to fill out the customer profile sheet that all brokers must complete. Sarah explained the circumstances to Jack: she was working a minimum wage job, had no investment experience and wanted to use the money as a down payment for a home, but was unsure as to when she would be able to qualify for a mortgage.

Sarah told Jack what she knew about money markets and how she had heard from a friend that money markets would give her a greater return than her standard savings account would. Jack explained to Sarah that her friend was correct, however, he could offer her something even better! Something that was similar to a money market, but that would make her even more of a return. The broker told Sarah that all she needed to do when she wanted to get her money was to call him and he would have the money for her within seven days. Sarah asked how that was possible, as it sounded too good to be true, and Jack enthusiastically stated that ARS were the way to go these days.

Sarah signed the brokerage firm contract (which of course had a mandatory arbitration clause built into it) and purchased $50,000 worth of ARS holdings at the suggestion of her broker, Jack. Between 2000 and 2007, she made a great return and was very satisfied with her investment. By the end of 2007, Sarah finally qualified for a home mortgage. In February of 2008, she was ready to purchase her dream house. Because she was still in a lease in her apartment, Sarah signed a contract to sublet the apartment to a friend. The sublet period was to begin March 1, 2008 and to last for the remainder of the term of the lease. Sarah called Jack and told him she needed access to her $50,000 as she was purchasing her first home the following week.

Jack informed Sarah that there suddenly was no market for ARS and he would not be able to get her the $50,000. Sarah didn't understand, she needed her money within the next two weeks or else the seller of the home would put it back on the market. Jack apologized and explained that the ARS auctions were failing, the market was illiquid and that this was an "unprecedented" event. He did, however, offer to loan Sarah the $50,000 at an interest rate that was one and a half times the rate of return she was collecting from the ARS. She refused the loan.

February 2008 turned out to be a heartbreaking time for Sarah. She was unable to purchase her dream home and had to move out of her apartment due to the subletting contract she had signed with her friend. Sarah had to move into a new apartment that cost her double the rent; the old apartment only cost $500 per month, whereas now she could not find a new apartment for anything less than $1000 per month.

Sarah called a lawyer for legal advice on March 1, 2008. The lawyer informed her that the market for ARS froze and her investment was illiquid, meaning that there was no way for her to get the $50,000 out of the market. He also told her that there were ongoing investigations into the ARS market by the SEC and other securities regulators. The lawyer explained to Sarah that she had several options. First, she could hold out until there was a successful auction. The lawyer explained that if the market fails to become liquid, the ARS that Sarah had invested in would not mature for another 25 years. She could not believe this! There was no way she could wait 25 years to get her money, she needed it as soon as possible to purchase a home. The second option was to borrow money from Jack's firm using the ARS as collateral. Sarah explained to her lawyer that Jack had already offered that possibility, but she refused to accept the loan because she could not afford to pay the interest rate. The lawyer then told Sarah that her final option was to sell the security at a loss on a secondary market (if one was available). She considered this possibility, but of course there was no secondary market.

Sarah was not satisfied with any of the options that were before her. The lawyer advised her to wait and see what the outcomes of the securities regulators' investigations would bring. In August 2008, she began to hear news of ARS settlements with large brokerage firms such as Citigroup and UBS. Sarah again spoke to the lawyer, who explained to her that the settlements at those large firms were not going to help her. The brokerage firm that Sarah had purchased her ARS holdings from was considered a "downstream" seller and probably would not be forced to settle via the securities regulators.

B. *What is Sarah to Do?*

Sarah is not an "eligible customer" under any of the settlements the securities regulators have reached with brokerage firms because she had purchased her ARS from a downstream seller. As a result of her being ineligible, Sarah does not get the benefit of FINRA's special arbitration procedures for her consequential damages, i.e., the damages she suffered by not being able to purchase a home and in turn, being forced to pay double what she had previously paid in rent. The only way for her to potentially recover is if she proceeds to arbitration, which is her only available avenue per the brokerage contract, but the defendants may contest liability as to the illiquidity of her ARS holdings. Sarah cannot base her arbitration claim on a violation of federal securities laws or rules because she cannot prove that her broker intended to misrepresent the risks associated with ARS since even he did not know the true economics behind the ARS markets. Sarah's only recourse is to file an arbitration claim against her broker under a state securities law.

1. If the Investor is a Resident of New York?

Assume that Sarah is a resident of New York. She cannot premise her cause of action upon the Martin Act because, as explained above, there is no implied private right of action for violations of the Martin Act. Now she is left only with common law causes of action.

Should Sarah choose to base her arbitration claim upon common law fraud, she will in all likelihood lose the case. She can probably satisfy four of the five fraud elements: she can show that there was a representation, that the representation was false, that there was deception, and that she justifiably and detrimentally relied upon such false representation. The one element that will be almost impossible for Sarah to satisfy is scienter.

Scienter, under common law fraud in New York, is the acting or speaking with the intent to make misrepresentations, or reckless disregard in making it without knowledge.[118] Sarah will be hard-pressed to find any evidence that her broker, Jack, intended to make, or with reckless disregard did make, any misrepresentations with regard to the ARS. It is highly possible that brokers, especially those like Sarah's who worked for downstream sellers without access to the issuing firms' information on ARS, were not aware of the risks associated with ARS. Sarah could perhaps prove that the broker acted with reckless disregard by selling a security to her without full knowledge of its risks. However, the downstream sellers and brokers likely believed that they were knowledgeable about the ARS market at the time they sold the securities. Historically, ARS were good investments and a broker with a decent lawyer could argue that the misrepresentations were not recklessly made at the time Sarah purchased the ARS. If brokers did not know of the risks and were not reckless when making the misrepresentations, investors like Sarah will not satisfy the element of scienter, which is necessary to prevail in a common law fraud action.

Sarah may attempt to sue Jack for negligent misrepresentation. She could possibly establish the first element of negligent misrepresentation, that Jack was "'careless[ ] in imparting words upon which [she was] expected to rely and upon which [she] did act . . . to [her] damage.'"[119] Jack told her that ARS were just like money markets, except that ARS would make her more of a return. Sarah also could likely prove that Jack "express[ed] the information 'directly, with knowledge or notice that it [would] be acted upon, to one to whom the author is bound by some relation of duty. . . to act with care if he acts at all.'"[120] Jack did know that Sarah was

118. *See* GRANT, *supra* note 97, at 185.

119. Black & Gross, *supra* note 100, at 1007 n.99 (quoting White v. Guarente, 372 N.E.2d 315, 319 (N.Y. 1977)).

120. *Id.* (quoting *White*, 372 N.E.2d at 319). The New York Court of Appeals has not yet answered the question of whether an investor may claim negligent misrepresentation when faced with a violation of the Martin Act.

going to rely on his recommendation; she had no prior investment experience and was, for all intents and purposes, an entirely unsophisticated investor. Because he was Sarah's broker, Jack owed her certain fiduciary duties. Although she may be able to successfully bring a claim for negligent misrepresentation, the trial and intermediate level courts in New York are split as to whether investors may sue for negligent misrepresentation based upon a violation of the Martin Act. The New York Court of Appeals has not yet addressed this issue, making a successful cause of action under this theory questionable at best.

2. If the Investor is a Resident of Missouri?

Now assume that Sarah is a resident of Missouri, which means that in arbitration, she can take advantage of the MSA. The MSA provides for a private right of action based upon a violation of the MSA itself; therefore Sarah need not worry that she will not be successful based upon common law causes of action. Under MSA Section 409.5-501, Sarah's strongest claim is that her broker, Jack, made "an untrue statement of a material fact or omit[ted] to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading."[121]

Under the MSA, it is irrelevant that Jack may not have known of all risks associated with ARS. Sarah can rely on the MSA liability provisions that hold the seller of the security liable for "sell[ing] a security . . . by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading."[122] Sarah then must satisfy the burden of proving that she "did not know and, in the exercise of reasonable care, could not have known of the untruth or omission" at the time she purchased the ARS.[123] Surely she could prove that she did not know that Jack was not telling her all of the relevant facts related to ARS.

See Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452 (S.D.N.Y. 2001).

121. § 409.5-501(2).

122. *Id.* § 409.5-509(b).

123. *Id.*

Sarah knew nothing about investments of any kind. Even if she had exercised reasonable care by conducting additional research regarding ARS, there was no public information that would have led Sarah to speculate that the markets were being supported by large brokerage firms and that there was a chance that the markets may freeze once those firms stopped supplying supporting bids. Sarah will likely win her claim based upon the MSA.

If Sarah is successful based upon her underlying claim, she is entitled to receive the amount she paid for the investment—here, $50,000—less any income she received from it.[124] She may also receive eight percent interest on the recoverable amount and may be reimbursed for her costs and reasonable attorneys' fees that she incurred as a result of pursuing her claim.[125] It is entirely possible that the broker would be willing to offer to rescind the contract Sarah signed, meaning that the broker would repurchase the ARS from her for the amount she paid for it, less the income she received, plus interest of eight percent.[126]

C. *The Blessings of a Statutory Private Right of Action*

As a result of the above hypothetical, it is evident that Sarah would fare much better as a resident of Missouri. If she were a resident of New York, she would likely recover nothing in arbitration.[127] The opposite is true if she were a resident of

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124. *Id.* § 409.5-509(b)(1).

125. *Id.*

126. *Id.* § 409.5-510.

127. While there is the possibility that Sarah could prevail on a negligent misrepresentation claim, it is unlikely that a New York court would overturn an arbitration decision, as the grounds for doing so are limited.

> 1. The award shall be vacated on the application of a party who either participated in the arbitration or was served with a notice of intention to arbitrate if the court finds that the rights of that party were prejudiced by: (i) corruption, fraud or misconduct in procuring the award; or (ii) partiality of an arbitrator appointed as a neutral, except where the award was by confession; or (iii) an arbitrator, or agency or person making the award exceeded his power or so imperfectly executed it that a final and definite award upon the subject matter submitted was not made; or (iv)

Missouri. There, Sarah would recover everything: her investment (less income she received) plus interest, reasonable attorneys' fees, and the possibility of rescission. The only parts of Sarah's loss that may not be recoverable are her consequential damages, e.g., her increased rent. The MSA makes no mention of consequential damages and it is questionable whether the arbitrator would allow Sarah to recover those if they are not expressly allowed in the statute.

V. Conclusion

ARS are only one form of investment that took the market, and probably the world, by surprise with their devastating effects. In the future, there will be other securities that will do the same. While federal and state regulatory authorities have securities laws that they use in their attempts to remedy the harm created by such investments, it is impossible for those regulators to be involved every time a broker makes a misrepresentation to an investor regarding a certain type of investment. When regulators are not involved, investors are on their own.

State legislatures around the country have adopted, in some fashion, the Uniform Securities Act. This Comment urges New York's legislature to do the same. For New York investors to be at such an extreme disadvantage in a suit, or arbitration claim, against their brokers—simply because of their state of residence—is extremely unfair and burdensome. Why should New York investors suffer and, in the case of ARS, almost surely fail, in their attempts to remedy the wrongs their brokers and brokerage firms have committed against them? ARS may be an exaggerated example of how damaging the effects of broker misconduct can be, but the same effects are felt every day by New York investors who have little to no recourse due to the State's legislature and its failure to provide them with a remedy.

> failure to follow the procedure of this article, unless the party applying to vacate the award continued with the arbitration with notice of the defect and without objection.

N.Y. C.P.L.R. § 7511(b) (McKinney 1998).

The purpose of this Comment is to urge the New York State legislature to adopt a version of the Uniform Securities Act. The legislature could do so without hindering the power given to the Attorney General in the Martin Act. A New York statute that authorizes a private right of action based upon violations of the Martin Act would grant New York investors the many benefits that investors in almost all other states receive.